WORKING PAPER ON NATIONAL LAWS RELATING TO OVER-THE-COUNTER DERIVATIVES TRANSACTIONS AND THE PUBLIC POLICY OBJECTIVES OF FINANCIAL REGULATION

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This paper initially was prepared as reference material for the use of Commission staff in a review of existing regulatory approaches to over-the-counter derivatives markets in non-U.S. jurisdictions. The analysis of national and supranational laws regarding over-the-counter derivatives set out in this paper was undertaken by OIA staff and does not reflect the views or opinions of the CFTC, any of its Offices or Divisions, or the national authorities in any of the jurisdictions mentioned. Further, although OIA staff has attempted to provide a complete overview of relevant national laws through March 2000, this is a rapidly evolving and complex area and changes in the regulations of many jurisdictions are currently in process.

UPDATE

As noted on the cover page, this internal working paper reflects the status of the international developments in the regulation of over-the-counter derivatives through March 2000. The following international developments have occurred since the completion of this paper:

- The United Kingdom has adopted the Financial Services and Markets Bill. However, implementation of the bill's provisions is not expected until Spring 2001.

- The UK's Financial Services Authority has published a new consultative paper on inter-professional markets: FSA Consultative Paper No. 47, *The Inter-Professionals Code* (May 2000).

- Japan transferred supervisory powers over derivatives from its Ministry of Finance to its new Financial Services Agency on July 1, 2000.

- As part of an on-going codification project, the EU has consolidated Directives 73/183, 77/780 ("First Banking Directive"), 89/299 ("Own Funds Directive"), 89/646 ("Second Banking Directive"), 89/647 ("Solvency Directive"), 92/30 ("Consolidated Supervision Directive") and 92/121 ("Large Exposures Directive") into new Directive 2000/12, O.J. L126/1 (26 May 2000), relating to the taking up and pursuit of the business of credit institutions.

- The European Union's ECOFIN Council reached political agreement on a Common Position on a European Parliament and Council Directive on the reorganisation and winding up of credit institutions. This political agreement removes the last obstacle to approval of a Common Position by the Council that will permit submission of the Common Position to the European Parliament for a second reading. *See* the Press Release issued after the 8 May 2000 ECOFIN Council Meeting at http://ue.eu.int/newsroom/main.cfm?LANG=1.

- The European Commission published a Second Report on the EU's Action Plan for Financial Services titled *Progress on Financial Services*, COM (2000) 336 (31 May 2000) available at http://europa.eu.int/comm/internal_market/en/finances/actionplan/progress2en.pdf.

- The European Commission has announced that it is preparing a proposal for a Directive on collateral to eliminate legal uncertainties which unnecessarily increases counterparty and settlement risk. The proposed Directive would facilitate cross-border collateralization techniques to eliminate legal uncertainty in respect of (i) the title transfer which underpins repo activity and (ii) the location of collateral for purposes of settlement. *See* the Second Report on the EU's Action Plan for Financial Services titled *Progress on Financial Services*, COM (2000) 336 (31 May 2000), paragraph 4, p. 10.

Although OIA staff has endeavored to list in this update all international developments that have come to its attention since the completion of this paper, given the rapid developments in this area, there may have been further developments not noted in this update. This report does not address developments in U.S. law.

Updated as of 9 July 2000.

WORKING PAPER ON NATIONAL LAWS RELATING TO OVER-THE-COUNTER DERIVATIVES TRANSACTIONS AND THE PUBLIC POLICY OBJECTIVES OF FINANCIAL REGULATION

I. Executive Summary

This paper examines the extent to which and the manner in which the national laws of non-United States jurisdictions relating to derivatives and, in particular, over-the-counter derivatives, address the following areas:

- prevention of manipulation;
- fraud and customer protection;
- financial integrity and reduction of systemic risk;
- regulatory cooperation;
- legal authority, risk, and choice of law; and
- regulatory parity.[1]

This paper is based on:

- the results of a survey ("CFTC Survey")[2] of 16 jurisdictions[3] regarding nine sets of questions[4] on the regulation of over-the-counter derivatives conducted by the Commodity Futures Trading Commission ("CFTC") staff between January 1998 and March 1999;
- an independent CFTC staff review of the national laws of non-U.S. jurisdictions, European Union ("EU") law, and other international initiatives (*e.g.*, in the Basel Committee on

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[1] This paper is intended to respond, in part, to questions raised by the letter dated 30 September 1998 from Senator Richard G. Lugar, Chairman, Senate Agriculture Committee, and Representative Robert Smith, Chairman, House Agriculture Committee, to then Treasury Secretary Robert Rubin, in which Senator Lugar and Representative Smith requested that the President's Working Group on Financial Markets provide legislative recommendations to Congress regarding the over-the-counter derivatives markets. Senator Lugar and Representative Smith stated:

> There are several matters that we would like to see specifically addressed during your analysis of this issue: 1) What is the current regulatory treatment of the OTC derivatives market? (2) How has the market changed since its inception? (3) If regulation is recommended, what public policy goals will regulation help achieve (i.e. consumer protection, minimizing systemic risk)? (4) What is the risk that regulation of this market will cause the domestic transacting of these instruments to move offshore? (5) What is the proper agency to oversee this market and why? (6) Does the type or sophistication of entities or individuals transacting OTC derivatives require differing regulatory considerations (i.e. hedge funds, pension funds, municipalities, mutual funds)? (7) Does further oversight of this market require additional legal authority? (8) Should on-exchange and OTC instruments that are functionally equivalent receive regulatory parity?

[2] *CFTC 1999 Survey on Regulation of Over-the-Counter Derivatives Transactions* (March 1999).
[3] Australia, Belgium, Brazil, Canada (including Ontario and Quebec), France, Germany, Hong Kong, Italy, Japan, The Netherlands, Spain, Sweden, Switzerland, and the United Kingdom.
[4] *See* the attached Annex.

Banking Supervision ("BCBS") and in the International Organization of Securities Commissions ("IOSCO")); and

- information self-reported by national authorities of non-U.S. jurisdictions on the regulation of derivatives markets, products and financial intermediaries presented in a common framework of analysis under the auspices of IOSCO ("Regulatory Summary").[5]

In general, the CFTC Survey indicates that derivatives are regulated by national authorities as part of a broader regulatory scheme applied to the universe of financial investment and risk management products. Overall, however, the materials indicate that there is no one preferred regulatory technique for achieving desired regulatory objectives. That being said, at the international level, there is substantial interest in identifying core standards generally applicable to all financial markets and products.

1. Prevention of Manipulation

1.1. There is a broad consensus among international regulators that price (market) manipulation should be prevented. However, there are divergences regarding the conduct that is prohibited by anti-manipulation provisions and the manner in which manipulation is defined.

1.2. Traditionally, manipulation has been viewed as primarily a market (price discovery) protection with collateral benefits for customer protection and the real economy. Existing prohibitions usually speak in terms of effects on markets. Regulators in designing techniques to detect, deter and sanction manipulation or other abusive activity may refer to the relative susceptibility of various products and/or markets to such activity. In some cases, existing prohibitions may be broad enough to cover conduct involving over-the-counter transactions, especially if such conduct affects a regulated or an organized market.

1.3. Whether or not national manipulation prohibitions extend directly to over-the-counter transactions, where there is no impact on organized markets and where prices are opaque; the legal definition of manipulation; the authority to implement laws regarding manipulation; and the techniques for addressing manipulation differ substantially among jurisdictions. For example:

1.3.1. The nature of particular products (that is, certain financial products and cash products) may affect the extent to which such products are covered by laws

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[5] From 1990 to 1997, initially the CFTC, and subsequently IOSCO, published annually, a survey currently entitled *International Regulation of Derivatives Markets, Products and Financial Intermediaries* (IOSCO December 31, 1996) ("Regulatory Summary"). The Regulatory Summary includes a collation of individual jurisdictions' descriptions of existing regulation using a common framework of analysis. This survey addresses only exchange-traded derivatives products and, in the most recent survey, market authorities from 19 jurisdictions participated: US Securities and Exchange Commission ("SEC") and CFTC, UK Financial Services Authority ("FSA") and Securities and Futures Authority ("SFA"), France, Japan, Australia, Ontario, Quebec, Hong Kong, Chile, Sweden, New Zealand, Italy, Spain, Argentina, Germany, Malaysia, South Africa, China, and Hungary.

regarding manipulation. For example, in some jurisdictions, bank products, all of which are dealer-type products (*i.e.*, forward rate agreements), and in most jurisdictions, foreign currency may not be covered.

1.3.2. There are practical problems with the application of trade practice abuse rules (intended to address disorderly, abusive or manipulative conduct) directly to over-the-counter derivatives transactions where prices are formed by bilateral negotiation. It is, therefore, less likely for specific, prophylactic provisions such as anti-wash trading rules to apply directly to over-the-counter transactions than to organized markets. Future work in some jurisdictions, particularly in the UK, may examine this issue.

1.3.3. In many jurisdictions, information on over-the-counter exposures may not be readily accessible to the relevant authorities, or only available as necessary to monitor a related regulated market. Internationally, work continues to proceed on what over-the-counter information should be disclosed and to whom.

1.4. Most jurisdictions endorse appropriate access to information on risk positions and information sharing between market authorities to combat manipulative and other abusive practices. The accessibility of information on over-the-counter exposures to regulators, however, differs from jurisdiction to jurisdiction.

1.5. In any event, there is a clear consensus (i) that preventing manipulative and other abusive activity, by enforcement and/or oversight, is essential to fair and efficient markets and (ii) that surveillance and enforcement powers should be sufficient to effectuate manipulation provisions with respect to all relevant market activities.

2. Fraud and Customer Protection

2.1. The national laws reviewed indicate a broad international consensus regarding the necessity to provide appropriate customer protections in connection with all securities transactions, including transactions in derivatives products. For example, the IOSCO Objectives and Principles of Securities Regulation ("IOSCO Core Principles"), in which securities are defined to include derivatives generally, provide that:

2.1.1. Customers need protection from misleading, fraudulent and abusive practices;

2.1.2. Full disclosure is material to customers making informed investment or risk management decisions;

2.1.3. Only authorized persons should be permitted to hold themselves out as conducting investment business;

2.1.4. Client assets should be protected from defalcation or intermediary insolvency; and

2.1.5. Intermediaries should act honestly and fairly, with due skill and diligence, in the best interests of customers and the integrity of the markets.

2.2. Over-the-counter transactions, however, may not be covered by national customer protection or conduct of business requirements because:

2.2.1. Relevant customer protection and prudential rules only apply to authorized firms. Over-the-counter derivatives business generally is undertaken on a principal-to-principal basis and, therefore, counterparties acting for their own account, and not acting as brokers or holding themselves out as dealers, professional counterparties, or market makers, may not be subject to authorization and corresponding conduct of business requirements vis-a-vis their counterparties;[6]

2.2.2. Certain customer protections are not extended to so-called sophisticated counterparties (including end-users) under relevant national law even when they are transacting opposite an authorized counterparty and most over-the-counter transactions are accomplished by sophisticated counterparties;

2.2.3. Market protections (such as transparency requirements) are ordinarily not extended to individually-negotiated over-the-counter derivatives transactions; and

2.2.4. Even for non-sophisticated counterparties, there are national differences as to whether and what financial activity in the over-the-counter derivatives markets is covered by existing conduct of business rules.

2.3. There are fewer differences relating to the content of conduct of business regulation than as to: (i) who is in fact covered and (ii) the manner in which parties are covered.

2.3.1. With respect to over-the-counter markets, many of the protections traditionally accorded retail customers do not apply. There are differences in national law as to how this result is achieved. In some cases, the business is transacted by banks in jurisdictions where conduct of business rules traditionally have not applied to banks (except as an aspect of operational controls) or where banks are under a separate regulator from securities firms. In other circumstances, certain counterparties are not required to be authorized. In still others, the business is exempt from certain requirements if the counterparties meet certain eligibility criteria. The standards of eligibility differ because, among other things, existing harmonizing legislation, such as that in the EU, is very general and conduct of business regulation is in general not harmonized.

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[6] All jurisdictions surveyed require the authorization of firms engaging in a securities or futures business on a professional basis. What constitutes a securities or futures business is a matter of definition.

2.3.2. Additionally, there are differences in the means of achieving the desired regulatory objectives, ranging from Codes of Conduct contemplating self-policing of bilateral transactions, to administrative encouragements, to private sector benchmarks, to explicit rules.

2.4. Specific customer protection requirements may or may not be applicable to over-the-counter transactions:

2.4.1. Disclosure. In general, financial disclosure and reporting requirements are applied to authorized financial institutions.

2.4.1.1. Currently, financial disclosure and reporting by authorized financial institutions are required by all national jurisdictions, but the specificity of treatment of various instruments differs, and some counterparties to over-the counter transactions are not authorized financial institutions.

2.4.1.2. Certain recommendations for international disclosure and/or reporting relating to over-the-counter business are based primarily on voluntary compliance.

2.4.1.3. Accounting standards, which usually are set by private standard setters and apply to public companies, in addition to authorized financial services providers, do address specific instruments, including over-the-counter instruments.

2.4.2. Transparency. Although certain over-the-counter markets may be regarded as organized, bilateral transactions in over-the-counter derivatives generally are not considered to be accomplished on regulated markets and, therefore, are not subject to specific transparency requirements. To the extent that there are "exempt market" treatments for over-the-counter transactions, these treatments parallel regulation of financial intermediaries rather than of markets. Nevertheless, there are issues regarding the desired level of transparency of all financial exposures to counterparties and there is international agreement that issues exist relating to the adequacy of price transparency and of the transparency of risk exposures of authorized financial institutions to financial regulators and to the general public.

2.4.3. Recordkeeping. Most jurisdictions have recordkeeping requirements for authorized firms that relate to all financial transactions and are not particularized to over-the-counter products.

2.4.3.1. To the extent that there are specific requirements for authorized institutions (*e.g.*, confirmations, periodic reports), these may, in some cases, be disapplied to financial transactions with sophisticated customers. Providing and/or keeping such records, however, would be considered good business practice.

2.4.3.2. Over-the-counter transactions generally are documented by each counterparty using master agreements recommended as a matter of industry practice. In some jurisdictions, use of such agreements meeting specified requirements is necessary under national legislation to achieve certain types of netting for capital and insolvency relief.

2.4.3.3. Other general laws, such as tax codes may require the keeping of adequate records.

2.5. Conduct of Business, Customer Protection and Differential Treatment of Sophisticated Customers – Various Exemptive Models

Although firms (and in Australia, markets) engaging in certain counterparty transactions in over-the-counter derivatives are subject to national securities (or investment services) law, applicable exemptions relating to the treatment of sophisticated counterparties operate in such a way that conduct of business requirements are disapplied to sophisticated counterparties and are restricted primarily to transactions with retail counterparties or customers.

2.5.1. A basic structure which differentiates between retail and sophisticated customers may be achieved in several ways. Three different national approaches to counterparty distinctions are discussed in this paper, as well as the approach of the EU generally: (i) the UK wholesale market regime, (ii) the Australian safe harbor for exempt futures markets, and (iii) the proposed Ontario treatment of over-the-counter counterparty transactions with qualified persons. Each of these countries' regimes also limits the extraterritorial application of its national law.

2.5.2. In the EU, recognition of the special needs of retail customers is accomplished by explicit recognition in the Investment Services Directive ("ISD") that professionals may not need the same protections as other customers.

2.5.3. In the UK, many, if not most, over-the-counter financial derivatives transactions would be expected to take place under the UK's wholesale markets or proposed inter-dealer regime which disapplies many of the requirements applicable to transactions with private clients. New legislation, expected to be adopted by the end of the year 2000, will streamline and expand this approach.

2.5.4. In Canada,

2.5.4.1. Banks' securities transactions are handled differently than securities transactions by other persons or firms. Banks are subject to the federal authority of the Office of the Superintendent for Financial Institutions ("OSFI"). No conduct of business rules are applied to banks except as implied from safety and soundness requirements.

2.5.4.2. Derivatives transactions that are trades in securities are subject to provincial law, but there is a pending proposal to exempt certain transactions and sophisticated customers and counterparties from these provincial securities laws. An Ontario Securities Commission proposed rule, as most recently amended in January 2000, would create three categories of derivatives subject to regulation and establish "appropriate" regulatory treatment for each, removing uncertainty as to the applicability of Ontario Securities law to such transactions. The appropriate treatment is based on the nature of the instrument and the nature of the counterparty and effectively clarifies that only certain securities law requirements (such as generic risk disclosure related to the specific risks of over-the-counter products and suitability requirements) will be imposed on over-the-counter transactions and then only on retail business. Transactions that previously may have been considered not to be transactions in securities would be explicitly exempted from the securities laws thereby clarifying the treatment of such transactions and removing any ambiguity as to what (if any) securities rules must be complied with. As proposed, the rules would apply to authorized banking as well as securities firms.

2.5.5. In Australia, a special regime permits the trading of over-the-counter derivatives by non-bank counterparties acting as principals outside a regulated exchange subject to lesser requirements than exchange transactions. Like the exemptions discussed above, this exemption depends on the nature of the business and the nature of the counterparty. (Under this regime, all retail business and all brokered business must be done on an exchange or opposite a bank. All contracts for differences in non-cash products must be conducted on a market or an exempt market.) No retail counterparty can participate in an exempt futures market. Exempt futures markets can be conducted free of many regulatory controls applicable to regulated futures markets. Such markets are, however, subject to the general regulatory conditions for operating an exempt market, that the person conducting the market not engage in conduct that is misleading or deceptive or that is likely to mislead or deceive. New legislation would apply similar treatment to all financial products irrespective of the type of counterparty that is offering the product.

2.6. In many countries, work is proceeding to more clearly articulate the basis for interprofessional exemptions and to eliminate some of the disparities in treatment of similarly situated customers and products based on definitional differences related to various investment products and financial institutions.

2.7. This is a rapidly evolving area and almost every jurisdiction has its rules and requirements under constant review.

3. Financial Integrity and the Reduction of Systemic Risk

To the extent that firms engaging in financial transactions are required to be authorized as credit institutions (that is, banks) or investment firms, they are subject to capital and other prudential requirements related to that type of authorized firm, regardless of customer distinctions:

3.1. Most capital regimes take account of the specific risks (that is, credit risk and the sensitivity of credit risk in over-the-counter instruments to market risk) of specific products, including over-the-counter derivatives transactions, although there are differences among securities jurisdictions as to how capital is allocated relative to this risk.

3.2. In some jurisdictions, the capital requirements for banks and securities firms are different; in others, there has been an attempt to harmonize capital requirements applicable to all investment service providers. Such requirements also may be adjusted based upon the nature, size or sophistication of the firm (*e.g.*, firms meeting specified requirements may be able to use proprietary models to allocate capital relative to market risk).

3.3. Depending on the regulatory model, capital compliance may be monitored by a different regulator than the regulator which monitors compliance with conduct of business rules.

3.4. Because of the interlinkages among financial institutions, most national jurisdictions agree that close cooperation is necessary among regulators of different sectors of national financial systems and across national boundaries to assure the financial integrity of authorized financial institutions and to reduce systemic risk.

3.5. The increasing use of derivatives has resulted in enhancements to required internal accounting and operational controls for firms subject to capital requirements and, in some jurisdictions, for collective investment schemes. Guidance regarding internal controls and risk management generally recommend that firm management have procedures in place to take account of the risks of the specific types of investment business undertaken by authorized firms, including those particular to derivatives, off-balance sheet risks and exotic transactions (such as credit or weather derivatives).

3.6. Specific prudential requirements may or may not apply to persons or firms engaging in over-the-counter transactions:

3.6.1. Capital. In general, capital rules apply only to authorized financial institutions. Therefore, counterparties (unless authorized as credit institutions or investment firms or, in the case of Hong Kong, leveraged forex traders, and, in Australia, qualified facility providers) are not subject to regulatory capital requirements. In general, jurisdictions apply prudential rules to authorized firms without regard to the professional nature of their customer base. Certain large market participants (counterparties) that engage in proprietary transactions, but that do not engage in a dealing or brokerage business, are not required to be authorized firms. Therefore, they are not subject to regulatory capital requirements. However, passive investment vehicles, such as collective investment schemes, may have structural (*e.g.*, leverage and dilution limitations, redemption and valuation requirements, and prudent man investment limitations) or other requirements intended to protect their participants and the markets in which they trade.

3.6.2. Internal Controls. Providing consensus guidance on approaches to appropriate internal risk management controls was the first objective of financial regulation commonly approached by securities and banking regulators.

3.6.2.1. The emphasis on management of risks associated with derivatives, and particularly, over-the-counter derivatives, reflects, among other things (i) that certain counterparties are not authorized institutions, and (ii) that, when transacting in over-the-counter derivatives instruments, credit and market risk are related -- the unrealized gain of one party to the transaction reflects the potential risk of loss by that party due to a credit failure of (that is, a default by) its counterparty. Such potential losses may be greater where price moves are not marked to market and settled daily or more frequently. Because prudential rules generally have not been designed (even where they specifically apply) to cover outlier price moves (or so-called fat tails of extreme price movements), effective risk management and internal controls regimes are especially necessary to address leverage related to derivatives and other off-balance sheet products.

3.6.2.2. Existing internal controls standards are intended to cause authorized institutions to determine the legal and credit capacity of their counterparties. It is broadly understood that transactions can potentially lead to severe losses, be set aside, or lead to litigation if such control procedures are not followed.

3.6.2.3. Existing international guidance recommends that end users refer to the internal controls and risk management methodologies designed for authorized firms when evaluating the risks of undertaking leveraged transactions.

3.6.2.4. Trading of derivatives on an exchange may reduce certain risks, in particular the credit risk, legal risk, and settlement risk often associated with transacting in over-the-counter markets. The laws, rules and procedures for trading on exchange set the parameters for approved transactions and are generally transparent, whereas the laws, rules, and procedures relative to over-the-counter transactions, which are "private" contracts, are less accessible.

3.6.2.5. There appears to be substantial agreement that prudential regulation is an important aspect of maintaining financial stability, as well as customer protection, notwithstanding that existing law does not subject non-intermediated business or all market counterparties to prudential requirements.

3.7. Customer Funds and Defaults. There is international consensus that identification of customer funds and segregation of such funds from authorized firm funds facilitates the transfer of non-defaulting customers from a defaulting firm thereby reducing the potential for contagion from a firm failure. The means of according client funds protection differs and the extent to which such protections are extended to (or needed in the case of) over-the-counter transactions in jurisdictions where such transactions are bilaterally negotiated or can be entered into on exempt markets or through exempt parties is unclear.

3.8. Insolvency and Default Procedures. Insolvency law that supports the movement of non-defaulting customers from a failed institution can reduce potential contagion and hence systemic risk. Insolvency rules for derivatives transactions are not harmonized and many jurisdictions do not have market-friendly insolvency provisions. That being said, insolvency law addresses matters other than financial institutions and generally differs from jurisdiction to jurisdiction.

3.8.1. In the case of over-the-counter products, most insolvency-related issues arise with respect to the level of certainty accorded the treatment of margin or collateral posted by counterparties and to the ability to offset or net obligations.

3.8.2. Where legislation has not been enacted to address the validity of netting and the insolvency treatment of derivatives transactions in general, and over-the-counter derivatives and related documentation of such derivatives in particular, the insolvency treatment of such transactions cannot be assured, even if standard documentation practices are followed.

3.8.3. IOSCO has recommended that default and insolvency procedures of regulated markets be transparent and, in particular, that information related to the transfer of non-defaulting customer positions from a defaulting firm be readily accessible.

3.8.3.1. With respect to over-the-counter positions, there are additional issues with respect to defaults. For example, there are issues relating to the ability to close out, in tandem, hedge positions that are taken over-the-counter and in more than one regulated market, the enforceability of acceleration clauses in master agreements, and the treatment of collateral in insolvency.

3.8.3.2. There is international consensus that more work, at least in the private sector, could be done on these issues, which currently are addressed, to the extent possible, primarily by master agreement documentation or not at all.

3.9. Cooperation and Market Disruption. It is well established that cooperation and information sharing arrangements are essential to the management of market disruptions and financial disruptions at firms, especially with the increasingly global nature of the marketplace for financial investments and the multi-national nature of investment firms and credit institutions. In general, most national jurisdictions support information sharing for regulatory and/or supervisory purposes. Most of the jurisdictions responding to the CFTC Survey are signatories to the *Boca Declaration* (*see* note 46, *infra*), and many participated in the Windsor initiative and in the *Tokyo Communiqué* (*see* note 57, *infra*). The G-7 Ministers also have encouraged the G-7 and other national jurisdictions to remove impediments to agreed forms of information sharing. These arrangements, however, may not extend to transactions that occur solely over-the-counter.

4. Legal Certainty.

There are a number of issues with respect to the legal certainty of over-the-counter derivatives transactions that are of prudential concern.

4.1. Issues giving rise to legal uncertainty relate primarily to the enforceability of over-the-counter transactions under certain circumstances and between certain counterparties and to the enforceability of the contractual arrangements that are intended to govern the use of collateral and the close out or liquidation of derivatives positions in the event of a default or an insolvency.

4.2. The International Securities and Derivatives Association ("ISDA") Master Agreement provides some certainty regarding the law that will be applied to international agreements and establishes practitioner conventions for the drafting of agreements concerning derivatives transactions. Such conventions can help to abate concerns about the regulatory inconsistencies among jurisdictions.

4.3. Regulatory or legislative authorities could attempt to reach an international consensus on the documentation that will be honored internationally under local insolvency law.

5. Regulatory Parity

5.1. Differences in Treatment of Products or Participants. Applicable national law evidences some differences in treatment of various products and market participants by financial services regulation, the justifications for which may, in some cases, warrant further examination, especially as the differences between on-exchange and off-exchange transactions and between products offered by different financial institutions diminish.

5.1.1. For example, where prudential and conduct of business regulation is not harmonized across financial institutions, it is possible that products sold by banking entities will not be subject to sales practice or specific anti-manipulation and anti-fraud requirements. Where securities and other products are regulated separately, it is possible that transactions in over-the-counter derivatives that do not meet the definition of securities may be concluded by entities that are not required to be authorized and that, therefore, are not subject to prudential requirements.

5.1.2. Although some jurisdictions are developing special requirements for organized and/or exempt markets as opposed to regulated markets, generally market protections are not applied to over-the-counter markets in which derivatives trading is restricted to dealers.

5.1.3. Although some jurisdictions are moving toward clearing swaps transactions, which will render risks more transparent for that portion of the market that is cleared, in general, the risks associated with over-the-counter transactions are less transparent than the risks undertaken on regulated markets.

6. Fair, Efficient and Transparent Markets

Although transactions in derivatives concluded over-the-counter, may be subject to anti-manipulation provisions (see paragraph 1 above), required price transparency for over-the-counter derivatives transactions is atypical. One exception is Brazil, where the price at which over-the-counter derivatives transactions are concluded must be registered.

7. Why Regulators Have Been Asked to Keep Over-the Counter Instruments Under Review

7.1. Derivatives are inherently suited to global trading and, by their nature, raise international issues. The design of derivative products generally have few geographic limits because, theoretically, nothing prevents an issuer (dealer or market) in one geographic location from designing a product based on debt, currency, investments, yields, rights, or interests in another location. Thus, it is not particularly surprising that growth in global financial markets increasingly has been accompanied by growth in derivatives and, particularly, over-the-counter derivatives products.

7.2. Although it is generally agreed that the risks of financial transactions in all types of financial products are conceptually similar, derivatives and, in particular, over-the-counter derivatives are sometimes viewed as reflecting the impact of market changes more quickly and more dramatically than other, more traditional, financial instruments, thus, potentially heightening systemic risks. Derivatives, especially over-the-counter derivatives, may be difficult to value and difficult to liquidate under adverse market conditions because of their lack of transparency and the need to reverse transactions with the original counterparty after a change in conditions. These factors also may raise systemic concerns and pose issues for regulators as to the appropriateness of the counterparties who enter into the transactions.

7.3. The international dimension of the over-the-counter derivatives market also can magnify the risk generated by inconsistencies and legal uncertainty, especially as to the scope and intention of applicable law. A unilateral attempt in a jurisdiction like the United States to "heighten" standards could drive market participants to move to more "friendly" jurisdictions or, at a minimum, to require the use of choice of law clauses that adopt the laws of friendlier jurisdictions. Reliance solely on choice of law clauses or shifts to legal systems less experienced in over-the-counter derivatives may generate new uncertainties or risks.

8. Conclusions and Recommendations

8.1. The CFTC Survey and this paper's analysis demonstrate a wide array of differences in approaches to over-the-counter derivatives. There are differences in:

(i) the products addressed by applicable legislation;

(ii) how those products are covered;

(iii) the treatment of counterparties;

(iv) what counterparties are subject to regulation; and

(v) when counterparties become subject to regulation.

8.1.1. Other than the CFTC Survey and IOSCO Regulatory Summary, which are not detailed reviews, there is no current compendium of the laws applicable in this area. The multiple regulatory authorities involved in each national jurisdiction make it difficult to compile such information reliably.

8.1.2. There is significant divergence among national jurisdictions as to who is an eligible counterparty and for which counterparties special disclosures are required.

8.1.3. There remain issues in several jurisdictions as to whether specific types of transactions are legal, whether transactions that are ultra vires are voidable, and whether wagering laws can render otherwise legal transactions unenforceable.

8.1.4. According to the CFTC Survey, and other materials reviewed in connection with this analysis, there remain jurisdictions in which it is not clear whether common provisions included in the documentation of over-the-counter transactions, including liquidation clauses, closeout netting provisions, and collateral treatments would be honored in an insolvency. International work in this area is ongoing.

8.1.5. Substantial work has been completed relating to internal controls for regulated intermediaries, but such controls often fail when firms are making money, and control guidance generally has not been extended to all market participants.

8.1.6. Much work has been accomplished on international cooperation. International regulators agree that it is important to devise appropriate regulatory treatments to address problems of market integrity and confidence, interlinkages among markets, and resulting susceptibility to shocks or problems of individual firms, and that such cooperation extends to events involving any financial activity. Regulators have relied primarily on advocating increased transparency of market exposures generally to more direct regulatory intervention. Extending guidance concerning surveillance and information needs of regulated markets to over-the-counter derivatives transactions and markets would be a complex undertaking that is subject to ongoing analysis at the international level.

8.1.7. As innovative means of delivering financial services are developed, inquiry as to appropriate regulatory approaches may become increasingly necessary.

8.2. In participating in international forums and in designing approaches to over-the-counter business, national regulators may find it useful to consider the following recommendations:

8.2.1. *Coverage; Accessibility of Applicable Law; Market Infrastructure*

- Improve the accessibility of applicable law, rules and procedures affecting over-the-counter transactions using a common framework of analysis

- Continue examining basic "market" infrastructure issues to determine how the existing framework should reflect differences between products, customers and markets.

8.2.2. *Improve Information on and Consistency of Interpretations as to Who Is an Eligible Counterparty and Differences in Applicable Requirements Among Counterparties*

- Improve transparency of national law as to which counterparties are eligible for which transactions and with what protections;

- Clarify when public offering requirements apply;

- Explore the possibility of more uniformity across jurisdictions -- *i.e.*, work toward common understandings regarding the categorization of professional counterparties; and

- Discourage permitting counterparties to act for undisclosed principals.

8.2.3. *Clarify Legality of Instruments or Transactions*

- Clarify that otherwise legal contracts for differences cannot be voided under gambling legislation and that a party entering a contract cannot claim *ultra vires* as a defense; and

- Clarify international parameters regarding acceptable documentation.

8.2.4. *Promote Financial Integrity of Transactions*

- In jurisdictions where it remains unclear, clarify the validity of netting, including closeout netting arrangements, and the counterparties and products to which such arrangements may apply;

- Promote legislative endorsement of documentation that meets international standards;

- Provide support, irrespective of the type of insolvency system, for pre-bankruptcy law which supports the management of positions (and workouts), as well as their liquidation, to avoid disruptions resulting from the insolvency of firms that are large position holders with multiple counterparties;

- Provide more guidance on the "law of the transaction" or validity of choice of law provisions; and

- Develop mechanisms or regulatory strategies or incentives to assure internal control policies are followed and are promoted to all market participants.

8.2.5. *Promote Cooperation and Information Sharing*

- Review existing work at the international level on cooperation and information sharing and the extent to which it is intended to facilitate sharing of information regarding over-the-counter exposures in appropriate cases;

- Identify over-the-counter information that it is desirable to disclose and to share and for what purposes;

- Continue to take steps toward removing national barriers to sharing information across borders and financial sectors for agreed purposes; and

- Assure arrangements are in place for cross-border and intersectoral cooperation (that is, cooperation between prudential and conduct regulators, if they are different, and among insurance, securities and banking regulators, if they are different).

8.3. Regulators should also explore the following means to promote international harmonization and/or to reduce the inconsistencies in of regulatory approaches:

8.3.1. *Expose regulatory differences and commonalities*

Understanding existing regulatory systems and the extent of the differences between them is one good means of moving toward commonality and removing regulatory gaps or unnecessary overlaps. Therefore, regulators should consider expanding and developing more fully the CFTC Survey of existing regulatory systems affecting over-the-counter transactions through IOSCO, through IOSCO and the BCBS jointly, through the Joint Forum on Financial Conglomerates (a group organized under the auspices of IOSCO, the BCBS, and the International Association of Insurance Supervisors), through encouragement of a private-sector initiative, or through some specially convened group of derivatives regulators. (The purpose of such an exercise would be to develop more fully, using existing materials, follow-up interviews and review of original documents, the applicable law in various jurisdictions so as to attempt, by consensus, to identify with particularity gaps, differences, or overlaps in coverage.)

8.3.2. *Promote public dialogue on the need for regulatory changes based on changes in technology and in the structure of markets as they apply to over-the-counter derivatives*

Consider convening an international roundtable of regulators, self-regulators, intermediaries, dealers, end-users and international financial institutions and academics on potential areas where structural changes are warranted and harmonization is desirable, focussing on technological changes in the structure of markets, products and market users.

8.3.3. *Continue to promote stronger national programs to foster the enhancement and effective implementation of internal controls*

As controls failures continue to be the source of most financial disruptions and deceptive sales practices, remind individual national jurisdictions of the various existing international guidances on internal controls. A menu of various implementation strategies for regulators to evaluate in determining how to encourage authorized firms to develop appropriate controls were listed in IOSCO's 1994 guidance on internal controls for over-the counter products as follows:

- Adopt performance or design standards;

- Interpret existing rules affecting authorized firms to subsume management control requirements for over-the-counter business;

- Collect information from authorized firms on risks and risk management controls and policies;

- Require assessment of counterparties by authorized firms;
- Require management assessments and regulatory examinations or auditors' reports either by internal independent audit staff or third party auditors;
- Require self-regulatory organization oversight by reference to industry standards;
- Require pre-clearance of systems and controls as part of fitness determinations; and
- Promote best practices by non-regulated market participants.

The appropriateness of the use of the various alternatives proposed by IOSCO depends on the overall regulatory structure in a given jurisdiction and on the characteristics and attributes of the markets in that jurisdiction.

The Financial Stability Forum ("FSF")[7] also has developed a map of recommendations on internal controls which consolidates banking supervisory and securities standard-setters recommendations regarding highly leveraged institutions.

8.3.4. *Provide training opportunities*

Develop a training program core curriculum specific to oversight of derivatives markets to assist regulatory authorities in addressing issues related to implementing regulatory programs that address the agreed objectives of financial regulation and to assist authorized firms in managing risks.

8.3.5. *Identify bases for cooperation to address over-the-counter exposures*

Specifically identify elements of appropriate information to be shared among regulators and market authorities across exchange, over-the-counter, and cash markets upon the occurrence of a market event.

8.3.6. *Provide guidance on best practices for maintaining liquidity and continue to evaluate the effectiveness of existing mechanisms to address the adequacy of the liquidity arrangements of large leveraged participants in the financial system*

[7] A group organized pursuant to an initiative of the Group of Seven Countries consisting of a Chairman (from the Bank for International Settlements), representatives of national authorities (three from each of the participating countries [from the treasury, central bank, and supervisory agency]: Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, United Kingdom, and the United States), the International Financial Institutions (the International Monetary Fund, the World Bank, the Bank for International Settlements, the Organisation for Economic Co-operation and Development), the International Regulatory and Supervisory Groupings (BCBS, IOSCO, and the International Association of Insurance Supervisors), and Committees of Central Bank Experts (the Committee on the Global Financial System and the Committee on Payment and Settlement Systems). *See* www.fsf.org. *See also* note 9, *infra*.

Provide guidance on best practices for maintaining liquidity and continue to evaluate the effectiveness of existing mechanisms to address the adequacy of the liquidity arrangements of all large leveraged participants in the financial system to address the potential need to close out large positions held in different markets without jeopardizing market and financial stability.

8.3.7. *Clarify the products, activities, and entities to which financial services law applies*

Continue to follow international work on whether, and the extent to which, certain core financial activities, the undertaking of positions or exposures over a specified amount, or the use of a specified degree of leverage by firms over a specified size should be covered by certain core requirements irrespective of the institutional structure of the financial services provider or market participant or the nature of the positions or exposures undertaken, particularly with regard to the following:

- Internal accounting, risk management and operational controls;
- Adequate liquidity, funding arrangements and credit risk controls;
- Timely documentation of transactions;
- Recordkeeping and retention; and
- The appropriate level of disclosure or reporting to regulators, counterparties, and the public.

In this context, due consideration should be given to the benefits of implementing multiple levels of regulation that can be calibrated to the regulatory requirements associated with products and markets of varying characteristics and attributes, as well as to the costs of maintaining multiple regulatory structures.

This report is intended to complement other on-going work with respect to both over-the-counter derivatives markets and highly leveraged institutions, such as (i) the President's Working Group on Financial Markets reports on *Hedge Funds, Leverage, and the Lessons of Long Term Capital Management* (April 1999) and *Over-the-Counter Markets and the Commodity Exchange Act* (November 1999), (ii) the BCBS reports on *Banks' Interactions with Highly Leveraged Institutions* (January 1999), *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999), and *Banks' Interactions with Highly Leveraged Institutions: Implementation of the BCBS's Sound Practices Paper* (January 2000); (iii) the report of the IOSCO Technical Committee on *Hedge Funds and Other Highly Leveraged Institutions* (November 1999); and (iv) the *Report of the Working Group on Highly Leveraged Institutions* of the Financial Stability Forum. Those reports address many of the issues raised and are pursuing some of the areas that are the subject of recommendations in this report in the context of United States domestic over-the-counter derivatives markets or with respect to highly leveraged institutions specifically. Many of the suggestions contained in this Working Paper have been taken forward in these forums by individual national regulators. This report primarily analyzes the regulatory structures and approaches of other jurisdictions and is intended to describe the manner in which such non-U.S. jurisdictions approach the regulation of over-the-counter markets and products.

A more complete analysis of the international regulation of over-the-counter derivatives follows. The CFTC Survey is attached for reference.

II. Introduction

Significant work has proceeded at an international level toward consensus on a high-level framework for the regulation of financial products, markets and intermediaries effective to achieve the identified common goals of:

- *protection of customers;*
- *fair, efficient and transparent markets; and*
- *reduction of systemic risk.*[8]

Additionally, during the last decade in particular, regulatory and private sector organizations have moved to develop common responses to public concerns about (i) securing the benefits, while mitigating the risks, posed by the global linkages among cash, derivatives, and over-the-counter markets, and (ii) the expanding use of derivatives, especially through over-the-counter derivatives transactions. In developing these responses, they have attempted to design rules and to fashion other mechanisms or techniques that promote the goals of financial regulation without impeding continuing growth and innovation in the global over-the-counter derivatives market.

Notwithstanding a high level of attention to developing general benchmarks or guidance for reference by national regulatory authorities, particularly in the area of risk management and measurement, public reporting and disclosure, including accounting disclosure and information sharing, very little work has been done to date on the extent to which regulations or other measures effectuating such guidance have been implemented in the various national jurisdictions, or on the extent to which the general financial regulatory framework actually has been applied to counterparty transactions. Still less work has been done, except in certain selected areas such as netting, on the differences among jurisdictional approaches.[9]

This paper presents a current picture of the extent to which the public policy objectives of financial regulation detailed above are currently being addressed on a national basis with respect

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[8] *See* IOSCO Core Principles, setting out three main objectives of securities/derivatives regulation and thirty principles that give practical effect to those objectives. *See also* the Regulatory Summary, note 5, *supra*.

[9] In comparison, the BCBS has evaluated the status of compliance of internationally active banks with the Basel Capital Accord of 1988, which addressed off-balance sheet risks (*see e.g.*, the BCBS's Report on *International Developments in Banking Supervision*, No. 11, October, 1998); the International Swaps and Derivatives Association has compiled work on the status of national laws with respect to netting and use of collateral and has developed recommended master agreement documentation that takes account of local law; and the BCBS and the Technical Committee of IOSCO, since 1995, have issued an annual joint survey on public trading and derivatives disclosures of banks and securities firms. Financial institutions voluntarily participate in this survey. *See* the discussion at p. 40 *et seq.*, *infra*. These surveys cover financial institutions from the G-10 jurisdictions and prior to 1998, Hong Kong. Additionally, IOSCO is in the process of conducting a study of the implementation of the IOSCO Core Principles using self-assessment and "quality control" survey-like assessment methodologies and techniques, but this process has not yet been completed and does not focus on over-the-counter products. Lastly. the BCBS and IOSCO both are participants in an exercise to encourage implementation of a compendium of core standards being compiled by the Financial Stability Forum ("FSF"). *See* "Financial Stability Forum endorses policy actions aimed at reducing global financial vulnerabilities" at http://www.fsforum.org/Press/Home.html.

to over-the-counter derivatives.[10] In particular, it examines the approach of certain of the principal national financial markets to manipulation, customer protection and fraud, financial integrity, and reduction of systemic risk.

To understand better the regulatory response to derivatives and, in particular, over-the-counter derivatives in the principal financial centers, the CFTC conducted a survey of the treatment of over-the-counter products in 16 participating jurisdictions.[11] This analysis draws on the resulting report, the CFTC Survey.[12] That report includes a general overview of, and the statements of the participating jurisdictions in their own words regarding, the regulation of over-the-counter derivatives transactions. The report focuses specifically on the various national approaches to regulation of (and/or exemption of) over-the-counter derivatives transactions. In general, however, the CFTC Survey indicates that derivatives are regulated as part of a broader regulatory scheme applied to the universe of financial investment and risk management products. This analysis also draws on the 1997 edition of the Regulatory Summary,[13] the IOSCO Core Principles,[14] independent analysis of the national laws of certain countries, as cited herein, and other materials as set forth. Overall, these source materials indicate that there is no one preferred technique for achieving commonly agreed regulatory objectives. Based on these materials, the following conclusions can be drawn about each of the identified public policy objectives.[15]

III. Prevention of Manipulation

- *There is broad consensus that price (or market) manipulation should be prevented. However, there is divergence as to what conduct is prohibited by anti-manipulation provisions and the manner in which manipulation is defined.*

- *Traditionally, manipulation has been viewed as primarily a market (price discovery) protection with collateral benefits for customer protection and the real economy. Existing prohibitions usually speak in terms of effects on markets. Regulators in designing techniques to detect, deter and sanction manipulation or other abusive activity may refer to the relative susceptibility of various products and/or markets to such activity. In some cases, existing prohibitions may be broad enough to cover conduct involving over-the-counter transactions, especially if such conduct affects a regulated or an organized market.*[16]

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[10] In general, most of the conclusions in an IOSCO Working Paper 3 report on *Transactions in On and Off-Exchange Derivatives: Global Regulation*, which was attached as an Annex to a CFTC Report on *OTC Derivatives and Their Regulation* (October 1993), remain true today.

[11] *See* note 2, *supra*..

[12] *See* note 2, *supra*.

[13] *See*, note 5, *supra*

[14] *See* p. 3, *supra*.

[15] This paper does not examine in any detail the evolution of lesser or non-regulated electronic execution or communication facilities or markets. Increasingly, electronic technology is being used to facilitate the posting of bids and offers, communications between counterparties, and anonymous matching of counterparties based on price. These electronic facilities generally are not treated as fully regulated markets.

[16] IOSCO explicitly has recognized that risks of manipulation and congestion are different in kind and likelihood depending on the nature of the underlying product. *See* the report on *Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*, IOSCO (September 1998). *See also* the report on *Hedge Funds and Other Highly Leveraged Institutions*, IOSCO (September 1999). *See further* note 104, *infra*.

- *Most jurisdictions endorse appropriate access to information on risk positions and information sharing between market authorities to combat manipulative and other abusive practices.*

A. Individual Jurisdictions

In individual national jurisdictions, manipulation is a common concern. IOSCO found that:

> The fairness of the markets is closely linked to investor protection and, in particular, to the prevention of improper trading practices. ... Regulation should detect, deter and penalize market manipulation and other unfair trading practices. Regulation should aim to ensure that investors are given fair access to market facilities and market or price information. Regulation should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable.[17]

However, existing anti-manipulation and fraud provisions may not apply to all products, may not be explicitly tailored to financial markets, may not be subject to direct enforcement by administrative action of securities or derivatives market authorities, and may not extend to counterparty transactions. To the extent manipulation is described as activity that affects prices occurring in a market, some jurisdictions may not define over-the-counter counterparty transactions as occurring in a market and hence may not find such transactions, in themselves, to be "susceptible to manipulation."

In exchange-traded markets, market disruptions, disorderly markets and congestion or price aberrations frequently are addressed by structural measures such as position and exercise limits, circuit breakers, trading halts and restrictions of specified types of trading activity, such as wash trading, together with the imposition of self-regulatory responsibilities on exchanges or market sponsors to maintain orderly markets. Such markets must operate openly and competitively and maintain audit trails.[18] Consequently, positions taken in them are transparent to the exchange and prices taken in them are transparent to the public. Over-the-counter counterparty transactions, on the other hand, are not required to be transparent and are generally not currently subject to direct or routine surveillance. Additionally, existing legislative or regulatory prohibitions of specific market practices may not apply to such markets. This may be because, traditionally, such transactions have been negotiated individually as to price and maturity and not concluded by open and competitive auction. However, electronic technology is blurring the distinctions between over-the-counter and exchange markets, and between markets and intermediaries.[19] As a consequence, individual jurisdictions' approaches to defining and preventing abusive activities and fraud are evolving.

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[17] IOSCO Core Principles, at paragraph 4.2.2.
[18] *See* Regulatory Summary, Section II. B. 5.
[19] *See e.g.,* Australian Corporate Law Economic Reform Program, Paper No. 6 on *Financial Markets and Investment Products* (December 1997) ("CLERP 6 Paper"); see *also* Australian Corporate Law Economic Reform Program, Consultation Paper on *Implementing CLERP 6: Financial Products, Service Providers and Markets – An Integrated Framework* ("CLERP 6 Consultation"). Additional changes in Australian law are due to be made this summer. *See also* the UK FSA's Discussion Paper on *The FSA's approach to regulation of the market infrastructure* (January 2000) ("FSA Infrastructure Paper"). Additional changes are due to be made to UK law by the end of the year 2000.

Applicable anti-manipulation and fraud provisions expressly apply to certain over-the-counter transactions in the UK and Australia. Canadian federal law could be made applicable to Canada's proposed exempt over-the-counter derivatives transactions, and, within the EU, existing provisions may be broad enough to cover some over-the-counter conduct, especially in organized markets. Japan and Hong Kong's prohibitions on manipulation and fraud may provide protections to specified regulated markets concerning over-the-counter activities. Many of these provisions, however, have not been tested in actual cases.

Some examples of the approaches in major markets to the prevention, detection and sanctioning of manipulation follow:

1. *United Kingdom – Specific Guidance – Anti-manipulation rules apply to over-the-counter transactions that are investments*

In the United Kingdom, certain over-the-counter transactions are covered by Section 47 (an anti-fraud and anti-manipulation provision) of the *Financial Services Act of 1986* ("FSAct") as well as by the general statements of principle of the FSA of high standards of market conduct and high standards of integrity. Section 47 applies to investments and provides that attempts to manipulate a market (which need not be a regulated or organized market) by "any person" is a criminal offense.

Swaps, futures (including "off-exchange futures"), and contracts for differences on any permitted underlying reference price (that is, over-the-counter transactions) are included within the definition of "investments under Schedule 1 of the FSAct." Any persons who engage in investments (market participants as well as authorized banks and investment firms) are subject to the anti-manipulation and anti-fraud provisions of Section 47. These provisions make it a crime (i) to make "misleading statements, promises or forecasts for the purpose of inducing others to enter, or [to] refrain from entering, investment agreements or [to] exercise or to refrain from exercising rights conferred by any investments with respect to such investments" and (ii) to create "a false or misleading impression as to the market in or the price or value of any investments" with the intent both to create that impression and to " induce" another person to act or fail to act with respect to those investments. [20]

[20] Until 1993, the UK had construed its regulatory requirements primarily to apply to market participants rather than markets, including exchange-traded markets. In 1993, the Securities and Investments Board issued two guidances on wash trading and other discouraged market conduct: Guidances 1-93 and 2-93, relating to "Proper Trades in Relation to On-Exchange Derivatives" and "Proper Markets in Relation to On-Exchange Derivatives," demonstrating a concern that entity-based regulation was insufficient in these cases. The British House of Commons is currently considering a proposed Financial Services and Markets Bill ("FSM Bill") that will further consolidate the supervision of financial services in the UK in the FSA. The FSA has already undertaken an extensive consultation process to revise and consolidate the rules and guidance that govern the provision of financial services in the UK (including banking, securities, portfolio management, and insurance, among other financial services). Upon adoption of the FSM Bill, the FSA intends to promulgate an FSA Handbook of Rules and Guidance that will include several "sourcebooks" that set out rules and guidance regarding specific matters. The FSA currently is in the process of drafting a Market Conduct and Infrastructure Sourcebook that will include definitions of abusive market practices, including practices such as corners. The FSM Bill is expected to be adopted by the end of the year 2000.

The *Oil Market Code of Conduct* ("Brent Code") which applies to certain over-the-counter transactions in oil explicitly notes that such transactions are subject to Section 47.[21] Similarly, interest rate and currency swaps (regardless of maturity), forward rate agreements, and other contracts for differences based on money market instruments (*i.e.*, transactions which commonly occur over-the-counter) undertaken by listed money market institutions[22] can be consummated in a wholesale market pursuant to Section 43 of the FSAct, the so-called "Grey Paper", and the London Code of Conduct (collectively, the "Grey Paper" or "wholesale markets" regime).[23] Grey Paper transactions are otherwise exempt from the requirements of the FSAct, but are nonetheless subject to Section 47. Section 47, however, may not apply to direct spot transactions in sterling, forex, and bullion which are not defined as investments by the FSAct.

Section 47 can be enforced by the Department of Trade and Industry ("DTI") with respect to authorized firms. The Serious Fraud Office also is entitled to prosecute under Section 47. In practice, however, indications are that the DTI has not brought cases under Section 47, due to the difficulty of prosecution and other matters, and the Serious Fraud Office has generally brought cases where only a small element of the activity in question related to conduct subject to the FSAct.

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[21] Brent Code, Appendix 2, paragraph (7): "A market participant should not attempt improperly to mislead its counterparties or dishonestly to conceal material facts from them. Market participants are reminded that activity of this kind may amount to a criminal offence, for example, under section 47(1) of the Financial Services Act." Brent Code, Appendix 2, paragraph. (8): "A market participant should not attempt improperly to manipulate the market. Activity of this kind may amount to an offense under section 47(2) of the Act." *See also* SFA Rules – Rule No. 2. The Brent Code is in the nature of guidance and is not a regulation.

[22] Wholesale money-market institutions (*i.e.*, banks, securities houses and name-passing brokers) admitted to a list maintained by the Financial Services Authority (previously, by the Bank of England), subject to approval of HM Treasury.

[23] See the FSA's paper on *The regulation of the wholesale cash and OTC derivatives markets under section 43 of the Financial Services Act of 1986* ("Grey Paper") and the *London Code of Conduct: For principals and brokering firms in the wholesale markets*, FSA (June 1999) ("London Code"). The London Code addresses, among other matters, general standards, controls, dealing principles and procedures, market conventions, and guidelines for exchanging settlement instructions. The London Code is primarily concerned with ensuring orderliness in the markets for Grey Paper Instruments -- sterling, forex and bullion, and certain investments, such as over-the-counter derivatives, and many of its provisions relate to "market confidence" and market conduct. The provisions of the London Code are also commended by the Chartered Institute of Public Finance and Accountancy and the Association of Corporate Treasurers (*e.g.*, to end-users who act as market counterparties). The FSA recently published a Discussion Paper titled *Differentiated regulatory approaches: future regulation of inter-professional business* (October 1998) ("Wholesale Market Paper") on the Grey Paper regime, available at http://www.fsa.gov.uk/pubs/discussion/index-1998.html. Public comment on the Wholesale Market Paper concluded on 30 January 1999 and the FSA indicates that a new consultation paper on the wholesale market will be published in May 2000. A final professional, inter-dealer regime which is intended to supersede and simplify the London Code and the Grey Paper will be adopted as part of the Market Conduct and Infrastructure Sourcebook expected to be come into effect subsequent to the adoption of the proposed FSM Bill. However, certain provisions of the London Code will be incorporated into the Conduct of Business Sourcebook which will supersede the existing FSA (formerly Securities and Investment Board) Rules, the Investment Management and Regulatory Organization Rules, and the Securities and Futures Authority Rules subsequent to the adoption of the FSM Bill. Two FSA Consultation Papers on *Market abuse Part 1: Consultation on a draft Code of Market Conduct and on Market abuse Part 2: Draft Code of Market Conduct* were published in June 1998 and can be found at. http://www.fsa.gov.uk/pubs/cp/index-1998.html. *See* the discussion at p. 30, *infra*, and note 53, *infra*. An FSA Consultation Paper on the Conduct of Business Sourcebook also can be found at http://www.fsa.gov.uk/pubs/cp/index-2000.html. *See* the discussion at p. 47, *infra*, and note 122, *infra*.

2. *Australia – General prohibitions on fraud and manipulation in the Corporations Law apply to all futures markets, including exempt (certain over-the-counter) markets*

In Australia, a person must not be involved in a transaction that creates an artificial price or creates a false or misleading appearance of active dealing in a futures market and must not make misleading statements likely to effect the raising, lowering, maintaining or stabilizing of the price for dealings in futures contracts on a futures market.[24] An exempt futures market, that is, a principals' market in adjustment contracts or contracts for differences that has been declared "exempt" pursuant to *Policy Statement 70 -- Exempt Futures Markets* ("Australian PS"),[25] is considered to be a futures market for this purpose.[26] Therefore, over-the-counter transactions occurring on exempt futures markets[27] are covered by the anti-manipulation and anti-fraud provisions contained in the offenses section of Australian Corporations Law. However, there have been no cases on this point.

The Australian Securities Investment Commission ("ASIC") is responsible for market integrity of regulated and exempt markets generally. However, in Australia, most over-the-counter activity occurs in currency swaps, interest rate swaps, and forward exchange rate or forward interest rate contracts to which an Australian bank or merchant bank is a party.[28] Such transactions are not futures and are not currently required to be conducted on an exempt futures market. As a consequence, such transactions would not be subject to anti-manipulation and/or anti-fraud provisions that specifically apply to futures transactions on markets. Under the new Australian regulatory regime, however, ASIC is responsible for the conduct of business of banks.

To promote market integrity, an exempt futures market must be operated by a facility provider that is subject to prudential regulation and must agree to keep records and to report on market activity or exposures to the appropriate regulatory authorities.[29]

3. *European Union Countries[30] – There currently are no specific anti-manipulation requirements under the Investment Service Directive or other EU Directives. Anti-manipulation rules of individual national jurisdictions may be broad enough to apply to over-the-counter transactions.*

The European Union has no general directive on fraud or manipulation by market participants.[31] The ISD,[32] which like all other such directives, must be transposed into national law, only

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[24] *See e.g.*, Australian Corporations Law, Sections 1259, 1260, and 1261; *Collation of responses received from regulatory authorities to the surveys on contract design, market surveillance and information sharing*, following the November 1996 London Commodity Futures Markets Conference (London, June 1997) ("London Survey") at pp. 118, 144 - 153; the CFTC Survey, at p. 52; and the Regulatory Summary, at Section II. C. 4. (d).
[25] Available at http://www.cpd.com.au/asic/asichome.htm. *See* also the discussion at p. 50, *et seq.*, *infra*.
[26] Australian Corporations Law, Section 1127.
[27] *See* the discussion at pp. 37, *et seq., infra,* under Customer Protection.
[28] *See* the London Survey, at p. 110; and the CFTC Survey, at pp. 1, 6, and 8
[29] Australian PS, at paragraphs 70.39 and 70.64.
[30] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden and the United Kingdom.
[31] However, the European Commission is currently considering proposing such a directive, the objective of which would be "to enhance market integrity and investors [sic] confidence by reducing the possibility of market

contains general principles on conduct of business by investment firms. Member States are required to adopt rules of conduct which include a requirement that an investment firm: "acts honestly and fairly in conducting its business activities in the best interest of its clients and the integrity of the market."[33] The ISD "presupposes that a host Member State has the right and the responsibility both to prevent and to penalize any action within its territory by investment firms contrary to rules of conduct and other legal or regulatory provisions it has adopted in the interest of the general good and to act in emergencies."[34] "Acting in the [interests of the] integrity" of the market is a general conduct of business principle of the ISD and, as such, would apply both to investment firms (including dealers) and to credit institutions (that is, banks) doing investment business over-the-counter in investments covered by the ISD. Provisions of individual EU Member States that address manipulation and fraud are permitted rules of conduct that can be adopted in the interest of the general good.

Existing, national criminal anti-manipulation provisions in EU Member States may not extend explicitly to over-the-counter transactions, but may be broad enough to a cover such transactions if they can be said to occur in, or to be related to, a market. For example, in France, manipulative conduct includes "to carry out, or try to carry out, either directly or indirectly, a maneuver with a view to hampering the smooth operation of a market for a financial instrument by misleading other parties."[35] Section 88 of the German Exchange Act (Börsengesetz), renders punishable "providing misleading information about any circumstances which have a considerable influence on the evaluation of securities, goods or derivatives."[36]

In several jurisdictions in Europe, manipulation and fraud are penal offenses that must be prosecuted by the penal authorities, although in France, the *Commission des Opérations de Bourse* ("COB") also can bring administrative actions. The authority that can initiate action, however, may differ from jurisdiction to jurisdiction. For example, in Germany, the securities supervisory authorities of the Länder (German states) normally initiate criminal investigations, but the federal securities regulator (the Bundesaufsichtsamt fur den Wertpapierhandel) also may do so. In Italy, the Commissione Nazionale per le Società e la Borsa ("CONSOB") must report manipulation to the law courts and provide the public prosecutor with the documentation

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participants to rig EU securities markets." Financial Services Action Plan Forum Group on Market Manipulation, *Issues Paper for the First Meeting of the Group* ("EU Manipulation Paper") at http://europa.eu.int/comm/dg15/en/finances/actionplan/index.htm. *See also*, Commission Recommendation 77/534/EEC, OJ L212/37 (20 August 1977) concerning a European code of conduct relating to transactions in transferable securities. Further, the Forum of European Security Commissions ("FESCO"), which consists of the 15 EU jurisdictions and Iceland and Norway (the non-EU members of the European Economic Area, other than Liechtenstein), have published Standards for Regulated Markets Under the ISD, which also address issues regarding market manipulation, available at http://www. europefesco.org.

[32] Investment Services Directive 93/22/EEC, Official Journal L 141/27 (6 June l993), as amended by Directive 95/26/EC, Official Journal L 168/7 (8 July 1995).

[33] ISD, Article 11, *supra*, note 32, at p. 37.

[34] ISD, *supra*, note 32, at Preamble, p. 30.

[35] France's Financial Activity Modernization Act 96-597 of July 2, 1996 ("French FAMA"). In France, the COB may administratively address price setting in exchange and over-the-counter "markets." *See* COB Regulation 90-04.

[36] London Survey, at p. 118. In Germany, enforceable over-the-counter contracts are generally considered connected to an exchange. *See* the CFTC Survey, at pp. 39, 55.

collected during its investigation of explicitly prohibited practices such as corners and manipulation of settlement prices.[37]

4. Canada - Ontario - Anti-manipulation and anti-fraud provisions are broad enough to cover over-the-counter activity, but may only be enforceable at the Federal level especially to the extent counterparty transactions with certain qualified parties are exempted from the application of the securities laws

The Federal Law of Canada makes it a crime for one who by “deceit, falsehood or other fraudulent means,” with intent to defraud, affects the market price of “shares” or “anything that is offered for sale to the public” or to engage in wash trading. There are also explicit requirements of provincially enforced securities laws that could be said to prevent abusive practices and relevant organized markets have rules intended to ensure fair and orderly markets.[38] The scope of provincial rules penalizing manipulation were potentially called into question in a Canadian constitutional case relating generally to the separation of powers in Canada, and specifically, to whether federal laws or provincial securities law provisions were applicable to a transaction. The provincial provisions were ultimately upheld.[39] The proposed changes to Ontario securities laws to address certain over-the-counter transactions in securities, however, would not extend its provincial securities laws to certain over-the-counter transactions, except as explicitly set forth therein.[40] Additionally, although banking institutions are regulated under Canadian federal law, the federal provision may not reach privately negotiated or arms length transactions.[41] It could be broad enough, however, to extend to bilateral transactions that had an effect on a related public market or to over-the-counter transactions marketed to the retail public. Ontario is in the process of fine-tuning new rules implementing expanded authority clarifying how it will apply securities regulation to certain types of over-the-counter derivatives transactions, subject to specified exemptions for certain transactions between qualified counterparties.

5. Hong Kong – Anti-manipulation and anti-fraud requirements are part of product-by-product limitations that cover certain products

In Hong Kong, manipulation is a criminal offense prohibited by specific Ordinances that apply to specific financial products, *e.g.,* securities, futures (which are exchange-traded only), and collective investments. For example, it is an offense for a person “to intentionally create or cause to be created or do anything with the intention of creating a false or misleading appearance of active trading in any securities on the Unified Exchange.” It is also an offense to engage in “any act which has the effect of preventing or inhibiting the free negotiation of market prices for the purchase or sale of a listed security.” Certain over-the-counter activity, such as leveraged

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[37] *See* the Regulatory Summary, at Section II. C. 4. (d). For more recent information on the laws in this area, *see also*, when concluded, the work of IOSCO Working Party 4 on manipulation (“WP4 Report”) (expected to be published in May 2000).
[38] Regulatory Summary, at Section II. C. 4. d.
[39] R.V. Smith [1960] S.C.R. 776 (May 1960), upholding 1959 Caswell Ont. – 127 [1959] O.R. 365 (May 1959), revising [1959] O.R. 86 (January 1959).
[40] *See* the discussion of Ontario exemption, at p. 49, *infra*.
[41] The CFTC Survey, however, indicates that where over-the-counter transactions are sold, this generally occurs through a securities subsidiary, even if the transaction is booked in the bank. CFTC Survey, at p. 2.

forex trading, which is the subject of a special regulatory regime, also would be covered by specific prohibitions, as would certain activity by collective investment vehicles. Currently, legislative changes are under consideration for market manipulation to be dealt with by a Tribunal, using civil standards of proof, with power to fine and order the disgorgement of the profits of the manipulative activities.[42]

6. Japan – Anti-manipulation measures exist, but the scope is limited to over-the-counter products based on listed securities

Regulations prohibiting "spreading a rumor, using a deceptive device, resorting to violence to intimidate another person in connection with the purchase and sale of or other forms of trading in a security or with the aim of causing a change in the price of a security," "wash sales," or "creating a misleading appearance of active trading" are prohibited conduct. The prohibitions extend to over-the-counter transactions in listed securities as well as transactions on regulated markets.[43] Japan, in recently permitting over-the-counter securities derivatives, took account of a May 20, 1997 Report of the Securities and Exchange Council on *Securities-Related Over-the-Counter Derivatives Trading* which cited the close relationships among the prices of securities in the cash market, the value of derivatives trading on securities exchanges, and the value of over-the-counter derivatives as reasons for interpreting securities rules against price manipulation to apply to over-the-counter activities related to listed securities. However, with respect to the recent financial reforms, such report also noted: "It would not be appropriate to broaden coverage of the Securities Exchange Law, in its current form, to financial instruments with different characteristics. As wider reform of the financial system proceeds and as greater diversity in intermediaries investment products and services occurs, there will be a need to rethink what system of investor protection is desirable in order to cover those products and services that are more bilateral than markets based in nature."[44]

Japan's Ministries of Agriculture, Forestry and Fisheries and International Trade and Industry, (MAFF and/or MITI), under The Commodity Exchange Law, monitor(s) market exposures, especially large trader exposures on domestic exchanges, including exposures of foreign holders. MAFF and MITI have authority to review over-the-counter activity. Prohibitions on over-the-counter derivatives on commodities in Japan were lifted in 1999.[45] MAFF and MITI are signatories to the Boca Declaration,[46] which addresses information sharing on abusive practices, but do not have direct regulatory authority themselves to address manipulation.

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[42] *See the* Securities Ordinance for securities trading, Commodity Trading Ordinance for commodities futures contracts trading, Leveraged Foreign Exchange Trading Ordinance for leveraged foreign exchange contracts trading, and Protection of Investors Ordinance for trading of what are usually referred to as collective investment schemes. *See also* the newly proposed *Securities and Futures Bill - White Bill* (April 2000) and the *Consultation Paper on the Securities and Futures Bill* (April 2000) at the website of the Hong Kong Securities and Futures Commission under "Composite Bill" at http://www.hksfc.org.hk/eng/index.htm.

[43] Japanese Securities and Exchange Law, Sections 158, 159(1), (2), and 159(2).

[44] *See* the CFTC Survey, at p. 79. The Japanese system for the regulation of financial markets remains under review and new changes relating to the organization of regulation are due in the summer of 2000.

[45] *See* the CFTC Survey, at p. 7. *See also* Australian PS, note 25, *supra*.

[46] *The Declaration on Cooperation and Supervision of International Futures Markets and Clearing Organizations of 15 March 1996*, as amended in March 1998, available at http://www.cftc.gov/oia/bocadec0398.htm. *See further* the discussion of the *Boca Declaration* in Section D below.

In Japan, market surveillance and orderly markets can, however, be based on contractual agreements between the parties concerned.[47] Moreover, the law in Japan is evolving as part of an overall modernization of its financial system, and consolidation of certain regulatory functions in the Financial Supervisory Agency. Further reforms and consolidations are expected in July of this year.[48]

7. *Multiple Authorities*

In jurisdictions in which banking and securities authorities are different, securities authorities (or in some cases the securities markets) are often responsible for surveillance relating to the prevention of manipulation -- as manipulation is considered more directly related to the supervision of markets and the supervision of the provision of investment services to protect customers from abusive practices and not as directly related to the safety and soundness of banks. *In some jurisdictions, banking products may not be covered by anti-manipulation provisions.*

B. Availability of Over-the-Counter Information Relevant to Surveillance and Detection, Deterrence and Sanctioning of Manipulation or Other Abusive Practices

The accessibility of information regarding over-the-counter positions to regulators differs from jurisdiction to jurisdiction. In the UK, existing surveillance practices take account of over-the-counter positions. Exchanges may require routine reports of information on large positions, including over-the-counter positions, to oversee market practices.[49] A London Metals Exchange large position electronic reporting system for exchange-registered contracts has been in place since December 1997. Rules calling for reporting on an *ad hoc*, for cause basis of certain over-the-counter positions of members, their affiliates, and their beneficial owners in relation to exchange positions were implemented in September 1999. In the UK, the exchanges and the London Clearing House have contractual powers to call for information from their members on individual client positions. SFA routinely gathers information in respect of authorized firms' capital exposures on over-the-counter positions as part of its position risk rules. SFA also has powers to call from its members such information as it deems necessary in respect of over-the-counter exposures or positions. In Germany, long over-the-counter derivative positions routinely are reported to the Central Bank for credit risk purposes. In Japan, commodity authorities can review over-the-counter positions related to their markets. In Australia, exempt markets must report their exposures to applicable regulatory authorities.[50]

C. Future Developments at National Level

The United Kingdom is in the process of adopting new financial services legislation that would expand the authority of the FSA to take action against manipulative conduct and to sanction abusive market practices directly. It also is conducting a consultation on a Code of Market Conduct that would specify particular types of abusive market conduct. At least initially, this

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[47] *See* the London Survey, Section on Market Surveillance, Practices and Procedures, Response to Question ii.
[48] *See* the CFTC Survey, at pp. 26, 78-79.
[49] *See* the London Survey at p. 127, 131.
[50] *See* the London Survey at pp. 97-98, 123, and 125.

Code is proposed to apply only to regulated markets, but the FSA's Consultation Paper indicates that it could be expanded over time to other markets, including to over-the-counter transactions. The status and scope of the Brent Code and the nature of the requirements that should be applied to professional counterparties also are currently under review.[51] The Australian Treasury's CLERP 6 Paper on *Financial Markets and Investment Products* also proposes new regulatory approaches to financial innovation. In particular, it proposes movement to uniform regulation of financial instruments stating that, among other things, innovative financial services driven by technological developments blur the distinction between exchanges, over-the-counter markets and financial intermediaries.[52] Japan and Hong Kong also are contemplating changes.[53]

D. Cross-Border Implementation of Information Sharing Measures to Address Manipulation and Susceptibility of Markets to Manipulation

At international level, regulatory authorities have indicated that over-the-counter market information can be relevant to preventing manipulation and abusive practices in related markets and that the extent to which surveillance techniques to prevent manipulation in exchange markets can and should be expanded to over-the-counter markets is not a priority issue, but could be explored.[54] The twenty-four authorities with responsibility for the oversight of commodity derivatives transactions, that executed an amendment to the *Boca Declaration*[55] in March 1998 to make clear that information could be requested thereunder based on unusual price moves, have endorsed the view that information about over-the-counter exposures is appropriate to protect exchange markets from manipulation and other abusive practices. That Declaration evidenced the executing authorities' commitment to share information to address manipulative and other abusive practices to the extent that such information can be obtained and shared under relevant bilateral information sharing arrangements. Most existing bilateral MOUs specifically permit information exchanges relative to alleged manipulative activities where such activities are violations of futures or options laws in either jurisdiction.[56] The *Tokyo Communiqué*, a communiqué issued subsequent to the Tokyo Commodity Futures Markets Regulators' Conference in June 1997, also details the types of abusive practices that market authorities should seek to deter, detect and sanction and the circumstances under which, and the types of

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[51] FSA, Consultation Paper, *Financial Services and Markets Bill*, (July 1998). *See also*, FSA, Consultation Papers, *Market abuse Part 1: Consultation on a draft Code of Market Conduct; Market abuse Part 2: Draft Code of Market Conduct* (June 1998) note 23, *supra*; and the FSA's Wholesale Market Paper, note 23, *supra*. The FSA now plans to include the draft Code of Market Conduct in a Market Conduct and Infrastructure Sourcebook that will be part of the FSA's Handbook of Rules and Guidance. *See* note 20, *supra*.
[52] *See* note 19, *supra*.
[53] *See* note 102, *infra.*
[54] *See e.g.*, the IOSCO Technical Committee Report on the *Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts* (September 1998).
[55] Regulatory authorities from the following jurisdictions are signatories to the *Boca Declaration*, as amended: Argentina, Australia, Austria, Belgium, Brazil, Canada-Quebec and Ontario, Denmark, France, Germany, Hong Kong, Hungary, Ireland, Italy, Japan (MITI, MAFF), Malaysia, Netherlands, New Zealand, Portugal, Singapore, South Africa, Spain, Sweden, Taiwan, Turkey, UK (FSA), and US (CFTC). The *Boca Declaration* is available at http://www.cftc.gov/oia/bocadec0398.htm.
[56] For example, In Australia, exempt futures markets must declare that they will "provide assistance" to the ASIC, including information with respect to the particulars of transactions on the market and compliance with the conditions of the Exempt Market Declaration. Australian PS, note 25, *supra*, at paragraph 70.64.

information, that should be shared in such cases.[57] The *Tokyo Communiqué*, as expanded by work in IOSCO to financial as well as commodity derivatives markets, makes clear that over-the-counter information or exposures -- a market participant's complete position -- can be relevant to financial as well as physical exchange-traded markets and sets benchmarks for the type of surveillance techniques that can be effective in such markets.[58] The *Tokyo Communiqué*, which primarily relates to deliverable commodities of finite supply, endorsed guidances related to contract design, surveillance and information sharing relevant to rendering derivatives products not susceptible to manipulation. IOSCO's expanded work, explicitly notes that physical delivery commodity markets are more likely to be subject to manipulation than broader financial markets. The IOSCO Technical Committee deferred for the time being a further extension of the Tokyo *Communiqué* and related Guidances to over-the-counter markets while indicating that more work was necessary to account both for differences between exchange and over-the-counter markets and evolving convergence between such markets, especially where there is screen-based trading.

E. Future Work at International Level

Working Party 4 of the Technical Committee of IOSCO, the IOSCO Working Party which addresses issues relating to enforcement, has recently completed work comparing the approaches to manipulation in various member jurisdictions. The results of this work are scheduled to be considered and approved at the Annual Meeting of the IOSCO Technical Committee in May 2000.

Apart from whether manipulation prohibitions extend directly to over-the-counter transactions, where there is no impact on organized markets and where prices are opaque, the legal definition, the authority to implement the law, and the techniques for addressing manipulation differ substantially among jurisdictions.

The nature of products also may affect the extent to which particular products (that is, certain financial products and cash products) are covered by such provisions. For example, in some jurisdictions, bank products may not be covered. It is less likely for specific, structured provisions such as anti-wash trading rules to apply directly to over-the-counter transactions, although future work in some jurisdictions, particularly in the UK, may examine this issue. There are also practical problems with applying trade practice abuse rules to over-the-counter business directly to the extent prices are formed by bilateral negotiation. Further, in many

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[57] The following jurisdictions were participants in the *Tokyo Communiqué*: Australian Securities Commission, Australia; Commissao de Valores Mobiliarios, Brazil; Canadian Grain Commission, Canada; Bundesaufsichtsamt fur den Wertpapierhandel, Germany; Securities and Futures Commission, Hong Kong; Hungarian Banking and Capital Market Supervision, Hungary; Commissione Nazionale per le Società e la Borsa, Italy; Ministry of International Trade and Industry and Ministry of Agriculture, Forestry and Fisheries, Japan, Ministry of Finance and Economy, Korea; Malaysian Securities Commission, Malaysia; Securities Board of The Netherlands, The Netherlands; Singapore Trade Development Board, Singapore; Financial Services Board, South Africa; Financial Services Authority, United Kingdom; and the Commodity Futures Trading Commission, United States. To obtain a copy of the *Tokyo Communiqué*, *see* the "International Program" at http://www.cftc.gov/oia/Tokyorpt.pdf.

[58] *See* the IOSCO Technical Committee Report on the *Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts* (September 1998), available at http://www.iosco.org/iosco.html (Document No. 83).

jurisdictions, information on over-the-counter exposures may not be readily accessible to the relevant authorities or may only be available as necessary to monitor a related regulated market.

Nonetheless, there is a clear consensus that preventing manipulative activity, by enforcement and/or oversight, is essential to fair and efficient markets and that surveillance and enforcement powers should be sufficient to effectuate such provisions with respect to the activity to which they are relevant.

IV. Fraud and Customer Protection

A. Regulatory Standards for Authorized Firms

Internationally, customer protection generally is addressed by regulatory standards that are imposed on authorized financial intermediaries. Including the provisions on manipulation and fraud discussed above which relate to markets as well as entities, at the international level, the following types of provisions are considered minimum elements of a framework for financial services regulation:

- authorization of firms providing investment services as a business and carrying customer funds based on fitness determinations and financial capacity;
- disclosure of information material to investment decisions;
- protection of customer funds;
- supervision of intermediaries;
- dispute resolution mechanisms; and
- effective enforcement.[59]

National law also indicates broad national consensus that:

- *customers need protection from misleading, fraudulent and abusive practices;*
- *full disclosure is material to customers making informed investment or risk management decisions;*
- *only authorized persons should be permitted to hold themselves out as conducting investment business;*
- *client assets should be protected from defalcation or intermediary insolvency; and*

[59] *See e.g.*, IOSCO Core Principles, paragraph 4.2.1.

- *intermediaries should act honestly and fairly, with due skill and diligence in the best interests of customers and the integrity of the markets.*[60]

Over-the-counter transactions, however, may not be covered by national customer protection or conduct of business requirements because:

- *Such business generally is undertaken on a principal-to-principal basis and therefore counterparties dealing for their own account that are not acting as brokers or market makers may not be subject to authorization and corresponding conduct of business requirements vis-a-vis their counterparties.*

- *Certain customer protections may not be extended to so-called sophisticated counterparties (including end-users) under relevant national law even when they are transacting opposite an authorized counterparty.*

- *Market protections (such as, transparency requirements) are ordinarily not extended to individually-negotiated over-the-counter derivatives transactions.*

- *There are national differences as to whether and what financial activity in over-the-counter derivatives is covered by existing conduct of business rules. This is true notwithstanding harmonization efforts.*

B. Individual Jurisdictions

The following summaries of applicable national law relating to the principal elements of a conduct of business regime illustrate these points.

Authorization only applies to defined business activities. Generally, conduct of business and other requirements are imposed only on authorized firms.[61]

1. Overview

In general, counterparties acting for their own account over-the-counter and not holding themselves out as market makers or brokers are not subject to authorization requirements.[62] *All*

[60] *See e.g.,* the conduct of business rules in the UK's SFA Rules; *compare* the conduct of business rules in the London Code regarding the wholesale market regime under the Grey Paper; *see also* the CFTC Survey; the Hong Kong Code of Conduct for Persons Registered with the Securities and Futures Commission (March 1996), which contains general principles, similar to those in the ISD, which relate, among other things, to knowing your customer, client agreements, discretionary accounts, client priority, treatment of clients' assets, soft dollars, handling of complaints and generic risk disclosure; French FAMA, *supra,* note 35, Title III, Ch. 1, Sec. 3, Article 58, which lists ISD-type general principles; the Italian Consob's Regulation 11522 Implementing Legislative Decree 58 of 24 February 1998 concerning the Rules Governing Intermediaries, Articles 26-31 *et seq.* ("Consob Reg. 11522"); and the Guideline of the German Federal Securities Supervisory Office, in accordance with Section 35 (2) of the German Securities Trading Act (*Gesetz über den Wertpapierhandel, WpHG*) on the details concerning the rules of conduct according to Sections 31 and 32 of the WpHG relating to the commissions, fixed price and agency business, available at http://www.bawe.de. *See also*, the Regulatory Summary, at Section II. B.

[61] *But see* the conduct of business rules in the UK's SFA Rules; *compare* the conduct of business rules in the London Code regarding the wholesale market or Grey Paper regime.

jurisdictions require the authorization of firms engaging in a securities or futures business on a professional basis. What constitutes a securities or futures business is a matter of definition.

In the EU, transferable securities and over-the-counter financial derivatives are each treated as regulated investments. In some jurisdictions, however, there is ambiguity as to the treatment of over-the-counter derivatives products because of applicable definitions. Those that are not traditionally defined as securities may not be directly regulated and, therefore, can be traded outside an authorized securities firm or credit institution. In some jurisdictions, credit institutions that act as dealers, while subject to prudential requirements, are not subject to conduct of business rules that are applicable to securities dealers. Institutions dealing in bullion, spot and forward forex, or commodities are not considered to be doing an investment business in the EU and such products may not be considered securities or investment contracts attracting authorization requirements in other jurisdictions.[63] What constitutes dealing as opposed to proprietary activity also may differ among jurisdictions.

Therefore, whether or not authorization is required in a given case would vary between jurisdictions. Authorization ordinarily includes a fitness determination as to the firm and its principals and a determination that the firm can meet applicable capital requirements among other things. Authorization carries with it the responsibility to meet ongoing prudential requirements of the authorizing jurisdiction (national and sectoral) and conduct of business requirements dependent upon with whom and where the authorized firm does business (that is, certain sophisticated or wholesale customers or offshore customers may not be covered).[64] In Australia, Hong Kong and Canada, product and service definitions remain an issue in determining what authorization is required.

2. European Union

The EU system is intended to apply consistent prudential and conduct of business requirements to all firms providing investment services cross-border within the EU's internal market.[65] In the EU, dealing or engaging in agency transactions in over-the-counter financial derivatives, such as contracts for differences, constitutes covered investment business.[66] Although over-the-counter derivative products are not directly regulated, as such, by individual jurisdictions in the EU and a principal (*i.e.*, an "end-user") engaging as a counterparty in an over-the-counter transaction is not necessarily, as the result solely of that activity, subject to authorization or conduct of business requirements under the framework of the ISD, EU firms doing business solely in over-the-

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[62] *See* the CFTC Survey, Overview at p. xx.
[63] The London Code, at Box, note 5, stating that "ordinary forward foreign exchange (and bullion) transactions fall outside the FSAct…." *See also*, ISD, *supra*, note 32, Annex, Section B. Italy considers commodity derivatives "investment" business, as does the UK. *See e.g.,* FSAct, at Schedule 1, Sections 8 and 9.
[64] *See e.g.*, ISD, Article 8, *supra*, note 32.
[65] The ISD focuses on the requirements applicable to firms doing passported business across borders pursuant to the single authorization or license issued to the firm by its "Home Country," that is, the country in which the firm is domiciled or established. Individual Member States, in general, may apply lesser or greater requirements to firms operating solely within their national boundaries.
[66] In Belgium, for example, dealing for own account falls within the scope of the law requiring authorization where such dealing is carried out in a manner that is a service to participants in the financial markets, *i.e.*, market making or regularly offering to stand as a counterparty.

counter derivative transactions must be authorized and must meet the other requirements of the ISD and other applicable directives to be permitted the European passport to conduct business outside their home countries in the EU's internal market. In this connection, the home state jurisdiction must notify proposed host countries of any limitations on the business its authorized firms may do in the host country. A firm could be precluded from undertaking over-the-counter derivative transactions, for example, if the home authority did not believe that it was organized in a manner to manage the risks of such activity.[67]

The Investment Services Directive sets out broad general principles[68] that apply to firms doing investment business.[69] These principles address each of the matters considered by national authorities and international organizations to be essential elements of customer protection. The ISD framework contemplates that Member States will have rules of conduct and prudential rules which address these broad principles that are observed at all times. Investment firms must be authorized and supervised prudentially, including supervision of the handling and safeguarding

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[67] ISD, Articles 3(1), 3(4), 14(1), and 17(3), *supra*, note 32.

[68] ISD, Article 4 sets down the general conditions for taking up business: Without prejudice to national law (1) enough capital to meet the requirements of the Capital Adequacy Directive, *infra*, note 74, and (2) fitness of the persons who effectively direct the business (i.e., persons of good repute and sufficiently experienced). Article 11 sets out general conduct of business principles, requiring that an investment firm: act honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market; act with due skill, care and diligence, in the best interests of its clients and the integrity of the markets; have and employ effectively the resources and procedures that are necessary for the proper performance of its business activities; seek from its clients information regarding their financial situations, investment experience and objectives as regards the services requested; make adequate disclosure of relevant material information in its dealings with its clients; try to avoid conflicts of interests and, when they cannot be avoided, ensure that its clients are fairly treated, and comply with all regulatory requirements applicable to the conduct of it business activities so as to promote the best interests of its clients and the integrity of the market. ISD, *supra*, note 32, at p. 37.

ISD, Article 10 sets out general prudential rules and requires Home Member States to require that each investment firm: have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms including, in particular, rules for personal transactions by its employees; make adequate arrangements for instruments belonging to investors with a view to safeguarding the latter's ownership rights …; make adequate arrangements for funds belonging to investors with a view to safeguarding the latter's rights and, except in the case of credit institutions, preventing the investment firm's using investors' funds for its own account; arrange for records to be kept of transactions executed which shall at least be sufficient to enable the home Member State's authorities to monitor compliance with the prudential rules which they are responsible for applying; such records shall be retained for periods to be laid down by the competent authorities; be structured in such way as to minimize the risk of clients' interests being prejudiced by conflicts of interest between the firm and its clients or between one of its clients and another. ISD, *supra*, note 32, at p. 36.

[69] A core investment service, as set forth in Section A of the Annex to the ISD is: (i) reception and transmission of orders in relation to one or more "financial instruments" (as defined below), and bringing two or more investors into contact to carry out a transaction in relation to a financial instrument; (ii) execution of such orders other than for an investment firm's "own account"; (iii) dealing in any financial instrument for an investment firm's "own account," including market making and principal dealing: (iv) managing portfolios of investments in financial instruments on a discriminatory (discretionary), client-by-client basis; and (v) underwriting in respect of issues of any financial instruments and/or the placing of such issues. "Financial instruments" are generally defined as: (i) transferable securities, *e.g.*, shares in companies and other equivalent securities, bonds and other forms of securitized debt, which are negotiable on the capital market, and any other securities normally dealt in giving the right to acquire any such financial instruments giving rise to a cash settlement, excluding instruments of payment; (ii) units in collective undertakings; (iii) money-market instruments; (iv) financial futures contracts; (v) forward interest-rate agreements; (vi) interest-rate, currency and equity swaps; and (vii) options to acquire or dispose of any of the above.

of customer assets and recording of transactions by their home states, and are subject to conduct of business rules applied in each host state.

The ISD applies these broad prudential and conduct of business principles to *all* intermediaries established in the European Union that provide core investment services; that is, in general, the ISD applies equally to investment firms and credit institutions that seek to take advantage of the European passport to provide investment services.[70] Similarly, the provisions related to transparency (of regulated markets) apply across the board to investment firms and credit institutions.[71] Like European Directives generally, the ISD provisions set out a framework within which national legislation is implemented. As of today, most EU jurisdictions have implemented the ISD in full. However, some technical difficulties or deficiencies may still exist in some EU Member States.[72]

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[70] ISD, Article 2(1), *supra*, note 32. Credit institutions were initially accorded the single passport for their activities under the Second Banking Directive, 89/646/EEC, Official Journal L386/1 (15 December 1989), as amended by Directive 92/30, Official Journal L 110/52 (28 April 1992). The ISD complements the Second Banking Directive and extends the single passport regime to investment firms. As a consequence of the directives regarding credit institutions and investment firms, the regulation of credit institutions and investment firms largely has been harmonized across the EU with respect to authorization, capital requirements, the monitoring of credit risk, and the calculation of "own funds," among other things. Such harmonization is directed to creating a single internal market for financial services within the EU and to creating equal conditions of competition, both cross-border and cross-sectoral, within the EU internal market. *See* the Second Banking Directive; the "Own Funds" Directive 89/299/EEC, Official Journal L 124/16 (5 May 1989) on the own funds of credit institutions, as amended by Directive 91/633, Official Journal L 339/33 (11 December 1991) and Directive 92/16, Official Journal L 75/48 (21 March 1992) and the "Consolidated Supervision" Directive 92/30, Official Journal L 110/52 (8 April 1992); the "Solvency" Directive 89/647/EEC on the solvency ratio for credit institutions, Official Journal L386/14 (30 December 1989), as amended by the "Consolidated Supervision" Directive and Directive 95/15, Official Journal L125/23 (8 June 1995); the "Netting" Directive 96/10, Official Journal L 85/17 (3 April 1996); Directive 98/32, Official Journal L 204/26 (21 July 1998) and Directive 98/33, Official Journal L 204/29 (21 July 1998); the ISD, as amended, *supra*, note 32; and the Capital Adequacy Directive, as amended, *infra*, note 74. For a complete list of directives relating to financial services in the EU, *see* the directives listed under "banks" and "stock exchange and other securities markets" at http://europa.eu.int/eur-lex/en/lif/ind/en_analytical_index_06.html.

Moreover, the EU's efforts to create a single internal market in financial services are ongoing. The European Commission is in the process of preparing a Green Paper regarding a revision of the ISD, and among the issues being considered is a harmonization of conduct of business rules and a refinement of the rules regarding the categorization of professional versus retail customers for purposes of the application of conduct of business rules. The allocation of responsibilities between the Home Member State and the Host Member State regarding the oversight of compliance with conduct of business rules is also under discussion. *See* the EU *Action Plan for Financial Services* and the five Issues Papers for the first meeting of Forum Groups on *Market Manipulation; Retail Financial Services: Overcoming Remaining Barriers; On the ISD Green Paper; Communication Codifying Clear and Comprehensible Information for Purchasers,* and *On the Cross-Border Use of Collateral* at http://europa.eu.int/comm/dg15/en/finances/actionplan/index.htm.

[71] "Whereas, with the two-fold aim of protecting investors and ensuring the smooth operation of the markets in transferable securities, it is necessary to ensure that transparency of transactions is achieved and that the rules laid down for that purpose in this Directive for regulated markets apply both to investment firms and to credit institutions when they operate on the market;" ISD, Preamble, *supra*, note 32, at p. 30.

[72] The European Commission had previously officially cited Greece, Spain, Portugal and Luxembourg for non-transposition of the ISD and Germany for incomplete transposition. *See* Official Journal C250/29 (August 8, 1998). However, in some instances, deficiencies or failures identified by the EU Commission may have been rectified or resolved. The current status of implementation is indicated at http://europa.eu.int/scadplus/leg/en/mne/m93_6.htm.

At the moment, the conduct of business rules and authorization requirements though flowing from a single framework are not harmonized although discussions are ongoing in the Forum of European Securities Commissions[73] about areas of financial regulation that could be harmonized further. Authorized firms, however, must meet capital adequacy requirements that have been harmonized across the EEA and between investment firms and credit institutions by the Capital Adequacy Directive.[74]

C. Specific Aspects of Customer Protection; Disclosure, including Financial Disclosure, Transparency, and Recordkeeping

The approach of many national jurisdictions to the regulation of over-the-counter derivatives and, to some extent, the international approach, has been by driven by banking supervisors (in cooperation with securities authorities) because in many countries as much as ninety percent (90%) of the over-the-counter derivatives activity is conducted through transactions in which at least one counterparty is a bank.[75] Not all banking supervisors directly relate conduct of business (or sales practices) where sales are made through the bank itself.

1. Risk Disclosure

Most jurisdictions require risk disclosure to non-sophisticated customers.[76] Indeed, in some jurisdictions, the enforceability of particular over-the-counter contracts depends on the adequacy of disclosure relative to the nature of the counterparty.[77]

2. Disclosure can be Product Specific

In general, conduct of business rules do not differ by type of financial product, however, risk and other disclosures, where required, must reflect the nature of the product. Although the general code of conduct for investment business applicable to all authorized firms may not explicitly mention over-the-counter derivatives, the code of conduct is generally applicable. For example, in Spain, the code of conduct states that: "The information provided to clients must be correct, accurate, sufficient and timely in order to avoid incorrect interpretations. Particular emphasis must be placed on the risks involved in each transaction, particularly in high-risk financial products, so that the client knows precisely the effects of the transaction being arranged."[78] In the UK, Italy, Belgium, and Ireland, generic risk disclosures particularly address the risks of

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[73] FESCO is comprised of the Securities Commissions of the 15 European Union Member States and of Norway and Iceland (the non-EU members of the European Economic Area, other than Liechtenstein). For ongoing harmonization projects, *see* the FESCO website at http://www.europefesco.org/. *See also* note 70, *supra*.

[74] Directive 93/6/EEC, Official Journal L141/1 (15 March 1993), as amended by Directive 98/31, Official Journal L 204/13 (21 July 1998) and Directive 98/33, Official Journal L 204/29 (21 July 1998).

[75] *See e.g.*, the BCBS and IOSCO Technical Committee *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms* (October 1999) (reflecting the results of a survey of the derivatives activities of internationally active banks and securities firms during 1998), at Table 1, indicating that, in all G-10 countries but the United States, the largest financial institutions conducting such derivatives activities are banks. *See also* the French FAMA, note 35, *supra*

[76] *See* Discussion at pp. 45 *et seq.*, *infra* below, regarding differential treatment of sophisticated investors or customers.

[77] *See e.g.*, Germany; the CFTC Survey, at pp. 51-52

[78] Quoted in the CFTC Survey, at p. 22.

highly leveraged (geared) derivatives products and the potential that over-the-counter products could involve additional risks to those posed by other financial instruments. Italian regulations state "Authorized intermediaries may not carry out transactions or supply management services until they have provided investors with adequate information on the nature, risks, and implications of the transaction or service in question for the purpose of making informed investment or disinvestment decisions. Authorized intermediaries also must not carry out transactions that are not appropriate for investors in terms of type, object, frequency or size."[79]

With respect to certain specific disclosures that are relevant because of the lack of transparency for over-the-counter transactions, in the UK, valuation methodology must be disclosed to private (*i.e.*, non-sophisticated) clients and in Japan, such disclosure is recommended. Japan also recommends disclosure with respect to the underlying equity security for securities-related derivatives. In Germany and Hong Kong, valuation methodologies, although not required to be disclosed, must be accessible to the regulatory authority, and in other jurisdictions, such information would be accessible to the regulators, if not specifically required to be reported. In Hong Kong, authorized financial institutions, as well as securities and futures dealers, must disclose risks if they are acting in an advisory as opposed to a proprietary capacity. In the UK, counterparties must disclose whether they are acting as agents or principals.

3. Disclosure or Use Limitations Can Be Customer Specific

Notwithstanding the amount of disclosure, suitability requirements (*see e.g.*, UK and Italy discussed above) and other requirements may restrict the types of clients who are eligible to transact in over-the-counter derivatives. For example, some end-users, such as collective investment schemes, in addition to providing special disclosure about derivative risks and valuations to their participants, are also limited in their use of derivatives. For example, use of derivatives by Undertakings for Collective Investments ("UCITs") that are sold to the public cross-border pursuant to the European passport are limited to "efficient portfolio management" and "to provide protection against exchange risk in the context of the management of their assets and liabilities."[80] Use of over-the-counter derivatives by collective investment schemes authorized nationally also may be restricted and additional disclosures and controls on this business may be required.[81] Some nationally authorized schemes, which may not use the EU passport, may involve more leverage than passportable constructions. In addition, certain jurisdictions permit offshore, unregulated funds to be sold to sophisticated investors without specified protections.[82]

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[79] Consob Reg. 11522, *supra*, at Articles 27 and 28.

[80] Article 21, UCITS Directive 85/611, Official Journal L375/3 (31 December 1985), as amended by Directive 88/220/EEC, Official Journal L 100/31 (19 April 1988). Certain proposals to amend the UCITS Directive are pending before the EU Council of Ministers (i) to extend the scope of Directive 85/611/EEC to include collective investment undertakings investing in financial assets other than transferable securities, such as money market instruments, bank deposits, standardised financial futures and options, and units of other collective investment undertakings and (ii) to update the regulation of management companies and the information documents given to investors. For a further description of such proposals, see http://europa.eu.int/scadplus/leg/en/lvb/l24036a.htm

[81] *E.g.*, Belgium and Spain; *see* the CFTC Survey, at pp. 19-20, 22-23.

[82] *See* the CFTC Survey, at pp. 17-18 regarding the UK. In the UK, local portfolio managers would, however, be required to be authorized.

Separately, corporate or public charters or the law applicable to particular types of companies (insurance and mortgage banks, pension funds, trusts) may limit the use of over-the-counter derivatives altogether.[83]

4. Financial Disclosure and Reporting

In general, financial disclosure and reporting requirements are applied to authorized institutions. Currently, financial disclosure and reporting are required by all national jurisdictions, but the specificity of treatment of various instruments differs and some counterparties to over-the counter transactions are not authorized financial institutions. Certain recommendations for international disclosure and/or reporting are primarily based on voluntary compliance. Accounting standards, which usually are set by private standard setters, do address specific instruments.

a) National Financial Disclosure Requirements

A number of jurisdictions require reporting of derivatives risks on periodic reports to regulators or supervisory authorities (UK, Italy, Germany, Belgium, Sweden) which reports include over-the-counter derivatives as well as other derivative positions. Canada indicates that its required reports for financial institutions are comparable to those received by the US regulatory authorities.[84] Switzerland and Japan recently enhanced derivatives disclosure. For example, as of the period ending March 1998, disclosure of market value information for over-the-counter instruments is required in Japan. Switzerland now requires over-the-counter and other derivatives to be separately stated in financial statements and all trading positions, including over-the-counter derivatives positions, to be marked to market daily.[85] The Institute of German Auditors, which is a private institution, has issued opinions as to the accounting and auditing for certain derivatives transactions. French guidance on market risk disclosure requires banks and investment firms supervised by the French *Commission Bancaire* to disclose information on accounting principles and rules, profitability of banking activities, counterparty risk in derivatives activities and off-balance sheet items (especially derivatives).[86] The UK requires UK entities to provide a comprehensive range of information about the risks arising from their financial instruments and their attitude and response to those risks. This information includes interest rate risk, currency risk, liquidity and maturity disclosures, information on fair values and the effects of hedge accounting. The UK report requires separate statements of over-the-counter and other derivatives positions.[87] Australian accounting standards, although not legislatively adopted, also provide special guidance on derivatives.[88] The standard encourages disclosure of

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[83] *See* the CFTC Survey, at pp. 19-24.
[84] *See* the CFTC Survey, at p. 67.
[85] *See* the CFTC Survey, at p. 50.
[86] France: 1998 National Accounting Council, Advice n. 98.05 and Recommendation n. 98.R.01
[87] UK Accounting Standards Board, Financial Reporting Standard 13 "Derivatives and Other Financial Instruments: Disclosure." *See also* the compendium of national initiatives included in the joint report of Basel and IOSCO public disclosures by banks and securities firms in 1997 entitled *Trading and Derivatives Disclosures of Banks and Securities Firms* (November 1998).
[88] *See* the CFTC Survey; AASB 1033 "Presentation and disclosure of financial instruments;" *see also* Financial Accounting Standards Board, Statement 133 on *Derivative Instruments and Hedging Activities* (16 June 1998)

information about the nature and extent of the entity's use of financial instruments, the business purposes that they serve, the risks associated with them, and management's policies for controlling those risks.

b) International Initiatives - Guidance on Financial Disclosures and the Annual Survey of Public Disclosure by Internationally Active Dealers

There is significant international agreement on the basic elements of financial disclosure and suggested reporting for financial institutions. Joint projects to identify these basic elements represented some of the first cooperative efforts between banks and securities authorities in establishing international standards in the regulation of financial services.

(1) Recommended Framework

In 1995, BCBS and IOSCO published a *Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* ("Framework") which contains recommendations for quantitative and qualitative financial disclosures. The paper has been described as a catalogue of data on derivatives activities organized into data on credit risk, liquidity risk, market risk, and earnings. The paper reflected a consensus among banking and securities authorities on desirable financial reporting to the public and to supervisors and regulators. It encouraged supervisors and regulators to draw from the Framework in expanding and improving their reporting systems. The Framework was intended to promote development of more consistent approaches to evaluating derivatives risks among regulators. It drew on the types of information that institutions then produced internally. One part listed a minimum subset of data that regulators should have available for large internationally active derivatives dealers. The Framework recommended that (i) institutions should disclose quantitative information produced by internal risk measurement and management systems, on their risk exposures and their actual performance in managing these exposures and (ii) institutions should provide financial statement users with a clear picture of their trading activities and their overall involvement in the derivatives markets, as well as the impact of these activities on earnings.[89] Since 1995, a joint annual survey of the disclosures made by internationally active banks and securities firms has been published by the BCBS and the IOSCO Technical Committee based on the Framework.[90]

("FASB 133"); and International Accounting Standard No. 39, on *Financial Instruments – Recognition and Measurement*, International Accounting Standards Committee (5 March 1999) ("IAS 39").

[89] The Framework recommended collecting information on notional amounts and values of derivatives by contract type and maturity, cash flows, net and gross replacement costs and collateral values, and revenues, and specified for what purposes such information could be used by regulatory or supervisory authorities. *Compare* the G-22 Report on Transparency (October 1998) which states that to be useful, meaningful and understandable, private sector disclosures should address five broad elements: timeliness, completeness, consistency, risk management, and the audit and control processes.

[90] *Public disclosure of the trading and derivatives activities of banks and securities firms* (November 1995); *Survey of disclosures about trading and derivatives activities of banks and securities firms* (November 1996); *Survey of disclosures about trading and derivatives activities of banks and securities firms 1996* (November 1997); *Survey of disclosures about trading and derivatives activities of banks and securities firms 1997* (November 1998), and *Trading and Derivatives Disclosures of Banks and Securities Firms* (December 1999).

(2) Recent Enhancements to the Recommended International Framework

In a report entitled *Enhancing Bank Transparency*, issued by the BCBS in September 1998, the BCBS recommended that banks, in their financial reports and other disclosure to the public, provide timely information which facilitates market participants' assessments of such banks' financial condition listing the following six categories of needed information: financial performance, financial position (including capital, solvency and liquidity), risk management strategies and practices, risk exposure (including credit risk, market risk, liquidity risk and operational, legal and other risks), accounting policies, and basic business, management and corporate governance information. Such disclosure is intended to facilitate accountability of market participants and to promote market discipline by facilitating the capacity of market participants to know their counterparty.

Additional work recently has been completed on enhancing the basic reporting framework, especially with respect to market risk and risk management. The BCBS and the Technical Committee of IOSCO, in their joint report on *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms* (October 1999) recommended certain enhancements, such as, that the reporting institution disclose whether use of derivatives is primarily for trading or non-trading purposes and whether the institution is primarily involved in exchange-traded or over-the-counter derivatives. The reporting institution is encouraged to provide separate disclosures for each. Information also is requested on whether the institution is a dealer, engages in proprietary trading or acts as a counterparty to customers and whether there is material activity in innovative, exotic or leveraged instruments. Inclusion of an analysis which links the institution's risk management control procedures to the institution's activities is also encouraged. The results of stress test and risk management performance have also been added to the list of recommended items to be disclosed.

The most recent BCBS/IOSCO joint annual survey issued in December 1999 identifies certain improvements in the amount or quality of disclosures by internationally active banks and securities firms, in particular enhanced discussions of operating and legal risks, increases in disclosures of market values, more information about counterparty credit quality and concentrations, and an expansion of disclosures of market risk information. As stated in the cover note for the 1999 annual survey, the participating organizations recognize that improved transparency of institutions financial condition, performance, business activities, risk profile and risk management practices, facilitates effective market discipline and sound and efficient functioning of financial markets. Thus, it is said, transparency can reinforce supervisory efforts to promote safety and soundness in individual institutions and financial systems as a whole. The report, however, continues to note significant disparities both within and across countries as to the types and usefulness of the information disclosed.[91]

New elements of disclosure also recently have been recommended with respect to credit risks. These include gross current exposure -- positive mark-to-market -- potential change in credit exposure from changes in market value -- average credit exposure or range over the reporting period and by maturity band. New disclosures were recommended to capture liquidity risk both

[91] *See* the joint report by the BCBS and the IOSCO Technical Committee on *Trading and Derivatives Disclosures of Banks and Securities Firms* (December 1999). *See also* the CFTC Survey, Overview at p. xxix.

in terms of market risks and funding risks.[92] To this end, maturity schedules would be provided to highlight maturity mismatches.[93]

Since the near failure of Long-Term Capital Management, a number of additional reports work have been published that address transparency, particularly with respect to hedge funds and other highly leveraged institutions, including several reports by the BCBS and IOSCO.[94] Further work on transparency is on-going in the Multidisciplinary Working Group on Enhanced Disclosure, an *ad hoc* group organized by the Committee on the Global Financial System of the Bank for International Settlements, and in the HLI Working Group of the Financial Stability Forum.[95]

5. Transparency

Although certain over-the-counter markets may be regarded as organized, bilateral transactions in over-the-counter derivatives generally are not considered to be accomplished on regulated markets and, therefore, are not subject to specific transparency requirements. To the extent that there are "exempt market" treatments for over-the-counter transactions, these treatments parallel regulation of financial intermediaries rather than of markets. Nevertheless, there are issues regarding the desired level of transparency of all financial exposures to counterparties and there is international agreement that issues exist relating to the adequacy of price transparency to the general public and of risk exposures of authorized financial institutions to financial regulators.[96]

The ISD sets out certain minimum requirements for transparency of *regulated markets* within the EU. As such, it sets standards for jurisdictions that previously did not require transparent markets and it also sets the framework within which jurisdictions, such as France and The

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[92] Liquidity risk is the risk that a party to a securities instrument may not be able to sell or transfer that instrument quickly and at a reasonable price, and as a result, incur a loss. Liquidity risk includes the risk that a firm will not be able to unwind or hedge a position. *See* the report on *Risk Management and Control Guidance for Securities Firms and Their Supervisors*, IOSCO (May 1998), at p. 5. Market risk is the risk inherent in any investment that the investment will not be as profitable as the investor expected because of fluctuations in the market. Market risk involves the risk that prices or rates will adversely change due to economic forces. Such risks include adverse effects of movements in equity and interest rate markets, currency exchange rates, and commodity prices. Market risk can also include the risks associated with the cost of borrowing securities, dividend risk, and correlation risk. Funding Liquidity Risk is the risk that the entity has insufficient cash flows to meet its obligations (payments, delivery of collateral, *etc.*) when due. *See* the report of the Counterparty Risk Management Policy Group on *Improving Counterparty Risk Management Practices* (June 1999). *See also* the report of the IOSCO Technical Committee on *Hedge Funds and Other Highly Leveraged Institutions* (November 1999), at Annex C.

[93] BCBS Report on *Best Practices for Credit Risk Disclosure* (July 1999).

[94] *E.g., Banks' Interactions with Highly Leveraged Institutions* (January 1999); *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999); and *Banks' Interactions with Highly Leveraged Institutions: Implementation of the BCBS's Sound Practices Paper* (January 2000). *See also*, the report of the IOSCO Technical Committee on *Hedge Funds and Other Highly Leveraged Institutions* (November 1999). *See also* the joint report by the BCBS and the IOSCO Technical Committee on *Supervisory Information Framework for Derivatives and Trading Activities* (September 1998).

[95] See the FSF *Report of the Working Group on Highly Leveraged Institutions* at http://www.fsforum.org/Reports/RepHLI.html. *See also* the President's Working Group on Financial Markets report on *Hedge Funds, Leverage, and the Lessons of Long Term Capital Management* (April 1999) and the CFTC's Proposed Rule on *Public Reporting by Operators of Certain Large Commodity Pools*, 65 FR 20395-20403 (April 17, 2000).

[96] ISD, Article (13) *supra*, note 32. *But see*, note 99, *infra*, regarding off exchange price reporting in Germany. *See also* the discussion at p. 50, *et seq.* regarding Australian "exempt markets."

Netherlands which had pre-existing requirements, must now operate. There are no price reporting requirements for over-the-counter counterparty transactions in the EU under the ISD, but there are transaction reporting requirements for over-the-counter transactions related to regulated markets. In the EU, regulated market transparency requirements permit delayed reporting of prices and reporting of aggregate prices.[97] As a practical matter, however, prices may be reported by vendors on a real time basis, and there are price reporting services that even include swaps quotes.[98] In the EU, off-market trading of securities and derivatives that are listed or traded in an organized or regulated market in general must be reported. Italy and Germany, for example, have certain transparency requirements for organized markets that are not regulated markets under the ISD.[99]

In addition to price and exchange-related over-the-counter transaction reporting, certain national jurisdictions require credit or position risk reporting that includes over-the-counter as well as regulated market positions.[100] The Large Exposures Directive also requires reporting of non-collateralized single and aggregate over-the-counter and credit exposures above a specified size and imposes limits on large exposures to a single client or group of clients.[101]

In comparison, for example, Australia does not require price reporting for exempt futures markets or other over-the-counter transactions, but it does require access to information on exempt market exposures and an audit trail.[102] Ontario would not require price reporting under

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[97] ISD, Article 21, *supra*, note 32: With respect to regulated markets, each competent authority must provide at least the weighted average price, the highest and lowest price and the volume dealt in for the prior day's trading. Note that ISD Article 1(13) defining "regulated markets" cross-references the transparency requirements of Articles 20 and 21. For continuous order-driven or quote-driven markets, publication is required: at the end of each hour's trading on the market, of the weighted average price and the volume dealt in on the regulated market in question for a six-hour trading period ending so as to leave two hours' trading on the market before publication; and every 20 minutes, of the weighted average price and the highest and lowest prices on the regulated market in question for a two-hour trading period ending so as to leave one hour's trading on the market before publication. Publication may be suspended or delayed where justified: by exceptional market conditions; in small markets to preserve anonymity of transactions; and for large transactions or highly illiquid transactions in accordance with criteria published in advance. *Compare* the CFTC's rule regarding trading volume, open contracts, prices and critical dates at 17 CFR § 16.01; the swaps markets use LIBOR, *etc*. [mature broadly accessible price increases].

[98] *E.g.*, in Italy, Associazione Tesorieri Istituzioni Creditizie (ATIC) provides quotes for overnight interest rate swaps; in Australia, quotes are available for plain vanilla swaps. *See* the CFTC Survey at p. 35-37. *See also*, the requirements in the U.K.'s London Code regarding the wholesale markets at Section IV "Dealing Principles," providing that "all firms, whether acting as principal, agent or broker, have a duty to make absolutely clear whether the prices they are quoting are firm or merely indicative. Prices quoted by brokers should be taken to be firm in marketable amounts unless otherwise qualified." Preamble to paragraph 73, *London Code;* paragraphs 73-77, and especially paragraph 77 regarding swaps.

[99] CONSOB Communication No. 9809774, 24 December 1998, states: "An organized market is considered to be any system of rules and structures, even automatic, that allows continually or periodically (a) the gathering and distributing of bids and asks, (b) the executing of such proposals pursuant to the terms and conditions provided by the system." Rules of functioning, particularly with respect to pricing, must be submitted to CONSOB. *See also* the German Securities Trading Act § 9 (1) and the German Ordinance on the Reporting Requirements Relating to Trades in Securities and Derivatives § 5 (both relating to the trading of securities and derivatives listed on an organized or regulated market in Germany, whether the trade is consummated on or off exchange). *See also* the London Code, paragraphs 66-68 regarding transaction reporting requirements in relation to UK wholesale market transactions.

[100] *E.g.*, UK and Germany. *See* the discussion on p. 29, note 50, *supra*, and p. 69, *infra*.

[101] Directive 92/121, Official Journal L 29/1 (5 February 1993).

[102] CFTC Survey, Overview at p. xxvii, and p.64.

its new proposal for the regulation of over-the-counter transactions, although it is separately looking at alternative trading systems.[103] The London Code, wholesale market regime, requires wholesale market counterparties to specify whether prices are indications or firm quotes.[104]

6. Recordkeeping

In the EU, authorized investment firms must keep at the disposal of authorities for 5 years data on investment transactions covered by the ISD in instruments dealt in on a regulated market whether carried out in the regulated market or not (this includes over-the-counter transactions in financials).[105] Member States may, in a non-discriminatory way, adopt more stringent rules.[106]

Recordkeeping requirements can be general or more specific. For example, the UK rule states that "A firm must take reasonable steps, including establishment and maintenance of procedures to ensure sufficient information is recorded and retained about its regulated business and compliance with the regulatory system." Transaction records to be maintained are specified in an Appendix.[107]

Most jurisdictions have recordkeeping requirements for authorized firms that are not particularized to over-the-counter products. Some of these specific requirements (e.g., confirmations, periodic reports) are disapplied to transactions with sophisticated customers.[108] *However, over-the-counter transactions generally are documented using master agreements recommended as a matter of industry practice.*[109] *In some jurisdictions, use of such agreements meeting specified requirements is necessary under national legislation to achieve certain types of netting for capital and insolvency relief.*[110]

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[103] *See* the Ontario *Alternative Trading System Proposal*, July 2, 1999, available at http://www.osc.gov.on.ca/en/ Regulation/Rulemaking/Rules/rules.html.

[104] *See* note 98, *supra*. Several jurisdictions are revisiting questions of market structure in connection with growth of alternative trading systems and the use of electronic technology. *See e.g.*, the Australian CLERP 6, *supra*, note 19, and the CLERP 6 Consultation, *supra*, note 19; the FSA Infrastructure Paper, *supra*, note 19; Hong Kong's Steering Committee on the Enhancement of the Financial Infrastructure, *Report on the Enhancement of the Financial Infrastructure in Hong Kong "an eFrastructure for a Leading eEconomy"* (September 1999) at http://www.hksfc.org.hk/eng/index.htm; and the Consultation Paper of the Malaysian Securities Commission on the *Framework for the Implementation of Electronic Commerce in the Capital Market* (March 2000), at http://www.sc.com.my/html/publications/discussion/E-Commerce.PDF.

[105] ISD, Article 20, *supra*, note 32.

[106] ISD, Article 21 (3), *supra*, note 32.

[107] SFA Rule 5-54 and Appendix 25. *See also*, SFA Rule Book -- Chapter 10. Recordkeeping requirements will be set out in the Conduct of Business Sourcebook to be included in the FSA Handbook of Rules and Guidance upon adoption of the FSM Bill. *See* the FSA Consultation Paper on the *Conduct of Business Sourcebook* at paragraph 4.14, 4.15, available at http://www.fsa.gov.uk/pubs/cp/index-2000.html. *See* note 20, infra.

[108] *See* the discussion below.

[109] *See* the CFTC Survey, Overview, at p. xxv, and pp. 63-64. *See also* the Report by the Committee on Payment and Settlement Systems and the Euro-currency Standing Committee of the central banks of the Group of Ten countries on *OTC Derivatives: Settlement Procedures and Counterparty Risk Management* (September 1998) at p. 16; the Report of the Counterparty Risk Management Policy Group on *Improving Counterparty Risk Management Practices* (June 1999), at pp. 37-49; and the London Code, at paragraphs 107-109.

[110] *E.g.*, French FAMA, *supra*, note 35, Title II, Chapter 3, Article 52 "The terms and procedures of cancellation, valuation and set-off prescribed by the General Regulations [of the Conseil des Marché Financiérs] of a national or international master agreement organizing the relations of two parties, at least one of whom is an investment service provider or an institution, undertaking or body eligible for the benefit of Article 25 of this Act [which includes

D. Conduct of Business, Customer Protection and Differential Treatment of Sophisticated Customers – Various Exemptive Models

Although firms (and or in Australia, markets) engaging in certain counterparty transactions in over-the-counter derivatives are subject to national securities (or investment services) law, applicable exemptions relating to the treatment of sophisticated counterparties operate in such a way that conduct of business requirements primarily apply to retail counterparties or customers.

1. Overview

A basic structure which differentiates between retail and sophisticated customers may be achieved in several ways. Three different national approaches to counterparty distinctions are discussed below, as well as that of the EU generally: (i) the UK wholesale market regime, (ii) the Australian safe harbor for exempt futures markets, and (iii) the proposed Ontario treatment of over-the-counter counterparty transactions with qualified persons. Each of these regimes also limits the extraterritorial application of its national law.[111]

2. European Union - Customer protection requirements should take account of the professional nature of counterparties

In the EU, recognition of the special needs of retail customers is accomplished by recognition in the ISD that professionals may not need the same protections as other customers. Within the EU, conduct of business requirements may vary on a national basis with the nature of the counterparty. Article 11 of the ISD indicates that the principles of conduct of business it sets forth "must be applied in such a way as to take account of the professional nature of the person for whom the service is provided."[112] In most jurisdictions, disclosure and other customer protection requirements are reduced for certain professional customers, to reflect an acknowledgement that professional customers typically have a higher degree of sophistication and knowledge with respect to investments, and the financial resources to withstand the risk of their investments, than the average individual investor may. For example, in Italy, with respect to certain customers classified as "professional investors,"[113] distinctions are made with respect to the information that investment firms are required to supply to and to obtain from customers, the contents of the account agreement that investment firms are required to enter into, the appropriateness (suitability) of transactions and certain recordkeeping and reporting

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futures and commodities brokers] or a non-resident having comparable status shall be set off according to the valuation rules in such General Regulations or master agreement." The effect of this provision is to make master agreements binding on attaching creditors. *See also* the CFTC Survey at p. 70 regarding Spain.

[111] It may be interesting to compare the Australian exempt market and the proposed Ontario exemptions to the CFTC's Rules on the Regulation of Hybrid Instruments and the Exemption of Swap Agreements at 17 CFR Parts 34 and 35, respectively.

[112] ISD, *supra*, note 32, at p. 37. *See also* FESCO's Report on *Implementation of Article 11 of the ISD - The Categorisation of Investors for the Purpose of Conduct of Business Rules* (7 November 1999) at http://www.europefesco.org/ ("FESCO Categorisation Report").

[113] Some of the provisions of Consob Reg. 11522, *supra*, note 60, in particular, Articles 26-30 and 60-62, *etc.*, do not apply to authorized intermediaries, foreign persons who engage in securities investment business on a professional basis in their country of origin, asset management companies, insurance companies, certain financial companies, and companies and legal persons having a specialized competence and experience in the securities.

requirements. The detailed requirements applicable to retail customers do not apply to institutional counterparties. In jurisdictions with single regulators, such as Sweden, differential conduct of business rules for institutions may partly be a product of differences related to the nature of banking and retail securities business. Some conduct of business duties also may be less for transactions in regulated, as opposed to over-the-counter, markets.[114] For example, in France, persons who would not be eligible for membership on the MATIF division of the ParisBourse are considered non-professionals.[115] In Germany, the failure to make appropriate disclosure to a retail customer may render a valid over-the-counter contract unenforceable.[116]

3. United Kingdom - Basic customer protections need not be extended to non-private clients or market counterparties

In the UK, much of the basic financial regulatory framework is disapplied depending on the nature of the transaction, the nature of the counterparty, and the location of the transaction.[117]

a) Basic Regime

Consistent with the ISD, under the terms of the FSAct, it is an offense for any person in the UK to deal in (which includes buying and selling as a counterparty), arrange deals in, manage, or advise on transactions in investments, whether on-exchange or over-the-counter, unless they are either:

- Authorized (*i.e.*, licensed) to carry on investment business;
- Exempt from authorization requirements (*e.g.*, because they perform specifically defined functions such as those of a recognized investment exchange or of a wholesale money market institution); or
- Fall within one of the exclusions set out in the Act.[118]

Authorized persons must comply with rules set by their "regulator" (now the Financial Services Authority or a surviving self-regulatory organization which exists under the umbrella

[114] In Belgium, the duty to use skill and diligence, taking account of the customers' professional knowledge ("know your customer") and act in their best interests, is presumed satisfied, however, if a transaction is carried out on a regulated market, consistent with exchange rules and any client instructions. *See also*, Italy, which presumes specific best execution and price requirements are satisfied in this case. Consob Reg. 11522, Article 32, *supra*, note 60.

[115] *See, e.g.,* French FAMA, Article 58, *supra,* note 35: "The rules set forth in the Article must be applied with due regard for the professional investment service expertise of the person to whom the investment service is provided." *See also* COB Rule 90.09. With increased electronic trading, some of these membership standards may be relaxed resulting in concomitant changes in categorizing an investor as a professional or non-professional customer. *See* the FESCO Categorisation Report, note 112, *supra*.

[116] *See* the CFTC Survey, at p. 3. *See also* the FESCO Categorisation Report, note 112, *supra*.

[117] The SFA's conduct of business rules do not apply to authorized persons (or passported business) to the extent that they are acting as exempted persons. *See* the CFTC Survey, at p. 23-24.

[118] These include an exclusion for overseas persons engaging in certain restricted activities. *See* the CFTC Survey, at p. 17.

organization of the FSA).[119] Requirements differ according to whether the authorized persons are conducting business on their own account or are engaging in transactions on behalf of clients. In the former case, the regime is generally lighter, while in the latter case the requirements are lighter in relation to sophisticated investment professionals than they are in relation to unsophisticated investors.

In general terms, the requirements relate to:

- capital and risk control (*e.g.*, a requirement for authorized persons to set position limits);

- reporting of transactions (including those in over-the-counter financial derivatives) to the regulator;

- segregation of client money and custody of client assets; and

- conduct of business and, in particular, a requirement that authorized persons ensure any recommendations for unsophisticated investors (*i.e.*, private clients who do not themselves carry on investment business or who are not corporations, partnerships of trusts satisfying certain size requirements) are suitable and that various specified risk warnings are given.

Over-the-counter transactions undertaken on a discretionary basis for any customer or for a private client are subject to a suitability requirement.[120]

Certain of these basic regime requirements, in particular segregation, disclosure, suitability confirmations, and periodic reporting of valuations are not required for authorized firms doing business opposite non-private clients.[121]

b) Wholesale Markets Regime

In addition to the reduced requirements for private clients, the Grey Paper or wholesale markets regime applies to s.43 listed money market institutions (exempted persons under the FSAct)

[119] Although the FSA has taken over the oversight role of the former Securities and Investment Board in relation to the securities and futures sector, the Securities and Futures Authority will continue to be the supervising authority for investment firms in the United Kingdom until the FSM Bill, currently pending in the British House of Commons, comes into force.

[120] In assessing the suitability of an over-the-counter derivatives transaction for a customer, the firm must have regard to the customer's understanding of the nature of the risks involved. Among other considerations, the suitability of an over-the-counter derivatives transaction for a private customer will depend on the customer's financial standing. Firms should consider whether the cost to the customer of the transaction, or the strategy of which it may form a part, could materially impair the customer's financial standing. SFA Rule 5-31.

[121] The main protections afforded exclusively to private customers are: risk warning, suitable advice, prior disclosure of charges, and specified customer agreements. (Under some circumstances, a firm may treat a private customer as a non-private customer if it can show that the customer has sufficient experience—subject to the customer receiving a written warning of the protections that would be lost and the customer giving his or her consent.) In addition to the listed protections, a private client that waves customer protections also will not have access to the Customer Arbitration Scheme.

entering into over-the-counter derivative transactions under the terms of the London Code.[122] This regime applies to s.43 listed institutions to the extent they enter into transactions in certain financial derivatives with a value of £500,000 or more. Wholesale money-market institutions must comply however with the London Code which requires such participants to know their counterparty and to assess such counterparty's creditworthiness.

Under the London Code, for example, such institutions are recommended to have clearly articulated processes for dealing with counterparties for the first time which consider: documentation of what information is available on the legal status of the counterparty; who initiated the product request; are both parties clear what reliance the customer is placing on advice given; and whether this is documented by agreement.[123] The London Code also requires that (i) facts believed to be material to completing a specific transaction be disclosed before the transaction is consummated, except where such disclosure would reveal confidential information about the activities of another firm and (ii) claims or acknowledgements about, or relevant to, a particular transaction being considered should, as far as the dealer or broker is aware, be fair and not misleading.[124] All listed institutions must maintain complete and comprehensive records of transactions within the regulatory ambit for three years.[125] Prompt confirms, use of standard settlement instructions and documentation is also recommended.[126] Listed institutions that do not follow the London Code can be reprimanded or delisted.[127]

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[122] *See* note 23, *supra*. Currently the SFA Rules and the FSA's Grey Paper reflect broadly similar approaches to certain market counterparties. Both schemes recognize that professionals should be treated differently but their treatment of professionals is not identical. The SFA approach distinguishes private and non-private clients and market counterparties. Market counterparties are exempt from most requirements (SFA Conduct of Business Rule 4-5). The counterparty approach uses a transaction-by-transaction or an all-in-one approach. The transactional approach requires investment firms to classify counterparties on each transaction. Under that approach, a "market counterparty" (for which reduced disclosure and recordkeeping is permitted) defines a counterparty as a person dealing with the investment firm as a principal or an agent (for an unidentified principal) in the course of investment business of the same description as that of the firm and to whom the firm sends a required notification. The once-and-for-all test includes firms listed under s.43 and other member firms of the SFA.

The Grey Paper applies a lighter regime to transactions concluded by listed money market institutions deemed to be a professional in all their dealings in products covered by the regime (essentially money market instruments, bullion, and currency) and certain other financial transactions that exceed a minimum size. A s.43 wholesale money market institution listed by the FSA must file a business plan setting out the types of instruments (and currencies) in which it intends to trade; its permitted scope of activities will be limited to those described in the business plan. Among other attributes of the Grey Paper regime, special investor compensation arrangements apply to Grey Paper business that is covered by the ISD (adopted pursuant to the EU's Investor Compensation Directive); segregation requirements are generally applicable to Grey Paper business that is covered by the ISD unless the counterparty is not a private individual and the listed firm has written to the counterparty to inform him that he will rank as a general creditor in the event of the firm's insolvency and the counterparty has given his written consent to his money not being segregated by the firm (Grey Paper, paragraph, 80 (b)); and risk warnings must be given to small investors that transactions of a specified size that are with listed institutions or excluded persons (such as overseas persons) lose the protections of the FSAct. *See e.g.*, the London Code, at paragraph 36. A new professional transaction structure is being subjected to the FSA's consultation process. *See* the FSA's Wholesale Market Paper, note 23, *supra*.

[123] The London Code, at paragraph 31.

[124] The London Code, at paragraph 24.

[125] The Grey Paper, at paragraph 60, *et seq.*

[126] The London Code, at paragraph 91-104.

[127] The London Code, at paragraph 10.

In addition to these requirements, the FSA may from time to time ask listed firms to provide to it information on particular transactions or aspects of their business (*e.g.*, on turnover in particular products, liquidity management policies, etc.). However, in general, listed institutions need not make daily reports of their individual over-the-counter transactions unless otherwise covered by SFA's position risk reporting requirements.[128]

Further:

- to the extent listed section 43 institutions are conducting investment business, and wish to enter into transactions with a value below £500,000 with persons not themselves falling within the scope of the wholesale markets regime, they will have to be authorized and comply with the more detailed requirements of the basic regime; and

- to the extent they may enter into investment transactions with a value of £500,000 or more on behalf of unsophisticated investors, the wholesale markets regime has a requirement broadly similar to the suitability requirement for authorized persons, and also requires that certain risk warnings be given.[129]

Many, if not most, over-the-counter financial derivatives transactions would be expected to take place under the UK's wholesale markets scheme. This regime is in the process of being simplified and modified.[130]

4. Canada - Ontario - Exemptions for Qualified Persons and Transactions

Banks' securities transactions are handled differently from securities transactions by other persons or firms. Banks are subject to the federal authority of the Office of the Superintendent for Financial Institutions ("OSFI"). No conduct of business rules with respect to securities transactions are applied to banks except as implied from safety and soundness requirements.[131]

In Canada, derivatives transactions that are trades in securities are subject to provincial law. Therefore, in Ontario, they are subject to the provisions of the *Ontario Securities Act*, including the registration (of dealers and intermediaries) and the prospectus requirements of the Act. The Ontario Securities Commission's (OSC) proposed rule relating to over-the-counter derivatives products was issued pursuant to legislation that permits the OSC to make rules in respect to derivatives "regardless of whether the derivatives transactions constitute trades in securities." OSC's revised version of its 1994 proposal, published in 1996, republished in December, 1998, and again, in part, in January 2000, would explicitly require licensing of agency transactions and dealer transactions in over-the-counter derivatives to the extent these transactions are not defined as exempt. A final rule is expected to be published shortly.

The OSC proposal, as most recently amended in January 2000, is intended to remove any uncertainty as to the application of the Ontario Securities Act to over-the-counter derivatives.

[128] The Grey Paper, at paragraphs 66, 67.
[129] *See* the London Code, paragraphs 34-37. *See also* the CFTC Survey, at pp. 23-24.
[130] *See* the FSA's Wholesale Market Paper, note 23, *supra*.
[131] *See* the CFTC Survey, at p. 28.

The proposed rule would create three categories of derivatives subject to regulation and establish "appropriate" regulatory treatment for each. The appropriate treatment is based on the nature of the instrument and the nature of the counterparty and effectively clarifies that only certain securities law requirements (such as generic risk disclosure related to the special risks of over-the-counter products and suitability requirements.) will be imposed and then only on retail business. Transactions that previously may have been considered not to be securities would be explicitly exempted from the securities laws thereby clarifying the treatment of such transactions and removing any ambiguity as to what (if any) securities rules must be complied with.

The three categories are:

- Transactions totally exempted from all provisions of the securities laws—forex contracts in which one party is qualified or hedging, interest rate contracts in which each party is qualified or hedging, and other specified derivatives in which each party is qualified for the transaction;

- Transactions exempt from registration and prospectus provisions without conditions—(equity derivatives) in which each party is qualified;

- Transactions that are exempt from registration and prospectus provisions with conditions, that is, transactions in certain over-the-counter products with unqualified parties. (These transactions require delivery of generic risk disclosure and that one party be a registered dealer).

The Draft Policy issued in conjunction with the proposed rule would clarify its extraterritorial effect by clarifying the OSC's view that the rule is not intended to protect counterparties located outside of Ontario or to apply to over-the-counter derivatives transactions that do not raise Ontario investor protection concerns.[132]

Qualified parties are generally certain listed persons or commercial users which meet minimum regulatory or financial requirements. Differential rules apply to Canada-based entities. The minimum requirement for an individual would be $5,000,000 of net worth, not including a principal residence.[133]

5. Australia - Exempt Futures Market for Appropriate Customers and Transactions

Australia also has a special regime that permits the trading of over-the-counter derivatives by non-bank counterparties acting as principals outside a regulated exchange subject to lesser requirements than exchange transactions. Like the exemptions discussed above, this exemption

[132] OSC Proposed Rule and Policy, Section 3.1., published December 18, 1998, 21 OSCB 7755, the 1998 Draft Rule having been amended in the Notice Of Proposed Rule And Policy Under The Securities Act Proposed Rule 91-504 Over – The - Counter Derivatives and Companion Policy 91-504cp available at www.osc.gov.on.ca/en/Regulation /Rulemaking/Rules/91-504_20000107.html.

[133] *Compare* the laws in Quebec, where authorization is required for persons doing an investment business, including business in over-the-counter derivatives, with the exception of all dealing activities opposite sophisticated persons.

depends on the nature of the business and the nature of the counterparty. (Under this regime, all retail business and all brokered business must be done on exchange or opposite a bank.)

a) Basic Regime

In Australia, the term "futures market" is defined broadly, and includes any facility by which futures contracts (which do not include currency and interest rate forwards and swaps to which a bank is a party, but do include contracts for differences otherwise) are regularly acquired or disposed of. Market-making by over-the-counter dealers, and interdealer markets, are both caught by the definition. Persons carrying on these activities must therefore seek market authorizations. A market can be authorized as a (1) futures exchange or (2) an exempt futures market. Each exempt futures market is regulated through its conditions of authorization.

b) Exempt Market Regime

All transactions in an exempt futures market must, among other things:

- have the person who is permitted to provide the exempt futures market as a party to each contract and be entered into by each counterparty as a principal or on behalf of a body corporate or as a trustee of a trust or manager of a fund but not otherwise on behalf of another person;
- be entered into after individual credit assessment of the counterparty;
- create obligations that can be transferred or terminated (other than in the case of agreed events) only with the consent of the counterparty; and
- not be supported by the credit of a clearing organization or a mark-to-market margin and settlement system routinely involving a third party.

Only entities subject to approved forms of prudential supervision (or a reasonable analogue thereof) may be authorized to conduct exempt futures markets (as "facility providers"). Entities who meet this description and qualify as "regulated facility providers" include:

- Australian banks; other banking institutions (however described) whose activities are formally regulated in accordance with the standards set down by the BCBS;
- authorized short term money market dealers (a category of person formerly recognized under the Banking Act);
- Australian-licensed brokers and dealers whose debt is rated investment grade;
- approved foreign holders of broker-dealer licenses whose debt is rated investment grade; and
- entities whose exempt futures market obligations are guaranteed by one of the foregoing.

As stated above, no retail counterparty can participate in an exempt futures market. A person who enters into a transaction on an exempt market must be an "appropriate person." These are: regulated facility providers (as described above); and other sophisticated persons (holders of futures brokers licenses; holders of securities dealers licenses that are unrestricted as to the type of securities in which licensees may deal; persons who have total tangible assets of more than $10 million; trustees or fund managers of trusts or funds totaling at least $50 million; certain classes of persons who can be expected to enter agreements for hedging purposes only; governments and government agencies; and related corporate bodies of any of the foregoing.)[134]

Exempt futures markets can be conducted free of many regulatory controls applicable to regulated futures markets.[135] *Such markets are, however, subject to a general requirement under the conditions for an exempt market to operate, that the person conducting the market not engage in conduct that is misleading or deceptive, or is likely to mislead or deceive.* The person in conducting the market is further required to use its best endeavors to ensure that its employees, agents or others acting in, or in connection with, the acquisition or disposal of a futures contract in an exempt futures market not engage in conduct that is misleading or deceptive, or that is likely to mislead or deceive.

6. Other Non-EU Jurisdictions

Outside the EU there may be additional differences to those discussed in detail here in how conduct of business rules apply. For example, in jurisdictions where banking and securities supervision is divided, it may be the case that no conduct of business rules (although internal controls may address sales operations from a safety and soundness perspective) apply to banking institutions. For example:

a) Japan

As of June 22, l998, all private financial institutions, which include commercial and investment banks, became subject to authorization and supervision by the Financial Supervisory Authority. Such Authority now has regulatory authority over swaps, forwards on interest rates and forex, which were not regulated previously. Foreign currency futures traded on-exchange remain under the supervision of MOF (the Securities Bureau of the Ministry of Finance). Until April 1, 1998, only credit institutions could engage in forex transactions. Since the liberalization in April 1998, securities companies can also trade in such instruments. Japan's rules related to supervision of financial institutions are rapidly evolving and the regulatory system is expected to be further reorganized this year.[136]

b) Hong Kong

If a transaction is considered a dealing in securities, the dealer must be licensed by the Securities and Futures Commission ("SFC") as a securities dealer, or be an exempt dealer (such as an

[134] Australian PS, note 25, *supra*. *See also* the CFTC Survey, at pp. 1, 15, 19, 25, 28, and 46.

[135] Indeed, the facility provider which is the common counterparty for over-the-counter transactions is in effect treated as a financial intermediary or dealer.

[136] *See* the CFTC Survey at pp. 15, 26, 55, 78-79.

authorized institution licensed by the banking regulator, the Hong Kong Monetary Authority ("HKMA")). The SFC indicates that over-the-counter business is covered. If the transaction is a dealing in leveraged foreign exchange, the person either must be an authorized institution licensed by HKMA, or be licensed as a leveraged foreign exchange trader with the SFC.

If a person deals only with licensed persons or professionals, the person need not be licensed by the SFC or HKMA. Although the SFC does license futures dealers, futures are defined as being executed on an exchange, and, therefore, exclude over-the-counter transactions. To the extent a futures dealer engages in over-the-counter transactions incidental to exchange-based activity, it would be subject to the regulatory regime for futures dealers (*e.g.*, capital requirements, business conduct, *etc.*).[137]

7. Future Work at National or Supranational Level on Inter-professional Markets

Nationally work is proceeding to articulate more clearly the basis for interprofessional exemptions and to eliminate some of the disparities of treatment of customers based on definitional differences related to various investment products and financial institutions. In this connection, the UK FSA recently has issued the Wholesale Markets Paper[138] to explore further how the FSA should regulate the conduct of business between authorized firms and their professional counterparties, and on how it should regulate other aspects of inter-professional conduct in the markets -- to assure the appropriate degree of protection for consumers having regard to:

- their differing experience and expertise;
- the general principle that they should take responsibility for their decisions;
- the varying degrees of risk attached to investments; and
- maintaining confidence in the markets.

The Wholesale Markets Paper also expresses concern about ensuring a level playing field among professionals who are equally expert, but where one party has significantly greater market power than the other.

Separately, the Australian Treasury's CLERP 6 Paper[139] proposes a framework that would provide comparable regulation of all financial products; financial instruments covered by the proposal would include all securities, futures and other derivatives, as well as foreign exchange, superannuation, general and life insurance and deposit accounts. In order to achieve the policy objectives of neutrality and flexibility, the Australian Treasury proposes to provide a regulatory regime which is not based around particular market structures or investment products. The new

[137] *See* the CFTC Survey, at pp. 3, 14-15. *See also* the newly proposed *Securities and Futures Bill - White Bill* (April 2000) and the *Consultation Paper on the Securities and Futures Bill* (April 2000) at the website of the Hong Kong Securities and Futures Commission under "Composite Bill" at http://www.hksfc.org.hk/eng/index.htm.
[138] See note 23, *supra*. A further proposal is due to be published in May 2000.
[139] *See* note 19, *supra*.

regime will provide consistent regulation of functionally similar markets and products. Existing, diverse regulatory arrangements for financial markets and investment products, including industry codes, will be harmonized. One purpose will be to address the lesser regulation of over-the-counter markets. Persons will be prohibited from conducting a market in financial instruments or providing financial intermediary services unless they hold an appropriately endorsed financial markets license. Consultation on these proposals is ongoing pursuant to a recently published Consultation Paper.[140]

8. Future Work at National or Supranational Level on Harmonization

Additional work on harmonization also is ongoing by European countries through the Forum of European Securities Commissions. Consensus on certain authorization and fitness standards have been reached.[141] Work on conduct of business requirements and classification of professional and non-professional business is on-going.[142] Finally, the European Commission has organized several Forum Groups in connection with the EU's Action Plan for Financial Services that are analyzing, among other issues, whether it would be appropriate to apply home country conduct of business rules to passported wholesale business under the ISD and to allocate to the home country responsibility for supervision of compliance with conduct of business rules applicable to wholesale markets.[143]

With respect to most conduct of business issues, however, there remain differences between jurisdictions in how basic, agreed-to principles are applied by individual national jurisdictions.

There are fewer differences relating to the content of conduct of business regulation than as to: (i) who is in fact covered and (ii) the manner in which parties are covered.
With respect to over-the-counter markets, many of the protections traditionally accorded retail customers do not apply. There are differences in national law as to how this result is achieved. In some cases, the business is transacted by banks in jurisdictions where conduct of business rules traditionally have not applied to banks (except as an aspect of operational controls) or where banks are under a separate regulator from securities firms. In other circumstances, certain counterparties are not required to be authorized. In still others, the business is exempt from certain requirements if the counterparties meet certain eligibility criteria. The standards of eligibility differ because, among other things, existing harmonizing legislation, such as that in the EU, is very general and conduct of business regulation is in general not harmonized.

Additionally, there are differences in the means of achieving the desired regulatory objectives, ranging from Codes of Conduct contemplating self-policing of bilateral transactions, to administrative encouragements, to private sector benchmarks, to explicit rules.

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140 *See* note 19, *supra*.
141 See FESCO's *European Standards on Fitness and Propriety to Provide Investment Services* (2 April 1999) at http://www.europefesco.org/.
142 *See* FESCO's Consultation Paper on *Implementation of Article 11 of the ISD - The Categorisation of Investors for the Purpose of Conduct of Business Rules* (7 November 1999) at http://www.europefesco.org/.
143 Financial Services Action Plan Forum Group on the ISD Green Paper at http://europa.eu.int/comm/internal_ market/en/finances/actionplan/index.htm.

V. Financial Integrity and the Reduction of Systemic Risk

To the extent that firms engaging in financial transactions are required to be authorized as credit institutions or investment firms, they are subject to capital and other prudential requirements. Most capital regimes take account of the specific risks of over-the-counter derivatives transactions (that is, credit risk and the sensitivity of the credit risk associated with such instruments to market risk), although there are differences among jurisdictions as to how this risk is priced. In some jurisdictions, the capital requirements for banks and securities firms are different; in others, there has been an attempt to harmonize capital requirements applicable to investment activities.[144] *Requirements also may be adjusted based upon the nature of the firm (e.g., firms meeting specified requirements being able to use proprietary models to price market risk). Depending on the regulatory model, capital compliance may be monitored by a different regulator from the regulator which monitors conduct of business compliance.*

*The increasing use of derivatives has resulted in enhancements to required internal accounting and operational controls for firms subject to capital requirements and, in some jurisdictions, for collective investment schemes. Certain large market participants (counterparties) that engage in proprietary transactions, but do not engage in a dealing or brokerage business are not subject to regulatory financial requirements, although passive investment vehicles, such as collective investment schemes may have structural (*e.g., *leverage and dilution limitations; redemption and valuation requirements; or prudent man investment limitations) or other requirements intended to protect their participants and the markets in which they trade. Existing international guidance recommends that end users refer to the internal controls and risk management methodologies designed for authorized firms when evaluating the risk of undertaking leveraged transactions.*[145] *Guidance regarding internal controls and risk management generally recommend that firm management have procedures in place to take account of the risks of the types of investment business undertaken by authorized firms. Trading of derivatives on an exchange may reduce certain of these risks, in particular the credit risk, legal risk, and settlement risk often associated with over-the-counter instruments.*

Because of the interlinkages among financial institutions, most national jurisdictions agree that close cooperation is necessary among regulators of different sectors of the national financial system and across national boundaries.

It is unambiguously agreed that the reduction of the potential for systemic risk is a principal objective of financial regulation. IOSCO has stated:

> Although regulators cannot be expected to prevent the financial failure of market intermediaries, regulation should aim to reduce the risk of failure (including

[144] *See* note 70 and 74, *supra*.

[145] This report is not intended to provide a complete discussion or analysis of the issues relating to highly leveraged institutions or to issues relating to financial integrity and systemic risk generally. Such issues have been considered in numerous national and international fora, including, but not limited to, the Financial Stability Forum. This report addresses issues addressed by non-U.S. national and supranational legislation specific to over-the-counter markets. *See* note 94, *supra*.

> through capital and internal control requirements). Where financial failure nonetheless does occur, regulation should seek to reduce the impact of that failure, and, in particular, attempt to isolate the risk to the failing institution. Market intermediaries should, therefore, be subject to adequate and ongoing capital and other prudential requirements. If necessary, an intermediary should be able to wind down its business without loss to its customers and counterparties or systemic damage.[146]

Similarly, the BCBS, in adopting the Core Principles for Effective Banking Supervision, stated:

> The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors.[147]

The following is a summary of national approaches to issues that have financial integrity and systemic implications: capital, internal controls, insolvency, and legal risk, including, documentation and choice of law.

A. Capital

In general, capital rules apply only to regulated entities.[148] *Therefore, counterparties (unless authorized as credit institutions or investment companies or, in the case of Hong Kong, leveraged forex traders and in Australia, qualified facility providers) are not subject to such rules.*

1. European Union

The capital regime established by directives in the European Union is intended to establish a minimum capital requirement for firms doing investment business cross-border pursuant to the European passport and to harmonize capital requirements for investment activities across financial institutions, that is, between investment firms and credit institutions.

The first directives adopted in the EU regarding financial services related solely to credit institutions. Regarding capital requirements, credit institutions are, in general, subject to the

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[146] IOSCO Core Principles, Section 4.2.3.

[147] BCBS, *Core Principles for Effective Banking Supervision* (September 1997), at Introduction, p. 8.

[148] As a point of comparison, minimum financial or capital requirements applicable internationally to banks and securities firms vary from the minimum financial and capital requirements applicable to United States securities and futures firms; in many non-U.S. jurisdictions, securities firms are generally subject to capital requirements equivalent to those applicable to banks (*e.g.*, for the credit risk associated with unsecured receivables, an 8% charge against assets, subject to a risk weighting or haircuts) while, in the United States, securities and futures firms are subject to a higher level of capital charges, *e.g.*, a 100% charge with respect to the credit risks associated with unsecured receivables. *See*, however, the SEC's so-called "broker-lite" rules which apply essentially the Basel capital standards to an affiliate of a broker/dealer that elects to become an OTC derivatives dealer. *See* 17 CFR §240.15c3-1, Appendix F -- Optional Market and Credit Risk Requirements for OTC Derivatives Dealers; see *also* Exchange Act Release No. 39454 (Dec. 17, 1997), 62 FR 67940 (Dec. 30, 1997).

Second Banking Directive[149] (which established the European passport for credit institutions and which sets the initial capital requirement for credit institutions), the Solvency Directive[150] (which sets a required solvency ratio and risk weightings for on and off-balance sheet items for credit institutions), the Capital Adequacy Directive (which harmonizes capital requirements with respect to the trading book of credit institutions and investment firms), and the Large Exposures Directive[151] (which contains certain concentration requirements). Subject to exceptions for certain collateralized exposures and government assets, all exposures exceeding 10% of own funds to a single client or group of connected clients must be reported to the competent authorities. An overall limit on exposures to an unrelated or a related client or group of connected clients and an aggregate limit on the total of all large exposures also are imposed.[152]

The ISD extended the single European passport regime enjoyed by credit institutions under the Second Banking Directive to investment firms. The Capital Adequacy Directive[153] establishes the capital regime for investment firms and harmonizes the capital treatment of the trading book of investment firms and credit institutions as noted above. The Capital Adequacy Directive includes charges for position risk, settlement risk and delivery risk. The Capital Adequacy Directive also sets initial capital requirements for investment firms and charges for counterparty risk, foreign exchange risk, and large exposures, and subjects investment firms to the other requirements of the Large Exposures Directive. Subsequent amendments to the Capital Adequacy Directive apply common market risk requirements to investment firms' and credit institutions' trading books. The concept of a trading book was extended to positions in commodities as well as financial instruments in 1998.

In the EU, capital for both investment firms and credit institutions is calculated taking into account the recognition of contractual netting under the Netting Directive, which permits the competent authority, in calculating market risk, to recognize valid netting arrangements where the institution has received a reasoned legal opinion that the netting arrangement will be recognized and observed in the event of the default, bankruptcy or liquidation of the relevant counterparty, under (i) the laws of the jurisdiction in which the counterparty is incorporated and any relevant branch is established, (ii) the law of the transactions included in the arrangement, and (iii) the law that governs any contract necessary to achieve the netting.[154]

In 1998, investment firms and credit institutions were authorized to determine capital requirements with respect to position risk, foreign exchange risk and commodities risk by reference to internal risk management models, provided that the competent authority (national regulator) is satisfied that the institution's risk management system is conceptually sound, meets qualification standards specified in the Directive, and is implemented with integrity. Also in

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[149] *See* notes 70 and 74, *supra*.
[150] *See* notes 70 and 74, *supra*.
[151] *See* note 101 and the EU Commission's description of this directive at http://europa.eu.int/scadplus/leg/en/lvb/l24013b.htm.
[152] *See* the Large Exposures Directive, note 101, *supra*.
[153] *See* notes 70 and 74, *supra*.
[154] Directive 96/10/EEC, which amends the Solvency Directive, *see* note 70, *supra*,; *see also* the Capital Adequacy Directive, note 74, *supra*, regarding the requirement that investment firms treat over-the-counter derivatives consistently with the Solvency Directive (Annex II). This provision effectively permitted banks in the EU to take advantage of international guidance issued by the BCBS.

1998, a directive was adopted permitting cleared over-the-counter derivatives contracts to be treated equivalently to exchange-traded contracts (*i.e.*, as without counterparty credit risk) for capital adequacy purposes. The EU Member States are obligated to transpose the 1998 Directives[155] into national law by 21 July 2000.

The EU capital-related directives set minimum requirements. Any national jurisdiction is permitted to adopt more stringent requirements.[156]

As a consequence of these directives, any authorized firm operating under the common European passport (whether a bank or an investment firm) must meet harmonized capital requirements relating to its investment activities, which include consideration of the specific risks related to over-the-counter derivatives positions.

2. Other Jurisdictions

Where banking and securities firms are regulated subject to separate requirements, capital requirements may not be harmonized. For example, in Canada, banking institutions which are subject to federal oversight must comply with the Basel Capital Accord[157] while securities firms, which are regulated provincially, are subject to provincial securities law requirements. In Ontario, interestingly, dealers in over-the-counter derivatives transactions that are members of the Investment Dealers Association of Canada ("IDA") (a trade association) are subject to the By-laws, rules, policies and regulations of IDA relating to capital adequacy. Such requirements also are monitored by IDA. In Australia, banking firms are subject to capital requirements set down in the Basel Capital Accord, while qualified facility providers providing exempt futures markets that are not banking firms must have an investment grade credit rating pending adoption of other requirements. Securities firms also may refer to the Basel Capital Accord for guidance

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[155]Directive 98/31/EC, Official Journal L 204/13 (21 July 1998) amending the Capital Adequacy Directive, note 74, *supra*; and Directive 98/33/EC, note 74, *supra*, amending the "First Banking Directive," Directive 77/780/EEC, Official Journal L 322/30 (17 December 1977), the Solvency Directive, note 70, *supra,* and the Capital Adequacy Directive.

[156] The EU jurisdictions largely have implemented the Capital Adequacy Directive, although there may remain certain technical disparities which are being examined by the European Commission. For an indication of the status of implementation of the Capital Adequacy Directive, *see* http://europa.eu.int/scadplus/leg/en/mne/m93_6.htm. The Capital Adequacy Directive generally reflects the Basel Capital Accord. For example, in France, the *Commission Bancaire*, uses value at risk with a multiplier of three in applying capital adequacy rules; Germany considers over-the-counter derivatives risk assets for credit-risk ratios under the German Banking Act and the Principles concerning Capital and Liquidity of Institutions, and the long value of certain derivatives positions have to be included in the calculation of major loans of banks and securities firms which must be reported to the German Federal Bank in accordance with the Ordinance Concerning the Valuation of Credits; the UK follows the European Directives as reflected in the detailed capital rules of the Securities and Futures Authority at Chapter 10 of the SFA Rule Book. SFA Rule Book – Chapter 10 includes provisions regarding lead regulation arrangements, records and systems of internal controls, form and content of financial reporting statements and accounting policies, appointment and duties of auditors, initial capital and financial resources requirements, position risk requirements, several calculation methodologies, counterparty risk requirements, large exposures requirements, and general principles of consolidated supervision, among other things. In comparison, Switzerland requires banks and securities dealers to follow the standards established by the Bank for International Settlements (*i.e.*, the Basel Accord), subject to slight modifications.

[157] This is similar to the capital regime applied to banks and investment firms by the European Directives.

or may be subject to requirements set by the exchanges on which they are trading.[158] In Hong Kong, banks, securities firms and leveraged forex dealers are each subject to separate requirements.[159] In Japan, market risk with respect to over-the-counter trading in interest rate swaps and forward rate agreements is not included currently in capital requirements. Japan, however, reports to the CFTC that it is moving toward accounting and other standards that meet international norms.[160]

B. Internal Controls

Providing consensus guidance on approaches to appropriate internal risk management controls was the first objective of financial regulation commonly approached by securities and banking regulators.

The emphasis on management of risks associated with derivatives, and particularly, over-the-counter derivatives, reflects, among other things (i) that certain counterparties are not authorized institutions and (ii) that, when transacting in over-the-counter derivatives instruments, credit and market risk are related -- the unrealized gain of one party to the transaction reflects the potential risk of loss by that party due to a credit failure of (that is, a default by) its counterparty. Such potential losses may be greater where price moves are not marked to market and settled daily or more frequently. Because prudential rules generally have not been designed (even where they specifically apply) to cover outlier price moves (or so-called fat tails of extreme price movements), effective risk management and internal controls regimes are especially necessary to address leverage related to derivatives and other off-balance sheet products.

Existing internal controls standards are designed to cause authorized institutions to determine the legal and credit capacity of their counterparties. Transactions can potentially lead to severe losses, be set aside, or lead to litigation if such control procedures are not followed.

Existing international guidance recommends that end users refer to the internal controls and risk management methodologies designed for authorized firms when evaluating the risk of undertaking leveraged transactions.

Trading of derivatives on an exchange may reduce certain risks, in particular the credit risk, legal risk, and settlement risk often associated with transacting in over-the-counter markets. The

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[158] Australian PS 70 notes that to be a qualified facility provider a firm must be subject to minimum capital standards which take into account the organization's derivatives market activities. *See* paragraphs 46 and 47. ASIC (formerly the ASC) acknowledges that capital standards applying to holders of securities dealers licenses and futures brokers licenses do not currently conform to the criteria set out in paragraphs 46 and 47 of the Australian PS. The ASIC is proposing to review these standards to ensure that they are brought into conformance. Until that process is complete, Australian licensees will also be required to be rated "investment grade' by a ratings agency to whose ratings the ASIC refers. Until the ASIC's review of Australian capital standards is complete and a basis is established for comparing these standards with those applying in other jurisdictions, a ratings requirement will also apply to facility providers holding licenses in other jurisdictions. *See* paragraph 49. Additional requirements may be adopted relative to certain specialized exempt markets, such as that in electricity. *See* the CFTC Survey, at p. 35.
[159] *See* the CFTC Survey, at p. 58.
[160] *See* the CFTC Survey, at p. 58.

laws, rules and procedures for trading on exchange set the parameters for approved transactions and are generally transparent, whereas the laws, rules, and procedures relative to over-the-counter transactions, which are "private" contracts, are less accessible.

There appears to be substantial agreement that prudential regulation is an important aspect of maintaining financial stability, as well as customer protection, notwithstanding that existing law does not subject non-intermediated business or all market counterparties to prudential requirements.[161]

1. European Union Countries

Article 8 of the Capital Adequacy Directive states: "Member States shall require that investment firms and credit institutions provide the competent authorities of their home Member States with all the information necessary for the assessment of their compliance with the rules adopted in accordance with that Directive. The Member States also must ensure that institutions' internal control mechanisms and administrative and accounting procedures permit the verification of their compliance with such rules at all times." Article 10 of the ISD also requires sound administrative and accounting procedures and internal controls mechanisms, protection of customer funds and appropriate records.[162]

Many of the various EU jurisdictions have provided additional guidance.[163] Most indicate that risks are not analyzed on a product-by-product basis, but rather by elements of risk, *e.g.*, credit risk and market risk -- and limits are set for certain of such elements.

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[161] Both IOSCO and the BCBS have published numerous reports addressing internal controls at credit institutions and securities firms. *See e.g.*, *Risk Management Guidelines for Derivatives*, BCBS (July 1994); Operational *and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms,* IOSCO (July 1994); *Client Asset Protection*, IOSCO (August 1996); Risk *Management and Control Guidance for Securities Firms and their Supervisors*, IOSCO (May 1998); *Operational Risk Management*, BCBS (September 1998); and *Framework for Internal Control Systems in Banking Organisations*, BCBS (September 1998). Recent reports regarding highly leveraged institutions have also addressed the issue of risk management controls in general and in the specific context of interactions with highly leveraged institutions. *See e.g.*, *Hedge Funds and Other Highly Leveraged Institutions*, IOSCO (November 1999); *Sound Practices for Banks' Interactions with Highly Leveraged Institutions*, BCBS (January 1999); and *Banks' Interactions with Highly Leveraged Institutions*, BCBS (January 1999); *see also* the *Report of the Working Group on Highly Leveraged Institutions* of the Financial Stability Forum (March 2000).

[162] *See* notes 70 and 74, *supra*.

[163] For example, Belgium with respect to both credit institutions and investment firms follows the BCBS's July 1994 *Risk Management Guidelines for Derivatives* and has issued specific guidelines relating to internal organization and monitoring of transactions on the money and forex markets and guidelines relating to internal control and audit, which catalogues types of risks and how they are monitored; France's *Commission Bancaire Reglement No. 97-02—internal controls* addresses reconstruction of the order of transactions, credit risk procedures for on and off-balance sheet risks, global risk limits, back-testing, separation of functions, reporting to management and to the Board of Directors; Germany's Federal Bank Supervisory Office, October 1995 Announcement of the German Federal Banking Authority on the Minimum Requirements for the Carrying Out of Trading Transactions identifies trading transactions for which limits must be established by an entity different from the trader; Spain requires investment firms and Collective Investment Schemes to have risk policies, measurement and reporting systems subject to regular review, effective communication systems including to the Board of Directors, appropriate and sufficient human and technical resources, appropriate and secure systems, clearly defined operating limits and approval procedures, procedures to ensure compliance with all regulatory requirements and with internal policies; Sweden

For example, the UK reports that, in general, authorized firms are required to organize and control their internal affairs in a responsible manner.[164] In addition, the effect of various specific requirements (including those related to know-your-customer, suitability for certain classes of clients, recordkeeping and risk management) is such that authorized firms would be expected to have some regard to the internal controls of their counterparties when entering into over-the-counter derivatives transactions. In particular, firms need to establish both that the person they are dealing with is authorized to commit the counterparty to the transaction and to satisfy themselves that the counterparty has sufficient resources.[165] Credit institutions also follow the BCBS Guidance issued in 1994.[166] Counterparties which are exempt from authorization would be subject to the lighter regime of the London Code or any superseding code, which also includes general standards related to recordkeeping and knowing your counterparty.[167] Italy also has requirements for authorized firms and special requirements for managed portfolios and over-the-counter exposures.[168]

Although proper documentation is acknowledged to be an aspect of controlling risk in over-the-counter transactions, all jurisdictions report that there are no specific documentation requirements for over-the-counter transactions, that matters such as settlements and the use and administration of collateral are negotiated between counterparties, and that industry custom and practice is to use practitioner-designed master agreements subject to general requirements that apply to authorized institutions.[169]

2. Other Jurisdictions

In Australia, there are no special requirements for counterparties except that counterparty creditworthiness must be assessed for parties participating in exempt futures markets. However, certain bank dealer markets are not treated as exempt futures markets and operate independently of these rules. Australia reports that participants in the markets, as a matter of good commercial practice, are developing corporate governance procedures, including risk management policies,

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also has issued general guidelines. Italy, Spain and Belgium also have special requirements or have extended requirements for investment firms to collective investment schemes. *See* the CFTC Survey, at pp. 59-63.

[164] *See e.g.*, SFA Rulebook, Chapter 10, 10-10 to 10-13 requiring sufficient records to disclose "with reasonable accuracy" the financial condition of the firm and to demonstrate whether or not the firm is in compliance with its financial requirements, details of exposure limits for trading positions and counterparty credit limits which are appropriate to the type, nature and volume of business undertaken and disclosed in such a way that they are capable of being summarized to enable actual exposures to be measured readily and regularly against these limits, appropriate management information records, and the ability to demonstrate the objectives and operation of its systems of controls to its auditor, reporting accountant and SFA. Under the new FSM Bill, internal controls and other prudential standards for financial service providers will be set out in a Prudential Sourcebook to be included within the new FSA Handbook on Rules and Guidance. An FSA Consultation Paper on the FSA's Approach to Setting Prudential Standards (November 1999) is available at http://www.fsa.gov.uk/pubs/cp/cp31.pdf.

[165] *See* the CFTC Survey, at p. 63. *Compare* with requirements related to wholesale markets discussed at p. *44 et seq.*, *supra*.

[166] BCBS, Amendment to the Capital Accord of July 1988 (July 1994).

[167] The FSA intends to supersede the London Code with the Prudential Sourcebook. *See* note 164, *supra*.

[168] Italy Consob Reg. 11522, note 60, *supra*, at Articles 28, 44, and 56-59. *See also*, Articles 60-63 regarding recordkeeping and reporting requirements.

[169] *See further* Section V. C. below. *But see* note 110, *supra*, regarding statutory recognition of master agreements relating to netting agreements and insolvency.

to manage their exposures in these markets and that the Australian Securities and Investments Commission may adopt special requirements for certain markets, such as electricity.[170]

Hong Kong's SFC has published extensive guidance on operational and risk management controls. It issued such guidance on over-the-counter derivatives in 1995 based on a 1994 report by IOSCO's Technical Committee[171] and subsequently issued *Management, Supervision and Internal Control Guidelines for Persons Registered with or Licensed by the Securities and Futures Commission* (May 1997). The Guidelines relate to the manner in which all registered or licensed persons, that is, dealers, dealing partnerships, investment advisers, and investment advisers partnerships registered under the Securities Ordinance; dealers and commodity trading advisers registered under the Commodities Trading Ordinance; and licensed leveraged foreign exchange traders licensed under the Leveraged Foreign Exchange Trading Ordinance, structure, manage and operate the respective businesses for which they are registered/licensed and in particular, the existence of satisfactory internal control and internal management systems.[172]

In Japan, specific standards are not set, but reference is made to IOSCO and other relevant reports, such as the guidance issued by the BCBS.[173]

Existing internal controls standards are intended to cause authorized institutions to determine the legal and credit capacity of their counterparties. It is broadly understood that transactions can potentially lead to severe losses, be set aside, or lead to litigation if such control procedures are not followed.

C. Customer Funds Protection

1. European Union Countries

Article 10 of the ISD requires the protection of customer funds and prevents investment firms and credit institutions from using for their own account instruments belonging to investors, except with the investor's consent.[174] An investment firm is also prohibited from using for their own account cash balances maintained by investors at the investment firm. On the other hand, amounts maintained by investors at credit institutions are treated like deposit accounts and the credit institution is permitted to use such funds for its own account like any other deposit. Client money requirements are considered to be prudential rules.[175] Therefore, the rules of the home jurisdiction generally apply to investment firms doing passported business. Protection of customer funds is accomplished by a variety of methods in the various EU jurisdictions, ranging from physical segregation, holding individual customer accounts at the clearing organization,

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[170] *See* the London Survey at p. 111 and the CFTC Survey, at p. 59

[171] SFC Guidance on *Core Operational and Financial Risk Management Controls for Over-the-Counter Derivatives Activities of Registered Persons* (March 1995).

[172] These Guidelines address Management and Supervision, Segregation of Duties and Functions, Personnel and Training, Information Management, Compliance, Audit, Operational Controls, Risk Management and Suggested Control Techniques and Procedures.

[173] *See* the CFTC Survey, at p. 61.

[174] *See* ISD, Article 10, Note 32, *supra*.

[175] *See* ISD, Article 10, Note 32, *supra*. In the US, segregation also is viewed as a market protection mechanism because it facilitates the movement of the positions of non-defaulting customers at a defaulting firm.

compensation schemes and guarantees.[176] Such rules may not reach all over-the-counter activity -- either because counterparty activity between unauthorized firms would not be affected or because certain business is not subject to such requirements. For example, UK's rules state that client money rules or segregation do not apply to exempted business (that is, non-investment business, such as forex and bullion) of an exempted institution or to oil market investment activity.[177] However, under the Grey Paper's wholesale market regime, money or assets of a counterparty held by a listed institution in connection with business covered by the ISD generally must be segregated, provided that a counterparty that is not a private individual can opt out of the Grey Paper's segregation requirements. Upon such an opt out, the counterparty is treated as a general creditor in the event of the listed institution's insolvency.[178] Client money or segregation rules also would not apply to commercial business as such business does not constitute "investment" business under the applicable law. Commercial business under the FSAct includes any non-exchange-traded "futures" contract if, under the terms of the contract, delivery is to be made within 7 days.[179] Further, even under the general rules of the SFA, certain non-private customers (including market counterparties) can "opt out of" or "waive" segregation requirements in the UK.[180]

2. Other Jurisdictions

Japan recently has adopted requirements that firms treat customer funds related to financial instruments, investments or trades separately from firm funds, but the rules implemented by certain exchanges raise some questions about the treatment of funds of related companies.[181] Funds deposited in connection with commodity derivatives have traditionally been segregated consistent with US practice in Japan.[182]

In Australia, Section 12009 of the Corporations Law and also Sydney Futures Exchange Articles provide for segregation of client funds and property. The segregation of client funds ensures that any money the client deposits with a licensed futures broker, or that the broker otherwise

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[176] *See* the Regulatory Summary, Section II. A. 5. Some jurisdictions (*e.g.*, Italy) believe that physical segregation is necessary to satisfy Article 10 of the ISD.
[177] SFA Rule Book Chapter 4, 4-50. *Compare* France, FAMA, note 35, *supra*, Title III, Ch.1 Article 63: Investment service providers…shall protect the title to the financial instruments of the investors whose accounts they keep. They may use such securities for their own purposes only with the explicit consent of the customer; Investment firms may not under any circumstances use for their own purposes funds deposited with them by their customers, subject to (rights under clearing arrangements).
[178] *See* the Grey Paper, paragraphs 78-85.
[179] FSAct, Schedule I, paragraph 8, note (3).
[180] *See* the Regulatory Summary, Section II. A. 5. For accounts subject to the Commodity Exchange Act, the U.S. CFTC requires segregation on a gross basis at the futures commission merchant ("FCM") as of the close of business on the day of the trade. At a clearing house, customer funds in an FCM's omnibus customer account are treated as "customer funds" of that FCM and are commingled. In any case, deficits in the customer accounts must be topped up by the FCM by the close of business each day. The clearing house cannot take funds in an FCM's omnibus customer account to cover defaults or shortfalls in the FCM's proprietary account, but can treat the omnibus customer account as one for purposes of covering defaults or shortfalls in the customer account. Consequently, while customers are insulated from liabilities arising out of a default by the FCM, customers have a certain exposure in the event of a default by a fellow customer of its FCM if the capital of the FCM is insufficient to cover such default.
[181] *Compare* Tokyo International Financial Futures Exchange and Tokyo Stock Exchange rules.
[182] *See* the Regulatory Summary, Section II. A. 5.

receives for or on behalf of the client in connection with dealings in futures contracts is deposited in the client segregated account.[183] Such provisions would appear to apply to exempt contracts, but not to bank dealer business in financial derivatives.

In Canada, customers, although their funds are identified, are unsecured creditors for their deposits with a registered dealer. Such clients would be protected by the Canadian Investors Protection Fund for securities transactions. Under the Ontario proposal for over-the-counter derivatives, it does not appear that such (CIPF) protections would be extended to counterparty transactions between qualified persons.

In Hong Kong, dealers must deposit clients' monies (less brokerage and other proper charges relating to the requirements of any clearing house) within four days after receipt into segregated accounts kept with registered deposit-taking companies or licensed banks. Such monies shall not be available for payment of debts of dealers or be liable to be paid or taken in execution under the order or process of any court with the exception of certain specified claims and liens. The securities and futures exchange rules require segregation of client funds within two days of receipt. These rules appear to apply to all transactions.[184]

Although there is international consensus that identification of customer funds and separation of such funds from firm funds facilitates the transfer of non-defaulting customers from a defaulting firm thereby reducing the potential for a contagion effect from a firm failure, the means of according client funds protection differs and the extent to which such protections are extended to over-the-counter transactions in jurisdictions where such transactions can be entered into on exempt markets or through exempt parties is unclear.[185] *Moreover, in the case of over-the-counter products, most issues arise with respect to the treatment of collateral posted by counterparties.*

D. Insolvency

Insolvency law that supports the movement of non-defaulting customers from a failed institution can reduce potential contagion and hence systemic risk.[186] *That being said insolvency law as a general matter differs from jurisdiction to jurisdic*tion. *Where legislation has not been enacted to address the validity of netting and insolvency treatment of derivatives in general, and over-the-counter derivatives and related documentation of such derivatives in particular, the insolvency treatment of such transactions cannot be assured, even if standard documentation practices are followed.*[187]

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[183] *See* the Regulatory Summary, Section II. A. 5.
[184] *See* the Regulatory Summary, Section II. A. 5.
[185] Report on *Client Asset Protection*, IOSCO (August 1996); *The Windsor Declaration*, issued May 17, 1995, by regulatory bodies from 16 countries responsible for supervising the activities of the world's major futures and options markets (Australia, Brazil, Canada – Quebec and Ontario, France, Germany, Hong Kong, Italy, Japan, The Netherlands, Singapore, South Africa, Spain, Sweden, Switzerland, US-CFTC, UK) available at internet website www.cftc.gov.
[186] *Id.*
[187] *See* Report of the President's Working Group on Financial Markets on *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management* (April 1999), at http://www.ustreas.gov/press/releases/docs/hedgfund.pdf.

1. European Union Countries

No specific competence over bankruptcy or insolvency is granted to the European Community pursuant to the *Treaty Establishing the European Community*. Consequently, national jurisdictions currently are free to maintain or establish their own national bankruptcy or insolvency law.[188] The EU has, however, attempted to harmonize investor compensation and depositor guarantee schemes. A Directive on deposit–guarantee schemes,[189] applicable to depositors in credit institutions, was adopted in 1994; a Directive on investor-compensation schemes,[190] applicable to customers of investment firms, was adopted in 1997. These directives are coordinated to provide depositors in credit institutions and customers of investment firms the same level of cover in the event a credit institution or investment firm becomes insolvent. Such coordination is intended to maintain equal conditions of competition between credit institutions and investment firms within the EU's internal market. Member states were required to transpose the Investor-Compensation Directive into national law by 26 September 1998. The Investor-Compensation Directive:

- establishes a minimum level of protection that must be afforded in each member state (E20,000 or approximately US$19,000 at current exchange rates);
- coordinates coverage offered where an investment firm operates in more than one state;
- coordinates compensation coverage available when a credit institution engages in investment services business; and
- specifies certain minimal procedural requirements relative to making claims.

This scheme covers all investments, including over-the-counter products, but the coverage available is minimal relative to the over-the-counter exposures of most counterparties involved in over-the-counter markets. Participants in the over-the-counter markets, as a consequence, must look at other factors or products to address the risk of loss arising out of a potential failure of their counterparties. Professional and institutional investors, as well as certain governmental entities, can also opt out of the investor compensation scheme.

Additionally, in 1996, the EU adopted the Netting Directive on the recognition of contractual netting regarding over-the-counter interest rate and exchange rate contracts in connection with

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[188] A European Convention on Insolvency Proceedings, a European Directive on Insolvency Proceedings, as well as specialized Directives on the reorganization and winding-up of credit institutions and deposit-guarantee schemes and on the winding up of insurance undertakings all have been proposed in Europe, but have not been adopted. The specialized directives on the winding up of credit institutions and insurance undertakings still are being pursued as part of the EU's Financial Services Action Plan and are pending before the EU Council of Ministers. *See* http://europa.eu.int/scadplus/leg/en/lvb/l24008.htm for a discussion of the directive on the winding up of credit institutions. *See* http://europa.eu.int/comm/dg15/en/finances/actionplan/index.htm for a progress report on the Financial Services Action Plan.

[189] Directive 94/19/EC, Official Journal L 135/5 (31 May 1994) on deposit-guarantee schemes. For a further description of this directive, *see* http://europa.eu.int/scadplus/leg/en/lvb/l24012b.htm

[190] Directive 97/9/EC, Official Journal L 84/22 (26 March 1997) on investor-compensation schemes. For a further description of this directive, *see* http://europa.eu.int/scadplus/leg/en/lvb/l24038.htm.

the calculation of capital requirements by credit institutions.[191] This treatment of these over-the-counter derivative transactions for purposes of calculating capital requirements was extended to investment firms by the Capital Adequacy Directive.[192] Member states were required to transpose such directive into national law by 30 June 1996. Australia, Japan, and Canada also honor closeout netting provisions.[193] In addition, in May 1998, the EU adopted a Directive on settlement finality in payment and settlement systems. This directive was adopted to harmonize the laws of the Member States regarding the enforceability of multilateral netting arrangements in a payment or settlement system and the effect of the insolvency or bankruptcy of a participant in such a system on the rights of other participants in the system. This Directive would make netting arrangements and instructions that result in the transfer of money, the assumption or discharge of a payment obligation, or the transfer of a security pursuant to the rules of a settlement system legally enforceable and binding on third parties if the orders were entered before the opening of insolvency proceedings as defined in the Directive. The Directive is applicable to EU payment and securities settlement systems (designated as such and notified by the Member State to the European Commission) and to collateral posted by system participants, including third country participants. Such settlement finality provisions supersede national insolvency and other relevant law. The EU Member States were obligated to transpose the Settlement Finality Directive into national law by 11 December 1999.[194]

Some jurisdictions also have legislation that fosters the transfer of positions and the operations of clearing facilities.[195] Also, some jurisdictions have clearing facilities that clear over-the-counter products; specifically, Sweden, The Netherlands, and the United Kingdom have functioning clearing systems for over-the-counter transactions. Belgium, Italy, Spain and Switzerland are exploring or developing such facilities.[196] Such proposals potentially both enhance transparency of the transactions and reduce counterparty and legal risk. In fact, Brazil requires the registration of all over-the-counter positions and permits their clearing.

E. Default Procedures

IOSCO has recommended that default procedures of regulated markets be transparent and, in particular, that information related to the transfer of non-defaulting customer positions from a defaulting firm be accessible. With respect to over-the-counter positions, there are additional

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[191] Directive 96/10/EC, Official Journal L 85/17 (3 April 1996), amending the Solvency Directive, *see* note 70, *supra*.
[192] *See* note 74, *supra*.
[193] *See* the CFTC Survey, Overview at p. xxix and p. 69-70. *See also* ISDA projects regarding netting legislation, netting opinions, and collateral opinions at http://www.isda.org/isda-c.html.
[194]Directive 98/26/EC, Official Journal L166/45 (11 June 1998), on settlement finality in payment and securities settlement systems.
[195] *See e.g.,* French FAMA, note 35, *supra*, at Article 49, 50 and 51.
[196] *See* the CFTC Survey, pp. 39-41. The UK extended its market insolvency protections for transfers of positions and netting to over-the-counter transactions that are cleared, effective August 21, 1998. *See* the CFTC Survey, at p. 70. *Compare* ongoing analysis in the United States regarding the clearing of over-the-counter transactions: The President's Working Group Report on *Over-the-Counter Markets and the Commodity Exchange Act* ("PWG Report") noted generally the benefits associated with clearing, but, because of issues relating to definitions and jurisdiction concluded that "…Congressional action is necessary to establish appropriate policy guidance for the establishment and oversight of clearing systems for OTC derivatives…. PWG Report, at p. 15. The PWG Report also recommends that "…clearing of swap agreements be permitted…" PWG Report at p. 17.

issues with respect to defaults. For example, there are issues related to the ability to close out in tandem hedge positions that are in more than one market, as to the potential impact of acceleration clauses in master agreements, and as to the treatment of collateral in insolvency. More work could be done on these issues, which currently are addressed primarily by master agreement documentation or not at all. [197]

F. Cooperation Arrangements

It is well established that cooperation and information sharing arrangements are essential to the management of market disruptions and financial disruptions at firms, especially with the increasingly global nature of the marketplace for financial investments and the multi-national nature of investment firms and credit institutions. [198]

For example, IOSCO includes among its Core Principles, the following:

- The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

- Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

- The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.[199]

There is significant internationally-agreed guidance on the types of information that should be available and should be shared.[200] Some of these guidances (as discussed more fully above) specifically mention the usefulness of being able to understand a market participant's whole trading book, that is, its positions in cash and over-the-counter as well as regulated exchange markets.[201]

1. European Jurisdictions

The ISD specifically requires cooperation between regulators of investment firms within a national jurisdiction, cooperation between sectoral authorities -- that is those responsible for supervising markets, credit institutions, insurance and financial undertakings with those

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[197] Report on *Cooperation Between Market Authorities and Default Procedures*, IOSCO (March 7, 1996).
[198] Both the Federation Internationale des Bourses de Valeurs (FIBV) and IOSCO maintain a current list of memoranda of understanding and other information sharing arrangements between markets and regulatory authorities. *See* http://www.fibv.com/ and http://www.iosco.org/iosco.html.
[199] IOSCO Principles 11, 12 and 13.
[200] *The Windsor Declaration*, *see* note 185, *supra;* the *Tokyo Communiqué*, *see* note 57, *supra;* the *Boca Declaration*, *see* note 55, *supra;* and the IOSCO Technical Committee's *Guidance on Information Sharing* (November 1998) available at www.iosco.org.
[201] *Tokyo Communiqué*, *see* note 57, *supra*; the IOSCO Technical Committee Report on the *Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts* (September 1998); IOSCO Technical Committee's *Guidance on Information Sharing* (November 1998).

supervising investment firms, and cooperation between Member States with respect to firms operating in one or more Member States.[202] Member States also can conclude cooperation agreements providing for exchanges of information with the competent authorities of third countries provided that the information disclosed is covered by guarantees of professional secrecy at least equivalent to those provided under the ISD.[203] Such cooperation encouragement covers all investment services, including over-the-counter financial derivatives transactions, that are treated as investments under the ISD.

2. Other Jurisdictions

In general, most national jurisdictions support information sharing for regulatory and/or supervisory purposes. Most of the jurisdictions responding to the CFTC Survey are signatories to the *Boca Declaration*, and many participated in the Windsor initiative and in the *Tokyo Communiqué*. The G-7 Ministers also have encouraged the G-7 and other national jurisdictions to remove impediments to agreed forms of information sharing.[204] These arrangements, however, may not extend to transactions that occur solely over-the-counter.[205]

There appears to be substantial agreement that prudential regulation is an important aspect of maintaining financial stability, as well as customer protection, notwithstanding that existing law does not subject non-intermediated business or all market counterparties to prudential requirements.

VI. Legal Certainty

There are a number of issues that can affect legal certainty. These relate primarily to the enforceability of over-the-counter transactions under certain circumstances and between certain counterparties and as to the enforceability of the contractual arrangements that are intended to govern the use of collateral and the close out or liquidation of derivatives transactions in the event of default or an insolvency.

A. Anti-wagering and Gambling Laws

Although courts have focussed primarily on the legality of over-the-counter transactions with retail or unsophisticated counterparties, in some jurisdictions, speculative contracts-for-

[202] ISD, Article 23, note 32, *supra*,. *See also* the Capital Adequacy Directive, Article 9 (4), note 74, *supra*.
[203] ISD, Article 25 (3), note 32, *supra*. See also FESCO's Multilateral Memorandum on the Exchange of Information and Surveillance of Securities Activities (January 1999),available at http://www.europefesco.org/.
[204] *See* Report of the G-7 Finance Ministers on *Information Sharing: Ten Key Principles* (May 1998). *See also* Report of the G-7 Working Group on Financial Crime on *Ten Key Principles for the Improvement of International Co-operation Regarding Financial Crime and Regulatory Abuse* (May 1999).
[205] For example Title 5, Article 80 of the French FAMA, note 35, *supra*, permits (subject to reciprocity) "market undertakings" and "clearing houses of regulated markets" to supply their foreign counterparts with the information necessary for the discharge of their respective duties concerning access to and the organization and security of markets, provided that such counterpart organizations are also bound by an obligation of professional secrecy within a legislative framework offering similar guarantees to those in force in France. "In the case of market undertakings that organize trading and clearing houses of regulated markets, such information, for the supervision of the risks incurred by their members, includes positions taken on the market, security or margin deposits and the composition thereof, as well as margin calls."

differences settled in cash can raise issues under anti-gaming or wagering laws. Some jurisdictions have legislatively clarified when such provisions do not apply. For example, in the UK, no contract which was entered into by either or each party "by way of business," the "making or performance of which" would constitute "dealing in investments" as a principal or an agent would be void or unenforceable as a gambling contract under applicable UK gaming law.[206] In Germany, so-called "exchange-related-options and-futures-transactions" within the meaning of Section 58 of the Stock Exchange Act are legally valid and enforceable. These are transactions that have typical conditions and relate to a futures and options market, for which a counter-transaction may be concluded at any time. "These requirements have been broadly interpreted to include basically all over-the counter derivatives transactions concluded between professional market participants." However, although valid, over-the-counter derivatives transactions may be unenforceable where they were concluded with an unsophisticated counterparty and adequate disclosure was not effected. In addition, transactions which are speculative contracts for differences "which do not qualify as exchange-related-options-and-futures-transactions" may be unenforceable pursuant to certain wagering provisions of the German Civil Code. According to the German responses to the CFTC Survey, German case law focuses practically exclusively on the protection of unsophisticated counterparties; nonetheless, the law may raise issues with respect to the enforceability of exotic over-the-counter transactions. In comparison, questions raised under the criminal gambling laws with respect to certain over-the-counter equity-related derivatives instruments in Japan have been resolved by the recent changes to the Securities Exchange Law and were resolved with respect to commodities by April 1999.[207] In Australia, the Australian Companies & Securities Advisory Committee noted that while legal decisions have not rendered swaps illegal, the application of State gaming and betting laws could potentially invalidate certain over-the-counter transactions absent an exemption. Australia is further clarifying that over-the-counter transactions conducted in an unauthorized market are nonetheless valid.[208]

B. Legal Capacity and Prohibited Transactions

The legality of over-the-counter transactions depends on the nature of the counterparties, the nature of the product, and the nature of the regulatory and legislative framework. In some jurisdictions, particular types of transactions are unenforceable: in Australia, a retail or agency transaction opposite a security broker that is concluded off-exchange; in Hong Kong, a transaction between an unauthorized person and a third party; in the UK, a transaction solicited by cold call; in Germany, a transaction with a retail person without acceptable disclosure; in France, transactions by French nationals in financial instruments traded on a regulated market, otherwise than on the regulated market, unless the trade satisfies the requirements of the General Regulations of the Conseil des Marchés Financiers regarding its size, the investor's status, the nature of the financial instrument, and the reporting of price information to the regulated market on which the instrument is listed; in The Netherlands, Japan and Hong Kong, over-the-counter

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[206] FSAct, Section 63; *see also* the CFTC Survey, Overview, at p. xxiv regarding Italy.

[207] *See* the CFTC Survey, at pp. 21, 30.

[208] *See* the CFTC Survey, Overview, at p. xxiv. *Compare* the PWG Report which recommends removing the "death penalty" for over-the-counter derivatives transactions stating "The CEA should be amended to clarify that a party to a transaction may not avoid performance of its obligations under, or recover losses incurred on, a transaction solely on the failure of that party (or its counterparty) to comply with the terms of an exclusion or exemption under the [Commodity Exchange Act]." PWG Report, at p. 18.

transactions priced off exchange prices; and in Brazil, certain portfolio investments by foreign entities.[209]

The capacity of various entities to enter into over-the-counter derivatives transactions also may be limited by law related to the entity rather than the transaction. For example, in the EU, authorized collective investment schemes and schemes eligible for the EU passport are generally limited in their use of derivatives. Belgian law is typical. In addition to limits on collective investment schemes, it provides as follows: For individuals, there are no limits except for general rules regarding the capacity to contract (*e.g.*, limitations on minors); for corporations, the corporate charter delimits the scope of permitted activities, but a corporation may be bound by its actions even if they are beyond the scope of its charter, unless the third party knew the action exceeded its charter; and, for public entities, transactions must be within the framework and the public trust purpose for which they were created.[210] Insurance companies, trusts and other types of companies with special responsibilities may have limitations on permitted investments under relevant law or by contract.[211] Capacity also may turn on the market in which the transaction is to be concluded (regularly functioning and liquid), the type of transaction (hedging or speculative), or the amount of risk undertaken. The London Code in the UK recommends that counterparties determine the capacity of their counterparty to enter transactions in the wholesale market and any limits, legal or otherwise, on such capacity.[212]

C. Documentation Requirements

The CFTC Survey on over-the-counter derivatives regulation found that the 16 jurisdictions surveyed generally have not developed documentation requirements specific to over-the-counter derivatives transactions and vary with regard to the requirements that are applied to these transactions. Some jurisdictions, *e.g.*, France, Hong Kong and Sweden, apply their existing documentation requirements to particular institutions, rather than to the particular products or transactions involved. Switzerland uses general documentation requirements in its rules of conduct, and the United Kingdom looks to its general conduct of business requirements.[213]

Canada, Germany, Japan, Spain, Switzerland and the United Kingdom also, however, report the general use of standard agreements, especially for cross-border transactions, and in particular the ISDA Master Agreement.[214] Documentation requirements in Australia also are determined by

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[209] *See* the CFTC Survey, at pp. 30-31.
[210] For example, in the case of *Hazell v. Hammersmith & Fulham Borough Council*, 2 W.L.R.372 (Eng. H.L. 1991), local government authorities in the United Kingdom were found to be precluded from engaging in swap transactions, being beyond the authorities' actual or implied lawful functions to borrow. *See also* the discussion regarding choice of law at p. 70 below.
[211] *See* the CFTC Survey, Overview, at p. xxiv.
[212] *See* the London Code, note 23, *supra*.
[213] For a further discussion of documentation practices in the over-the-counter markets, *see* the Report of Counterparty Risk Management Policy Group on *Improving Counterparty Risk Management Practices* (June 1999); Report by the Committee on Payment and Settlement Systems and the Euro-currency Standing Committee of the central banks of the Group of Ten countries on *OTC Derivatives: Settlement Procedures and Counterparty Risk Management* (September 1998); and the London Code, paragraphs 88-90, 91-99, and 107-109.
214 The ISDA Master Agreement, now commonly used for cross-border transactions, includes a choice-of-law provision. Available schedules to the Master Agreement specify that it will be governed by either English law or the laws of the State of New York.

agreement between the parties, and the industry widely uses standard documentation such as the so-called "Aussie ISDA" master agreement. Some jurisdictions create incentives to use standardized documentation or acknowledge the desired legal effects of standardized documentation. For example, French and Spanish law explicitly provide that master agreement provisions can prevail over existing insolvency law.[215]

The ISDA Master Agreement provides some certainty regarding the law that will be applied to international agreements and establishes practitioner conventions for the drafting of agreements concerning derivatives transactions. Such custom and practice can help to abate concerns about the regulatory inconsistencies among jurisdictions.[216] *However, regulatory or legislative authorities could attempt to reach an international consensus on the documentation that will be honored under local insolvency law worldwide.*

D. Choice Of Law

Most countries' conflict of laws rules relating to contracts are largely consistent with one another. All legal systems recognize the possibility of an express choice of law in a contract. However, circumstances deemed to imply a choice of law are not uniform across jurisdictions. In the absence of an express choice of law, countries use various criteria to determine the law applicable to a contract.[217]

In the United States, under the *Restatement [Second] of Conflict of Laws*, the laws of the state chosen by the parties to govern their contractual rights and duties will be applied if the parties could have resolved the particular issue by an explicit provision in their agreement directed to the issue. Further, the laws of the state chosen by the parties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to the issue, unless either (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or (b) application of the laws of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which would be the state of the applicable law in the absence of an effective choice by the parties.[218] In the absence of an effective choice of law by the parties, the local law of the state which, with respect to the issue, has the most significant relationship to the transaction and the parties will govern the rights and duties of the parties with respect to that issue.[219] The Uniform Commercial Code also contains its own specific conflict of laws rules

[215] *See* note 110, *supra.*

[216] The International Standby Practices ("ISP98") is an example of another effort to standardize documentation and reflect generally accepted practice, custom and usage. ISP98 is a set of rules recently approved by the International Financial Services Association and the ICC Banking Commission. It was expected to become widely used in drafting standby letters of credit as of January 1, 1999. Michael E. Avidon, *Getting Ready for ISP98 – The International Standby Practices*, Documentary Credit World (October 1998), at 33.

[217] H. van Houtte, *The Law of International Trade* §§ 1.24, 1.30, Sweet & Maxwell 1995; *Restatement [Second] of Conflict of Laws*, American Law Institute §§ 187, 188 (1971), as revised (the "Restatement").

[218] Restatement § 187.

[219] Restatement § 188.

applicable to transactions governed by the Code.[220] Specific choice of law provisions are also applicable to transactions covered by certain sections of the Code.[221]

In the United States, the Supreme Court has established that choice of law and forum-selection clauses are presumptively valid.[222] Such clauses will be found unreasonable and thus unenforceable only when: (i) they are the result of fraud or overreaching; (ii) the plaintiff effectively would be denied its day in court because of the inconvenience or unfairness of the chosen forum; (iii) the fundamental unfairness of the chosen law would deprive the plaintiff of a remedy; or (iv) enforcement of the provisions would contravene a strong public policy of the forum in which the suit is brought, whether the policy is declared by statute or judicial decision.[223]

Internationally, a country's private international law rules address the enforceability of a choice of law clause. As a general rule, if a court that acquires jurisdiction over a case involving a contractual dispute determines that a foreign law has been chosen to govern a contract, but that application of the foreign law would lead to results which are unacceptable to that court or its national jurisdiction because it would infringe on the fundamental principles of the ethical, political or economic order of the national jurisdiction, the court may decline to apply the foreign law (the exception of *ordre publique* or public order). If the court declines to apply the foreign law based on this exception, the court may apply the laws of its own jurisdiction. Similarly, if a particular substantive law of a jurisdiction is deemed to be of vital importance to the jurisdiction,

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[220] Uniform Commercial Code § 1.105. The state of New York represents the most significant state with respect to contracts relating to over-the-counter derivatives transactions. New York has adopted both sections of the Restatement cited above and the UCC. *North American Bank, Ltd. v. Schulman*, 474 N.Y.S. 2d 383 (Westchester Co. Court 1984); *Spink & Son, Ltd. v. General Atlantic Corporation*, 637 N.Y.S. 2d 921 (Sup. Ct. New York Co. 1996); *Marine Midland Bank, N.A. v. United Missouri Bank, N.A.*, 643 N.Y.S. 2d 528 (Sup. Ct. App. Div. First Dept. 1996).

[221] *See e.g.*, Uniform Commercial Code § 8-110 governing choice of law related to securities issuers, securities intermediaries, and securities certificates.

[222] A choice of forum clause is a contractual provision in which the parties specify the forum in which disputes will be resolved. Choice of forum clauses can operate independently or in conjunction with a choice of law clause. *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 11-15 (1972) (recognizing that the elimination of uncertainty "by agreeing in advance on a forum acceptable to both parties is an indispensable element in international trade, commerce, and contracting"). The Supreme Court noted that the forum-selection clause in this case also acted as a choice of law clause. *Id.* at 13 note 15. In the securities context, eight federal courts of appeals recently examined choice of law and forum-selection clauses in international contracts between U.S. investors and Lloyd's of London ("Lloyd's") and found the clauses valid and enforceable. *Lipcon v. Underwriters at Lloyd's, London*, 148 F.3d 1285 (11th Cir. 1998); *Richards v. Lloyd's of London*, 135 F.3d 1289 (9th Cir. 1998), cert. denied, 119 S. Ct. 365 (1998); *Haynsworth v. The Corporation a/k/a Lloyd's of London*, 121 F.3d 956 (5th Cir. 1997), cert. denied, 118 S. Ct. 1513 (1998); *Allen v. Lloyd's of London*, 94 F.3d 923 (4th Cir. 1996) (differing slightly because restructuring plan at issue deemed not to be a security or solicitation subject to federal securities laws); *Shell v. R.W. Sturge, Ltd.*, 55 F.3d 1227 (6th Cir. 1995) (differing slightly because the claims were asserted under state, rather than federal, securities laws); *Bonny v. Society of Lloyd's*, 3 F.3d 156 (7th Cir. 1993), cert. denied, 510 U.S. 1113 (1994); *Roby v. Corporation of Lloyd's*, 996 F.2d 1353 (2d Cir. 1993), cert. denied, 510 U.S. 945 (1993); *Riley v. Kingsley Underwriting Agencies, Ltd.*, 969 F.2d 953 (10th Cir. 1992), cert. denied, 506 U.S. 1021 (1992).

[223] *Carnival Cruise Lines, Inc. v. Shute,* 499 U.S. 585, 594-95 (1991); Bremen, 407 U.S. at 12-13, 15, 18. Each of the courts in the Lloyd's cases determined that English law provided adequate recourse and remedies to the U.S. plaintiffs and was not "fundamentally unfair". Lipcon, 148 F.3d at 1297-98; Richards, 135 F.3d at 1296; Haynsworth, 121 F.3d at 967, 969-70; Allen, 94 F.3d at 928-29; Shell, 55 F.3d at 1231-32; Bonny, 3 F.3d at 161-62; Roby, 996 F.2d at 1363, 1365-66; Riley, 969 F.2d at 958.

the courts of that jurisdiction may always apply its own laws to a contract that has some connection with the forum (the exception for *mandatory laws*).[224]

Consequently, in the event a transaction or the parties to it have a connection with multiple jurisdictions, a possibility exists that a court in any of such jurisdictions may hear a case involving the transaction. In such event, the court that hears the case will apply its own conflict of laws rules to determine what law to apply to the case.[225] And, there is some possibility, and some risk, that a court which hears the case may conclude that the laws of the country chosen violates (i) the fundamental policy, mandatory laws, or *ordre publique* of the country whose law would have applied in the absence of a choice of law provision, or (ii) the fundamental policy, mandatory laws, or *ordre publique* of the country of the court hearing the case, in which event the court may determine not to apply the laws of the country designated in the contract. Consequently, whenever the transaction or the parties have connections with more than one jurisdiction, there is always some risk that the choice of law made by the parties to govern their contract will not be respected by a court hearing a case regarding the transaction.

All of the jurisdictions surveyed by the CFTC recognize choice of law provisions. The Canadian province of Québec requires application of its laws in matters pertaining to the distribution of a security where the subscriber or purchaser reside in Québec. Germany notes that, although choice of law provisions generally are valid under German law, where transactions are effected by counterparties in different jurisdictions, issues of German *ordre publique* may affect choice of law provisions. UK case law and commercial practice suggest that an English court is unlikely to strike down an agreement between non-English counterparties that have expressly chosen English law to govern the terms of a contract. However, there is some support for the view that the English courts are free, although not obliged, to strike down a choice of law unconnected with a contract.[226]

Courts in the United States, on several occasions, have been called upon to determine whether a choice of law provision designating a foreign law to be applicable to a contract obviates the application of United States' regulatory law to matters incident to the relationship between the parties arising out of the contract.

In a case involving the marketing and sale of a swap transaction, a federal district court granted a motion to dismiss claims under the Racketeer Influenced and Corrupt Organizations Act ("RICO") and Commodity Exchange Act ("CEA") based on a choice of law clause that specified

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[224] The mandatory law exception to a choice of law clause may be distinguished from the exception relating to *ordre publique* in that the exception for mandatory laws imposes some substantive law, but does not otherwise obviate the application of the normal conflict of laws rules. H. van Houtte, *The Law of International Trade* § 1.24, Sweet & Maxwell 1995. In Europe, the rules of private international law regarding choice of law clauses have been harmonized between many countries by treaties. *See e.g.*, the Convention on the Law Applicable to Contractual Obligations - Rome 1980 (the "Rome Convention"). The exceptions for *ordre publique* and *mandatory laws* are incorporated into the Rome Convention, arts. 7, 16. Separate conflict of laws rules may be applicable to specific kinds of contracts (*see e.g.*, the United Nations Convention on Contracts for the International Sale of Goods - Vienna 1980).

[225] In the event the courts of more than one jurisdiction were to hear a case involving the same transaction, in applying their own respective conflict of laws rules, such courts may come to inconsistent conclusions regarding the law governing the transaction.

[226] *See* the CFTC Survey, at pp. 71-72.

English law as the governing law of the agreement.[227] In *Adimitra*, an Indonesian company sued Bankers Trust Company ("BT") and Bankers Trust International P.L.C. in New York over a swap transaction that was documented using a standard ISDA Master Agreement that specified English law as the governing law (and included a forum-selection clause that contained a submission to the jurisdiction of English courts). The court found no evidence that the choice of law clause was limited solely to contractual claims and was not intended to apply to *all* claims relating to the agreement. Although the court acknowledged that the RICO and CEA claims were not recognized under English law, it found that "English law provides adequate remedies that will both vindicate plaintiffs' substantive rights and protect the public policies established by the United States RICO and commodities laws."[228]

The issue of whether to apply United States law to international financial transactions is significant because it represents a major policy choice on the part of the United States with regard to how the international community will approach dealing with US investors.

The United States is not the only jurisdiction in which it could be claimed that an entity could attempt to avoid private enforcement of legislation by designing novel investments and then entering into agreements with customers that specify governance by the laws of a foreign jurisdiction. This could undercut the legislative enactment of specific statutes that convey private protections and individual remedies beyond those generally available. On the other hand, failure to honor such choices would create uncertainty about the legality of the contracts. It also potentially would generate systemic risk if parties are uncertain as to the operability of specific clauses intended to address defaults or if a market event occurs and parties cannot rely on the enforceability of documents. Such problems are compounded where it is not clear where the transaction occurs.

VII. Regulatory Parity

The preceding overview of applicable national law evidences some differences in treatment of various products and market participants by financial services regulation, the justifications for which may, in some cases, warrant further examination, especially as the differences between on-exchange and off-exchange markets and between products diminish.

- *For example, where prudential and conduct of business regulation is not harmonized across financial institutions, it is possible that products sold by banking entities will not be subject to sales practice or specific anti-manipulation and anti-fraud requirements.*

- *Where securities and other products are regulated separately, it is possible that over-the-counter derivatives that do not meet the definition of securities may be transacted in by entities that are not required to be authorized and that, therefore, are not subject to prudential requirements.*

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[227] *P.T. Adimitra Rayapratama v. Bankers Trust Company, et al.*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,508 (S.D.N.Y. Aug. 16, 1995). Although an appeal was filed in the Court of Appeals for the Second Circuit (Dkt. # 95-7878), the case was closed on December 8, 1995.

[228] Adimitra, ¶ 26,508 at 43,299. Further, even though BT was not a party to the swap agreement, the court dismissed the claims against BT on the theory that BT was a third-party beneficiary of the choice of law clause in the agreement. Id. at 43,300.

- *Although some jurisdictions are developing special requirements for organized and/or exempt markets as opposed to regulated markets, generally market protections are not applied to over-the-counter dealing markets in derivatives.*

- *Although some jurisdictions are moving toward clearing swaps which will render risks in such markets more transparent for that portion of the market that is cleared, in general, over-the-counter risks are less transparent than risks undertaken on regulated markets. Price transparency is atypical of over-the-counter derivatives transactions, although in Brazil, such transactions must be registered.*

Other differences, which are not unique to these markets are that sophisticated customers generally do not receive sales practice protection, including rules related to account documentation, disclosure and recordkeeping, notwithstanding the complexity of the transactions. Some jurisdictions require documentation that a counterparty is acting as a counterparty and not as a fiduciary to clarify the nature of the relationship between the parties. In addition, large market participants that need not be authorized are not subject to prudential constraints or internal controls requirements. To the extent electronic markets permit such participants direct access (as opposed to intermediated access) to a market, there may be issues as to whether such constraints are desirable. The existence of these differences may be justified by basic differences in the nature of the market, the market participants, and the products traded.

VIII. Why Regulators Have Been Asked to Keep Over-the-Counter Markets Under Review

Derivatives are inherently suited to global trading and, by their nature, raise international issues. The design of derivative products generally have few geographic limits because, theoretically, nothing prevents an issuer (dealer or market) in one geographic location from designing a product based on debt, currency, investments, yields, rights, or interests in another location. Thus, it is not particularly surprising that global financial markets growth increasingly has been accompanied by growth in derivatives and, particularly, over-the-counter derivatives products.

Although it is generally agreed that the risks of financial transactions in all types of financial products are conceptually similar, derivatives and, in particular, over-the-counter derivatives are sometimes viewed as reflecting the impact of market changes more quickly and more dramatically than other, more traditional, financial instruments, thus, potentially heightening systemic risks. Derivatives, especially over-the-counter derivatives, may be difficult to value and difficult to liquidate under adverse market conditions because of their lack of transparency and the need to reverse transactions with the original counterparty after a change in conditions. These factors also may raise systemic concerns and pose issues for regulators as to the appropriateness of the counterparties who enter into the transactions.

The international dimension of the over-the-counter derivatives market also can magnify the risk generated by inconsistencies and legal uncertainty, especially as to the scope and intention of applicable law. A unilateral attempt in a jurisdiction like the United States to "heighten" standards could drive market participants to move to more "friendly" jurisdictions or, at a minimum, to require the use of choice of law clauses that adopt the laws of friendlier jurisdictions. Reliance solely on choice of law clauses or shifts to legal systems less experienced in over-the-counter derivatives may generate new uncertainties or risks.

IX. Conclusions and Recommendations

A. Coverage; Accessibility of Applicable Law; Market Infrastructure

The CFTC Survey demonstrates a wide array of differences in approaches to over-the-counter derivatives. There are differences in the products addressed by applicable legislation, how those products are covered, differences in treatment of counterparties, differences in what counterparties are subject to regulation and when counterparties become subject to regulation. Other than the CFTC Survey and IOSCO Regulatory Summary, which are not detailed reviews, there is no current compendium of the laws applicable in this area -- and the multiple regulatory authorities involved make it difficult to compile such information reliably.

Recommendation:

- Improve the accessibility of applicable law, rules and procedures affecting over-the-counter transactions using a common framework of analysis.

- Continue examining basic "market" infrastructure issues to determine how the existing framework should reflect differences between products, customers and markets.

As innovative means of delivering financial services are developed, this type of inquiry may become increasingly necessary.

B. Counterparty Eligibility

There is significant divergence as to who is an eligible counterparty and for which counterparties special disclosures are required.

Recommendations:

- Improve transparency of national law as to which counterparties are eligible for which transactions and with what protections;

- Clarify when public offering requirements apply;

- Explore the possibility of more uniformity across jurisdictions -- *i.e.*, work toward common understandings regarding the categorization of professional counterparties; and

- Discourage permitting counterparties to act for undisclosed principals.

C. Legality of Instruments or Transactions

There remain issues in several jurisdictions as to whether specific types of transactions are legal, whether transactions that are ultra vires are voidable, and whether wagering laws can render otherwise legal transactions unenforceable.

<u>Recommendations:</u>

- Clarify that otherwise legal contracts for differences cannot be voided under gambling legislation and that a party entering a contract cannot claim *ultra vires* as a defense; and

- Clarify international parameters regarding acceptable documentation.

D. Financial Integrity of Transactions

According to the CFTC Survey, and other materials reviewed in connection with this study, there remain jurisdictions in which it is not clear how liquidation clauses, closeout netting and collateral would be treated in an insolvency. Work in this area has been on-going. Work also has been done on internal controls for regulated intermediaries, but such controls often fail when firms are making money and control guidance had not been extended to all market participants.

<u>Recommendations:</u>

- In jurisdictions where it remains unclear, clarify the validity of netting, including closeout netting arrangements and the counterparties to which such arrangements may apply;

- Promote legislative endorsement of documentation that meets international standards;

- Provide support, irrespective of the type of insolvency system, for pre-bankruptcy law which supports the management of positions (and workouts) as well as their liquidation to avoid disruptions resulting from the insolvency of firms that are large position holders with multiple counterparties;

- Provide more guidance on the validity of choice of law provisions; and

- Develop mechanisms or regulatory strategies or incentives to assure internal control policies are followed and are promoted to all market participants.

E. Cooperation/Information Sharing/Transparency

Significant work already has been done on international cooperation. Regulators agree that it is important to devise appropriate regulatory treatments to address problems of market integrity and confidence, interlinkages among markets and resulting susceptibility to shocks or problems of individual firms, but that extending guidance concerning surveillance and information needs *of regulated markets to over-the-counter markets was a complex undertaking that required further analysis.*

Recommendations:

- Review existing work at the international level on cooperation and information sharing and the extent to which it is intended to facilitate sharing information regarding over-the-counter exposures in appropriate cases;

- Identify over-the-counter information that it is desirable to disclose and to share and for what purposes;

- Continue to take steps toward removing national barriers to sharing information across borders and financial sectors for agreed purposes; and

- Assure arrangements are in place for cross-border and intersectoral cooperation (that is, cooperation between prudential and conduct regulators, if they are different, and among insurance, securities and banking regulators, if they are different).

F. Means To Promote International Harmonization

Regulators should also explore the following means to promote international harmonization and/or to reduce the inconsistencies in regulatory approaches:

- *Expose regulatory differences and commonalities*

Understanding existing regulatory systems and the extent of the differences between them is one good means of moving toward commonality and removing regulatory gaps or unnecessary overlaps. Therefore, regulators should consider expanding and developing more fully the CFTC Survey of existing regulatory systems affecting over-the-counter transactions through IOSCO, through IOSCO and the BCBS jointly, through the Joint Forum on Financial Conglomerates (a group organized under the auspices of IOSCO, the BCBS, and the International Association of Insurance Supervisors), through encouragement of a private-sector initiative, or through some specially convened groups of derivatives regulators. (The purpose of such an exercise would be to develop more fully, using existing materials, follow-up interviews and review of original documents, the applicable law in various jurisdictions so as to attempt, by consensus, to identify with particularity gaps, differences, or overlaps in coverage.)

- *Promote public dialogue on need for regulatory structural changes based on changes in the landscape and nature of (formerly) truly individually-negotiated positions*

Consider convening an international roundtable of regulators, self-regulators, intermediaries, dealers, end-users and international financial institutions and academics on potential areas where structural changes are warranted and harmonization is desirable or gaps are perceived, focussing on technological changes in the structure of markets, products and market users that make such an inquiry warranted.

- *Continue to promote stronger national programs to foster the enhancement and effective implementation of internal controls*

As controls failures continue to be the source of most financial disruptions and deceptive sales practices, remind individual national jurisdictions of the various guidances on internal controls. A menu of various implementation strategies for regulators to evaluate in determining how to encourage authorized firms to develop appropriate controls were listed in IOSCO's 1994 guidance on internal controls for over-the counter products as follows:

- Adopt performance or design standards;
- Interpret existing rules to subsume management control requirements for over-the-counter business;
- Collect information from authorized firms on risks and risk management controls and policies;
- Require assessment of counterparties by authorized firms;
- Require management assessments and regulatory examinations or auditors' reports either by internal independent audit staff or third party auditors;
- Require self-regulatory organization oversight by reference to industry standards;
- Require pre-clearance of systems and controls as part of fitness determinations; and
- Promote best practices by non-regulated market participants.

The Financial Stability Forum also has developed a map of recommendations on internal controls regarding highly leveraged institutions.

- *Provide training opportunities*

Develop a training program core curriculum specific to oversight of derivatives markets to assist regulatory authorities in addressing issues related to implementing regulatory programs that address the agreed objectives of financial regulation and to assist authorized firms in managing risks.

- *Identify bases for cooperation to address over-the-counter exposures*

Specifically identify elements of appropriate information to be shared among regulators and market authorities across exchange, over-the-counter, and cash markets upon the occurrence of a market event.

- *Provide guidance on best practices for maintaining liquidity and continue to evaluate the effectiveness of existing mechanisms to address the adequacy of the liquidity arrangements of large leveraged participants in the financial system*

Provide guidance on best practices for maintaining liquidity and continue to evaluate the effectiveness of existing mechanisms to address the adequacy of the liquidity arrangements of all large leveraged participants in the financial system to address the potential need to close out large positions held in different markets without jeopardizing market and financial stability.

- *Clarify the products, activities, and entities to which financial services law applies*

Continue to follow international work on whether, and the extent to which, certain core financial activities, the undertaking of positions or exposures over a specified amount, or the use of a specified degree of leverage by firms over a specified size should be covered by certain core requirements irrespective of the institutional structure of the financial services provider or market participant or the nature of the positions or exposures undertaken, particularly with regard to the following:

- Internal accounting, risk management and operational controls;
- Adequate liquidity, funding arrangements and credit risk controls;
- Timely documentation of transactions;
- Recordkeeping and retention; and
- The appropriate level of disclosure or reporting to regulators, counterparties, and the public.

In this context, due consideration should be given to the benefits of implementing multiple levels of regulation that can be calibrated to the regulatory requirements associated with products and markets of varying characteristics and attributes, as well as to the costs of maintaining multiple regulatory structures.

This report is intended to complement other on-going work with respect to both over-the-counter derivatives markets and highly leveraged institutions, such as (i) the President's Working Group on Financial Markets reports on *Hedge Funds, Leverage, and the Lessons of Long Term Capital Management* (April 1999) and *Over-the-Counter Markets and the Commodity Exchange Act* (November 1999), (ii) the BCBS reports on *Banks' Interactions with Highly Leveraged Institutions* (January 1999), *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999), and *Banks' Interactions with Highly Leveraged Institutions: Implementation of the BCBS's Sound Practices Paper* (January 2000); (iii) the report of the IOSCO Technical Committee on *Hedge Funds and Other Highly Leveraged Institutions* (November 1999); and (iv) the *Report of the Working Group on Highly Leveraged Institutions* of the Financial Stability Forum. Those reports address many of the issues raised and are pursuing some of the areas that are the subject of recommendations in this report in the context of United

States domestic over-the-counter derivatives markets or with respect to highly leveraged institutions specifically. Many of the suggestions contained in this Working Paper have been taken forward in these forums.

The CFTC's *1999 Survey of the Regulation of Over-the-Counter Derivatives* is attached for reference.