United States
Commodity Futures Trading Commission

REGULATION OF OVER-THE-COUNTER DERIVATIVES TRANSACTIONS

1999 SURVEY

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Office of International Affairs
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

Telephone: (202) 418-5645
Facsimile: (202) 418-5548
E-mail: <international@cftc.gov>
WWW: <www.cftc.gov>

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1999 Survey of Regulation of Over-the-Counter Derivatives Transactions

Preface

This Survey of Regulation of Over-the-Counter Derivatives Transactions examines the regulatory regimes in 16 jurisdictions across Europe, Asia, and North and South America, and summarizes how these jurisdictions' regulatory regimes address (or do not address) those transactions.

The survey responses indicate a number of approaches.[‡] In some cases, regulation is largely confined to the prudential regulation of financial intermediaries and is not differentiated by product. In others, most products are subject to regulation, but certain transactions between specified counterparties are exempted or prohibited.

This report is intended to serve as a resource to make existing requirements with respect to over-the-counter (OTC) derivatives transactions more accessible and to facilitate further study of the appropriate regulatory treatment of OTC derivatives transactions.

The information provided in this report is a summary of the responses and materials submitted by various surveyed foreign regulatory authorities to a questionnaire provided by CFTC's Office of International Affairs (OIA). This document is based on information submitted and reviewed by staff of the participating foreign authorities. It has not been reviewed by the Commission and should not be referred to as an opinion of the CFTC or CFTC staff. It should also not be used or relied on for legal analysis of the underlying law. Such analysis requires consulting source material, a partial list of which is included. To complete portions of this report, the staff of the Office of International Affairs has interpreted some materials submitted by respondents and has consulted with contributors on the presentation of the information received. Any errors of interpretation are solely the responsibility of OIA.

[‡] There may be a number of explanations for differences in regulatory structure and practice among jurisdictions. These include:

- the different nature and structure of markets – for example, pit trading as compared to screen-based or other electronic trading mechanisms;
- the different nature and design of products and/or transactions;
- different cultural and national customs and practices;
- legal or juridical distinctions among jurisdictions – for example, differences between common law and civil law jurisdictions, public and private markets, and universal banking and non-universal banking or mixed jurisdictions; and
- historically, different legal implications of specified conduct – for example, in some jurisdictions, concerns related to anticompetitive practices are a fundamental aspect of the regulatory system.

SUMMARY CHART
OTC DERIVATIVES TRANSACTIONS
REGULATORY AUTHORITIES AND LIMITATIONS

JURISDICTION	RESPONSIBLE REGULATORY AUTHORITY (IES)	COUNTERPARTY LIMITATIONS*	PRODUCT LIMITATIONS
AUSTRALIA	Australian Securities and Investments Commission (all consumer protection issues for all financial services providers, including life insurance and superannuation; supervision of securities firms, including market integrity oversight and payment systems) and Australian Prudential Regulation Authority (prudential supervision of banks and deposit-taking institutions and life insurance and superannuation issuers).	On certain retail transactions and on brokered transactions.	No limit as to reference prices – if cleared, however, not regarded as "OTC" or subject to treatment as exempt futures market. Most OTC derivatives contracts are defined as "adjustment contracts" (contracts for differences), which are defined as "futures."
BELGIUM	Banking and Finance Commission (banks and investment firms), Insurance Supervisory Board (insurance firms).	None, but the use of OTC derivatives and swap structures by authorized collective investment schemes (CIS) is restricted.	None (OTC transactions are generally bilateral).
BRAZIL	Commissão de Valores Mobilierios (equity, including OTC equity and equity index products), Banco Central de Brazil (all other financial products).	Third parties must transact opposite a regulated intermediary; no foreign investors.	OTC products only permitted on certain listed financial products, not including commodities and mutual fund shares; products must be found to serve an economic purpose.
CANADA	Office of Supervision of Financial Institutions (banks and some insurance).	None.	Bank's ability to use products requiring delivery of certain physical commodities within the bank may be limited.
ONTARIO	Ontario Securities Commission (securities firms).	Only if regarded as securities and not exempt.	None.
QUÉBEC	Commission des Valeurs Mobilières du Québec (securities firms).	None, except on certain retail transactions.	None.
FRANCE	Commission des Operations de Bourse (CIS and information sharing), Conseil des Marchés Financiers, a self-regulatory organization (SRO), (general principles for market operations, conduct of business), Commission Bancaire (prudential supervision of all investment services providers), Comité des Établissements de Crédit et des	None, but the use of OTC derivatives and swap structures by authorized collective investment schemes (CIS) is restricted.	None.

* This category does not relate to restrictions based on credit limits.

JURISDICTION	RESPONSIBLE REGULATORY AUTHORITY (IES)	COUNTERPARTY LIMITATIONS	PRODUCT LIMITATIONS
FRANCE [CONT'D]	Entreprises d'Investissement (licensing of all investment services providers), Comité de la Réglementation Bancaire et Financière (prudential rules for all investment services providers).		
GERMANY	Bundesaufsichtsamt für den Wertpapierhandel (BAWe) (investment service providers, conduct of business for all financial service providers -- including providers of OTC products -- information sharing), Bundesaufsichtsamt für das Kreditwesen (interpretations of prudential rules and prudential supervision of credit and financial institutions), Hessisches Ministerium für Wirtschaft, Verkehr und Landesentwicklung (local exchange supervision).	Certain parties are restricted in the use of derivatives (*e.g.*, CIS, insurance companies, mortgage banks) and unsophisticated persons must receive appropriate disclosure before engaging in derivatives transactions.	None; there are laws, however, which may affect the enforceability of OTC derivatives contracts primarily with unsophisticated persons for whom appropriate disclosure has not been made.
HONG KONG	Securities and Futures Commission (all business conducted by securities and futures dealers, leveraged forex traders authorized by the SFC, prudential supervision and market integrity oversight, clearing and settlement systems supervision), Hong Kong Monetary Authority (authorized institutions, including banks and deposit-taking companies).	None.	Some restrictions apply to OTC options on listed securities. "Futures" are defined as exchange-traded only.
ITALY	Commissione Nazionale per le Societa e la Borsa (CONSOB) (market regulation for financial instruments, conduct of business for all intermediaries including banks), Bank of Italy (supervision of government securities market), Bank of Italy, in consultation with CONSOB (prudential regulation for all intermediaries including investment firms), Ministry of Treasury (rules affecting government securities). Italy treats all commodity derivatives as financial instruments.	None.	None, except "futures" ordinarily are considered to be exchange-traded.
JAPAN	Ministry of Finance and Prime Minister [Financial Revitalization Commission (as of Dec. 15, 1998)] authorizes markets in financial futures and securities; Financial Supervisory Authority (FSA) (supervises, licenses, inspects all financial institutions,); Ministry of International Trade and Industry and Ministry of Agriculture, Forestry and	None.	None, except commodity derivatives priced off of trades on an exchange are prohibited until April 1999.

JURISDICTION	RESPONSIBLE REGULATORY AUTHORITY (IES)	COUNTERPARTY LIMITATIONS	PRODUCT LIMITATIONS
JAPAN [CONT'D]	Fisheries (each authorizes commodity futures markets). Interest rate, currency swaps are not regulated, but subject to FSA authority. Securities and Exchange Surveillance Commission (conducts investigations, addresses fairness of securities and financial futures trading).		
THE NETHERLANDS	Securities Board of The Netherlands (investment firms), Dutch Central Bank (credit institutions and CIS).	None.	No limits except on uncleared OTC transactions that use specifications of derivative products listed on Amsterdam Exchanges.
SPAIN	Comision Nacional del Mercado de Valores (investment firms and CIS managers), Bank of Spain (banks), Insurance General Directorate (insurance).	None, but the use of derivatives by CIS is restricted, and special risk disclosures and internal control procedures are required to be in place.	None, except for CIS that can exclusively trade on derivatives listed in their applicable rules.
SWEDEN	Finansinspektionen (all matters – financial capacity and conduct of business).	None.	Any non-standardized, non-exchange-traded product is defined as OTC and there are no limits on reference prices.
SWITZERLAND	Swiss Federal Banking Commission (securities dealers, banks and investment firms).	None.	None, generally bilateral.
UNITED KINGDOM	Financial Services Authority (all financial service providers); residual authority remains in Securities and Futures Authority (SFA), Investment Management Regulatory Organization (IMRO), Personal Investment Authority (PIA), and Insurance Directorate until phased out by 2000.	None, subject to suitability and risk disclosure.	None.

SUMMARY CHART
OTC DERIVATIVES TRANSACTIONS
REGULATORY REQUIREMENTS AND PROPOSALS

JURISDICTION	LICENSE OR AUTHORIZATION REQUIREMENTS	PRODUCT SPECIFIC REQUIREMENTS	RELEVANT REPORTS & DEVELOPMENTS
AUSTRALIA	"Futures" license or exemption required for OTC products, except currency and interest rate forwards to which a bank is a party. Marketmaking OTC dealers and interdealers in OTC products must be authorized or exempted	Yes, to be treated as exempt from exchange requirements. Otherwise, no specific requirements, but disclosure, and capital must take account of OTC risks.	1994 report by The Companies and Securities Advisory Committee. *See also* Wallis Report on Structure of Financial Regulation.
BELGIUM	Providing investment services in financial instruments, including OTC, requires the prior granting of a license as a bank or investment firm. Dealing for one's own account is covered if it is carried out in such a way that it is a service to other market participants.	With regard both to banks and investment firms, no specific requirements, except for CIS – disclosure, internal controls, capital must take account of nature of instrument – valuation methodology must be disclosed and OTC liabilities must be disclosed in financial reports.	New proposals for commodity-linked instruments and CIS are being contemplated for future development.
BRAZIL	One party must be a commercial bank, investment bank or brokerage firm licensed with Central Bank and must specify technically qualified director for risk management.	Yes, for internal controls, design, recordkeeping and reporting of impact on capital. Also, all OTC transactions must be registered with an authorized registering system	Exposure drafts are contemplated.
CANADA	None if solely OTC.	No specific regulations – safety and soundness provisions such as capital, internal controls must reflect risks of derivatives, including OTC.	MacKay report on general structure of financial system.
ONTARIO	None unless OTC derivative is considered security, then registration is required unless exemption applies subject to "universal registration" requirement.	None.	Proposal based on 1994 report to include more products within securities regulatory framework pending since 1996; re-proposed December 1998.
QUÉBEC	None unless doing investment business (which includes OTC financial derivatives) and dealing activities are not limited to sophisticated counterparties or purchasers.	None.	None.
FRANCE	None, if acting for self. Yes, for any investment business (agency, dealing) which includes dealings on swaps, forwards and futures.	No special regulations except capital rules reflect risks based on nature of instrument.	1993 Report of Commission Bancaire.
GERMANY	None, if acting for self. Yes, if agency or dealing transaction, or otherwise engaging in investment business.	Generally no. There is an advisory on duties for banks engaging in trading transactions, including OTC business; capital requirements reflect risk of OTC business.	January 1, 1999 new insolvency code.

JURISDICTION	LICENSE OR AUTHORIZATION REQUIREMENTS	PRODUCT SPECIFIC REQUIREMENTS	RELEVANT REPORTS & DEVELOPMENTS
HONG KONG	License required for dealing in securities, including OTC. Exemption may apply if dealing only with licensed or professional persons.	All general requirements apply – including code of conduct and guidance on internal controls. Leveraged forex trading is governed by a separate statute with different requirements.	Securities and futures markets legislation to be consolidated and reformed via new legislation in 1999; recent survey on securities and futures intermediaries activities; and amendments to the Securities (Disclosure of Interests) Ordinance.
ITALY	None, if acting for self. If providing investment services on a professional basis (*e.g.*, agency or dealer transactions or asset management), must be licensed as a bank, investment firm or asset manager.	OTC products are regulated only if conducted on "organized" (*i.e.*, that is not "regulated") markets and not if individually-negotiated, non-standardized products. If sold to more than 200 persons, product is deemed regulated. Otherwise, no product-specific rules except capital rules which take into account OTC risk. However, conduct of business rules apply to all investment firms dealing with OTC derivatives.	None.
JAPAN	If OTC derivatives are securities-related, then license is required for either one party or the agent; if commodity derivatives, then registration is required for either party. Securities companies must be authorized to conduct other OTC derivatives transactions.	No specific requirements; if concluded by banks, subject to banking law. Participants in negotiated transactions, however, are encouraged to address appropriate disclosure to "customers." Some special disclosures as to valuation have been recommended, as has IOSCO guidance on risk management.	Recommendations of the Securities and Exchange Council to reform securities market. New insolvency law. Expansion of permitted OTC products.
THE NETHERLANDS	If solely individually tailored OTC – none. To conduct any kind of investment business (agency, dealing), including OTC, must be licensed as credit institution or investment firm.	No product-specific requirements, except that capital rules reflect specific risks.	None.
SPAIN	None, if acting for self. To conduct any investment business (agency or dealing), including OTC financial products, must be licensed as a bank or investment firm.	No product-specific requirements, except for CIS and that capital rules reflect specific risks. Accounting and disclosure rules and internal control guidelines address derivatives risk generally.	None.
SWEDEN	Banks or securities firms that have authorization to trade financial instruments generally.	No product-specific requirements, although capital requirements reflect OTC risk. Accounting and disclosure rules and internal controls guidelines address derivatives risk generally.	None.

JURISDICTION	LICENSE OR AUTHORIZATION REQUIREMENTS	PRODUCT SPECIFIC REQUIREMENTS	RELEVANT REPORTS & DEVELOPMENTS
SWITZERLAND	None, if *only* individually tailored OTC transactions. Otherwise, if a contract with the same structure and denomination is publicly offered or placed with more than 20 customers, it is considered to be suitable for mass trading, and then investment business licensing requirements apply. Licenses are conditioned on the ability to address OTC risks.	No product-specific requirements, but capital rules, risk management guidance, and reporting rules address derivatives risk generally.	The first part of the Federal Act on Stock Exchanges and Trading in Securities (SESTA) went into effect February 1, 1997; the second January 1, 1998.
UNITED KINGDOM	None to handle contracts for commercial purposes (defined generally as delivery to be made in 7 days). Cannot deal, manage or advise, whether or not OTC derivatives, unless authorized, exempt or excluded or an individual acting as a principal opposite an authorized, exempt or overseas person. Authorized persons are – currently SFA, IMRO, PIA-supervised persons (broker-dealers, fund managers, insurance, law and independent financial advisors, respectively) or FSA-supervised banks. Exempt persons, currently are – wholesale money market institutions (in general banks) engaging in money market, bullion, and certain OTC transactions in excess of £500,000.	No product-specific requirements except licensed firm disclosure, capital, internal controls address OTC risks. Also position reporting to SFA includes OTC as well as exchange-traded derivatives positions.	New provisions on insolvency and OTC clearing; Financial Reporting Standard 13: UK Accounting Standards Board, "Derivatives and Other Financial Instruments Disclosures," September 1998.

1999 SURVEY OF REGULATION OF OVER-THE-COUNTER DERIVATIVES TRANSACTIONS

Overview

The Office of International Affairs surveyed 16 major jurisdictions[1] regarding the current status and scope of national regulation of over-the-counter (OTC) derivatives transactions. The intention of conducting this survey was to produce a resource on contemporary regulation of OTC derivatives outside of the United States.[2] This report compiles materials received in response to a questionnaire first distributed in January 1998, and is current as of its date of issuance.

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[1] Australia, Belgium, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, The Netherlands, Ontario, Québec, Spain, Sweden, Switzerland, and the United Kingdom. Mexico's Comision Nacional Bancaria y de Valores, which indicates that Mexico addresses OTC derivatives instruments primarily by intermediary, rather than product-based supervision, was also asked to contribute to the report. However, as Mexico's law is evolving, the CNBV indicated an interest in participating at a later date.

Note with regard to the Australian entries. As of July 1, 1998, the Australian Securities Commission (ASC), officially became the Australian Securities and Investments Commission (ASIC), which has retained all of the ASC's functions, and has gained responsibility for consumer protection in relation to all financial services and financial products, among other new regulatory responsibilities. The newly-created Australian Prudential Regulation Authority supervises the prudential regulation of life insurance or superannuation issues and also supervises the prudential standards for banks and other deposit-taking financial institutions domiciled in Australia.

Note with regard to the Canadian entries. Entries from Canada include responses from the Office of the Superintendent of Financial Institutions (OSFI), the Ontario Securities Commission, and the Québec Securities Commission (Commission des valeurs mobilières du Québec). OSFI is the agency of the federal government of Canada responsible for the regulation of banks and federally chartered insurance and trust companies, pursuant to Canadian federal laws. In Canada, banks may only be chartered at the federal level, while insurance and trust companies may be chartered at either the federal or provincial levels. OSFI is a prudential regulator with indirect interest in conduct of business issues. Regulation of the securities industry in Canada is a provincial responsibility. The provincial and territorial securities regulators cooperate through the Canadian Securities Administrators (CSA) to facilitate coordinated development of policies and legislation across Canada. The CSA is made up of the securities regulatory authorities of each of the Canadian provincial territories. The role of the CSA is to encourage a high level of national harmony in securities regulation. This forum has helped to bring substantial uniformity to legislation in Canada. References in the report to "Canada" refer to responses provided by OSFI, while references to "Ontario" and "Québec" refer to responses provided by the Ontario and Québec Securities Commissions, respectively.

Note with regard to Japan. As of June 22, 1998, the Financial Supervisory Agency, under the Prime Minister's Office [Financial Revitalization Commission as of December 15, 1998], has been responsible for inspecting and supervising all private financial institutions (including commercial banks, insurance companies, securities companies, non-banks and other private institutions dealing with financial transactions). The Ministry of Finance retains authority over formulating securities regulation, supervision of securities markets, and disclosure.

Note with regard to the United Kingdom. In 1997, the UK Government began a process of regulatory reform. When this is complete, most likely in the year 2000, the Securities and Futures Authority (SFA), Investment Management Regulatory Organization (IMRO), and Personal Investment Authority (PIA), will cease to exist and responsibility for regulation of all authorized persons will be transferred to the Financial Services Authority.

[2] A review of OTC derivatives regulation in the United States is contained in *The Report of the Commodity Futures Trading Commission OTC Derivatives Markets and Their Regulation: Working Papers* (1993).

The report should not be considered a legal analysis of the underlying law[3] or referred to as an opinion of the CFTC or CFTC staff. Analysis of survey responses is complicated by the fact that different jurisdictions use the same terms to mean different things.[4] In fact, it would be difficult to overestimate the complexity of describing the regulatory treatment of over-the-counter derivatives in most jurisdictions.

Most jurisdictions described a system in which OTC derivatives are permitted financial products. Counterparties who seek to engage in tailored OTC transactions subject to corporate charter, foreign investment limitations or other special laws directed to the class of counterparty (*e.g.*, insurance, pensions) generally can do so and are not required to be licensed. Some jurisdictions, however, indicated that they impose additional requirements on, or limit or prohibit, OTC transactions with retail or unsophisticated counterparties. Others report special requirements for collective investment schemes (CIS). Still others report lesser requirements for wholesale or professional markets, or different requirements for derivatives based on commodities than for those based on financial instruments. But, for the most part (although the Australian approach is market-based and Japan currently restricts transactions in certain products), OTC transactions are not regulated through market or product-based requirements, but through prudential and conduct regulation of the financial institutions (*e.g.*, banks, securities or futures brokers) which ordinarily act as counterparties to, at least, one side of such transactions. In jurisdictions where banking and securities activities are required to be conducted in separate entities, often the business is booked in a bank, and sales are accomplished through such banks' securities subsidiary, with each entity being subject to its own institutional requirements.

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[3] *See* Sources Consulted or Noted in Responses *infra* p. 87. Note: all internal references within this report are to section beginnings in order to better facilitate comparisons among differing regulatory approaches.

[4] For purposes of this paper, an OTC derivative is defined as a contract, the value of which is based on an underlying reference price or index (which could be a financial instrument, an equity or a commodity, and could include swaps, forward rate agreements, options and hybrid constructions), that is not concluded on a regulated market. (Some jurisdictions consider OTC derivatives to include transactions in organized but unregulated markets, others limit OTC derivatives to bilateral, individually negotiated transactions). Most jurisdictions describe forwards as derivatives; generally, this does not include currency forwards or spot transactions. In some jurisdictions (*e.g.*, Italy), commodity derivatives, are included in the term "financial instruments."

Note that in the EU, the term "regulated market," as defined in Article 1 of the *Investment Services Directive*, Council Directive 93/6/EEC (15 March 1993),means:

> A market for the instruments listed in Section B of the Annex [financial instruments not including commodities] which:
>
> - Appears on the list provided for in Article 16 drawn up by the Member State which is the home Member State as defined in Article 1 (6)(c),
> - Functions regularly,
> - Is characterized by the fact that regulations issued or approved by the competent authorities define the conditions for the operation of the market, the conditions for access to the market and, where Directive 79/279/EEC is applicable, the conditions governing admission to listing imposed in that Directive and, where that Directive is not applicable, the conditions that must be satisfied by a financial instrument before it can effectively be dealt in on the market,
> - Requires compliance with all the reporting and transparency requirements laid down pursuant to Articles 20 and 21.

The manner in which OTC transactions are characterized under applicable financial services law also differs. In the European Union (EU),[5] OTC financial derivatives transactions (not including currency forwards and commodity derivatives) would be considered investment business pursuant to the *Investment Services Directive* (ISD),[6] but in Ontario, for example, the law only recently clarified that OTC derivatives could be treated as securities. In Australia, most would be classified as futures (except when executed opposite a bank), while in Hong Kong and Italy, futures are considered to be exchange-traded instruments. A recent court case in Australia suggests that an instrument can be regulated as either, or both, a security and a future if it can be said to meet both definitions. Further, Australia and Hong Kong currently define, and Ontario proposes to define, cleared derivatives transactions as not eligible for exemptions accorded to OTC transactions. In contrast, Sweden and The Netherlands currently have operating OTC clearing systems, while the UK contemplates clearing OTC derivatives, and would define such activity as investment business.

The regulation of OTC derivatives is a rapidly evolving area. In this connection, special attention should be paid to the section on Recent and Contemplated Changes.[7] A brief summary of survey responses follows; more detailed answers are provided separately for each participating jurisdiction.

Types of Over-the-Counter Derivatives Transactions Permitted

Permitted Transactions

Most jurisdictions reported that they did not have product-based restrictions or that current restrictions were being lifted, subject to general public policy restraints. In some jurisdictions, non-standardized, bilateral OTC transactions, or transactions in currency and interest rates between licensed counterparties or banks, are not regulated at all. A few jurisdictions indicated that OTC transactions are not permitted for particular classes of customer.

For example, Hong Kong made special note of a prohibition barring dealers from conferring an option on a security listed on the Stock Exchange of Hong Kong Ltd., except as provided in related regulations. Under Canadian federal banking law, there may be some limitations on the types of commodities on which banks can take delivery within the bank itself. Australia and Hong Kong define, and Ontario proposes to define, "permitted OTC contracts" as "non-cleared." Ontario has new legislation that permits

[5] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden and the United Kingdom. Ireland, Liechtenstein and Norway, which are members of the European Economic Area, are treated as members of the EU for purposes of the *Investment Services Directive* and the *Capital Adequacy Directive*, Council Directive 93/22/EEC (10 May 1993), pursuant to the Agreement on the European Economic Area, 1994 O.J. (L 1) 3.

[6] *Investment Services Directive*, Annex Section B.

[7] *See infra* p. 73.

certain derivatives to be treated as securities. Japan has liberalized restrictions on OTC equity derivatives and expects to remove restrictions on commodities in the future.

USE OF HYBRID TRANSACTIONS IN OTC DERIVATIVES

Participating jurisdictions were asked whether they permitted hybrid instruments[8] (*i.e.*, OTC derivatives that are part futures, forwards, contracts for differences, or futures options, and part deposit or debt or equity security). No surveyed jurisdiction reported an explicit regulatory definition of hybrid transactions, although Spain requires deconstruction of hybrids into their component parts for certain purposes (*e.g.*, risk management) in its CIS regulations. An Italian legislative decree includes in the definition of derivatives a combination of contracts and securities, and Ontario's proposed rule may cover certain debt-like structures that could be considered hybrids.

AUTHORIZATION AND LICENSING OF COUNTERPARTIES IN OTC TRANSACTIONS

In general, licensing or authorization requirements are applied to firms, not products.[9] In the EU and in Japan, however, a home country can determine whether or not to license a particular entity for a full range of financial services or whether to restrict such entity's ability to conduct OTC business based on an assessment of fitness and properness and the capacity of the entity to undertake such business. In Japan, a special authorization is needed for securities firms to engage in OTC transactions.

More particularly, for example, France, Germany, Italy, Sweden and the UK responded that they have no licensing requirements specifically directed to OTC counterparties, but that firms must be licensed as investment firms or credit institutions to engage in investment business, and that agency or dealing transactions in OTC financial derivatives are considered investment business under the European Union's *Investment Services Directive*. Thus, a firm engaged solely in non-own account OTC financial derivatives transactions would be required to be authorized in EU Member States. In Germany, for example, such a firm would be required to be authorized by the Federal Banking Supervisory Office (Bundesaufsichtsamt für das Kreditwesen or BAKred) under Section 32 of the Kreditwesengesetz (KWG, the German "*Banking Act*"). However, for firms engaged solely in OTC transactions in physical commodity derivatives, for which there is no EU "passport," requirements can differ from jurisdiction to jurisdiction. Sweden noted that while a license is not necessary for non-professional trading of OTC derivatives, irrespective of the counterparty, a license, though not required for OTC transactions *per se*, is required for professional transactions as part of an investment business (those conducted by investment firms or credit institutions). Switzerland specifically responded that a license was required for securities dealers involved in "standardized securities suitable for mass trading" not especially created for single counterparties and which includes products offered to 20 or more persons; in

[8] The survey questionnaire defined "hybrid instrument" as "an equity or debt security or depository instrument with one or more commodity-dependent components that have payment features similar to commodity futures or commodity option contracts or combinations thereof."

[9] This contrasts, however, with the Australian "exempt futures market," and Brazilian approach.

Italy the number is 200. The UK indicated that it applies more limited requirements to certain markets of professional traders known as wholesale markets. Hong Kong reported that no license is required for those who deal exclusively with other licensed persons.

Australia, Belgium, Hong Kong and Ontario (for derivatives that are securities) indicated that they have authorization requirements for those seeking to intermediate or to provide advice concerning OTC transactions. A firm which only provides advice, and is not otherwise involved in investment business activities, may not need a license in certain EU countries. In Belgium and other European Union countries, market making or regularly offering to act as a counterparty requires licensing; pure proprietary ("own account") trading does not require licensing.

Germany and the UK reported special requirements where investment firms are opposite unsophisticated counterparties, and Australia answered that unsophisticated counterparties are not allowed to trade under its exempt futures declaration and thus must use exchange markets.

Prohibitions on Counterparties or on Engaging in OTC Derivatives Transactions

In general, there are three basic approaches: (1) no restrictions on counterparties, except under general contract or company law; (2) conditions on retail counterparties or CIS that are either limited to such counterparties or more comprehensive than those related to other counterparties; and (3) prohibitions on transacting by non-professional counterparties.

France, Germany, Italy, and Ontario and Switzerland had no prohibitions, and indicated no limits on individuals engaging in OTC derivatives transactions, although special disclosures are required when transacting opposite an unsophisticated counterparty in Germany and similar requirements are being proposed for certain transactions in Ontario. Belgium indicated that specific categories of persons were not authorized to act as counterparties, while Australia reported that only specific categories of persons *were* authorized to act as counterparties and that there should be *no* over-the-counter trading with unsophisticated counterparties; other jurisdictions (Québec, UK) reported certain categories were exempt from regulation. In addition, Belgium noted that certain counterparties may be restricted from concluding OTC derivatives transactions by limitations contained in corporate charters or special laws applicable to particular classes of entities. Germany reported that certain counterparties may be restricted by similar limitations contained in corporate charters or special laws.

Identification of Responsible Authorities and Applicable Rules to OTC Derivatives Transactions

Respondents were asked to indicate the agency (including any self-regulatory organization or commercial association) that regulates or supervises OTC derivatives transactions in their jurisdiction with regard to prudential supervision/financial capacity, conduct of business, legality of transactions, and market making, administration of collateral, and netting and clearing.

The relevant oversight or supervisory agency varies from jurisdiction to jurisdiction (*see* Summary Chart *supra* p. vii). In some jurisdictions, banks and securities firms are supervised by the same entity. In others, prudential regulation and sales practice regulation is divided between bank and securities agencies and coordinated between them. In others, rulemaking and supervision is divided. In still others, matters like internal controls are set through guidances and endorsed by self-regulatory organizations.

PRUDENTIAL SUPERVISION/FINANCIAL CAPACITY

Prudential regulation, or regulation of financial capacity generally, applies to the regulated financial institution, as a whole, and not to specific products. However, the risk of an OTC product is weighted differently from an exchange derivative in most jurisdictions. Ontario employs a system involving both government and non-government entities, in which the former regulates OTC derivatives traded by banks and other financial institutions, and the latter monitors the activities of member dealers involved in such transactions.

CONDUCT OF BUSINESS

In general, conduct of business rules are applied to agency-type businesses, businesses between counterparties of unequal bargaining power, or between professional and unsophisticated counterparties although, in certain jurisdictions, no sales practice rules apply to banks. Australia, Germany, Hong Kong, Italy, Sweden and Switzerland indicated government regulatory bodies execute business conduct supervision. In France, conduct of business supervision is handled by a self-regulatory organization. Germany also answered that counterparties were charged with ascertaining the capacity of primarily unsophisticated counterparties to enter into a transaction.

LEGALITY OF TRANSACTIONS[10]

France, Hong Kong, Italy, Japan, and Switzerland indicated national government agencies have responsibility for supervising transactions in OTC derivatives. In general, however, supervision of OTC contract terms is not the province of regulation. For example, Australia, Belgium, and France have no specific rules, but indicate that general laws of contract and limitations on corporate charters apply and that transactions will not be set aside unless the counterparty knew the transaction was invalid. Australia proposes to clarify further that transactions that take place on an unauthorized market are not void. Germany indicated that wagering laws will not invalidate an OTC transaction provided certain requirements set forth in the Börsengesetz (BorsG, the German "*Stock Exchange Act*") are met or if the transaction is for hedging purposes. Italy and the UK also report that otherwise applicable wagering laws do not affect OTC transactions negotiated as part of investment services. Sweden's regulation or supervision of OTC transactions is conducted through supervision of investment firms or credit institutions.

[10] *See infra* note 34 and accompanying text.

MARKET MAKING, ADMINISTERING COLLATERAL, NETTING CASH FLOWS, CLEARING

Although most jurisdictions responded that no specific rules were applicable to market making and administering collateral, France and Germany noted that market professionals were responsible in this area. Germany, specifically, indicated that the counterparties to a transaction negotiate issues such as collateral using standard master agreements. In general, International Swaps and Derivatives Association (ISDA) master agreements address handling of collateral and netting. In Australia exempt futures markets (*i.e.*, OTC markets) are prohibited from having clearing facilities. Sweden, in contrast, would permit such clearing, and the EU Directives propose to provide that equivalent capital treatment can be applied to cleared OTC and on-exchange derivative contracts.

TRANSACTIONS OCCURRING OVER MULTILATERAL ELECTRONIC EXECUTION FACILITIES

Of the jurisdictions surveyed, only France and Sweden indicated the existence of multilateral electronic execution facilities for certain OTC transactions. Most responses indicated that such facilities were not yet in existence, except in cash markets, or were currently being explored. Australia indicated that screen-based systems for posting prices, such as for "plain vanilla" swaps, are increasingly common.

CLEARING FACILITIES USED FOR OTC DERIVATIVES TRANSACTIONS

Sweden and The Netherlands described functioning clearing systems for OTC transactions. Hong Kong indicated delivery of stocks or bonds related to OTC transactions can be made through its central stock or bond clearing systems. Among the other jurisdictions, Belgium, Italy, Spain and Switzerland reported efforts at exploring or developing appropriate systems for electronic matching and clearing facilities (*e.g.*, the Continuous Linked Settlement system). Brazil reported that it permits registration of OTC derivatives transactions with the Brazilian Commodities and Futures Exchange, and that these transactions may be cleared for an additional fee. In the UK, the London Clearing House has well-advanced plans to offer swap clearing.[11]

REGULATORY REQUIREMENTS

Respondents were asked to indicate whether a number of possible regulatory requirements were applied specifically to OTC transactions: design of transaction; custodianship of collateral; use or hypothecation of collateral; means of valuation of the transaction; disclosure of valuation methodology; other disclosure requirements; conduct of business generally (*i.e.*, pricing,

[11] *See* descriptions of clearing, settlement, or collateral management arrangements listed in Annex 4 of *OTC Derivatives: Settlement Procedures and Counterparty Risk Management*, 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, BANK FOR INTERNATIONAL SETTLEMENTS (Sept. 1998) (*e.g.*, S.W.I.F.T. (Society for Worldwide Interbank Financial Telecommunication), Londex International: OPEX, Cedel Bank: Global Credit Support Service (GCSS), Euroclear: Integrated Triparty Derivatives Support (ITDS)).

conflicts of interest); capital; internal controls of counterparties; documentation; recordkeeping; financial reporting; and insolvency. In general, requirements specific to OTC derivatives were few, although capital requirements distinguish between OTC and exchange counterparty risks.

Transaction Design

In general, there are no requirements related to OTC transaction design. Australia, however, reported five criteria that transactions in exempt futures markets must meet; that is, markets where futures-type instruments (*e.g.*, contracts for differences) can be traded OTC. Brazil reported that special approval was required for contracts not explicitly listed in the rules.

Custody of Collateral

None of the respondents reported special custody requirements for OTC collateral by credit institutions and investment firms.

Use or Hypothecation of Collateral

None of the respondents cited special requirements for OTC products. Canada's OSFI noted, however, that approval is generally required from it before assets may be pledged by a banking institution.

Means of Valuing a Transaction

Several jurisdictions reported general prudential requirements consistent with Basle. Australia, and France reported no specific requirements for valuing OTC transactions. Belgium did not indicate any particular means requirements, but did note that instruments held by credit institutions and investment firms that do not have a liquid market are valued differently from instruments that do have such a market. Germany, Hong Kong, Sweden and Switzerland reported the existence of means requirements. In Italy, specific requirements on valuation are provided for collective investment schemes and portfolio management services.

Disclosure of Valuation Methodology

Regulators generally have access to all information relating to a regulated institution or intermediary. Australia, France and Italy did not indicate any disclosure requirements for valuation methodology. Belgium requires disclosure according to the characteristics of derivatives transactions, as well as disclosure to counterparties of the valuation methodology to be used. Switzerland reported that financial statements of banks and securities dealers must contain information on the valuation policies used for derivatives. In some jurisdictions, the valuation methodology only need be disclosed to the competent supervisory authority. For example, in Germany the valuation methodology has to be disclosed to the Federal Banking Supervisory Office (BAKred) by banks and certain securities firms (which are allowed to hold assets for their clients). In Hong Kong,

licensed institutions also are required to disclose their valuation methodology to authorities.

OTHER DISCLOSURE

France and Switzerland reported no special requirements. Australia indicated that an exempt futures market operator must not engage in misleading and deceptive conduct, and is required, under accounting requirements and standards, to disclose its derivatives liability. Belgium reported no special requirements for credit institutions or investment firms, but that it does require Undertakings for Collective Investment to explicitly and comprehensively indicate the risks and yield perspectives of the instruments they use, and whether a promoter or depository acts as a counterparty. Spain also reported new requirements relating to internal controls, product use and financial reporting for Collective Investment Schemes, and that disclosure to unsophisticated customers must emphasize risks (particularly for high-risk transactions). Hong Kong requires "risk disclosure" by securities and leveraged foreign exchange traders, and institutions are required to disclose when they are acting in an advisory capacity as opposed to as a principal; Italy also has adopted a "risk disclosure statement" policy. Sweden reported the existence of rules on off-balance sheet accounting, and a requirement that a customer receive written information about risks before engaging in derivatives transactions unless "manifestly unnecessary."

CONDUCT OF BUSINESS

As stated above, most jurisdictions reported no product-specific requirements. In some jurisdictions, (*e.g.*, Belgium) conduct of business requirements are satisfied if business is done on a regulated market consistent with exchange rules and client instructions. In many jurisdictions, conduct of business requirements are reduced or not applied to transactions with professional or sophisticated counterparties.

CAPITAL

In general, the basic approach to capital requirements affecting credit institutions' credit risk is that weightings for OTC derivatives should reflect the nature of the counterparty, the underlying interest, and the maturity of the instrument. Capital rules apply only to regulated entities. Therefore, in general, counterparties (unless otherwise authorized as credit institutions or investment firms or, in the case of Hong Kong, leveraged forex traders) are not subject to such rules.

With respect to market risk, proprietary models of risk are permitted in several jurisdictions, including Canada, France, the UK, and Switzerland, although discussions are ongoing (post-Asian crisis) as to whether the assumptions of these models need readjusting. (*See* Bank for International Settlement (BIS) report, "*International Banking and Financial Markets Developments*," May 1998). The EU's *Settlement Finality in Payment and Securities Settlement Systems Directive*, Council Directive 98/26/EC (May

19, 1998), would permit cleared OTC contracts to be treated like exchange-traded derivatives for capital purposes, subject to national implementation.

INTERNAL CONTROLS OF COUNTERPARTIES

Australia and Italy reported no direct requirements with regard to internal controls of counterparties. However, Australia noted that counterparty creditworthiness must be assessed and each counterparty must be subject to some form of prudential regulation, such as compliance with Basle requirements. Australia also is looking at developing requirements for some types of specialized OTC markets, such as electricity. Belgium, France, Hong Kong, Sweden and Switzerland replied that there are internal control requirements for banks and investment service providers functioning as counterparties. Belgium, Italy and Spain also noted particular requirements for CIS. With the exception of capital adequacy rules, generally, there were no differences between the required institution-based controls reflecting the types of financial products traded. Both the Committee on Banking Supervision[12] (Basle) and the Technical Committee of the International Organization of Securities Commissions[13] (IOSCO) have published guidance on internal controls and risk management for derivatives and OTC derivatives, respectively, in 1995, which some jurisdictions have adopted into law, and others (*e.g.*, Japan) refer to for guidance. Additional guidance by these international organizations was published September 1998.

DOCUMENTATION

In general, documentation requirements are not particular to OTC derivatives. In practice, industry standards in most jurisdictions favor use of the relevant ISDA Master Agreement.

RECORDKEEPING

In general, recordkeeping requirements are applied to regulated institutions irrespective of the financial product carried or traded. Notwithstanding the fact that certain OTC derivatives markets are considered exempt markets in Australia, the ASIC normally requires an audit trail-type record of transactions in such markets.

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[12] The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, The Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

[13] The Technical Committee of IOSCO is a committee of the supervisory authorities for securities firms in major industrialized countries. It consists of senior representatives of the securities regulators from Australia, France, Germany, Hong Kong, Italy, Japan, Mexico, Ontario, The Netherlands, Québec, Spain, Sweden, Switzerland, the UK, the US, and Malaysia and Argentina as chairs of the Emerging Markets and Executive Committees.

FINANCIAL REPORTING

In general, financial reporting requirements are applied to institutions, not products. However, accounting standards do address specific instruments. For example, the Australian, French and Canadian accounting bodies have each released a standard with special requirements for financial instruments, both on and off-balance sheet.

Belgium requires that OTC instruments be included specifically in the financial reports of credit institutions and investment firms, and that promoters or depositaries acting as counterparties must be so indicated in periodic reports and prospectuses. Japan recommends that qualitative information on derivatives be provided and, in Switzerland, requirements for the treatment of OTC and exchange-traded derivatives are set forth in Guidances regarding the preparation of the financial statements issued by the Swiss regulator. The UK's new accounting standard also requires reports on OTC positions.

In 1995, Basle 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 disclosures. A 1996 survey of derivatives activities of major G-10 banks and securities firms based on the Framework, the responses to which are voluntarily provided, indicates substantial disparities in public disclosures on derivatives. The 1997 survey reflects improvements in disclosures reflective of recommendations made in the Framework, but also continues to demonstrate disparities in the type and usefulness of the information disclosed. In 1998, the Framework was expanded to address more comprehensively the market risk exposure arising from trading in both cash and derivatives instruments. It is expected that the next framework will be modified further, following consultation, to add additional information addressing risk management practices and exposures.

INSOLVENCY

Many jurisdictions indicated that insolvency law was not directed to specific products. France responded that insolvency law is a part of French commercial law and applies to all institutions. Similarly, Switzerland reported that general insolvency laws are currently used, although changes to address financial institutions are contemplated. In Canada and Italy, however, specific reference to derivatives products is made. Several jurisdictions, according to legal opinions provided by independent counsel to ISDA, permit closeout netting in insolvency. France, Japan, Spain and Sweden, for example, have explicit legislation. Germany and the UK are clarifying that such netting is valid for purposes of insolvency, or expanding the reach of such provisions. Where bilateral netting is available and valid, the EU capital directives regard it as risk reducing and provide capital concessions for the counterparty institution.

OTHER REQUIREMENTS

Belgium reported that swap contracts may not involve "disproportionate risks" for participants in undertakings for collective investment. Spain also has special provisions for CIS using derivatives.

CHOICE OF LAW PROVISIONS

Most jurisdictions accepted "choice of law provisions" subject to international law. The validity of OTC derivatives transactions in Germany may, however, be subject to German *ordre public.* The UK indicated that a choice of English law could be challenged for lack of sufficient nexus, although case law and commercial practice suggest that such a challenge is unlikely to succeed where both counterparties have expressly chosen English law to govern the terms of a contract. English law is one recommended choice of law by ISDA swap documentation.

RECENT AND CONTEMPLATED CHANGES

Australia, Belgium, Germany, Hong Kong, Japan, Ontario, and the UK indicated that some changes to the existing regulatory regime for OTC products were in process. These changes are set forth in summary form in the section on Recent and Contemplated Changes.[14]

[14] *See infra* p. 73.

Regulation of Over-the-Counter Derivatives Transactions

Types of Over-the-Counter Derivatives Transactions Permitted

Please list the types of over-the-counter ("OTC") derivatives transactions (swaps; options, including caps, collars and floors; hybrids) that are permitted in your jurisdiction for each of the following types of underlying reference values or interests: an equity, government debt or interest rates, forex, a commodity, an intangible, or an event (*i.e.*, a credit-based derivative which pays a return if a party defaults), explicitly specifying any transaction types that are prohibited. Please indicate whether you view any type of transaction as a "hybrid" and, if so, provide a definition of this term.

Permitted Transactions

- ***Australia:*** The *Corporations Law* in Australia (the Law) currently regulates "securities" and "futures contracts." Products that are neither (such as currency and interest rate forwards and swaps to which a bank is a party) are not regulated by the Law. A broad range of derivative contracts fall under the defined term "futures contract." Four types of "futures contract" are defined in § 9 and regulated under the Law:

    - *Eligible commodity agreement* – a contract over a commodity which is capable of delivery on settlement; for instance, a physical commodity.
    - *An adjustment agreement* – an agreement based on an underlying thing that is not capable of delivery (*e.g.*, an index), or whose terms preclude delivery of a thing. This covers a contract which involves a cash adjustment between the parties according to the value of a commodity or level of an index at a future time, sometimes called a "contract for differences" in other jurisdictions.
    - *A futures option* – an option over an eligible commodity agreement or an adjustment agreement.
    - *An eligible-exchange traded option* [this category is not relevant to a discussion of OTC derivatives].

  Most cash-settled OTC derivatives will be adjustment agreements. It appears that a "bare option" is not within the definition of futures contract, although the courts have not fully settled this issue. The *Corporations Law* is administered by the Australian Securities and Investment Commission (formerly, the Australian Securities Commission, *see supra* note 1).

- ***Belgium:*** There are no restrictions on the type of OTC derivatives contracts that may be subscribed to, except that the contracting parties must have the capacity to contract and the transaction must not infringe on Belgian public policy rules.[15] OTC derivatives contracts are normally not subject to the public offering laws.

[15] Belgian public policy rules that might affect OTC derivatives transactions include bankruptcy and default rules and interest limits, such as the rules relating to penalty and compound interest clauses. These rules may affect the ability to engage in and/or the design of credit derivatives.

- ***Brazil:*** Brazilian law regulating over-the-counter derivatives transactions is fairly new. Most of it addresses swap transactions. The *National Monetary Council Resolution no. 2138 (12/29/94)* is the main regulation concerning these transactions. It lists the following transactions which are permitted in Brazil:

  - Plain vanilla swaps;
  - Swaps with caps, floors, or collars;
  - Swaptions; and
  - OTC options.

  Underlying swap variables mentioned in *Resolution no. 2138* are gold prices, exchange rates, interest rates and price indexes. Underlying assets for OTC options mentioned are stocks, corporate debentures, warrants and commercial paper. Further guidance issued by the CVM authorizes stock baskets as underlying variables.

- ***Canada:*** There are no prohibited transactions at the federal level. Most securities activities by a bank, such as underwriting and brokering, must be conducted in a securities subsidiary, which is subject to provincial regulation. In practice, unless a particular type of transaction is *specifically* precluded, it is permissible.

  Under Canadian federal banking law, there may be some limitations on the types of commodities on which banks can take delivery within the bank itself.

  - ***Ontario:*** The Ontario Securities Commission currently does not specifically regulate over-the-counter derivatives (although derivatives, to the extent considered securities, would be subject to the securities laws). There are no restrictions on the types of OTC products that may be traded in Ontario. Rules first proposed in 1996 and re-proposed in December 1998 would define the OTC market as one in which parties contract directly with each other off-exchange and without the interposition of a clearing organization, and would regulate such transactions under the securities laws (*see* Recent and Contemplated Changes *infra* p. 73). The proposed definition treats forwards as OTC derivatives contracts; it is proposed that credit derivatives will be specifically excluded.

  - ***Québec:*** The principal types of OTC derivatives[16] transactions are:

[16] Québec defines "derivatives" to mean "instruments, agreements or securities the value of which is based upon the market price, value or level of an index, or the market price or value of a security, commodity, economic indicator or financial instrument other than:

a) conventional convertible securities;
b) asset backed securities;
c) securities of a mutual fund;
d) index participation units;
e) securities of a non-redeemable fund;
f) government or corporate strip bonds;
g) listed equity dividend shares of subdivided equity or fixed income securities.

- Swaps
- Forwards
- OTC options, futures and other composite products
- Foreign exchange, interest-rate instruments, equity and commodity derivatives contracts.

- ***France:*** There is no direct regulation of OTC derivatives transactions, as such, under French law. As a result, there is no limit to the types of instruments created, whether they are caps, collars, floors, or hybrids; nor are there any regulations regarding the underlying reference values on which such products may be designed. However, participants in these transactions are subject to prudential regulation. The Commission Bancaire (CB), Comité de la Réglementation Bancaire et Financière (CRBF) and the Comité des Établissements de Crédit et des Entreprises d'Investissement (CECEI) supervise the intermediaries which develop and trade OTC derivatives.

- ***Germany:*** German law generally permits all of the derivatives transactions listed in the questionnaire. Derivatives transactions are legally valid and enforceable as so-called exchange-related-options-and-futures-transactions ("Börsentermingeschäft") within the meaning of Section 58 of the *Stock Exchange Act* (BörsG). Exchange-related-options-and-futures-transactions within this context require (i) transactions with typical conditions; (ii) which relate to a futures and options market; and (iii) where a counter-transaction may be concluded at any time. These requirements are broadly interpreted, to include basically all OTC derivatives transactions concluded between professional market participants. However, OTC derivatives transactions may be valid, although unenforceable (i) when concluded with an unsophisticated counterparty and (ii) where adequate disclosure has not been effected. In addition, transactions which do not qualify as exchange-related-options-and-futures-transactions (see above) may, in certain circumstances, be unenforceable pursuant to certain wagering provisions of the Bürgerliches Gesetzbuch (or BGB, the German "*Civil Code*"). To appreciate the practical importance of this issue under German law for professional market participants, it should be noted that case law focuses practically exclusively on the protection of unsophisticated counterparties in OTC derivatives transactions.

- ***Hong Kong:*** Most OTC derivatives transactions are permitted. One exception is a prohibition against dealers conferring an option on a security listed on the Stock Exchange of Hong Kong Ltd., except as provided in relevant regulations. "Futures" are *defined* as being executed on an exchange, and therefore OTC transactions are not considered to be futures.

- ***Italy:*** OTC derivatives transactions (futures contracts, swaps, forward rate agreements--including cash-settled forwards--options to acquire or to dispose of previously mentioned instruments, or combinations of contracts and securities), are not prohibited in Italy.

  The Commissione Nazionale per la Societa e la Borsa (CONSOB) may establish by regulation when financial instruments (other than government or government-qualified securities) must be carried out on regulated markets. The Minister of Treasury, in

consultation with the Bank of Italy and CONSOB, may specify the characteristics of wholesale markets and approves the regulations adopted by the market itself. Traditionally, futures contracts are not exchanged outside the regulated markets.

The Italian securities investment legislation applies to OTC transactions. Specific regulation applies to those transactions conducted on organized exchanges outside regulated markets. An organized exchange is considered to be any system of rules and structures, "even automatic," that continually or periodically allows: a) the gathering and distribution of bids and asks; and b) the execution of such proposals pursuant to the terms and conditions provided by the system.

Before commencing, persons promoting the establishment of organized exchanges must submit the following to CONSOB:

- Rules of functioning (with particular reference to those concerning prices);
- Structures used;
- Intermediaries admitted to the system;
- Financial instruments negotiated and their issuers.

The organizers of the system must assure that electronic procedures for recordkeeping of executed transactions are in place.

In cases of transactions of an amount less than 300 million lire, detailed information must be disclosed to the public (*CONSOB Communication No. 9809774 of 24 December 1998*).

CONSOB has the authority to prohibit organized markets in the public interest.

- ***Japan:*** Most OTC derivatives transactions are permitted when authorization or registration requirements for their parties or agents are fulfilled.

- ***The Netherlands:*** Most OTC derivatives transactions are permitted, regardless of the underlying reference values or interests.

- ***Spain:*** In general terms, there are no restrictions on the type of OTC derivatives transactions that may be carried out by licensed firms. Indeed, these transactions are considered to be permitted financial products and there is no explicit regulation of them.

- ***Sweden:*** Under Swedish law, all derivatives that are non-standardized and not exchange-traded are defined as OTC derivatives. Both standardized and non-standardized derivatives are financial instruments. If a bank or securities firm is authorized under the *Securities Business Act* (1991:981), it is authorized to deal or trade in derivatives. Thus, the law permits all OTC derivatives transactions transacted directly with authorized banks and securities firms. The permitted transactions include transactions relating to all of the underlying reference values or interests listed in the questionnaire.

- ***Switzerland:*** No permission is needed for any type of over-the-counter derivatives transaction. Derivatives are defined in Article 5 of the *Ordinance of the Federal Council on Stock Exchanges and Trading in Securities* (SESTO) as financial contracts, the prices of which are derived from:

    - Assets such as shares, bonds, commodities, precious metals; and
    - Reference rates such as currencies, interest rates and indexes.

  OTC derivatives are not supervised by product, but through supervision of the individual institutions which engage in these transactions (*i.e.*, banks, securities dealers).

- ***United Kingdom:*** There is no system of product regulation for derivatives in the UK. Derivative instruments generally fall within the definition of an "investment"[17] under the terms of the *Financial Services Act 1986*, although there are exceptions. In the case of OTC derivatives, all types of instruments may be transacted on all types of underlying reference values or instruments.[18]

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[17] The definition of investment is set out in Schedule 1 to the *Financial Services Act 1986*. The definition, as it relates to derivative products, is a broad one and includes:

- **Options** on:

    - any investment as defined (which would include, for example, equity options);
    - currency; and
    - certain precious metals (including gold and silver).

- **Futures** (defined as "rights under a contract for the sale of a commodity or property of any other description under which delivery is to be made at a future date and at a price agreed upon when the contract is made") provided these are entered into for investment and not commercial purposes.

    - Any future traded *on-exchange* is regarded as entered into for investment purposes.
    - Any future traded *off-exchange* (*i.e.*, OTC) is regarded as entered into for commercial purposes if, under the terms of the contract, delivery is to be made within 7 days.
    - That aside, whether OTC futures are entered into for investment or commercial purposes is a matter of fact in each case. Various guidelines for determining this fact are given in the Act. Broadly, these mean that any OTC future transacted on standardized terms, based on a standardized underlying, on which margin is payable, or for which performance is ensured by an exchange or clearing house, is likely to be regarded as entered into for investment purposes.

- **Contracts for differences**. These are defined as "rights under a contract for differences or under any other contract the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the contract." This covers a wide variety of contracts, including OTC-traded contracts such as forward rate agreements and cash-settled swaps.

[18] Under § 63 of the Act, contracts which are entered into by either or both parties by way of business and which are contracts for the buying or selling of *investments* will not be void under UK gaming laws.

Prohibited Transactions

- ***Australia:*** No product-specific prohibitions exist, but speculative retail OTC trading is prohibited unless the retail counterparty is guaranteed by certain specified persons (*e.g.*, a person with more than $10 million in tangible assets). There may be more flexibility for hedge transactions entered into by certain classes of persons that would be expected to enter transactions of this type.

- ***Belgium:*** As noted above, there are no general restrictions as to the types of OTC derivative contracts, provided they do not infringe upon Belgian public policy rules.

  Undertakings for Collective Investment may use futures and option contracts ("even in the case of swap construction") only if they are traded on a regulated public market and are normally authorized for the UCI. Swaps must be used without prejudice to the open nature of a UCI and may not expose the UCI or an investor to "unjustified" or unknown costs. The use of OTC derivatives transactions must not compromise the principle of risk spreading (or diversification).

- ***Brazil:*** *National Monetary Council Resolution no. 2138 (12/29/94)* limits permitted transactions to:

  - Plain vanilla swaps;
  - Swaps with caps, floors, or collars;
  - Swaptions; and
  - OTC options.

  As noted previously, underlying swap variables mentioned in *Resolution no. 2138* are gold prices, exchange rates, interest rates and price indexes. Underlying assets for OTC options mentioned are stocks, corporate debentures, warrants and commercial paper. Further guidance issued by the CVM authorized stock baskets as underlying variables.

  Therefore, all other transactions with other underlying assets, including commodities and mutual fund shares are prohibited.

- ***Canada:*** There are no prohibited transactions.

  - ***Ontario:*** There are no product-specific restrictions.

  - ***Québec:*** The *Québec Securities Act* does not specify any transaction types that are prohibited. However, it does list which types of transactions are exempt from the application of the *Securities Act* and which are not.[19]

- ***France:*** There are no product-specific prohibitions.

[19] *See also infra* notes 26, 30.

- ***Germany:*** Germany does not prohibit any of the derivatives transactions listed in the questionnaire.[20] It does, however, preclude trading on-exchange derivatives in Kammzug, a textile. This prohibition, dating from 1899, is expected to be removed soon.

- ***Hong Kong:*** Dealers are prohibited from conferring an option on a security listed on the Stock Exchange of Hong Kong Ltd., except as provided in regulations.

- ***Italy:*** No specific products are prohibited.

- ***Japan:*** OTC derivatives transactions can raise questions under Japan's criminal gambling laws if they do not fulfill requirements for authorization or registration for their parties or agents. In addition, such transactions can breach the rules of the *Securities and Exchange Law*, and the *Commodity Exchange Law*, *etc.*, if they are priced off of trades on exchanges. Equity derivatives were permitted in December 1998, and in April 1999 commodity related derivatives will be permitted.

  Swap transactions are not regulated by any formal laws or administrative guidances. In order to control OTC trading in swap transactions, however, the Ministry of Finance has required stricter disclosure rules by financial institutions dealing in such derivatives.

- ***The Netherlands:*** The rules and regulations of Amsterdam Exchanges (AEX) do not allow Admitted Institutions to execute OTC transactions in options and futures with exactly the same specifications as options and futures listed on AEX. However, exceptions do apply for OTC transactions cleared by the clearing house of AEX (called AEX-Option Clearing in the case of derivatives) and transactions between an Admitted Institution of AEX and professional parties in accordance with the rules and regulations of AEX.

- ***Spain:*** A system of product-based regulations has been developed in Spain under the rules governing derivatives transactions of Collective Investment Schemes (CIS). Such rules include a list of specific types of derivative contracts that may be subscribed by these entities. Apart from futures and options transacted on-exchange, forwards, options, warrants, caps, floors and collars, swaps and hybrids can be considered as permitted OTC contracts on the following underlying elements: interest rates, exchange rates, equity, dividends, or stock indexes. Other derivatives transactions can only be carried out by a CIS if previously and explicitly authorized by the Comision Nacional del Mercado de Valores (CNMV).

- ***Switzerland:*** There are no specific product restrictions.

- ***United Kingdom:*** As noted above, all types of derivative instruments may be transacted on all types of underlying reference values or instruments. No transaction types are explicitly prohibited. Instead, the *Financial Services Act 1986*, and the rules and regulations that flow from it, impose certain restrictions on who is able to transact in

[20] *But see* Permitted Transactions *supra* p. 1 (with regard to "exchange-futures-contracts").

those OTC derivatives that fall within the definition of "investment," and how they behave in so doing. In practice, there are controls on exchange-traded derivatives arising from the application of Schedule 4 of the Act to recognized investment exchanges (*see* Transactions Occurring Over Multilateral Electronic Execution Facilities *infra* p. 35, *and* Regulatory Requirements *infra* p. 43).[21]

"Hybrid" Transactions

- ***Australia:*** There is no express provision in the Law dealing with hybrid products. The definition of "security" expressly excludes a futures contract, but a recent court case has suggested that an instrument that met both statutory definitions might be regulated as both (or as either) a security and a futures contract.[22] The Law was amended to allow regulations so that features of both the securities and the futures regime can be made to apply to a product. This provision has been used to permit the stock exchange to trade products which have futures characteristics, and for the futures exchange to trade securities-like products.

  There are law reform proposals at an advanced stage that will extend the *Corporations Law* to cover all "financial instruments," including all derivatives, whether OTC or exchange-traded (*see* Recent and Contemplated Changes *infra* p. 73).

- ***Belgium:*** There is no definition of "hybrid" transactions.

- ***Brazil:*** None.

- ***Canada:*** There are no restrictions on credit derivatives and no restrictions on "hybrid" instruments.

  - ***Ontario:*** None. But pending proposals may affect credit derivatives and certain debt-like, structured derivatives which could be considered to be "hybrids."

  - ***Québec:*** There is no specific definition of "hybrid" or "composite" in the *Québec Securities Act*.

- ***France:*** There is no limit or prohibition on "hybrid" transactions, as noted above.

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[21] Derivatives traded on-exchange are standardized, and will be subject to product specific requirements, set (in accordance with the requirements of Schedule 4 of the *Financial Services Act 1986*) by the Registered Investment Exchange (RIE) on which trading takes place. The Financial Services Authority was a co-sponsor, with the U.S. CFTC and Japanese colleagues at the Ministries of International Trade and Industry and Agriculture, Forestry and Fisheries, of the international work done between commodity futures market regulators that resulted in the Tokyo Communiqué of October 1997, and the associated guidance papers on contract design and market surveillance intended to reduce the susceptibility of contracts to manipulation or other abusive practices.

[22] *SFE v. ASX*, 16 ACSR 148 (1995).

- ***Germany:*** There are no specific rules for "hybrid" transactions, nor is there a legal definition of "hybrid" transactions.[23]

- ***Hong Kong:*** No definition of a "hybrid" was provided; however, structured debt transactions are available in Hong Kong.

- ***Italy:*** Combinations of OTC contracts and securities are contemplated by the general definition of derivatives.

- ***Japan:*** There are no specific rules for "hybrid" transactions.

- ***The Netherlands:*** An official definition of a "hybrid instrument" does not exist.

- ***Spain:*** Although there is no official definition of "hybrids" in Spain, an explicit reference to this kind of transaction can be found under the CIS rules. Under these rules, a hybrid or structured financial product is understood to be a combination of various derivative instruments (such as collars) or securities and derivatives instruments. The result of such a combination is very commonly a financial instrument that has features characteristic of both equity and deposit or debt instruments, although its special features can vary widely. Under CIS rules, hybrid transactions have to be fractionated into their simple component parts in order to comply with accounting requirements and operational limits.

- ***Sweden:*** The Swedish regulatory authority, Finansinspektionen, is not familiar with hybrid transactions that have both equity-related instruments and one or more commodity-dependent components.[24]

- ***Switzerland:*** There are no specific rules for "hybrid" transactions.

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[23] Hybrid *financial instruments*, however, have the dictionary definition of:

> 1. Financial instruments that have features characteristic of both equity and debt capital. Their special features differ among countries. Common features are: hybrid instruments are not asset-backed, they are subordinated and fully paid; the bearer cannot demand repayment unless the banking supervisory authority consents first; they can participate in losses without the bank being forced to discontinue its business activities – which is the case for conventional subordinated liabilities. . . .
>
> 2. Financial instruments or methods . . . combining characteristic features of different – in particular international – financial markets, . . . or combining components of syndicated loans and bond financing . . . Among others, hybrid instruments are . . . rollover credits, where long term credits (capital market financing) are refinanced through the money market. Similarly: floating rate notes, multi-option financing facilities, Euro commercial papers, *etc.*

[24] OM Stockholm AB (OM) offers a flexible clearing service for its members (which need not be based in Sweden) known as tailor made clearing. Theoretically, OM could clear so-called hybrid products.

- ***United Kingdom:*** As there is no system of product regulation, there is no official definition of a "hybrid" transaction in the UK. But a hybrid transaction is generally understood to be a composite transaction that refers to two or more underlying factors.

Authorization/Licensing of Counterparties

> For each type of transaction, under what circumstances (*e.g.*, entering individually negotiated transactions for proprietary purposes, making an interdealer market, engaging in agency trades or trades on behalf of a customer), if any, are counterparties required to be licensed or authorized to engage in OTC derivatives transactions? If so required, which authority is responsible for such licensing?

- ***Australia:*** The *Corporations Law* of Australia applies the same way to all futures contracts. It prohibits a person from:

  - conducting an unauthorized futures market,
  - carrying on a business of dealing in futures contracts on behalf of others, and/or
  - advising about futures contracts without a license.

  Market Authorization: "Futures market" is defined in broad terms, and includes any facility by which futures contracts are regularly acquired or disposed of. Market-making by OTC dealers, and interdealer markets, are both caught by the definition. Persons carrying on these activities must therefore seek market authorizations. Authorization is the responsibility of the relevant federal Minister. A market can be authorized as a (1) futures exchange or (2) an exempt futures market. Exempt futures markets are regulated through conditions of authorization.

  All OTC futures markets are currently authorized as exempt futures markets. The Australian Securities and Investments Commission (ASIC) policy on exempt futures markets is not to support applications for exempt futures market status unless participation is limited to professional investors and there are no retail counterparties to contracts traded on these markets.

  There is only one futures exchange in Australia, the Sydney Futures Exchange. This provides the usual range of exchange related services, including clearing and settlement of contracts traded on the exchange.

  Licensing: Futures brokers and those who give advice on futures contracts (which do not include currency and interest rate forwards and swaps to which a bank is a party) are required to be licensed under the *Corporations Law*. In particular, the Law requires that a person must not:

  - deal in a futures contract on another person's behalf; or
  - hold out that the person carries on a futures broking business unless the person holds a futures broking license.

  The ASIC is responsible for licensing futures brokers and advisers in accordance with the requirements of the *Corporations Law*. All futures brokers must be members of the Sydney Futures Exchange.

ASIC policy on exempt futures markets prohibits broking in OTC futures markets and requires that transactions are individually negotiated by the parties to contracts (as principals).

- ***Belgium:*** Belgian law treats "financial instruments" and "commodity-linked instruments" differently. With respect to "financial instruments," investment firms (that is, non-credit institutions), the normal business of which is to provide third parties with investment services in Belgium on a professional basis, are required to be authorized by the Banking and Finance Commission (BFC) as:

    - a stockbroking firm; or
    - a portfolio management company; or
    - a financial instrument broking firm.

  Investment services requiring authorization include dealing for own account transactions in some circumstances. According to the Banking and Finance Commission, dealing for own account falls within the scope of the Law where this service is carried out in such a manner that it is a service to the participants on the financial markets. This is the case where the activity of a company on one or more markets consists in market making, or where that enterprise operates actively as a participant (possibly as a referring intermediary) on these markets by regularly proposing to other market participants to act as a counterparty in transactions in financial instruments.

  The type of authorization depends on the type of services the firm intends to provide.[25] Requests for authorization shall be accompanied by a program of operations complying with conditions laid down by the BFC setting out, *inter alia*, the volume of business proposed and the structural organization of the investment firm. Applicants indicate which of the authorizations they wish to obtain, and which of the services they intend to provide. Decisions regarding authorization confirm the investment services and non-core services which the investment firm is authorized to provide. The BFC may, in the interest of the sound and prudent management of an investment firm, limit a firm's license to the provision of certain services, or may impose conditions on the provision of certain services. Financial instruments include financial futures contracts, (including equivalent cash-settled instruments); forward interest rate agreements; interest rate, currency and equity swaps; and options on financial instruments (including equivalent cash-settled instruments).

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[25] This license requirement, according to the *Law of 6 April 1995*, does not apply to credit institutions which are governed by the *Banking Law of 22 March 1993*. Banking activities include, *inter alia*:

-- Trading for own account or for the account of customers in
  (a) money market instruments
  (b) foreign exchange
  (c) financial futures or options
  (d) exchange and interest rate instruments
  (e) transferable securities
-- Participation in share issues
-- Money brokering
-- Portfolio management.

With respect to "commodity-linked instruments," Belgian law authorizes the adoption of registration requirements for Belgian intermediaries (professionals who receive, transmit or execute orders on behalf of customers, portfolio managers or investment advisers) in connection with futures, options and other financial instruments relating to the acquisition or disposal of raw materials, goods and commodities. However, regulations have not yet been enacted. Meanwhile, the *Royal Decree nr. 72 of 30 November 1939* imposes a prohibition on engaging in the business of acting as an intermediary through accepting orders from customers as a broker, agent, or otherwise, with respect to *forward trading* in commodities, without being duly authorized. This Decree applies to orders to be executed on (foreign) exchanges, not to OTC instruments.

There is no licensing requirement for intermediaries (as defined above) that engage in other transactions. In a 1997 legislative hearing, it was stated that "among 146 credit institutions in Belgium, only 'about fifteen' are active in these [OTC derivatives] sorts of transactions."

- ***Brazil***: Only commercial banks, investment banks and brokerage firms registered with the Central Bank are allowed to participate in OTC derivatives transactions. Third parties must use such firms as intermediaries to engage in such transactions. According to *National Monetary Council Resolution no. 2138*, the participation in OTC derivatives transactions is conditioned on the financial institution nominating a technically qualified statutory director, who is liable to the monetary authorities for the internal controls and risk management systems pertaining to the OTC transactions.

- ***Canada:*** There are no requirements in the *Bank Act (Canada)* relating to counterparty licensing for proprietary, interdealer or agency traders.

  - ***Ontario:*** Derivatives transactions that are trades in securities are subject to the provisions of the *Ontario Securities Act*, including the registration (of dealers and intermediaries) and prospectus requirements of the Act. The Ontario Securities Commission's revised version of its 1994 proposal, published in 1996 and republished in December 1998, would require licensing of agency transactions and dealer transactions to the extent OTC derivatives transactions are not defined as exempt (*see* Recent and Contemplated Changes *infra* p. 73).

  - ***Québec:*** No dealer or advisor may carry on investment business unless registered as such with the Commission or exempt from registration.[26]

[26] Registration by the following, as a dealer, is not required:

- A person who limits his activities as a dealer to the distribution, through a registered dealer, of securities of his own issue or securities subscribed or acquired by him with the benefit of a prospectus exemption;
- A person who limits his activities as a dealer to the distribution of securities to sophisticated purchasers with the benefit of an exemption under section 43 (re: Sophisticated Purchaser [*see infra* note 30]), provided that such distributions are only a secondary activity of the person;
- A person who, having a mandate which includes the sale of property of other persons, is required to sell securities at or upon a judicial sale, a bankruptcy or a winding-up.

- ***France:*** Because OTC derivatives transactions are not regulated in France, licensing requirements are not specifically directed to the activities of counterparties in this area. Counterparties are nonetheless subject to various rules concerning their authority to provide financial services. The Comité des Établissements de Crédit et des Entreprises d'Investissement (CECEI) grants authorization to all investment service providers based on the programs of activity undertaken by such providers,[27] and manages the European passport regarding them. The Comité de la Réglementation Bancaire et Financière (CRBF) sets prudential rules, which apply, to all investment service providers, and the Commission Bancaire (CB) is responsible for the prudential supervision of all investment service providers. Investment firms whose main business is portfolio management are directly authorized, regulated and supervised by the COB.

- ***Germany:*** Generally, any otherwise competent firm or individual may negotiate, buy and sell OTC derivatives contracts and, thus, may engage in OTC derivatives transactions for any purpose. If a party to an OTC derivatives transaction effects the transaction for proprietary purposes, it does not need a license. If a firm undertakes OTC derivatives transactions on behalf of customers, it must be licensed as a financial services or credit institution and is then subject to special supervision. The Federal Banking Supervisory Office (BAKred) is the responsible authority for the licensing of financial service institutions and credit institutions. Further supervision is carried out by the Bundesaufsichtsamt für den Wertpapierhandel (or BAWe, the "Federal Securities Supervisory Office").

- ***Hong Kong:*** If the transaction is a dealing in securities, the dealer must be licensed by the Securities and Futures Commission as a securities dealer, or be an exempt dealer (such as authorized institutions licensed by the banking regulator, the Hong Kong Monetary Authority (HKMA)). If the transaction is a dealing in leveraged foreign exchange,[28] the person either

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[27] Or the Commission des Opérations de Bourse (COB) when it concerns portfolio management.

[28] "Leveraged foreign exchange trading," subject to subsection (2), means:

> (1)(a) The act of entering into or offering to enter into, or inducing or attempting to induce a person to enter into or offer to enter into, a contract or arrangement whereby any person undertakes –
>
> (i) to make an adjustment between himself and another person according to whether a currency is worth more or less, as the case may be, in relation to another currency; or
>
> (ii) to pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency; or
>
> (iii) to deliver to another person at an agreed future time an agreed amount of currency at an agreed price;
>
> (b) the provision of any advance, credit facility or loan directly or indirectly to facilitate foreign exchange trading, or to facilitate an act of the description mentioned in paragraph (a)(i), (ii) or (iii); or
>
> (c) the act of entering into or offering to enter into, or inducing or attempting to induce a person to enter into, an arrangement with another person, on a discretionary basis or otherwise, to enter into contracts to facilitate an act of the description mentioned in paragraph (a)(i), (ii) or (iii) or (b).
>
> . . .

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 OTC transactions. To the extent a futures dealer engages in OTC transactions incidental to exchange-based activity, it would be subject to the regulatory regime for futures dealers (*e.g.*, capital requirements, business conduct, *etc.*).

- ***Italy:*** The provisions of investment services to the public on a professional basis are restricted to investment firms and banks. In circumstances established by the Bank of Italy in consultation with the CONSOB, financial intermediaries entered into the register under Article 107 of the *Banking Law* may deal for their own account in derivatives (including futures, swaps and forwards and options on commodities), and place issues (with or without commitment to issuers). There are no special authorizations required for execution of OTC derivatives contracts by counterparties. CONSOB has the authority to obtain information on organized markets and to determine how such information should be disclosed to the public.

- ***Japan:*** The *Securities and Exchange Law* (SEL) requires the licensing of securities companies. The license requirement does not apply to banks. As of June 22, 1998, all private financial institutions, which include commercial and investment banks, are subject to authorization and supervision by the Financial Supervisory Authority.

  Currently, Article 65 precludes banks from undertaking investment business. Although the licensing process is being overhauled, authorization will continue to be required for securities-related OTC derivatives business. Remaining restrictions on the range of business activities for securities subsidiaries of banks are to be eliminated between October 1999 and March 2000. Once accomplished, there will be no difference between ordinary domestic securities companies and banks' securities subsidiaries established under 1993 Financial System Reforms. Interest rate derivatives (excluding bond derivatives), foreign exchange derivatives and commodities derivatives are not regarded as securities-related derivatives. The *Commodity Exchange Law* requires registration by the Ministry of International Trade and Industry or the Ministry of Agriculture, Forestry and Fisheries for commodity-based OTC derivatives.

- ***The Netherlands:*** Parties such as credit institutions and investment firms have to be licensed or authorized to provide investment services, but not specifically in relation to OTC derivatives products. The Securities Board of the Netherlands (STE) is responsible for the

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(2) For the purposes of subsection (1), . . . "leveraged foreign exchange trading" [does] not include any act performed for or in connection with a contract or arrangement or a proposed contract or arrangement –
(a) wholly referable to the provision of property, other than currency, or services or employment at fair or market value;
(b) where the contract or arrangement is entered into by a limited company.

licensing of investment firms, while the Dutch Central Bank (DNB) is responsible for the authorization of credit institutions.

- ***Spain:*** There are no licensing requirements specifically directed to OTC transactions. Nevertheless, firms must be licensed as investment firms or credit institutions to engage in investment business. Financial derivatives are considered investment business under the European Union's *Investment Services Directive*.

  Investment firms have to be authorized by the Comision del Mercado de Valores (CNMV), while credit institutions receive their authorization from the Bank of Spain.

  In terms of European Union regulations, specifically the *Investment Services Directive* and the *Second Banking Directive*, a bank and an investment firm authorized in a European Member State may set up a branch or provide cross-border services in another Member State, on the basis of its Home State authorization. Both Directives cover transactions involving financial derivatives contracts (not commodities derivatives), whether OTC or on-exchange. Authorization and prudential supervision of these entities remains the responsibility of the Home State regulator, although they are required to comply with the conduct of business rules of the Host State regulator.

- ***Sweden:*** Banks or securities firms that have authorization to trade financial instruments may trade OTC derivatives products without informing Swedish regulatory authorities. A bank or securities firm does not need special permission to develop or trade an OTC derivatives product.

- ***Switzerland:*** Agents or dealers dealing solely in individually tailored OTC transactions are not covered by the licensing requirements of the *Federal Act on Stock Exchanges and Trading in Securities* (SESTA). Agents engaged in securities trading are required to be licensed as security dealers by the Swiss Federal Banking Commission due to SESTA, in order to engage only in securities transactions, or if they offer securities which are standardized and suitable for mass trading. Securities, book entry securities and derivatives which are offered to the public in the same structure and denomination, or placed with more than 20 customers, are deemed to be standardized securities suitable for mass trading, provided that they are not especially created for single counterparties.

  In order to qualify as a bank and/or securities dealer several licensing requirements must be fulfilled; the main are:

  - The organization and internal rules of the applicant are such as to ensure compliance with legal duties;
  - The applicant meets the required minimum capital or can provide the required security;
  - The applicant and its senior staff can show that they have the required professional knowledge;
  - The applicant, its senior staff and principal shareholders can give assurances of proper business conduct; and

- The applicant must define a clear area of business, organize itself in order to ensure the separation of functions, maintain a control system and internal audit function, determine its place of management, give information about its senior staff and principal shareholders, provide for an internal and external audit, fulfill the provisions on own funds, risk spreading and accounting, and report any change in the requirements for authorization.

- ***United Kingdom:*** Under the terms of the *Financial Services Act 1986* (the Act), 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 OTC, 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.

  Authorized persons engaged in OTC derivatives transactions are most likely to be regulated in the UK by the Securities and Futures Authority (SFA). Those not regulated by SFA are likely to be regulated by the Investment Management Regulatory Organization (IMRO). A small minority may be regulated by the Personal Investment Authority (PIA). SFA, IMRO, and PIA are self-regulating organizations under the terms of the Act. They set various conduct of business and capital requirements with which their members must comply.[29]

  Exempt Persons most likely to be engaged in OTC derivatives transactions are wholesale money market institutions (*i.e.*, banks, securities houses and name-passing brokers). These exempt persons are money market institutions admitted to a list under the terms of § 43 of the Act. These persons deal in money market instruments, foreign exchange and gold and silver contracts, and certain OTC contracts defined as investments for purposes of the Act. The Financial Services Authority (previously the Bank of England) sets conditions for admission to this list (subject to approval from HM Treasury), and also sets the terms of the *London Code of Conduct* with which the listed institutions must comply.

  The Act sets out a number of exceptions to the general requirement for authorization or exemption. In terms of persons who might engage in OTC derivatives transactions, the most important of these are:

  - Where transactions are entered into as principal with or through an authorized or exempted person, or with or through an overseas person (subject to certain restrictions);

[29] Under the current regulatory regime, SFA regulates broker-dealers, IMRO regulates fund managers, and PIA regulates independent financial advisers and insurance companies providing pension and other investment products directly to members of the investing public.

- Where transactions are entered into as principal between bodies corporate in the same group, or are entered into as principal between persons participating in a joint enterprise and for the purposes only of that enterprise;
- Where transactions are entered into in the course of non-investment business and special permission has been granted under the Act; and
- Where overseas persons are engaged in certain restrictive activities in the UK.

With regard to obligations arising from European Union Directives, the *Investment Services Directive* and the *Second Banking Directive* are relevant to an understanding of authorization and licensing factors. Under those Directives, a bank or non-bank investment firm incorporated and authorized in another European Member State may set up a branch in the UK, or provide cross-border services in the UK, on the basis of its "Home State" authorization. Further UK authorization is not required for the range of business covered by the Directives. Both Directives cover activities involving financial derivatives contracts (not commodities derivatives), whether carried out on-exchange or OTC. However, although the authorization and prudential supervision of such institutions will be the responsibility of their Home State regulator, they will be required to comply with applicable UK rules relating to the conduct of business carried on in the UK. In the case of branches, applicable rules will generally include the SFA's conduct of business rules. In addition, the relevant UK regulatory agency will formally be notified in advance of banks and investment firms intending to operate in the UK in accordance with the Directives.

Interestingly, the *Investment Services Directive* has the effect of limiting the availability to EU investment firms of the exclusions from authorization in the UK noted above since, under the Directive, the requirement to be Home-State authorized to provide any service in the UK, defined as a core investment service, would stand.

Prohibitions on Counterparties or on Engaging in OTC Derivatives Transactions

For each type of transaction, under what circumstances, if any, are particular persons or entities (retail, unsophisticated, other) prohibited from being counterparties or otherwise engaging in such transactions? If such transactions are prohibited to a class of persons or entities or limited to eligible entities, please explain.

- ***Australia:*** Australian Securities and Investments Commission policy on exempt futures markets (*e.g.*, OTC derivatives markets) has two requirements relating to who may enter transactions:

  - Only entities subject to approved forms of prudential supervision (or a reasonable analogue thereof) should be authorized to conduct exempt futures markets;

    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 Basle Committee on Banking Supervision; 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.

  - Markets authorized in this way should not involve retail participants;

    A person who enters into a transaction on an exempt market must be an "appropriate person." These are: regulated facility providers (as described above); 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.

- ***Belgium:*** Belgian law distinguishes between general rules and specific limits for certain categories of persons.

  General Provisions

  Individuals. There are no limits on individuals engaging in OTC derivatives transactions, except for normal rules regarding the capacity to contract (*e.g.*, limitations on minors).

  Corporations. A Belgian company's corporate charter determines the scope of the company's activities. However, the corporate purpose clause in the charter has no external effect. Thus, a company may be bound by its actions even if they are beyond the

scope of its purpose clause, unless the third party knew the action exceeded the scope of the clause. As corporate boards must act in the interests of the company, a court could decide that a prudent intermediary should have examined the corporate purpose clause of a counterparty to verify its capacity to engage in an OTC derivatives transaction, or should have verified whether an OTC derivatives transaction is in the corporate interest.

Public entities. Public entities must act within the framework of a "specialty principle," which requires them to act only to realize the purpose of the public interest for which they were created.

Specific provisions

Undertakings for Collective Investment: With respect to specific limits for certain categories of persons, Undertakings for Collective Investment (UCIs) must invest only in one of the authorized investment categories under Belgian law for which implementing measures have been enacted. Currently, the following categories are authorized for Belgian UCIs: investments that meet conditions established in an European Union directive; transferable securities and liquid assets; real property; receivables ("securitization" UCIs); and unlisted and fast-growing companies.

Other UCIs may not be publicly-traded in Belgium. This prohibition covers UCIs investing in commodity-linked futures and options or futures and options on securities, currencies or stock index contracts. For authorized UCIs, investing in derivatives products is subject to strict limits. For example, futures and options generally only may be resorted to for a limited percentage and, *inter alia*, only if they are traded on a regulated market which is properly administered, offers sufficient liquidity, is duly registered, and is open to the public. Further, counterparty risk in swap contracts must be limited by restricting the choice of counterparties to regulated intermediaries that are subject to harmonized prudential rules.

Insurance companies: These are authorized to invest in futures contracts, options on securities and other derivatives instruments, provided that the instruments are traded on a regulated, liquid, recognized, open and regularly functioning market (*i.e.*, not OTC). The Insurance Supervisory Board supervises the application of these requirements.

- ***Brazil:*** Brazilian or foreign mutual funds (including Annex IV to *National Monetary Council Resolution no. 1289 (3/20/87)*, the most common mechanism allowing foreign investors to invest in Brazilian capital markets, which was a managed portfolio) are *not* allowed to engage in OTC derivatives transactions.

- ***Canada:*** There are no restrictions under the *Bank Act (Canada)*.

  - ***Ontario:*** There are currently no prohibitions in place under the *Ontario Securities Act.* However, the OSC proposal of 1996, as amended and re-proposed in 1998, does prescribe some requirements based upon who are the parties to the transaction. Note that derivatives transactions are typically sold by securities companies, and that a significant

portion of derivatives transactions sold by securities companies or investment firms are booked by banks.

- ***Québec:*** Any person doing business as a dealer or advisor *exclusively* with sophisticated purchasers[30] is exempt from registration.

- ***France:*** There are no restrictions on the types of entities or individuals that may engage in OTC derivatives transactions.

- ***Germany:*** There is no general prohibition on entities or individuals engaging in OTC derivatives transactions. Entities conducting certain types of businesses are subject to statutory restrictions with regard to their investments. Such restrictions apply, for example, to insurance companies and mortgage banks. Other entities may be subject to similar restrictions set forth in their articles of association or by-laws. However, a contravention of these prohibitions will generally not void the transaction, provided the counterparty acted in good faith. In addition, derivatives transactions with unsophisticated counterparties may be unenforceable pursuant to Section 53 of the *Stock Exchange Act* (BörsG), if adequate disclosure as provided in the Act was not effected.

- ***Hong Kong:*** There are no prohibitions on who may be a counterparty.

- ***Italy:*** There are no authorizations required for, or prohibitions on, the execution of OTC derivatives contracts by special categories of persons.

- ***Japan:*** There are no specific regulations or restrictions on the types of entities or individuals that may engage in OTC derivatives transactions except applicable non-financial laws, license restrictions, *etc.* OTC derivatives transactions are not regulated on a product-specific basis.

- ***The Netherlands:*** There are no prohibitions on particular persons or entities (retail or unsophisticated) from being the opposite party in OTC derivatives transactions. However, a few large banking corporations dominate the OTC derivatives market in The Netherlands with professional parties like insurance companies, pension funds and multinationals as their most important counterparties.

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[30] The term "sophisticated purchasers" includes: a provincial or federal government-owned company, a bank governed by the *Bank Act (Canada)* or the *Québec Savings Banks Act*, specified loan and investment societies, savings and credit unions, trust companies, and dealers or advisors, amongst others. Note that registration as a dealer to carry on business as an intermediary in futures contracts trading is also not required where a person trades solely for the account of hedgers, subject to three conditions:

- The person is a member or an associate member of the Montreal Exchange;
- The person is subject to the by-laws and rules of the Montreal Exchange concerning futures contracts; and,
- The person responsible for the trading of the contracts meets the qualification requirements of the Montreal Exchange.

- ***Spain:*** In general terms, there are no limits on individuals or companies engaging in OTC derivatives transactions, and civil and commercial law rules govern the legality and enforceability of derivatives transactions.

  Nevertheless, special disclosures are required by financial intermediaries when transacting opposite unsophisticated investors. Accordingly, although the general code of conduct for the securities markets, applicable to all licensed firms, does not make explicit mention of OTC derivatives transactions, it establishes 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, very particularly in high-risk financial products, so that the client knows precisely the effects of the transaction being arranged."

  Various special disclosures are also applicable to the Spanish Collective Investment Institutions Management Companies operating in derivatives:

  - First, an explicit mention of the purpose of the Management Companies to carry out derivatives business has to be made, making clear whether these transactions will have the exclusive objective to hedge, or the entity plans to also take speculative positions.
  - Second, a standardized warning clause has to be included in the informative prospectus for the investors to know that the high leverage characteristic of such transactions makes them especially vulnerable to the fluctuations of the underlying price, and can multiply the portfolio's losses.
  - Third, whenever the Management Companies plan to carry out OTC derivatives transactions, explicit mention of that also has to be made, adding this fact to the above mentioned warning clause, with notice that this type of business implies additional risks, as customers are exposed to the failure of a counterparty.
  - When guaranteed funds are planning to exceed the general operating limits (as allowed by regulations), a special warning of such circumstances must also be included in the prospectus.
  - Finally, Management Companies carrying on derivatives transactions are subject to stringent and detailed reporting requirements to the regulator.

  Other requirements, both in terms of operating limits and internal control obligations, are also established by the rules governing the derivatives transactions of CIS. The following are exclusively applicable to CIS OTC business:

  - Purpose: only hedging or the achievement of a concrete objective of profitability.
  - Kind of counterparties: they have to be either financial entities incorporated in Organisation for Economic Cooperation and Development Member States and under prudential supervision, or international bodies with Spanish membership, transacting in a professional way on these instruments, and with an adequate level of solvency.

- Liquidity: contractual clauses have to explicitly contemplate the possibility for the CIS to close out the transaction or transfer it to a third party. To ensure the effectiveness of this requirement, counterparties have to provide daily unconditional bid and offer prices.
- Valuation: contractual clauses have to include the valuation methodology on which the above mentioned quotations are based.

- ***Sweden:*** There are no prohibitions on who can be a counterparty.

- ***Switzerland:*** In order to be granted a license under the *Ordinance of the Federal Council on Stock Exchanges and Trading in Securities* (SESTO), a security dealer must specify in which types of securities it trades and which other businesses it conducts, in which markets it trades, and for which types of customers it trades. After being granted a license, a security dealer or bank is also required to notify the Swiss Federal Banking Commission of all changes. Based upon these licensing requirements, the SFBC can control whether the activities of a securities dealer are appropriate. The SFBC controls on a case-by-case basis whether a security dealer is able to fulfill the requirements in order to deal with different kinds of derivative products.

- ***United Kingdom:*** Authorized persons must comply with rules set by their regulator (usually the Securities and Futures Authority). These rules do not prohibit such persons from being either counterparties themselves in any OTC derivatives transactions or from engaging in any such transactions on behalf of clients. But they do contain requirements designed to impose general controls on the activities of authorized persons, and to protect the interests of their clients. Broadly, these relate to:

  - Capital and risk control (*e.g.*, a requirement for authorized persons to set position limits);
  - Reporting of all transactions (including those in OTC derivatives) to the regulator;
  - Segregation of client money and custody of client assets; and
  - Conduct of business and, in particular, a requirement that they ensure any recommendations for private clients (*i.e.*, clients who do not themselves carry on investment business or who are not corporations, partnerships or trusts satisfying certain size requirements) are suitable, and that various specified risk warnings are given.

  These requirements differ according to whether the authorized persons are conducting business on their own account or are engaging in transactions on behalf of clients. The regime is generally lighter for the former, while in the latter case the requirements are lighter in relation to sophisticated investment professionals than they are in relation to unsophisticated investors.[31]

[31] Fewer requirements apply to listed money market institutions (exempted persons under the *Financial Services Act 1986*—*e.g.*, securities houses such as Morgan Stanley and banks such as Chase Manhattan) entering into OTC derivatives transactions under the terms of the *London Code of Conduct*. However:

In practice, these requirements limit the extent to which an authorized person is likely to act as a counterparty to, or otherwise to engage in, OTC derivatives transactions. In particular, the requirements mean that authorized persons are unlikely to engage in OTC derivatives transactions on behalf of unsophisticated investors.

This regime (known as the "wholesale markets regime") only applies to money market institutions who enter into investment transactions with a value of £500,000 [$828,500 on January 25, 1999] or more. Listed money market institutions wishing to enter into investment transactions below that value require authorization, and have to comply with the requirements outlined above in respect of those transactions; and

To the extent exempt persons may enter into investment transactions with a value of £500,000 or more, on behalf of private clients, 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.

Applicable Rules/Responsible Authorities

For each type of transaction, specify which authority (including any self-regulatory authority or commercial association), if any, is responsible for, and/or which rules (banking, securities, other) apply to:

- Supervision of financial capacity (prudential supervision);
- Supervision of conduct of business;
- Supervision of legality of transactions (propriety of trading over-the-counter, authority of the counterparty to enter the transaction); and
- Supervision of making a two-way market, of administering collateral arrangements and netting cash flows, and of clearing.

Financial Capacity/Prudential Supervision

- ***Australia:*** Prudential supervision formerly was the responsibility of the Reserve Bank of Australia for Australian banks and the Australian Financial Institutions Commission for non-bank financial institutions such as credit unions and building societies. Fund managers and insurance houses which participate in derivatives markets normally were subject to a capital standards regime set either by the Australian Securities and Investments Commission (as *Corporations Law* licensees), or by the Insurance and Superannuation Commission. Since July 1, 1998, these functions have been assumed by the newly-created Australian Prudential Regulation Authority. The ASIC currently still retains the prudential supervisory responsibilities for securities firms which formerly were performed by the ASC.

- ***Belgium:*** Generally, regulation is directed at intermediaries who provide investment services. The Banking and Finance Commission, in cooperation with a statutory auditor, is responsible for the prudential supervision of credit institutions, investment advisers and investment firms. This supervision covers the internal organization, financial health, and legal compliance of these entities. The Insurance Supervisory Board regulates insurance companies.

- ***Brazil:*** OTC derivatives transactions based on stocks and stocks baskets are under CVM's jurisdiction. The remainder of such transactions are regulated by the Central Bank. Financial capacity of financial institutions is regulated and supervised by the Central Bank.

- ***Canada:*** Supervision in Canada is divided between the federal banking authority and provincial securities regulators. OSFI is the federal supervisory agency for banks, and does not regulate brokers, including those which are subsidiaries of banks. OSFI does, however, regulate on a consolidated basis.

    - ***Ontario:*** If dealers are involved in an OTC derivatives transaction and are members of the Investment Dealers Association of Canada (the "IDA") [a trade association], then they are subject to the By-laws, Rules, Policies and Regulations of the IDA as applicable. Certain of these by-laws, rules and policies could have an impact on trading in OTC derivatives (*e.g.*, capital requirements). The IDA monitors member

firms in terms of their capital adequacy and internal controls. The IDA carries out continuous surveillance of its members including periodic audits.

- ***Québec:*** Supervision of financial capacity and conduct of business is accomplished through supervision of the securities dealers/brokers and is not related to the OTC product itself.

- ***France:*** The Commission Bancaire (CB) is responsible for prudential supervision of investment services providers (investment firms and credit institutions), including those engaged in swaps, forwards, *etc.*

- ***Germany:*** Prudential supervision of credit institutions and financial institutions is carried out by the Federal Banking Supervisory Office (BAKred). Such supervision includes the effects of OTC derivatives transactions on the financial capacity of such institutions. Additional prudential supervision is carried out by exchanges with regard to their members, insofar as they are not already supervised by the BAKred.

- ***Hong Kong:*** The Securities and Futures Commission supervises matters if a person is a securities dealer licensed by the SFC. Similarly, the Hong Kong Monetary Authority is responsible for supervision of HKMA-authorized institutions (*e.g.*, banks).

- ***Italy:*** The Bank of Italy, in consultation with the CONSOB, develops regulations on capital adequacy, limitation of risk, identification of sources of capital, and deposit of funds. CONSOB, in consultation with the Bank of Italy, develops regulations on internal control procedures, and records of transactions.

- ***Japan:*** As of June 1998, under the Financial System Reform, the Financial Supervisory Agency has been authorized to supervise and to inspect all private financial institutions.[32] This includes a transfer of all supervisory authority, including the ability to grant and revoke licenses and, in the case of failed institutions, issue corrective orders, suspend business operations, and approve mergers. The Bank of Japan also will conduct examinations and will have responsibility to undertake appropriate measures to maintain financial stability, such as provide liquidity, in consultation with the Financial Supervisory Authority. The Ministry of Finance will not have supervisory authority over individual commercial banks and other private financial institutions. However, the authority to license securities exchanges, financial futures exchanges, and securities dealers associations is shared by the Financial Revitalization Commission[33] (or the Commissioner of the Financial Supervisory Agency under statutory delegation), and the Minister of Finance.

- ***The Netherlands:*** The Securities Board of the Netherlands (STE) is responsible for the supervision of the financial capacity of investment firms and implements the *Act on the*

[32] The term "private financial institutions" refers to commercial banks, insurance and securities companies, non-banks and other private institutions dealing in financial transactions.

[33] As of December 15, 1998.

Supervision of Securities Trading. The Dutch Central Bank (DNB) regulates credit institutions and implements the *Act on the Supervision of Credit Institutions*.

- ***Spain:*** Prudential supervision does not apply to specific products, but to regulated financial institutions as a whole, with the Bank of Spain responsible for the prudential supervision of credit institutions, and the CNMV responsible for investment service firms and CIS Management Companies. Insurance companies are under the surveillance of the Insurance General Directorate.

  At the EU level, relevant rules applicable to investment firms and credit institutions are Council Directives 93/22/EEC (*Investment Services Directive*) and 93/6/EEC (*Capital Adequacy Directive*), both of which are implemented into Spanish domestic regulation. Under the *Capital Adequacy Directive*, the only specific references to OTC derivatives are the different risk weightings applicable to them, as compared to exchange derivatives, and the conditions under which netting agreements can be recognized to reduce counterparty risk.

  Additionally, securities firms, their groups and portfolio management companies are also required to comply with the CNMV's recent rules regarding systems of internal control, monitoring and on-going evaluation of risks. Similar requirements also have been imposed on the CIS Management Companies.

- ***Sweden:*** Finansinspektionen is responsible for supervising financial capacity, conduct of business, legality of transactions, and other matters relating to OTC derivatives transactions in accordance with Council Directives 93/22/EEC (*Investment Services Directive*) and 93/6/EEC (*Capital Adequacy Directive*), which are implemented in the *Securities Business Act* (1991:981).

- ***Switzerland:*** The Swiss Federal Banking Commission provides supervision. Note that the supervision of OTC derivatives transactions is accomplished through the supervision of the individual institutions (banks, security dealers) and not related to the product itself. A dealer must also comply with the *Risk Management Guidelines for Trading and for the Use of Derivatives* of the Swiss Bankers Association.

- ***United Kingdom:*** In respect of authorized and exempt persons who also are registered as banks or are listed as *Financial Services Act 1986* § 43 institutions, the Financial Services Authority (previously the supervision division of the Bank of England) has additional responsibility for prudential supervision.

  In respect of authorized and exempt persons who also are registered as insurance companies, the Insurance Directorate of HM Treasury has additional responsibility for prudential supervision. The Insurance Directorate's responsibilities will pass to the Financial Services Authority in the year 2000, once the current process of regulatory reform is complete.

The position in relation to European firms operating in the UK under the terms of the *Investment Services* or *Second Banking* and related Directives, is that the Home State regulator is responsible for financial capacity/prudential supervision. The Host State (*i.e.*, the UK) is only responsible for conduct of business supervision/regulation.

Conduct of Business

- ***Australian:*** This is the responsibility of the Australian Securities and Investment Commission, which is responsible for regulation of market conduct and market integrity issues under the *Corporations Law*.

- ***Belgium:*** Rules of conduct for financial intermediaries apply to transactions in financial instruments, including any proprietary transactions. The civil courts enforce these rules. The market authorities of the Belgian exchanges have specified further rules for their members relating to financial instruments dealt in on their markets. There are no specific rules of conduct for other instruments such as commodity-linked instruments, except common law rules on the contractual and extra-contractual responsibilities of an intermediary, which may be invoked before a court. OTC derivatives are not normally subject to the rules on public offerings.

- ***Brazil:*** OTC derivatives transactions based on stocks and stock baskets are under CVM's jurisdiction. The remainder of such transactions are regulated by the Central Bank.

- ***Canada:*** OSFI is a prudential regulator with indirect interest in conduct of business issues. It has an interest in conduct of business matters to the extent that systemic problems could lead to a material loss of reputation and eventually impair the safety and soundness of a credit institution. In relation to this risk, OSFI assesses the role, responsibility and effectiveness of corporate compliance departments which are generally responsible for dealing with such risk.

  - ***Ontario:*** There are no applicable rules.

  - ***Québec:*** There are no specific rules applicable.

- ***France:*** The Conseil des Marchés Financiers (CMF) is the self-regulatory organization responsible for establishing general principles and best practices for the smooth functioning of the market.

- ***Germany:*** Matters relating to the conduct of business may be taken to a civil court in Germany. The Federal Securities Supervisory Office (BAWe) monitors investment services providers' compliance with business conduct rules. Exchanges monitor their members' compliance with exchange rules relating to the conduct of business.

- ***Hong Kong:*** The Securities and Futures Commission supervises matters if a person is a securities dealer licensed by the SFC. Similarly, the Hong Kong Monetary Authority is responsible for supervision matters of HKMA-authorized institutions.

- ***Italy:*** CONSOB, in consultation with the Bank of Italy, issues rules of conduct on dealings with customers. *CONSOB Regulation no. 11522 of 1 July 1998* provides specific conduct of business rules on derivatives activities, generally. CONSOB oversees compliance with conduct of business rules by investment firms doing OTC business.

- ***Japan:*** Because OTC derivatives trading is undertaken in the form of negotiated transactions, and many instruments entail complex risks, companies are encouraged by the Japanese authorities to frame rules for dealing with customers relating to suitability, disclosure and timely provision of information on execution of transactions and profits and losses. With regard to settling complaints, arbitration rules were added in 1998 to make dispute resolution easier. The Japan Securities Dealers Association (JSDA) and exchanges are organized under the *Securities and Exchange Law* and operate as self-regulatory organizations by formulating and implementing rules related to investor protection.

- ***The Netherlands:*** The Securities Board of the Netherlands (STE) sets rules of conduct in its own regulations implementing the *Act on the Supervision of Securities Trading.*

- ***Spain:*** The CNMV is responsible for the definition and surveillance of conduct of business rules, including the rules governing relations between clients and firms.

  The scope of these rules extends to public and private persons or firms that carry out activities relating to the securities market in any form. Apart from financial intermediaries themselves, these are deemed to include those persons or firms which provide advice or disseminate information relating to the securities market, those whose purpose is to administer and to represent collective investment schemes and corresponding departments of securities issuers. The rules affect not only firms themselves, but also their personnel, regardless of whether their activities involve securities traded in an organized market, whether located in Spain or abroad, or whether or not securities are traded in such markets.

  The general code of conduct included in Spain's domestic rules is essentially based on the rules of conduct arising from the meetings of the International Organization of Securities Commissions (IOSCO) Technical Committee and the recommendations of the Commission of the European Communities.

- ***Sweden:*** Finansinspektionen is responsible for supervising the conduct of business.

- ***Switzerland:*** The Swiss Federal Banking Commission provides supervision. A security dealer must comply with the rules of conduct (article 11 SESTA) and also with the *Risk Management Guidelines for Trading and for the Use of Derivatives* of the Swiss Bankers Association.

- ***United Kingdom:*** The regulatory responsibility for conduct of business currently lies with the self-regulating organizations (as described *supra* note 29) but will ultimately be taken over by FSA. *See also* Regulatory Requirements *infra* p. 43.

Legality of Transactions[34]

- ***Australia:*** There is no supervisor of these aspects, generally. However, there are restrictions in the common law of Australia; for example, the law of contract and agency recognizes limits on the capacity and powers of people. For some entities, there may be statutory restrictions on investment in such contracts; for example, under the *Trustee Acts* in each State and territory, a trustee is not empowered to invest in futures contracts, so it would be necessary that the terms of the relevant trust specifically empower the trustee to make such investments, otherwise the transactions would be a breach of trust. Building societies and credit unions may only enter into derivatives for particular purposes (*e.g.*, hedging).

- ***Belgium:*** No specific rules are applicable. Companies are bound even if transactions are beyond their purpose clause unless it can be proved that the counterparty knew the transactions were *ultra vires.*

- ***Brazil:*** OTC derivatives transactions based on stocks and stocks baskets are under CVM's jurisdiction. The remainder of such transactions are regulated by the Central Bank.

- ***Canada:*** In general, OSFI does not have any specific rules.

  - ***Ontario:*** None.

  - ***Québec:*** No specific rules are applicable.

- ***France:*** There are no specific provisions relating to legality of the transaction related to the structure thereof.

- ***Germany:*** Matters relating to the legality of transactions may be taken to a civil court in Germany. The legality of transactions may be challenged mainly on the basis of certain provisions of the *Civil Code* and the *Stock Exchange Act*. *See also* Prohibitions on Counterparties or on Engaging in OTC Derivatives Transactions *supra* p. 19.

- ***Hong Kong:*** The Securities and Futures Commission supervises matters if a person is a securities dealer licensed by the SFC. Similarly, the Hong Kong Monetary Authority is responsible for supervision matters of HKMA-authorized institutions. Transactions by unlicensed intermediaries for third parties are invalid.

[34] Some respondents answered this question by addressing the structure of the transaction and powers to enter transactions of the counterparties; others by reference to conduct of business (which could include suitability or eligibility determinations) supervision.

- ***Italy:*** CONSOB checks compliance with conduct of business rules on the provision of investment services in OTC derivatives.

- ***Japan:*** The legality of OTC transactions is clarified in the new financial reform legislation; in particular, securities derivatives have been permitted as of December 1998.

- ***The Netherlands:*** The Securities Board of the Netherlands (STE) has no specific rules in relation to the legality of OTC derivatives transactions.

- ***Spain:*** From a regulatory point of view, no specific rules are applicable to OTC derivatives transactions, or indeed to other securities markets activities. Consequently, general civil and commercial laws of contract can be considered relevant to this issue.

  From a supervisory point of view, the CNMV is responsible for the surveillance of the legality of securities market transactions, including OTC derivatives, for those firms included under the scope of the *Securities Markets Law* (in general terms, investment services firms, excluding credit institutions, and CIS Management Companies).

- ***Sweden:*** Finansinspektionen is responsible for supervising the legality of transactions.

- ***Switzerland:*** No specific rules are applicable.

- ***United Kingdom:*** This area is quite complex. Broadly speaking, legality of transactions is covered in general English statutory and case law. However, there are some specific provisions of relevance in the *Financial Services Act 1986.* These are directed at protecting investors from inappropriate investments and, as such, could capture derivatives sales. For example, a transaction entered into as a result of an unsolicited call to an investor would not be enforceable against that investor (section 56 of the Act). In practice, the UK OTC derivatives markets are almost exclusively professional markets to which these additional provisions are of limited relevance.

Market Making, Administering Collateral, Netting Cash Flows, Clearing

- ***Australia:*** The Australian Securities and Investments Commission has general responsibility for supervision of OTC markets that involve dealings in futures contracts. However, under ASIC policy, exempt futures markets must *not* have clearing facilities and agency transactions are not permitted.

- ***Belgium:*** No specific rules are applicable.

- ***Brazil:*** OTC derivatives transactions based on stocks and stock baskets are under CVM's jurisdiction. The remainder of such transactions are regulated by the Central Bank.

- ***Canada:*** There are no applicable rules.

- ***Ontario:*** There are no applicable rules.

- ***Québec:*** No specific rules are applicable.

- ***France:*** Market making, administering collateral, netting cash flows, and clearing matters are negotiated or reviewed by market professionals and, in particular, the International Securities Dealers Association.

- ***Germany:*** Responsibility for market making, administering collateral, and netting cash flows, is negotiated between the counterparties to OTC derivatives transactions. Professionals typically use standard master agreements: a domestic agreement for German transactions, and ISDA master agreements for cross-border transactions.

- ***Hong Kong:*** No specific rules apply.

- ***Italy:*** No specific rules apply. *See also* Insolvency *infra* p. 69.

- ***Japan:*** Responsibility for market making, administering collateral, and netting cash flows, is negotiated between the counterparties to OTC derivatives transactions. Professionals typically use standard master agreements: for example, domestic agreements for Japanese transactions, and ISDA master agreements for cross-border transactions.

- ***The Netherlands:*** The Securities Board of the Netherlands (STE) has no specific rules for making a two-way market, the administration of collateral arrangements and netting of cash flows, or for clearing.

- ***Spain:*** Counterparties are the responsible agents in the area of administering collateral, *etc.*, as these considerations are normally handled through master agreements. Although some domestic master agreements have been designed, the one developed by ISDA remains the most commonly used, especially for cross-border transactions.

- ***Sweden:*** OM Stockholm AB, which is authorized as both an exchange and a clearing organization, offers its members a service known as "tailor made clearing." This service allows members to clear a variety of OTC derivatives transactions involving stocks, indexes, currency, bonds, and commodities; it also administers collateral and nets cash flows.

- ***Switzerland:*** No specific rules are applicable. Market making, administering collateral, netting cash flows and clearing matters are negotiated or reviewed by market professionals or between the counterparties to OTC derivatives transactions. Normally, standard master agreements are used, like the ISDA master agreements.

- ***United Kingdom:*** No rules apply specifically to OTC derivatives transactions. There are general conduct of business rules relevant to these functions which are the responsibility of the self-regulating organizations and/or FSA. Recent amendments to UK legislation

have opened the way for Recognized Clearing Houses to provide clearing services to the OTC markets. Recognized Clearing Houses are supervised by FSA against criteria set out in the *Financial Services Act 1986*.[35]

[35] "Clearing" is an activity which, in the sense of taking on the obligations of a party to a contract, is investment business under the Act. *See* Financial Services Act, 1986, § 39 (Eng.).

Transactions Occurring Over Multilateral Electronic Execution Facilities

In your jurisdiction, are there any OTC transactions occurring over multi-lateral electronic execution facilities? If so, please specify.

- ***Australia:*** The Australian Securities and Investments Commission has received some proposals for use of multilateral screen-based trading facilities for certain limited markets (*e.g.*, electricity derivatives), but multilateral trade execution facilities are, as yet, not widely used. Screen based information systems (*e.g.*, posting prices for plain vanilla swaps) are increasingly common.

- ***Belgium:*** OTC derivatives transactions are normally concluded bilaterally.

- ***Brazil:*** According to *National Monetary Council Resolution no. 2138*, OTC derivatives transactions in Brazil must be registered with an authorized registering system. Currently, there are two of them: that of the Brazilian Commodities and Futures Exchange (BM&F), based in São Paulo, and the Financial Settlement and Custody Centre (CETIP), based in Rio de Janeiro.

  The following are the OTC derivatives transactions which may be registered[36] by financial institutions at BM&F's system:

  - Swaps and OTC options based on the appropriate reference values or interests.[37]

  - Types of Options:

    1. Call and put options on the commercial or floating R$/US$ exchange rate.
       - American or European options
       - Barrier options allowed
       - Options may include collateral guarantees by the seller

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[36] *See* Recordkeeping *infra* p. 64.

[37] Underlying reference values/interests for swaps:

1. A fixed interest rate.
2. Average interbank deposits daily interest rate.
3. Commercial R$/US$ exchange rate.
4. Floating R$/US$ exchange rate.
5. Reference Interest Rate, determined by the Central Bank of Brazil.
6. IGP consumer price index.
7. Price of gold in the "available BM&F market.
8. SELIC rate—average daily interest rate for government debt.
9. Basic Financial Rate.
10. Average time deposits interest rate.
11. Ibovespa—São Paulo Stock Exchange Index.
12. FGV 100—Getúlio Vargas Foundation Stock Index.
13. Long Term Interest Rate (TJLP)—determined by the Central Bank of Brazil.
14. A portfolio of stocks traded in the São Paulo Stock Exchange.

- Underlying dollar price may be defined in several ways (close, average, *etc.*)

2. Call and put options on the São Paulo Stock Exchange index (Ibovespa).
   - American or European options
   - Barrier options allowed. Barriers can be defined as:
     - Knock-in: option is triggered if the barrier price is reached
     - Knock-out: option ceases to exist if the barrier price is reached
     - Knock-in and -out: barriers may be combined in a single option
   - Options may include collateral guarantees by the seller
   - Underlying stock index may be based on the daily close or daily average

The CETIP registers the following:[38]

- Plain vanilla swaps;
- Swaps with caps, floors or collars;
- Forward swaps;
- Swaptions; and
- Warrants.

- ***Canada:*** *See* Clearing Facilities for OTC Derivatives Transactions *infra* p. 39.

  - ***Ontario:*** None.

  - ***Québec:*** There are no such facilities.

- ***France:*** There is only one multilateral electronic execution facility for OTC transactions, used by the Spécialistes du valeurs du Trésor (SVT), which clears transactions between bond specialists. The facility is a cash system as well as a system for executing OTC derivatives transactions.

- ***Germany:*** OTC derivatives transactions are normally concluded bilaterally.

- ***Hong Kong:*** Hong Kong is not presently aware of any transactions occurring over multilateral electronic execution facilities.

- ***Italy:*** There are information systems that will quote prices of OTC derivatives contracts managed by the intermediaries' organizations (*e.g.*, Associazione Tesorieri Istituzioni

[38] Underlying reference values/interests for swaps include:

1. Fixed interest rate.
2. Average interbank deposits daily interest rate.
3. Commercial R$/US$ exchange rate.
4. Reference Interest Rate, determined by the Central Bank of Brazil.
5. Price of gold in the "available" BM&F market.

Creditizie (ATIC) for overnight interest rate swaps). The Markets Division of CONSOB is currently undertaking an analysis that aims to determine precisely the existence and types of OTC organized derivatives exchanges.

- ***Japan:*** There are no rules that specifically address OTC transactions occurring over multilateral electronic execution facilities.

- ***The Netherlands:*** The Securities Board of the Netherlands (STE) is not aware of OTC transactions occurring over multilateral electronic execution facilities in its jurisdiction. OTC transactions are normally completed between two individual parties.

- ***Spain:*** Such facilities are not yet in existence, except in cash markets, although derivatives exchanges are currently exploring the possibility of introducing them for the execution of some very specific OTC contracts.

- ***Sweden:*** The OM Stockholm clearing service offered to its members is an electronic multilateral system. The matching of trades registered with the system occurs within the system.

- ***Switzerland:*** There are no rules that specifically address OTC transactions occurring over multilateral electronic execution facilities. OTC transactions are normally concluded bilaterally.

- ***United Kingdom:*** Any person offering multi-lateral execution facilities in the UK in respect of investments would almost certainly be regarded as doing investment business under the terms of the *Financial Services Act 1986*, and would therefore require authorization or exemption.[39] Persons offering multi-lateral execution facilities in respect of OTC derivatives that did not fall within the definition of investment would not be subject to the requirements of the Act. In respect of OTC derivatives that are not investments for the purposes of the

[39] Any person authorized or exempt for the purposes of offering such a facility would fall into one of the following broad categories:

A **Recognized Investment Exchange** (RIE). RIEs are exempt persons with regulatory responsibilities of their own who must comply with the terms of Schedule 4 of the Act. All derivatives traded on RIEs are regarded as being traded on-exchange.

A **Service Company**. Service companies are authorized persons directly regulated by the Financial Services Authority (*i.e.*, not regulated by a self regulating organisation such as SFA). Due to the restricted nature of their activities (providing services to professional market participants) a special "light" regulatory regime applies to such companies. None of the service companies regulated by the Financial Services Authority runs a multilateral execution facility for OTC derivatives.

An **authorized firm** regulated by a self-regulating organisation. Firms falling into this category are, subject in certain circumstances to the permission of their regulator, able to undertake any of a wide variety of activities. These activities may include the running of a multilateral execution facility for OTC derivatives. However, the Financial Services Authority is not itself aware of any such facility being offered by an authorized firm in the UK. It is, however, aware of at least one prospective applicant for authorized firm status with plans to introduce such a facility.

Act, the Financial Services Authority is currently aware of two multilateral electronic matching facilities, both of which are provided by § 43 listed institutions (*see also supra* note 31).

Clearing Facilities for OTC Derivatives Transactions

In your jurisdiction, are there any clearing facilities for OTC transactions? If so, please specify.

- ***Australia:*** There are no such clearing facilities in Australia.

- ***Belgium:*** Currently, bilateral clearing arrangements are used. "BELFOX," the company that organizes the Belgian Futures and Options Exchange and clearing house, is developing a multilateral clearing service for OTC derivatives transactions.

- ***Brazil:*** The Brazilian Commodities and Futures Exchange (BM&F) is the main futures exchange in Brazil. Its role in OTC derivatives transactions is circumscribed to the registering of swap transactions and two kinds of OTC options: stock index options and forex options. OTC derivatives transactions may be cleared through the exchange's clearing house, if parties so agree, at an additional fee.

  The Financial Settlement and Custody Centre (CETIP) is the largest electronic registry system in Brazil and Latin America, originally created in 1986 in a joint effort between the Central Bank of Brazil and a group of financial institutions with the objective of facilitating transactions involving interest rates and debt instruments. Today the institution offers a wide range of services to the market, among them the registration of OTC derivatives transactions. The system has no clearing house.

- ***Canada:*** Certain Canadian banks are members of Multinet International Bank, which while not operating at present, is designed to clear OTC forex transactions.

  - ***Ontario:*** There are no regulated clearing facilities for OTC derivatives transactions.

  - ***Québec:*** There are no clearing facilities for OTC derivatives transactions.

- ***France:*** There are no clearing facilities for OTC derivatives transactions.

- ***Germany:*** The Federal Securities Supervisory Office (BAWe) has no information about the existence of independent facilities for clearing OTC derivatives. However, Eurex Clearing AG will handle the clearing of transactions entered into off the Eurex exchange pursuant to special conditions (Block Trades and Basis Trades), to the extent that the contract specifications of such transactions correspond to those contracts admitted for trading at Eurex Deutschland and Eurex Zurich.

  The CASCADE-System of the Deutsche Börse AG allows the settlement of certain off-floor transactions by transmission of corresponding instructions to Deutsche Börse Clearing AG.

- ***Hong Kong:*** There are no centralized or regulated clearing facilities for OTC derivatives. However, delivery of stocks or bonds related to OTC transactions may be made through the stock or bond clearing systems.

- ***Italy:*** Currently, CONSOB is not aware of systems for clearing OTC derivatives. However, the Bank of Italy, in agreement with CONSOB regulates the operation of the clearing and settlement services for transactions involving financial instruments (which include derivatives). Bank of Italy and the CONSOB also have the authority to require regulated market [exchange] derivatives transactions to be settled exclusively though a clearing house.

- ***Japan:*** There are no specific rules for clearing facilities for OTC transactions.

- ***The Netherlands:*** Clearing facilities for OTC transactions do exist. The system is provided by the Amsterdam Exchanges and makes use of clearing members. The clearing organization accepts OTC transactions for clearing purposes if they meet the following conditions:

    - The buy and sell side of the transaction match in all material respects;
    - The contract specifications comply with the criteria determined by the clearing organization;
    - Transactions have been concluded for the account of customers of the clearing members concerned; and
    - The transactions are reported on the business day they were executed or the next business day.

- ***Spain:*** Such facilities are not yet in existence, except in cash markets, although derivatives exchanges are currently exploring the possibility of introducing them for the execution of some very specific OTC contracts.

- ***Sweden:*** As mentioned above, OM Stockholm offers clearing services to its members for OTC derivatives transactions. The clearing rules direct banks and securities firms to register a contract in OM's clearing system, which is an electronic multilateral system. The matching of trades takes place within this system.

- ***Switzerland:*** There are no specific rules for clearing facilities for OTC transactions, but general rules do exist. Each stock exchange (Swiss Exchange and Eurex Zurich) has a clearing organization handling the clearing of transactions entered pursuant to specific conditions. Swiss banks also participate in the "Continuous Linked Settlement" (CLS) system originated by the Group of Twenty, which is a real-time electronic system for the settlement of forex transactions.

- ***United Kingdom:*** HM Treasury has recently consulted on changes to UK law that will improve the regulatory framework for OTC clearing through an extension of the protection from the normal operation of insolvency law to OTC (as well as exchange) contracts.[40]

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[40] *The Clearing of Over the Counter Investment Transactions: A Proposal for Consultation by HM Treasury*, HM TREASURY (Apr. 9, 1998) [hereinafter *Consultation Paper from HM Treasury*], *and* Recent and Contemplated Changes *infra* p. 73. *See also* Appendix I: Special Note on the European Union and OTC Derivatives *infra* p. 105.

Currently, there are two OTC clearing facilities operating in the UK:

(1) The first is the Exchange Clearing House (ECHO), which provides a cross-border netting facility for forex spot and forward contracts.[41] These are not regarded as investments for the purposes of the *Financial Services Act 1986*; however, ECHO is listed as a money market institution under § 171 of the *Companies Act 1989* and is supervised in that capacity by the Financial Services Authority. (Prior to June 1, 1998, it was supervised by the Bank of England).
(2) The other recognized clearing facility is OMLX, a recognized investment exchange subject to the requirements of Schedule 4 of the *Financial Services Act*, that clears OTC derivative instruments not traded on its exchange. The instruments cleared by OMLX are investments for purposes of the Act.

In addition, the London Clearing House has well-advanced plans for introducing a clearing facility for OTC derivatives transactions, specifically swaps.

[41] CLS Services, Ltd., a UK company, owns ECHO and CLS Bank, a New York bank. CLS is a real-time gross settlement system, and ECHO is a multilateral netting arrangement. CLS Services, Ltd. shareholders are the 68 largest forex market participants, including the former Group of 20 banks and investment banks.

Regulatory Requirements:

For each product, specify whether there are requirements relative to:

- Design of transaction;
- Custodianship of collateral;
- Use or hypothecation of collateral;
- Means of valuation of the transaction;
- Disclosure of valuation methodology;
- Other disclosure;
- Conduct of business generally (pricing, conflicts of interest, advice or sales tactics);
- Capital;
- Internal controls of counterparties generally, or internal controls of counterparties that are otherwise subject to financial services regulation (please explain any differences);
- Documentation;
- Recordkeeping;
- Financial reporting; and
- Insolvency.

In each case, specify any differences between these requirements and those that would apply to other financial products.

General Comments

- ***Belgium:*** There are no specific requirements regarding OTC derivatives with respect to credit institutions, except for valuation and disclosure of valuation methodologies, capital, internal controls, and financial reporting. Investment firms are subject to similar, if less formal, requirements.

- ***France:*** Although regulations in France are not product-based, focusing instead on the institutions involved in trading, the French regulatory scheme indirectly addresses the products traded by establishing institutional regulatory requirements which necessarily take into account the financial instrument transacted in. For example:

  Reglement no. 97-02: Internal Controls

  In general, without distinctions as to the nature of the product traded, credit institutions are required to have systems of controls which include:

  - systems addressing internal operations and procedures;
  - an accountable organization;
  - systems to survey and manage risks;
  - systems to measure risks and results;
  - systems for documenting information appropriate to the nature and volume of their activities, their size and the other types of risk to which they are exposed; and
  - systems which are periodically tested as to adequacy.

These internal control requirements also apply to all investment firms which are supervised by the Commission Bancaire.

In implementing the regulations, affected institutions must have an internal audit committee with specified responsibilities, including for monitoring credit risk, market risk, interest rate risk, liquidity risk, settlement risk, operational risk, legal risk, as well as the responsibility to consider the maximum potential loss at specified stress levels.

The institution must:

- maintain an audit trail, as required, that permits, among other things, reconstruction of the order of transactions;
- preserve the confidentiality and security of information systems;
- maintain credit risk procedures which address both on and off-balance sheet risks;
- back-test systems;
- provide for separation of functions;
- set global risk-limits by type of risk consistent with the system used for risk measurement; and
- report on a periodic basis to the decision-making body and, at least, once per year to the board of directors.

- ***Germany:*** There are no prescribed legal requirements concerning the items listed in the questionnaire. Many of these items usually form part of a contract between the counterparties to an OTC derivatives transaction. In October 1995, the Federal Banking Supervisory Office (BAKred) issued a statement concerning minimum requirements for credit institutions focusing on duties of banks related to derivatives business, including:

  - Responsibility of management;
  - Qualifications of staff;
  - Preservation of records;
  - Use of risk limits;
  - Separation of functions;
  - Renewal of forward exchange dealing.

- ***Italy:*** There are no provisions that relate specifically to OTC products. Institutions, whether investment firms or credit institutions, are subject to provisions relating to capital, internal controls, recordkeeping, and reporting, that include all transactions they undertake as well as conduct of business rules. CONSOB regulates investment firms which may provide "core services," including "dealing and reception and transmission of orders and [the] bringing together of two or more investors to engage in derivatives." The Bank of Italy authorizes provisions of investment services, including derivatives dealing for banks, and, in consultation with CONSOB, for other, non-investment, financial intermediaries. The *Investment Services Directive*, as implemented in Italy, covers swaps and forward rate agreements. Italy permits investment firms to operate in such derivatives under the ISD passport.

- ***Ontario:*** Derivative products are not regulated on a product basis, but rather on a jurisdictional basis – that is, the jurisdiction (federal or provincial) to which the counterparties are subject (*see supra* note 1).

  The Ontario Securities Commission may regulate counterparties if the transaction is a trade in a security and therefore subject to the *Ontario Securities Act*, or if the counterparty is a registrant subject to the Act. Insolvency matters are governed by federal legislation.

- ***Québec:*** There are no specific requirements relative to OTC derivatives.

- ***The Netherlands:*** The *Act on the Supervision of Securities Trading* sets no special requirements for the items mentioned in relation to OTC derivatives products. The only exception relates to capital requirements for OTC derivatives products which differ for each product, dependent on the maturity, position (net long or short) or in case of options, whether the option is in-, at-, or out-of-the-money.

- ***Spain:*** As noted previously, regulations in Spain are not product-based, but are entity-based, with the exception for rules governing derivatives transactions of CIS entities. However, financial reporting, capital, conduct of business and internal control and risk surveillance rules indirectly address the products by establishing regulatory requirements on the activities carried out by credit institutions and investment firms. Many of the elements listed are explicitly dealt with in the contract subscribed to by the counterparties to the OTC derivatives transaction.

  New regulations regarding internal controls of CIS Management Companies operating in derivatives, as well as investment firms, whatever their activities, have been recently issued. Among other things, these new regulations establish that the Board of Directors must assume full responsibility for the development, implementation and on-going effectiveness of internal controls based on:

  - Regular and effective communication systems within the entity to ensure that the Board of Directors is continually and timely informed of the risks assumed;
  - Risk policies and measurements and reporting systems that are subject to regular review;
  - Enough, and appropriate, human and technical resources, and an effective organizational structure, which ensure that functions are conducted in a sound, efficient and effective manner, are in place, including:
    - Recruitment policies that ensure the company only employs people who are fit and proper to perform the duties for which they are employed, and that adequate training suitable for the employees is implemented;
    - Key functions that are appropriately segregated; that is: I) management, II) back-office and accounting, and III) risk control;

- Electronic information systems appropriate to carry out the entity's functions, operating in a secure and adequately controlled environment;
- Responsibilities, authorizations, approvals, and operating limits that are clearly defined and communicated to, and followed by, staff;
- Procedures which are established to ensure the compliance with all regulatory requirements and with the entity's own internal policies; and
- Establishment of an appropriate and effective compliance function that is maintained within the entity, independent of all operational and business functions, and which reports directly to the Board of Directors.

- ***Sweden:*** There are no special requirements for OTC derivatives transactions, although the items listed in this survey question are mentioned in the *Securities Business Act* (1991:981) and Finansinspektionen's *Regulations on Securities Trading and Services* (FFFS 1997:36).

- ***Switzerland:*** There are no specific requirements regarding OTC derivatives. The *Federal Act on Stock Exchanges and Trading in Securities* (SESTA) applies to securities dealers engaging in any type of transaction covered thereby, which would include those OTC derivatives which qualify as securities (as defined in Article 2 of the SESTA). Individually negotiated transactions which are not standardized as to their terms are not covered.

- ***United Kingdom:*** With the exception of product design (because there is no system of product regulation in the UK for OTC derivatives), there are conduct of business requirements for all the areas listed in the survey. These requirements normally apply to investment transactions, generally, rather than to OTC transactions specifically.[42]

Transaction Design

- ***Australia:*** All transactions in an exempt futures market must:

  (a) Have the person who has been permitted to provide the exempt futures market as a party to the contract;
  (b) Be entered into by each counterparty:
  (i) as principal on the person's own account;
  (ii) on behalf of a related body corporate; or
  (iii) as trustee of a trust or manager of a fund
  but not otherwise on behalf of another person;
  (c) Be entered into after individual credit assessment of the counterparty;
  (d) Create obligations that can be transferred or terminated (other than in the case of agreed events) only with the consent of the counterparty; and
  (e) Not be supported by the credit of a clearing organization or a mark-to-market margin and settlement system routinely involving a third party.

[42] The general conduct of business requirements are set out in regulatory rulebooks. They differ according to whether the authorized persons are conducting business on their own account, or are engaging in transactions on behalf of clients, for which different regulatory regimes, as noted previously, operate.

- ***Belgium:*** None.

- ***Brazil:*** New products must serve an economic purpose, and prior authorization by the Central Bank or CVM is required.

- ***Canada:*** None.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No applicable requirements.

- ***France:*** None.

- ***Germany:*** No specific requirements.

- ***Hong Kong:*** None.

- ***Italy:*** None.

- ***Japan:*** There are no requirements specific to the design of OTC derivatives.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** None.

- ***Sweden:*** None.

- ***Switzerland:*** None.

- ***United Kingdom:*** None. There is no formal system of product regulation for derivatives in the UK. In the case of OTC derivatives, there are no product-specific requirements, and therefore no requirements that relate to the design of the transaction.[43]

Custody of Collateral

- ***Australia:*** There is no legislative requirement; this is a matter for individual agreement.

- ***Belgium:*** There are no specific requirements regarding OTC derivatives with respect to credit institutions or investment firms.

- ***Brazil:*** No specific requirements.

[43] However, derivatives traded on-exchange are standardized, and will be subject to product specific requirements set (in accordance with the requirements of Schedule 4 of the *Financial Services Act 1986*) by the recognized investment exchange on which trading takes place.

- ***Canada:*** None.
  - ***Ontario:*** No applicable product-based rules.
  - ***Québec:*** No applicable requirements.
- ***France:*** None.
- ***Germany:*** No specific requirements.
- ***Hong Kong:*** There are requirements for securities dealers and leveraged foreign exchange traders as to custodianship of collateral.
- ***Italy:*** There are no requirements specific to OTC derivatives transactions.
- ***Japan:*** There are no requirements specific to OTC derivatives transactions.
- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.
- ***Spain:*** Only licensed entities (either credit institutions or investment firms) can act as custodians.
- ***Sweden:*** None.
- ***Switzerland:*** None.
- ***United Kingdom:*** Broadly speaking, the current position is that, where an authorized firm is holding collateral as agent on behalf of a client, that collateral must be legally registered and held as directed by the client, and clearly segregated from the firm's own assets. Assets held as collateral for a firm's own principal deals must be clearly identifiable as such in the firm's records, and not held in a way that conflicts with contractual arrangements in place between the firm and its counterparty. UK collateral rules are currently under review.

Use or Hypothecation of Collateral

- ***Australia:*** There is no legislative requirement.
- ***Belgium:*** There are no specific requirements regarding OTC derivatives.
- ***Brazil:*** No specific requirements.
- ***Canada:*** Approval by OSFI is generally required before assets may be pledged by banks subject to its supervision.

- ***Ontario:*** No applicable product-based rules.

- ***Québec:*** No applicable requirements.

- ***France:*** None.

- ***Germany:*** No specific requirements.

- ***Hong Kong:*** There are requirements for securities dealers and leveraged foreign exchange traders for the use or hypothecation of collateral.

- ***Italy:*** There are no requirements specific to OTC derivatives transactions.

- ***Japan:*** There are no requirements specific to OTC derivatives transactions.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** No specific requirements for OTC derivatives products.

- ***Sweden:*** None.

- ***Switzerland:*** None.

- ***United Kingdom:*** The basic requirement on authorized firms is that collateral (whether held as agent for a client or in relation to principal deals entered into by the firm) can only be used or hypotheticated by the firm as allowed for in the written agreement between the relevant parties.

Means of Valuing a Transaction

- ***Australia:*** There is no legislative requirement.

- ***Belgium:*** With respect to credit institutions and investment firms, instruments that do not have a liquid market are valued differently from instruments that do have such a market, (*e.g.*, there is no mark-to-market requirement for instruments for which there is no liquid market).

- ***Brazil:*** No specific requirements. The impact of swap transactions on the risk-adjusted equity value is detailed in the information on Financial Reporting *infra* p. 66.

- ***Canada:*** General prudential requirements consistent with the Basle guidelines apply. Canada permits the use of proprietary models or a standardized approach for market risk. OSFI has a models group which is intended to assure the integrity of the models used.

- ***Ontario:*** No applicable product-based rules.

- ***Québec:*** No applicable requirements.

- ***France:*** None.

- ***Germany:*** No specific requirements.

- ***Hong Kong:*** There are requirements for securities dealers, leveraged foreign exchange traders, and for authorized institutions, as to the means of valuing a transaction.

- ***Italy:*** Specific requirements on valuation are provided by the Bank of Italy for collective investment schemes, and portfolio management services.

- ***Japan:*** *See* Disclosure of Valuation Methodology *infra* p. 51.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** There are no requirements currently in place specific to OTC derivatives transactions or directly applicable to other types of entities, although internal control rules require that investment firms and CIS Management Companies have available means for adequate valuation of transactions, as well as procedures implemented to compare market risk, when available, with internal valuations.

- ***Sweden:*** The *Capital Adequacy Directive* applies mark-to-market accounting to OTC derivatives.

- ***Switzerland:*** The *Guidelines of the Swiss Federal Banking Commission* concerning the preparation of the financial statements of banks and/or securities dealers set forth valuation rules applicable to derivative financial instruments. All trading positions, including OTC derivatives positions, are to be marked to market daily. Other guidance requires trading positions to be valued daily using consistent criteria, and market data profit and loss to be calculated daily. Positions in derivatives that are not part of a trading book must be valued periodically, taking account of market liquidity and position size. Model parameters must be set from independent sources, the models have to be tested, and also have to be reviewed periodically.

- ***United Kingdom:*** No specific valuation method is required. The requirement is a general one to the effect that authorized firms must ensure that their valuation of transactions is fair (*i.e.*, broadly speaking, a mark-to-market valuation).

Disclosure of Valuation Methodology

- ***Australia:*** There is no legislative requirement, but there is a general requirement that any representations related to a product not be misleading.

- ***Belgium:*** Derivatives transactions must be disclosed according to their characteristics and the valuation methodology must be disclosed, as well. With respect to options, there is no legal obligation to distinguish between OTC and exchange-traded transactions, although some banks make the distinction in their public disclosures.

- ***Brazil:*** No specific requirements.

- ***Canada:*** There is no requirement at the federal level to report to counterparties. All records and valuation methodologies are fully accessible to OSFI.

    - ***Ontario:*** No applicable product-based rules.

    - ***Québec:*** No applicable requirements.

- ***France:*** None.

- ***Germany:*** The methods for valuation of the credit and market risk ratio have to be disclosed to the Federal Banking Supervisory office (BAKred).

- ***Hong Kong:*** Licensed institutions are required to disclose their valuation methodology to the Securities and Futures Commission or Hong Kong Monetary Authority.

- ***Italy:*** There are no requirements specific to OTC derivatives transactions.

- ***Japan:*** The Report of the Securities and Exchange Council on *Securities-Related Over-the-Counter Derivatives Trading* recommended creating a duty to explain the method of computing indicators consistent with customers' capability and experience.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** The periodic informative reports of CIS Management Companies carrying out derivatives business have to include a description of the valuation methodologies they have in place. There are no other requirements specific to OTC derivatives transactions.

- ***Sweden:*** None.

- ***Switzerland:*** The *Implementing Ordinance on Banks and Savings Banks* (Article 25c, paragraphs 2 and 4.3), and the *Guidelines of the Swiss Federal Banking Commission* concerning the preparation of financial statements of banks (paragraphs 144, 147, 149, 193-197), require information on the valuation and presentation policies used both for on-

and off-balance sheet posting, particularly with regard to the use of derivative financial instruments in preparing financial statements by both security dealers and banks. Exchange-traded and OTC transactions must be separately stated. At year end, interest values and contract volumes must be analyzed by the following categories: interest rates, foreign currencies, precious metals, equity securities/indexes, and others.

- ***United Kingdom:*** Authorized firms are required to produce periodic valuation reports for their clients, including on derivatives transactions. These valuation reports must include a statement of the basis on which the valuation was made. There is an exception to this requirement in respect of OTC derivatives transactions which a firm has entered into, with, or on behalf of a non-private customer (*i.e.*, a sophisticated investor), provided they were not acting as a discretionary investment manager in so doing.

Other Disclosure

- ***Australia:*** A condition of the exempt futures market is that the operator must not engage in misleading and deceptive conduct (including misleading and deceptive disclosures). Other legislation, such as the federal *Trade Practices Act* and its State equivalents, prohibit misleading and deceptive conduct in commerce generally.

  The disclosure requirements under the accounting requirements of the *Corporations Law* and the accounting standards require the disclosure of the relevant person's derivatives liability (*see* Financial Reporting *infra* p. 66).

- ***Belgium:*** There are no specific requirements regarding OTC derivatives with respect to credit institutions. However, with respect to Undertakings for Collective Investment, a stated investment policy must explicitly and comprehensively indicate the risks and yield perspectives of the instruments it uses. Counterparty risk inherent in OTC derivatives transactions must be limited by restricting the choice of counterparties to regulated intermediaries that are subject to harmonized prudential rules. Information about the counterparty to a transaction is an integral part of the information to be provided to an investor. If a promoter or depository acts as a counterparty, this must be clearly indicated in the UCI's prospectus and periodic reports.

- ***Brazil:*** No specific requirements.

- ***Canada:*** None.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No applicable requirements.

- ***France:*** None.

- ***Germany:*** None. Risks of derivatives generally must be disclosed to unsophisticated counterparties.

- ***Hong Kong:*** Securities dealers and leveraged foreign exchange traders are required to disclose risk. In addition, authorized institutions are required to provide risk disclosures if they are acting in an advisory capacity, as opposed to in a principal role.

- ***Italy:*** There are no requirements specific to OTC transactions, but the Italian generic risk disclosure statement relating to derivatives expressly refers to OTC derivatives.

- ***Japan:*** For securities-related derivatives, "in view of their character, it is necessary to disclose to investors not only information such as the method of computing redemption, the exercise price and creditworthiness of the issuing companies of the relevant securities [derivatives], but also information pertaining to the underlying stocks."

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** Both the quarterly and annual reports of CISs have to include an explicit and comprehensive description of investment criteria and policies for their derivatives transactions, particularizing objectives, instruments' types, risks assumed, and risk limits connected with these kinds of transactions. Additionally, detailed information on these transactions is required, including data on the gains and losses originated. For hedging transactions, information has to be provided on the gains and losses of both the hedging and the hedged transactions, as well as the net result.

  With specific regard to OTC derivatives transactions, the CIS entity also has to indicate credit ratings of all its counterparties, as well as whether the depository or an entity belonging to the same group as the CIS or the CIS Management Company is one of the subscribers.

- ***Sweden:*** There are rules for off-balance sheet accounting. Further, before engaging in a derivatives transaction for the first time, a customer must receive written information about specific risks associated with derivatives transactions. However, this information may not need to be provided "if it is manifestly unnecessary."

- ***Switzerland:*** There are no applicable requirements.

- ***United Kingdom:*** Authorized persons engaging in OTC derivatives transactions on behalf of unsophisticated investors are required to issue detailed risk-warnings which the investors must sign and return in advance of a transaction taking place. No such requirements apply where transactions are being entered into on behalf of sophisticated customers. In all cases, authorized persons are required to disclose whether they are entering into a transaction as principal or agent.

Conduct of Business

- ***Australia:*** There is 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 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 is likely to mislead or deceive.

General prohibitions in the *Corporations Law* apply to all types of futures markets, including OTC markets. These include prohibitions on:

- Futures market manipulation;
- False trading and market rigging;
- False or misleading statements in relation to futures contracts;
- Fraudulently inducing persons to deal in futures contracts.

- ***Belgium:*** Article 36 of the *Law of 6 April 1995* establishes certain rules of conduct for financial intermediaries (*e.g.*, regarding honesty and fair dealing, acting in the best interests of clients, *etc.*; *compare with* ISD Article 11). For exchange products, the duty to use skill and diligence, taking account of the customers' professional knowledge ("know your customer"), and to act in their best interests, is presumed satisfied if the transaction is carried out on a regulated market, is consistent with exchange rules, and any client instructions. These rules apply to transactions in financial instruments including proprietary transactions by intermediaries. The Belgian exchanges are required to adopt their own rules to implement these rules of conduct, subject to oversight by the Banking and Finance Commission and the Minister of Finance.

- ***Brazil:*** No specific requirements.

- ***Canada:*** Banks are required to implement, and to monitor adherence to, a comprehensive code of conduct that is applicable to directors, management and staff. The code generally pertains to the ethical behavior of directors, management and staff in relation to the bank and/or its clients. Banks are required to perform a self-assessment of their compliance with this requirement. OSFI reviews the self-assessment for completeness and material deficiencies. Banks are also required to designate an officer to be responsible for corporate wide compliance matters. OSFI assesses the effectiveness of corporate compliance processes.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No applicable requirements.

- ***France:*** The Conseil des Marchés Financiers (CMF) sets the general principles for market operations, which include rules of conduct for investment services providers, the fundamental principles for the organization and operation of regulated markets and clearing houses. These apply to such providers without regard to the underlying product.

- ***Germany:*** The Federal Securities Supervisory Office (BAWe) monitors compliance of investment service enterprises (*i.e.*, credit institutions, exchange brokers, portfolio managers, investment brokers) with rules of conduct pursuant to Sections 31 *et seq.* of the Wertpapierhandelsgesetz (WpHG, the German "*Securities Trading Act*"). Such rules of conduct concern *inter alia* conflicts of interest, disclosure, documentation and internal organization. They are set forth in greater detail in regulations enacted by the BAWe (Richtlinie zur Konkretisierung der §§ 31 und 32 WpHG für das Kommissions-, Festpreis- und Vermittlungsgeschäft der Kreditinstitute, "*Guideline on the Details Concerning Sections 31 and 32 of the WpHG Relating to the Commission, Fixed Price and Agency Business of Credit Institutions*"; and Richtlinie zur Konkretisierung der Organisationspflichten von Wertpapierdienstleistungsunternehmen, "*Guideline Setting Out the Details of the Organizational Requirements of Investment Services Enterprises*"). Furthermore, the Federal Banking Supervisory Office (BAKred) has laid down regulations, which, although directly applicable only to banks, offer important guidance to all investment service enterprises (Verlautbarung über Mindestanforderungen an das Betreiben von Handelsgeschäften der Kreditinstitute, the "*Announcement on Minimum Requirements for the Carrying Out of Trading Transactions by Banks*"). Additional monitoring is undertaken by exchanges with regard to their members.

- ***Hong Kong:*** Securities dealers and leveraged foreign exchange traders are subject to disclosure and conduct of business requirements which apply generally to all types of transactions.

- ***Italy:*** Article 44 of *CONSOB Regulation no. 11522 of 1 July 1998* provides detailed rules on OTC derivatives transactions for portfolio management services.

- ***Japan:*** The *Securities and Exchange Law*, its related ministerial ordinance, and the rules of the Japan Securities Dealers Association (JSDA, one of the self-regulatory organizations) set out requirements governing financial institutions that apply to all securities transactions, including securities-related OTC derivatives. They include, for example, a risk disclosure requirement, prohibition of solicitation to clients unsuitable to the transactions and of conduct that is deceptive or is likely to deceive, *etc.*

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** There are no product-specific requirements.

- ***Sweden:*** Exchange rules and the laws on insider trading govern pricing and conflicts of interest. There are no rules for the provision of investment advice and sales practices. Further, a securities firm must adopt rules for transactions undertaken by employees and related persons. These rules must stipulate that the minimum holding period for financial instruments and foreign currencies may not be less than three months. However, there are exceptions in certain circumstances, including when acquiring financial instruments (but not derivative instruments with redemption periods of less than three months and

where the redemption amount is known at the time of acquisition). In general, however, existing rules are not specific to OTC products.

- ***Switzerland:*** The *Federal Act on Stock Exchanges and Trading in Securities* (SESTA Article 11) and the *Code of Conduct for Securities Dealers* set out detailed requirements governing securities dealers that apply to all securities transactions (*i.e.*, "as well as over-the-counter transactions in both spot and forward trading"). These rules state, for example, that risk disclosure of special risks in particular transactions be standardized for all clients, or individually tailored to the client's experience; they also establish, for example, guidance on the timing of execution and allocation of orders, prohibition of frontrunning, *etc.*

- ***United Kingdom:*** The general principles[44] of conduct of business apply. The detailed rule books of the various self-regulating organizations underpin these general principles.[45]

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[44] The Principles:

1. *Integrity* – A firm should observe high standards of integrity and fair dealing.
2. *Skill, Care and Diligence* – A firm should act with due skill, care and diligence.
3. *Market Practice* – A firm should observe high standards of market conduct. It should also, to the extent endorsed, for the purposes of this principle, comply with any code or standard as in force from time to time as it applies to the firm either according to its terms or by rulings made under it.
4. *Information About Customers* – A firm should seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfill its responsibilities to them.
5. *Information For Customers* – A firm should take reasonable steps to give a customer it advises, in a comprehensible and timely way, any information needed to enable him to make a balanced and informed decision. A firm should similarly be ready to provide a customer with a full and fair account of the fulfillment of its responsibilities to him.
6. *Conflicts of Interest* – A firm should either avoid any conflict of interest arising or, where conflicts arise, should ensure fair treatment to all its customers by disclosure, internal rules of confidentiality, declining to act, or otherwise. A firm should not unfairly place its interests above those of its customers and, where a properly informed customer would reasonably expect that the firm would place his interests above its own, the firm should live up to that expectation.
7. *Customer Assets* – Where a firm has control of or is otherwise responsible for assets belonging to a customer which it is required to safeguard, it should arrange proper protection for them, by the way of segregation and identification of those assets or otherwise, in accordance with the responsibility it has accepted.
8. *Financial Resources* – A firm should ensure that it maintains adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject.
9. *Internal Organization* – A firm should organize and control its internal affairs in a responsible manner, keeping proper records, and where the firm employs staff or is responsible for the conduct of investment business by others, should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures.
10. *Relations with Regulators* – A firm should deal with its regulator in an open and cooperative manner and keep the regulator properly informed of anything concerning the firm which might reasonably be expected to be disclosed to it.

[45] This matter also has been previously addressed in the U.S. Commodity Futures Trading Commission, U.S. Securities and Exchange Commission, and U.K. Securities and Investment Board Joint Statement, dated March 15,

Capital

- ***Australia:*** There are no rules for the capital requirements for products. "Regulated facility providers" are either banks subject to banking capital requirements (Basle capital standards), broker-dealers subject to broker-dealer requirements, or authorized foreign broker-dealers whose debt is rated investment grade.

- ***Belgium:*** With respect to credit institutions and investment firms, credit risk weightings for OTC instruments are a function of the nature of the counterparty, underlying interest, and maturity of the instrument. These instruments are subject to market (position) risk weightings if they are considered trading instruments. Belgium thus implements the *European Solvency, Capital Adequacy* and *Large Exposures Directives*, as well as the *Basle Capital Accord.*

- ***Brazil:*** The Central Bank specifies minimum capital requirements based on the Bank for International Settlements' recommendations for all authorized financial institutions, which institutions must be the counterparty of an OTC derivatives transaction. Investment banks must have a net worth of US$ 500,000. In addition, swap operations are taken into account when the Central Bank measures a financial institution's risk exposure *(see* Appendix II: Supplement on Brazilian Financial Reporting *infra* p. 109).

- ***Canada:*** Banks, generally, are required to follow the standards established by the Bank for International Settlements.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No applicable requirements.

- ***France:*** The Commission Bancaire, in providing prudential supervision of financial services firms, applies rules of capital adequacy relating to market risk that are based on

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1994, for oversight of the OTC derivatives market (US-UK Joint Statement), in which the parties declared, among other things:

> Having regard to the complexity and lack of transparency characteristic of many OTC derivatives products, the Authorities, as necessary, will encourage the development of a regulatory framework that addresses the particular suitability, know your customer or access issues arising in OTC derivatives transactions. The Authorities will request relevant self-regulatory organizations to review, and where necessary, amend their customer transaction requirements to reflect the nature of the OTC derivatives business. One approach would be for the self-regulatory organizations to work with market participants to consider what steps are necessary to ensure, in appropriate cases, that members making a recommendation for an OTC derivatives transaction to a customer other than a dealer in OTC derivatives possess sufficient information about the customer and its resources to assess the appropriateness of the transaction for the customer, including information about whether the customer, by reason of its business or experience, has the capability to understand the risks relating to the transaction. The Authorities will take appropriate steps to encourage regulated end-users to establish and maintain management controls that address the risks posed by their transactions in derivative products.

value at risk (VAR) with a multiplier of three. Exchange-traded derivatives are not considered to have counterparty credit risk.

- ***Germany:*** The Federal Banking Supervisory Office (BAKred) oversees how the derivatives positions of credit institutions and financial institutions are incorporated into their capital ratio requirements. OTC derivatives transactions are risk assets for credit-risk ratios under the *Banking Act* (KWG) (*cf.* also Section 4 of Principle I of the Grundsätze über die Eigenmittel und die Liquidität der Institute; the "*Principles Concerning Capital and Liquidity of the Institutions*"). Under Sections 19 (1), 13 and 14 of the *Banking Act* and the Großkredit- und Millionenkreditverordnung (GroMiKV, "*Ordinance Concerning the Valuation of Credits*") most derivatives have to be included in the calculation of major loans of banks and investment firms to debtors. Such loans (i) have to be reported to the German Federal Bank (Bundesbank) and the Federal Banking Supervisory Office (BAKred); and (ii) must not exceed a certain percentage of the creditor's equity without approval by the BAKred.

- ***Hong Kong:*** Securities dealers, leveraged foreign exchange traders, and authorized institutions all have capital requirements.

- ***Italy:*** The specific risks of OTC derivatives are considered in the formation of capital ratios for regulated intermediaries. Ordinarily exchange-traded derivatives are not considered to involve counterparty risks.

- ***Japan:*** Under current capital rules, market risk with respect to OTC trading in interest rate swaps and FRAs is not included. The OTC report recommended that rules be modified to include a market risk charge for *all* derivatives, including securities derivatives. To ensure that the realities of hedge transactions are reflected appropriately, the requisite measures for netting the amount of risk between positions will be formulated. Capital ratios will also be required to be published. Accounting standards for financial instruments are also designated for review, including the use of mark-to-market methodology. Through these initiatives, a system of accounting standards and disclosure particulars that are in line with international norms should be put into place. The Business Accounting Council issued a proposal on June 6, 1997 to revise the consolidated system of accounts. Other accounting issues will also be examined in due course.

- ***The Netherlands:*** The *Act on the Supervision of Securities Trading* sets no special requirements for the items mentioned in relation to OTC derivatives products. The only exception relates to capital requirements for OTC derivatives products, which differ for each product, dependent on the maturity, position (long or short) or in case of options, whether the option is in-, at-, or out-of-the-money.

- ***Spain:*** The capital requirements affecting regulated entities (credit institutions and investment firms) are based on an estimation of the credit risk assumed, which for OTC derivatives transactions takes into account the nature of the counterparty, the underlying interest, and the maturity of the instrument. Exchange-traded derivatives are considered as not being exposed to counterparty risk.

As part of the EU, Spanish rules are the result of the implementation of the *European Solvency, Capital Adequacy, Large Exposures* and *"Netting" Directives*. Two new Directives have been approved as recently as last June and should be implemented before the end of June 2000. One modifies the *Capital Adequacy Directive*, allowing the use of proprietary models to measure market risk for capital purposes, and the other allows for the treatment of cleared OTC transactions as exchange-traded derivatives.

- ***Sweden:*** There are rules covering initial capital and capital requirements for credit and market risks.

- ***Switzerland:*** Banks and securities dealers are required to follow the standards established by the Bank for International Settlement (BIS) which have been slightly modified. General capital requirements exist depending on the institution. Securities dealers must have a minimum capital of 1.5 million Swiss francs, which must be fully paid-in; collateral of at least 1.5 million Swiss francs in the form of a bank guarantee or of a cash payment on a blocked bank account. Banks must have capital of at least 10 million Swiss francs. The detailed regulation concerning regulatory capital is described in the *Banking Ordinance,* the *Ordinance Regarding Stock Exchanges and Securities Dealers*, and in the *Guidelines of the Swiss Federal Banking Commission Governing Capital Adequacy Requirements to Support Market Risks.*

- ***United Kingdom:*** The EU *Capital Adequacy Directive* and/or the *Second Banking Directive* apply to financial intermediaries.[46] These Directives address risks related to all traded off-balance sheet instruments. The requirements of these Directives are supported by detailed capital rules set out by the self-regulating organizations.

Internal Controls of Counterparties

- ***Australia:*** There is no direct prescription as to internal controls required for counterparties, apart from the requirement that counterparty creditworthiness must be assessed. This reflects the fact that the participation in the market is limited to "professionals." Participants in the markets, as a matter of good commercial practice, are developing corporate governance procedures, including risk management policies, to manage their exposures in these markets. ASIC is proposing some general internal controls requirements for participants in specialized markets, such as electricity derivatives.

- ***Belgium:*** With respect to credit institutions and investment firms, Banking and Finance Commission rules follow the Basle Committee's *July 1994 Risk Management Guidelines for Derivatives*.

[46] The US-UK Joint Statement, *supra* note 45, states "The Authorities will work to promote the establishment of prudent risk-based capital charges for securities and futures firms, taking into account prudential policies on customer funds. The Authorities also recognize that it is important for prudential reasons, for securities and futures firms using proprietary models to incorporate and to undertake stress simulations approximating severe market movements."

As mentioned above, under Belgian securities law an Undertaking for Collective Investment must observe certain rules for spreading risk. An OTC derivatives transaction must be flexible enough to allow a UCI to maintain its investment objectives without excessive costs, regardless of any fluctuation in the number of participants in the UCI. UCIs and depository institutions must be organized appropriately and have sufficient operational experience to correctly assess contracts and related risks. Assessment rules must make it possible to justify the transaction on the basis of the UCI's investment policy, and to allow permanent monitoring of its investment objectives.

The Banking and Finance Commission issued specific guidelines to credit institutions relating to internal organization and monitoring of transactions on the money and forex markets. It also recently issued general instructions to credit institutions relating to internal control and internal audit (*Circular Letter of 30 June 1997*).

Principal types of risks related to products are generally catalogued, and examples of how such risks are monitored or surveilled are as follows:

- Credit risk (risk of not honoring obligations):
  - Concentration of risks in one counterparty, in an economic sector, in a particular country
  - Settlement risk
- Market risk (risk of loss from price movements):
  - General interest rate risk
  - Exchange rate risk
  - Positions immediately affected by market changes, volatility
- Liquidity risk (risk that needed financing cannot be timely found, or positions cannot be covered because of insignificant market depth)
- Operational risk (risk of losses due to human error, insufficient information systems, inadequate controls)
- Legal risk (risk that a contract is not properly documented or is *ultra vires*).

For risk management purposes, risks are not analyzed on a product-by-product basis. Instead, the different elements of risk are distinguished and limits are set.

- ***Brazil:*** As already mentioned, the financial institutions must have, among the statutory directors, a "technically qualified administrator" who becomes liable for the internal controls and risk management systems used in OTC derivatives transactions (as well as non-derivatives transactions). A signed formal statement from this administrator is required by *National Monetary Council Resolution no. 2138*, Article 5, declaring that the

internal models used in the OTC derivatives transactions risk management systems are adequate. The statement must be presented to the Central Bank of Brazil before the startup of the OTC derivatives operation, and it is the legal instrument by which the administrator becomes liable for any fraud or negligence in the transactions. There are no requirements for disclosure either of the internal models themselves or of the procedures or tests used to validate them.

- ***Canada:*** Banks are required to have prudent risk management processes for all exposures, including counterparty exposure in OTC derivatives transactions. OSFI's supervisory processes include assessing the effectiveness of these risk management practices.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No applicable requirements.

- ***France:*** There are internal control requirements for counterparties such as banks and investment services providers. However, there are no differences between these controls and the application of them based on the types of financial products traded, with the exception of capital adequacy rules, which are different in terms of the risks carried.

- ***Germany:*** Chapter 3 of the Announcement of the Federal Banking Authority (BAKred) on *Minimum Requirements for the Carrying Out of Trading Transactions by Banks* provides that banks have to set up a system for the measurement and monitoring of risk positions. Subchapter 3.2.1 identifies trading transactions, except for stock market transactions as well as cash transactions in which the equivalent amount either was provided or is to be provided simultaneously or for which cover is available. These transactions have to be made only with contractual parties for whom contracting party limits have been granted by an entity independent of the traders, and undertaken with reference to the regulations applying to the granting of loans and rules of procedure which make allowance for any changes in the financial standing of the other parties to the contract.

- ***Hong Kong:*** Securities dealers, leveraged foreign exchange traders, and authorized institutions all have requirements for internal controls. The SFC has published guidance on operational and risk management controls for over-the-counter transactions which is based on related IOSCO guidelines. The HKMA also has published guidelines on the risk management of derivatives, based on Basle guidance.

- ***Italy:*** There are no requirements particular to OTC derivatives transactions.

- ***Japan:*** Financial institutions are required to have internal management systems for all risks, including the ones in OTC derivatives transactions (under the *Banking Law* and the *Securities and Exchange Law* (SEL), *etc.*). In relation to securities-related derivatives, there are more detailed requirements (under the SEL) for authorized institutions.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** In general terms, there are no specific internal control requirements for counterparties. However, internal control rules applicable to investment firms and CIS entities require them to have a risk measurement and control system based on the counterparty's credit quality, the expected recovery rates, and the current and potential risk exposures. Particular emphasis is required when the affected entities engage in OTC derivatives transactions. The requirement of setting credit risk limits by counterparty, entity or business group also has been included in these rules.

- ***Sweden:*** Finansinspektionen has issued general guidelines for internal controls of counterparties under supervision.

- ***Switzerland***: Authorization requirements for securities dealers generally are set forth in Article 10 of the *Federal Act on Stock Exchanges and Trading in Securities* (SESTA), and include an assessment of fitness, which covers the dealers internal control systems. In particular, an authorization shall only be granted if the organization and internal rules of the applicant are such as to ensure compliance with its duties under the Act.

  Articles 17-20 of the *Ordinance of the Federal Council on Stock Exchanges and Trading in Securities* (SESTO) provide more specific information on format of organization and controls required for authorization. The securities dealer shall ensure effective internal separation of functions between trading, portfolio management and settlement. The dealer must ensure an effective internal control system; in particular, the dealer shall entrust a unit independent of the management with the internal auditing function, not at least with regard to the control of counterparties. The unit shall also verify compliance with the duties of disclosure, diligence and loyalty pursuant to the rules of conduct. The securities dealer shall define in regulations or internal directives the basic principles of risk management, the responsibility and the procedure for authorizing transactions involving risks for the purposes of identifying, limiting and monitoring the risks present. These regulations have to be approved by the Swiss Federal Banking Commission. Specifically, the dealer must be able to identify, limit, and monitor market, credit, default, settlement, liquidity, and image or reputational risks, as well as operational and legal risks. This also extends to counterparties. With respect to transactions entailing risks, the management shall assemble all the documents necessary for decision making and monitoring. These documents must also allow the auditors to form a reliable opinion on the conduct of business.

  Similar requirements for banks are set forth in Article 3 of the *Federal Banking Act*, and Article 9 of the *Implementing Ordinance on Banks and Savings Banks*. The Swiss Bankers Association *Risk Management Guidelines for the Trading and Use of Derivatives* specifically identify credit risk and valuation issues particular to OTC business.

- ***United Kingdom:*** Authorized firms, in general, are required to organize and control their internal affairs in a responsible manner. In addition, the effect of various specific requirements (including those related to know-your-customer, suitability, 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 OTC derivatives transactions. In particular, they need to establish both that the person they are dealing with is authorized to commit the counterparty to the deal, and to satisfy themselves that the counterparty has sufficient financial resources. Credit institutions refer to the Basle Guidance published in 1994.[47]

Documentation

- ***Australia:*** The requirements for documentation are determined by agreement between the parties. Industry standard documentation (such as the so-called Aussie ISDA master agreement) is widely used.

- ***Belgium:*** There are no specific requirements regarding OTC-derivatives with respect to credit institutions.

- ***Brazil:*** No specific requirements.

- ***Canada:*** There are no requirements set by OSFI, although the ISDA master agreements are frequently used.

    - ***Ontario:*** No applicable product-based rules.

    - ***Québec:*** No applicable requirements.

- ***France:*** Requirements are applied to the institutions rather than the types of derivatives such institutions trade on an OTC basis. Appropriate documentation supports close-out netting.

- ***Germany:*** No specific requirements are applicable. ISDA master agreements, however, are commonly used for cross-border transactions. *See also* Recordkeeping *infra* p. 64.

- ***Hong Kong:*** Securities dealers, leveraged foreign exchange traders, and authorized institutions all have documentation requirements.

- ***Italy:*** There are no requirements specific to OTC derivatives transactions.

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[47] The US-UK Joint Statement, *supra* note 45, supported management controls. The UK participated actively through leadership of an IOSCO working party in the design of IOSCO risk management guidance for OTC derivatives published in 1994 in conjunction with the Basle Guidance, Risk Management Guidelines for Derivatives (July 1994). *See also* Partial Bibliography of International Guidance Related to OTC Derivatives *infra* p. 97.

- ***Japan:*** The requirements for documentation are determined by agreement between the parties. In practice, standard master agreements are typically used; for example, domestic agreements and ISDA master agreements.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** There are no specific documentation requirements for OTC derivatives transactions. Transactions are usually documented using standard master agreements, and in accordance with the requirements of such agreements.

- ***Sweden:*** Documentation requirements for OTC derivatives transactions are set forth in Finansinspektionen's *Regulations on Securities Trading and Services* (FFFS 1997:36). All securities institutions (*e.g.*, securities companies, Swedish banking institutions licensed to conduct securities business, and foreign enterprises which conduct securities business through a branch) are required to prepare "contract notes" (or have them prepared by a clearing organization) containing specified information; the notes must be retained for 10 years and are available to the Finansinspektionen on request.

- ***Switzerland:*** The requirements are described in a general way with the rules of conduct defining how the relations towards clients are to be organized, as set out in the *Federal Act on Stock Exchanges and Trading in Securities* (SESTA) and the *Code of Conduct for Securities Dealers*. The *Risk Management Guidelines for Trading and for the Use of Derivatives* recommend the use of appropriate documentation. Furthermore, the requirements regarding documentation also are part of the rules regarding the organization of banks and/or securities dealers. In practice, ISDA master agreements are used.

- ***United Kingdom:*** General conduct of business requirements. In practice, industry standard ISDA master agreements are frequently used.

Recordkeeping

- ***Australia:*** As part of the requirements for conducting an exempt market, the market operator must keep records of each futures contract acquired or disposed of in the market in enough detail to identify the material terms of each contract.

- ***Belgium:*** There are no specific requirements regarding OTC derivatives with respect to credit institutions [or investment firms]. General recordkeeping requirements apply. Furthermore, the Banking and Finance Commission's guidelines to credit institutions relating to internal organization of forex operations, provide that the actual conclusion of each transaction must be recorded. This information must be kept for a sufficient length of time, to be able to be used for supervisory purposes.

- ***Brazil:*** In accordance with *National Monetary Council Resolution no. 2138*, Article 3, every OTC derivatives transaction must be registered in a system administered by the

Financial Settlement and Custody Centre (CETIP) or any other system authorized by the Central Bank or CVM. *Central Bank Circular No. 2770*, establishes the following procedures for the bookkeeping in regard to swap transactions:

1. The notional value of swap contracts must be recorded in compensation accounts.
2. The net difference between receivables and payables from each contract must be recorded on income or expense accounts, reflecting the respective balance accounts.
3. Each swap contract, except third party contracts and guaranteed swaps, must be marked-to-market in its respective compensation account.

- ***Canada:*** There are no specific derivatives recordkeeping requirements. OSFI expects the internal control processes of an institution to address recordkeeping and documentation.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No specific requirements regarding OTC products.

- ***France:*** Requirements are applied to the institutions rather than the types of derivatives such institutions trade on an OTC basis, and apply to all transactions undertaken by such establishments.

- ***Germany:*** General accounting rules set forth in Section 238 *et seq.* of Handelsgesetzbuch (HGB, the German "*Commercial Code*") require that the information necessary for settlement, accounting and valuation of transactions is properly documented. Such requirements are applicable to OTC derivatives transactions. More detailed requirements are set forth in chapters 4.3 and 2.6 of the *Minimum Requirements for the Carrying Out of Trading Transactions by Banks*. Section 34 of the Wertpapierhandelsgesetz (WpHG, the "*Securities Trading Act*") contains requirements to keep and retain records in carrying out investment services. Investment services enterprises are obliged to keep a record of the order and pertinent instructions of the customer as well as the execution of the order.

- ***Hong Kong:*** Securities dealers, leveraged foreign exchange traders, and authorized institutions all have recordkeeping requirements.

- ***Italy:*** There are no requirements relative to OTC derivatives transactions. However, general requirements on recordkeeping would apply.

- ***Japan:*** Recordkeeping requirements concerning OTC derivatives transactions are included as part of general recordkeeping requirements.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** Recordkeeping requirements are included as part of the general conduct of business rules.

- ***Sweden:*** There are no special requirements. Finansinspektionen recommends tape recording of orders for recordkeeping purposes, but it is not required.

- ***Switzerland***: The requirements are laid down in Article 15 of the *Federal Act on Stock Exchanges and Trading in Securities* (SESTA), and Article 1 of the *Ordinance of the Federal Council on Stock Exchanges and Trading in Securities* (SESTO), and require a journal of orders received and trades made which include OTC, as well as other, transactions. A practical guidance, the Swiss Federal Banking Commission circular on the *Maintenance of Security Journal by Securities Dealers*, states that the obligation to maintain a journal generally applies to securities which are admitted for trading on a stock exchange or on a regulated market accessible to the public; but it also fully applies to securities which are capable of being traded on other OTC markets as instruments of, in part, only limited marketability (*e.g.*, OTC derivatives).

- ***United Kingdom:*** There are no special requirements for OTC derivatives transactions, but investment firms are required to keep certain records of all transactions entered into.

Financial Reporting

- ***Australia:*** There are no financial reporting requirements other than those contained in accounting standards (*i.e.*, quarterly for public companies). The Australian accounting bodies have, however, released a general accounting standard with specific requirements: *AASB 1033 Presentation and disclosure of financial instruments.*

  The standard aims to enhance a financial report user's understanding of the significance of on-balance sheet and off-balance sheet financial instruments to an entity's financial position performance and cash flows. The presentation standards deal with the classification of financial instruments between liabilities and equity, the classification of related interests, dividends, losses and gains, and the circumstances in which financial assets and financial liabilities may be set off.

  The disclosure standard deals with information about factors that affect the amount, time and uncertainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. The standard encourages disclosure of 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.

- ***Belgium:*** OTC instruments are included in the financial reports of credit institutions and investment firms (per instrument category, currency, maturity, *etc.*), or depository of an Undertaking for Collective Investment. Further, if a promoter or depository acts as counterparty, that must be indicated in the prospectus and periodic reports of the UCI. Without prejudice to periodical aggregate reporting requirements, it is evident that the

Banking and Finance Commission has access to all information concerning operations of individual credit establishments (on request, in the course of an on-site inspection, or "par le truchement du commissaire-réviseür), without such information being required to be transmitted routinely.

- ***Brazil:*** Annex IV to *National Monetary Council Resolution no. 2099* determines that financial institutions must keep an equity estimate adjusted by the risk of their assets. *NMC Resolution no. 2399* modifies the risk adjustment rules to include swap transactions.[48]

- ***Canada:*** Both the Canadian Institute of Chartered Accountants and OSFI have established financial statement derivatives disclosure requirements. Taken together, these requirements generally result in a disclosure regime comparable to that required in the United States.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No specific requirements regarding OTC products.

- ***France:*** Requirements are applied to the institutions rather than the types of derivatives such institutions trade on an OTC basis, and apply to all transactions undertaken by such institutions.

- ***Germany:*** There are special legal requirements only concerning repos and currency conversion matters (Sections 340b and 340h of the *Commercial Code* (HGB)). There are no further special laws for the accounting or financial reporting of derivatives transactions. The Institute of German Auditors (Institut Deutscher Wirtschaftsprüfer, IDW), however, which is a private institution, has issued opinions as to the accounting and auditing of certain derivatives transactions (Bilanzierung und Prüfung von Financial Futures und Forward Rate Agreements, 2/1993, "*Accounting and Auditing for Financial Futures and Forward Rate Agreements*"; Bilanzierung von Optionsgeschäften, 2/1995, "*Accounting for Options Transactions*"; Währungsumrechnung bei Kreditinstituten, 3/1995, "*Currency Conversion for Credit Institutions*") which auditors comply with and which are thus valid for the accounting of companies. Under Section 36 of the Verordnung über die Rechnungslegung der Kreditinstitute ("*Ordinance on the Accounting of Credit Institutions*"), banks have to include in the notes to their financial statements a list of the categories of almost all derivatives transactions which have not been settled as of the balance-sheet date.

- ***Hong Kong:*** Securities dealers, leveraged foreign exchange traders, and authorized institutions all have financial reporting requirements.

[48] *See* Appendix II: Supplement on Brazilian Financial Reporting *infra* p. 109.

- ***Italy:*** There are no requirements relative to OTC derivatives transactions. OTC transactions should, however, be included in monthly financial reporting to CONSOB and the Bank of Italy.

- ***Japan:*** In 1996, financial statement rules (*Regulations Concerning Terminology, Forms and Method of Preparation of Financial Statements, etc.*) were revised to enhance derivatives disclosures of all firms, effective for the period ended March 1997. These revisions require qualitative information as to the content of transactions, operating policy and risk management systems, as well as notional amount disclosure for all derivatives including OTC instruments. The revision recommends disclosure of quantitative information on market and credit risk. Further, as of April 1, 1997, Japanese banks and securities firms may adopt mark-to-market accounting for their trading activities (including derivatives), provided they meet certain approval standards on internal control valuation and accounting procedures set by the Ministry of Finance. This change improves the information available to the public about banks' and securities firms' periodic performance in their trading and derivatives activities. Information on contract amounts, value of profits and losses also was improved. Moreover, beginning with the period ended March 1998, market value information for OTC instruments is required.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain:*** In general terms, financial reporting requirements apply to institutions, not products. There are, however, some specific requirements affecting CIS, as noted above. Additionally, general conduct of business rules require adequate disclosure of the risks assumed.

- ***Sweden:*** Since June 1998, investment firms and credit institutions are obliged to report statistics on, and credit risks in, OTC transactions to Finansinspektionen on a bi-annual basis.

- ***Switzerland:*** Requirements for treatment of OTC and exchange-traded derivatives are set forth in the *Guidelines of the Swiss Federal Banking Commission* (notes 58-63, 75-76, and 97-ss, table L) concerning the preparation of financial statements of banks and/or securities dealers generally.

- ***United Kingdom:*** Firms are required to report their position risks and counterparty risks to the regulators on a regular basis, and must ensure, in accordance with their self-regulating organization's rules, that they have sufficient capital to cover those risks at all times. Firms must maintain records on exposures under the new accounting standard adopted for reporting periods ending after March 23, 1999 (*see also* Recent and Contemplated Changes *infra* p. 73).

Insolvency[49]

- ***Australia°:*** There are no specific insolvency requirements for particular products.

- ***Belgium°:*** In derogation of general insolvency laws, the banking law provides a safe harbor for netting agreements involving banks, investment firms and other financial institutions, *inter alia*, in OTC derivatives transactions.

- ***Brazil:*** No specific requirements. However, as all transactions must be registered, counterparties may opt whether or not to use collateral, which can be liquidated in cases of insolvency.

- ***Canada°:*** There are no specific insolvency requirements for particular products.

  - ***Ontario:*** No applicable product-based rules.

  - ***Québec:*** No specific requirements regarding OTC products.

- ***France°:*** Insolvency law is part of French commercial law and applies to all institutions, without regard to the different types of financial products offered by them. The *Financial Modernization Act*, 96-597 of 2 July 1996, provides some special insolvency protections to financial transactions including clearing arrangements and master netting agreements that meet certain requirements.

- ***Germany°:*** A new insolvency code effective January 1, 1999 will recognize close out netting on financial futures. As of 1994, "close out netting" has been recognized for "fixed date transactions" (*e.g.*, swaps). Contractual netting agreements will be respected in case of insolvency under Sections 94, 95 and 104 of the new insolvency code. Thus the law allows netting by novation and close out netting for transactions if this has been agreed upon before the insolvency.

- ***Hong Kong:*** There are no special provisions.

- ***Italy°:*** Article 203 of Legislative Decree 58/1998 provides that financial derivatives which are in force at the date of declaration of bankruptcy of an intermediary party to the contract are resolved as of that date. Compensation of debts and claims would therefore apply. For these purposes, substitution costs of derivative instruments (with reference to their market values on the date of bankruptcy) are applicable.

- ***Japan°:*** The validity in bankruptcy and reorganization proceedings of closeout netting of OTC derivatives transactions by financial institutions has been clarified by the *Law on*

[49] Jurisdictions which ISDA records indicate have received legal opinions stating close-out netting is valid as of January 1999, are designated with °. Those with legislation to validate close-out netting under consideration are designated with •. For the most recent information on approved legislation, *see* International Securities Dealers Association, *Status of Netting Legislation at* <http://www.isda.org/c6.html>. Note: changes in the UK's status post-date the ISDA listing.

Closeout Netting of Specified Transactions by Financial Institutions, etc., which is one of the Financial System Reform Laws. Special bankruptcy procedures apply to bankruptcies of banks, securities companies, *etc.*, under the *Law for Improving the Reorganization and Bankruptcy Procedure for Financial Institutions*.

- ***The Netherlands:*** There are no special requirements in relation to OTC derivatives products.

- ***Spain°:*** Insolvency law is part of Spanish commercial law, and applies to all institutions. (*See also* Recent and Contemplated Changes *infra* p. 73). However, special insolvency protections are provided to master netting agreements that meet certain requirements.

  When bilateral netting is available and valid, the EU Capital Directives regard it as risk reducing, and provide capital concessions. The same approach has been taken under the rules setting operating limits to CIS entities' OTC derivatives transactions.

- ***Sweden°:*** An agreement of two parties when dealing in financial instruments or in currencies to settle obligations on a net basis that "all outstanding obligations shall be closed out and settled net in the event of one of the parties becoming bankrupt is binding on the estate of the party in bankruptcy and on the creditors in bankruptcy."

- ***Switzerland°:*** The rules applied to insolvency cases in general are used. The question of developing more specific rules applicable to banks and securities dealers is being discussed.

- ***United Kingdom:*** The UK extended its market insolvency protections for transfers of positions and netting to OTC derivatives transactions that are cleared, effective August 21, 1998.[50]

Other Requirements

- ***Belgium:*** A swap contract may not entail disproportionate risks for participants in a UCI. The only transactions accepted to date by the Banking and Finance Commission technically guarantee that investors in a UCI will recover their initial contribution upon final maturity of the contract.

[50] *See, e.g.*, Consultation Paper from HM Treasury, *supra* note 40.

Choice of Law Provisions

For each such product, does the law of your jurisdiction honor an agreement as to choice of law where the transaction is effected by counterparties in different jurisdictions?

- ***Australia:*** There are no general statutory provisions which identify or specify the law of the contract, or that an agreement will be subject to the law of a particular jurisdiction. The issue is ultimately determined by principles of private and public international law.

- ***Belgium:*** Belgian law allows the parties freely to choose the law applicable to their contractual relationship, subject to certain limits such as the provisions of international public policy.

- ***Brazil:*** Brazilian law provides for choice of law under international law principles. However, the participation of foreign investors in OTC derivatives markets through portfolios is prohibited.

- ***Canada:*** OSFI is not aware of specific restrictions on the ability of parties to specify choice of law in OTC transactions. The issue is ultimately determined by principles of private and public international law.

    - ***Ontario:*** Ontario honors agreements as to the choice of law, subject to conflict laws that are common law rules.

    - ***Québec:*** In matters pertaining to the distribution of a security, the laws of Québec are applicable where the subscriber or purchaser resides in Québec, regardless of the place of the contract. Any contrary stipulation as to the jurisdiction of the courts or the applicable legislation is null and void.

- ***France:*** French law honors an otherwise valid agreement as to choice of law.

- ***Germany:*** For cross-border transactions, the contracting parties typically use master agreements based on English or New York law. The most commonly used master agreement for international transactions is the ISDA master agreement. Generally, a choice of law provision where a transaction is effected by counterparties in different jurisdictions is valid under German law (*cf.* Article 27 of the Introductory Law to the *Civil Code* (EGBGB)). However, issues of German *ordre public* may impact choice of law provisions.

- ***Hong Kong:*** Hong Kong law allows for agreements as to choice of law.

- ***Italy:*** Choice of law provisions are recognized in Italy under principles of private international law.

- ***Japan:*** The authorities are not aware of specific restrictions on the ability of parties to specify choice of law in OTC transactions. The issue is ultimately determined by principles of private and public international law.

- ***The Netherlands:*** Choice of law provisions are recognized in accordance with the principles of international law.

- ***Spain:*** There are no specific provisions applying to OTC derivative contracts. Spanish civil and international law allows the parties freely to choose the law applicable to their contractual relationship, unless the chosen law is unconnected with the contract. In practice, given the extended use of the ISDA master agreement for cross-border transactions, many OTC derivatives transactions are subject to English Law.

- ***Sweden:*** Sweden honors choice of law provisions (*e.g.*, those contained in the ISDA master agreement).

- ***Switzerland***: There are no rules or conventions applicable to all cases in Switzerland. Rather, it is a matter of civil and international private law, and assessment of the validity of such a choice is done on a case-by-case basis. Usually, ISDA master agreements are used.

- ***United Kingdom:*** Case law and commercial practice suggest that an English court is unlikely to strike down an agreement between non-English counterparties who 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.

  In practice, many OTC derivatives transactions are subject to English Law. For instance, ISDA master documentation adopts English Law.

Recent and Contemplated Changes

- ***Australia:*** The Companies & Securities Advisory Committee commenced an extensive review of off- and on-exchange derivatives in mid-1994, including international regulations. The review was conducted in expectation of continued market growth in volume, diversity, and complexity. This growth was expected to be due to:

    - The deregulation of capital flows and advances in communication technology;
    - Advances in financial engineering techniques.
    - The difficulties and uncertainties in applying current Australian law to derivatives markets.

  Among other things, the recommendations of the Committee would generally have core provisions for financial markets and instruments, distinguish for limited purposes between derivatives and securities on exchanges and OTC transactions, and require:

    - Licensing of counterparties except banks and other entities supervised by the Reserve Bank (now the Australian Prudential Regulatory Authority), or entities whose capital and risk management standards are satisfactory to the ASC (now the ASIC);
    - Endorsement of an advisor's license to provide advice on OTC derivatives;
    - Generic risk disclosure; and,
    - "Know your client" minimums if personal recommendations are made.

  This regime would regulate derivatives and securities as both if it was not possible to recognize them as one instrument or the other. It would not, however, render void any instrument entered on an unauthorized market.

  Separately, the Australian Treasury's Corporate Law Economic Reform Program "*Financial Markets and Investment Products*" paper sets forth nine target areas for reforming the Australian business environment. The proposed reforms are designed to revamp regulation of Australia's financial markets and investment products to provide a *flexible* and *adaptable* framework to encourage innovation and competition by providing comparable regulation of all financial products, including securities, futures and other derivatives, superannuation, life and general insurance and bank-deposit products, markets, and financial instruments. OTC derivatives transactions, traditionally falling within exempt market provisions, will similarly be regulated under the proposed harmonized regime.

  The resulting benefits of a *uniform* regime for the regulation of financial instruments will include:

    - Simplification of the regulatory framework for the trading of financial instruments by removing unnecessary legal distinctions;
    - Increased opportunities for competition and financial innovation without the need to seek dual regulatory authorization, and the removal of incentives for regulatory arbitrage; and

- Creating flexibility that will accommodate inevitable change and permit market participants to respond in a timely manner to market developments.

- ***Belgium:*** New regulations may be adopted to require persons receiving, transmitting or executing orders in commodity-linked instruments to be registered under existing enabling legislation. Additional legislation may expand or codify the UCI policy.

  Pending legislative action, the Banking and Finance Commission has developed a policy on the use of OTC derivatives and swaps in "fix" and "equifix" constructions by Undertakings for Collective Investment.[51] For example, the Commission would not prohibit a UCI from entering into a swap contract, provided it would not unacceptably change the nature of the UCI's investment risk and create additional "inadmissible" risks for investors (the only schemes so far accepted by the Commission technically guarantee that investors will receive their initial contribution at maturity). The UCI must be capable of monitoring the risk and substantiating that the design or structure of the product is consistent with the UCI's investment policies. Absent this policy, the strict terms of existing law (1996), dictate that authorized UCIs can only use futures and options for limited purposes, in limited amounts, if traded in a regulated market.

- ***Brazil***: It would not be an overstatement to say that Brazilian OTC derivatives transactions, and correspondingly their regulative body of law, are in their infancy. There are no known recent studies addressing these transactions in the domestic financial markets. Nevertheless, due to the recent interest that OTC options have attracted, specific regulations on the subject are under study at CVM.

- ***Canada:*** OSFI's capital adequacy requirements for deposit-taking institutions changed, effective January 31, 1998, to incorporate capital charges for the market risk of OTC derivatives on institutions' trading books. Market risk is in addition to the counterparty credit risk capital charges that have been in place for OTC derivatives since the *1988 Basle Capital Accord.* Market risk capital requirements are calculated on a portfolio basis, typically using a Value-at-Risk model reviewed by OSFI. Hence, the market risk requirements reflect the contributions to market risk made by OTC derivatives trading activities.

  OSFI also has begun a system-wide trading risk management study that includes core functions that are essential to trading, including derivatives trading. These functions include limit allocation and monitoring, valuation and mark-to-market procedures, back office deal capture, and audit trail.

  - ***Ontario:*** In 1994, subsequent to conclusions by the Capital Markets Branch of the Ontario Securities Commission of a study of the OTC derivatives market—to determine

[51] A "fix" construction for a UCI is a fixed maturity UCI with a built-in financial engineering structure that unequivocally determines the final value of the investment with respect to both principal and income. An "equifix" construction is a fixed maturity UCI for which the final value of the principal amount is unequivocally determined in financial engineering terms while, through the use of derivatives, the income is based on the change in a stock exchange index or value of a basket of shares.

more about its nature, and how Ontario securities law should apply—the OSC published a *Draft Ruling and Policy Statement* concerning the regulation of derivatives. In November 1996, a rule[52] reformulating the prior pronouncement based on the comment process, was proposed and, as amended based on comment, was re-proposed in December 1998.

The OSC study concluded that the most immediate concern of the Commission should be "to remove, to the extent possible, the uncertainty surrounding the relationship of OTC products to the [Ontario] *Securities Act*." Since the study, the *Securities Act* was amended by Bill 190 which permits the OSC to make rules regulating or "varying the Act" in respect to derivatives, "regardless of whether the derivatives transactions constitute trades in securities."

Interestingly, the proposed rule would apply to all OTC derivatives and include exotic constructions.[53] The rule, as proposed, creates three categories and establishes "appropriate" regulatory treatment for each:

- Exempt transactions which are excluded from all provisions of the act — for example, interest rate/forex derivatives in which each party is either a "qualified party"[54] or is hedging, or a specified derivative (*i.e.*, agricultural

[52] 19 OSCB 5954-5969. The comment period on the draft rule expired March 3, 1997. *See Proposed Rule: 91-504 91-504CP Over-The-Counter Derivatives and Companion Policy 91-504CP*, ONTARIO SECURITIES COMM. (Dec. 18, 1998), *available at* <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/pr_91-504_19981218.html>

[53] The rule specifically recognized "cash settled forwards." OTC derivatives are expressly defined as "not part of a fungible class of agreements standardized as to their material economic terms; creditworthiness of a party would be a material consideration in determining the terms, and the agreement is not entered into or traded on an organized market or exchange or cleared by a clearing corporation." Questions were raised during the comment period on the scope, including geographic scope, and application of the rule, and on the complexity and difficulty of interpretation. Requirements or conditions apply only to non-exempt transactions with non-qualified parties. The amended draft published in December 1998 does not address credit derivatives.

[54] As of 1998, "qualified parties," as noted above, are certain listed persons, or "commercial users" for a transaction, with differing minimum regulatory, financial (based on a consolidated balance sheet) or other requirements, which may vary both on the nature of the counterparty and on whether the counterparty is domestic or foreign:

Banks;
Credit Unions and Caisses Populaires;
Loan and Trust Companies;
Insurance Companies;
Governments/Agencies;
Municipalities;
Corporations and other Entities;
Pension Plan or Fund;
Mutual Funds and Investment Funds;
Brokers/Investment Dealers;
Future Commission Merchants;
Charities;
Affiliates;
Guaranteed Parties;
Managed Accounts.

products, metals, softs, electricity, insurance losses, and others specified by the OSC), in which each specified party is qualified for that transaction. (These corresponded to transactions not considered to constitute securities under the former law.)

- Transactions exempt from registration and prospectus provisions, *without* conditions — normally non-exempt transactions in which each party is qualified (*e.g.*, equity derivatives and any transaction that would be otherwise exempt if a security).
- Transactions exempt from registration and prospectus provisions, *with* conditions — transactions with unqualified parties (must at a minimum deal with registered dealers subject to suitability requirements, who must provide generic risk disclosure).

The 1994 study also cited a number of issues at the international level, likely to be a focus of regulators:

> (a) there will be an increased focus on the risk management systems in place at the relevant institutions; although there appears to be a view in some circles that institutions have focused much of their efforts on internal controls, weaknesses in the management of portfolios have also been noted, and regulators, as they become more knowledgeable about derivatives, can be expected to focus more of their attention on such issues; an important issue for regulators will be the extent to which market participants increase their internal capacity to keep up with the mathematics and technology which are an important part of the derivatives industry; unless they do so, regulators will

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Also included are an individual who has a net worth of at least $5 million, or its equivalent in another currency, excluding the value of his or her principal residence, and "sophisticated entities," which are defined as a person or company that:

1. Has entered into one or more transactions involving OTC derivatives with counterparties that are not its affiliates, if (a) the transactions had a total gross dollar value of or equivalent to at least $1 billion in notional principal amount; and (b) any of the contracts relating to one of these transactions was outstanding on any day during the previous 15-month period, or

2. Had total gross marked-to-market positions of or equivalent to at least $100 million aggregated across counterparties, with counterparties that are not its affiliates in one or more transactions involving OTC derivatives on any day during the previous 15-month period.

In 1998, Section 3.1 also was added to the Draft Policy Statement to specify the intended limitations on extraterritorial application of the proposed rule.

In addition, the Commission reminded the market that the proposed rule is intended to intervene as little as possible in the OTC derivatives market. New regulatory requirements, namely, the dealer and risk disclosure statement requirements, are imposed only on the small segment of transactions that involve the use of certain OTC derivative products by non-qualified parties.

be unable to monitor the actual market exposures of organizations under their supervision;

(b) ongoing attention will be paid to the appropriate capital and margin rules applicable to derivatives transactions; at the present time, there is uncertainty about the proper levels;

(c) there will be a continued movement globally towards regulatory certainty, as regulators attempt either to clarify the treatment of OTC derivatives under existing laws or implement regulatory regimes appropriate to derivatives;

(d) there will be a more relaxed attitude generally towards the risks imposed by derivatives, but likely further study of systemic risk issues and their implications; some comfort seems to have been taken over the fact that major failures, such as those of the Bank of New England, Drexel Burnham Lambert and Olympia & York, all active participants in the derivatives markets, did not cause any widespread catastrophes;

(e) there will be increasing difficulty in distinguishing OTC derivative products from exchange-traded derivatives as users seek to solve the credit risk problem by looking towards exchanges and as the exchanges seek to increase their market share by offering products that allow a degree of customization so that some of the business lost to the OTC markets can be recaptured; and

(f) there will be increased attention paid to accounting and disclosure issues as OTC derivatives become more pervasive.

Finally, the OSC study cites the risks of OTC transactions as:

- Market Risk (general, specific, systemic);
- Credit Risk;
- Liquidity Risk;
- Management or Operational Risk;
- Legal risk; and,
- Settlement Risk.

The amended proposal was published December 1998 for broader comment with the view to finalizing an approach shortly thereafter.

Staff at the OSC have reviewed the comments on the November 1996 proposal and engaged in intensive consultation with various parts of the industry and the government, including OSFI, as stated in the general responses to this survey. ***See also*** **<http://www.osc.gov.on.ca>.**

- ***France:*** In general, France has addressed growth of over-the-counter derivatives through participation in international forums on prudential supervision of intermediaries, such as the Basle Committee on Banking Supervision, the G-10, and the European Union. A 1993

Commission Bancaire research report on the *Prudential Surveillance of Activity in Derivative Products* discusses differences between organized and OTC markets, and discusses measurement of credit and market risk, concerns about concentration, valuation and lack of transparency, and potential systemic risk resulting therefrom. This report also discusses the added need for internal controls adequate to manage risks of sharp market reassessments of value.

In December 1998, the Commission des Operations de Bourse and the Commission Bancaire released a joint report, "*La transparence financière*," emphasizing the need for quality financial information from banks. In regard to derivatives-counterparty risk, the report encouraged institutions to focus on weak areas "which could induce suspicion and increase risk premiums or deteriorate their bargaining power in OTC transactions. Institutions are invited to strike a more adequate balance between their financial disclosure and the different types of exposures they are faced with." The report commends the information framework jointly defined by Basle and IOSCO, and that banks upgrade their disclosure along the lines of the recent body of work of the National Accounting Council.

- ***Japan:*** In the wider financial system reform currently under way, the competitive environment in the securities market has been strengthened through such measures as abolition of Japan's regulation prohibiting non-securities business by securities companies and allowing a wider scope of business. In the banking sector, measures that will lead to greater freedom and diversity of products, business and corporate structure are also taking place. Moreover, the use of a holding company structure that was previously prohibited by the *Antimonopoly Law* will be freed, so that entry via this route will also become possible.

  Along with the progress in inter-market competition, Japan believes "a need will emerge to establish, in good order, non-organized markets such as those handling unlisted or unregistered stocks, those making use of an electronic means of trading, or those trading in a variety of securitized products. Rules, therefore, need to be established to secure fair trading in those new markets." In order to secure fairness in the markets, "stringent actions and measures by the governmental and self-regulatory organizations against violation" of regulations in this area are advocated.

  In response to a wider variety of trading patterns, surveillance activities are expected to play an increasingly larger role for securing fairness in the market, with Japan's self-regulatory bodies increasing their surveillance function. "Although inspection, surveillance and other similar functions are to be carried out separately by the governmental authority and self-regulatory organizations for their own respective purposes, arrangements should be made among the regulators in regard to the substance of inspection and the like, so as not to force those inspected to bear excessively heavy business burdens."

  Reform of the rules applying to OTC derivatives is part of the Japanese initiative to have markets that are "Fair, Free and Global" by the Year 2000. The special committee on derivatives met 20 times on issues related to such transactions before issuing the *Securities and Exchange Council Report*. This was part of a comprehensive reform initiative that also involved substantial consultation. As part of Financial Reform, Japan has effected improvements to its

law to clarify that OTC trading in contracts for differences based on equity securities are legal and do not infringe upon either securities or criminal anti-wagering laws. The legislation also permits financial institutions to engage in derivatives business under certain conditions. One important finding of the aforementioned *Securities and Exchange Council Report* that formed the basis for ongoing financial reform in this area, was that "it is appropriate that recognition of the existence of adequate risk-management capabilities and the appropriate capacity to conduct business not be limited to securities companies, but also encompass banks that engage actively in OTC derivatives trading with interest rate or exchange rate contracts as the underlying assets, insofar as there are no transfers of the underlying assets." Along with the reform of the OTC derivatives rules, the *Law on the Closeout Netting of Specified Transactions by Financial Institutions, etc.*, was introduced, and the validity in bankruptcy and reorganization of closeout netting of OTC derivatives transactions by financial institutions has been clarified.

The investor protections of the *Securities and Exchange Law* are market-based. "It would not be appropriate to broaden coverage of the *Securities and 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 market-based in nature."

- ***Spain:*** New regulations were passed in June 1997 allowing, for the first time, the investment in OTC products by CIS entities. Linked to these rules, specific internal control obligations and new financial reporting and disclosure requirements were recently imposed on these entities, including a set of preferred criteria and models for the valuation of derivatives transactions (especially options contracts) in the absence of a market price. A new rule concretely defining the operating limits applying to CIS's derivatives transactions has just been approved and, while providing entities with an adaptation period, will enter into force next April. Additionally, the CNMV is currently reviewing the possibility of introducing some specific regulations modifying the disclosure and financial reporting requirements applicable to OTC derivatives transactions.

  In December 1997, a new rule allowing bilateral netting of financial derivatives transactions under insolvency situations was passed. For this rule to apply, a master agreement should be in place, which entails the creation of a unique legal obligation embracing all transactions carried out between the parties, and at least one of the subscribers has to be an investment firm or a credit institution.

  Finally, internal control rules affecting investment firms have also come into force very recently, and the whole set of conduct of business rules is currently under review.

- ***Switzerland:*** The complete *Federal Act on Stock Exchanges and Trading in Securities* (SESTA) regulation was introduced on February 1, 1997 (the second part on January 1, 1998).

- ***United Kingdom:*** Recent changes were made to UK law that will improve the regulatory framework for OTC clearing through an extension of protection from the normal operation of

insolvency law to OTC contracts. The changes, which became effective in August 1998, are designed to "encourage the orderly development of the UK's clearing services industry and will, in turn, help safeguard the operation of the financial markets," by extending modifications to the insolvency laws to the clearing of OTC contracts carried out by recognized investment exchanges or recognized clearing houses.[55] The London Clearing House has announced its intention to offer such clearing services once the changes are implemented, and is developing the SwapClear facility for this purpose.

FRS13, "*Derivatives and Other Financial Instruments: Disclosure*," which was issued in September 1998 by the Accounting Standards Board, 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. The FRS comes into force for periods ending on or after 23 March 1999, and applies to listed companies, other than insurance undertakings, and to all banks. The main disclosures will be interest rate risk disclosures, currency disclosures, liquidity and maturity disclosures, information on fair values, and the effects of any use of hedge accounting. The standard requires quantitative and qualitative disclosures by type of financial instrument. As a result, OTC exposure must be particularly identified.

The Financial Services Authority's October 1998 discussion paper, "*Differentiated Regulatory Approaches: Future Regulation of Inter-Professional Business*," focuses on two key aspects of the draft *Financial Services and Markets Bill*:

- Securing 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 and the varying degrees of risk attached to investments; and
- Maintaining confidence in the financial system.

These points reflect the commitment to make appropriate differentiation in the regulatory treatment of professional and non-professional business, according to participants' degrees of

[55] The changes to the *Companies Act 1989* are focused on two goals, as set forth in the Consultation Paper from HM Treasury, *supra* note 40:

> Amending the definition of market contracts to allow for the extension of Part VII modifications to insolvency law to the OTC trades cleared by RCHs and RIEs; and
>
> Amending the recognition criteria so that the Financial Services Authority can examine the default rules relating to the OTC transactions of RCHs and RIEs.
>
> The Government believes that the proposed changes are likely to expand the markets for clearing services for OTC contracts by reducing the risks inherent in such clearing. This also should allow for a reduction in risk to counterparties involved in a trade as the clearing house would become the counterparty to every cleared trade (and thus corresponding reduction in contagion in the event of default). This in turn should reduce the amount of collateral firms currently require either as margin or under capital adequacy requirements, freeing up capital which can be invested in other projects. There should also be benefits for the clearing of exchange-traded contracts because of the close links between OTC and investment exchange business and the possibility of margin offsets between the exchange and OTC positions.

experience and expertise and their relative need for protection against the risks they face. This differentiation is to be achieved without compromising the levels of protection required for the less expert investor.

The UK's *Draft Code of Market Conduct* (subject to consultations and adoption of enhancing statutory authority) would apply initially to all investments on RIEs and any conduct (whether or not expressly subject to the rules or arrangements of an exchange) that has a manipulative effect on those markets. HM Treasury may add other markets if it would be in the public interest to do so.

Recent Studies and Other Reports on the Regulation of OTC Derivatives

Please identify any recent studies, literature, or exposure drafts or concept pieces on the appropriate regulation of OTC derivatives developed by governmental or other sources in your jurisdiction.

- ***Australia:*** Corporate Law Economic Reform Program, *Paper No. 6: Financial Markets and Investment Products*, issued by Treasury in December 1997. Suggests general review of the regulation of financial markets and those engaged in providing services to these markets.

  Regulation of On-Exchange and OTC Derivatives Markets Final Report, COMPANIES & SECURITIES ADVISORY COMM. (June 1997). Proposes reform measures for the regulation or derivatives.

  Financial System Inquiry, *Final Report* ("Wallis Committee"), issued March 1997. Examines the general regulation of the financial system in Australia.

  Report on Over-the-Counter Derivatives Markets, AUSTRALIAN SECURITIES COMM. (May 1994). Identifies regulatory concerns about OTC derivatives.

  Policy Statement 70: Exempt Futures Markets, AUSTRALIAN SECURITIES COMM. DIGEST (Nov. 15, 1993). Explains the ASC approach to regulation of OTC markets.

- ***Belgium:*** *Hearing of Representatives of the Banking and Finance Commission on the Organization and (Internal) Control of Foreign Exchange Transactions by Banks and Financial Institutions*, Belgian House of Representatives, Commission of Finance and Budget (parliamentary documents, session 1996-1997, nr. 736/7).

  Policy with Regard to the Use of Over-the-Counter Derivatives and Swap Structures by Undertakings for Collective Investment, Annual Report 1995-1996, Banking and Finance Commission, pp. 135-137.

- ***Brazil:*** None.

- ***Canada:*** None. However, Canada recently completed a major study of the structure and regulation of the financial sector: *Report of the Task Force on the Future of the Canadian Financial Services Sector* (Sept. 1998) [*The MacKay Report*].

  - ***Ontario:*** *Proposed Rule: 91-504 91-504CP Over-The-Counter Derivatives and Companion Policy 91-504CP*, ONTARIO SECURITIES COMM. (Dec. 18, 1998), *available at* <http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/pr_91-504_19981218.html>.

    In November 1996, the Ontario Securities Commission published the second request for comments on Draft Rule 91-504, "*Over-the-Counter Derivatives*," together with proposed Companion Policy 91-504CP.

In January 1994, the Ontario Securities Commission published its original request for comments on a policy with respect to OTC derivatives, entitled "*Over-the-Counter Derivatives in Ontario – An OSC Staff Report.*"

- ***France:*** *La transparence financière*, Commission des Operations de Bourse et la Commission Bancaire (Dec. 1998).

  La surveillance prudentielle de l'activité sur produits dérivés, Rapport 1993, Commission Bancaire (1993). This report covers the prudential supervision of derivatives transactions generally, and is *not* linked to OTC derivatives transactions.

- ***Germany:*** There are no recent studies on the regulation of OTC derivatives transactions. There is substantial literature on netting, insolvency and the validity of such transactions, however.

- ***Hong Kong:*** *Report of the Surveys on the Over-the-Counter Derivatives Activities by Registered Firms*, SECURITIES & FUTURES COMM. (Apr. 1997).

  Guideline on Risk Management of Derivatives and Other Traded Instruments, HONG KONG MONETARY AUTHORITY (Mar. 1996).

  Core Operational and Financial Risk Management Controls for Over-the-Counter Derivatives Activities of Registered Persons, SECURITIES & FUTURES COMM. (Mar. 1995).

  Risk Management of Financial Derivatives Activities, HONG KONG MONETARY AUTHORITY (Dec. 1994).

- ***Italy:*** G. Lusignani, P. Mammola, D. Sabatini – "Il mercato italiano degli stramenti derivati OTC" (The Italian Market of OTC Derivatives Instruments) – CONSOB – Quaderni di Finanza – n. 20 – Agosto 1997.

- ***Japan:*** Securities and Exchange Council, "Securities-Related Over-the-Counter Derivatives Trading," MINISTRY OF FINANCE (May 20, 1997).

- ***The Netherlands:*** None.

- ***Spain:*** E. López Blanco, "Productos derivados. Control de los riesgos e información al mercado" (Derivative Products. Risk Control and Market Information), Documento de Trabajo (Working Paper), División de Estudios, CNMV.

  No. 1/98 Documento de trabajo para el establecimiento de limites a las operaciones en instrumentos derivados de las instituciones de Inversión Colectiva (Working Paper for the Setting of Operating Limits to CISs' Derivatives Transactions), CNMV.

- ***Sweden:*** None.

- ***Switzerland***: There are no recent studies or other reports on the regulation of OTC derivatives. However, there is substantial literature available dealing with the different topics covered by this survey.

- ***United Kingdom***: *The Clearing of Over the Counter Investment Transactions: A Proposal for Consultation by HM Treasury*, HM TREASURY (Apr. 9, 1998).

  The *Financial Services and Markets Bill* remains pending with Parliament.

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- ***Belgium***

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{The Law of 6 April 1995 on Secondary Markets, the Legal Status and Supervision of Investment Firms, and Intermediaries and Investment Advisors}

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[*] That is, in addition to the answers provided by the respondents. These instruments may have been provided by the respondents or unilaterally used by the CFTC.

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{Royal Decree of 22 February 1991}

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{The Law of 4 December 1990 [Financial Transactions, Financial Markets]}

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- ***Brazil***

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- ***Canada***

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  - ***Ontario***

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{Securities Act (Ontario)}

- ***Québec***

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Verlautbarung über Mindestanforderungen an das Betreiben von Handelsgeschäften der Kreditinstitute vom 23. Oktober 1995, Aktenzeichen I 4 - 42 - 3/86 [*Announcement on Minimum Requirements for the Carrying Out of Trading Transactions by Banks*].

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[56] The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of very senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers.

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- ***Italy:*** CONSOB, International Relations Office.

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APPENDICES

APPENDIX I

SPECIAL NOTE ON THE EUROPEAN UNION AND OTC DERIVATIVES

- All investment products, except commodity derivatives and forex spot or forward transactions, are defined as investment business within the scope of the passport provisions of the *Investment Services Directive* (ISD).[57]
- OTC derivatives are merely one form of investment business.
- Agency and dealing transactions in OTC derivatives must be done through intermediaries authorized in their home jurisdictions.
- Generally, there are no restrictions on product types and public offering laws do not apply.
- There are no financial services restrictions on who can transact, although other national law may apply and, in some jurisdictions, special disclosure is required where a dealer is opposite an unsophisticated customer.
- The *Capital Adequacy Directive* (CAD) sets forth capital requirements for traded investments and distinguishes between exchange transactions, and transactions bilaterally negotiated on a non-regulated market.
- The relevant European Directives attempt to harmonize bank and securities prudential regulation and the capital treatment of traded products. Prudential regulation is the responsibility of the home jurisdiction. *See* ISD Article 10, the *Second Banking Directive*,[58] the *Solvency Directive*,[59] the *Large Exposure Directive*,[60] and the CAD II.[61]
- Conduct of business is the responsibility of the host jurisdiction. Article 11 of the ISD requires each Member State to draw up rules of conduct reflecting specified principles which all investment firms and credit institutions must follow in their conduct of business in that Member State. The ISD further provides, however, that Member States shall apply the rules of conduct in a manner that takes into account the professional nature of the person (that is, the investor or counterparty as the case may be) for whom the investment service is provided.
- Most business is done by banks. [As universal banks are permitted, securities business can be done within the bank itself and a bank can itself have direct access to a regulated market subject to reassessment at the end of 1998.]

The EU Directives on settlement finality, recognition of contractual netting by competent authorities, capital adequacy and insolvency, take account of over-the-counter derivatives.

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[57] The EU's ISD effectively defines "instrument equivalent to a 'financial futures contract'" as a contract for differences.

[58] Council Directive 89/646/EEC (15 December 1989).

[59] Council Directive 89/647/EEC (18 December 1989).

[60] Council Directive 92/21/EEC (21 December 1992).

[61] Council Directive 98/31/EC (22 June 1998).

Contracts traded on "recognized exchanges,"[62] forex contracts (but not bullion) with an original maturity of 14 days or less and, until December 31, 2006, OTC contracts cleared by a clearing house as a legal counterparty,[63] are proposed to be treated (like exchange contracts) as having no counterparty risk for purposes of the capital requirements for investment firms and credit institutions.[64]

The EU recognizes bilateral netting agreements as risk-reducing, for capital purposes, subject to a provision of a legal opinion as to such agreements' validity. No netting contract containing a "walkaway" clause (that is, eliminating payments due to defaulter; *i.e.*, a creditor) will be regarded as risk-reducing.[65]

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[62] Exchanges "recognized" by competent authorities are those which: "(i) function regularly, (ii) have rules issued or approved by appropriate authorities of the home country of the exchange, which define conditions for the operation of the exchange, the conditions for access to the exchange, as well as the conditions that must be satisfied by a contract before it can effectively be dealt on the exchange, (iii) have a clearing mechanism that provides for daily margin for contracts listed in Annex III [including futures options, forwards and swaps on interest rates and similar contracts on forex or gold and contracts on other reference prices or indexes, such as equities, commodities and precious metals other than bullion, and contracts of a similar nature] to be subject to daily margin requirements providing an appropriate protection in the opinion of the competent authorities." Article 2, EU Directive 98/33/EC (22 June 1998), amending the *Solvency Directive.*

[63] Where participants collateralize fully their exposure to the clearing house on a daily basis, and competent authorities are satisfied that posted collateral gives adequate protection from build-up of clearing house exposure beyond market value.

[64] EU Directive 98/33, *supra* note 62, states in the recitals:

> (8). The clearing of over-the-counter (OTC) derivative instruments provided by clearing houses acting as a central counterparty plays an important role in certain Member States. It is appropriate to recognize the benefits from such a clearing in terms of a reduction of credit risk and related systemic risk in the prudential treatment of credit risk. However, in doing so: (1) it is necessary for the current and potential future exposures arising from cleared OTC derivatives contracts to be fully collateralized and for the risk of a build-up of the clearing house's exposures beyond the market value of posted collateral to be eliminated in order for cleared OTC derivatives to be granted for a transitional period the same prudential treatment as exchange-based derivatives; and (2) the competent authorities must be satisfied as to the level of the initial margins and variation margins required and the quality of and the level of protection provided by the posted collateral.

[65] Council Directive 96/10/EC, amending Council Directive 89/647/EEC, *Recognition of Contractual Netting by Competent Authorities*, states:

> Conditions for recognition. In general, the competent authorities may recognize contractual netting as risk-reducing only under the following conditions:
>
> i. A credit institution must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstances, the credit institution would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;
> ii. A credit institution must have made available to the competent authorities written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (i), find that the credit institution's claims and obligations would be limited to the net sum, as described in (i), under:

The EU's Directive on *Settlement Finality in Payment and Securities Settlement Systems*, Council Directive 98/26/EC (19 May 1998), provides that transfer orders and netting of transactions made to or by a payment or settlement system (which need not be clearing organizations but can be contractual arrangements) for securities (which include financial derivatives), and which may include commodity derivatives concluded before date of insolvency, shall be legally enforceable, binding on third parties, and cannot be set aside by law, rule or practice. EU members are to draft implementing legislation.

Under the ISD, EU Member States are required to cooperate in financial regulation under Article 23, so as best to effect the goals of the Directive:

1. Where there are two or more competent authorities in the same Member State, they shall collaborate closely in supervising the activities of investment firms operating in that Member State.
2. Member States shall ensure that such collaboration takes place between such competent authorities and the public authorities responsible for the supervision of financial markets, credit and other financial institutions and insurance undertakings, as regards the entities which those authorities supervise.

- The law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located,
- The law that governs the individual transactions included, and
- The law that governs any contract or agreement necessary to effect the contractual netting;

iii. A credit institution must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws.

The competent authorities must be satisfied, if necessary after consulting the other competent authorities concerned, that the contractual netting is legally valid under the law of each of the relevant jurisdictions. If any of the competent authorities is not satisfied in that respect, the contractual netting agreement will not be recognized as risk-reducing for either of the counterparties.

The competent authorities may accept reasoned legal opinions drawn up by types of contractual netting.

APPENDIX II

SUPPLEMENT ON BRAZILIAN FINANCIAL REPORTING

As noted previously, financial institutions must keep an equity estimate adjusted by the risk of their assets. *National Monetary Council Resolution no. 2399* modifies the risk adjustment rules to include swap transactions. Briefly, the risk-adjusted equity is calculated according to the following formula:

$$PLE = F' \sum_{i-1}^{n} RCD_i + F \times Apr$$

Where:

PLE stands for the adjusted equity;
F′ is a multiplier on the credit risk of swap transactions, currently set at 0.16;
RCD_i is the Credit Risk of the i-th swap transaction;
F is a multiplier on Risk Adjusted Assets (Apr), currently set at 0.10;
Apr represents the Risk Adjusted Assets.

The credit risk of a swap transaction is the product of the reference value of the transaction and a risk factor. The formula is:

$$RCD_i = VN_i \sqrt{R_{a_i}^2 + R_{p_i}^2 - 2_{a_i p_i} R_{a_i} R_{a_p}}$$

Where:

RCD_i is the Credit Risk of the i-th swap transaction;
V_{ni} is the notional value of the transaction;
R_{ai} is the "active" underlying risk of the swap, as established by the Central Bank of Brazil;
R_{pi} is the "passive" underlying risk of swap, as established by the Central Bank of Brazil;
r_{aipi} is the correlation coefficient, as established by the Central Bank of Brazil.

The risk of each underlying variable for swaps, and the correlation between them, are estimated periodically by the Central Bank of Brazil. The values in August 1998 were:

UNDERLYING VARIABLES RISKS

Time to Maturity (days)	Floating Interest Rate	R$/US$ Exchange Rate	Gold	Ibovespa	Fixed Interest Rate	Anbid Interest Rate	Others
30	0.0010	0.0042	0.0314	0.0163	-	-	0.0202
60	0.0017	0.0066	0.0443	0.0231	0.0016	0.0017	0.0286
90	0.0029	0.0076	0.0543	0.0282	0.0028	0.0029	0.0350
180	0.0105	0.0142	0.0768	0.0399	0.0100	0.0105	0.0495
360	0.0420	0.0330	0.1086	0.0565	0.0399	0.0420	0.0700
720	0.0594	0.0467	0.1536	0.0799	0.0564	0.0594	0.0990

CORRELATION BETWEEN UNDERLYING VARIABLES

	Floating Interest Rate	R$/US$ Exchange Rate	Gold	Ibovespa	Fixed Interest Rate	Anbid Interest Rate	Others
Floating Interest Rate	1	0.3	0.2	0.4	0.8	0.8	0
R$/US$ Exchange Rate		1	0.3	0.2	0.3	0.3	0
Gold			1	0.1	0.2	0.2	0
Ibovespa				1	0.4	0.4	0
Fixed Interest Rate					1	0.7	0
Anbid Interest Rate						1	0
Others							0