

United States
Commodity Futures Trading Commission

**REGULATION
OF
OVER-THE-COUNTER
DERIVATIVES TRANSACTIONS**



**1999
SURVEY**

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**1999 SURVEY OF REGULATION OF
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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	Comissão de Valores Mobiliários (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 Società 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. <i>See also</i> 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 (<i>e.g.</i> , 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>i.e.</i> , 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 <i>only</i> 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 jurisdictions¹ 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.

¹ Australia, Belgium, Brazil, Canada, France, Germany, Hong Kong, Italy, Japan, The Netherlands, Ontario, Québec, Spain, Sweden, Switzerland, and the United Kingdom. Mexico's Comisión 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 law³ 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.

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 instruments⁸ (*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 TRANSACTIONS¹⁰

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 Supervision¹² (Basle) and the Technical Committee of the International Organization of Securities Commissions¹³ (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.

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 derivatives¹⁶ 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 Società 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

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.

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.

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).

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

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

(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 purchasers³⁰ 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.

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 Commission³³ (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 Transactions³⁴

- **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 registered³⁶ 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

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 through 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

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.