Regulatory Requirements:

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

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

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

General Comments

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

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

  Reglement no. 97-02: Internal Controls

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

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

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

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

The institution must:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Transaction Design

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

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

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

- ***Belgium:*** None.

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

- ***Canada:*** None.

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

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

- ***France:*** None.

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

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

- ***Italy:*** None.

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

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

- ***Spain:*** None.

- ***Sweden:*** None.

- ***Switzerland:*** None.

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

Custody of Collateral

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

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

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

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

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

Use or Hypothecation of Collateral

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

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

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

- ***France:*** None.

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

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

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

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

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

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

- ***Sweden:*** None.

- ***Switzerland:*** None.

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

Means of Valuing a Transaction

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

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

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

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

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

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

- ***France:*** None.

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

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

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

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

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

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

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

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

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

Disclosure of Valuation Methodology

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

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

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

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

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

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

- ***France:*** None.

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

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

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

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

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

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

- ***Sweden:*** None.

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

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

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

Other Disclosure

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

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

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

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

- ***Canada:*** None.

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

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

- ***France:*** None.

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

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

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

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

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

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

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

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

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

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

Conduct of Business

- ***Australia:*** There is a general requirement under the conditions for an exempt market to operate that the person conducting the market not engage in conduct that is misleading or

deceptive, or is likely to mislead or deceive. The person conducting the market is further required to use its best endeavors to ensure that its employees, agents, or others acting in, or in connection with, the acquisition or disposal of a futures contract in an exempt futures market not engage in conduct that is misleading or deceptive, or is likely to mislead or deceive.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[44] The Principles:

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

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

Capital

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Internal Controls of Counterparties

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Documentation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Recordkeeping

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Financial Reporting

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

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

  The disclosure standard deals with information about factors that affect the amount, time and uncertainty of an entity's future cash flows relating to financial instruments and the accounting policies applied to those instruments. The standard encourages disclosure of information about the nature and extent of the entity's use of financial instruments, the business purposes that they serve, the risks associated with them, and management's policies for controlling those risks.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Insolvency[49]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Other Requirements

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

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

Choice of Law Provisions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- ***United Kingdom:*** Case law and commercial practice suggest that an English court is unlikely to strike down an agreement between non-English counterparties who have expressly chosen English law to govern the terms of a contract. However, there is some support for the view that the English courts are free, although not obliged, to strike down a choice of law unconnected with a contract.

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

Recent and Contemplated Changes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The investor protections of the *Securities and Exchange Law* are market-based. "It would not be appropriate to broaden coverage of the *Securities and Exchange Law*, in its current form, to financial instruments with different characteristics. As wider reform of the financial system proceeds and as greater diversity in intermediaries, investment products and services occurs, there will be a need to rethink what system of investor protection is desirable in order to cover those products and services that are more bilateral than market-based in nature."

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

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

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

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

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

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

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

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

- Securing the appropriate degree of protection for consumers, having regard to their differing experience and expertise, the general principle that they should take responsibility for their decisions and the varying degrees of risk attached to investments; and
- Maintaining confidence in the financial system.

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

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

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

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

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

Recent Studies and Other Reports on the Regulation of OTC Derivatives

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

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

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

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

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

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

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

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

- ***Brazil:*** None.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- ***Sweden:*** None.

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

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

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

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- ***Australia***

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{Trade Practices Act}

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- ***Belgium***

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{The Law of 9 July 1995 {Insurance Undertakings]}

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

Circular Letter of 1 September 1994 [Accompanying the "Risk Management Guidelines for Derivatives" of July 1994].

{Banking Law of 22 March 1993}

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

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{Regulation of 28 April 1992 [Periodic Reporting Requirements]}

Regulations on Undertakings for Collective Investment, Royal Decree of 4 March 1991 Relating to Certain UCIs.

{Royal Decree of 22 February 1991}

{Royal Decree of 9 January 1991}

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

Circular B 90/1 to Banks & S 90/2 to Private Savings Banks [Guidelines Relating to the Internal Organization and Control of Foreign Exchange Operations] (Apr. 17, 1990).

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- ***Brazil***

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National Monetary Council Resolution no. 2399 (June 25, 1997).

National Monetary Council Resolution no. 2138 (Dec. 29, 1994).

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National Monetary Council Resolution no. 1289 (Mar. 20, 1987) [and amendments].

- ***Canada***

{Bank Act (Canada)}

{National Policy Statement No. 39 [An agreement entered into by the Canadian provinces.]}

  - ***Ontario***

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{Securities Act (Ontario)}

- ***Québec***

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Wertpapierhandelsgesetz in der Fassung der Bekanntmachung vom 9. September 1998 [*Securities Trading Act*].

Richtlinie gemäß § 35 Abs. 2 des Gesetzes über den Wertpapierhandel (WpHG) zur Konkretisierung der §§ 31 und 32 WpHG für das Kommissions-, Festpreis- und Vermittlungsgeschäft der Kreditinstitute vom 26. Mai 1997 [*Guideline on the Details Concerning Sections 31 and 32 of the WpHG Relating to the Commission, Fixed Price and Agency Business of Credit Institutions*].

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

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

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APPENDICES

APPENDIX I

SPECIAL NOTE ON THE EUROPEAN UNION AND OTC DERIVATIVES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

APPENDIX II

SUPPLEMENT ON BRAZILIAN FINANCIAL REPORTING

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

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

Where:

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

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

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

Where:

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

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

UNDERLYING VARIABLES RISKS

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

CORRELATION BETWEEN UNDERLYING VARIABLES

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