Foreword

Representatives of regulatory bodies from 16 countries responsible for supervising the activities of the world's major futures and options markets (collectively, the "Authorities") met on May 16 and 17, 1995 at Windsor in the United Kingdom. After reviewing developments in, and discussing the regulatory implications of, the growing volume of cross-border transactions on international futures and options exchanges increasingly linked by common members, participants and products traded, the Authorities issued the "Windsor Declaration" which reflected points of consensus and called for further work by IOSCO on four issues of importance to regulatory authorities, financial intermediaries, futures and options exchanges and clearing houses: cooperation between market authorities; protection of customer positions, funds and assets; default procedures; and regulatory cooperation in emergencies.

The Technical Committee of IOSCO, at its meeting in Paris in July 1995, mandated the Working Party No. 2 on the Regulation of Secondary Markets to undertake work on two of those issues, i.e. cooperation between market authorities and default procedures. The list of members of the Working Party is contained in the Annex.

The result is two papers entitled "Cooperation Between Market Authorities" and "Default Procedures". In the course of preparing these papers, the Working Party received significant assistance regarding Information Sharing Arrangements (ISAs) from Working Party 4 on Enforcement and the Exchange of Information. Indeed, in the paper on "Cooperation between Market Authorities", the part on ISAs should be considered a joint work by the two Working Parties. Working Party No. 2 also received valuable comments on both papers from the Consultative Committee.

The two papers were approved by the Technical Committee at its Rome meeting in March 1996. The Technical Committee believes that the two papers agreed are highly constructive and very useful in helping to promote a cross-jurisdictional understanding of the risks affecting markets and how international cooperation can help develop a response to these risks.

COOPERATION BETWEEN MARKET AUTHORITIES

Introduction

1. This paper outlines the views of IOSCO on cooperation between market authorities with regard to the monitoring of and exchange of information on large exposures on futures and options markets.

   Note: The term "market authority" is used to refer to the authority in a particular jurisdiction which has statutory or regulatory powers with respect to the exercise of certain regulatory functions over a market. The relevant market authority, depending on the jurisdiction, may be a regulatory body, a self-regulatory organization and / or the market itself. The term "market" includes the clearinghouse for a market.

Large Exposures

2. A survey among WP2 members of current procedures for identifying large exposures (open positions in futures and options transactions) in individual markets (Appendix) shows that exposures are monitored in each market to identify potentially risky as well as manipulative positions. Some jurisdictions employ position limits for preventing the accumulation of large exposures, and, in addition, some jurisdictions use trigger levels for identifying such exposures.

3. A "large exposure" means hereafter an open position in futures and options on a market which is sufficiently large that it may put the market at risk if the member who holds it were to default; a large exposure will also include an open position which is sufficiently large relative to the market member's known financial resources to cause concern that the member may default when the member has substantial counterparty relationships with other derivatives market participants.

Establishment of Trigger Levels

4. It is recommended that market authorities establish qualitative and / or quantitative criteria appropriate to their markets as trigger levels for identifying large exposures.

5. Market authorities should continuously monitor the size of positions on their markets to identify whether or not they reach trigger levels. Such monitoring will be most effective where market authorities have ready access to the size and ownership of positions held by direct customers of market members. When a market authority believes that beneficial owners of positions (including positions held through omnibus accounts) could potentially pose a risk to the market, the market authorities may regard it as good practice to establish arrangements to identify those owners, when this is possible, so as to be able to assess the risk posed. When such information is not available, the market authorities should be able to exercise the power in paragraph 8. When customers are located in another jurisdiction, information may also be sought through appropriate channels from relevant authorities in that jurisdiction.

Evaluation of Exposures Reaching Trigger Levels

6. Market authorities, when they have ascertained that the trigger level has been reached, should carefully evaluate the risk of the particular market member defaulting because of the exposure and the risk to the market should the default occur. The type of information which may assist in this evaluation would include positions of the market member and its affiliates on other markets and cash and OTC transactions that augment, reduce or offset the exposure of the market member. Where the authorities of a particular market are not themselves responsible for assessing the

financial resources of a particular market member, they should establish cooperative arrangements with the market or other authorities which are so responsible.

Note: If the above analysis indicates that the exposure represents an undue level of risk to the market, market authorities should take any steps they consider necessary to determine that the market member will meet its commitments, such as requiring the reduction of the exposure or the payment of increased margin.

Access to Information

7. Three possible sources for obtaining the information in paragraph 6 are:

- the market member;
- the regulatory or market authority that is responsible for monitoring the financial soundness of the market member (its "prudential supervisor"); and
- other relevant markets or their regulators.

8. If a market member does not make available information it has, including beneficial owners, to assist the market authority to evaluate an exposure, the market authority should be able to take appropriate action such as imposing limitations on future trading by the member, requiring liquidation of positions, increasing margin requirements and/or revoking trading privileges.

9. Examples of cases where other relevant markets or their regulators may be useful as information sources are:

- where the market member is unwilling to provide the information;
- where there is doubt as to the accuracy of the information provided by the market member;
- where there might be a delay with the other sources; and
- where prudential supervisors may not have the most up-to-date information.

10. Market authorities should promote mechanisms which facilitate the sharing of the above information through appropriate channels. These mechanisms could include informal arrangements to share such information or more formal information sharing arrangements, subject to appropriate confidentiality protections.

Information Sharing Arrangements

11. Mechanisms whereby large exposure and other relevant information is and could be shared on a bilateral or multilateral basis among regulators and markets would include Information Sharing Arrangements (ISAs) that may be concluded between market authorities. The following are the factors for market authorities to consider in developing ISAs, including the arrangements to ensure confidentiality and that the information is used solely for the regulatory purpose for which it was provided:

(1) Purpose of ISAs

ISAs can be useful to relevant market authorities to share pertinent surveillance and regulatory information on related derivative markets, cash markets and / or with respect to common or related participants.

In determining the markets for which such ISAs would be useful, consideration should be given to the degree of similarity and price correlations among products, extent of common participation, amount of open interest and the relative sizes of the markets as compared to each other.

If no market authority in a jurisdiction is able to obtain information domestically or to share such information with other foreign market authorities without breaching domestic law, consideration should be given to recommending appropriate amendments to the domestic law to enable such information to be obtained and shared with other market authorities.

(2) Subject Matter

An ISA should specify the types of information covered by the arrangement. It should also articulate the procedures for sharing information. Such procedures must be consistent with applicable laws and regulations.

(3) Responsible Market or Regulatory Authorities

The market authorities best situated to obtain and / or act on the information shared should, wherever possible, enter into the ISA. However, since the content and form of markets regulation vary by jurisdiction, the differences between the legal or regulatory framework of each jurisdiction must be examined to identify the market or regulatory authority who has supervisory responsibility for relevant markets and participants and / or who is able to provide or receive the information to be covered by the ISA. The arrangements should identify the counterparts to each of the market authorities in the various jurisdictions, taking into account the discussion of this issue in Section I of the 1990 IOSCO Report addressing the Difficulties Encountered while Negotiating and Implementing Memoranda of Understanding ("1990 Report").

(4) Types of Communication

An ISA should state the types of communication for the sharing of information such as (i) sharing based on the occurrence of specified trigger levels, and / or (ii) sharing subsequent to a request.

(5) Confidentiality

The arrangement should provide that a market authority that receives information will protect that information with the highest possible level of confidentiality which, at a minimum, should provide that the information should be treated with the same level of confidentiality that is given to similar information that it collects from its own market. In addition, the arrangement should provide market authorities with the opportunity to identify the level of confidentiality that they expect to be attached to information they exchange and, when required, proper enforcement arrangements should be undertaken.

Note: IOSCO notes that in some jurisdictions some of its recommendations regarding access to and sharing of information may not be fully consistent with domestic confidentiality laws. It also notes that some jurisdictions have provided expressly for confidentiality laws to accommodate regulatory access to and sharing of information.

(6) Permitted Uses

An ISA should state how information received pursuant to its terms can be used by the market authority receiving the information. At a minimum, the authority should be able to use the information received for its own supervisory purposes. When the market authority receiving the information also has a commercial function, such as an exchange, consideration should be given to ensuring that information received in the regulatory context is not used for competitive advantage.

The ISA should also address whether and under what circumstances the information received may be provided to other authorities. In the case where information sharing is between non-governmental authorities, the ISA should provide that shared information should be available to relevant governmental authorities.

(7) Limitation of Liability

Market authorities may wish to consider including in the ISA a provision addressing the limitation of liability and the right of third parties.

(8) Consultation

An ISA may provide for routine consultations by market authorities concerning the content, scope, format and procedures for communicating relevant information so as to assure its optimal use. The ISA also may contain a provision in which the authorities express their intent to consult on relevant issues as they arise.

(9) Relationship to Other Arrangements

The market authorities should include a provision in an ISA addressing the relationship of the ISA to other existing arrangements such as memoranda of understanding. It is noted that this issue is addressed extensively in Section VI of the 1990 Report.

(10) Public Policy Exception

An ISA may provide that the market authority maintains the right to refuse to provide the information in instances where the transmission of the information would violate public policy. The concept of public policy would include issues affecting sovereignty, national security, or other essential interests.

DEFAULT PROCEDURES

Introduction

1. This paper outlines the views of IOSCO on market default procedures related to futures and options transactions, especially with regard to transparency of such procedures and best practices on the treatment of positions, funds and assets.

   IOSCO notes that certain of its recommendations regarding best practices may not be fully consistent with the domestic insolvency laws in some jurisdictions. It also notes that some jurisdictions have provided expressly for insolvency law to accommodate market default procedures. It recommends disclosure of the relevant insolvency law position.

   Note: The term "market authority" is used to refer to the authority in a particular jurisdiction which has statutory or regulatory powers with respect to the exercise of certain regulatory functions over a market. The relevant market authority, depending on the jurisdiction, may be a regulatory body, a self-regulatory organization and / or the market itself. The term "market" includes the clearinghouse for a market. "Market default procedures" means procedures operated by a market authority which are designed to address a default by a market participant. The term "market participant" includes both market members and customers.

Transparency of Default Procedures

2. Transparency of market default procedures is important for the following reasons:

   (a) it provides certainty and predictability to market participants;
   (b) it facilitates orderly handling in case of an actual default; and
   (c) it enables market participants to make an informed assessment about markets.

3. The information which should be disclosed should cover:

   - the circumstances in which action may be taken;
   - who may take it; and
   - the scope of actions which may be taken.

4. The following is a template or a list of information items that should be available to market participants as to market default procedures regarding futures and options transactions:

   (1) The circumstances in which action may be taken should be disclosed in some detail. These circumstances might include:

      (i) unremedied failure by a market member to meet a test of its solvency under the applicable laws of the jurisdiction;
      (ii) suspension, expulsion or termination as a market member or suspension or withdrawal of trading privileges;
      (iii) cessation by a market member of any part or all of its operations either through liquidation, winding up or voluntary cessation;
      (iv) failure by a market member to pay, within the time specified, any amounts required to be paid to a market including initial margins, variation margins or intra-day margins;
      (v) failure by a market member to meet obligations under contracts or the business rules of the market authority which result in payment failure;
      (vi) failure to abide by any agreement or understanding entered into with a market authority and failure to comply with any reasonable directions of a market authority where such

failure requires the firm to cease operating or renders it unable to comply with its financial obligations toward its customers, or:

(vii) any other event or series of events, whether related or not, occurring which in the opinion of the market authority has a material effect on the capacity of the market member to meet its obligations to the market.

The procedure for identifying the above circumstances should also be disclosed.

(2) The treatment of both proprietary and customer positions, funds and assets should also be disclosed in some detail, including the kinds of cases where customer positions are transferred and those where positions are liquidated.

In cases where positions would be transferred, concrete terms and conditions therefor should be described, including:

(i) where customer positions are transferred automatically, information to the customer that the customer position will be transferred;
(ii) where customers must request a transfer of their positions, any documentation necessary for customers requesting transfer;
(iii) the price of the position at transfer;
(iv) the treatment of pending settlements, for example, unrealized gains, if any, between the customers and the transferring firm;
(v) a possible requirement for remargining positions, for example, where margin cannot be transferred with the positions;
(vi) the availability of indemnifications for transferees;
(vii) the treatment of commissions and fees;
(viii) obligations of transferees to the transferred accounts; and
(ix) any differences in the treatment of different classes of customers.

In cases where positions would be liquidated, concrete terms and conditions therefor should be described, in particular:

(i) where a suspension of trading rights will be imposed in respect of both proprietary and customer positions of the defaulting member, information to the customer that such a suspension will be imposed on the member's customer positions; and
(ii) where all open proprietary and customer positions will be netted together into a single net position for liquidation in the market, information to the customer of such procedure, including how the liquidation price of customer positions will be identified.

(3) The mechanisms to address the defaulting member’s and / or clearinghouse’s obligations to market counterparties should be disclosed, including:

(i) the use of margin funds;
(ii) the use of other available funds in the market such as exchange guarantee funds;
(iii) the availability of a parent guarantee;
(iv) the possible sale of the defaulting firm's market membership; and
(v) the assessment procedure among market members if any has been established.

Note: “Assessment procedure” means procedure for requiring members of a market to contribute to the costs of a default.

(4) The mechanisms to address the defaulting member’s obligations to its customers should be disclosed, including, where applicable:

(i) segregation and / or separate identification of exchange member positions, funds and assets from those of its customers;

(ii) a clearinghouse guarantee;
(iii) insurance of customer accounts and compensation fund mechanisms; and
(iv) the existence of other regulatory funding and / or depository requirements intended to protect customer funds.

(5) There should be a description of how each of the information items above might be affected, if at all, by the occurrence of other events, e.g. insolvency proceedings.

Concerning the items listed in the template, and in order to enhance transparency, it is recommended that information should be available to market participants for each market in clearly understandable terms.

Communications Upon Implementation of Default Procedures

5. It is recommended that market authorities establish mechanisms whereby information collection can be coordinated in the event that default procedures are implemented. Unless disclosure is considered prejudicial to the management of the default procedures, those mechanisms should also provide for such information to be efficiently and effectively communicated to market participants. Those mechanisms may include special communications to market professionals and investors through publication in newspapers, announcements made on the trading floor, faxes, E-Mail and screen-based trading terminals, and a telephone number where market participants can obtain information.

Best Practices on the Treatment of Positions, Funds and Assets

6. Best practices by market authorities with regard to the treatment of positions, funds and assets in the event of a default at a member firm so as to permit the prompt isolation of the problem at the failing firm would include the following:

(1) Proprietary positions of the defaulting firm at the market will be liquidated in the market as swiftly as practicable, taking the potential market effect into account, to contain a possible expansion of the losses.

(2) Proprietary funds and assets of the defaulting firm at the market, such as margin funds, liquidation proceeds, guarantee funds and security deposits, if any, will be used to meet the obligations of the defaulting firm to market counterparties including the clearinghouse.

(3) Customer positions of the defaulting firm at the market will preferably be transferred swiftly to other firms to avoid financial harm to customers, and to avoid spreading the damage from the default; in cases where the nature of the positions makes transfer impracticable, or in cases such as where the customer has not completed the necessary documentation for the transfer or the applicable regulation does not allow for transfers, customer positions may be liquidated in the market as swiftly as practicable, taking the potential market effect into account.

(4) There should also be a mechanism in place to protect customer funds and assets in order to avoid financial harm to customers, and to avoid spreading the damage from the default. This could be obtained by transferring customer funds and assets to other firms or by employing a guarantee system.

7. Where customer positions are to be transferred to other firms, the necessary arrangements for distinguishing firm and customer positions, deposits and accruals should preferably be implemented at the market level in the interests of speed of action.

8. In order to assure that the positions, funds or assets of firms materially related to the failing firm would not be transferred but conserved to address the failing firm's obligations, the underlying nature

of participants in omnibus accounts should be identified in jurisdictions where materially related firms may be liable for the obligations of the failing firm.

9. In the event that the position to be liquidated is of a size that may threaten the stability of the market, exchanges and regulators should be provided with sufficient flexibility to dispose of such position in a reasonable amount of time.

10. Relevant market authorities should develop contingency plans addressing the procedures to be implemented to minimize the adverse effects of a firm default. Where there is more than one market authority which could take actions under market default procedures, there should be a clear delineation of respective roles and responsibilities, and a procedure for coordinating actions in each jurisdiction.

11. Where an event or series of events has occurred which in the opinion of the market authority may potentially have a material effect on the capacity of a market member to meet its obligations to the market, but the event or series of events does not yet formally constitute a default, market authorities should consider:

    - increasing the monitoring of the member;
    - placing restrictions on the ability of the member to take on further positions;
    - requiring the member to reduce its risk exposure; and
    - consulting with other relevant authorities.

Annex

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