

# **INTERNATIONAL STANDARDS FOR DERIVATIVES MARKET INTERMEDIARY REGULATION**

## **Final Report**



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## Chapter 1 - Executive Summary

In 2009, the Leaders of the G-20 committed to reforms in the over-the-counter (“OTC”) derivatives market to improve transparency, mitigate systemic risk, and protect against market abuse. The intent of this Report is to further these objectives by providing high-level international standards for the regulation of market participants that are in the business of dealing, making a market or intermediating transactions in OTC derivatives (“OTC derivative market intermediaries” or “DMIs”). Historically, market participants in the OTC derivatives market have, in many cases, not been subject to the same level of regulation as participants in the traditional securities market. This lack of sufficient regulation allowed certain participants to operate in a manner that created risks to the global economy that manifested during the financial crisis of 2008. This Report focuses on the regulation of DMIs, taking into account the distinctions between the OTC derivatives market and the traditional securities markets, and the differences in jurisdictional approaches of international market authorities. The recommendations in the Report are intended to address:

- DMI obligations that should help mitigate systemic risks;
- Requirements intended to manage counterparty risk in the OTC derivatives markets; and
- Protecting participants in the OTC derivatives markets from unfair, improper or fraudulent practices.

In particular, this Report focuses on the market participants who should be regulated as DMIs, given their type and level of involvement within the OTC derivatives market, and describes the substantive areas that generally comprise regulation. The regulation of DMIs should be primarily focused on areas where capital, counterparty or client money and public confidence may be most at risk.

The Report begins by providing a description and definition of the market participants who should be considered DMIs, including a discussion of the characteristics distinguishing DMIs from traditional securities market intermediaries. The remainder of this Report makes recommendations with respect to the following substantive areas:

- Registration/licensing standards;
- Capital standards or other financial resources requirements for non-prudentially regulated DMIs;
- Business conduct standards;
- Business supervision standards; and
- Recordkeeping standards.

Cross-border consistency among market authorities with respect to the regulation of DMIs is essential to successful oversight of the global OTC derivatives market particularly because many DMIs operate in multiple jurisdictions.

## SUMMARY OF RECOMMENDATIONS

Recommendation 1: DMIs should generally include those who are in the business of dealing, making a market or intermediating transactions in OTC derivatives. However, DMIs should not include end-users and market participants who enter into OTC derivatives transactions but are not engaged in the business of dealing, making a market or intermediating transactions. DMIs should be subject to registration or licensing and applicable substantive regulations and/or requirements and standards once registered or licensed in some form by the relevant market authority or authorities, recognizing that in certain limited circumstances full application of substantive regulations and/or requirements and standards may not be appropriate for certain types of entities.

Recommendation 2: Registration or licensing requirements applicable to DMIs should be tailored to OTC derivatives activities.

Recommendation 3: The registration or licensing of DMIs should establish minimum standards and require DMIs to provide and update information with regard to their OTC derivatives activities to regulators to assist them in determining whether registration or license should be granted and/or revoked. All registering or licensing authorities should have the power to grant or reject and suspend or withdraw the registration or license of DMIs registered or licensed by such authority.

Recommendation 4: Relevant material information on licensed or registered DMIs should be made publically available.

Recommendation 5: If a DMI registered or licensed in its home jurisdiction is carrying on OTC derivatives business in another jurisdiction in which the DMI is not registered or licensed, the market authority of the host jurisdiction in which the DMI is carrying on business should ensure that there are appropriate supervisory arrangements in place for the OTC derivatives business carried on by that DMI. These arrangements should take into account how the DMI is supervised in the host jurisdiction and any cooperative arrangements in place between the market authorities of the home and host jurisdictions. Market authorities should closely cooperate to identify overlaps, conflicts and gaps between jurisdictions with respect to cross-border issues relating to DMI supervision and to ensure that the DMI's activities in the host jurisdiction are adequately supervised. It is further recommended that jurisdictions coordinate their approaches via multilateral or bilateral channels to reduce overlaps and conflicts, to the extent possible.

Recommendation 6: Market authorities should consider imposing some form of capital or other financial resources requirements for DMIs that are not prudentially regulated that reflect the risks that these intermediaries undertake.

Recommendation 7: DMIs should be subject to business conduct standards. These standards would include, among other things, prohibitions against fraud, misrepresentation, manipulation and other abusive practices.

Recommendation 8: Business conduct requirements should be tailored, as appropriate, for the OTC derivatives market. This could be based on the reasonable assessment of the nature of the party dealing with a DMI or on the complexity of and the risk associated with the specific OTC derivatives market product or service.

Recommendation 9: For cleared OTC derivatives transactions, DMIs should segregate collateral belonging to clients from their own proprietary assets and employ an account structure that enables the efficient identification and segregation of positions and collateral belonging to DMI clients. Where applicable and possible, DMIs should have in place procedures to facilitate the rapid transfer or porting of cleared client positions and collateral.

Recommendation 10: DMIs should be required to have effective corporate governance frameworks designed to ensure appropriate management of OTC derivatives activities within the DMI.

Recommendation 11: DMIs should be required to design supervisory policies and procedures to manage their OTC derivatives operations and the activities of their representatives.

Recommendation 12: DMIs should be required to maintain risk management systems and organization to properly identify and manage their OTC derivatives related business risks.

Recommendation 13: DMI's management should be required to establish, maintain and apply policies, procedures and systems of control sufficient to provide reasonable assurance that the DMI and each individual acting on its behalf are competent and comply with applicable regulatory standards and the DMI's internal policies and procedures.

Recommendation 14: DMIs should be required to develop and maintain an effective business continuity plan, based on their size, risks, and the nature of their operations, to allow them to mitigate, respond to and recover from business disruptions or disasters.

Recommendation 15: DMIs should be required to retain OTC derivatives transaction records and be able to provide them in a timely, organized and readable manner. The record retention period for OTC derivatives transactions should apply for a specified period after its termination, maturity or assignment.

## INTRODUCTION

In this Report, the Task Force considers standards that should apply to the regulation of market participants who act as intermediaries in the over-the-counter (“OTC”) derivatives market and makes specific recommendations for regulatory standards for their operation. Historically, market participants in the OTC derivatives market have, in many cases, not been subject to the same level of regulation as participants in the traditional securities market. This lack of sufficient regulation allowed certain participants to operate in a manner that created risks to the global economy that manifested during the financial crisis of 2008. The intent of this Report is to set standards for the regulation of certain OTC derivative market participants and activities. Comprehensive and internationally consistent regulation of participants who act as intermediaries or derivatives dealers will help to ensure that OTC derivatives markets operate efficiently and safely, that risks to the global financial system are addressed and that market participants who transact with OTC derivative market intermediaries are afforded protection from unfair, improper or fraudulent practices.

### *Scope*

This Report focuses on the regulation of derivative market intermediaries (“DMIs”) in the OTC derivatives market, taking into account the distinctions between OTC derivatives and the traditional securities market, and the differences in jurisdictional approaches of international market authorities.

For the purposes of this Report, and as discussed in greater detail in Section A, DMIs generally include those entities that are in the business of dealing, making a market or intermediating transactions in OTC derivatives. However, DMIs do not include end-users and market participants<sup>1</sup> that enter into OTC derivatives transactions but are not engaged in the business of dealing, making a market or intermediating transactions in OTC derivatives. Although the Task Force acknowledges that providing advice with respect to OTC derivatives is an activity that should, in certain circumstances, be subject to regulation, this Report does not address the regulation of those market participants solely providing advisory services with respect to OTC derivatives.

While in some IOSCO jurisdictions certain derivatives may be classified as “securities”, the term “traditional securities market” is used throughout this Report to refer to conventional securities, such as bonds and exchange-traded equities and options, in contrast to those instruments that would be considered OTC derivatives<sup>2</sup>.

When used in this Report, the term “market authority” refers to the IOSCO Member or self regulatory organization(s) with delegated authority to which these recommendations apply. The standards in this Report do not purport to prescribe what type of governmental regulator or combination of governmental regulators should be responsible for the regulation and

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<sup>1</sup> Such as funds and asset management companies when they exclusively operate on behalf of a fund.

<sup>2</sup> For the purpose of this Report an over-the-counter or OTC derivative does not include products listed on an exchange.

oversight of DMIs in a particular jurisdiction.<sup>3</sup> For example, where a market authority does not have jurisdiction over prudential oversight of DMIs, the market authority can rely on the prudential authority to address the recommendations relevant to prudential rules.

The recommendations made in this Report are focused on DMIs dealing with non-retail clients/counterparties who currently comprise the majority of the clients/counterparties in the OTC derivatives market. Although standards and measures vary across jurisdictions, this Report uses the term “non-retail” to refer to financial, institutional, professional, corporate or certain other market participants that in some jurisdictions are considered sophisticated. In some jurisdictions, traditional securities market intermediaries dealing with non-retail participants may be eligible for certain registration/licensing exemptions. However, as discussed in Section D of this Report, because the majority of the OTC derivative market is composed of non-retail clients/counterparties, a general exemption for DMIs who only transact with non-retail entities would defeat the objectives of registering or licensing DMIs and would not be appropriate. The “retail” category of client/counterparty is intended to capture market participants with lower levels of investment knowledge and expertise. Retail participants are typically afforded greater levels of protection than non-retail entities. With respect to DMI counterparties or clients participating in the OTC derivatives market that would be considered to fall within the retail classification, the Task Force would expect at least the same duties applicable to intermediaries dealing with retail clients/counterparties in the traditional securities market to apply, to the extent such transactions are permitted by the jurisdiction.

### *Objectives*

This Report and the recommendations made herein aim to provide high-level international standards for the regulation of DMIs. The recommendations in this Report relate to specific commitments to improve transparency, mitigate systemic risk, and protect against market abuse.<sup>4</sup> Specifically the recommendations are intended to address:

- DMI obligations that should help mitigate systemic risks relating to OTC derivatives activities;
- requirements intended to manage counterparty risk in the OTC derivatives markets; and
- protecting participants in the OTC derivatives markets from unfair, improper or fraudulent practices.

In particular, this Report focuses on the market participants who should be regulated as DMIs, given their type and level of involvement within the OTC derivatives markets, and describes the substantive areas that generally comprise regulation. Regulation of DMIs should include specification of entry criteria, business conduct standards, capital regulation and the ongoing supervision and discipline of DMIs. The regulation of DMIs should be

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<sup>3</sup> For example, in some jurisdictions a prudential regulator may be the registering or licensing authority with respect to a DMI. For greater clarity, this Report is not intended to make recommendations to non-IOSCO members but rather to provide standards which could be used by each IOSCO member to assess whether the recommendations in this Report have been implemented in its jurisdiction.

<sup>4</sup> “Statement: The Pittsburgh Summit” (September 24-25, 2009) (“G20 Statement”) available at [http://www.g20.org/pub\\_communique.aspx](http://www.g20.org/pub_communique.aspx).

primarily focused on areas where capital, counterparty or client<sup>5</sup> money and public confidence may be most at risk.<sup>6</sup> Therefore, the Task Force proposes to make recommendations with respect to the following:

- registration/licensing standards;
- capital standards;
- business conduct standards;
- business supervision standards; and
- recordkeeping standards.

Section A provides a description and definition of the market participants who should be considered DMIs and includes a discussion of the characteristics distinguishing DMIs from traditional securities market intermediaries while Section B focuses on the Task Force's recommendations for registration/licensing standards. The remainder of this Report addresses standards for DMIs in the substantive areas listed above. In particular, Section C considers capital requirements. Section D focuses on business conduct standards and Section E discusses business supervision obligations. Lastly, Section F considers recordkeeping requirements. Each section includes a brief overview of the current regulatory regimes for market intermediaries in IOSCO member jurisdictions.

#### *Consistency with Existing IOSCO Recommendations Relating to Market Intermediaries*

IOSCO has extensive experience in developing objectives and principles for traditional securities market intermediaries.<sup>7</sup> Although most of these objectives and principles were not developed in contemplation of the OTC derivatives market, there are many parallels between the activities of traditional securities market intermediaries and DMIs. IOSCO has directed that, where the context permits, principles and concepts relating to traditional securities markets and regulations should be understood to include reference to derivatives.<sup>8</sup> However, although existing principles regarding market intermediaries may have application to the

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<sup>5</sup> In this Report references to "counterparty" are used to indicate the party on the other side of an OTC derivatives transaction entered into by a DMI. In certain instances a DMI may provide intermediary services with respect to an OTC derivatives transaction where they do not become a "counterparty". The term "client" will be used throughout this Report to represent such a relationship.

<sup>6</sup> IOSCO Objectives and Principles of Securities Regulation, June 2010 ("IOSCO Principles") and IOSCO Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, September 2011 ("IOSCO Methodology") at p. 178, available at [www.iosco.org](http://www.iosco.org).

<sup>7</sup> See for example: IOSCO Principles; Guidelines for the Regulation of Conflicts of Interest Facing Market Intermediaries, Report of the Emerging Markets Committee of IOSCO, 25 November 2010; Guidelines to Emerging Market Regulators Regarding Requirements for Minimum Entry and Continuous Risk-Based Supervision of Market Intermediaries, Report of the Emerging Markets Committee of IOSCO, 21 December 2009; Market Intermediary Management of Conflicts that Arise in Securities Offerings - Final Report, Report of the Technical Committee of IOSCO November 2007; Examination Procedures for SROCC Members to Determine Implementation of IOSCO Principles on Outsourcing by Market Intermediaries Outsourcing Their Activities, Report of the SRO Consultative Committee of IOSCO November 2007; Compliance Function at Market Intermediaries - Final Report, Report of the Technical Committee of IOSCO, March 2006; Report On Cross-Border Activities Of Market Intermediaries In Emerging Markets, Report of the Emerging Markets Committee of IOSCO, March 2005; Principles On Outsourcing Of Financial Services For Market Intermediaries, Report of the Technical Committee of IOSCO February 2005.

<sup>8</sup> IOSCO By-Laws, Explanatory Memorandum.

OTC derivatives market there is a need to expand the application and tailor regulation for the unique characteristics of OTC derivatives. Therefore, the purpose of this Report is to develop standards for DMIs that seek to ensure that the OTC derivatives market is regulated appropriately and to the same general level of standards that are applied to traditional securities market intermediaries.

For the purposes of this Report, the Task Force has leveraged the extensive work done by IOSCO with respect to traditional securities market intermediaries in an effort to harmonize the recommendations applicable to DMIs and to avoid the creation of unnecessary burdens on entities that act as both traditional securities market intermediaries and DMIs. The *IOSCO Objectives and Principles of Securities Regulation* (“IOSCO Principles”, and where a specific principle is referred to herein “IOSCO Principle #”) provide that “market intermediaries” generally include those who are in the business of managing individual portfolios, executing orders, dealing in or distributing securities and providing information relevant to the trading of securities.<sup>9</sup> In many ways, the definition of traditional securities market intermediaries is applicable in the OTC derivatives context. Where there are differences between traditional securities markets and OTC derivatives markets, this Report attempts to identify and explain these differences in order to tailor objectives and standards specifically to market intermediaries operating in the OTC derivatives market.

#### *The Challenges to International Regulatory Consistency and Coordination*

The Task Force recognizes that approaches to the regulation of market intermediaries, including DMIs, differ across IOSCO member jurisdictions. Furthermore, IOSCO members are not the sole regulatory authorities overseeing such entities. In some instances, the subject matter contained in this Report overlaps with the authority of non-IOSCO regulators, such as prudential regulators and central banks.

Cross-border consistency of the regulation of DMIs is essential to successful regulatory oversight of the global OTC derivatives market particularly because many DMIs operate in multiple jurisdictions.

This Report is designed to provide guidance in areas where international coordination among market authorities is key, and where differences in rules or requirements across jurisdictions may present regulatory risk, including the risk of regulatory arbitrage. Regulators should attempt to achieve the highest possible level of cooperation in order to identify both gaps and overlaps in the regulation of DMIs.

#### *The Need for Regulation of OTC Derivatives and DMIs*

The broad objectives of regulation enumerated by IOSCO in the context of securities market regulation are: protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk.<sup>10</sup> These objectives are equally applicable in the OTC derivatives context. However, certain differences between traditional securities products, such as equities, and OTC derivatives products, their respective markets and their participants, require

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<sup>9</sup> IOSCO Methodology, *supra* note 6 at p. 32.

<sup>10</sup> IOSCO Principles, *supra* note 6, at 3.

a re-thinking of the approach to implementing each of these objectives in the context of OTC derivatives regulation.

Currently, the majority of the notional volume of the OTC derivatives market is comprised of privately negotiated transactions between financial, institutional or professional counterparties in which each assumes the credit risk of the other and manages this risk bilaterally. The nature of the parties generally involved in OTC derivatives transactions suggests the possibility of a lesser emphasis on market participant protection as compared to traditional securities markets in which transactions with retail investors are present. Therefore, in many situations, requirements designed to protect certain traditional securities market participants, such as retail customers, may not be entirely relevant in OTC derivatives markets.

The OTC derivatives market is extremely large and, in many products, is dominated by a limited number of DMIs. In addition to other intermediating activities, these DMIs negotiate OTC derivatives contracts with counterparties and manage the resulting risk exposures through offsetting transactions in the underlying assets, exchange traded derivatives, and further transactions with DMIs and counterparties in OTC markets. DMIs are therefore often highly interconnected through a network of transactions, creating contagion risk in the market.<sup>11</sup> The default of a DMI may result in significant counterparty losses from exposures to the defaulting DMI or from the cost of replacing OTC derivative transactions in times of stress. This could trigger a chain of credit-related losses which could cause severe market disruptions.

Further, a 2010 report issued by the Financial Stability Board explains that:

...The failure of a major OTC derivatives market participant also could lead to contagion because of uncertainty regarding who is linked to the failed participant, which in turn could cause markets to become illiquid. Although collateralisation typically is used to mitigate counterparty credit risks, if markets become illiquid, firms may encounter falls in the value of collateral and increases in mark-to-market counterparty exposures, as well as delays and difficulty when seeking to sell collateral. This may reduce credit protection, and in turn lead to further downward price adjustments, thereby increasing the amount of collateral required to support position-taking.<sup>12</sup>

Due to the size and interconnectedness of the OTC derivatives market, the objectives of ensuring that markets are fair, efficient and transparent and reducing systemic risk should be given added weight. This supports the application of registration or licensing<sup>13</sup> requirements on DMIs that deal with non-retail participants, in what is referred to in some jurisdictions as the “wholesale”, “professional” or “exempt” market.

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<sup>11</sup> Financial Stability Board, *Implementing OTC Derivatives Market Reforms*, October 25, 2010 available at [http://www.financialstabilityboard.org/publications/r\\_101025.pdf](http://www.financialstabilityboard.org/publications/r_101025.pdf) at page 9. It should be noted that G-20 commitments to reforms in the OTC derivative market, including increasing clearing and exchange and electronic platform trading of standardized OTC derivatives, may result in a potential reduction in the use of non-standardized products and potential reduction of counterparty risk as a result of clearing requirements.

<sup>12</sup> Ibid.

<sup>13</sup> When used in this Report the term “registration” or “licensing” is intended to include authorization and other similar regimes or processes.

To facilitate a better understanding of the standards that should apply to DMIs, it is useful to analyze characteristics of OTC derivatives and OTC derivatives markets that differentiate them from many traditional securities and traditional securities markets. Although the Task Force recognizes that there is a wide range of products that comprise both the OTC derivatives and traditional securities markets, the following examples illustrate some fundamental differences, which, in turn, demonstrate why distinctions in the regulatory approach to OTC derivatives are appropriate.

(a) **Contractual Relationship:** Securities trades involve an agreement to purchase and sell a specific security. Generally, the contractual relationship between the intermediary and the seller and purchaser with respect to such security is concluded once the security and agreed upon consideration for the security have been exchanged. In contrast, an OTC derivatives transaction results in the creation of an ongoing contractual relationship between two counterparties which may last for many years. A DMI, in addition to providing intermediary services, may be a counterparty to an OTC derivatives transaction in an ongoing manner that does not necessarily occur in traditional securities intermediation.

(b) **Level of Complexity:** Notwithstanding the increasing standardization of OTC derivative products, an OTC derivative may not be liquid, fungible and/or traded in the same way as a traditional security. In a cash securities transaction, such as the sale of a listed equity, the purchase price of the security is the primary variable and a purchaser's loss is limited to the price paid for the security. In many OTC derivatives transactions, the terms of the derivative contract are negotiated by the parties to reflect not only price, but a number of other variables, including the counterparty credit risk. Payment obligations under the terms of the transaction are often ongoing and not limited to any finite amount. More generally, the risks associated with these products, and in particular their relative risk/reward profiles, can make them difficult for the client or counterparty to understand, depending on the details of the particular OTC derivatives transaction.

(c) **Nature of Parties:** In many traditional securities transactions, securities market intermediaries owe duties to their clients. Unlike traditional securities transactions where broker/dealers act for and on behalf of clients, the relationship between counterparties to an OTC derivatives transaction is not typically characterized as one of "dealer" and "client". Many OTC derivatives transactions involve non-retail counterparties. In some instances, imposing a retail client-dealer relationship model on OTC derivative transactions would be inconsistent with the commercial reality of the nature of the participants and their relationship.

## **A. Description of which entities constitute "DMIs"**

The Task Force believes that all derivatives market participants acting as DMIs should be subject to registration or licensing and applicable substantive regulations and/or requirements and standards once registered or licensed in some form by the relevant market authority or authorities, recognizing that in certain limited circumstances full application of substantive regulations and/or requirements and standards may not be appropriate for certain types of entities. It should be noted that although the registering or licensing authority will often be the authority implementing the substantive regulations and/or standards and requirements for DMIs, this is not necessarily the case. When referred to in this Report, registration or

licensing requirements should be read to include substantive requirements that are imposed by market authorities that may not be responsible for registration or licensing.<sup>14</sup>

The Task Force recommends that “DMIs” generally include those who are in the business of dealing, making a market or intermediating transactions in OTC derivatives. Examples of DMI activities include, but are not limited to, providing intermediation services in order to allow clients to enter into OTC derivatives; creating market liquidity by quoting prices in a particular OTC derivative; marketing OTC derivatives to counterparties; and providing indirect clearing services for parties to OTC derivatives that are not able or willing to clear directly with a central counterparty clearing house (“CCP”). However, the definition of DMI is not intended to capture end-users and market participants who enter into OTC derivatives transactions but are not engaged in the business of dealing, making a market or intermediating transactions.

**Recommendation 1: DMIs should generally include those who are in the business of dealing, making a market or intermediating transactions in OTC derivatives. However, DMIs should not include end-users and market participants who enter into OTC derivatives transactions but are not engaged in the business of dealing, making a market or intermediating transactions. DMIs should be subject to registration or licensing and applicable substantive regulations and/or requirements and standards once registered or licensed in some form by the relevant market authority or authorities, recognizing that in certain limited circumstances full application of substantive regulations and/or requirements and standards may not be appropriate for certain types of entities.**

**(i) Exemptions**

Most jurisdictions’ securities regimes include exemptions from registration or licensing requirements for certain market intermediaries. Examples of common exemptions include exemptions for entities that only engage in intermediating activities on a limited scale, and exemptions for foreign registered or licensed intermediaries. The Task Force recognizes that exemptions may be justified for certain DMIs. However, any exemptions should be explained and clearly defined by the relevant market authority. Furthermore, as discussed in Section D, the majority of the OTC derivative market is composed of non-retail entities and therefore a general exemption for DMIs who only transact with non-retail entities would defeat the objectives of registering or licensing DMIs and would not be appropriate.

## **B. Registration/Licensing Standards**

In preparation for this Report, the Task Force carried out two surveys to gather information about member jurisdictions’ approaches to DMI regulation and how this compares with the regulation of traditional securities market intermediaries.

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<sup>14</sup> Registration and licensing are processes intended to specify entities to which substantive regulations and/or requirements and standards apply once registered or licensed. For purposes of this Report, references to “registration or licensing” regimes and “registration and licensing” regimes for DMIs include the process of registration or licensing and the substantive regulations and/or requirements and standards that apply to such registered or licensed entities once registered or licensed unless specified.

The results of the surveys show that currently, there is not a consistent international approach to the regulation of DMIs operating in OTC derivatives markets. This is a cause of concern. Cross-border consistency with respect to the registration or licensing of DMIs is essential to ensuring that regimes interact and work together to provide broad and comprehensive regulation of DMIs, many of whom operate in multiple jurisdictions. DMIs conducting OTC derivatives activities in multiple jurisdictions may have an incentive to concentrate these activities in jurisdictions that do not require registration or licensing or have less inclusive classifications for registration or licensing. International consistency in defining what activities trigger DMI registration or licensing requirements for market participants is crucial to reducing incentives and opportunities for regulatory arbitrage and to prevent the undermining of registration and licensing objectives. With respect to specific requirements imposed on DMIs, the greater the cross-border coordination that can be achieved, the more successful regulatory oversight of the global OTC derivatives market will be. In short, consistent application of the DMI definition across jurisdictions should facilitate the goals of registration and licensing articulated in this Report. The recommendations made throughout the remainder of this section are intended to achieve this goal to the greatest extent possible while recognizing that regulatory approaches do and will differ across jurisdictions.

***(i) Overview of jurisdictions' approaches to registration and licensing standards as applicable to DMIs as compared to such obligations applicable to traditional securities market intermediaries.***

Only a limited number of jurisdictions have or are contemplating distinct licensing or registration regimes that are designed to apply specifically to DMIs. The majority of jurisdictions surveyed do not have licensing or registration requirements specific to DMIs; rather, they have more general registration requirements for intermediaries in financial products, which may include acting as an intermediary for OTC derivatives. In these jurisdictions, the registration requirements for dealing in OTC derivatives are the same as, or similar to, those for dealing in traditional securities markets. In many jurisdictions, financial institutions such as commercial banks can act as DMIs without a separate registration or license. In one jurisdiction, registered securities firms who also want to operate as DMIs are required to obtain authorization and fulfill additional requirements established by their central bank.<sup>15</sup> However, this jurisdiction also does not require foreign DMIs to register with them when conducting business in their jurisdiction, or follow their local OTC derivatives rules.

**(a) Registration or Licensing Triggers**

Where registration or licensing requirements exist for a DMI, they are generally triggered by a DMI's OTC derivatives activities with, and services provided to, third parties. Certain jurisdictions also require registration for institutions considered to be systemically important or that take significantly large positions in the OTC derivatives market, regardless of their activities with third parties.<sup>16</sup>

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<sup>15</sup> For example Mexico and the Central Bank in Mexico.

<sup>16</sup> For example, the United States.

In order to be registered, many jurisdictions require an entity to be physically located within their jurisdiction. This may be accomplished by forming a separate legal entity in the jurisdiction, with a local head office or registered office, or by partnering with a local registered or licensed firm. Others permit foreign DMIs to engage in business in their jurisdiction without having a physical presence either through registration or licensing, an exemption from registration, or through a “passport system”. Generally, conditions for exemption or the use of a “passport” include that the entity is appropriately regulated and supervised for the activity in their home jurisdiction with similar requirements. In any event, such an exemption necessitates coordination between the jurisdictions concerned. As discussed in the recommendations below, the Task Force recognizes that where a DMI carries on business in a foreign jurisdiction, the market authority in such foreign jurisdiction may choose to rely, to some degree, upon supervision by the DMI’s home regulator, provided that such foreign market authority determines that the regulatory requirements of the DMI’s home jurisdiction are sufficiently rigorous and that practical and effective mechanisms for cooperation between authorities are in place.

### **(b) Registration or Licensing Classifications**

Many jurisdictions are not contemplating the creation of a separate licensing or registration requirement for DMIs at this time.<sup>17</sup> Some jurisdictions intend that an intermediary registered or licensed to conduct activities in traditional securities markets would also be able to carry on OTC derivatives activities as part of their business.<sup>18</sup> Other jurisdictions will only permit registered or licensed intermediaries to also act as a DMI if the market authority is satisfied that the entity is capable of properly managing the risks associated with engaging in the OTC derivatives activities.<sup>19</sup> In other cases, market authorities may restrict the types of counterparties DMIs can deal with, such as limiting them to non-retail clients.<sup>20</sup>

### **(c) Registration Refusal or Revocation**

All market authorities have the ability to refuse registration or licensing where an applicant fails to meet prescribed requirements. Once a DMI is licensed or registered, there are typically conditions attached, such as the requirement to meet capital and margin, business conduct and supervision, recordkeeping and reporting requirements. The registration or license is generally granted for an indefinite term, provided that the conditions of registration or license continue to be met. The failure to meet these and other requirements may result in the suspension, termination or revocation of the DMI’s license or registration by the market authority. All jurisdictions surveyed have a process in place to suspend, terminate or revoke a registration or license. The market authority may take these steps, for example, when there has been serious misconduct or non-compliance with requirements, failure to maintain adequate capital or assets, or failure to provide information to the market authority. The DMI

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<sup>17</sup> For example, ASIC Australia, BaFIN Germany, FSA UK, JFSA Japan, CMVM Portugal, AMF France and CVM Brazil.

<sup>18</sup> For example, ASIC Australia, BaFIN Germany, CMVM Portugal and CMB Turkey.

<sup>19</sup> For example, CNBV/Central Bank in Mexico.

<sup>20</sup> For example, U.S. CFTC states that transactions in OTC swaps markets are restricted to “eligible contract participants” as defined in the Commodity Exchange Act.

may also apply to the market authority to withdraw or surrender their registration, and many jurisdictions have a process for doing so, including providing notice to counterparties or clients, ensuring counterparty or client obligations are met, and resolving any counterparty or client complaints. Two jurisdictions require their intermediaries to be actively engaged in the business for which they are registered in order to maintain their registration.<sup>21</sup>

In most cases, the market authority that registers the intermediary or grants it a license is also responsible for performing related compliance and enforcement functions. But in some cases, the responsibility to oversee intermediaries and/or to enforce some of the requirements is shared with another authority, such as a prudential regulator or an exchange, and registration/licensing itself may be granted by a prudential regulator.

### ***(ii) Task Force Recommendations regarding Registration and Licensing Standards***

Registration and licensing regimes should specify the entities to which substantive regulations and/or standards and requirements should apply once they are registered or licensed. The goal of these substantive regulations, standards and requirements should be to reduce the risk of loss to market participants and the broader economy caused by negligent or illegal behaviour or inadequate risk management practices.<sup>22</sup> In particular, IOSCO Principle 6 states that regulators should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate. The Task Force is of the view that only duly registered or licensed persons should be permitted to act as a DMI, or to hold themselves out to the public as doing so.

Across IOSCO jurisdictions, there is a range of practices with respect to the registration or licensing of DMIs and the requirements or standards applicable to them. Most registration regimes tend to be “activity-focused” as opposed to “product-focused”. As such, DMIs are regulated through existing registration or licensing categories and their activities are subject to the same or similar registration or licensing requirements as other intermediaries regardless of the type of instruments. The Task Force does not intend to propose a specific registration or licensing model, but rather seeks to develop an agreed upon set of standards for DMIs that would apply irrespective of the applicable registration or licensing process or categories. The form the requirements take is less important than the outcome of them. As long as all the standards proposed herein apply, it should not matter whether there is a separately identifiable DMI registration or licensing scheme or a structure.

Across the IOSCO member jurisdictions surveyed, the market authorities responsible for overseeing market participants engaged in DMI activities vary based on the nature of the market participant. For example, in some jurisdictions, banks fall under the primary authority of prudential regulators. The Task Force does not intend to recommend who should have primary authority over particular market participants, but rather to recommend that all market participants operating as DMIs be subject to registration or licensing with the relevant market authority or authorities. Furthermore, such authority or authorities should have the power to impose the standards recommended in this Report upon such market participants.

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<sup>21</sup> For example, FAS (UK) and BaFin (Germany).

<sup>22</sup> IOSCO Methodology, *supra* note 6, see IOSCO Principle #29 at p. 180.

As discussed, many jurisdictions do not have licensing or registration requirements specific to DMIs, but rather have more general registration or licensing categories for intermediaries in financial products. Therefore, the Task Force recommends that in jurisdictions where DMIs are registered under more general registration categories, these regimes should tailor specific requirements applicable to DMIs, which may not apply to registrants or licensees not involved in OTC derivatives intermediary activities. Conversely, where existing market intermediary standards or requirements are not as relevant to DMIs, the Task Force recommends that market authorities consider whether they should be applied. DMI-specific requirements and traditional securities markets requirements that may not be necessary for DMIs will be discussed in Sections C through F which deal with substantive registration or licensing requirements.

**Recommendation 2: Registration or licensing requirements applicable to DMIs should be tailored to OTC derivatives activities.**

Registration or licensing regimes for DMIs may be applicable to transactions across a broad range of categories and asset classes of OTC derivatives products.<sup>23</sup> Although there are a wide range of products that comprise the OTC derivatives market, and each product has different risks (such as systemic risk or risk of market abuse) jurisdictions should consider whether there is a regulatory need for creating specific registration requirements for each type of derivative product. Furthermore, jurisdictions should consider whether creating distinctions between products subject to a registration or licensing regime could create the potential for regulatory arbitrage and a migration of market participants to products that are subject to lesser standards or requirements.

Consistent with the IOSCO Principles, the Task Force recommends that registration or licensing of DMIs should establish minimum standards for such market participants and provide consistency of treatment for all DMIs.<sup>24</sup> During the financial crisis, certain OTC derivatives market participants that carried on business as DMIs without being expressly subject to regulation regarding these activities became a source of systemic risk.<sup>25</sup> In light of the global financial crisis and the size and scope of the OTC derivatives market, the Task Force encourages market authorities to take a comprehensive approach to OTC derivatives registration or licensing regimes to help ensure that the applicable requirements are applied consistently and that all DMIs are subject to appropriate regulation.

Registration and licensing processes should include an assessment of applicants, and authorities should have the power to reject applicants who do not meet required standards. This assessment should include the applicant, and any parties who have the ability to control or materially influence the applicant. Rules should be developed and consistently applied to determine the conditions or criteria to be met by the DMI and individuals acting on its behalf. DMI registration or licensing should clearly indicate the services or activities that the

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<sup>23</sup> It should be noted that the definition of what constitutes a OTC derivative may vary across jurisdictions and this is one area where registration or licensing regimes with respect to products may vary. For example in some jurisdictions certain commodity or forward contracts may not be included in the definition of OTC derivatives for registration or licensing purposes.

<sup>24</sup> IOSCO Methodology, *supra* note 6, see Principle 29 at p. 180.

<sup>25</sup> *Principles for the Regulation and Supervision of Commodity Derivatives Markets*, Technical Committee of IOSCO, September 2011 available at [www.iosco.org](http://www.iosco.org), at 10.

intermediary is permitted to engage in or provide. Although there is overlap between the entities acting as intermediaries in the traditional securities market and OTC derivatives markets, in order to achieve consistency of treatment, regulatory oversight of the OTC derivatives market may involve requiring the application of registration or licensing requirements to a range of entities that may not have previously been under such obligations.

A registration or license should be contingent not only on meeting minimum initial standards, but also complying with ongoing substantive regulations and/or standards and requirements. To help ensure that the registration or license remains valid on an ongoing basis, there should be periodic updating of relevant, material information by the DMI to the relevant market authority or authorities. For example, DMIs should be required to report changes in control to the relevant market authority or authorities so that such market authority or authorities may re-assess if registration or licensing of the DMI is still appropriate. Authorities should have the power to withdraw or suspend the registration or license or otherwise sanction the DMI (such as by applying conditions to the registration or license) at any time when the required standards are not met.

**Recommendation 3: The registration or licensing of DMIs should establish minimum standards and require DMIs to provide and update information with regard to their OTC derivatives activities to regulators to assist them in determining whether registration or license should be granted and/or revoked. All registering or licensing authorities should have the power to grant or reject and suspend or withdraw the registration or license of DMIs registered or licensed by such authority.**

To ensure that counterparties or clients can make informed decisions about a DMI they are considering engaging, a market authority should make available to the public relevant material information on the DMI or require the DMI itself to make such information publicly available. This information may include the names of senior management and those acting on its behalf, the category of license held, its registration status and its permitted activities. This is particularly important for counterparties of DMIs, as they may be entering into lengthy OTC derivatives transactions with the DMI.

**Recommendation 4: Relevant material information on licensed or registered DMIs should be made publically available.**

The international nature of the OTC derivatives market is such that DMIs regularly transact with counterparties or clients located in other jurisdictions. As discussed, DMIs should be subject to registration or licensing in their home jurisdiction and associated requirements would apply to activities in that jurisdiction. However, a DMI carrying on business in foreign, or host jurisdictions must also be monitored and subject to licensing or registration requirements. Host jurisdictions may choose to require that foreign DMIs carrying on OTC derivative business in their jurisdiction also be registered or licensed in their jurisdiction.

However, the Task Force recognizes that in certain situations where a DMI is carrying on business in a host jurisdiction, that host jurisdiction's market authorities may choose to rely, to some degree, upon supervision by the DMI's home regulator. For example, if a DMI is registered or licensed in its home jurisdiction, a host jurisdiction's market authorities may

choose to exempt such DMI from its registration or licensing or substantive requirements.<sup>26</sup> However, such exemption or reliance should consider whether: the DMI's home jurisdiction registration or licensing standards and substantive requirements meet the standards proposed in this Report, the DMI's home jurisdiction authority has authority to oversee the activities of its registrant in the host jurisdiction and/or appropriate supervisory arrangements, such as a memorandum of understanding or passport regime, are in place between the two jurisdictions.<sup>27</sup> Supervisory arrangements should include appropriate coordination to ensure that no regulatory gaps or overlaps exist. In particular, the Task Force is concerned that, although a DMI may be subject to an effective registration or licensing regime relating to the activities it carries on in its home jurisdiction, the DMI's activities in a host jurisdiction may not be appropriately supervised. There may be difficulties associated with the ability of the home jurisdiction's regulator to oversee the activities of a registrant or licensee in a host jurisdiction and therefore it may not be possible for the host jurisdiction's regulator to rely entirely on the home jurisdiction regulator. In such situations the home jurisdiction and host jurisdiction market authorities should closely cooperate to identify overlaps, conflicts and gaps and to ensure that the DMIs activities in the host jurisdiction are adequately supervised. Further, jurisdictions should coordinate their approaches via multilateral or bilateral channels to reduce overlaps and conflicts, to the extent possible.

**Recommendation 5: If a DMI registered or licensed in its home jurisdiction is carrying on OTC derivatives business in another jurisdiction in which the DMI is not registered or licensed, the market authority of the host jurisdiction in which the DMI is carrying on business should ensure that there are appropriate supervisory arrangements in place for the OTC derivatives business carried on by that DMI. These arrangements should take into account how the DMI is supervised in the host jurisdiction and any cooperative arrangements in place between the market authorities of the home and host jurisdictions. Market authorities should closely cooperate to identify overlaps, conflicts and gaps between jurisdictions with respect to cross-border issues relating to DMI supervision and to ensure that the DMI's activities in the host jurisdiction are adequately supervised. It is further recommended that jurisdictions coordinate their approaches via multilateral or bilateral channels to reduce overlaps and conflicts, to the extent possible.**

## C. Capital Requirements

The maintenance of adequate capital standards by DMIs and the imposition of appropriate margin requirements to OTC derivatives transactions involving DMIs are essential mechanisms to better ensuring that OTC derivatives markets operate soundly. Specifically, capital and margin requirements can provide a level of protection against a DMI's insolvency by mitigating the risk that a DMI's liabilities may exceed the realizable value of its assets.

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<sup>26</sup> The decision not to require registration or licensing may be based on cross-border cooperation, which may include among other arrangements, cross-border regulation/supervision, passport regime or recognition of equivalence.

<sup>27</sup> For further guidance on supervisory cooperation see IOSCO, *Principles Regarding Cross-Border Supervisory Cooperation - Final Report*, May 2010, avail at [www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf](http://www.iosco.org/library/pubdocs/pdf/IOSCOPD322.pdf)

Public awareness of a robust regulatory regime with minimum capital and margin requirements placed upon DMIs can instil confidence among derivative market participants, encourage trading activity, deepen liquidity and reduce concerns over systemic risk in world financial systems. Transparent capital and margin positions can also provide relevant authorities with important information regarding the solvency of a DMI and its fitness for continued registration or licensing. Furthermore, capital and margin standards can provide important systemic benefits by preventing the accumulation of leverage within the financial system and reducing regulatory arbitrage.

The Task Force recognizes that capital requirements for DMIs in many jurisdictions are within the purview of prudential supervisors and therefore it is not appropriate to make specific recommendations concerning requirements in this Report. However, within jurisdictions there may be DMIs not supervised as banks. The Task Force believes that the maintenance of adequate capital by DMIs to support their OTC derivatives activities is essential to the stability and integrity of financial markets. Accordingly, the Task Force supports the continued development of robust requirements for DMIs that accurately reflect the risks of their OTC derivatives transactions.

CCPs have rules specifying the amount and quality of margin required to safeguard the value of derivative transactions and in doing so can provide market authorities with a view into the counterparty risk exposure undertaken by the CCP. DMIs that clear their OTC derivatives transactions with a CCP are subject to the margin rules, requirements and conditions of such CCP. Uncleared derivative transactions have typically not been governed by regulatory regimes requiring margin. It is left to the counterparties involved to bilaterally negotiate and specify the terms and conditions of any margin requirements that will apply. In many jurisdictions there may be uncleared transactions where one or both counterparties do not provide margin.

IOSCO is involved in two working groups focusing on margin requirements for OTC derivative transactions and therefore the Task Force will not make recommendations with respect to margin. For OTC derivatives transactions cleared through a CCP, margin requirements are determined in accordance with a CCP's rules. The April 2012 final report produced by a working group jointly established by the Committee on Payment and Settlement Systems ("CPSS") and IOSCO entitled *Principles for financial market infrastructures* ("FMI Principles") addresses CCP margining requirements.<sup>28</sup> The Task Force notes that IOSCO and the Basel Committee on Banking Supervision are co-chairing an international work stream developing standards on margining for non-centrally cleared derivatives ("Working Group on Margining Requirements"). CPSS and the Committee on the Global Financial System are also participating in the work stream that aims to develop a consultative report by June 2012.

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<sup>28</sup> The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions' final report entitled *Principles for financial market infrastructures* (April 2012) ("FMI Principles") available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf> at 50.

## **(i) Task Force Recommendations regarding Capital or Other Financial Resources Requirements for Non-Prudentially Regulated DMIs**

As noted above, within each jurisdiction, there may be DMIs not supervised by prudential regulators. To the extent that such DMIs enter into cleared OTC derivatives transactions, they would be bound by the financial resources standards of the CCP through which the derivatives transaction is cleared. Where such DMIs transact in OTC derivatives that are not cleared through a CCP, in many jurisdictions, there may be no market or other authority imposing financial resources requirements on these entities.

Ensuring that non-prudentially regulated DMIs have sufficient financial resources to meet their obligations facilitates the sound operation of the OTC derivatives market and assists in preventing difficulties arising from loss of confidence such as those experienced during the financial crisis. Generally, capital adequacy standards should be designed to allow DMIs to absorb a range of loss scenarios incurred through OTC derivatives trading and also facilitate an orderly wind-down of its operations with minimal losses to its customers' and counterparties' positions. IOSCO Principle 30 states that "[t]here should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake."

The activities of DMIs not subject to specific capital or other financial resources requirements pose a potential risk to other derivative market participants and the overall functioning of the OTC derivatives market. Market authorities should consider whether entities that are not prudentially regulated but are acting as DMIs in the OTC derivatives market should be subject to capital standards or to other appropriate financial measures to mitigate the risks associated with inadequate capitalization. The Task Force notes that the G20 leaders agreed that "[n]on-centrally cleared contracts should be subject to higher capital requirements."<sup>29</sup> The Task Force recommends that authorities consider that appropriate capital or other financial resource standards be extended to DMIs who are not prudentially regulated.

**Recommendation 6: Market authorities should consider imposing some form of capital or other financial resources requirements for DMIs that are not prudentially regulated and that reflect the risks that these intermediaries undertake.**

### **D. Business Conduct Standards**

Business conduct standards are important mechanisms to prevent improper behavior and to foster confidence in the OTC derivatives market. These standards are fundamental to the regulation of traditional securities market intermediaries and relevant standards should be extended to DMIs. However, the current state of the global OTC derivatives market is such that OTC derivatives activity generally is concentrated among non-retail counterparties who typically negotiate the terms of OTC derivatives bilaterally or execute transactions, which may then be cleared through a CCP. In these relationships, each counterparty bears the onus of conducting its own due diligence, including counterparty credit analysis for bilateral

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<sup>29</sup> G20 Statement, *supra* note 4.

transactions and CCP analysis for cleared transactions. For this reason, business conduct requirements applicable to DMIs may, to a certain extent, diverge from standards applicable to traditional securities market intermediaries whose counterparties or clients include retail investors. Notwithstanding the relative size or sophistication of many OTC derivatives participants in the current market, the Task Force recommends that certain standards should apply, regardless of the nature of the counterparty or client.

This section will provide an overview of IOSCO member jurisdictions' approaches to business conduct standards and make recommendations regarding which of these standards should apply to DMIs. As discussed elsewhere in this Report, these recommendations are formulated with the assumption that the majority of counterparties or clients to OTC derivatives transactions will continue to be the non-retail entities that currently dominate the OTC derivatives market. With respect to OTC derivatives activities involving retail investors, the Task Force would expect that the full range of safeguards included in a jurisdiction's business conduct standards under its traditional securities market regime would apply, to the extent that such transactions are permitted by the jurisdiction.

***(i) Overview of jurisdictions' approaches to business conduct standards, as applicable to DMIs and as compared to such standards applicable to traditional securities market intermediaries.***

Many jurisdictions do not currently have specific business conduct requirements for DMIs, but in some cases, such requirements are under development or consideration. However, all jurisdictions surveyed have general business conduct standards for registered or licensed market intermediaries in traditional securities markets, which in most cases apply to trading in OTC derivatives. In jurisdictions that do not have specific DMI requirements, the business conduct standards for trading in OTC derivatives are generally the same as, or similar to, that for trading in traditional securities markets and therefore, at present, DMIs typically are required to follow the same business conduct requirements that apply to other market intermediaries.

Examples of business conduct requirements that may apply to DMIs include assessing counterparty or client suitability, disclosing inducements, acting with the requisite degree of expertise, care and diligence in dealings with counterparties or clients, ensuring all marketing and communications to counterparties or clients are fair, clear and not misleading, safeguarding the interests of, and providing adequate information to, counterparties or clients. These types of requirements often include exemptions for non-retail entities. Therefore, although many DMIs are currently subject to the business conduct standards applicable to traditional securities market transactions, in many instances, due to the nature of derivative market participants, exemptions for non-retail entities effectively result in these standards not applying to OTC derivatives transactions.

**(a) Business Conduct Standards Specific to DMIs**

Certain jurisdictions have business conduct requirements that apply specifically to DMIs. For example, one jurisdiction<sup>30</sup> requires financial intermediaries to establish a code of ethics and

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<sup>30</sup> For example, Mexico.

professional conduct that applies when dealing in derivatives transactions, including OTC derivatives. Another jurisdiction<sup>31</sup> requires that for certain OTC derivatives, DMIs must comply with business conduct standards that relate to fraud, manipulation, and other abusive practices and communicate in a fair and balanced manner based on principles of fair dealing and good faith. This jurisdiction also has proposed or adopted rules that business conduct standards provide additional protections with regard to OTC derivatives transactions, including a duty to verify that any counterparty meets certain eligibility criteria to trade and disclosure of material risks and characteristics of a derivative. Certain entities that may have previously been considered sophisticated<sup>32</sup> will soon be required to have independent representation before entering into a transaction with a DMI.<sup>33</sup>

### **(b) Segregation of Client Assets**

In most IOSCO member jurisdictions, DMIs collecting margin assets that continue to belong to a client<sup>34</sup> are required to segregate these amounts from the DMI's own assets. This generally means holding the margin in a separate bank account from the DMI's bank accounts and adequately safeguarding and recording the margin attributable to each client. The margin amounts are not permitted to be used by the DMI except in limited circumstances. The segregation requirements for DMIs are generally consistent with the segregation requirements applicable to other market intermediaries.

In some jurisdictions<sup>35</sup>, rules regarding the treatment of client assets apply to firms that are involved in OTC derivatives transactions and collect client margin. These rules require a firm to make adequate arrangements to safeguard clients' ownership rights, and minimize the risk of loss or misuse of client assets. These requirements include rules regarding the registration of assets and the placement of assets with third parties (custodians, banks, other intermediaries), as well as requirements on records, accounts and reconciliations. Specifically, for margin monies collected, the rules of some jurisdictions require a firm on a daily basis to calculate and segregate the "client's equity balance". The client's equity balance is the amount which a firm would be liable to pay to a client in the event that such client's open positions were liquidated.

### **(c) Conflicts of Interest**

Most jurisdictions require or anticipate requiring DMIs to have standards pertaining to the management of conflicts of interest in place. Some jurisdictions<sup>36</sup> stated that these conflict of interest standards may vary depending on the type of counterparty or client.

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<sup>31</sup> For example, the United States.

<sup>32</sup> These are referred to as "Special Entities" and include government agencies, States, cities, counties, municipalities, pension plans and endowments.

<sup>33</sup> The CFTC adopted such rules [week of January 9 2012]. The SEC proposed such business conduct obligations in June 2011.

<sup>34</sup> These requirements do not necessarily apply to counterparty margin held by a DMI in a bilateral transaction with a non-retail counterparty.

<sup>35</sup> For example, the United Kingdom and France.

<sup>36</sup> For example, Japan, France and the United Kingdom.

Where conflict of interest standards apply to DMIs, they typically include establishing and maintaining effective information barriers, disclosing conflicts of interest to counterparties or clients in writing, separating the supervision of relevant persons, removing direct remuneration links, and taking measures to prevent or limit any person from exercising inappropriate influence.

Two jurisdictions<sup>37</sup> stated that where a DMI has a material interest in a transaction that gives rise to an actual or potential conflict of interest, it should neither advise, nor deal in relation to that transaction unless it discloses the material interest or conflict to the client and takes all reasonable steps to ensure fair treatment of the client.

#### **(d) Application of Business Conduct Standards When Dealing With Non-Retail Counterparties or Clients**

In most IOSCO member jurisdictions, business conduct standards vary depending upon the size, nature of the counterparty, status or other characteristics of the counterparty or client. In these jurisdictions, DMIs are required to apply all traditional securities market conduct standards in relation to their dealings with retail counterparties or clients. In contrast, some or none of these conduct requirements may apply in relation to non-retail entities. In the case of non-retail entities, DMIs are often permitted to assume, or in some jurisdictions must have a reasonable basis to believe, that these entities possess sufficient experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur. Examples of business conduct standards that do not apply or may be waived for DMIs in relation to certain non-retail entities include disclosure of risk, and the need to ensure suitability of recommendations. Two jurisdictions<sup>38</sup> stated that their business conduct standards do not vary depending upon the size, sophistication, status or other characteristics of the counterparty or client.

#### ***(ii) Task Force Recommendations Regarding Business Conduct Standards***

Business conduct standards are crucial to market confidence and efficiency and the prevention of fraud and abuse. Although non-retail entities, which comprise the majority of OTC derivatives market participants, are typically presumed not to need all of the same regulatory protections as retail counterparties or clients, the Task Force believes that, irrespective of client classification as retail or non-retail, all DMIs should be required to act honestly, fairly, professionally and in good faith in accordance with standards that should be set out by market authorities in rules of business conduct. In general, where information on derivative transactions and services are provided by DMIs, it should be communicated in a comprehensible manner and not be misleading even where OTC derivatives activity takes place between the most sophisticated counterparties.

In connection with the IOSCO Principles, IOSCO has developed a methodology for assessing implementation of the Principles, which include principles for market intermediaries in the

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<sup>37</sup> For example, Hong Kong and France.

<sup>38</sup> For example, CNBV/Central Bank in Mexico and CVM, Brazil.

conduct of their business. The Task Force is of the view that the following principles from the methodology are applicable to DMIs:

- A firm should observe high standards of integrity and fair dealing.
- A firm should observe high standards of market conduct.
- A firm should comply with any law, code or standard relevant to regulation as it applies to the firm.<sup>39</sup>

Regardless of the nature of a counterparty or client, DMIs should be subject to business conduct standards designed to ensure they operate in an ethical manner. Furthermore, all market participants, including DMIs, should be strictly prohibited from engaging in any illegal or abusive activities. The Task Force recognizes that in most jurisdictions, prohibitions against fraud, manipulation and other abusive practices are currently dealt with in existing securities and/or criminal legislation. The Task Force recommends that such prohibitions be extended to OTC derivatives and DMIs.

**Recommendation 7: DMIs should be subject to business conduct standards. These standards would include, among other things, prohibitions against fraud, misrepresentation, manipulation and other abusive practices.**

**(a) Applying an Elevated Standard to Certain Non-Retail Entities or Extending Certain Business Conduct Requirements to Certain Non-Retail Entities**

Business conduct standards are often determined based on the status of the counterparty or client (e.g., retail vs. non-retail) dealing with a market intermediary. With respect to traditional securities markets, most jurisdictions have business conduct requirement exemptions or more general exemptions for market intermediaries when dealing with non-retail entities. Generally, the vast majority of current participants in the OTC derivatives market are non-retail entities and therefore transactions with such entities may be eligible for exemptions. However, the Task Force cautions that market participants who may be eligible for exemptions with respect to their traditional securities market activities, such as equity trading, may not have the requisite expertise to appropriately manage and understand risk in the OTC derivatives market. Therefore, jurisdictions that are contemplating providing any exemptions from requirements for DMIs dealing with non-retail entities should consider whether the current standards of sophistication that apply to traditional securities market activities are adequate for OTC derivatives or whether these standards should be modified to reflect the complexity of and the risks associated with the specific OTC derivatives market product or service. Alternatively, market authorities could consider extending certain business conduct requirements applicable to DMIs interacting with retail counterparties or clients to certain non-retail entities.

The IOSCO Technical Committee published a final report on *Unregulated Financial Markets and Products* (September 2009) that recommended considering a re-evaluation of ‘sophisticated investor’ standards in order to better identify investors who are effectively equipped to make independent investment choices.<sup>40</sup> The waiver or inapplicability of

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<sup>39</sup> IOSCO Methodology *supra* note 6 at p. 177.

<sup>40</sup> IOSCO, *Unregulated Financial Markets and Products*, September 2009, at 21.

business conduct standards for non-retail entities should only be available if qualifying entities are capable of assessing and managing the risk of their positions independently of a DMI counterparty. This assessment and risk management can be significantly more complex when dealing in OTC derivative products than traditional securities. Therefore, the Task Force recommends that market authorities consider implementing higher standards to determine which non-retail market participants may be treated as sophisticated in the context of the OTC derivatives market or by assessing the nature of the market participant by reference to the complexity of and the risks associated with the specific OTC derivatives market product or service. Moreover, DMIs may be required to extend retail-level business conduct requirements to transactions with certain non-retail clients or counterparties. In all cases market authorities should clearly articulate their standards for market participants to be treated as sophisticated in the OTC derivatives market.

### **(b) Application of Business Conduct Standards to Non-Retail Entities Based on the Nature of the Counterparty or Client**

As discussed, the Task Force believes that certain business conduct standards should apply to DMIs regardless of the nature of the counterparty or client with whom they are transacting. However, there are certain standards that may not be consistent with the nature of OTC derivatives markets. Additionally, market authorities may also consider not applying, or permitting certain DMIs or other highly sophisticated non-retail entities to waive other standards (e.g., suitability) when dealing with a DMI.

Business conduct standards for DMIs relating to conflicts of interest provide an illustration of a distinction between traditional securities and OTC derivatives suggesting different regulatory treatment. When dealing with traditional investment products, conflicts of interest are usually required to be avoided, disclosed or otherwise managed regardless of the nature of a counterparty or client. A conflict of interest may be any circumstance where the interests of different parties, such as the interests of a counterparty and those of a market intermediary, are inconsistent or divergent.

When DMIs act as intermediaries to entities that would be considered to fall within the retail investor classification<sup>41</sup> the Task Force expects that their business conduct standards would include a duty to proactively manage or disclose all conflicts of interest, including conflicts arising between the DMI and individuals acting on its behalf, and a counterparty or client. This is consistent with IOSCO Principle 8 which states that “[t]he Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed”. This may include requirements that market intermediaries avoid the activity or transaction that gives rise to the conflict, eliminate the circumstances that give rise to the conflict or manage the conflict through appropriate disclosure or other effective means.

With respect to OTC derivatives transactions, it is often the case that the terms of a contract ensure an economic conflict of interest between a DMI and its counterparty. In such cases, it may be inappropriate, given the commercial realities of a transaction to impose conflict of interest standards that require a DMI to avoid or eliminate a conflict of interest. However,

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<sup>41</sup> For the meaning of “retail” for the purposes of this Report please see discussion on page 7.

even when conflicts of interest are inherent to a transaction, such conflicts may be mitigated through additional disclosures or other effective means. Furthermore, market authorities should consider, in the case of a DMI providing recommendations or inducements, whether additional conflicts management coupled with disclosures is appropriate.

Dealer-client style suitability obligations is another example of a business conduct standard that may not be necessary, or for which requirements may be waived, in transactions between DMIs. Most current OTC derivative transactions between DMIs do not include such obligations because each party is expected to be capable of looking out for its own interests. For transactions between certain non-retail entities, such as DMIs, the protections afforded by suitability requirements would provide minimal benefits as such entities are presumed to be capable of independently analyzing product and counterparty risk in order to be competitive in the OTC derivatives market.

However, there may be certain entities that meet jurisdictional criteria for non-retail status but still are in need of regulatory protections. For example, during the recent financial crisis, some entities that were thought to be capable of independently assessing OTC derivatives transactions, such as local authorities and municipalities, in retrospect, did not appear to have the ability to independently understand the risks to which they were exposed through their OTC derivatives activities. Therefore, certain safeguards not afforded to other non-retail entities may be necessary. While it may not be appropriate or desirable to treat such entities as retail clients, jurisdictions may wish to apply certain safeguards traditionally not afforded to non-retail entities. As discussed in Section D(i)(a), certain jurisdictions are proposing or considering imposing suitability obligations on DMIs when making recommendations to certain non-retail entities, even though such institutions would traditionally be presumed to be able to independently assess the transactions. Other jurisdictions apply specific business conduct requirements to both retail and non-retail entities. These requirements recognize that even among non-retail entities certain participants may require more protection than others.

A recent IOSCO report<sup>42</sup> focusing on the suitability obligations relating to the distribution of complex financial products by market intermediaries is relevant in this regard. The report includes OTC derivatives as one of the various types of complex financial products. The report recommends suitability obligations for intermediaries dealing in complex products while giving jurisdictions the flexibility to differentiate or waive such obligations depending on the counterparty or client classification. The Task Force supports these recommendations with respect to suitability requirements and believes that other business conduct requirements should also be applied to DMIs who are dealing with non-retail entities in need of additional protections. The Task Force therefore recommends that jurisdictions consider whether certain classes of non-retail entities are in need of added protections through business conduct standards such as conflict of interest or suitability requirements. Alternatively, market authorities may extend retail-level business conduct requirements to both retail and certain non-retail clients and counterparties.

**Recommendation 8: Business conduct requirements should be tailored, as appropriate, for the OTC derivatives market. This could be based on the reasonable assessment of**

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<sup>42</sup> *Suitability Requirements with respect to the Distribution of Complex Financial Products*, Consultation Report, Technical Committee of IOSCO, February 2012 available at [www.iosco.org](http://www.iosco.org).

**the nature of the party dealing with a DMI or on the complexity of and the risk associated with the specific OTC derivatives market product or service.**

**(c) Segregation and Portability<sup>43</sup>**

In cleared OTC derivative transactions, DMIs that are clearing members of a CCP are expected to require that their clients<sup>44</sup> deliver assets as collateral to secure their obligations. This collateral may be held by the DMI or, some or all of it may be delivered to a CCP. Client collateral can be put at risk in the event that the DMI defaults or becomes insolvent.

The FMI Principles include a principle that all CCPs should have rules and procedures that enable the segregation and portability of positions and collateral belonging to clients of a clearing member.<sup>45</sup>

The Task Force notes that treatment of collateral associated with uncleared OTC derivatives transactions may be considered by the Working Group on Margining Requirements as part of its work to develop a proposal for margin requirements on uncleared OTC derivatives and therefore will not make recommendations on this topic.

The Task Force believes that for cleared OTC derivatives transactions business conduct requirements should ensure DMIs operate in a manner that provides protection to collateral belonging to clients particularly in the case of a DMI insolvency.<sup>46</sup> If the collateral cannot be distinguished from the proprietary assets of a DMI it may not be recoverable in an insolvency situation. Therefore, the Task Force believes that DMIs that hold client assets as collateral should have safeguards in place to segregate and protect these assets. DMIs should segregate collateral belonging to the client from their own proprietary assets and employ an account structure that enables the efficient identification and segregation of positions and collateral belonging to DMI clients.

In addition to safeguarding client collateral, effective segregation can also facilitate the transfer or novation of client or counterparty positions and collateral in respect of transactions cleared by a DMI (that is a member of the CCP) on behalf of a client through a CCP. This capability is known as “portability”, which refers to the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party by means of a conveyance of money or financial instruments.<sup>47</sup> If portability arrangements are effective, in the event of a DMI default, client positions and collateral could be transferred to one or more

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<sup>43</sup> Please note that for the purposes of this Section the term “client” refers specifically to entities who indirectly clear OTC derivative transactions through a DMI who is a CCP clearing member. This is to be distinguished from the broader use of the term explained *supra* note 5.

<sup>44</sup> The term “client” and not “counterparty” is used in this Section to reflect the fact that segregation and portability standards are primarily intended to apply for entities that clear OTC derivatives transactions indirectly through a DMI that is a CCP clearing member. It should be noted that depending on the clearing model a DMI client may also be a counterparty to that DMI.

<sup>45</sup> FMI Principles, *supra* note 28, at Principle 14.

<sup>46</sup> It is important to note that in some jurisdictions collateral posted by way of title transfer is not considered as collateral belonging to clients.

<sup>47</sup> FMI Principles, *supra* note 28 at p. 82.

non-defaulting DMI clearing members without the necessity of liquidating and re-establishing the positions. Where possible, for transactions cleared through a CCP, the Task Force believes that DMIs should have in place procedures to facilitate the transfer or porting of client positions and collateral.

**Recommendation 9: For cleared OTC derivatives transactions, DMIs should segregate collateral belonging to clients from their own proprietary assets and employ an account structure that enables the efficient identification and segregation of positions and collateral belonging to DMI clients. Where applicable and possible, DMIs should have in place procedures to facilitate the rapid transfer or porting of cleared client positions and collateral.**

## **E. Business Supervision Obligations**

In order for DMIs to effectively manage risks, internal supervisory structures must be adequate to recognize and monitor risk across all lines of business activity, including OTC derivatives. Jurisdictions should consider how to impose appropriate business supervision obligations on DMIs with respect to their OTC derivatives activities. Incidents involving inadequate supervision of OTC derivative activities at DMIs contributed to the 2008 financial crisis and persist to this day.

In order to better ensure effective management of a market intermediary's risks, business supervisory obligations generally require market intermediaries to have appropriate supervisory policies and procedures, internal controls, risk management systems and processes to ensure compliance with the intermediary's policies and procedures and regulatory requirements. The supervisory procedures typically cover both the intermediary itself and the representatives acting on its behalf. This section will review jurisdictional approaches to business supervision obligations and make recommendations for DMIs and their OTC derivatives trading activities.

### ***(i) Overview of jurisdictions' approaches to business supervision obligations, as applicable to DMIs and as compared to such obligations applicable to traditional securities market intermediaries***

Based on the responses received to the IOSCO surveys, many jurisdictions have general business supervision obligations for registered or licensed market intermediaries in financial or investment products which generally apply to DMIs and trading in OTC derivatives. Although some jurisdictions<sup>48</sup> have or are considering specific business supervisory obligations that uniquely apply to DMIs and their OTC derivatives activities, most jurisdictions have not yet developed such obligations. Therefore, in many jurisdictions, business supervision obligations for transacting in OTC derivatives are the same as, or similar to, that for trading in securities or other financial products. These include having a supervisory structure in place to effectively monitor and oversee the activities of its representatives; having a compliance system in place to assess the extent to which a DMI complies with regulatory requirements and internal policies and procedures; and a risk management system to identify and manage the risks facing the firm.

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<sup>48</sup> For example, U.S. SEC, U.S. CFTC and U.S. Federal Reserve Board.

One jurisdiction requires market intermediary compliance staff to report to senior management and the supervisory board on the appropriateness and effectiveness of the policies, resources and procedures regarding compliance with regulatory requirements, on at least an annual basis.<sup>49</sup> These reports are intended to indicate whether appropriate measures have been taken to remedy any contraventions of the regulatory obligations, or to eliminate the risk of such contraventions. Also, some jurisdictions require intermediaries to establish an audit function in charge of reviewing, at least once a year, the fulfillment of their policies and procedures for operational and internal controls, as well as the proper documentation of transactions.<sup>50</sup>

Certain jurisdictions have implemented business supervision obligations that are specifically tailored for derivatives. In one jurisdiction, DMIs must establish a system to allow both the risk management and trading areas to supervise their derivatives activity on a systematic and a timely basis.<sup>51</sup> Further, they have a requirement that the DMI establish a department head responsible for:

- measuring, evaluating and following-up on, market and credit risks for derivative instruments;
- communicating, as soon as it is known, any deviation from the internal limits, in order to address and ensure the elimination of the risks of such operations; and
- reporting on derivatives trading to management on a daily basis, and periodically to the board of directors.

Another market authority with DMI-specific business supervision obligations includes requirements for DMIs to:

- monitor trading in derivatives to prevent violations of applicable position limits;
- establish risk management procedures adequate for managing the day-to-day business of the DMI;
- disclose to the applicable regulators general information relating to certain derivatives trading, practices, and financial integrity;
- implement conflict of interest systems and procedures that establish certain structural and institutional safeguards;
- refrain from taking any action that would result in an unreasonable restraint of trade or impose a material anticompetitive burden on trading or clearing;
- use reasonable efforts to determine that supervisors are qualified and meet standards of training, experience and competence necessary to effectively supervise DMI activities; and

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<sup>49</sup> For example, BaFIN (Germany).

<sup>50</sup> For example, CNBV Mexico and CMVM Portugal.

<sup>51</sup> For example, the Central Bank in Mexico.

- establish, maintain and enforce written policies and procedures addressing the supervision of the types of business in which the DMI is engaged.<sup>52</sup>

These DMI-specific requirements provide examples of more robust standards for business supervision at DMIs.

*(ii) Task Force Recommendations regarding Business Supervision Obligations*

Business supervision obligations are essential to the efficient operation of DMIs and the OTC derivatives market in general. There have been a number of high profile incidents involving large losses through OTC derivatives trading by individual employees of institutions acting as DMIs that were not detected by the management of these institutions. These supervisory failures demonstrate the inadequacy of the internal procedures relating to OTC derivatives activities at some DMIs recognized as being sophisticated institutions.

**(a) Governance**

Appropriate and effective corporate governance frameworks are a precondition to successful oversight and management of any DMI. Good governance should provide the proper incentives for a DMI's board and management to pursue objectives that are in the interests of its stakeholders and the broader public interest. A high priority should be placed on the safety of DMIs in order to ensure that they do not create any risks to economic stability. Governance frameworks should include appropriate responsibilities for the management bodies and efficient organizational requirements ensuring that OTC derivatives trading activities are supervised by personnel who are sufficiently independent and possess requisite expertise. Governance arrangements at a DMI should provide clear and direct lines of responsibility and ensure that functions such as risk management are granted sufficient independence.

**Recommendation 10: DMIs should be required to have effective corporate governance frameworks designed to ensure appropriate management of OTC derivatives activities within the DMI.**

IOSCO Principle 31 states:

Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.

It is extremely important that the board or management of a DMI be required to maintain and enforce rigorous business supervision standards. As a result, the Task Force believes that jurisdictions should impose obligations on DMIs to establish sufficient and appropriate internal policies and procedures to ensure compliance with regulatory requirements, and to have appropriate internal organization, supervisory systems and risk management systems in

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<sup>52</sup> For example, U.S. CFTC.

place. These obligations should be tailored to the unique aspects of transacting in OTC derivatives. The intention of these rules is not to remove risk from the market place, but instead to require DMIs to adequately manage the risks they face.

**Recommendation 11: DMIs should be required to design supervisory policies and procedures to manage their OTC derivatives operations and the activities of their representatives.**

### **(b) Risk Management**

Internal risk management procedures and policies are essential to reducing risk and promoting stability within firms as well as the broader economy. Management of risks relating to the OTC derivatives activities of DMIs and their employees and agents, requires the implementation of appropriate supervisory policies and procedures governing risk management. DMI governance should determine and regularly review the internal risk management framework and develop a clear risk tolerance policy with lines of responsibility to implement it. DMI management should ensure that their OTC derivatives activities are consistent with these pre-determined objectives and strategies. Internal risk management controls and procedures should be subject to regular review and testing and, if necessary, updated on a regular basis.

The complexity of certain OTC derivatives, particularly those that are bespoke or customized, may create unforeseen or unpredictable risks. Bilateral transactions create additional risks related to the failure of counterparties to perform their obligations in accordance with the terms of a transaction. It follows that more sophisticated and rigorous risk management standards are necessary for DMI supervisory systems. Therefore, DMIs should have a sound risk management framework applying specifically to OTC derivatives activities that can effectively identify, measure, monitor and manage related risks and should employ risk management tools that identify excessive risk taking within a DMI. The expertise and resources of risk management personnel will be essential in this regard. Authorities should also consider requiring that risk management functions and personnel be independent from business units. Furthermore, senior management of DMIs should understand the nature of their firm's OTC derivatives activities, its internal control procedures and its policies on the assumption of risk.

**Recommendation 12: DMIs should be required to maintain risk management systems and organization to properly identify and manage their OTC derivatives related business risks.**

### **(c) Compliance and Competency**

DMIs should have processes in place to ensure that they are in compliance with all applicable laws as well as their internal risk management policies and procedures. The Task Force considers compliance with a DMI's internal procedures to be a key function of the DMI's management. An effective compliance system will help protect counterparties and clients and reduce the risk of legal or regulatory sanctions, financial loss or reputational damage. In certain cases, it may be appropriate for DMIs to create a separate compliance function that

reports to senior management and/or the board of directors, and is structured in a manner that makes it independent of staff that transact in OTC derivatives.<sup>53</sup>

Management should be responsible for establishing, maintaining and applying policies and procedures including systems of controls that are sufficient to provide reasonable assurance that the firm and each individual acting on its behalf complies with applicable business conduct standards including those recommended in Section D. These controls include ensuring that the DMI is appropriately structured and adequately resourced based on the nature of its business activities, including having skilled and knowledgeable staff and service providers.

DMIs should ensure that their agents or employees involved in OTC derivatives activities possess the necessary levels of knowledge and expertise to understand the risks and obligations resulting from OTC derivatives transactions and the operation of OTC derivatives markets in general. Individuals acting on behalf of DMIs should have the education, training and experience necessary to perform OTC derivatives activities competently or to supervise the performance of OTC derivative activities, including understanding the structure, features and risks of each derivative transaction or product. The competency of DMI representatives is important to ensure that, where applicable, counterparties or clients are provided sound service and advice. Furthermore, adequate expertise is essential for individuals involved in proprietary OTC derivatives trading on a DMI's behalf so that representatives do not subject their firms to undue risks. Therefore, the Task Force believes that jurisdictions should consider imposing competency requirements on representatives of DMIs involved in OTC derivatives activities.

**Recommendation 13: DMI's management should be required to establish, maintain and apply policies, procedures and systems of control sufficient to provide reasonable assurance that the DMI and each individual acting on its behalf are competent and comply with applicable regulatory standards and the DMI's internal policies and procedures.**

#### **(d) Business Continuity**

As part of managing a DMI's key business risks, DMIs should develop and maintain an effective business continuity plan ("BCP"). The purpose of a BCP is to permit the firm to mitigate, respond to and recover from a range of potential business disruptions or disasters that impact its ability to provide services to counterparties or clients, protect assets received from counterparties or clients by way of margin and meet its obligations to counterparties or clients. A BCP should cover the key functions of the DMI's business and be appropriate based on its size, risks, and the nature of its operations, including trading in OTC derivatives. The goal of the BCP is to allow the firm to resume its operations in a reasonable period of time after a business disruption so that it may meet its obligations to counterparties or clients, and permit counterparties or clients to timely access their assets.

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<sup>53</sup> See Compliance Function at Market Intermediaries, Final Report: A Report of the Technical Committee of the IOSCO, March 2006.

**Recommendation 14: DMIs should be required to develop and maintain an effective business continuity plan, based on their size, risks, and the nature of their operations, to allow them to mitigate, respond to and recover from business disruptions or disasters.**

## **F. Recordkeeping Requirements**

Due to the complexity of many OTC derivatives transactions, it is essential that detailed records are kept so that market authorities are able to gain an accurate view of individual transactions, as well as DMI activities more broadly. Diligent recordkeeping is necessary to ensure that market authorities have access to relevant information with respect to a DMI. It also is a precondition for the efficient and organized operation of a DMI that interacts with market participants. Recordkeeping allows DMIs to quantify their risk exposures, prepare and file financial information and determine capital and margin positions to confirm compliance with applicable regulatory requirements. It is widely accepted that thorough and accurate recordkeeping is fundamental to a DMI's ability to meet risk management related objectives, such as the segregation and portability of client assets. This section will provide an overview of jurisdictional approaches to recordkeeping requirements and make recommendations for DMIs.

*(i) Overview of jurisdictions' approaches to recordkeeping requirements, as applicable to OTC derivatives transactions and as compared to such requirements applicable to traditional securities market transactions.*

All jurisdictions have general recordkeeping requirements for market intermediaries registered or licensed with them. Such recordkeeping requirements apply to the intermediary's business activities, financial affairs and counterparty or client transactions. Many jurisdictions do not yet have recordkeeping requirements that are specifically tailored to DMIs or OTC derivatives transactions. Rather, most jurisdictions surveyed have recordkeeping requirements that apply to intermediaries in traditional securities markets but which extend to DMIs and OTC derivative transactions. In some cases, specific recordkeeping requirements for OTC derivatives are under consideration, but would be similar to requirements for traditional securities market intermediaries.

The recordkeeping requirements that apply to DMIs are generally high-level and principles-based. This approach ensures that most business activity, including transactions in OTC derivatives, is captured by the requirements. The high-level, principles-based requirements are often supplemented by prescribed and specific requirements to maintain certain records, such as details on instructions received from counterparties or clients, and the full details of all OTC derivative transactions, including name of the counterparty or client, date of transaction, quantity and price and other terms of the transaction. A key objective of recordkeeping is to maintain an audit trail of the transaction.

DMIs carrying on business in multiple jurisdictions may be subject to recordkeeping requirements in each of those jurisdictions. In some cases, DMIs may rely on a "passport" system for recordkeeping and therefore need not comply with local requirements in each jurisdiction in which they carry on business.<sup>54</sup>

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<sup>54</sup> For intermediaries located in the European Economic Area that are subject to the Markets in Financial Instruments Directive (MiFID)

### **(a) DMI Specific Recordkeeping Requirements**

Some jurisdictions are in the process of developing recordkeeping requirements for DMIs. Proposed requirements include minutes from meetings of the entity's governing body, organizational charts, and audit documentation. Additionally, certain financial records, daily trading records, records of complaints against personnel, and marketing materials would be required to be kept.

One market authority requires DMIs to maintain records of information that are required to be submitted to a trade repository.<sup>55</sup> In this case, both the DMI and the trade repository would maintain records of the transactions. This market authority has also proposed rules that would prescribe daily trading record requirements, including records of transaction information for pre-execution, execution, and post-execution data. Pre-execution transaction data would include records of all oral and written communications that lead to the execution of an OTC derivative transaction. The proposed rules would require DMIs to ensure that they preserve all information necessary to conduct a comprehensive and accurate trade reconstruction for each OTC derivatives transaction, and that they maintain each transaction record as a separate electronic file which is identifiable and searchable by transaction and counterparty. Execution transaction data would include all terms of each executed OTC derivatives transaction and the date and time, to the nearest minute, that each OTC derivatives transaction was executed. Post-execution data would include records of all confirmations, reconciliations, and margining of OTC derivatives transactions.

Most jurisdictions require or propose to require records to be maintained for at least 5 years with some jurisdictions requiring records to be maintained for 6, 7, or 10 years. Retention periods generally apply for the period after the settlement, termination, maturity, expiration, transfer, assignment, or novation of the transaction. For example, DMIs would be required to maintain records for an OTC derivative from the termination of the contract. DMIs would generally be required to extend the recordkeeping period indefinitely for certain records that pertain to an investigation or an enforcement procedure by the market authority or another authority.

#### ***(ii) Task Force Recommendations regarding Recordkeeping Requirements***

DMIs should be required to maintain accurate records. Generally, these records should include all documents necessary for the proper recording of their business transactions, financial affairs and counterparty or client transactions. The records should be retained for the period of time required by their market authority, in a durable form, and in a secure manner that prevents unauthorized access to the records and maintains the confidentiality of the information, especially counterparty or client information.

Specific examples of records that the Task Force recommends jurisdictions consider requiring include:

- records that provide an audit trail for counterparty or client instructions and orders;

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<sup>55</sup> For example, U.S. CFTC.

- records of the terms of OTC derivatives transactions executed for counterparties or clients and any agreements or communications with such parties;
- records of all transactions where the DMI is facilitating the clearing of an OTC derivatives transaction on behalf of another person;
- records that permit the identification, as appropriate, of assets received from counterparties or clients (including any collateral held), and that demonstrate the extent of the DMI's compliance with applicable requirements;
- records containing information identifying the counterparty to each OTC derivatives transaction;
- records of interactions with CCPs;
- records of all orders entered on an OTC derivatives trading facility, including a facility operated by the DMI, and a record of all transactions executed on or reported to such facility; and
- any information obtained to monitor and assess the DMI's risk exposure.

The Task Force recommends that recordkeeping requirements be principles-based in order to be flexible and capture all future activity. The Task Force further recommends that principles-based requirements be supplemented with prescribed, specific requirements in order to provide guidance to DMIs on what information, at a minimum, should be recorded. Complete and accurate records of all OTC derivatives transactions should be made available to regulators in a timely, organized and readable manner.

The recordkeeping requirements for DMIs should be similar in nature to the requirements for traditional securities market intermediaries, with certain modifications designed to tailor requirements to the unique aspects of trading in OTC derivatives. For example, the record retention period for OTC derivatives transaction should apply for a period after its termination or maturity, not for a period after execution.

**Recommendation 15: DMIs should be required to retain OTC derivatives transaction records and be able to provide them in a timely, organized and readable manner. The record retention period for OTC derivatives transactions should apply for a specified period after its termination, maturity or assignment.**