Derivatives
Legal and Regulatory Aspects

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I. INTRODUCTION
1.1. Brief history of the derivatives regulatory framework

- No specific regulation for international or domestic derivative transactions.
- Transactions governed by general principles of the Brazilian Civil Code

Brazilian companies and banks are authorized to enter into international hedging transactions

Brazilian Banks are authorized to offer to their clients commodities, stocks, currencies and interest rates derivatives
1.1. Brief history of the derivatives regulatory framework

- **1994**: Credit Linked Deposits (simplified form of CLNs issued by Brazilian banks) are introduced to the Brazilian market.
- **2001**: Derivatives start to be treated as securities.
- **2002**: Credit Default Swaps and Total Return Swaps are authorized in the Brazilian domestic market.
- **2007**: Brazilian Securities Commission (CVM) issues regulation on standardization of agreements for derivatives traded in exchanges.
1.1. Brief history of the derivatives regulatory framework

**International Market:**
- 1992 / 1993: Central Bank Regulation authorizing Brazilian companies to operate in the international hedge market:
  - Resolution 2012
  - Circular 2348

**Domestic Market:**
- 1994 / 2002: Central Bank Regulation authorizing financial institutions to enter into derivatives transactions:
  - Resolution 2873/3505 interest rates, stocks, currencies and commodities
  - Resolution 2933 credit derivatives
  - Circular 3106
  - Resolution 2921 credit linked deposits
1.2. Overview of the most relevant legal issues

Bankruptcy Law:
   Cherry picking matters.

Netting:
   Reduced exposure of the counterparty.

Validity of Early Termination Clauses:
   Needed for effective close-out netting.

Validity of Sophisticated Clauses (Reset/Recouponing/Tear-Up):
   Important credit risk mitigating mechanisms.

Gambling and Betting:
   Issues related to the method of settlement of derivatives transactions.
II. DERIVATIVES IN THE INTERNATIONAL MARKET
2.1. Resolution 3312

- Authorizes hedging with interest rates, commodities prices and foreign currencies on the international over-the-counter market or stock exchanges.

- “Underlying Assets” are defined as:
  1. payments made and received in Brazilian currency resulting from transfer of obligations denominated in foreign currency;
  2. import, export or trades in the domestic market of commodities having their price established according to their quotations on stock exchanges abroad;
  3. transactions on futures and commodities exchanges in Brazil;
  4. exposures assumed in Brazil by banks authorized to deal in the currency exchange market with their customers, provided that they are linked to rights or obligations hedgeable abroad under Resolution 3312.

- Financial transfers relating to hedging against fluctuations in interest rates and in foreign currencies are also authorized:
  1. for the purpose of creating collaterals, escrow accounts;
  2. as necessary for hedging future currency exposure.
2.1. Resolution 3312

• Financial transfers relating to hedging against fluctuations in interest rates and in foreign currencies are also authorized:

1. for the purpose of creating collaterals, escrow accounts;

2. as necessary for hedging future currency exposure.

• No specific provision authorizing equity derivatives:
  - some uncertainty in the market as to the feasibility of contracting equity derivatives in the cross-border market;
  - Certain structures may be used to achieve the purpose of contracting equity derivatives relating to stocks of listed companies and stock indexes;
2.2. Restrictions / Limits

1. COUNTERPARTIES = > only financial institutions/stock exchanges

2. HEDGE = > speculative transactions are not allowed

3. TYPES = > (a) credit derivatives and (b) equity derivatives are forbidden

4. TAX ASPECTS = > no deductibility of expenses in transactions entered into in the over-the-counter market
III. DERIVATIVES IN THE DOMESTIC MARKET
3.1. Resolution 2873 (swaps / over-the-counter market)

- Broader derivatives regulatory framework
- Based primarily on market benchmarks
- Indexes, rates and prices should be publicly available, without control or manipulation by one of the parties

- Use of foreign indexes
  - Res. 3505/07 - Regulators response to a market request

Over-the-Counter Markets

- CETIP

- New Futures & Commodities Exchange (BM&F) over-the-counter market
3.2. Resolution 2933 and Circular 3106 (credit derivatives)

Credit derivative transactions-underlying assets:

1. credits resulting from loan, financing or finance lease transactions, credit instruments, securities, guarantees (*fianças*), *aval* guarantees, credit derivatives and other instruments; and
2. financial or commercial agreements subject to credit risk, negotiated and performed in the domestic market.

**Requirement:** The credit risk attaching to the underlying asset should necessarily be held by the protection buyer at the time of contracting, except when the underlying asset is regularly traded in organized markets and its pricing is verifiable.
3.2. Resolution 2933 and Circular 3106 (credit derivatives)

Current restrictions:

1. risk transfer is limited to the value of the underlying asset;

2. it is forbidden to assign, sell or transfer in any way, directly or indirectly, the underlying asset during the term of the credit derivative contract having it as underlying.

3. Only multiservice banks, the Federal Savings Bank, commercial banks, investment banks, credit, financing and investment companies, real estate credit companies and finance lease companies are authorized to act as protection seller.
   - Major bone of contention / consultation with the Central Bank and CVM
3.3. Resolution 2921 (credit linked deposits)

- Another credit derivative transaction => ?
  - Central Bank’s opinion is unfavorable

- Flexibility in entering into the fundraising instrument
  - Banking Deposit Certificate - CDB / Banking Deposit Receipt - RDB / Deposit Agreement

- Contractual issues that evidence full or partial default on the underlying asset
  - Moment of transfer / assignment of the underlying asset
  - Moment of disregard of the obligation to refund the amount deposited
3.4. Place of Negotiation (OTC x Clearings)

**OTC:**

- Transactions governed by Brazilian civil laws and regulations issued by the National Monetary Council, Central Bank of Brazil and Brazilian Securities Commission (CVM - *Comissão de Valores Mobiliários*).
  - Brazilian Civil Code as the main basis
  - Requirement to register each transaction at an approved register

- Main Register of OTC derivatives => CETIP
  - CETIP acknowledges and supports the *Contrato Global de Derivativos*
  - Regulators may have access to all transactions registered in its system

- New BM&F OTC market (not yet in place)
  - administration of collateral
  - Calculation agent as a third party
3.4. Place of Negotiation (OTC x Clearings)

CLEARINGS:

- Law 10,214 created to regulate the Brazilian Payment System - SPB
  - definition of “clearing” by law.

- Clearings = > counterparty x guarantor
- CVM-I 461/07 => standardization of agreements traded in exchanges

Netting:
- acknowledged even in case of bankruptcy/insolvency
- close-out netting expressly acknowledged by the new Brazilian Bankruptcy Law (Law 11,101)

Margin/Collateral:
- elimination of the bankruptcy/insolvency risk
- unique provision under Brazilian law
IV. FREQUENTLY ASKED QUESTIONS
4.1. Gambling and Betting

Previous scenario:
- 1916 Civil Code.
  - Stock Exchanges operate without any problems and/or restrictions.
  - Derivatives transactions entered into under the scope of the Central Bank and CVM regulations should not be viewed as gambling or betting.

Current scenario:
- The New Civil Code expressly provides that financial contracts are excluded from the rule set out in the Civil Code:
  
  “Article 816. The provisions of articles 814 and 815 do not apply to contracts dealing with stock exchange instruments, commodities or assets, which stipulate that settlement is to be made exclusively by the difference between the agreed price and their quoted price at maturity of the contract.”
4.2. Contractual Innovations

- **Abusive nature of contractual provisions**
  - right of only one of the parties to make determinations or decisions;
  - unilateral nature of early termination clauses.

- **Problem of the Calculation Agent**
  - Ideal: bona-fide and creditworthy third party.
  - BM&F: New Over-the-Counter Market

- **Mark-to-Market:**
  - Criteria for definition/calculation formula

- **Reset / Recouponing / Tear-Up / Vanishing:**
  - CETIP recent innovation - reset

- **Contractual linking for other hedge transactions**
  - Possibility of description of the hedge in the agreement
4.3. Cherry Picking under Brazilian law

Concept:
- Possibility of the trustee choosing the contracts to be performed (or not) by the bankruptcy estate.

Legal Basis:
- Article 117 of the Bankruptcy Law:
  - “Bilateral contracts are not terminated by bankruptcy and may be performed by the trustee, upon authorization of the Committee, if performance reduces or prevents an increase in the liabilities of the bankruptcy estate or is necessary to maintain and preserve its assets.”

Risk:
- Increased exposure of the other party.
- Impossibility of settling obligations by netting.
4.3. Close-out netting under Brazilian Law

Concept:
• “Netting is the settlement of mutual obligations, where creditors are concomitantly debtors.” (Osvaldo da Silva Rico)

Legal Basis:
• Article 368 of the Civil Code
• Article 476 of the Civil Code
• Article 122 of the Bankruptcy Law
• Articles 3 and 7 of Law 10214/01*
• Article 30 of Provisional Measure - MP 2192-70
• Resolution 3263

* Only for derivative transactions contracted in clearings.
4.3. Netting under Brazilian law

**Requirements:**
- Same Counterparties.
- Matured Obligations.
  - Early or normal termination.
- Undisputed Obligations.
  - Not subject to dispute
- Homogeneous Obligations.
  - Same nature.

**Importance of the Agreement:**

Early Termination Clause.
4.3. Validity of Early Termination Clause

Validity of the Early Termination Clause:

• Principle of free will of the parties.

• The clause should not be abusive or excessively burdensome for either party.

• Accepted by legal writings and case law.
  “(...) – Breach of a contractual clause with the consequent acceleration of the debt and its charges - Validity of this clause decreed by court decision - (...).” (JTACSP 166/22)

• Early termination clauses are valid and have a binding effect between the parties, provided that they do not violate any public policy rule.
4.3. Conclusion (close out netting)

Current Status: “Sound Legal Basis” for bankruptcy

What can still be done: Amendment to the Bankruptcy Law:
- Judicial / out-of-court reorganization
- Need for clarification of the legal text or supporting court precedents

World Bank:
- Principle 14: “(...) It is unjust that the defaulter should insist on payment but not pay himself. Setoff helps creditors escape the debacle and so mitigates the knock-on or cascade effect of bankruptcy. Setoff is fundamental in wholesale markets and for payments systems to mitigate systemic risk. Setoff reduces exposures and hence the cost of credit. Setoff avoids circuity and hence reduces transaction costs. (...)”
V. MASTER DERIVATIVES AGREEMENT
5.1. History

1st ATTEMPT - 1992/1993:

- drafting of a standard agreement registered at a registry office
- contracting parties were encouraged to adhere to the registered document.

1994/1995:

- ISDA initiates a “Brazilian Task Force” to improve legislation on close-out netting and standardization of local agreements;
- further incentive to resume standardization of agreements
5.1. History

**November 2000 - Mexico:**
- seminar organized by the FED gathers central banks from various countries;
- discussions on the benefits of standardization;
- presence of the Central Bank of Brazil;
- Brazilians get closer to ISDA and a work group is set up to develop derivatives market projects in Brazil.

**2001-2002:**
- CAAR (local association) takes the lead in the project aimed at standardization of a derivatives agreement for the domestic market.
5.2. Advantages

- **Benefits:**
  - no mismatch
  - greater security for market players;
  - easier trading - only once;
  - easier negotiation of better financial conditions / rates with each bank;
  - development of the derivatives market.
5.3. Drafting

Drafting:

- first draft based on the firm’s past experience and on sample agreements.

- submission of the draft for comments by ISDA and its local members:
  » 1st round: January 21, 2002
  » 2nd round: March 12, 2002
  » 3rd round: January 13, 2003
  » final version: October 30, 2003

- official launch: July 22, 2004
5.4. Structure

Structure:

- **Master Derivatives Agreement**
  - Name
  - Place
  - Date
  - Signature

+ **Schedule**
  - Possible Adaptations
  - Venue / Arbitration
  - Other specifications.
5.5. Clauses

Clauses:

- **Clause I. - Subject Matter:**
  - Describes the derivatives transactions covered by the agreement.

- **Clause II. - Interpretation:**
  - Sets out the concepts for interpretation of the agreement:
    - Definitions;
    - Inconsistency between documents;
    - Single agreement concept.

- **Clause III. - Definitions:**
  - Sets out the definitions used in the agreement and its schedules.
5.5. Clauses

Clauses:

- **Clause IV. - Representations and Warranties:**
  - Sets out the premises for entering into transactions:
    - existence;
    - non-violation of laws and regulations;
    - possibility of contracting.

- **Clause V. - Procedures for Derivatives Transactions:**
  - Contains the procedures for derivatives transactions:
    - Rules for contracting over the telephone;
    - Rules for sending the signed Confirmation.
5.5. Clauses

Clauses:

- **Clause VI. - Registration of Transactions:**
  - Establishes the obligation of registration with systems and chambers approved and authorized by the Central Bank and by CVM;
  - Adhesion to the regulations of the systems and chambers where transactions are registered:
    - The regulations take precedence over the agreement.

- **Clause VII. - Confirmation and its terms:**
  - Rules applicable to any confirmations entered into under the agreement:
    - Determination of the amounts owed (regular): CETIP/BM&F;
    - Absence of rate, index or price;
    - Settlement Form.
5.5. Clauses

Clauses:

- **Clause VIII. - Payment or Delivery:**
  - Establishes that the derivatives transactions will be settled either by payment or by delivery of goods/products;

- **Clause IX. - Taxes, Penalties and Default Interest:**
  - General rules on taxes, penalties and default interest.

- **Clause X. - Events of Default and Termination Events:**
  - Sets out the events of early termination of the derivatives transactions:
    - Events of default: there is a defaulting party;
    - Termination events: early termination of the transactions with no defaulting party;
    - Early termination upon agreement: acceleration.
5.5. Clauses

Clauses:

- **Clause XI. - Consequences of Early Termination of the Derivatives Transactions:**
  - Rules on settlement and calculation of the amounts payable upon early termination of derivatives transactions:
    - Mark to market;
    - No rate, index or price.

- **Clause XII. - Setoff of Obligations:**
  - Provides for application of the Civil Code, Law 10214 and Provisional Measure 2192/70 to the derivatives transactions entered into under the agreement.
5.5. Clauses

Clauses:

- **Clause XIII. - Term:**
  - Term of the agreement:
    - indefinite;
    - may be terminated upon 30 days’ prior notice.

- **Clause XIV. - Relationship between the parties:**
  - Establishes primarily that:
    - none of the parties is entering into the agreement upon express recommendation of the other;
    - both parties are acquainted with derivatives transactions and their risks and obligations.
5.5. Clauses

Clauses:

- **Clause XV. - Miscellaneous:**
  - General rules applicable to the agreement and its schedules:
    - assignment upon consent;
    - recording of telephone calls; use as means of evidence.

- **Clause XVI. - Governing Law and Jurisdiction:**
  - Governing Law: Brazil;
  - Venue: Judicial or Arbitral:
    - Parties must make their choice in the Schedule.
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