



भारतीय रिज़र्व बैंक

RESERVE BANK OF INDIA

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FINANCIAL MARKETS REGULATION DEPARTMENT

Notification No. FMRD.FMD.XX/2020-21 dated December XX, 2020

Draft Reserve Bank of India (Market-makers in OTC Derivatives) Directions, 2020

In exercise of the powers conferred under section 45W of the Reserve Bank of India Act, 1934 (hereinafter called the Act) read with section 45U of the Act and in suppression of Directions no. [DBOD.No.BP.BC.86/21.04.157/2006-07 dated April 20, 2007](#), the Reserve Bank of India (hereinafter called the Reserve Bank) hereby issues the following Directions.

A reference is also invited to the Foreign Exchange Management Act, 1999 (42 of 1999) and Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 ([Notification no. FEMA.25/RB-2000 dated May 3, 2000](#)), as amended from time to time.

1. Short title, commencement and applicability

- i. These Directions shall be called the Reserve Bank of India (Market-makers in OTC Derivatives) Directions, 2020.
- ii. These Directions shall come into force on *<a specified date>*.
- iii. These Directions shall apply to entities permitted to act as market-makers in OTC derivatives in terms of the governing Directions.

2. Definitions

In these Directions, unless the context otherwise requires:

- i. 'Company' shall have the same meaning assigned to it in section 2(20) of the Companies Act, 2013.
- ii. 'Credit default swap' means an OTC derivative in which a protection seller commits to compensate the protection buyer for any loss resulting from a credit event with respect to a reference entity/obligation and in return, the protection buyer makes periodic payments (premium) to the protection seller until the maturity of the contract or the credit event, whichever is earlier.



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- iii. 'Currency swap' means an OTC derivative which commits two counterparties to exchange streams of interest payments in different currencies for an agreed period of time and/or to exchange principal amounts in different currencies at a pre-agreed exchange rate at maturity.
- iv. 'Derivative' shall have the same meaning assigned to it in section 45U(a) of the RBI Act, 1934.
- v. 'Electronic Trading Platform (ETP)' shall have the same meaning assigned to it in section 2(1)(iii) of the [Electronic Trading Platforms \(Reserve Bank\) Directions, 2018 dated October 05, 2018](#), as amended from time to time.
- vi. 'Exchange' means 'recognised stock exchange' and shall have the same meaning assigned to it in section 2(f) of the Securities Contract Regulation Act, 1956.
- vii. 'Foreign exchange forward' means an OTC derivative involving the exchange of two currencies at a rate agreed on the date of the contract for value on a specified date in the future (more than two business days later).
- viii. 'Foreign exchange option' means an OTC derivative that confer the right to buy or sell a currency with another currency at a specified exchange rate on a specified date (European option) or by an agreed date (American option) in the future.
- ix. 'Foreign exchange swap' means an OTC derivative involving the actual exchange of two currencies (principal amount only) on a specific date at a rate agreed at the time of the conclusion of the contract (the short leg), and a reverse exchange of the same two currencies at a date further in the future at a rate agreed at the time of the contract (the long leg).
- x. 'Forward rate agreement' means a cash-settled OTC derivative between two counterparties, in which a buyer will pay or receive, on the settlement date, the difference between a pre-determined fixed rate (FRA rate) and a reference interest rate, applied on a notional principal amount, for a specified forward period.
- xi. 'Governing Directions' for an OTC derivative means the following:
 - a. Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 ([Notification No. FEMA.25/RB-2000 dated May 3, 2000](#)) and Master Direction – Risk Management and Inter-bank Dealings ([Notification No. RBI/FMRD/2016-17/31 dated July 05, 2016](#)), as amended from time to time, for foreign exchange derivatives.



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- b. Rupee Interest Rate Derivatives (Reserve Bank) Directions, 2019 ([Notification no. FMRD.DIRD.20/2019 dated June 26, 2019](#)), as amended from time to time, for interest rate derivatives.
 - c. Guidelines on Credit Default Swaps for Corporate Bonds ([Notification no. IDMD.PCD.No.10/14.03.04/2012-13 January 7, 2013](#)), as amended from time to time, for credit derivatives.
- xii. 'Interest rate cap' means a series of interest rate call options (called caplets) in which the buyer of the option receives a payment at the end of each period when the underlying interest rate is above a rate agreed in advance (strike rate).
 - xiii. 'Interest rate floor' means a series of interest rate put options in which the buyer of the option receives a payment at the end of each period when the underlying interest rate is below a rate agreed in advance (strike rate).
 - xiv. 'Interest rate option' means an OTC derivative that gives a buyer the right, but not the obligation, to either buy (call option) or sell (put option) an interest rate instrument, or to either pay (put option) or receive (call option) an interest rate on a notional principal, at a pre-determined price/rate (strike price/rate), exercisable either on a specified future date (European option) or any time before a specified future date (American option).
 - xv. 'Interest rate swap' means an OTC derivative in which two counterparties agree to exchange one stream of future interest payments for another, applied on a notional principal amount, over a specified period.
 - xvi. 'Market-maker' means an entity which provides bid and offer prices to users and other market-makers in order to provide liquidity to the market.
Explanation: Authorised Persons, authorised as such under section 10(1) of the Foreign Exchange Management Act, 1999, permitted to undertake foreign exchange derivative transactions, with users and other such Authorised Persons, shall be treated as market-makers for such transactions.
 - xvii. 'Model risk' means the risk of loss arising from decisions based on derivative pricing/valuation models, whose outputs are incorrect or misused, when viewed against the model's design objective and intended use.



- xviii. 'Over-the-Counter (OTC) derivative' means a derivative other than those which are traded on exchanges, and shall include those traded on electronic trading platforms (ETPs).
- xix. 'Person resident in India' shall have the same meaning assigned to it in section 2(v) of the Foreign Exchange Management Act, 1999.
- xx. 'Person resident outside India' shall have the same meaning assigned to it in section 2(w) of the Foreign Exchange Management Act, 1999.
- xxi. 'Structured derivative' means an OTC derivative other than a generic derivative and can include cash instrument(s) and/or generic derivative(s) as its components. For the purpose of this definition, a generic derivative means the following types of OTC derivative:
- a. forward rate agreement;
 - b. foreign exchange forward;
 - c. interest rate swap;
 - d. foreign exchange swap;
 - e. currency swap;
 - f. credit default swap;
 - g. interest rate option (European);
 - h. interest rate cap (European);
 - i. interest rate floor (European);
 - j. foreign exchange option (European).
- xxii. 'User' shall have the same meaning as assigned to it in the governing Directions.
- xxiii. Words and expressions used, but not defined in these Directions, shall have the same meaning assigned to them in the RBI Act, 1934.

3. Governance

- i. The Board of Directors (or equivalent forum) and senior management of the market-maker should understand the nature of the derivative business undertaken by their respective entities and need to demonstrate through their actions that they have a strong commitment to an effective risk management environment throughout the organization in respect of the derivative business. In particular, they shall ensure implementation of:



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- a. Adequate and effective risk management and internal control policies and procedures including for structured derivative products;
 - b. Appropriate organization structure (with clear lines of responsibility and accountability), staff and other resources for prudent conduct of the derivative business, risk management function, internal control function and internal audit;
 - c. Adequate and effective measures towards regulatory compliance; and
 - d. Adequate and effective measures to address observations from internal and external audits.
- ii. Consistent with its general responsibility for corporate governance, the Board of Directors (or equivalent forum) of the market-maker shall approve written policies which define the overall framework within which the derivative business shall be conducted and the related risks managed. Such framework shall, at the minimum, cover the following aspects:
- a. Establish the entity's overall appetite for taking risk and ensure that it is consistent with its strategic objectives, capital strength and management capability to hedge or transfer risk effectively and expeditiously;
 - b. Define the approved derivative products / activities and allocate the broad product category-wise risks within the overall risk appetite or risk limit sanctioned for the derivative business;
 - c. Establish policies for:
 - i. Introduction of new OTC derivative products based on the broad principles enumerated in section 4 of these Directions;
 - ii. Conduct of pre-trade due diligence based on the broad principles enumerated in section 5(I)(iii) of these Directions;
 - iii. Risk management based on the broad principles enumerated in section 6 of these Directions;
 - iv. Internal control based on the broad principles enumerated in section 7 of these Directions; and
 - v. Conduct of internal audit based on the broad principles enumerated in section 8 of these Directions.



- d. Details of the type and frequency of reports which are to be made to the Board of Directors (or equivalent forum) and its committees.

4. Product due diligence, pricing and valuation

- i. The policy for introduction of new OTC derivative products shall, *inter-alia*, include the process for evaluation and approval of new products. All new products shall be approved by the Board of Directors (or equivalent forum).
- ii. **Due diligence**
 - a. Due diligence shall be carried out at the time of introduction of a new product, which shall, *inter-alia*, include an assessment of the following aspects:
 - i. Objectives of the product;
 - ii. Type of targeted client;
 - iii. Key risks that a targeted client who transacts in the product potentially faces;
 - iv. Costs and fees to be incurred by a targeted client transacting in the product as compared to other products with similar features offered by the market-maker; and
 - v. Measures necessary to mitigate any conflict of interest.
 - b. Features, components, nature and complexity of pay-off, associated risks and pricing of the product shall be thoroughly understood and documented.
 - c. Compliance risks in all new products shall be thoroughly analysed and appropriate risk mitigants by way of necessary checks and balances shall be put in place before launching them.
 - d. The Chief Compliance Officer (CCO) and the Chief Risk Officer (CRO) shall be involved in the mechanism for approval of new products and all such products shall be signed off by them.
- iii. **Pricing and valuation**
 - a. Market-makers shall not deal in a product, either directly or on a back-to-back basis, which they cannot price independently.
 - b. Details of pricing and periodic valuation methodology of the products shall be documented.



- c. Fair value of the products shall be arrived on the basis of the following preferential hierarchy:
 - i. Marking the product (or its component(s)) to market;
 - ii. Marking the product (or its component(s)) to a model.
- d. In cases where a model is used for valuation of a product:
 - i. The purpose, design, input variables, underlying assumptions, quantitative algorithms, and limitations of the model, including third-party models, shall be adequately understood and documented;
 - ii. Inputs underpinning the model shall be observable market variables, where available;
 - iii. If any of the input variables are non-observable/subjective, their use shall be justified and their calculations shall be documented; and
 - iv. Appropriate model validation and independent review activities, including periodic back-testing, shall be undertaken to ensure sound model performance and greater understanding of model uncertainties.

5. User dealing conduct

I. Pre-trade conduct

- i. **User classification:** The user shall be classified and offered derivative products in terms of the governing Directions. Market-makers may further classify the user as per their internal policy, subject to maintaining the classification as per the governing Directions.
- ii. **Product disclosure statement:** A product disclosure statement containing standard information about the product shall be provided to the user with the purpose of providing adequate information to the user to decide if the product will meet its needs and to facilitate comparison with other products. This statement shall, at the minimum, contain the following information about the product:
 - i. Features, including components (if any) and termination/unwinding options along with related conditions and costs;



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- ii. Costs and fees, including break-up and details wherever required as per the governing Directions;
 - iii. Benefits;
 - iv. Risks; and
 - v. An illustration of how the product works.
- iii. **Due diligence:** Due diligence in respect of following aspects shall be carried out before undertaking a derivative transaction with the user. Such due diligence will not be mandatory in case of plain vanilla foreign exchange forward and foreign exchange option (European) – both deliverable and non-deliverable.
- a. **Product suitability:** The product offered to the user shall be consistent with the objective and risk appetite of the user. In case a product is not found suitable for user in the assessment of the market-maker, the user shall be informed of the opinion. If the user nonetheless wishes to proceed, the market-maker shall document its analysis and its discussions with the user. The approval for such transactions shall be escalated to next higher level of authority at the market-maker as also for the user.
 - b. **User appropriateness:** A product shall be offered only to those users:
 - i. Who have the necessary knowledge and experience to understand the nature and risks of the product; and
 - ii. Who have the financial ability to bear these risks; and
 - iii. Whose business, financial operations, skills, sophistication, risk management framework (including risk management policy approved by the Board of Directors or equivalent forum) and internal policies are consistent with the product being offered.
 - c. **Risk disclosure statement:** A risk disclosure statement shall be provided to the user for each derivative transaction. This statement shall, at the minimum, contain the following information:
 - i. Description and rationale of the transaction;



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- ii. Sensitivity analysis identifying the various parameters that affect the product; and
 - iii. Scenario analysis encompassing the possible upside, possible downside and payouts in quantitative terms under different combination of underlying variables, and assumptions made for the scenario analysis.
- d. **Authority verification:** Due diligence shall be carried out to verify that the persons undertaking the derivative are duly authorised.

II. Trade conduct

- i. Transactions shall be undertaken in a fair and transparent manner.
- ii. Transactions shall be undertaken at prevailing market rates. Requirements stipulated in the governing Directions, in this regard, shall also be complied with.

III. Post-trade conduct

- i. A deal confirmation shall be provided to the user, for each transaction individually or on a consolidated basis, for all transactions undertaken by the user on a particular day.
- ii. Mark-to-market value of all the positions shall be provided to the user as per the periodicity mutually agreed between the market-maker and the user, and whenever demanded by the user.

IV. Information

- i. All material information given to the user shall be in writing (including in electronic form).
- ii. Information given to the user shall be clear and unambiguous in language and presentation. Warnings and important information shall be prominently presented and clearly explained.
- iii. Wherever an opinion is expressed, there shall be a reasonable basis for expressing the opinion and it shall be unambiguously stated that it is a statement of opinion.



- iv. Information given to the user shall be adequate and sufficient to help them make an informed decision.

6. Risk management

- i. Risks in the derivative business shall be monitored and controlled independently and distanced from the control and influence of the trading and sales function.
- ii. Various types of risk to which the entity is exposed on account of its derivative business lines and products, especially structured products, shall be identified and risk tolerance level should be set.
- iii. Processes shall be established to manage risks in light of the risk tolerance level. The inter-relationship between the different types of risks shall be taken into account.
- iv. A clear and comprehensive set of limits to control risks shall be established.
- v. Stress testing of risk positions shall be conducted.
- vi. Effective policies, procedures and controls shall be implemented to manage the model risk.
- vii. Legal risk, i.e. the risk that a derivative contract shall not be legally enforceable, should be recognized and the market-makers should seek to manage the same by use of standard documentation (e.g. the ISDA master agreement). Specific documentation, if used, should be subject to independent legal advice.
- viii. Counterparty credit risk from the derivative contract should be recognized and the maker-makers should seek to manage the same by undertaking counterparty credit assessment and, wherever permitted, by collecting appropriate collateral from the user.

7. Internal control

- i. Policies and procedures shall be established to apply internal controls at various stages in the work flow of processing and monitoring transactions. Where applicable, market-makers shall comply with the requirements stipulated in the [circular no. FE.CO.FMD.No.18380/02.03.137/2010-11 dated February 3, 2011](#) on Internal Control Guidelines, as amended from time to time.



- ii. There shall be clear separation, both functionally and physically, between the front office, which is responsible for the conduct of trading operations and the back office, which is responsible for processing the resultant trades.

8. Internal audit

- i. Derivative business shall be subjected to internal audit to review the adequacy and test the effectiveness of the risk management system and internal controls.

An illustrative list of focus areas is as follows:

- a. Investigate unusual occurrences such as significant breaches of limits, unauthorized trades and unreconciled valuation or accounting differences;
 - b. Evaluate the reliability and timeliness of information reported to senior management and the board of directors;
 - c. Trace and verify information provided on risk exposure reports to the underlying data sources;
 - d. Appraise the effectiveness and independence of the risk management process;
 - e. Evaluate and independently verify whether model risk management practices are comprehensive, rigorous, and effective;
 - f. Evaluate the adequacy of the derivative valuation process and ensure that it is performed by parties independent of risk-taking activities;
 - g. Test derivative valuation reports for accuracy; and
 - h. Evaluate the product disclosure statements and risk disclosure statements provided to users.
- ii. Internal audit shall be conducted by qualified professionals, who are independent of the business line being audited.
 - iii. Failure of management to implement the recommendations of the internal auditor within an agreed timeframe shall be reported to the Audit Committee of the Board of Directors (or equivalent forum).



9. Preservation of records

All business, control and monitoring records should be preserved up to the existing statutory retention periods. Wherever statutory retention periods are not stipulated, such records shall be preserved as per the internal policy of the market-maker subject to the condition that they are preserved for at least two years after the life of the product/transaction. Back up of crucial information and data shall be done and preserved according to the IT policy of the market-maker.

(Dimple Bhandia)
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