



# Definition of Derivatives

Australia • China • European Union • France • Germany  
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# Australia

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**SUMMARY** The Corporations Act 2001 and Corporations Regulations 2001 define a derivative as a type of financial product with certain features, including that a party must or may be required to provide consideration at some future time; that future time can be as short as one business day (or possibly less) for arrangements other than foreign exchange contracts, and three business days for these contracts; and the amount of consideration or value of the arrangement is determined by reference to something else. Certain arrangements are excluded from the definition. In 2011, the Corporations and Markets Advisory Committee advised the Australian government that the current definition is not unduly complex, is suitable and adequate, and is consistent with the regulatory objectives of the legislation.

## I. Introduction

In Australia, section 761D of the Corporations Act 2001 (Cth)<sup>1</sup> provides a broad definition of “derivative” in the context of it “being one of a wider class of things that fall within the legislative concept of a ‘financial product’ for the purposes of Chapter 7” of the Act, which regulates financial services and markets.<sup>2</sup> The definition is further clarified and supplemented by regulation 7.1.04 of the Corporations Regulations 2001 (Cth).<sup>3</sup> Both of these provisions are set out in full below, as is a definition of derivatives from the relevant Australian accounting standard.

In 2011, the Australian Corporations and Markets Advisory Committee (CAMAC) examined whether the definition of a derivative in the Corporations Act 2001 should be changed. CAMAC discussed the nature of derivatives and ongoing local and international initiatives related to the

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<sup>1</sup> Corporations Act 2001 (Cth), s 761D, [http://www.comlaw.gov.au/Details/C2013C00605/Html/Volume\\_4](http://www.comlaw.gov.au/Details/C2013C00605/Html/Volume_4). The definition of derivatives was added by the Financial Services Reform Act 2001 (Cth), sch 1, <http://www.comlaw.gov.au/Details/C2005C00498>. For background information on the formulation of the definition, see the Explanatory Memorandum related to the Financial Services Reform Bill 2001 (Cth), <http://www.comlaw.gov.au/Details/C2004B00956>.

<sup>2</sup> CORPORATIONS AND MARKETS ADVISORY COMMITTEE, DERIVATIVES 33 (Dec. 2011), [http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2011/\\$file/Derivatives\\_Report\\_Dec2011.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2011/$file/Derivatives_Report_Dec2011.pdf) (hereinafter “CAMAC Report”). Section 760A of the Corporations Act states that the object of Chapter 7 is to “promote (a) confident and informed decision making by consumers of financial products and services while facilitating efficiency, flexibility and innovation in the provision of those products and services; and (b) fairness, honesty and professionalism by those who provide financial services; and (c) fair, orderly and transparent markets for financial products; and (d) the reduction of systemic risk and the provision of fair and effective services by clearing and settlement facilities.”

<sup>3</sup> Corporations Regulations 2001 (Cth), reg 7.1.04, [http://www.comlaw.gov.au/Details/F2013C00813/Html/Volume\\_2](http://www.comlaw.gov.au/Details/F2013C00813/Html/Volume_2).

regulation of over-the-counter derivatives markets;<sup>4</sup> outlined the overall legislative framework for regulating derivatives in Australia;<sup>5</sup> and considered definitions of derivatives in New Zealand, the United Kingdom, and the United States.<sup>6</sup> It also looked at some recent Australian court cases that discussed elements of the section 761D definition.<sup>7</sup> Case law related to this definition is highlighted in Part IV of this report, below.

In terms of the definition, CAMAC noted that

[i]f a financial product that is covered by the definition of derivative in s 761D is also within another category of financial product, such as a ‘security’, it is treated as that other type of financial product, not a derivative.<sup>8</sup>

CAMAC also noted that there is a wide range of possible derivative financial products that may need to be regulated and stated that

[t]he general approach in the Corporations Act has been to emphasise the regulation-making powers as the appropriate way to adjust the definition of derivative or financial product, if necessary. The regulations may declare something to be, or not to be, a financial product, or to be, or not to be, a derivative. ASIC [the Australian Securities and Exchange Commission] can declare something not to be a financial product.<sup>9</sup>

CAMAC expressed the view that the definition in section 761D is not unduly complex<sup>10</sup> and that it is

suitable and adequate, with the intended breadth of the definition allowing for its application to innovative derivative products without disruption to the regulatory structure of derivatives markets. In this way, the existing definition is consistent with the regulatory objectives underpinning Chapter 7 of the Corporations Act.<sup>11</sup>

CAMAC did not believe it necessary to “adjust or supplement the definition with a list of particular financial products”<sup>12</sup> or to give ASIC the power to declare an arrangement to be a derivative.<sup>13</sup>

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<sup>4</sup> CAMAC Report, *supra* note 2, at 7–31.

<sup>5</sup> *Id.* at 33–50.

<sup>6</sup> *Id.* at 54–60.

<sup>7</sup> *Id.* at 60–71.

<sup>8</sup> *Id.* at 33.

<sup>9</sup> *Id.* at 71.

<sup>10</sup> *Id.* at 76.

<sup>11</sup> *Id.* at 73.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at 76.

In a press release, the Convener of CAMAC stated that

CAMAC recognises the important role that derivatives have as risk management products. It is essential that derivatives markets be regulated appropriately. In CAMAC's view, the Australian legislation regulating derivatives compares favourably with overseas regulatory systems, and regulatory initiatives in local OTC derivatives markets are fully in line with international developments.<sup>14</sup>

## II. Definitions in the Corporations Act 2001 and Corporations Regulations 2001

The following is the full definition of “derivative” set out in section 761D of the Corporations Act 2001 (Cth):

### 761D Meaning of derivative

- (1) For the purposes of this Chapter, subject to subsections (2), (3) and (4), a derivative is an arrangement in relation to which the following conditions are satisfied:
  - (a) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind or kinds to someone; and
  - (b) that future time is not less than the number of days, prescribed by regulations made for the purposes of this paragraph, after the day on which the arrangement is entered into; and
  - (c) the amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:
    - (i) an asset;
    - (ii) a rate (including an interest rate or exchange rate);
    - (iii) an index;
    - (iv) a commodity.
- (2) Without limiting subsection (1), anything declared by the regulations to be a derivative for the purposes of this section is a derivative for the purposes of this Chapter. A thing so declared is a derivative despite anything in subsections (3) and (4).
- (3) Subject to subsection (2), the following are not derivatives for the purposes of this Chapter even if they are covered by the definition in subsection (1):
  - (a) an arrangement in relation to which subparagraphs (i), (ii) and (iii) are satisfied:
    - (i) a party has, or may have, an obligation to buy, and another party has, or may have, an obligation to sell, tangible property (other than Australian or foreign currency) at a price and on a date in the future; and
    - (ii) the arrangement does not permit the seller's obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property; and

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<sup>14</sup> Press Release, Corporations and Markets Advisory Committee, Derivatives (Jan. 24, 2012), <http://www.camac.gov.au/camac/camac.nsf/byHeadline/Whats+New+Media+Release+definiation+of+derivatives?openDocument>.

- (iii) neither usual market practice, nor the rules of a licensed market or a licensed CS facility, permits the seller's obligations to be closed out by the matching up of the arrangement with another arrangement of the same kind under which the seller has offsetting obligations to buy;  
but only to the extent that the arrangement deals with that purchase and sale;
  - (b) a contract for the future provision of services;
  - (c) anything that is covered by a paragraph of subsection 764A(1), other than paragraph (c) of that subsection;
  - (d) anything declared by the regulations not to be a derivative for the purposes of this Chapter.
- (4) Subject to subsection (2), an arrangement under which one party has an obligation to buy, and the other has an obligation to sell, property is not a derivative for the purposes of this Chapter merely because the arrangement provides for the consideration to be varied by reference to a general inflation index such as the Consumer Price Index.

As noted above, the definition in the Corporations Act is supplemented by a regulation in the Corporations Regulations 2001 (Cth), which provides as follows:

#### 7.1.04 Derivatives

- (1) For paragraph 761D(1)(b) of the Act, the prescribed period is:
  - (a) for a foreign exchange contract—3 business days; and
  - (b) in any other case—1 business day.
- (2) For subsection 761D(2) of the Act, and subject to this regulation, an arrangement is declared to be a derivative if the following conditions are satisfied in relation to the arrangement:
  - (a) the arrangement is not a foreign exchange contract;
  - (b) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time (which may be less than 1 day after the arrangement is entered into) consideration of a particular kind or kinds to someone;
  - (c) the amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:
    - (i) an asset;
    - (ii) a rate (including an interest rate or exchange rate);
    - (iii) an index;
    - (iv) a commodity.
- (4) An arrangement under which:
  - (a) a party has, or may have, an obligation to buy tangible property (other than Australian or foreign currency) at a price and on a date in the future; and
  - (b) another party has, or may have, an obligation to sell that property; and
  - (c) the arrangement does not permit the seller's obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property; and

- (d) neither usual market practice, nor the rules of a licensed market or a licensed CS facility, permits the seller's obligations to be closed out by the matching up of the arrangement with another arrangement of the same kind under which the seller has offsetting obligations to buy;  
is not an arrangement to which subregulation (2) applies to the extent only that the arrangement deals with that purchase and sale.
- (5) An arrangement under which:  
(a) a party has an obligation to buy property; and  
(b) another party has an obligation to sell the property;  
is not an arrangement to which subregulation (2) applies merely because the arrangement provides for the consideration to be varied by reference to a general inflation index (for example, the Consumer Price Index).
- (6) A contract for the future provision of services is not an arrangement to which subregulation (2) applies.
- (7) A thing that is described in subsection 764A(1) of the Act, other than paragraph 764A(1)(c), is not an arrangement to which subregulation (2) applies.
- (8) Subregulations (4) to (7) apply whether or not a matter mentioned in those subregulations is described in subsection 761D(1) of the Act.

### III. Definition in Accounting Standards

A new Australian Accounting Standards Board (AASB) standard that sets out the principles for recognizing and measuring financial instruments in the preparation of financial information will become effective in January 2015.<sup>15</sup> Appendix A of this standard, AASB 9, defines a derivative as being

- [a] financial instrument or other contract within the scope of this Standard (see paragraph 2.1) with all three of the following characteristics.
- (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
- (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- (c) It is settled at a future date.<sup>16</sup>

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<sup>15</sup> AASB 9 – Financial Instruments, [http://www.aasb.gov.au/admin/file/content105/c9/AASB9\\_12-10\\_COMP\\_sep12\\_01-15.pdf](http://www.aasb.gov.au/admin/file/content105/c9/AASB9_12-10_COMP_sep12_01-15.pdf) and <http://www.comlaw.gov.au/Details/F2011L00347>.

<sup>16</sup> *Id.* App. A. This is essentially the same definition as is currently set out in AASB 139 – Financial Instruments: Recognition and Measurement, para. 9, <http://www.comlaw.gov.au/Details/F2011C00043>.



While this definition is different from the section 761D definition, CAMAC noted in its 2011 report that the two definitions are used for different purposes and that it was not aware of this causing any confusion or difficulties in practice.<sup>17</sup>

#### IV. Case Law

The court decisions examined by CAMAC in its 2011 report on the Corporations Act definition of derivatives included the following:

- *Chameleon Mining NL v International Litigation Partners Pte Ltd* [2010] NSWSC 972<sup>18</sup> and *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50.<sup>19</sup>  
This case concerned the classification of a litigation funding agreement. The majority of the judges held on appeal that the particular agreement was prima facie a financial product under the Corporations Act 2001. However, the three judges differed in their reasoning regarding whether or not the agreement was a derivative. The discussion included examination of the future liability and derived value elements of section 761D(1) and the exclusion of contracts for the future provision of services under section 761D(3).
- *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567<sup>20</sup> and *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100.<sup>21</sup>  
In this case the plaintiff argued that forward contracts for the supply of wheat and barley were financial products under section 761D and other provisions of Chapter 7 of the Corporations Act. The decision of the court of first instance included an examination of the interpretation of the derived value element in 761D(1)(c). In the end, the court held that the forward contracts were not derivatives because they fell within the exception related to arrangements for the physical delivery of tangible property in section 761D(3)(a). This finding was upheld on appeal.

Since the completion of the report there have been some further cases that have discussed the interpretation and application of aspects of the section 761D definition, including the following:

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<sup>17</sup> CAMAC Report, *supra* note 2, at 74.

<sup>18</sup> *Chameleon Mining NL v International Litigation Partners Pte Ltd* [2010] NSWSC 972, <http://www.austlii.edu.au/au/cases/nsw/NSWSC/2010/972.html>.

<sup>19</sup> *International Litigation Partners Pte Ltd v Chameleon Mining NL* [2011] NSWCA 50, <http://www.austlii.edu.au/au/cases/nsw/NSWCA/2011/50.html> (see CAMAC Report, *supra* note 2, at 60 & 65).

<sup>20</sup> *Keynes v Rural Directions Pty Ltd (No 2)* [2009] FCA 567, [http://www.austlii.edu.au/au/cases/cth/federal\\_ct/2009/567.html](http://www.austlii.edu.au/au/cases/cth/federal_ct/2009/567.html).

<sup>21</sup> *Keynes v Rural Directions Pty Ltd* [2010] FCAFC 100, <http://www.austlii.edu.au/cgi-bin/sinodisp/au/cases/cth/FCAFC/2010/100.html> (see CAMAC Report, *supra* note 2, at 62–65).

- *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200.<sup>22</sup> This case related to a structured financial product known as a “constant proportion debt obligation,” which the court held to be a derivative under section 716D.
- *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* [2012] FCA 1028.<sup>23</sup> This case concerned “synthetic collateralised debt obligations,” which were found to be derivatives contracts.
- *Joffe v R; Stromer v R* [2012] NSWCCA 277.<sup>24</sup> One of the issues in this case was whether particular arrangements were a “contract for the future provision of services” for the purposes of section 761D(3)(b) and so not a derivative.

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<sup>22</sup> *Bathurst Regional Council v Local Government Financial Services Pty Ltd* (No 5) [2012] FCA 1200, [http://www.austlii.edu.au/au/cases/cth/federal\\_ct/2012/1200.html](http://www.austlii.edu.au/au/cases/cth/federal_ct/2012/1200.html).

<sup>23</sup> *Wingecarribee Shire Council v Lehman Brothers Australia Ltd (in liq)* (includes corrigenda dated 1 October 2013 and 22 November 2012) [2012] FCA 1028, [http://www.austlii.edu.au/au/cases/cth/federal\\_ct/2012/1028.html](http://www.austlii.edu.au/au/cases/cth/federal_ct/2012/1028.html).

<sup>24</sup> *Joffe v R; Stromer v R* [2012] NSWCCA 277, <http://www.austlii.edu.au/au/cases/nsw/NSWCCA/2012/277.html>.

# People's Republic of China

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## I. Introduction

When the Law of the People's Republic of China on Securities (Securities Law) was amended in 2005, an article was added providing that the issuing and trading of "derivative varieties of securities" would be regulated by the State Council.<sup>1</sup> However, it appears that the State Council has not issued such a regulation.

Currently, a definition of "derivatives" is provided by the regulator of the country's banking sector, the China Banking Regulatory Commission (CBRC). The central bank, the People's Bank of China (PBOC), and the regulator of the country's insurance sector, the China Insurance Regulatory Commission (CIRC), have also defined the term by their own rules.

## II. CBRC Definition

According to the most recent (2011) version of the Interim Measures for Administration of Derivatives Trading by Financial Institutions, the CBRC defines derivatives (financial derivative instruments) as "a category of financial contracts whose value is dependent upon one or more underlying assets or indices. The contracts include forwards, futures, swaps, and options. The derivatives also include hybrid financial instruments with one or more features of forwards, futures, swaps, and options."<sup>2</sup>

## III. PBOC Definition

In 2009, the PBOC, joined by the State Administration of Foreign Exchange (SAFE), made an announcement on approving the Master Agreement on Financial Derivatives Trading in the National Interbank Market Issued by the National Association of Financial Market Institutional Investors (PBOC Announcement). According to the PBOC Announcement, financial derivative instruments refer to

financial derivative contracts reached by and between the market participants on a one-to-one basis, under which the trading clauses are formulated in accordance with the two parties' specific requirements, including the interest rate derivatives, exchange rate

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\* Law Library intern Bing Jia contributed to this report.

<sup>1</sup> 中华人民共和国证券法 [Securities Law] (promulgated by the Standing Committee of the National People's Congress (NPC), Dec. 29, 1998, last revised Oct. 27, 2005), 2005 P.R.C. LAWS 185.

<sup>2</sup> 金融机构衍生产品交易业务管理暂行办法 [Interim Measures for Administration of Derivatives Trading by Financial Institutions] (promulgated by the CBRC, Feb. 4, 2004, last amended Jan. 5, 2011), [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/20110127DDF80B410B158BA5FF0D9AF49BF86300.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/20110127DDF80B410B158BA5FF0D9AF49BF86300.html).

derivatives, bond derivatives, credit derivatives, and gold derivatives which satisfy the above conditions, and the combination of the aforementioned derivatives trading, etc.<sup>3</sup>

#### **IV. CIRC Definition**

On October 12, 2012, the CIRC issued the Interim Measures for the Participation of Insurance Funds in the Financial Derivative Instruments Trading, in which financial derivative instruments are defined as “financial contracts whose value is dependent upon one or more underlying assets, indices or specific events, including forwards, futures, options and swaps.”<sup>4</sup>

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<sup>3</sup> 中国人民银行关于同意中国银行间市场交易商协会发布《中国银行间市场金融衍生产品交易主协议》的公告 [The PBC Announcement Approving the “Master Agreement on Financial Derivatives Trading in the National Interbank Market” Issued by the National Association of Financial Market Institutional Investors] (jointly promulgated by the PBC and the SAFE, Mar. 11, 2009), <http://www.pbc.gov.cn/publish/jinrongshichangsi/284/2010/20100910151803847362126/20100910151803847362126.html>.

<sup>4</sup> 保险资金参与金融衍生产品交易暂行办法 [Interim Measures for the Participation of Insurance Funds in the Financial Derivative Instruments Trading] (promulgated by the CIRC, Oct. 12, 2012), <http://www.circ.gov.cn/web/site0/tab5225/info224691.htm>.

# European Union

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**SUMMARY** EU legislation on derivatives does not provide a definition of derivatives. The EU courts have not defined derivatives, either. Directive 2004/39/EC on Financial Instruments simply provides a list of financial instruments deemed to be derivatives.

## I. Statutory Definition of Derivatives

### A. Directive 2004/39/EC on Financial Instruments

At the European Union (EU) level, derivatives are governed by Regulation (EU) No. 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories, otherwise known as EMIR (the European Market Infrastructure Regulation).<sup>1</sup> This Regulation does not define derivatives or derivatives contracts;<sup>2</sup> rather, it describes what is included in the term “derivatives” by referring to Annex I, section C, points (4) to (10) of Directive 2004/39/EC on Markets in Financial Instruments.<sup>3</sup>

Pursuant to Annex II, section C, points (4) to (10) of the Directive 2004/39/EC, the following financial instruments are considered derivatives:

- (4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
- (5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
- (6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF [multilateral trade facility];
- (7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities, that can be physically settled not otherwise mentioned in section C(6) and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;

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<sup>1</sup> Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR), O.J. (L 201) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>.

<sup>2</sup> *Id.* art. 2(5) of Reg. No. 648/2012.

<sup>3</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and Repealing Council Directive 93/22/EEC, Annex I, § C(4)–(10), 2004 O.J. (L 145) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

- (8) Derivative instruments for the transfer of credit risk;
- (9) Financial contracts for differences.
- (10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognized clearing houses or are subject to regular margin calls.

In accordance with Commission Regulation (EC) No. 1287/2006 of August 10, 2006, which implements Directive 2004/39/EC,<sup>4</sup> EU Member States are required to establish competent authorities for one or more financial instruments. These authorities are obliged to establish and maintain a list of financial instruments, which must be updated. The first list was required to be established by June 2007.<sup>5</sup> EU Members must also ensure that the list is made available to the single competent authority, designated as a contact point, as provided in article 56 of Directive 2004/39/EC.

## **B. Implementing Regulation No. 1287/2006**

Implementing Regulation (EC) No. 1287/2006 of Directive 2004/39/EC does not define the concept of “derivatives,” either. However, it sheds light on the following issues on derivatives: (a) it clarifies the notion of a “derivative contract;” (b) it specifies the standards that must be confirmed by regulated markets when admitting to trading those derivatives provided for in points (4) to (10) in Annex I, section C, of Directive 2004/39/EC; and (c) it expands the list of derivatives that meet certain conditions.

### *1. Derivative Contract*

A derivative contract relates to a commodity or another factor when there is a direct link between that contract and the relevant commodity or factor. A derivative contract on the price of a commodity should therefore be regarded as a derivative contract relating to the commodity. On the other hand, a derivative contract on the transportation costs for the commodity should not be regarded as a derivative contract relating to the commodity.<sup>6</sup>

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<sup>4</sup> Commission Regulation (EC) No. 1287/2006 of 10 August 2006 Implementing Directive 2004/39/EC of the European Parliament and of the Council as Regards Recordkeeping Obligations for Investment Firms, Transaction Reporting, Market Transparency, Admission of Financial Instruments to Trading, and Defined Terms for the Purposes of that Directive, 2006 O.J. (L 241) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0001:0025:EN:PDF>.

<sup>5</sup> *Id.* art. 11.

<sup>6</sup> *Id.*, Preamble para. 25.

## 2. *Criteria*

Regulated markets must ensure that the following criteria are complied with:

- The terms of a derivative contract must be clear and unambiguous, and must also enable a correlation between the price of the financial instrument and the price or other value measure of the underlying.
- Sufficient information to properly value the derivative must be made available to the public.
- The arrangements for determining the settlement price of the contract must be such that the price properly reflects the price or other value measure of the underlying security or asset.
- Where the settlement of the derivative requires the delivery of an underlying security or asset rather than cash settlement, there must be an adequate arrangements to enable market participants to obtain relevant information about that underlying security or asset.<sup>7</sup>

## 3. *Additional Derivatives*

In addition to derivative contracts of the kind referred to in section C(10) of Annex I to Directive 2004/39/EC, a derivative contract relating to any of the following items also falls within that section:

- Telecommunication bandwidth
- Commodity storage capacity
- Commodities, whether cable, pipeline, or other means
- An allowance, credit, permit, right, or similar asset which is directly linked to the supply, distribution, or consumption of energy derived from renewable resources
- A geological, environmental, or other physical variable
- Any other asset or right of a fungible nature, other than a right to receive a service, that is capable of being transferred
- An index or measure related to the price or value of, or volume of transactions in, any asset, right, service, or obligation<sup>8</sup>

In addition, derivatives contracts that relate to one of the above items must meet certain requirements, including that the contract is settled in cash or may be settled in cash at the option of one or more of the parties, or the contract is traded on a regulated market.<sup>9</sup>

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<sup>7</sup> *Id.* art. 37.

<sup>8</sup> *Id.* art. 39.

<sup>9</sup> *Id.* art. 38(3).

## **II. Definition of Derivatives in Case Law**

Neither the General Court nor the European Court of the EU have issued a judgment that provides a definition of derivatives.



# France

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## I. Introduction: French Terminology

The concept of “financial derivative instrument” is commonly translated into French as “instrument financier dérivé,” “produit dérivé,” “instruments à terme,” or “contrat à terme.”<sup>1</sup> The latter two (“instrument à terme” and “contrat à terme”) tend to be the favored expressions in French legal texts.<sup>2</sup>

## II. Statutory Definition of Financial Derivative Instruments

There is no broad, conceptual definition of a financial derivative instrument in French law. Rather, French law defines this concept by means of a list of transaction types that are deemed to be financial derivative instruments.<sup>3</sup> This list-based definition is found in article D.211-1A of the *Code monétaire et financier* (Financial and Monetary Code), which states that the following are financial derivative instruments:

1. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to financial instruments, currencies, interest rates, yields, financial indices or financial measures that may be settled physically or in cash;
2. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties other than by reason of a default or other termination event;
3. Options, futures, swaps, and any other derivative contracts relating to commodities that can be physically settled provided that they are traded on a regulated market or a multilateral trade facility;
4. Options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned in (3) and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls;

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<sup>1</sup> JOSEPH-BENJAMIN MOJUYÉ, *LE DROIT DES PRODUITS DÉRIVÉS FINANCIERS (SWAPS, OPTIONS, FUTURES...) EN FRANCE ET AUX ETATS-UNIS [THE LAW OF FINANCIAL DERIVATIVES (SWAPS, OPTIONS, FUTURES...) IN FRANCE AND IN THE UNITED STATES]* 1 (Paris, 2005).

<sup>2</sup> *Id.* n.2.

<sup>3</sup> ALAIN COURET ET AL., *DROIT FINANCIER [FINANCIAL LAW]* 575 (Paris, 2008); *MÉMENTO PRATIQUE FRANCAIS LEFÈBVRE, COMPTABLE* 2013 at 968 (Levallois, 32nd ed. Sept. 1, 2012).

5. Derivative contracts for the transfer of credit risk;
6. Financial contracts with differential payment;
7. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties otherwise than by reason of a default or other termination event; [and]
8. Any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in (1) to (7), above, that have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an multilateral trade facility, are cleared and settled through a recognized clearing house, or are subject to regular margin calls.<sup>4</sup>

This definition was adopted in 2007, as part of the transposition into French law of the 2004 European Union Markets in Financial Instruments Directive (MiFID).<sup>5</sup> Consequently, this definition is extremely similar to some of the content of Annex I, section C, of the MiFID.<sup>6</sup>

French legislation provides that this definition must be established by way of a governmental decree.<sup>7</sup> It could therefore be modified without the need for legislative action.

### III. Lack of Court Decisions Defining Financial Derivative Instruments

There does not appear to be any French court decisions that define financial derivative instruments. The legal nature of derivatives generally does not present jurisdictional problems under French law, since all regulated financial markets and exchanges are placed under the supervision of one body, the *Autorité des marchés financiers* (Financial Markets Authority).<sup>8</sup> This absence of potential jurisdictional conflict largely explains the lack of jurisprudence defining the concept of derivative instrument.<sup>9</sup>

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<sup>4</sup> CODE MONÉTAIRE ET FINANCIER [FINANCIAL AND MONETARY CODE] art. D211-1A (translation by author).

<sup>5</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments, 2004 O.J. (L 145) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>, cited in COURET ET AL., *supra* note 3, at 573.

<sup>6</sup> Directive 2004/39/EC at 41–42.

<sup>7</sup> CODE MONÉTAIRE ET FINANCIER art. L211-1.

<sup>8</sup> MOJUYÉ, *supra* note 1, at 261.

<sup>9</sup> *Id.* at 197.

# Germany

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**SUMMARY** Germany defines derivatives in keeping with the requirements of European Union law while crafting a definition that aims at being more structured than that of the European Directive. The German courts have not contributed to defining or delineating the concept of derivatives.

## I. Statutory Definition

Section 2(2) of the German Securities Trading Act<sup>1</sup> defines derivatives, and it has been translated by the German Federal Financial Supervisory Authority (BaFin) as follows:

(2) Derivatives within the meaning of this Act are

1. firm contracts or option contracts in the form of acquisitions, swaps or in other forms which are to be settled at a future date and whose values are derived directly or indirectly from the price or value measure of an underlying instrument (futures and forward transactions) relating to the following underlying instruments:
  1. securities or money market instruments;
  2. foreign exchange or units of account;
  3. interest rates or other yields;
  4. indices of the underlying instruments specified in (a), (b) or (c), other financial indices or financial measures; or
  5. derivatives;
2. futures and forward transactions relating to commodities, freight rates, emission allowances, climatic or other physical variables, inflation rates or other economic variables or other assets, indices or measures as underlying instruments, provided
  1. they are cash-settled or grant the party to a contract the right to demand cash settlement without this right being contingent on default or another termination event;
  2. they are concluded on an organised market or a multilateral trading facility; or
  3. in accordance with Article 38 (1) of Commission Regulation (EC) No. 1287/2006 of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive (OJ EU no. L 241 p. 1), they have the characteristics of other derivatives and are not for commercial

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<sup>1</sup> Wertpapierhandelsgesetz, *repromulgated* Sept. 9, 1998, BUNDESGESETZBLATT I at 2708, *as amended, current version* at <http://www.gesetze-im-internet.de/wphg/index.html>, *translation* at [http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg\\_101119\\_en.html?nn=2821360#doc2684270bodyText6](http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html?nn=2821360#doc2684270bodyText6) (click on “Securities Trading Act” in right-hand column).

- purposes and if the conditions set out in Article 38 (4) of this Regulation are not satisfied;  
and if they are not spot contracts within the meaning of Article 38 (2) of Regulation (EC) No. 1287/2006;
3. financial contracts for differences;
  4. firm contracts or option contracts in the form of acquisitions, swaps or in other forms which are to be settled at a future date and are intended for the transfer of credit risk (credit derivatives);
  5. futures and forward transactions relating to the underlying instruments set out in Article 39 of Regulation (EC) No. 1287/2006 if they satisfy the conditions of no. 2.<sup>2</sup>

The German definition describes the derivative financial instruments that are subject to oversight by the financial markets authority.<sup>3</sup> The current set of definitions was enacted in 2004, to transpose the Financial Instruments Directive 2004/39 of the European Union (EU).<sup>4</sup> The German definition aims to live up to the elements of the Directive's definition but groups the qualifying underlying circumstances differently in a more structured and systematic manner, which is in keeping with German principles of legislative drafting that prefer abstract concepts to a mere listing of applicable events.<sup>5</sup>

The current German definition does not provide a general definition of derivatives, listing instead various groups of underlying transactions and events, the reference to which makes the financial instrument a derivative, yet according to expert commentary, the defining characteristic of a derivative is that valuation and price of the instrument depend in the future on an underlying value.<sup>6</sup>

## II. Cases

German case law has not expanded the definition of derivative financial instruments nor contributed to the development of the concept. The only recent case on derivatives adjudicates the issue of liability for imprudent investment advice. In a 2010 decision, the Regional Court of Cologne held that financial futures are derivatives within the meaning of section 2(2) of the Securities Trading Act.<sup>7</sup>

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<sup>2</sup> *Id.* (BaFin translation).

<sup>3</sup> *Id.* §§ 1, 4.

<sup>4</sup> *See* EU survey included in this report.

<sup>5</sup> HEINZ-DIETER ASSMAN & UWE SCHNEIDER, WERTPAPIERHANDELSGESETZ § 2(2) n.42 (6th ed. 2012).

<sup>6</sup> *Id.* n.43.

<sup>7</sup> Decision of Regional Court of Cologne (Landgericht Köln), Oct. 10, 2010, docket no. 3 O 608/09, available on the subscription database juris.

# Japan

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## I. Financial Instruments and Exchange Act

Article 2, paragraphs 20–23 of the Financial Instruments and Exchange Act define “derivative transactions” as follows:

- (20) The term “Derivative Transactions” used in this Act means Market Transactions of Derivatives, Over-the-Counter Transactions of Derivatives or Foreign Market Derivatives Transactions.
- (21) The term “Market Transactions of Derivatives” as used in this Act means the following transactions conducted in a Financial Instruments Market, in accordance with requirements and by using methods prescribed by the operator of the Financial Instruments Market:
  - (i) transactions wherein the parties thereto promise to deliver or receive Financial Instruments or consideration for them at a fixed time in the future, and, when the resale or repurchase of the underlying Financial Instruments are made, settlement thereof may be made by paying or receiving the difference;
  - (ii) transactions wherein the parties thereto promise to pay or receive the amount of money calculated based on the difference between the figure of a Financial Indicator to which the parties agree in advance (hereinafter referred to as the “Agreed Figure”) and the actual figure of the Financial Indicator at a fixed time in the future (hereinafter referred to as the “Actual Figure”);
  - (iii) transactions wherein the parties thereto promise that one of the parties thereto grants the other party an option to effect a transaction listed in the following items between the parties only by unilateral manifestation of the other party’s intention, and the other party pays the consideration for such option:
    - (a) sales and purchase of Financial Instruments (excluding those specified in item (i)); or
    - (b) any transaction listed in the preceding two items or the following item to item (vi)(including those designated by the Financial Instruments Exchange and equivalent to a transaction specified in the preceding item).
  - (iv) transactions wherein the parties mutually promise that, using the amount the parties have agreed to as the principal, one of the parties will pay the amount of money calculated based on the rate of change in the agreed period of the interest rate, etc. (referred to the interest rate or any other rate specified by a Cabinet Office Ordinance as being equivalent to the interest rate; the same shall apply hereinafter) of the Financial Instruments (excluding those listed in Article 2(24)(iii)) or of a Financial Indicator (excluding interest rates, etc. of Financial Instruments (excluding those listed in Article 2(24)(iii)) and figures calculated based on them; hereinafter

- the same shall apply in this item and item (v) of the following paragraph) agreed with the other party, and the other party will pay the amount of money calculated based on the rate of change in the agreed period of the interest rate, etc. of the Financial Instruments (excluding those listed in Article 2(24)(iii)) or of a Financial Indicator agreed with the former party (including transactions wherein the parties promise that, in addition to the payment of such amounts, they will also pay, deliver or receive the amount of money or financial instrument that amounts to the agreed principal);
- (v) transactions wherein one of the parties pays money, and the other party, as the consideration therefor, promises to pay money in cases where a cause agreed by the parties in advance and listed in the following items occurs (including those wherein one of the parties promises to transfer Financial Instruments, a right pertaining to Financial Instruments or monetary claim (excluding claims that are Financial Instruments or rights pertaining to Financial Instruments), but excluding those listed in the preceding three paragraphs); or
    - (a) a cause pertaining to credit status of a juridical person or other similar cause as specified by a Cabinet Order; or
    - (b) a cause which it is impossible or extremely difficult for either party to exert his/her influence on the occurrence of and which may have serious influence on business activities of the parties or other business operators as specified by a Cabinet Order (excluding those specified in (a)).
  - (vi) transactions similar to transactions listed in the preceding items and specified by a Cabinet Order.
- (22) The term “Over-the-Counter Transactions of Derivatives” as used in this Act means the following transactions which are conducted in neither a Financial Instruments Market nor a Foreign Financial Instruments Market (except those specified by a Cabinet Order as those for which it is found not to hinder the public interest or protection of investors when taking into account its content and other related factors).
- (i) transactions wherein the parties thereto promise to deliver or receive Financial Instruments (excluding those listed in Article 2(24)(v); hereinafter the same shall apply in this paragraph) or consideration for them at a fixed time in the future, and, when the resale or repurchase of the underlying Financial Instruments or other acts specified by a Cabinet Order is made, settlement thereof may be made by paying or receiving the differences;
  - (ii) transactions wherein the parties thereto promise to pay or receive the amount of money calculated based on the Agreed Figure and the Actual Figure or any other similar transactions; and
  - (iii) transactions wherein the parties thereto promise that one of the parties grants the other party an option to effect a transaction listed in the following items between the parties only by unilateral manifestation of the other party’s intention, and the other party pays consideration for such option, or any other similar transactions:
    - (a) sales and purchase of Financial Instruments (excluding those specified in item (i)); or
    - (b) any transaction listed in the preceding two items or items (v) to (vii).
  - (iv) transactions wherein the parties thereto promise that one of the parties grants the other party an option to, only by unilateral manifestation of his/her intention, effect a transaction wherein the parties promise to pay or receive

- the amount of money calculated based on the difference between a figure which the parties have agreed in advance to use as the Agreed Figure of the Financial Indicator when such manifestation is made and the Actual Figure of the Financial Indicator at the time of such manifestation, and the other party pays the consideration for such option, or any other similar transactions;
- (v) transactions wherein the parties mutually promise that, using the amount the parties have agreed to as the principal, one of the parties will pay the amount of money calculated based on the rate of change in the agreed period of the interest rate, etc. of the Financial Instruments (excluding those listed in Article 2(24)(iii)) or of a Financial Indicator agreed with the other party, and the other party will pay the amount of money calculated based on the rate of change in the agreed period of the interest rate, etc. of the Financial Instruments (excluding those listed in Article 2(24)(iii)) or of a Financial Indicator agreed with the former party (including transactions wherein the parties promise that, in addition to the payment of such amounts, they will also pay, deliver or receive the amount of money or financial instruments that amounts to the agreed principal), or any other similar transactions;
  - (vi) transactions wherein one of the parties pays money, and the other party, as the consideration therefor, promises to pay money in cases where a cause agreed by the parties in advance and listed in the following items occurs (including those wherein one of the parties promises to transfer the Financial Instruments, rights pertaining to the Financial Instruments or monetary claim (excluding claims that are Financial Instruments or rights pertaining to the Financial Instruments), but excluding those listed in item (ii) to the preceding item), or any other similar transactions;
    - (a) a cause pertaining to credit status of a juridical person or other similar cause as specified by a Cabinet Order; or
    - (b) a cause which it is impossible or extremely difficult for either party to exert his/her influence on the occurrence of and which may have serious influence on business activities of the parties or other business operators as specified by a Cabinet Order (excluding those specified in (a)).
  - (vii) in addition to transactions listed in the preceding items, transactions which have an economic nature similar to these transactions and are specified by a Cabinet Order as those for which it is found necessary to secure the public interest or protection of investors.
- (23) The term “Foreign Market Derivatives Transactions” as used in this Act means transactions which are conducted in a Foreign Financial Instruments Market and are similar to Market Transactions of Derivatives.<sup>1</sup>

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<sup>1</sup> Kinyū shōhin torihiki hō [Financial Instruments and Exchange Act], Act No. 25 of 1948, *amended* by Act No. 56 of 2013. An English translation of the Act is available on the Ministry of Justice’s online database, at <http://www.japaneselawtranslation.go.jp/law/detail/?printID=&ft=2&re=02&dn=1&yo=financial+instruments&x=82&y=12&ky=&page=1&vm=02> (last visited Jan. 30, 2014).

## II. Corporation Tax Act

The Corporation Tax Act defines “derivatives transaction” as follows:

Those prescribed by Ministry of Finance Ordinance out of the transactions, which include similar transactions, in which a transfer of money which amount is computed based on the balance between an actual figure of an index, such as interest, rate of currency, price of goods, at a specified time in future and a figure determined in advance, by contracts among persons concerned, as a figure of the said index.<sup>2</sup>

## III. Accounting Standards

Under the Accounting Standard for Financial Instruments, the derivatives transaction is defined as “futures transactions, forward transactions, options transactions, swap transactions, and other transactions that are similar to these.”<sup>3</sup>

## IV. Cases

Though there are many cases that relate to derivatives transactions, we could not locate a case that defines derivatives. Courts discuss specific derivatives contracts in their decisions.

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<sup>2</sup> Hōjinzei hō [Corporation Tax Act], Act No. 34 of 1965, *amended* by Act No. 5 of 2013, art. 61-5. An English translation of the Act is available on the website of the public interest association Institute of Tax Research and Literature, at [http://www.sozeishiryokan.or.jp/corporation\\_tax/corporation\\_tax2013e.html](http://www.sozeishiryokan.or.jp/corporation_tax/corporation_tax2013e.html) (last visited Jan. 30, 2014).

<sup>3</sup> Kinyū shōhin ni kansuru kaikei kijun [Accounting Standard for Financial Instruments], Corporate Accounting Standards No. 10 (Corporate Accounting Council, Jan. 22, 1999, last amended by Corporate Accounting Standards Committee, Mar. 10, 2008), sec. 4, [https://www.asb.or.jp/asb/asb\\_j/documents/docs/fv-kaiji/fv-kaiji.pdf](https://www.asb.or.jp/asb/asb_j/documents/docs/fv-kaiji/fv-kaiji.pdf) (in Japanese).



# Sweden

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## I. Statutory Definition of Financial Derivatives

Definitions of different financial instruments under Swedish law are found in chapter 1, section 4(1) of Lag (2007:528) om värdepappersmarknaden (the Law on the Securities Market).<sup>1</sup> The definition of financial instruments includes a long list of financial derivatives.<sup>2</sup> The list is not exhaustive but includes a catch-all reference to the European instruction for implementation.<sup>3</sup>

Some have argued that, although based on the EU's Markets for Financial Instruments Directive, the long list of examples of financial instruments makes it unclear what is considered a financial instrument under Swedish law.<sup>4</sup>

In chapter 1, section 4(5) financial derivatives are defined as derivatives belonging to one of the following categories:

- a) options, term contract, swaps, interests rates insurance agreements and every other derivative contract that pertains to securities, currencies, interest or earnings, or other derivative instruments, financial indices or financial measurements that can be terminated physically or in cash,
- b) options, term contract, swaps, interest rate insurance agreements and every other derivative contract that pertains to raw material that must be terminated in cash or that can be terminated in cash at one party's request, based on a reason other than missed payment or any other event that leads to the contract automatically terminating.
- c) options, term contracts, swaps and every other derivative contract that pertains to raw material that can be terminated physically, provided that it is traded on a regulated market or trading platform,
- d) options, term contracts, swaps, term contracts that are not traded on a regulated market place or equivalent market outside of the EES (forwards) and every other derivative contract that

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<sup>1</sup> LAG OM VÄRDEPAPPERSMARKNADEN [SECURITIES MARKET ACT] (Svensk Författningssamling ([SFS] 2007:528), [http://www.riksdagen.se/sv/Dokument-Lagar/Lagar/Svenskforfattningssamling/Lag-2007528-om-vardepappers\\_sfs-2007-528/?bet=2007:528](http://www.riksdagen.se/sv/Dokument-Lagar/Lagar/Svenskforfattningssamling/Lag-2007528-om-vardepappers_sfs-2007-528/?bet=2007:528)).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.* 5§ g st 2.

<sup>4</sup> WALLIN-NORMAN, FINANSIELLA INSTRUMENT [FINANCIAL INSTRUMENTS] 22 (2011).

- pertains to raw material,
- can be terminated physically,
- is not mentioned in c and is not for commercial purposes, and
- that is considered to have properties of other financial derivatives, taking into account whether clearing and termination takes place through recognized systems for clearing or if they are subject to regular marginal security demands,
- e) derivative instruments for transfer of credit risk,
- f) financial contracts on price differences,
- g) options, term contracts, swaps, interest insurance agreements and every other derivative contract that pertains to climate fluctuations, freight, emission rights, or the rate of inflation, or any other official financial statistic, which must be terminated in cash or can be terminated in cash at the request of one of the parties, for a reason other than missed payment or other event that leads to the contract being automatically terminated as well as every other derivative contract that
- pertains to assets, rights, duties, indices and measures that have previously not been mentioned in this item, and
- is considered to have properties that other financial derivatives have, considering whether it is traded on a regulated market or a trading platform, if clearing and termination occurs through recognized systems for clearing or if it is subject to regular marginal securities demands.

Additional provisions on which derivative instruments that are covered by 5§ d1st paragraph [section 5(d), para. 1] and 5§g [section 5(g)] can be found in articles 38 and 39 of the implementation directive. Lag (2013:579).<sup>5</sup>

The effect of the definition above is that all financial derivatives are treated the same as any other financial instrument. For instance, Finansinspektionen (the Swedish Financial Supervisory Authority) has the authority over all such transactions.<sup>6</sup> However, there are exceptions to the permit requirement for certain derivatives transactions.<sup>7</sup>

## II. Nasdaq Nordic OMX Stockholm Definition

The Nasdaq Nordic OMX Stockholm, commonly referred to as the Stockholm Stock Exchange, has rules for trading in derivatives at its market place but these do not include a separate definition of what derivatives are.<sup>8</sup>

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<sup>5</sup> SECURITIES MARKET ACT ch. 1:4 § 5 (translation by Elin Hofverberg).

<sup>6</sup> *Id.* ch. 1:5 § 2, and specifically for derivative services, ch 2:2 §.

<sup>7</sup> *Id.* ch. 2:5 §§ 11, 13, 14,

<sup>8</sup> NASDAQ OMX Nordic, Rules and Regulations of NASDAQ OMX Derivatives Markets, <http://www.nasdaqomx.com/nordicrules> (click on “Derivatives” under “General” heading) (last visited Jan. 29, 2014).

### III. Over-the-Counter (OTC) Derivatives

Sweden has implemented the European Market Infrastructure Regulation (Regulation 648/2012) of the European Union<sup>9</sup> through Law 2013:287.<sup>10</sup> This Swedish Law defines OTC derivatives as having the same meaning as the terms and expressions used in EU Regulation 648/2012.<sup>11</sup> EU Regulation 648/2012 does not list definitions but instead refers back to the definition found in articles 38 and 39 of Regulation (EC) No. 1287/2006, which in turn refers to the definition in Directive 2004/39.<sup>12</sup>

### IV. Definition of Derivatives as Financial Instruments for Tax Purposes

#### A. Swedish Tax Authority Opinions

The Swedish Tax Authority (Skatteverket) has published guidance on derivatives, one for each type.<sup>13</sup> Contracts for difference (CFD contracts) are treated as term contracts.<sup>14</sup> The Tax Authority treats raw material options differently compared to other options, as they are not considered shares or debt.<sup>15</sup> Term contracts for raw material do not need to be declared for the same reason.<sup>16</sup> Warrants that are not materialized are considered traded at zero value.<sup>17</sup> There is

<sup>9</sup> Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR), 2012 O.J. (L 201) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>.

<sup>10</sup> LAG MED KOMPLETTERANDE BESTÄMMELSER TILL EU:S FÖRORDNING OM OTC-DERIVAT, CENTRALA MOTPARTER OCH TRANSAKTIONSREGISTER [LAW ON SUPPLEMENTARY REGULATIONS ON EU-REGULATION ON OTC DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES] (SFS 2013:287), [http://www.riksdagen.se/sv/Dokument-Lagar/Lagar/Svenskforfattningssamling/Lag-2013287-med-komplettera\\_sfs-2013-287/?bet=2013:287](http://www.riksdagen.se/sv/Dokument-Lagar/Lagar/Svenskforfattningssamling/Lag-2013287-med-komplettera_sfs-2013-287/?bet=2013:287)

<sup>11</sup> *Id.*

<sup>12</sup> See European Union survey contained in this report; see also Regulation (EU) No. 648/2012, *supra* note 9; Commission Regulation (EC) No. 1287/2006 of 10 August 2006, Implementing Directive 2004/39/EC of the European Parliament and of the Council as Regards Recordkeeping Obligations for Investment Firms, Transaction Reporting, Market Transparency, Admission of Financial Instruments to Trading, and Defined Terms for the Purposes of that Directive, 2006 O.J. (L 241) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:241:0001:0025:EN:PDF>.

<sup>13</sup> See notes 15–18, respectively, below.

<sup>14</sup> *CFD-kontrakt [Contracts]*, SKATTEVERKET, <http://www.skatteverket.se/privat/skatter/vardepapperforsakringar/derivat/cfdkontrakt.4.233f91f71260075abe8800022347.html> (last visited Jan. 30, 2014).

<sup>15</sup> *Optioner [Options]*, SKATTEVERKET, <http://www.skatteverket.se/privat/skatter/vardepapperforsakringar/derivat/optioner.4.233f91f71260075abe880009571.html> (last visited Jan. 30, 2014).

<sup>16</sup> *Terminer [Term Contracts]*, SKATTEVERKET, <http://www.skatteverket.se/privat/skatter/vardepapperforsakringar/derivat/terminer.4.233f91f71260075abe8800022181.html> (last visited Jan. 30, 2014).

<sup>17</sup> *Warranter [Warrants]*, SKATTEVERKET, <http://www.skatteverket.se/privat/skatter/vardepapperforsakringar/derivat/warranter.4.233f91f71260075abe880009577.html> (last visited Jan. 30, 2014).

no template calculation of value for derivatives,<sup>18</sup> nor can the value of the derivative ever be valued as below zero for tax deduction purposes.<sup>19</sup>

## **B. Swedish Tax Authority Preliminary Ruling**

A 2002 Swedish Tax Authority preliminary ruling deals with the taxation effect of derivatives where the underlying transaction is the sale or purchase of a share. In the case, the Tax Authority found that a derivative must be treated as a debt asset until realized.<sup>20</sup>

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<sup>18</sup> See notes 15,16, 17 and 18, respectively, above.

<sup>19</sup> SKATTEVERKET, *Skatteverkets ställningstaganden, Värdering av optioner, terminer och andra derivatinstrument på ett investeringssparkonto* [Tax Authority Opinion, Calculation of Options, Term Contracts and Other Derivative Instruments on an Investment Savings Account], May 7, 2012, <http://www.skatteverket.se/rattsinformation/reglerochstallningstaganden/stallningstaganden/2012/stallningstaganden2012/13117773912111.5.71004e4c133e23bf6db800078835.html>.

<sup>20</sup> SKATTEVERKET, *Riksskatteverkets rättsfallsprotokoll 30/02* (Område: Förhandsbesked, Ärende behandlat vid Riksskatteverkets rättsfallsseminarium den 4 november 2002. SRN:s förhandsbesked den 11 oktober 2002, rätt att förvärva aktier eller kontantbelopp), at 197, <http://www.skatteverket.se/download/18.deeebd104898a3a9c8000248/1119358165976/rattsfallsprotokoll2002.pdf>.

# Switzerland

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## I. Statutory Definition

According to article 2(a) of Switzerland's Federal Act on Stock Exchanges and Securities Trading,<sup>1</sup> derivatives are financial instruments that are subject to financial market oversight.<sup>2</sup> In implementation of this provision, article 5 of the Regulation on Stock Exchanges and Securities Trading defines derivatives.<sup>3</sup> The provision may be translated as follows:

Art. 5. Derivatives

Derivatives are financial contracts, the price of which derives from:

- a. assets such as stocks, debentures, commodities, [and] precious metals;
- b. reference rates such as currencies, interest, or indices.<sup>4</sup>

## II. Cases

There are no Swiss court decisions that analyze the scope of the statutory definition of derivatives or seek to change it. There is literature, case law, and administrative rulings on tax aspects of trading in derivatives.<sup>5</sup>

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<sup>1</sup> Börsengesetz [Stock Exchange Act], Mar. 24, 1995, *as amended*, SYSTEMATISCHE SAMMLUNG DES BUNDESRECHTS [SR] No. 954.1, <http://www.admin.ch/opc/de/classified-compilation/19950081/index.html>.

<sup>2</sup> *Id.* art. 1.

<sup>3</sup> Börsenverordnung, Dec. 2, 1996, *as amended*, SR No. 954.11, <http://www.admin.ch/opc/de/classified-compilation/19960659/index.html>.

<sup>4</sup> Translated by the author.

<sup>5</sup> Jean-Marie-Hainaut & Anne Widmer Dominé, *Commerce professionnel de titres*, DER SCHWEIZER TREUHÄNDER 768 (2012), available on the subscription database Swisslex.

# United Kingdom

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**SUMMARY** The regulator for banks in the UK, the Prudential Regulation Authority, has provided a definition of a financial derivative instrument in terms of agreements that can successfully form such an instrument. This definition reflects European Union requirements. Derivative contracts are also extensively defined in the Finance Act 2002, for corporate tax purposes. Her Majesty's Revenue and Customs has further defined financial derivative instruments as an instrument that derives its value from the cost of an underlying item. Judicial decisions have been issued in the UK that have involved derivatives, and these have determined whether such transactions are legal and whether the parties have the capacity to enter into the agreements.

## I. Statutory Definitions

The Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) defines derivatives in paragraph 13.3.3. This Sourcebook is issued by the Bank of England's Prudential Regulation Authority, which is responsible for regulating and supervising banks, building societies, credit unions, insurers, and major investment firms.<sup>1</sup>

Paragraph 13.3.3 of the Prudential Sourcebook defines financial derivative instruments by describing a list of qualifying instruments and adheres to the requirements of European law by referring to the governing European Union Directive.<sup>2</sup> The definition lists the following instruments as derivatives:

- (1) an interest-rate contract, being:
  - (a) a single-currency interest rate swap;
  - (b) a basis-swap;
  - (c) a forward rate agreement;
  - (d) an interest-rate future;
  - (e) a purchased interest-rate *option*; and
  - (f) other contracts of similar nature.
- (2) a *foreign currency* contract or contract concerning gold, being:
  - (a) a cross-currency interest-rate swap;
  - (b) a forward *foreign currency* contract;
  - (c) a currency future;

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<sup>1</sup> Financial Services and Markets Act 2000, c. 8, pt. 1A, <http://www.legislation.gov.uk/ukpga/2000/8/contents> (inserted by the Financial Services Act 2012, § 6, c. 21, <http://www.legislation.gov.uk/ukpga/2012/21/part/2/crossheading/financial-conduct-authority-and-prudential-regulation-authority/enacted>).

<sup>2</sup> See European Union survey in this report.

- (d) a currency *option* purchased;
- (e) other contracts of a similar nature; and
- (f) a contract concerning gold of a nature similar to (2)(a) to (e).

(3) a contract of a nature similar to those in 1(a) to (e) and 2(a) to (d) concerning other reference items or indices, including as a minimum all instruments specified in points 4 to 7, 9 and 10 of Section C of Annex I to the *MIFID*<sup>3</sup> not otherwise included in (1) or (2).<sup>4</sup>

Schedule 26 of the Finance Act 2002<sup>5</sup> provides an extensive and very lengthy definition of derivative contracts for purposes of the corporation tax.

Her Majesty's Revenue and Customs (HMRC) has defined the term "derivative" as

a financial instrument or other contract with all three of the following characteristics:

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (the "underlying"). In the case of a non-financial variable, that variable must not be specific to one party to the contract.
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and
- it is settled at a future date.<sup>6</sup>

HMRC defines the term "derivative financial instrument" by reference to Financial Reporting Standard (FRS) 13:

FRS13 defines a derivative financial instrument as:

'A financial instrument that derives its value from the price or rate of some underlying item.'

It goes on to say the following:

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<sup>3</sup> MIFID is the abbreviation for Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and Repealing Council Directive 93/22/EEC, Annex I, § C(4)–(10), 2004 O.J. (L 145) 1, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:145:0001:0044:EN:PDF>.

<sup>4</sup> BIPRU 13.3 Calculation of Exposure Values for Financial Derivatives and Long Settlement Transactions: General Provisions, <http://fshandbook.info/FS/html/handbook/BIPRU/13/3> (italics in original).

<sup>5</sup> Finance Act 2002, c. 23, sched. 26, <http://www.legislation.gov.uk/ukpga/2002/23/schedule/26>.

<sup>6</sup> *CFM16090 – Accounting for Financial Instruments: IAS 32 and IAS 39: Derivatives Within IAS 39*, HM REVENUE AND CUSTOMS, [www.hmrc.gov.uk/manuals/cfmmanual/cfm16090.htm](http://www.hmrc.gov.uk/manuals/cfmmanual/cfm16090.htm) (last visited Jan. 28, 2014); *see also* *CFM24000 – Accounting for Corporate Finance: Derivative Contracts*, HM REVENUE AND CUSTOMS, <http://www.hmrc.gov.uk/manuals/cfmmanual/cfm24000.htm> (last visited Jan. 28, 2014).

'Underlying items include equities, bonds, commodities, interest rates, exchange rates and stock market and other indices.'

and

'Derivative financial instruments include futures, options, forward contracts, interest rate and currency swaps, interest rate caps, collars and floors, forward interest rate agreements, commitments to purchase shares or bonds, note issuance facilities and letters of credit.'

The types of instrument which fall within this definition are, in general terms, those that the market recognises as derivatives.<sup>7</sup>

## II. Cases

In *Standard Chartered Bank v. Ceylon Petroleum Corporation* the Judge summarized derivative transactions as those

23. . . . used to hedge against exposures arising out of an underlying physical position. . . .  
. . . .

36. In each case, given that such derivative transactions are over-the-counter (or privately negotiated) transactions, the precise terms of any transaction are up to the parties to determine, subject only to the fact that the overall package of rights and obligations purchased and sold needs to be acceptable to both of them.<sup>8</sup>

In this case, the Ceylon Petroleum Corporation (CPC) entered into derivative contracts for oil with numerous UK-based companies. When the price of oil drastically dropped, the CPC argued that the derivative contracts were speculative, that, as a state-owned entity, it lacked capacity to enter into such a contract, and that, among other things the transactions were for hedging purposes or amounted to speculation. The Court held against CPC on all counts.<sup>9</sup>

The International Swaps and Derivatives Association has a Master Agreement that is used and referenced frequently by parties entering into transactions involving financial derivative instruments.<sup>10</sup> In *BNP Paribas v. Wockhardt EU Operations (Swiss) AG*, the court noted as follows:

[23] . . . the sooner the issue of its validity is determined the better: *AWB (Geneva) SA & Anor v North America Steamships Ltd & Anor* [2007] EWCA Civ 739.

[24] The desirability of a prompt determination cannot alter the test as to whether some

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<sup>7</sup> *CFM13082 – Taxing Derivative Contracts: Accounting Test: Definition of Derivative*, HM REVENUE AND CUSTOMS, [www.hmrc.gov.uk/manuals/cfmmanual/cfm13082.htm](http://www.hmrc.gov.uk/manuals/cfmmanual/cfm13082.htm) (last visited Jan. 28, 2014).

<sup>8</sup> *Standard Chartered Bank v. Ceylon Petroleum Corporation*, [2011] EWHC (Comm) 1785, ¶¶ 23, 36, [www.bailii.org/ew/cases/EWHC/Comm/2011/1785.html](http://www.bailii.org/ew/cases/EWHC/Comm/2011/1785.html).

<sup>9</sup> *Id.* (generally); *Standard Chartered Bank v. Ceylon Petroleum Corporation*, [2012] EWCA Civ 1049, <http://www.bailii.org/ew/cases/EWCA/Civ/2012/1049.html>.

<sup>10</sup> *BNP Paribas v. Wockhardt EU Operations (Swiss) AG*, [2009] EWHC (Comm) 3116.



form of summary judgment should be given, but:

*“ . . . on general principles the court should not be astute to interpret commercial transactions so as to invalidate them, particularly when . . . consequential doubt might be cast on other long-standing commercial arrangements”*: *Perpetual Trustee Co Ltd v BNY Corporate Trustees Services and another; Belmont Park Investments Pty Ltd v Corporate Trustee Services Ltd and another* [2009] EWHC 1912 (Ch) per Sir Andrew Morritt, QC.

*“It is also desirable that, if possible, the courts give effect to contractual terms which the parties have agreed. Indeed there is a particularly strong case for party autonomy in cases of complex financial instruments . . .”* per the Master of the Rolls at para 58 of the *Butters* appeal [2009] EWCA Civ 1160.<sup>11</sup>

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<sup>11</sup> *Id.* ¶¶ 23–24.