



MARKET MAKER'S LEGAL RISK UNENFORCEABILITY OF FINANCIAL DERIVATIVES CONTRACT

By Thejaka Perera

Senior Dealer - DFCC Group Treasurer

1. Introduction

Financial derivatives have been sometimes classified as financial weapons of mass destruction, which carry latent and potentially lethal dangers for the economic system. Prophecy of Sir Julian Hodge the famous Welsh scholar and banker stated "at some time in the future financial derivatives could bring the world's financial system to its knees." In spite of the doomsday remarks made by many on the financial derivatives, the world of finance is kept mesmerized by the capabilities and powers of the financial derivatives.

Sri Lanka is no exception. In recent years the handful of derivative deals struck in Sri Lanka obtained a place in the headlines of the financial mass media. Yet, the derivatives remain an elusive area in the field of banking in Sri Lanka, partly due to the lack of knowledge in this area and mainly due to the risks inherent in the financial derivatives. Legal risk is just one of risks inherent in a financial derivative. Albeit in the presence of a sound and tested legal system but in the absence of a statutory legal infrastructure and the required maturity in the markets can the Sri Lankan legal system support the emerging derivatives market in Sri Lanka?

There have been many a writing and discussion among the Sri Lankan financial and legal intelligentsia on the subject of legal risk inherent in financial derivatives. However the forgoing work attempts to discuss the most common legal risks with a particular emphasis on the risk of invalidation and counterparty termination of the derivatives contract.

2. Common Legal Risks

The legal risk is the risk that the counterparty's performance obligations are legally unenforceable, through:

- a counterparty lacking the power to enter into derivatives transactions (ultra vires)
- transactions breaching regulatory prohibitions (such as gaming and wagering legislation)
- the legal documentation being inadequate or unenforceable in cross-border transactions
- the netting provisions being ineffective under bankruptcy or insolvency laws.
- the counterparty repudiation or refusal to perform on the common law grounds



In the on-exchange market, clearing houses bear all legal risks (other than ultra vires risk, which is borne by the contracting brokers) for all registered transactions. In the OTC (over the counter) market, legal risk can be reduced through use of Master Agreements (which would address most of contract law issues), effective netting rules, methods to deal with the ultra vires problem, and appropriate exemptions from the gaming and wagering legislation.

Whilst the legal risk is given an analysis in the following text it should be recognised that all these risks are not confined to the derivatives market. Also, they should be dealt with to the greatest degree possible by internal market mechanisms and private and self-regulation without restricting the market activities. However, where necessary, these controls should be supported by various regulatory structures, in particular:

- Appropriate clearing or other contract protection arrangements for all on-exchange derivatives markets
- Risk disclosure, “know your client”, “client suitability” and other protections for retail end-users, and
- Legislation to uphold private netting arrangements and introduction of sui generis (unique in its characteristics) or specialised legal regimes.

3. Ultra Vires- (Beyond the Power)

Some entities may be restricted in dealing in derivatives by their charters of incorporation. The enforceability of any derivatives transactions into which they enter could be jeopardised by their lack of power to act as contracting parties. Theoretically, this ultra vires problem can apply to any financial market instrument. However, in practice, it is more likely for trusts (trust deeds) or incorporated bodies (Memorandum and Articles of Association) to place restrictions on derivatives transactions.

The ultra vires risk is unique to counterparties in the OTC derivatives market. In exchange derivatives markets with novation (act of replacing an obligation to perform with a new obligation bearing the features of the same) clearing, this risk is borne by the contracting brokers.

3.1. Ultra Vires in Incorporated Bodies

Almost all of world’s most significant financial entities are incorporated bodies. Unless the charters of incorporation permit it, the obligations undertaken by the entity may not be enforceable in law. However in Sri Lanka under the Companies Act, No. 7 of 2007, the doctrine of ultra vires has been abolished for the companies incorporated under the act.

3.2. Ultra Vires in Trusts

Some of the worlds largest fund managers are trusts. Also the trustees are personally liable for the misuse of the trust fund. There are several problems concerning the capacity of some



trustees to enter into these transactions as the trustee may lack authority to enter into all or some derivatives transactions under the instrument setting up the trust.

3.3. Ultra Vires in Life Insurance Companies

The ultra vires problem may also apply to life insurance companies. OTC derivatives counterparty to an insurance company should obtain evidence that the derivatives transaction is for the purposes of the business of the insurance company's statutory fund. This is necessary to ensure that the fund is available to meet the life company's liabilities under that transaction.

3.4. Ultra Vires in Other entities

The ultra vires doctrine may affect other entities such as friendly societies, building societies and government entities.

There are several regulatory policy suggestions in formulating laws for dealing with the conflicting interests of OTC derivatives market participants with respect to the doctrine of ultra vires.

Also it should be reiterated that any form of regulation should encourage smooth market functionality and wherever possible the markets should be self regulated.

4. Suggested Regulatory Policies

- a) The validity of any OTC derivatives transaction and its enforceability against entity assets cannot be challenged on the basis of lack of capacity.
- b) Unless a trust deed provides expressly to the contrary:
 - The trustee is presumed to have authority to enter into any OTC derivatives transaction
 - The exercise of that authority is taken to constitute a proper exercise of power by the trustee [unless the counterparty has actual knowledge to the contrary]
 - The trustee has an unqualified right of indemnification out of the trust fund in respect of any transaction falling within the presumption.
- c) Law would provide that any entity that has a prohibition, or restriction, on its capacity to enter into derivatives should identify itself in a public register. There would be a presumption in law that any entity not on that register has full power to enter into OTC derivatives contracts.
- d) Law would leave it to the contracting parties to deal with this matter through their own arrangements.



However even in the absence of clear-cut laws, the derivatives market is moving ahead. The banks in Sri Lanka seem to out do each other by executing derivative deals, which are announced through headline banners. Often the “Treasurer” of the end user counterparty usually executes most of the derivatives transactions. It is always possible for the end user to claim that the “Treasurer” carried out the transaction without proper authority.

As a precaution the bank must always take care to obtain the updated evidence as to the authorized representatives who are expressly authorized to transact on behalf of the end user counterparties. This evidence should be executed under the seal of the corporate as per the charter of incorporation of the end user counterparty.

5. Illegality of Derivative Contracts Due to Gaming and Wagering Legislation

The primary purpose of gaming and wagering legislation is to regulate various forms of gambling and betting. However the performance of a derivative contract depends on the occurrence of a future event and a party to the contract may not have any interest in the underlying subject matter of the contract. Thus, this legislation could also affect the validity of some derivatives transactions.

- On-exchange Markets:- Currently, all transactions on futures exchanges and option contracts on securities exchanges are exempt from gaming and wagering legislation.
- OTC Markets:- Doubts have been expressed from time to time as to whether financial contracts such as currency and interest rate swaps may be invalidated by gaming and betting laws.

It is useful to examine the legislative exemptions given to financial derivatives in jurisdictions where there are active derivative markets.

- United Kingdom

The Financial Services and Markets Act of 2000 (FSMA) governs the financial derivatives market. Under section 412 of FSMA Gaming and wagering legislation does not apply to transactions regulated by the FSMA with certain provisos.

- USA

State anti-wagering and bucketshop laws do not apply to contracts traded on futures exchanges. The securities legislation specifically exempts options traded in accordance with the rules of a self-regulatory organisation from State gaming, wagering and bucketshop laws.¹ The State laws may, however, apply to OTC derivatives.

¹ Securities Exchange Act s 28(a).



- Sri Lanka

Sri Lanka has been a follower of the English laws and precedents. Although the English system evolved to develop distinctions between games of chance and game of skill and to make exemptions on certain financial transactions, the Sri Lankan system has not.

According to the eminent Sri Lankan jurist Professor C G Weeramantri quote “ some such statutory provision would be a welcome sign to our law on the matter” unquote - of gaming and wagering.² However it is interesting to note that the transactions resembling the features of financial derivatives has been subjected to judicial review in Sri Lanka as early as 1939. Two leading cases are Erahim Lebbe Marrikar v. Arulappa Pillai (1939 16 CLW 25 PC) and Bartlet & Co v. Lebbe Marikar (1941 NLR 225 PC at 228).

In a commodity forward contract, the mere fact that one party performs the contract by paying the difference between the contract price and the market price on the due date does not make the contract a wagering contract.³ But there must be sufficient proof that it was a term of the arrangement between the parties that commodity purchased or sold was not to be delivered under the forward contract but that the contracts were to result merely in the payment of the difference.⁴

It was held that in order to establish the existence of a bet it is necessary to prove “that the contractual documents are a cloak and neither party intended them to have any effective legal operation”⁵. However a derivative contract if proved to have been executed for legitimate commercial purposes will undoubtedly be allowed to operate by the law.

6. Sovereign Immunity (Particularly for Cross-Border Transactions)

There is always the risk that a defaulting party to a cross-border derivatives transaction may take defence under sovereign immunity. This issue has to be addressed through international conventions and multilateral trade agreements. However, any counterparty that successfully claims this defence and the jurisdiction that allows this defence will have to face the serious consequence of market isolation.

Furthermore, a large fraction of derivatives volume (positions) is in the inter-dealer market (Who cannot afford to face market isolation) and non-financial end-users account for only a small fraction of transactions.⁶

² Law of Contracts – Vol 1 – pp 391 C G Weeramantri

³ Law of Contracts – Vol 1 – pp 395- C G Weeramantri

⁴ Erahim Lebbe Marrikar v. Arulappa Pillai (1939) 16 CLW 25 PC

⁵ Bartlet & Co v. Lebbe Marikar (1941) NLR 225 PC at 228

⁶ The Bank for International Settlements in its survey of OTC derivatives market activity (BIS, 2003) estimated total market value of gross OTC interest rate derivatives positions at USD 4,328 billion in 2003- H2 (interest rate derivatives account for 62 percent of all derivatives by market value). Of these, USD 1,872 billion (43 percent) were inter-dealer positions and only USD 687 billion (16 percent) were with non financial customers. www.bis.org



7. Harmonizing Sri Lankan Laws with Different Jurisdictions

While cross-jurisdictional disparities remain in the legal treatment for most contracts (Specially with respect to netting), there is widespread consistency in the treatment of derivative contracts in many jurisdictions. This argument has been made by regulators and industry groups⁷ and has been cited by legislatures when legislation has been passed. Any reform of laws in Sri Lanka must take into account comparable overseas laws and practices, including the nature and functions of derivatives regulation in other major jurisdictions, in particular the UK and the USA.

This international legal harmonization is required in the following areas.

- Contract protection controls
- Prudential regulation of OTC market-makers
- Risk disclosure
- “Know your client” requirements
- Protecting clients’ assets
- Record-keeping
- Discretionary accounts
- Derivatives activity disclosure
- Marking derivatives to market
- Supervisory disclosure, and
- Global regulatory and information-sharing arrangements

8. Unenforceability of Netting & Close Out Rights

Close-out and netting consist of two separate but related rights, often combined into a single contract.

- *Close-out*: The right of a counter party to unilaterally terminate contracts under certain specified conditions.
- *Netting*: The right to offset amounts due at termination of individual contracts between the same counterparties when determining the final obligation.

In the U.S., as in most countries with well-developed securities markets, derivative securities enjoy special protections under insolvency resolution laws. Most creditors are “stayed” from enforcing their rights while a firm is in bankruptcy. However, many derivatives contracts are exempt from these stays.

⁷ International Swap and Derivatives Association (ISDA), a trade group that coordinates industry documentation practices and lobbies for legislative changes to support the enforceability of those contracts.



Furthermore, derivatives enjoy netting and close-out privileges, which are not always available to most other creditors. By combining two offsetting contracts under the same master agreement the counter party would have to manage only the net position.

In the U.S. and some other jurisdictions, the governing contracts typically contain terms stipulating the actions to be taken in the event of default⁸. In other jurisdictions, such as the UK, a common law netting right exists. In Sri Lanka it was established by the case *De Costa V Bank of Ceylon*⁹, that law concerning the “Ordinary course of banking business” should be English Common Law and not Roman Dutch Law. If the counterparty to a derivate transaction is a bank, it could be argued that the transaction fall within ambit of “the ordinary course of banking business”.

The ordinary banking activities and practices has not been clearly defined. The eminent banking law scholar Dr Wickrema Weerasooria¹⁰ has stressed the need to have a clear list of practices and activities that fall under the ambit of banking business. Any future compilation of such a list should definitely include financial derivative transactions as a banking business.

9. Can Derivatives Contracts be Classified as Insurance Contracts?

Insurance contracts other than life policies are contracts of indemnity (contract shall limit value to the loss), whereas the financial derivatives are not always contracts of indemnity. Also derivatives differ from insurance in that derivatives do not require one party to suffer an actual loss for payment to be made.

An equivalent to the ‘Insurable interest’ which is the fundamental ingredient of a contract of insurance that means the insured must have interest in the subject matter of the contract, does not appear in a financial derivatives contract (Except in credit derivative contracts). In contrast to insurance contracts, counterparty to a derivatives contract (Except in credit derivative contracts) may not have any interest in the underlying asset and can enter into the derivative contract in pursuance of the profit.

Concepts found in insurance contracts such as “contribution” (in case of many insurers: apportion liability amongst them) and “subrogation” (Insured cannot make a profit from his loss and that for any profit he does make he is accountable to in equity to his insurer), are not found in derivatives contracts.

However a concept similar to the **Uberrimae Fidei** (Utmost good faith) has been imposed on the derivative markets by the regulators under the risk disclosure regulations. The risks associated with the derivatives have to be disclosed specially to the retail participants under these rules. *In*

⁸ A recent example is the acceleration of some \$4 billion of Enron’s debt following its downgrade by rating agencies. The firm could not meet the resulting demand for immediate payment of principal and was forced to file for bankruptcy.

⁹ (1969) 72 NLR 457

¹⁰ APB-Progressive Banker and the Law-13th Anniversary Convention- pp35



these circumstances, it is difficult to interpret a derivatives contract as a contract of insurance. Thus the financial derivatives contracts are exempt from common law obligations and regulatory scope of insurance contracts.

10. Other Laws

Other statutory and common law rules may apply to OTC derivatives market activities. In some instances, OTC market participants may be liable for misrepresentation, negligence or misleading or deceptive conduct in their dealings with clients or counterparties:

10.1. In Contract Law

In contract law the factors invalidating a contract are error or mistake, misrepresentation, duress, undue influence and illegality (Illegality has been addressed above). The most probable grounds that counterparty chooses to challenge a derivative contract or refuses to perform the obligations under the derivative contract would be mistake or misrepresentation¹¹.

Misrepresentation

Misrepresentation is false statement of fact made by one party to another party and has the effect of inducing that party to enter into the contract. This may be used as grounds to invalidate the Contract.

Mistake

A mistake is an incorrect understanding by one or more parties to a contract and this may be used as grounds to invalidate the contract.

Duress and Undue Influence

Duress is the "threat of harm made to compel a person to do something against his or her will or judgment. This means the compulsion under which person acts through fear of personal suffering. The concept of 'economic duress' is also used to vitiate contracts.

Undue influence is an equitable doctrine that involves one person taking advantage of a position of power over another person.

10.2. A Case Study - Proctor and Gamble v. Bankers Trust

Facts: On May 8, 1996, Judge John Feikens issued an order stripping from Procter & Gamble several legal grounds for recovery in its case against Bankers Trust Co. and BT Securities in federal court in Cincinnati, Ohio. In fact, in this ruling Judge Feikens enhanced considerably the strength of P&G's case by **finding that a legal requirement exists that the dealer disclose material information even if there is no fiduciary duty.**

¹¹ Proctor and Gamble v. Bankers Trust – This matter was settled out of court



Judge Feikens noted in his Opinion that “BT claims that P&G owes it over \$200 million.” With a trial date fast approaching, Bankers Trust agreed to settle this claim by receiving the sum of \$35 million. These terms, overwhelmingly favorable to P&G, presumably reflect the well-advised parties’ views as to the relative merits of the case. As such, the settlement can be viewed as recognition of the correctness from the outset of Procter & Gamble’s challenge of these trades.

The Opinion is helpful in that it is the first written holding by a judge in the United States to address the broad range of legal issues challenging the enforceability of swap and swap-related transactions. However, as a judicial precedent, the Opinion has several significant limitations.

- **The Opinion is not binding in any other case** - this Opinion by a single U.S. district judge is not legally binding. In the future other courts will be free to accept or reject Judge Feikens’s reasoning.
- **The decision was not legally tested** - these legal conclusions were not tested on appeal.
- **The choice of substantive law is questionable**-Judge Feikens looked to the contractual choice of New York law in the International Swaps and Derivatives Association (ISDA) agreement and, over P&G’s objection, then applied New York substantive law to decide the validity of these non-contractual claims. Another court elsewhere, applying its own state’s conflict of laws principles, could well limit the ISDA contractual choice of law only to contractual claims.
- **Bankers Trust owed no fiduciary duty to P&G** - After quoting case authority to the effect that in New York no fiduciary relationship can exist where the two parties were acting and contracting at arm’s length or between parties to a business relationship, the court noted that “P&G and BT were in a business relationship”-and therefore no fiduciary duty was owed by BT to P&G.
- **But Bankers Trust owed a duty to disclose material information to P&G** -Judge Feikens found that under New York law the agreement between the parties contained an implied covenant of good faith and fair dealing which, in turn, imposed a duty on Bankers Trust to disclose material information.

10.3. Mitigation of Common Contract Law Risks

The common law risks can be mitigated by the full disclosure of the nature of the transaction and requesting the customer (end user counterparty) to obtain independent advise as to the nature of the risk that is undertaken. Any adviser who gives advice in the course of a fiduciary relationship has a duty of care commensurate with that relationship. Where the relationship between the adviser and client is contractual, a term may be implied that the adviser will use the skill and diligence, which a reasonably competent and careful adviser would exercise.

It should be highlighted that at present Sri Lankan banks are in the practice of requesting customers to obtain independent professional opinions in respect of voluntary waiver of common



law rights. This is evident in the waiver of common law rights of the guarantors.

A similar approach could be adopted by the banks, in respect of customers who deal in derivative transactions. Thus the banks should in addition to the master agreement, request from the end user counter party;

- a risk disclosure statement read agreed and signed by the independent advisor and an authorized representative of the end user counterparty
- a waiver of common law rights (such as *lesio enormis* – undue enrichment) read agreed and signed by the independent counsel and an authorized representative of the end user counterparty.

11. Special Legislation

In limited circumstances, intermediaries (Brokers) may also have a common law duty to advise their clients of particular features of derivatives transactions or material changes to these derivatives transactions that may affect the client's financial position or obligations.¹²

11.1. Protections Offered to End User Counterparties by Regulators in Overseas Markets

Risk disclosure: All overseas jurisdictions have risk disclosure requirements for on-exchange derivative transactions. Australia has risk disclosure requirements for futures contracts and some securities. Australia, Canada and the US apply risk disclosure requirements to all participants whereas the UK requirements only apply to the least sophisticated clients.

Suitability requirements: The UK and Canada have a "know your client" rule, which includes a positive obligation to seek information from a client. In the UK, this rule only applies to transactions for the least sophisticated clients. Australia and the US have suitability requirements for securities, but not for futures or derivatives.

Most of these regulations award following protections to the investor:

Private customers have the following protections:

- exchange-trading requirement (no contingent liability transactions except currency risk hedges to be off-exchange)
- suitability requirements
- risk disclosure
- charges disclosure
- advertising controls

¹² *Oabate Pty Ltd v Nichols Commodities Pty Ltd* (November 1983, Supreme Court of NSW). The nature and extent of this duty should be determined by the circumstances of each case. Relevant factors would include:

- the volatility of the market for the commodity in question
- the client's trading experience



- transaction reporting obligations
- confirmation notes, difference accounts and valuations requirements
- communications controls (not misleading and presented fairly)
- Client funds segregation requirements.

Non-private customers have the following protections:

- suitability requirements (discretionary transactions)
- advertising controls
- transaction reporting obligations
- confirmation notes and difference accounts and valuations
- communications controls (not misleading)
- client funds segregation requirements (some non-private customers).

Non-customers (market counterparties) have more limited protections, namely:

- advertising controls
- transaction reporting obligations
- communications controls (not misleading)
- client funds segregation requirements

The protection against unsolicited calls applies to various “private investors”. Compensation fund claims are limited to eligible investors (excluding professional investors and business investors). All firms must comply with the financial supervision requirements.

12. Appropriateness of the Counterparty and the Suitability Test

A bank acting as a derivatives dealer should implement measures in order to assure that its counterparties (end users) have the legal and regulatory authority to engage in the contemplated activities and that the terms of any contract governing the bank’s derivatives activities with a user (counterparty) are legally sound. A bank acting as a dealer should also maintain documentation in the file that indicates if a user requested a transaction that a bank believed was inappropriate for that user given its level of financial sophistication. Although there is currently no legal bar against executing a derivatives transaction for any user, given the risks of liability, the bank should retain documentation that details the individuals involved in the discussions (both bank and user).

Banks should consider obtaining an opinion of counsel in the jurisdiction of any foreign counterparties to support bilateral netting agreements for purpose of calculating credit exposure for transactions with such counterparties. The legal status of netting for the users in some foreign countries is uncertain, and banks should obtain legal assurance that netting agreements will be valid in the event of default or bankruptcy.



12.1. Suitability and Appropriateness Policy

The objective of this policy is to protect the bank against the credit, reputation and litigation risks that may arise from a user's inadequate understanding of the nature and risks of the derivatives transaction. (As stated in Reserve Bank of India Circular on Draft comprehensive Guidelines on Derivatives)¹³

Before undertaking a derivative transaction with or selling a structured derivative product to a user, a bank should:

- a) document how the pricing has been done and how periodic valuations will be done. In the case of structured products, this document should contain a dissection of the product into its generic components to demonstrate its permissibility, on the one hand, and to explain its price and periodic valuation principles, on the other. This document should be shared with the user concerned.
- b) analyse the expected impact of the proposed derivatives transaction on the user;
- c) ascertain whether a users has the appropriate authority to enter into derivative transactions and whether there are any limitations on the use of specific types of derivatives in terms of the board memorandum/policy of the former, level at which derivative transactions are approved, the involvement of senior management in decision-making and monitoring derivatives activity undertaken by it,,
- d) identify whether the proposed transaction is consistent with the user's policies and procedures with respect to derivatives transactions, as they are known to the bank,
- e) ensure that the terms of the contract are clear and assess whether the user is capable of understanding the terms of the contract and of fulfilling its obligations under the contract,
- f) inform the customer of its opinion, where the bank considers that a proposed derivatives transaction is inappropriate for a customer. If the customer nonetheless wishes to proceed, the bank should document its analysis and its discussions with the customer in its files to lessen the chances of litigation in case the transaction proves unprofitable to the customer. The approval for such transactions should be escalated to next higher level of authority at the bank as well as the user,
- g) ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and payouts in quantitative terms under different combination of underlying market variables such as interest rates and currency rates, etc., assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement.

¹³ http://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=457



- h) guard against the possibility of any misunderstandings. All significant communications between the bank and user should be in writing or recorded in meeting notes.
- i) ensure to undertake transactions at prevailing market rates and to avoid transactions that could result in acceleration/deferment of gains or losses,
- j) should establish internal procedures for handling customer disputes and complaints. They should be investigated thoroughly and handled fairly and promptly. Senior Management and the Compliance Department/Officer should be informed of all customer disputes and complaints at a regular interval.

It may also be noted that in cases where a bank is dealing with a user directly or through another bank with the latter as an intermediary, it must still ensure a 'Customer Appropriateness and Suitability' review of the intermediary bank as also the end user. The forward contracts are in use for long time and are well understood by the market participants. Nevertheless, even for plain forward contracts, it is advisable that banks, in their own interest, may explain to the customer, the risk implications of the product.

13. Master Agreements

Globally recognized International Swaps and Derivatives Association (ISDA) and other Master Agreements are extensively used in the OTC derivatives market. These Master Agreements were originally developed in the USA and Europe in response to concerns about the enforceability of contractual netting arrangements, and to harmonise and expedite the documentation process in OTC markets. Master Agreements are continually evolving for existing and new derivatives products.

The extensive use of International Swaps and Derivatives Association (ISDA) agreement has made its place in the derivatives market as the standard documentation.

Lawyers who advise Sri Lanka's financial market participants are quite familiar with the ISDA Documentation. However a proper judicial test has not taken place in Sri Lanka.

14. Conclusion

The threat of invalidation of the contract may even come from the regulator. The board and senior management should make sure that all necessary regulatory approvals have been obtained, that adequate operational procedures and risk control systems are in place. Such derivative activities should be consistent with a bank's overall risk management policy and business plan. Even if a bank intends to invest in derivatives of a type and in a manner that does not require a formal application to its regulators, new types of derivative activities that present potential legal or business issues should be discussed with the appropriate regulators before implementation.



Also banks must continue to be vigilant as regulatory and legal standards in this area continue to evolve.

This article is a mere attempt taken at discussing the most common legal issues that a banker might encounter in enforcing a derivatives contract. The law of contract is a vast area of law: hence this is not an exhaustive and comprehensive text analyzing all legal aspects of financial derivatives.