Annexure 2

GLOBAL FINANCIAL MARKET/GLOBAL SECURITIES:

Global securities division of IB includes trading in equity and debts instruments in the capital markets. Trading in securities involve “intermediation”, providing “liquidity and taking risks”. The terminology “intermediation” describes the role of an investment banker in primary equity and debt market. However, in secondary market of financial instruments, currency and commodity markets, the IB’s role is mainly of “liquidity provider” and “risk taker”. An IB acts as a liquidity provider when it is willing to put a price on its client’s trade without having a counter trade in place. For example, if the client wants to sale a specific security, the bank will put a price on the security irrespective of the fact that the bank may not be able to sale the security immediately. While doing so, the IB assume risk that the price of the financial product moves before it is able to close/hedge its position. A bank provides liquidity sometimes via its client base, but often it is via exchanges, inter-bank brokers and electronic trading systems. Clients of the bank participates in financial or commodity market to invest, speculate or manage its financial risks. IB’s clients may be an issuer of capital (wants to raise money in primary market) or investor (wants to trade in various types of financial instruments securities in secondary market or wants to trade currencies or commodities) or may be a risk manager for hedging financial risk. When a client wishes to sale its stocks, it may approach its IB. The IB then has following options:

i. The IB will quote a price to its clients without any guarantee that it would be able to close its position. The IB then will close out its position by doing a counter trade with another IB through central market platform or the IB may do a counter trade with its own clients who may be willing to buy the stock. This is a risk-taking function and is sometime referred as “principal trade”.
ii. The IB will first find a client for a counter trade and then quote the price to its clients for a trade. This is a back to back trade and falls in the category of “broking”

FINANCIAL INSTRUMENTS

Banks deals in numerous types of financial products. Few of the products are plain vanilla and standard type and few may be highly innovative, tailored, exotic and structured for specific need of a client. Generally, financial instruments can be broadly classified as Equity and Fixed Income. While equity can be further subdivided in Cash and derivatives, Fixed Income can be sub classified as cash debts/loans, Rates products (repos, derivatives, exotics etc), forex products, Global Credit products (Collateralised debt obligations, Credit Default Swap etc), Securitised products (mortgage backed security, several other assets backed securities etc). This is merely a broad classification of types of products in which a bank deal. In actual practice there may be hundreds of types of instruments which may be structured and traded by the bank. The risk profile and risk shifting feature inherent in a financial instrument differ based on each specific types of instrument and therefore, a detailed analysis of the instruments, associated cash flows, specific risks analysis is a prerequisite for making any meaningful transfer pricing analysis of intra-group services, trade and capital for a multinational Investment Bank company.

The relative contribution of a particular entity/various types of people, mentioned in part 1 of the series, in the entire supply chain of a particular revenue source depends upon several factors including the nature of financial instrument, nature of trade, viz, plain broking or proprietary trading etc. Therefore, there cannot be one straight formula for determining the ALP of intra-group transaction within the IB. For example, in an exchange traded standardised instrument the role of a trader may not be as crucial as that of relationship sales person as against trading in a bilateral Over the Counter credit derivatives.

GLOBAL TRADING/DEALING OF FINANCIAL INSTRUMENTS

Globally financials markets have become very integrated as result of advent of modern technologies, financial innovations and changes in regulatory landscapes. Several multinational financial institutions trade financial instruments round the clock under broad guidance from central management. Global trading, as the name suggest, is characterised by trading of “positions” (long position/short position) on a global level by the IB group. The level of global trading depends on the type of instruments. For example, global trading is usually seen in derivatives and foreign exchange while equities are generally traded within the boundary of a country.

Global trading operations of an integrated IB are characterized by the centralized management of risk and personnel. The global trading business is managed as one global position for purposes of risk management. In global trading, one book is maintained and the trading authority for that book is "passed" from trading location to trading location at the close of each trading day.

The complexities and challenges in pricing the international transactions within the investment banking group may be gauged from the fact that the US Regulation[1] on global dealing was issued way back in 1998 but still has not been finalised. Further OECD, while issuing its guidance on profit attribution[2], decided to deal with profit attribution to a Permanent Establishment in respect of global dealing in a separately. In a global dealing operation, the company's inventory of a particular security, or its position in a particular instrument, resides in one legal entity, while the individuals responsible for managing the inventory or position reside in a variety of foreign entities (or branches).

The positions in a book are traded from one location to another location by traders in their respective locations. In global trading operations, ***a sales person*** connects with the clients and advises them as to how to manage the risks (price risks, interest rate fluctuation risk, forex fluctuation risk associated with their financial assets and liabilities). ***The trader*** quotes the price and manages the risks in respect of the financial instruments being traded. The role of trader in the value chain may vary in a continuum from a relatively simple role of executing customer's order to coordinating with structurer for developing and structuring complex financial instruments and its trading. The ***central risk management team*** sets the trading limits for each book and for each trader to manage the risks. Then there is the entity which ***provides capital***. Generally, the entity that provide capital may also records revenue. The entity providing capital can also house the central risk management team (this is particularly important from the perspective of ensuring non-routine returns for capital providing entity to be in line with guidance for capital as provided in Action 8-10). ***The support function*** performs various wide-ranging activities that assist the first three functions; including technology and information systems development and provision, credit analysis of customers and counterparties, accounting, contract administration, and coordination.

RISKS IN GLOBAL TRADING BUSINESS

Market Risk:

Market risk refers to the volatility of market price of the instruments, rate of interest, credit risk of issuer company, volatility of indices, foreign currency rate etc. Market risk management includes decision regarding quoting a price, decision to accept a trading position and managing the risks arising from taking a trading position. Market risk is mitigated by taking various types of hedging transactions. Traders are responsible for managing the market risk arising from an open position on day to day basis. Since the entity providing capital ultimately bear the consequences of risk crystallization, they also assume the market risk.

Here a relevant question comes up for consideration in terms of guidance regarding risk allocation provided in Action Plan 8-10, adopted in OECD TP Guidelines, 2017. In terms of revised guidance, contractual allocation of risks may not be sufficient to determine which entity assume the risks. An entity assuming risk should have the authority and should actually exercise control over the risk and should have the financial capacity to assume risks. The issue of risk/capital in the context of global dealing may arise when the capital is provided by an entity which is separate from the entity which employs traders who manages the day to day market risk. The moot issue is, whether an entity managing risk management functions (traders) be considered to have assumed risk when it does not have capital and can the entity providing capital be considered to have assumed risk when it does not have traders to manage the risk? Another closely related issue is the role of capital in case of global trading of financial instruments. Is a capital provider in global dealing entitled for residual profit in global dealing or merely a return (risk free or at the most risk adjusted cost of capital) on capital employed. In terms of OECD TP Guidelines 2017 risk management and risk assumptions are not the same thing. Risk assumption means taking on the upside and downside consequences of the risk with the result that the party

[1] US proposed Regulation 1.482-8, issued on 2 March 1998

[2] Report on the Attribution of profit to PE issued on 22 July 2010

assuming a risk will also bear the financial and other consequences if the risk materialises. Risk management comprises three elements: (i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function, (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision-making function, and (iii) the capability to mitigate risk, that is the capability to take measures that affect risk outcomes, together with the actual performance of such risk mitigation. Control over risk involves the first two elements of risk management functions listed above. Practically it is seen that in IB organises its global dealing businesses in a manner where although trader manages the market risk, central risk management team housed in capital providing entity employs senior level employees controlling the credit risk by setting various risk limits etc. Further, the role of capital in IB is not exactly same as other commercial organisation in a sense that extent of capital employed is a measure of risk assumed. Please refer Risk Management Functions explained in part 1of this series of article. Considering these, it may be concluded that capital provision is considered as non-routine functions for global dealing business of IB.

Counterparty Credit Risk:

Counterparty credit risk refers to the risk of failure by the counter party of the contract to honour the terms and conditions of the contract (read contract as “derivative contract” for a better understanding). The counterparty credit risk generally arises while trading bilateral OTC instruments. In the exchange cleared business, stock exchange mitigates the counter party credit risk by ensuring a level of margin money, collateral and enforcing its rights it enjoys in case of default by any of the trading participants. The risk of counterparty risk arises as a result of decision to enter into trade with a specific counterparty. This decision is generally taken by the trader but the management of this counterparty risk may be performed by a separate risk management team. This separate risk management team may be housed as per the overall organisational structure decided by IB group. In many cases it is housed in capital provider/booking entity.

Compliance and regulatory risk:

Compliance and regulatory risk arises as a result of failure to adhere to the regulatory framework prevailing in the country. Such a regulatory framework may impose significant fines and penalties for not complying with rules and regulations. In respect of global trading, booking entity is legally bound to suffer the consequences of the risk arising in the booking entity as a result of position taken by trading entity. Further, trading entity also is required to comply with regulatory norms as prevalent in the country where the trading entity is incorporated.

Operational risk:

Operational risk generally arises as a result of failure in internal control, processes and corporate governance. Most of the frauds or timely detection of frauds in the banking systems are the result inadequate or lack of internal control and processes.