



October 8, 2020
001/2020-VOP-BSM

EXTERNAL COMMUNICATION

Re: **Clarifications about Trading Securities Outside of the Markets Operated by B3**

Trading in securities outside of organized markets aims to meet investors' demand for securities that are not listed on an exchange, being known to the market as OTC desk trading.

Included among this demand are securities deriving from other securities which are listed and traded in the markets operated by B3 (for example, structured transactions, deltas and/or strategies), known hereafter as "combinations."

This External Communication consolidates B3 and BSM's understanding of the subject, which has been previously set out in workshops, seminars and decisions by the BSM Supervisory Board, all of which have been published on the BSM website. BSM has also covered the issue in specific meetings with the Participants.

In this regard, the present External Communication will set out: (1) the definition of OTC desk trading; (2) applicable regulations; (3) OTC desk trading conditions (4) examples (non-exhaustive) of OTC desk trading usage compatible with the regulations; (5) execution of transactions at B3 resulting from OTC desk trading of combinations that derive from listed securities; (6) example of an irregular transaction; (7) the difference between OTC desk trading and looking for a counter order and; (8) further information.

1. Definition of OTC desk trading

1.1. The market uses the term OTC desk trading to designate trading outside of the markets operated by B3, of securities¹, whereby:

¹ Securities are understood as being the assets as foreseen in art. 2 of Law 6.385/76.



001/2020-VOP-BSM

- a) intermediaries participate through their proprietary account or on behalf of clients and/or investors and, cumulatively,
- b) there is competitive interaction between buy and sell orders to define the quantity and price of a security.

2. Applicable regulations

2.1. Securities accepted for trading on B3's² organized markets are those traded through buy and sell orders entered into the trading system operated by B3, hereafter named "listed securities".

2.2. Combinations that derive from two or more listed securities are also considered to be listed securities, if these combinations are available for trading in the markets operated by B3. In this case, the trading of these securities also occurs through buy and sell orders entered to the trading systems operated by B3.

2.3. There are securities, derived or not from listed securities, that are not available for trading in the markets operated by B3. In this case the buy and sell orders can be OTC desk traded, performing an important role of granting liquidity for trading in securities that are not listed on B3 and thus being complementary and an accessory to trading in the markets operated by B3.

2.4. On the other hand, listed securities, that is, those traded via buy and sell orders entered to the systems operated by B3, cannot be OTC desk traded, according to article 59 of CVM instruction 461/07, which establishes that "Trading [is prohibited] outside the organized market of securities admitted therein(...)".

2.5. Table 1 below outlines the situations in which securities may be traded or not in OTC desk trading:

² According to article 57, paragraph 1 of CVM Instruction 461/07, securities accepted for trading on the organized exchange markets of B3 are understood as being registered by CVM and accepted for trading in B3's organized markets, as set forth in the Regulamento para Listagem de Emissores e Admissão à Negociação de Valores Mobiliários

001/2020-VOP-BSM

Table 1 – Outline of situations subject, or not, to OTC desk trading

Assets	OTC desk trading possibility
Security listed for trading on B3	Cannot be OTC desk traded
Security not listed for trading on B3	Can be OTC desk traded
Combination of listed securities and this combination is listed for trading on B3	Cannot be OTC desk traded
Combination of listed securities and this combination is not listed for trading on B3	Can be OTC desk traded
Combination comprised of a security listed for trading on B3 and a security not listed for trading on B3, or government bonds	Can be OTC desk traded



001/2020-VOP-BSM

2.6. Please note that art. 20, III³ and art. 32, I⁴ of CVM Instruction 505/11 assign to the intermediary responsibility for informing its clients about the regular practice of securities trading, as described in Table 1.

3. OTC desk trading conditions

3.1. OTC desk trading is allowed in unlisted securities, including combinations of listed securities unavailable for trading in the B3 systems, as described in Table 1.

3.2. The brokers that take part in OTC desk trading must comply with the rules of CVM Instruction 505/11, in particular those regarding recording orders, treatment of conflicts of interests and meeting best execution conditions.

4. Examples (not exhaustive) of OTC desk trading usage compatible with the regulations

4.1. Based on the understandings contained in items 2.1, 2.2 and 2.3, the following combinations exemplify regular OTC desk trading usage:

- a) Yield curve: One-Day Interbank Deposit Futures Contract (DI1), Futures Contract Referencing the Average Rate for One-Day Repurchase Agreements (OC1), ID x US Dollar Spread Futures Contract (DDI), U.S. Dollar Spread Futures Contract Referencing One-Day Repurchase Agreements (DCO). Excepting the combinations provided by B3 with FRA on ID x US Dollar Spread (FRC), Forward Rate Agreement on One-Day Repurchase Agreements x US Dollar Spread (FRO), Forward Rate Volatility Structured Transaction (VF1 to VF9) and Interbank Deposit Spot Rate Volatility (VID) Structured Transactions, which cannot be traded off of B3;

³ “Art. 20. The broker must establish rules, procedures and internal controls on the execution of orders in order to: (...) III – ensure that customers are informed about the different markets where the securities specified in the order can be negotiated.”

⁴ “Art. 32. The broker must: I – Ensure the integrity and regulate the operation of the market, including the selection of customers and the requirement of collateral;”



001/2020-VOP-BSM

- b) Ibovespa and IBrX-50 volatility curve: combinations between the cash portfolio of the BOVESPA Index (Ibovespa), Ibovespa Futures Contract (IND) and Options on Ibovespa; or combinations between the cash portfolio, Brazil Index 50 Futures Contract (BRI) and Options on Brazil Index 50 (IBrX-50), always with a minimum combination of two contracts;
- c) Transactions with U.S. Dollar: minimum combination of two contracts between spot U.S. Dollar and U.S. Dollar Futures Contract (DOL) or Currency Futures (in USD or BRL) and the U.S. Dollar Futures Contract (DOL). Except for Forward Points on US Dollar Futures (FRP) and US Dollar Volatility Transaction (VTC);
- d) Strategies comprised of listed options: specific combinations of listed options, such as bull spread, bear spread, long butterfly, short butterfly and strangle;
- e) Transactions with interest-linked government bonds: combination of government bond with a One-Day Interbank Deposit Futures Contract.

4.2. Pursuant to the above explanations, all securities or combinations made available for trading in the B3 system, as of the publication of this External Communication, cannot be OTC desk traded.



001/2020-VOP-BSM

5. Execution of transactions at B3 resulting from OTC desk trading of combinations that derive from listed securities

5.1. In OTC desk trading, combinations trading takes place through designating the price and quantity of the combination and not through the price and quantity of the listed securities that are components of the combination, hereafter named "legs".

5.2. Based on the definition of the price and quantity of the combination in OTC desk trading, the trader will execute the legs in the organized market, complying with the market conditions and price tunnel rules at B3.

5.3. As the trading price of the combination in OTC desk trading may be different to the sum of the strike prices of the combination's legs in B3's organized market, it is important that brokers alert their clients to the fact that OTC desk trading of the price and quantity of the combination does not guarantee execution of the legs on B3 at prices and quantities which, in total, reach the prices and quantities of the combination in OTC desk trading.

5.4. In this case, the Participant must comply with the organized market's trading rules and not execute trades that entail the creation of artificial conditions of supply, demand or price of securities, pursuant to CVM Instruction 8/79, subparagraphs I and II, item (a).

5.5. An example is shown below of order entry and execution of a trade, performed in OTC desk trading, in the B3 trading systems to affect the prices of listed securities, resulting from combination trading during OTC desk trading.

6. Example of an irregular transaction

6.1. The following is an example of trading an unlisted combination, derived from listed securities. Therefore, trading of the combination is allowed in OTC desk trading.

6.2. Trading the combination in OTC desk trading generated prices and legs that were different to the permitted prices for cross orders in the market operated by B3 (outside of the spread), according to B3's operating rules.

6.3. Upon execution at B3 of the cross order of the combination's price, the sum of the prices of the combination traded in OTC desk trading did not correspond to the market price of the combination's legs, in this example making its trading unviable as transactions must respect all of B3's trading rules.

6.4. The irregularity, in this case, consists of money passes in the exchange market operated by B3 (a fictitious exchange trade to transfer resources among parties) to obtain the OTC desk trading price, which was incompatible with the price of the leg traded in the exchange market operated by B3.

6.5. In this way, the price of executing the legs on B3's market, added to the value transferred in the money pass, corresponds to the price defined in the OTC desk trading. And as referred to above, the prices of the combination's legs in OTC desk trading were not tradable in the markets operated by B3, as they were incompatible with B3's trading rules.

001/2020-VOP-BSM

6.6. Tables 2 and 3 represent an unlisted combination, derived from listed security values, traded in OTC desk trading between Client A and Client B.

Table 2 – Example of a strategy⁵ in OTC desk trading

Strategy	Client	Side	Put option	Call option	Total of Premiums (R\$) (a)	Quantity (b)	Financial (R\$) (a x b x 50)
Straddle 1	Client A	S	DOLZGF5	DOLZG95	102.00	300	1,530,000
	Client B	B					-1,530,000
Straddle 2	Client A	S	DOLZG87	DOLZGD7	95.00	300	1,425,000
	Client B	BA					-1,425,000
					Financial Total	Client A	2,955,000
						Client B	-2,955,000

Source: B3

6.7. Upon execution of the trade in the organized market, the sum of available prices of the combination's legs did not reflect the price of the combination traded in OTC desk trading.

6.8. In this case, the Participant executed the legs in accordance with the prices available in the organized market, as set out in Table 3 below:

⁵ Option premium: in Brazilian Reals per USD1,000, each option refers to a US Dollar-Brazilian Reals exchange rate, whose size is USD50,000.

Table 3 – Example of a strategy in organized market trading

Strategy	Client	Side	Put option	Call option	Total of the Premiums (R\$) (a)	Quantity (b)	Financial (R\$) (a x b x 50)
Straddle 1	Client A	S	DOLZGF5	DOLZG95	111,00	300	1,665,000
	Client B	B					-1,665,000
Straddle 2	Client A	S	DOLZG87	DOLZGD7	100,00	300	1,500,000
	Client B	B					-1,500,000
					Financial Total	Client A	3,165,000
						Client B	-3,165,000

Source: B3

6.9. As a result of execution of a transaction in an organized market at a different price to that traded in OTC desk trading, Tables 2 and 3 show a financial difference of BRL 210,000.00, demonstrated in Table 4.

Table 4 – Example of fictitious transactions to compensate a financial difference of BRL R\$210,000.00

Qtd.	Price	Buyer		Seller	
		Client	Settlement	Client	Settlement
1,050	2,555.00	A	614,775.00	B	-614,775.00
1,050	2,551.00	B	824,775.00	A	-824,775.00
Financial compensation					Client A -210,000.00
					Client B 210,000.00

Source: B3

6.10. The Participant executed a day trade to compensate the difference of BRL 210,000.00, which was characterized as execution of a fictitious transaction on the organized market, as set out in Table 4.

6.11. Therefore, in the example given, the Participant performed an irregularity when executing a fictitious transaction to compensate the financial difference resulting from the execution of a transaction in the organized market at a different price to that in OTC desk trading.

001/2020-VOP-BSM

7. The difference between OTC desk trading and looking for a counter order

7.1. The intermediary's search for a counter order (buy or sell) outside of B3's trading system (including via proprietary account), for a security listed on B3, without competitive interaction between bids and asks, is not considered OTC desk trading.

7.2. The search for a counter order, including via proprietary account, for the transaction occurs when the intermediary:

- a) receives a buy or sell order equal to or greater, in line with the cross-order parameters defined by B3;
- b) seeks one or more counter orders for the transaction, without competitive interaction between the counter orders of the contacted parties;
- c) executes one or more trades via cross orders, in compliance with the rules defined by B3.

7.3. Seeking a counter order (buy or sell) is a regular practice, as long as the intermediary complies with the rules set out in CVM Instruction 505/11, in particular those regarding conflict of interests and best execution, and B3's trading rules.

8. Further information

8.1. The CVM validated the guidance of this External Communication via Letter 100/2020/CVM/SMI/GMA-2, dated September 30, 30/09/2020⁶.

8.2. Further information about this communication is available by telephone on +55 11 2565-6871/5315/6074.

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⁶ Attached letters BSM/DAR-3334/2020 and 100/2020/CVM/SMI/GMA-2. Item 3.2 of the present letter already encompasses the enhancement mentioned by CVM.