



International Swaps and Derivatives Association, Inc.

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9th October, 1998

Ms. Tipsuda Thavaramara
Director
Office of Market Supervision
Office of the Securities and Exchange Commission
16 Floor Diethelm Building Tower B
93/1 Wireless Rd., Pathumwan
Bangkok 10330
Thailand

Dear Madam,

The Derivatives Market Act

The International Swaps and Derivatives Association, Inc. ("ISDA") is pleased to submit this comment letter to the Securities and Exchange Commission of the Kingdom of Thailand (the "SEC") in response to its publication of the revised draft of the Derivatives Market Act (the "Act"). ISDA is sending this letter as a result of your meeting with Quentin Hills, Co-Chair of ISDA's Hong Kong and South-East Asia Regional Committee in July, 1998 and as a follow up to ISDA's letter of May 1, 1997 commenting on an earlier draft of the Act and your response of December, 1997 to that letter attaching the revised draft of the Act.

ISDA is an international organisation whose membership comprises over 350 of the world's largest commercial, merchant and investment banks, corporations, governmental entities and other institutions. ISDA's members represent a broad cross-section of the institutions that act as dealers and end-users of privately negotiated derivatives transactions, both in Thailand and world-wide. A recent list of ISDA's members is attached hereto as Annex A. Additional information about ISDA and its activities can be found on the Internet at www.isda.org.

At your meeting with Quentin Hills you asked that ISDA submit further comments on Chapter 9 of the draft Act and in particular the requirement that any forecasts provided by counterparties should not be misleading. ISDA is very pleased to have been invited to give further comments on Chapter 9.

ISDA would also be very grateful to be allowed to comment on some of the revisions to the draft Act. ISDA is pleased that the SEC agrees that regulations to protect retail clients should not be applied to an institutional market in such a way that would hinder market development. ISDA is pleased that its letter of 1st May, 1997 was helpful to the SEC in revising the draft Act to achieve this aim. ISDA does, however, have certain specific concerns and recommendations with respect to the revised draft of the Act.

ISDA recognises that it has only reviewed an official translation into English of the draft Act. As such, ISDA's comments may already have been dealt with in the actual legislation proposed or may be the result of a misunderstanding of the provisions of the proposed legislation. ISDA hopes and intends that any comments will be viewed by the SEC as constructive and helpful even though ISDA has not been able to review the actual terms of the proposed legislation.

Summary

ISDA has the following comments with respect to Chapter 9:

- ISDA agrees that it is important to regulate unfair practices and to prevent one party manipulating prices or creating a false market. ISDA believes that this is because markets should be transparent so that there is a level playing-field for all market participants.
- However ISDA also believes that any regulation should ensure that parties continue to deal on an arm's length basis so that ultimately each party is responsible for its own decision whether or not to enter into a transaction. ISDA believes that if regulations interfere with the principle that each party deals at its own risk this will distort prices and reduce the efficiency of the market in Thailand because counterparties will refuse to deal or will require compensation for the additional legal risks.

In addition ISDA has the following additional comments with respect to the revised draft Act:

- ISDA welcomes the inclusion of provisions in the Act which make clear that derivatives transactions are not gaming contracts.
- ISDA is concerned that off-shore entities should know the circumstances under which they need to comply with any of the conduct of business rules and prudential requirements when dealing with Thai counterparties. ISDA suggests that any requirements be reviewed to ensure that they do not discourage off-shore entities from entering into transactions with Thai counterparties.
- Where one (or both) of the parties agrees to provide collateral for its obligations under privately-negotiated derivatives transactions, ISDA is concerned that the Act imposes specific requirements which may not be appropriate commercially. ISDA believes that the determination of the terms of any collateral arrangement should be made by the parties to privately-negotiated derivatives transactions.
- ISDA believes that it would be better for any transfer of obligations from a derivatives intermediary to a third party in respect of privately-negotiated derivatives transactions to be subject to the consent of the affected counterparty. A counterparty will review its overall legal and business relationship with a derivatives intermediary and the credit-worthiness of the intermediary, before agreeing to enter into any transactions with that derivatives intermediary, and should be able to carry out a similar review before dealing with a third party (whether or not substituted at the SEC's instigation) with respect to any transaction.

Chapter 9

Chapter 9 (and in particular Division 2 thereof) of the Act prohibits “unfair practices”. However as part of this, Chapter 9 would impose an obligation on derivatives intermediaries to disclose all material facts inherent in privately negotiated derivatives transactions to counterparties and also not to give any forecasts which are false or misleading. In particular, the draft Act requires derivatives intermediaries not to “omit [any] facts which should have been known” (Division 2 paragraph 3) and not to give “a forecast or statement or [disseminate] information which is false or misleading” (Division 1 paragraph 3).

ISDA recognises that a derivatives intermediary’s relationship with its counterparty may fall into one of a number of categories. Although in certain circumstances a derivatives intermediary may, depending upon local laws, have a responsibility for advising as to the merits of a particular transaction (for example, where a fiduciary relationship exists), there are equally other circumstances (where the counterparty is a corporation or another financial institution) where the derivatives intermediary is merely acting as a participant in a market and should not be obliged to advise such a counterparty in the absence of a specific written agreement between the parties to that effect. In the latter case, the primary inducement for a counterparty to enter into a transaction is the price and terms on which a derivatives intermediary is prepared to deal and not any other information.

Even where a derivatives intermediary is merely acting as a market participant, it is usual practice when marketing potential transaction to counterparties to include forecasts of how a particular transaction might perform in particular circumstances. This will usually include both anticipated changes in market prices or a particular risk factor (such as interest rates) and also a comparison with other possible scenarios. However it is always possible (and perhaps likely) that the actual turn of events is not precisely the same as that envisaged in any forecasts. Paragraph 3 of Division 1 may make it difficult for a derivatives intermediary to give any such forecasts without being accused of their being false or misleading.

ISDA is therefore concerned that the provisions regarding unfair practices set out in the draft Act might be interpreted as being inconsistent with the fundamental principle for privately negotiated transactions that, absent a written agreement to the contrary, a derivatives intermediary’s counterparty is ultimately responsible for the decision as to whether or not to enter into a particular transaction.

These provisions might in certain circumstances be interpreted incorrectly as imposing on derivatives intermediaries certain duties or obligations which would not otherwise arise. If this were the case, it would put Thai regulated institutions at a relative disadvantage. In particular these provisions might suggest that a derivatives intermediary has an ultimate obligation to aid counterparties (including experienced institutional investors in the decision-making process, notwithstanding the stated principle that each party to a transaction is (in the absence of a written agreement to the contrary) responsible for its own decision.

If the effect of this is that extensive risk-disclosure statements are required by the Act this could exacerbate the potential misunderstanding that a derivatives intermediary is somehow responsible for its counterparty’s decisions with respect to derivatives transactions, by leading some parties to believe

that they may rely on a derivatives intermediary for information, and, more troubling, that they also may rely on a derivatives intermediary for decision-making purposes.

ISDA believes that any disclosure requirement ignores the predominantly sophisticated nature of the parties to privately negotiated derivatives transactions. Each party is ultimately responsible for deciding if such a transaction is in its best interests, because only that party can fully understand its own business and risk profile. A party therefore also should be responsible for establishing (internally or through independent advice) sufficient information on which to base its decisions. While derivatives intermediaries may contractually agree to provide information, recommendations or investment advice, they should not be required to do so in the absence of an agreement.

ISDA is also concerned that the requirements in Chapter 9 may make derivatives intermediaries dealing in Thailand feel compelled to provide generic statements disclosing the risks of derivative transactions each time they enter into a transaction with a Thai counterparty. Blanket disclosure requirements may result in some parties receiving information that they do not want or need, and other parties receiving insufficient information, yet would still impose significant costs and legal risks on derivatives intermediaries to comply with the mandated requirements.

ISDA suggests that derivatives intermediaries be allowed (rather than required) to develop and distribute information about transactions in a form that is appropriate to the size and nature of their transactions and counterparties. Receiving a statement disclosing all facts known to a derivatives intermediary should not be a mandatory prerequisite before its counterparty is able to form a decision to enter into a transaction; such an approach would be inconsistent with the principles underlying arm's length transactions and would harm end-users by reducing the speed with which they can act to hedge risks.

Gaming

ISDA strongly supports the proposal specifically to exclude the application of gaming and wagering legislation to privately negotiated derivatives transactions, so that those transactions may enjoy greater legal certainty under Thai law. This would appropriately recognise the commercial nature and the legitimate commercial uses of such transactions and would decrease costs by reducing legal risks. Several jurisdictions, including the United States, have passed such legislation in order to clarify the legal treatment of such transactions.

Definition of Derivatives Adviser

ISDA suggests that Chapter 1 be amended to make clear that "acting as a derivatives adviser" would not include any lawyer, accountant or other professional adviser advising on the contractual terms of a privately-negotiated derivatives transaction in his capacity as such.

Definition of Derivatives

ISDA is concerned that the specification of derivatives contract types in the Act does not specifically list "swap" transactions, which comprise a substantial majority of privately negotiated derivatives transactions. ISDA believes that swap transactions should be explicitly included in derivatives

categories set forth in the Act, or, if not included, ISDA would like a clarification of the intended effect of their non-inclusion.

Conduct of Business Rules and Prudential Requirements

Chapter 3 of the draft Act contains a combination of requirements relating to the conduct of derivatives business in Thailand and prudential requirements relating to the fitness of persons to conduct derivatives business.

The draft Act would require any person wishing to conduct a derivatives business in Thailand to be registered, and would also require that only certain types of entities (i.e. financial institutions) be eligible for registration. The SEC would also be empowered under Division 1 of Chapter 3 to introduce rules and regulations relating to customer protection. Effectively these would relate to the conduct by a derivatives intermediary of its business in Thailand; for example this includes matters such as customer agreements, advertisements, and risk disclosure requirements. The SEC would also be empowered to introduce rules relating to risk management and internal controls “for the benefit of safeguarding the integrity of the financial system”.

ISDA believes that it is appropriate for the SEC to introduce such rules and regulations for derivatives intermediaries incorporated in Thailand. However ISDA is concerned that entities outside Thailand will be treated as conducting a derivatives business in Thailand for the purposes of the Act simply by dealing with a counterparty in Thailand or in relation to Thai assets (whether as collateral or as the underlying assets or risk for a transaction). ISDA believes this may be made clearer if the definition of conducting a derivatives business in Thailand includes a test as to whether a person is dealing on or off-shore. ISDA believes it would be helpful generally for the SEC to define what constitutes doing business in Thailand.

Secondly, ISDA believes that it should be possible for an overseas entity with a presence in Thailand to qualify for registration under Chapter 3 on the basis of its status in its home jurisdiction. However, if that entity is regulated with respect to financial resources, internal controls and other prudential requirements in its home jurisdiction then ISDA suggests that it should not be required also to satisfy equivalent regulations in Thailand. ISDA believes that this approach has proved the best solution in other jurisdictions.

ISDA suggests that the same points should also apply in the rules of any self-regulatory organisation recognised by the SEC under Chapters 6 and 7.

Collateral Arrangements

Division 3 of Chapter 3 sets out certain requirements in relation to client assets. ISDA notes that these provisions are similar to those in Chapter 5 relating to client assets held by a Derivatives Clearing House. ISDA would like to suggest that derivatives intermediaries should not be subject to any rules with respect to holding of property received from a counterparty to a privately-negotiated transaction. As a preliminary matter, privately negotiated derivatives transactions do not normally contemplate one party holding the property of the other party during the course of the transaction.

Privately-negotiated transactions that do involve in the delivery of property from one party to another as collateral will normally be governed by a security arrangement or other credit support document that is also privately negotiated, such as the different forms of Credit Support Annex and Credit Support Deed developed by ISDA to supplement the ISDA Master Agreement. Such an arrangement or document will set forth explicitly the respective rights of the relevant party to hold, commingle and deal with collateral and will be reviewed carefully by the parties. The parties to privately-negotiated derivative transactions are usually highly sophisticated and will have access to their own independent legal advice.

ISDA is in the process of commissioning a legal opinion regarding the enforceability of the ISDA Credit Support Annexes and the ISDA Credit Support Deed in Thailand. ISDA understands that these documents would generally be enforceable in Thailand. ISDA believes that regulations affecting only derivative transactions should not override arrangements that would otherwise be enforceable under Thai law in relation to other privately-negotiated transactions (such as a loan of money). For example, ISDA believes that the most effective place to protect the rights of a chargor of collateral is in legislation relating to the rights and obligations of secured parties generally, rather than to introduce legislation just with respect to counterparties to privately-negotiated derivatives transactions. ISDA is also concerned that by including such requirements in the Act, the SEC may prevent the parties using collateral agreements governed by the laws of another jurisdiction when this would be appropriate. ISDA notes that it may be difficult to apply Thai laws (for example relating to the perfection of a security interest) to assets located outside Thailand.

Transfer of Business

ISDA notes that it is proposed in Chapter 3 Division 4 that the SEC should have powers to order the transfer of the obligations of a derivatives intermediary. ISDA notes that the transfer is expressed to be binding on every person concerned.

Under Section 7 of the ISDA Master Agreement, a transfer of obligations under the ISDA Master Agreement can only take place with the prior written consent of the counterparty except in certain limited circumstances. These circumstances are where a net amount is payable as a result of the termination of outstanding transactions or where all assets and liabilities of a party have been transferred to a third party pursuant to a merger (where that merger does not itself result in a right for the other party to terminate). ISDA believes that it would be better that a transfer of obligations under Division 4 of Chapter 3 in relation to privately-negotiated transactions should only take place with the consent of the counterparty of the derivatives intermediary. For example ISDA notes that the SEC as drafted would have the power to transfer individual derivatives positions and any assets of the counterparty held by the derivatives intermediary.

It is common for parties to privately-negotiated derivatives transactions to agree a master agreement which provides for exposures in respect of all outstanding transactions to be netted on default by one of the parties. Each party will consider the extent of its existing exposure (that is its rights and obligations under outstanding transactions) and the availability of rights of netting on insolvency before agreeing to enter into any further derivatives transactions with the other party. ISDA believes that a counterparty should be able to conduct a similar review before deciding whether to deal with a third

party substituted for a derivatives intermediary. In that way any counterparty continuing to deal with the third party would be bound to do so and not to terminate outstanding Transactions.

ISDA also believes that it would make it more difficult for Thai counterparties to enter into transactions if the SEC were able to order the transfer of derivatives positions in breach of any such netting agreement. ISDA believes that the Act may be interpreted as creating an insolvency regime for derivatives intermediaries if this were the case, separate from other insolvency legislation of general application. ISDA notes that the availability of netting is one of the criteria recognised under the Basle Capital Accord when calculating the capital adequacy requirements for the trading activities of financial institutions. If it is not clear whether foreign financial institutions can treat obligations owed by a derivatives intermediary as net on insolvency this will increase the cost of capital for each transaction and so increase the cost to the derivatives intermediary of entering into any new transaction or of restructuring existing transactions.

Conclusion

ISDA welcomes the intention behind the draft Act to provide a clear framework for derivatives transactions in Thailand. ISDA particularly welcomes the recognition by the SEC that different rules should apply for participants in an institutional market compared to those that apply when dealing with retail clients.

ISDA believes that it is important that any regulations adopted with respect to the institutional market do not disturb the principle that each party is dealing with the other on an arm's-length basis (unless otherwise expressly agreed between them). ISDA would like to suggest that the SEC review the regulations in relation to unfair practices so that derivatives intermediaries are not required to make disclosures of risks or other factors unless they have agreed to do so with counterparties and also so that by making any disclosures or forecasts a derivatives intermediary is not opening itself up to additional legal risks. ISDA also suggests that the SEC reviews any regulations relating to the holding of a counterparty's assets by a derivatives intermediary so as not to disturb the principle that party's deal with each other on an arm's-length basis.

ISDA also believes that any regulations adopted should not change the general regime applicable to areas such as the insolvency of a counterparty to a derivatives transaction, unless there is good reason to do so. Finally ISDA recommends that the draft Act define what conduct amounts to doing business in Thailand so as to distinguish between those parties dealing with Thai counterparties who are incorporated outside Thailand, and those parties which are incorporated in, or have a presence in Thailand and enter into transactions in Thailand.

ISDA

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ISDA is very grateful for the opportunity to submit further comments on the draft Act. If the members of the SEC or Commission staff have any questions regarding ISDA's comments or related issues, they should feel free to contact the undersigned, or any of the members of the ISDA Board of Directors listed in Annex B attached hereto. ISDA looks forward to assisting the SEC on this and other matters.

Yours sincerely,

Quentin Hills/Paul Wilkinson
Co-Chair of Hong Kong and South
East Asia Regional Committee
International Swaps and Derivatives
Association, Inc.

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