

ISDA

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Alan Napier
Department for Work and Pensions
The Adelphi (3rd Floor)
1-11 John Adam Street
London WC2N 6HT

Dear Mr. Napier,

Pensions: Investments Requirement

The International Swaps and Derivatives Association (ISDA) welcomes this opportunity to comment on the draft Occupational Pension Schemes (Investment) Regulations 2005, as set out in your consultation paper of 21 March 2005. Our comments focus on the particular concerns of our member firms, which enter into privately negotiated derivative transactions with pension funds.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, and leading end-users of, privately negotiated derivatives, as well as associated service providers and consultants. ISDA's structure presently counts 17 different committees covering four main areas: issues of industry infrastructure; products; oversight and supervision; and region-specific issues. These committees, together with related working groups, play an important role in facilitating the exchange of ideas, the examination of policy issues, and the flow of information among its members. The position expressed in this paper, in particular, has been developed on the basis of discussions held within the European Regulatory Committee, which gathers together representatives from banks, energy producers and traders, information vendors, auditing companies and law firms active in the European Union and Switzerland. For more information, please visit www.isda.org.

Our main concerns relate to the provisions in regulation 4(5) that apply to investment in derivatives. We are concerned that trustees and counterparties will need a high degree of legal certainty if they are to enter into derivatives transactions that are for the undoubted benefit of pension schemes. Accordingly:

- We do not agree that it is correct to transpose the directive by providing that pension schemes may "only" invest in derivatives to the extent that they contribute to a reduction of investment risks or facilitate efficient portfolio management. The directive clearly envisages that other derivative transactions are possible as well – see the reference to "other derivative operations" in article 18(1)(d), last sentence. Therefore, we consider that the implementing regulations should

simply make clear that trustees must avoid excessive risk concentrations in derivative transactions that are entered into for a purpose other than one of the two specified purposes.

- In any event, the regulations should make clear that they allow transactions that are entered into for "for the purposes of" risk reduction or efficient portfolio management *even if the outcome may not always be as originally planned*. The relevant tests should be applied at the time the trustees enter into the transaction.
- We consider that, without further clarification in the regulations, there is likely to be significant uncertainty about how trustees should interpret the requirement that the purpose of a transaction is to reduce investment risk or for efficient portfolio management. The consultation document suggests that these terms are "familiar terms in financial services regulation". However, in other contexts where these terms are used (such as for collective investment schemes or insurance companies), there are extensive rules and guidance providing detailed text on which parties can base legal interpretations. While it may be unnecessary to include the same volume of material here, the regulations should provide at least some more detailed explanation of what these terms mean in this context and DWP should provide an opportunity for the industry to comment on the more detailed proposals.
- We welcome the proposal to provide further definition of what constitutes a regulated market in regulation 4(6). However, we consider that it is unnecessary and confusing to add the requirements that:
 - the market be "adequately liquid" - this is too subjective a standard to be readily applicable;
 - have "adequate arrangements for unimpeded transfers of capital and income" – this would be a difficult standard for any securities market to meet, as normally stock exchanges do not make arrangements for the payments to be made with respect to the investments traded on the exchange. (It is difficult to know how the standard would be applied at all in relation to futures markets.)
 - "adequate custody arrangements can be provided for the investment when it is dealt in on that market" – it is unclear how this is applied in relation to futures contracts, where the investor does not obtain the contract traded on the market but rather a back-to-back contract with the broker.

We believe that the regulations should not adopt a standard which is substantially narrower than that set out in article 19(1) of the UCITS Directive 85/611/EC, which simply focuses on whether the market is a "regulated market which operates regularly and is recognized and open to the public". There is in any event the overarching requirement to assess the appropriateness of a particular investment imposed by the prudent-man test.

We hope that these comments are helpful. Please contact me if you have any questions on them.

Yours sincerely,

Jonathan Taylor
Chairman of the European Regulatory Committee