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# **A RETROSPECTIVE OF ISDA'S ACTIVITIES 2004 - 2005**

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**ISDA**

**INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.**



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## LETTER FROM THE EXECUTIVE DIRECTOR

# ISDA

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Dear ISDA Member:

As we enter the New Year, we do so with new leadership. In 2004 we welcomed Jonathan Moulds and Michele Faissola as our new Chairman and Vice Chairman. Jonathan, who is Head of International Debt and Equity Markets at Bank of America, and Michele, who is Global Head of Rates at Deutsche Bank's Global Markets Division, bring extensive expertise and experience to their new roles. We are very pleased to have Jonathan and Michele in these roles to help lead us through the fresh challenges and opportunities ahead.

Jonathan replaces Keith Bailey of Merrill Lynch Capital Services, who had served as ISDA Chairman since March 2000. Michele replaces Henning Bruttel of Dresdner Kleinwort Wasserstein, who had served as ISDA Vice Chairman since April 2002. We at ISDA would like to thank Keith and Henning for their service, dedication and thoughtful contribution to the Association in these roles and wish them continued success in their careers in the industry.

There were several other changes to the Board this past year. Douglas Bongartz-Renaud stepped down as Board Secretary and was succeeded in the role by Kaushik Amin. At the 2004 AGM, Jerry del Missier of Barclays Capital resigned from the ISDA Board and was succeeded from his firm by Benoit de Vitry. Masahiro Hosomi of the Bank of Tokyo-Mitsubishi resigned his Board position and was succeeded by Yusaku Manabe. Jose Manuel Hernandez Beneyto of Banco Santander Central Hispano was replaced in representing his firm by Marcelo Castro. During the course of the year, Luciano Steve stepped down upon his retirement from Intesa BCI. Giovanni Gorno Tempini of Banca Caboto joined in January, 2005, as did Robert Lawson of British Petroleum, a firm new to the Board. Eraj Shirvani joined, representing Credit Suisse First Boston. We thank all of these individuals for their dedication to ISDA over this and previous years.

These changes occur as ISDA and the derivatives and risk management industry prepare to celebrate an important milestone: the Association's 20th anniversary. ISDA plans to mark the occasion in a number of ways throughout the year, notably with a special anniversary dinner to honor the achievements of the Association and its Board over the last two decades. The celebration, which promises to be a major industry event, will be held on May 11, 2005 at London's Natural History Museum. We look forward to welcoming many of you to this historic event. ISDA's 20th Annual General Meeting in Barcelona is another opportunity to celebrate our anniversary with us. To highlight the event, ISDA will produce an anniversary publication with RISK magazine that will further explore the phenomenal growth of derivatives and the role ISDA has played and continues to play.

The past year for the Association has posed a range of challenging issues that have attracted the commitment of many ISDA members, Board and staff. The use of privately negotiated derivatives worldwide continued to soar. ISDA's Mid-Year 2004 Market Survey shows that notional outstandings of interest rate derivatives grew almost 16 percent to \$164.5 trillion, equity derivatives grew 9.7 percent to \$3.8 trillion, and credit derivatives grew 44

percent to \$5.4 trillion in the first six months of the year. The robust growth of the industry is reflected in ISDA's continuing ability to attract new firms to the Association. During 2004, we welcomed 45 new members, bringing our total membership to 624 firms based in more than 47 countries. The breadth and scope of ISDA's membership, coupled with the expertise and talent its members bring to industry issues, are largely responsible for the Association's continuing success in representing the derivatives business as we work in support of our mission.

We saw this dynamic play out in a number of areas over the past year, including the publication by the Basel Committee on Banking Supervision of its long awaited revised Capital Accord. After years of active involvement in the reform of the Accord, ISDA's assessment of the outcome was largely positive. We continue our work with the Committee as it moves toward implementation, specifically on issues where national discretions may result in inconsistent approaches being adopted by different regulators and on the capital treatments of double default risk and counterparty risk.

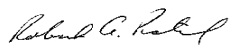
2004 also saw the issuance of new regulations for derivatives in China. ISDA applauds implementation of the Interim Rules on Derivatives Business of Financial Institutions by the China Banking Regulatory Commission. The Association and its membership were instrumental in lobbying for an appropriate legal and regulatory framework within the People's Republic of China and in advising and commenting on the Commission's draft rules throughout the process.

Documentation and netting remain fundamental to ISDA's work. We continued to expand the number of jurisdictions for which we obtain legal opinions on the enforceability of netting and collateral provisions of the ISDA Master Agreements, adding netting opinions for Greece, the Channel Islands and Poland.

ISDA's efforts to accelerate automated processing of OTC derivatives also stepped up in 2004 with an implementation plan that sets forth guidelines for improving operational efficiency in OTC derivatives processing, and recommends market-wide automation by 2006. The plan centers on adoption of Financial products Markup Language (FpML), the ISDA-led protocol, which in 2004 expanded to include all major product groups.

Educational outreach efforts, including ISDA conferences, also grew in 2004. Over 700 members attended the 19th Annual General Meeting in Chicago, and we were pleased to see many of you at our regional conferences in New York, London, Sydney, Tokyo and Singapore, which focused on the effects of the new Capital Accord. By popular demand, we continued to hold regional *Fundamentals of Derivatives* seminars. We also instituted *Demystifying Derivatives* seminars for regional press in North America, Europe and Asia, with over 80 editors and reporters attending these events. Another part of ISDA's educational outreach during the year included a survey of inter-dealer exposures after giving effect to netting and collateral. Published at the Chicago AGM, the survey found on average, a major dealer's five largest net interdealer exposures are about two percent of its entire derivatives exposure. The ISDA 2004 Margin Survey further emphasized efforts of market participants to reduce exposures, revealing a 41 percent increase in the amount of collateral in circulation to \$1.02 trillion. Another first, ISDA's survey of the academic community's perceptions of derivatives, revealed that finance professors at the world's top business schools believe derivatives help companies manage financial risk more effectively and have a beneficial impact on the global financial system.

As we prepare for a year of celebration and remembrance, we do so knowing that our success representing the interests of the privately negotiated derivatives industry would not have been possible without the support of our members. We thank you for your membership and extend to you our best wishes for the coming year.



Robert G. Pickel  
Executive Director and CEO

**INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.  
BOARD OF DIRECTORS DURING FIRST QUARTER OF 2005**

**Officers**

**Jonathan P. Moulds**, Chairman  
Head of International Debt and Equity Markets  
Bank of America

**Michele Faissola**, Vice Chairman  
Managing Director and Global Head of Rates,  
Global Markets Division  
Deutsche Bank

**Kaushik Amin**, Secretary  
Managing Director, Co-Head of Global Interest Rate  
Products  
Lehman Brothers Inc.

**Diane Genova**, Treasurer  
Managing Director & Co-General Counsel  
Investment Bank  
J.P. Morgan Chase & Company

**Directors**

**Michael Bass**  
Global Head, Interest Rate Derivatives  
Standard Chartered Bank

**Yusaku Manabe**  
Deputy General Manager, Business Development  
Office, Structured Products Division II  
Mitsubishi Securities Co., Ltd.

**Douglas Bongartz-Renaud**  
Managing Director, Group Risk Management Division  
ABN Amro Bank N.V.

**Sean Notley**  
Managing Director, Co-Head of Global Interest Rate  
Derivatives & Government Bond Trading  
Morgan Stanley

**Marcelo Castro**  
Head of Treasury for Europe  
Grupo Santander Central Hispano

**Ernest Patrikis**  
Senior Vice President and General Counsel  
American International Group, Inc

**Benoit de Vitry**  
Global Head of Commodities and Emerging Markets  
Rates  
Barclays Capital

**Robert Pickel**  
Executive Director and Chief Executive Officer  
ISDA

**Giovanni Gorno Tempini**  
Chief Executive Officer and Managing Director  
Banca Caboto

**Riccardo Rebonato**  
Global Head of CBFM Market Risk and Head of  
Quantitative Research & Quantitative Sales  
Royal Bank of Scotland

**Hidetaka Hara**  
Executive Director, Global Markets Planning  
Department  
Nomura Securities Co., Ltd.

**Thomas Riggs**  
Managing Director  
Goldman Sachs

**Frédéric Janbon**  
Managing Director and Global Head of Fixed Income  
Trading  
BNP Paribas

**Eraj Shirvani**  
Managing Director, Head of European and Pacific  
Credit Trading  
Credit Suisse First Boston Europe Limited

**Robert Lawson**  
Global Business Unit Leader - Finance, Energy &  
Risk Management  
British Petroleum

**Kenneth Tremain**  
Managing Director, Head of North American Interest  
Rate Derivative Trading and Government Bond  
Trading  
Citigroup



## ISDA ACTIVITIES 2004 - 2005

The International Swaps and Derivatives Association is perhaps best known for addressing issues from a legal, regulatory and documentation perspective, all of which naturally remain critical to ISDA's mission. An increasing part of its role lies also in the operational processing of the transactions that are at the fundamental core of its membership's businesses.

It is no doubt appropriate that such issues should be a major point of the Association's focus as it reaches the maturity milestone of its 20th anniversary. As ISDA and the industry mature together, they are tackling in tandem the issues that arise from their phenomenal growth and success. In the year 2004 - 2005, ISDA has made some of its greatest in-roads into helping solve some of the issues surrounding confirmation processing, auto-matching and settlement. These issues have attracted a certain amount of regulatory attention in the US and the UK to name but two. Representatives of the Federal Reserve and the Financial Services Authority respectively have commented on the need to address confirmation backlogs and to tighten up timeframes in the post-trade environment. ISDA has welcomed these comments, lending, as they do, a heightened awareness of issues in which the Association has been seeking to enhance performance and enlist full industry support. The implementation of ISDA's 2003 Operations Strategy Paper, addressing exactly these points, continues through the efforts of not only the Operations Committee but also the broader ISDA

membership. The operations metrics that ISDA polls monthly from its membership and the results of ISDA's Operations Benchmarking Survey, published annually, demonstrate that these efforts are not going unrewarded and that firms are making great strides to meet the targets set forth in the paper. These efforts can only benefit from such attention, while at the same time drawing additional encouragement and momentum. They are similarly helped by the hard work and dedication of those who give freely of their time to develop and enhance the infrastructure that enables this progress to occur. Financial products Markup Language (FpML), the industry messaging standard, facilitates smooth and effective transfer of all the information components that permit the post-trade process to take place. Since the standard was adopted by ISDA, it has incorporated all major derivatives products, barring commodity derivatives, which will be tackled as ISDA revises its documentation for this product set. FpML is now used by all major dealers. Its use is also gradually extending to end-users, who have been encouraged into the process by ISDA.

## ISDA MEMBER PORTAL

In 2004 ISDA launched the latest of its technology initiatives - the ISDA Portal. The ISDA Portal is a gateway to a wealth of information available to ISDA members in an interactive online environment. It has been personalized for each member and can be modified by each member to create a customized layout. A personal account has been created for each member. The ISDA Portal provides members quick access to netting and collateral opinions and ISDA event information. It also allows members to

join committees in real time and to quickly update their contact information. More than one-third of ISDA members have enrolled in the ISDA Portal since its launch. ISDA is committed to delivering timely and relevant information on the derivatives industry and will continue to seek new and innovative ways in which technology can be used to enhance the services it provides to its members. The ISDA Portal can be accessed through [www.isda.org](http://www.isda.org) or directly at [my.isda.org](http://my.isda.org).

## COLLATERAL

ISDA's Collateral Committee works towards the increased efficient functioning of collateralization of privately negotiated derivatives transactions through its efforts in relation to credit support documentation, guidelines, standards and collateral law reform.

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The ISDA Collateral Committee has undertaken a comprehensive review of the Guidelines for Collateral Practitioners, which were originally published in 1998. The 2005 ISDA Collateral Guidelines (the "2005 Guidelines") also revisit some of the recommendations made in the ISDA 1999 Collateral Review. The 2005 Guidelines are intended to document the state of collateral management practice at the end of 2004; discuss the nature and mechanics of collateralization, including the key legal foundations; describe the interaction of the collateral management function with other areas; identify the benefits and risk of collateralization; and outline current trends and possible future developments in collateral management.

ISDA continued its Collateral Practitioner Speaker Series in 2004 with a second luncheon seminar held in New York. A panel of senior risk managers from ISDA member hedge funds and dealers addressed an audience of over 100 members on topics ranging from operational and credit risks to client servicing trends associated with collateral management.

ISDA's Collateral Law Reform Group continued monitoring several international, regional and domestic law reform projects of relevance to the derivatives industry. ISDA is currently drafting comments on the latest preliminary draft of the Hague Securities Convention, which addresses the conflict of laws issue by setting down a uniform approach to determining the applicable law to the proprietary aspects of a transfer of book-entry securities.

The Association also continues to monitor the UNIDROIT (The International Institute for the Unification of Private Law) project, which addresses the substantive law

aspects of financial arrangements, including collateral arrangements, involving securities held with intermediaries. As of the publication of this Retrospective, the Hague Securities Convention is not yet in effect nor has UNIDROIT adopted a final form of draft Convention.

Another regional reform project which ISDA has supported is being spearheaded by the National Law Center for Inter-American Free Trade (NLCIFT). The NLCIFT is promoting the adoption of a treaty by the Organization of American States that will address issues raised by the creation of rights, including under financial collateral arrangements, in investment securities held through intermediaries in the Latin American, Central American and Caribbean region. This treaty would deal with the private international law and substantive law questions, in a way that is compatible with the Hague Securities Convention and UNIDROIT projects but is especially adapted to and reflective of the special concerns of the OAS member states. ISDA has encouraged OAS member states to urge that such a Treaty be put on the OAS agenda.

ISDA submitted comments on various U.K. initiatives during 2004, including the U.K. Law Commission's Consultative Report (CP No 176) on the reform of English law rules regarding the creation of company security interests. Comments were also submitted on the Financial Markets Law Committee's project on property security interests. ISDA's comments addressed views on its effects on financial collateral arrangements, the risk of re-characterization and the protection of set-off and close-out netting.

## DOCUMENTATION

The Association engaged in a wide range of documentation projects in 2004 and 2005, covering commodities, credit, equity, foreign exchange and interest rates, as well as new product areas.

In the commodities derivatives area, ISDA anticipates publication of the 2005 ISDA Commodity Definitions by June 2005. Transaction types have been expanded and physically-settled commodity transactions are covered through stand-alone annexes. A User's Guide will also be published in June 2005.

ISDA published the GTMA Part [6] Annex, designed to accommodate physical power trades in the U.K. power markets, and the North American Gas Annex and Canadian Addendum, designed to document trades in the U.S. and Canadian physical gas markets. ISDA also published a confirmation for EU Emissions Allowance Transactions to accommodate the establishment of the Emissions Trading Scheme in the European Union. ISDA is also working on coal and freight documentation.

ISDA undertook a number of documentation projects in the credit derivatives area, including the publication of a first to default confirmation template and accompanying guidance note and a knock-out swaption confirmation template.

ISDA also published a confirmation template for use with U.S. municipal Reference Entities and a revised Sovereign Master Confirmation Agreement.

ISDA is also nearing completion of confirmation templates for credit default swaps on asset backed securities, including a cash and physical settlement template, a dealer-oriented pay-as-you-go template and a monoline-oriented pay-as-you template.

ISDA published a Credit Default Swap Matrix, a Supplement to the 2003 ISDA Credit Derivatives Definitions, in order to facilitate more streamlined confirmation

practices. With respect to equity derivatives, ISDA published an Index and Share Variance Swap Master Confirmation Agreement as well as a Japanese Interdealer Master Equity Derivatives Confirmation Agreement for Index Options and Share Options. ISDA also initiated a fund definitional annex to the 2002 ISDA Equity Derivatives Definitions.

In the foreign exchange area, ISDA published a Supplement to Annex A of the 1998 FX and Currency Option Definitions to accommodate an amendment to the Turkish Lira. For interest rate and currency derivatives, ISDA continued to publish a variety of amendments to the Annex to the 2000 ISDA Definitions. A project was also initiated in 2005 to revise the 2000 ISDA Definitions and Annex. To address the increasing usage of inflation derivatives globally, ISDA published the 2005 ISDA Inflation Definitions.

ISDA also initiated the development of a standardized give-up agreement intended to cover a variety of products, including credit derivatives, foreign exchange and interest rate swaps.

The Association continued to expand the number of jurisdictions where it obtains legal opinions on the enforceability of netting and collateral provisions of the ISDA Master Agreement, adding new collateral opinions for Italy, Mexico and the Philippines.

ISDA also published new netting opinions for Greece, India and Italy and is commissioning new netting opinions for Barbados, the Czech Republic and Iceland. A technical paper was also published on the status of netting laws in the People's Republic of China and the Czech Republic.

## FpML

In 2004, ISDA continued its development of FpML Version 4.0, which covers all major asset classes, including interest rate, credit, equity and FX derivatives. Work also began on Version 4.1, which offers enhancements in pricing and risk and credit derivatives. Integral to the advancement of the standard is education, which remains a top focus for ISDA in 2005.

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FpML Version 4.0 was released as a Recommendation in April 2004. Version 4.0 is the first major version that covers the main derivatives asset classes.

Beyond interest rate and foreign exchange derivatives, Version 4.0 covers equity options and equity swaps, as well as credit derivatives.

Recommendation is the final step in the development process of a version, it reflects consensus within the FpML community, including feedback from users implementing the version, and bears the Standards Committee stamp of approval.

On a technical level, Version 4.0 is the first schema-based version of the standard. Schemas describe a document template in XML format.

Version 4.0 also has a messaging framework, which defines the necessary information to send and receive documents.

In addition, validation rules have been developed for the products covered in Version 4.0. In 2004, work began on a minor Version 4.1, which adds additional functionality. Technically, the minor version is backward compatible, in line with the change guidelines published by the FpML standards committee.

The main additions in Version 4.1, which is currently in Trial Recommendation, are in pricing and risk, for which a new working group was formed, and in credit derivatives, with an expanded coverage for indices, baskets and credit event notices.

Version 4.1 also contains full coverage of the 2002 Equity Derivatives Definitions, the equity option and swap supplements, and equity forwards and variance swaps. Additionally, the messaging coverage has been expanded with support for Novations, Terminations and Amendments.

Version 2.0 of the FpML editor/viewer was released in July 2004. This second version of the tool, which is intended to make FpML more accessible, supports Version 4.0, including the messaging framework. It additionally provides a confirmation view in line with the ISDA sample confirmations.

Assisting firms with the implementation of FpML remains a high priority. During 2004, ISDA held its first FpML training courses in New York and London.

The course is designed to educate participants about the FpML structure, and to explore some of the asset classes, as well as the messaging, validation and customization of FpML.

ISDA will continue to hold these courses in 2005. ISDA also continued its technical FpML symposiums during the year and held its yearly FpML conference in London. The Association has also launched a survey on the use and adoption of FpML.

ISDA continued its collaboration with other standards during 2004, The FpML-FIX and ISO 20022 Working Groups remain active. Discussions have also been launched with the Data Standard Working Group on its collaboration with FpML and the integration of its work into future versions of FpML.

## OPERATIONS

In 2004, the Operations Committee and its various Working Groups continued to focus on its long-term vision and framework for standardization and automation in OTC derivatives operations.

In 2004, the Operations Committee and its various Working Groups continued to focus on its long-term vision and framework for standardization and automation in OTC derivatives operations. The publication of the ISDA Operations Strategic Plan in late 2003 was followed by the release of its accompanying Implementation Paper at ISDA's 19<sup>th</sup> AGM in March 2004. The work of the Operations Committee and its Working Groups was focused though the past year on delivering against the automation targets set out in the Papers. The Implementation Paper sets forth guidelines for improving operational efficiency in OTC derivatives processing and recommends market-wide automation by 2006.

The Strategic Plan sets out target turnaround times for key processes, such as trade verification, confirmation dispatch and confirmation execution. It seeks to leverage to the greatest possible extent existing and potential technological solutions. Although there is a core group of original adherents to the Strategic Plan, the initiative is intended to be as inclusive as possible, and new adherents are being sought from all market sectors. The Process Working Group produced a number of important papers during the year. Since Standard Settlement instructions (SSIs) processing continues to present control issues for the industry, market participants drafted a paper providing data standards, and general formats for the notification, processing and verification of SSIs. An additional paper was published covering cash flow matching, netting and settlement. Common data standards were agreed upon, and it is hoped that the paper has proved useful to technology firms as they work towards building solutions in this area.

The paper envisages a tiered or modular approach allowing parties to simply and

bilaterally match cash flows prior to settlement, while still settling gross. Alternatively, bilateral net settlement is provided for, and there is interest in developing a centralized multilateral netting solution. Initial work has begun on market standards for portfolio reconciliation, which, as a process, has a 2006 target delivery date in the Strategic Plan. During 2004, an average of 15 firms contributed monthly statistics on levels of outstanding confirmations and automatching rates for the three main asset classes. The Metrics Working Group gathers and aggregates these statistics. The statistics are then circulated on an anonymous basis each month among the contributors. The annual Operations Benchmarking Survey will be published early April. At the request of ISDA Members, its format has been streamlined to focus solely on key metrics.

The Equity Operations Working Group concentrated on the introduction of automation for the equity asset class during the year, as online solutions have been made available? The Working Group is also seeking to establish an order of priority for the production of new product short form confirmations. The Rates Working Group produced a number of Supplements to the 2000 Definitions, as well as rate source and settlement matrices. This Rates Working Group will form part of a new working group that will rewrite and update the 2000 ISDA Definitions.

In 2004, the Operations Credit Derivatives working group focused on the processes to improve automation and reduce the number of outstanding confirms. The working group also focused on developing the Master Confirmations and Transaction supplements and the Credit Derivatives Physical Settlement Matrix.

## CREDIT DERIVATIVES

Focused on the issues affecting the business and practice of credit derivatives transactions, the Committee seeks to find consensus among dealers and end-users (both hedgers and protection sellers) and portfolio managers on the most efficient, effective and appropriate means of conducting OTC credit derivatives transactions.

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The Committee completed numerous documentation projects in the last 12 months, including: The Knock-Out Swaption Template for Corporates and Sovereigns; The First to Default Confirmation and accompanying Note, intended to document credit derivative trades with baskets or portfolios of Reference Entities; Additional Provisions for the Republic of Hungary and for the Russian Federation; The 2004 Sovereign Master Credit Derivatives Confirmation Agreement; The 2005 Monoline Supplement; and a form of Confirmation and Additional Provisions for use with U.S. Municipal Reference Entities.

The fast growing market of credit derivative indexes and the operational aspects of the credit derivatives market received increasing attention in 2004. To address the operational aspects, the Committee works in collaboration with the Operations Committee.

There has been a fair amount of regulatory interest in the operational aspects of the credit derivatives market, and ISDA received welcome comments from the Joint Forum on Credit Risk Transfer and the U.K. FSA. Both topics will stay high on the agenda for the foreseeable future.

The Committee also monitored evolutions on the tax treatment of credit default swaps in the U.S.; and followed discussions on the characterization of weather derivatives and the treatment of credit derivatives under the Basel rules. The work undertaken in 2003 on material nonpublic information for the U.S. market has been further expanded in

2004/2005 with an EU-focused companion paper. ISDA collaborated in a Joint Market Practices Forum of trade associations, representing a wide range of credit market participants, along with the International Association of Credit Portfolio Managers, the London Investment Banking Association, the Loan Market Association and The Bond Market Association.

The recommendations are intended to help ensure that material nonpublic information obtained by financial services firms in the ordinary course of their lending or other relationships with a company is not inappropriately shared with or used by other business units or personnel within the same institutions that transact in the securities and credit derivative markets.

The Statement of Principles recommends that credit market participants consider including certain key elements in their information controls, tailoring these approaches to a firm's particular business activities.

It provides a series of special considerations based on whether a firm has chosen to organize its credit portfolio management activities on the "private side" or the "public side" of an information wall.

Market participants can use the principles and guidelines as they review and refine their own in-house policies to ensure that their business practices and compliance are at the highest level.

ISDA will consider adapting this work to the Asian market in future.

## ENERGY, COMMODITIES & DEVELOPING PRODUCTS

The Energy, Commodities and Developing Products Committee strive to meet the dynamic needs of the business while fulfilling ISDA's mission of encouraging prudent and efficient development of privately negotiated derivatives.

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In 2004, ISDA published a number of new documents relating to the energy and commodity markets. The North American Gas Annex and Canadian Addendum, published in November 2004, are designed to document trades involving the purchase or sale of physical gas on a spot or forward basis, or options on physical gas in the U.S. and Canadian gas markets. It permits users to bring such trades under the ISDA Master Agreement architecture and to elect to incorporate existing credit support arrangements. The Annex also allows market participants to document trades in a manner consistent with the approach taken by the North American Energy Standards Board (NAESB). ISDA also published a long-form confirmation for trades in EU Emissions Allowances. The confirmation is intended for use in privately negotiated, physically settled transactions in European Union emissions allowances. The confirmation was designed to facilitate trading under the EU Emissions Trading Scheme, which became mandatory for certain industry sectors on January 1, 2005. The long-form confirmation enables firms to utilize their ISDA Master Agreements and, later this year, the 2005 ISDA Commodity Definitions to trade EU allowances.

Additionally, ISDA published new documentation that permits the incorporation of U.K. Grid Trade Master Agreement (GTMA) terms into trades documented under an ISDA Master Agreement. The GTMA Annex is designed to document trades in the English physical power market and relates to the Grid Trade Master Agreement published by the Futures and Options Association. ISDA is also in the process of updating the existing European Gas Annex to reflect 2004 ZBT Terms.

ISDA continues its documentation drafting efforts to provide the energy and commodity trading industry with more comprehensive trading contracts. ISDA will complete its update of the 1993 ISDA Commodity Derivatives Definitions and related 2000 Supplement in May 2005. The 2005 ISDA Commodity Definitions will be structurally different from the 1993 Definitions. The mechanics of a wide range of cash-settled commodity transactions, including swaps, options, caps, floors, swaptions, knock-ins, knock-outs and Bermudan options will be addressed in the main body of the Definitions. A series of Annexes will include revised Commodity Reference Prices and a series of sub-annexes with provisions for weather derivatives and physically-settled commodities such as Bullion, European and North American Natural Gas, UK and North American Power and EU Emissions Allowances. Users of the Definitions will implement the mechanics from the main body described above, and select those commodity-specific provisions from the sub-annexes.

ISDA submitted a comment letter in February 2004 to the National Association of Insurance Commissioners ("NAIC") regarding the NAIC's draft white paper entitled, "Weather Financial Instruments (Temperature): Insurance or Capital Markets Products?" ISDA's letter recommended that the NAIC reject the draft white paper. It discussed two major points: (i) weather derivatives are not insurance because they do not require a party to have an insurable interest and do not provide loss indemnification and (ii) the weather derivatives market needs no additional regulation. The draft white paper was ultimately not published.

## EQUITY DERIVATIVES

The Committee continues to focus its efforts on streamlining the process supporting trading activities in OTC derivatives through the creation and promotion of standardized documentation and by assisting in the development of a more liquid market. The Committee also follows issues of global market significance in the interest of furthering best practices.

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ISDA published the 2004 Americas Interdealer Master Equity Derivatives Confirmation Agreement covering Index Options, Index Swaps and Index Basket Swaps, Share Options, Share Swaps and Share Basket Swaps on U.S. and Canadian underliers. The Master Confirmation, which dealers will enter into bilaterally, incorporates the 2002 ISDA Equity Definitions, is subject to the applicable ISDA Master Agreement between such dealers, includes four General Terms Confirmations (each an Annex) with agreed upon house elections, and is supplemented with a related Transaction Supplement including trade details. Dealers may also agree on a bilateral basis to subject outstanding trades to the Master Confirmation retroactively.

Future annexes to the Master Confirmation have already been developed. In August, ISDA published the Index Variance Swap Annex and the Share Variance Swap Annex to the Master Confirmation. With the publication of the Variance Annexes, dealers now have the ability to trade index and share variance swaps under the Americas Master Confirmation. This is in addition to Index Options, Index Swaps, Index Basket Swaps, Share Options, Share Swaps and Share Basket Swaps on U.S. and Canadian underliers. Additional product annexes and supplements may be developed when members believe they are warranted.

In October, ISDA published a stand-alone Index and Share Variance Swap Master Confirmation Agreement for use where parties, such as hedge funds, do not have an Americas Master Confirmation in place, but

wish to take advantage of the Master Confirmation approach for Index and Share Variance Swap transactions.

ISDA also published the 2005 Japanese Interdealer Master Equity Derivatives Confirmation Agreement in February 2005.

In the Asia-Pacific region, ISDA is working on a draft equity template for Index Option Transactions, Share Option Transactions and Share Swap Transactions on underliers in Australia, Hong Kong, India, Indonesia, Korea, Malaysia, New Zealand, Singapore, Taiwan and Thailand.

Finally, to accommodate the rapid growth in derivative transactions linked to the performance of fund interests, ISDA is drafting definitions intended to supplement the ISDA 2002 Equity Definitions for fund-linked transactions.

The proposed definitions will provide standard terms and provisions for use in documenting OTC derivative transactions linked to funds, including private funds, hedge funds, mutual funds and exchange traded funds.

The Committee worked with the North American Tax Committee and North American Accounting Committee on various issues in 2004. The Committee is currently working with the European Regulatory Committee on a response to a Consultation Paper issued by the Code Committee of the U.K. Panel on Takeovers and Mergers. The Consultation Paper relates to proposed amendments to the Takeover Code and the Substantial Acquisition Rules.

## ACCOUNTING

In 2004, the focus continued to be on Europe and the introduction of International Financial Reporting Standards (IFRS) for over 7,000 listed companies. Controversy surrounded the EU Commission's rejection of parts of IAS 39. The Commission chose instead to endorse a "carved-out" version that will be exclusive to the EU. ISDA continues to be involved in attempts to resolve the outstanding areas of concern.

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In Europe, ISDA has been an active participant in the outstanding debate on IAS 39 and the Fair Value Option (FVO). ISDA fully supported the fair value option when it was introduced by the International Accounting Standards Board (IASB), and the Association has actively encouraged the introduction of similar provisions elsewhere, notably in North America.

ISDA continues to believe that in order to reduce volatility resulting from asymmetric accounting, adopters must be allowed to align the accounting treatment of financial transactions with the underlying business and risk management practices. ISDA has been invited to attend the IASB's FVO public roundtables in March 2005. ISDA also provided comment on the IASB's new proposals on Disclosures for Financial Instruments (ED-7). Concerns raised included the level of detail provided, calling into question whether the proposals were "principles-based," the requirements to disclose at subsidiary level and the extent to which disclosures on risk were to be included in the audited financial statements. The IASB is in the process of assessing the industry's comments before finalizing a standard. ISDA additionally provided input on three late amendments to IAS 39, including comments on cash flow hedge accounting of forecast intragroup transactions, transition and initial recognition of financial assets and financial liabilities and financial guarantee contracts and credit insurance.

ISDA hosted two events, in London and in New York, on the practical impact of IFRS. A cross-section of members from ISDA's various committees attended to hear about the work ISDA does with the IASB

and the likely implications for the derivatives industry.

In North America, ISDA formed a joint working group to respond to FASB's proposed statement of Financial Accounting Standards, Fair Value (Exposure Draft). In a letter submitted in September (available at [www.isda.org](http://www.isda.org)), it suggested clarifications that would enhance the usefulness of a final statement and improve its application. In addition to seeking those clarifications, the working group urged FASB to field-test the provisions of the fair value guidance before the issuance of a final statement. The board held a public roundtable discussion with constituents to discuss issues relating to the proposed statements. ISDA met with FASB staff and certain Board members to discuss the Board's projects on accounting for beneficial interests and elective fair value of financial instruments. In response to a Board member's request for a list of financial instruments that ISDA members believe should be eligible for the fair value election, ISDA provided a response in September 2004, asking the Board to consider the following two suggestions on an accelerated basis, separately from the broader project: 1. Hybrids with embedded derivatives requiring bifurcation under current guidance. 2. Liabilities recognized as a result of "failed sales" and consolidation of variable interest entities.

ISDA nominations to both the IASB and European Financial Reporting Advisory Group *Financial Instruments Working Group* were accepted, with European Committee Chair, Melissa Allen (CSFB) appointed to the IASB group, and Hugh Shields (Barcap), to the EFRAG group.

## REGULATORY - EUROPE

ISDA has continued to work toward a regulatory framework that ensures flexibility and legal certainty for derivatives in the European Union (EU), without creating regulatory hurdles to product development.

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Further to the final adoption in April 2004 of the Directive on markets in financial instruments (MiFID), ISDA has been actively involved in the consultation process undertaken by The Committee of European Securities Regulators (CESR) leading to the finalization of its technical advice to the European Commission for the adoption of the level 2 measures. These measures implement the general principles of regulation provided for in the directive. Particularly intensive, in this respect, has been the effort undertaken by the ERC<sup>2</sup> in providing detailed comments on two calls for evidence on the mandates from the Commission and seven consultation papers published by CESR in the relevant period. These include issues such as admission to trading, professional client agreements, best execution and market transparency, market integrity and transaction reporting and cooperation between competent authorities.

ISDA played a significant role in the definition of financial instruments, aimed at providing a balanced regulatory answer to issues raised by physically settled commodity derivatives and non-financial non-commodity derivatives having the characteristics of other derivatives financial instruments.

Consultation papers by CESR on best execution and market transparency are still pending. In order to aid the finalization of CESR technical advice to the EU Commission, ISDA is working with the EU Institutions (Commission, European Securities Committee, national governments and regulatory authorities) involved in the process leading to the adoption of the level 2 provisions and their subsequent transposition and implementation.

In the wake of the transposition of the Market Abuse Directive (MAD), due by October 2004 but still pending in a number of jurisdictions, ISDA is contributing to CESR work at level 3 on issues aimed at bringing further clarity to market participants on a number of operational requirements with which they are meant to comply under the directive. Work is currently under way to achieve a consistent and effective application of the directive across the EU also by better defining concepts such as accepted market practices and providing examples of market manipulations in breach of the directive.

A particularly sensitive issue relates to the requirement imposed on market intermediaries to report suspicious transactions and the related surveillance responsibilities. ISDA, together with other industry associations, provided input to the consultation paper of the Financial Services Authority and HMT concerning implementation of the directive in the U.K..

In late 2004, the European Institutions, including the Parliament, the Commission and the Inter-Institutional Monitoring Group, expressed their support of the functioning of the Lamfalussy approach, its ability to meet its key objectives and its future direction.

ISDA contributed to the consultation launched by CESR on its role at level 3 and, in particular, on how to achieve greater consistency across the EU in the implementation of EU law and establish greater convergence of supervision and enforcement. ISDA was also active in another consultation launched by CESR in on the so called Himalaya report.

## REGULATORY – NORTH AMERICA

Building on the Association's success in educating Congress and establishing key relationships, ISDA undertook several new initiatives as it worked to respond to heightened Congressional scrutiny of the financial markets.

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Working with The Bond Market Association, ISDA continued its efforts to reform the bankruptcy and bank insolvency laws in the United States. The joint industry proposal sought to update the Bankruptcy Code to reflect market developments since the FDIA and FDICIA were last updated in 1989 and 1991, respectively, and to ensure consistency between the two statutes and the Bankruptcy Code. In addition, the development of Basel II and a new consolidated supervisory structure affecting securities firms raised financial institutions' concerns regarding the legal certainty of netting. The industry wanted to make certain that systemic risk was mitigated by ensuring that financial intermediaries were able to exercise their rights in a timely manner. The new legislation also expanded the definition of "swap agreement" to reflect changes endorsed by the President's Working Group in 1996 that accommodated credit derivatives, equity derivatives and weather derivatives. The industry proposed to further expand the definition of "swap agreement" to include emissions and inflation derivatives.

ISDA was also actively engaged in the review of the Commodity Exchange Act, last amended in December 2000 with the passage of the Commodity Futures Modernization Act, and the reauthorization of the Commodity Futures Trading Commission (CFTC). The CFTC's mandate was last approved in December 2000 and must be reconsidered by the Congress every five years. ISDA Executive Director and CEO Robert Pickel testified before Congress in March 2005 to emphasize the industry's support for reauthorization of the CFTC. ISDA also monitored the legislative proposals regarding oversight of government

sponsored entities, such as Fannie Mae and Freddie Mac. ISDA was particularly concerned that any legislation considered by Congress contemplate netting provisions applicable to these entities.

ISDA, joined by The Bond Market Association and the Securities Industry Association, responded to the proposal by the Securities and Exchange Commission, the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision's proposal relating to complex structured finance transactions.

The industry comment letter focused on several key items, including the scope of the proposal, the international aspects of its scope, the possible introduction of new legal duties for financial institutions and documentation policies. In addition, the industry met with officials from the Federal Reserve Board, the Securities and Exchange Commission and the Office of the Comptroller of the Currency. To date, the U.S. Federal agencies have not revised their proposal, but it is anticipated that such a revision will occur in 2005.

On the educational front, ISDA held a documentation conference in Washington, D.C. to discuss various documentation issues as well as the fundamentals of derivatives. Acting Chairwoman Sharon Brown-Hruska gave the keynote address at ISDA's commodities conference in New York in November 2004. ISDA also participated in meetings with Congressional and agency staff on issues affecting the derivatives industry.

## RISK MANAGEMENT

ISDA continues to work with the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, the Committee of European Banking Supervisors and European Institutions to further enhance the Capital Accord and ensure that it is implemented and interpreted consistently by all relevant regulatory bodies.

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ISDA has supported regulatory initiatives aimed at enhancing the Capital Accord in the short to medium-term future. One initiative, the Trading Book Review, was launched jointly by the Basel Committee and the International Organization of Securities Commissions in early 2004 with the objective of ensuring that positions in the trading book attract amounts of regulatory capital proportionate to the risks that they create. For ISDA, this review is critical, as it will deliver a more risk sensitive treatment of counterparty credit risk arising from OTC derivatives transactions, as well as improved recognition of credit risk mitigation. ISDA has supported the Basel/IOSCO working group by producing and commissioning extensive research into future exposure measurement, with particular emphasis placed on wrong way risk, roll-over risk and actively managed short term exposures, including calibration of simple potential future exposure add-ons. ISDA's work has been closely coordinated with other trade bodies, including the London Investment Banking Association and the Institute of International Finance. ISDA will focus on the Trading Book Review throughout 2005.

A longer-term project that will assist the Basel Committee in upgrading the Accord in due course is the convergence of economic capital measurements study, which ISDA commissioned jointly with the International Association of Credit Portfolio Managers from Rutter Associates. This study paves the way for improved regulatory recognition of portfolio diversification effects. ISDA also continued work on the implementation of the Accord, with particular emphasis on areas impacting the amount of regulatory capital charged against OTC derivatives

business. At the international level, ISDA supported the Accord Implementation Group on validation of the IRB approach, the challenges presented by low default portfolios, and our work with the joint AIG/CTF working group on "downturn LGDs." ISDA also co-sponsors the European LGD Database initiative, now in its third operational year with eight major financial institutions contributing data and over 500 resolved observations pooled. At the European level, ISDA worked with the Commission and Her Majesty's Treasury at refining key articles of the Capital Requirements Directive, which transposes the Accord into EU legislation. The Directive will be presented to the EU Parliament for First Reading in the fall of 2005. Looking ahead, ISDA will assist CEBS on model validation issues and the Supervisory Review Process. ISDA also continues to work with the UK FSA and participate in the Credit Risk Standing Group meetings. ISDA will contribute to a number of newly created "Expert Sub-groups" of the CRSG, including those on low default portfolios, external models, and stress testing. On the Operational Risk front, ISDA sits on the UK FSA's Op-Risk Standing Group, which has looked at compliance with rules such as the Advanced Measurement Approach soundness standard and correlation measures. Home-host interaction, particularly for 'significant' subsidiaries remains a critical issue for the viability of the AMA approach.

In the US and Japan, ISDA continues to support local regulators' Accord implementation efforts in areas of particular relevance to the membership, including credit risk mitigation and the trading book review.

## TAX

ISDA continues to work with the US Department of the Treasury, the Internal Revenue Service and the UK's Inland Revenue to pass tax legislation and issue related regulations which provide certainty for market participants, reflect established market practice and sound policy, and encourage continued growth in the privately negotiated derivatives industry.

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The major focus of the European Tax Committee throughout 2004 has been the impact on the tax regime of a move to new international accounting standards (IFRS). ISDA has been an active participant in the "IAS 39 Working Group" set up by the UK Inland Revenue to explore the likely effects and discuss possible changes to tax legislation. We plan to continue to support the work of this group as new issues arise as companies begin to file tax returns based on IFRS.

The Committee has also focused on changes proposed in the UK's "Green Budget" to the taxation of derivatives based on property and share values. Finally, we continue to monitor the progress of the OECD work on the taxation of permanent establishments (PEs). Recently, following comments from ISDA, and other industry bodies, the OECD decided to defer their report on PEs until further work was done.

In the US, ISDA has responded to Treasury and IRS proposed regulations regarding the appropriate method for the inclusion into income or deduction of contingent nonperiodic payments made pursuant to a notional principal contract (CNPCs) and the treatment of such inclusions or deductions.

ISDA recommends that the "wait-and-see" method best reflects the economics of CNPCs, and should be retained. As an alternative, ISDA recommends that the "wait-and-see" method be retained for (i) all CNPCs with terms of five years or less and (ii) longer-dated CNPCs with contingent payments that are indeterminable as to both timing and amount when entered into (e.g., credit default swaps). Maintaining current law for such CNPCs should cover the

overwhelming majority of CNPCs. For CNPCs with terms greater than five years (but not those with contingent payments that are indeterminable as to their timing and amount), the full allocation method should be adopted, under which all income and deductions are deferred until the contingent payment is made. Regardless of the term of the CNPC, taxpayers should be permitted to elect to mark-to-market their CNPCs.

Treasury and IRS issued Notice 2004-52 requesting information regarding credit default swaps (CDS) in connection with the consideration by the government of taxpayer requests (including an ISDA formal request) for specific guidance on the tax treatment of CDSs.

ISDA maintains that a CDS is a financial instrument and that payments made thereunder to a non-US counterparty would not be subject to withholding taxes or insurance excise taxes. While practically all tax practitioners believe there are no withholding taxes applicable to CDSs, the IRS has never provided direct guidance on the point. In light of the large size and rapid growth of the market, ISDA thought it prudent to ask the IRS for specific guidance. ISDA has followed up with government staff on topics such as pricing, hedging and liquidity of CDS; nature of credit market participants; differences between credit default swaps and standby letters of credit and guarantees.

The American Jobs Creation Act was passed in October 2004. ISDA was instrumental in the removal of harmful language from the bill which would have repealed the qualified covered call (QCC) exception to the straddle rules of the US tax code for OTC options.

## ASIA-PACIFIC

Over the course of the past year, ISDA has continued its dialogue with regional regulatory bodies and members in the Asia-Pacific region to encourage development of the regional privately negotiated derivatives markets and to promote sound risk management practices.

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ISDA's Asia-Pacific Office, based in Singapore, focuses on developments in Australia, Hong Kong, India, Indonesia, Malaysia, New Zealand, People's Republic of China, Philippines, Singapore, South Korea, Thailand and Taiwan. Last year's key regional developments included:

In China, following the promulgation of the long awaited Provisional Administrative Rules Governing Derivatives Activities of Financial Institutions in February 2004, around 50 banks have received approval from the China Banking Regulatory Commission (CBRC) to conduct derivatives business in China. In December 2004, CBRC issued *Guidelines on the Market Risk Management of Commercial Banks*, which introduced some of the Basel Core Principles for Effective Banking Supervision and added more detail to the risk management concepts introduced by the new Derivatives Rules. ISDA continued its dialogue with regulators and lawmakers, in particular concerning the draft Bankruptcy Law, with a view to strengthening the legal framework relating to the enforceability of close-out netting.

In early 2005, the Securities and Futures Commission in Hong Kong issued a Consultation Paper on the Review of the Disclosure of Interests Regime under Part XV of the Securities and Futures Ordinance. ISDA provided comments seeking in particular an exemption for certain credit derivative transactions. Further dialogue on the issue is anticipated.

In India, ISDA continued to support the Reserve Bank of India's push to implement close-out netting legislation as well as to promote legal certainty in related areas.

ISDA also made available a first legal opinion on the enforceability of the termination, bilateral close-out netting and multibranch netting provisions of the ISDA Master Agreements in India.

ISDA further released a first collateral opinion for the Philippines on the validity and enforceability of collateral arrangements under the ISDA Credit Support Documents.

ISDA has been working to ensure the enforceability of collateral arrangements in South Korea through the proposed introduction of a close-out netting provision as part of the new Insolvency Legislation in Korea. A February 2003 Supreme Court case had cast doubt on this issue.

On a pan-regional basis, ISDA's monthly Asia-Pacific Legal & Regulatory Committee meetings in Hong Kong and Singapore served to monitor and discuss regional and regulatory developments as well as follow the work of ISDA's global Committees.

In addition to providing input on the revised Collateral Guidelines through its Asia-Pacific Collateral Committee, ISDA's efforts in the region continued to focus on education. Presently members are working on building a Chinese language glossary of collateral terms. ISDA's Asia-Pacific Risk Management Committee, which serves as an informational forum for risk practitioners in the region, continued its focus on information distribution and risk management education. In 2004, together with PRMIA, ISDA organized a series of risk seminars in the region. ISDA also continues to promote the Asian ISDA-RMA Loss Given Default database with members and regulators.

## CANADA

The focus of the past year has been on providing certain Canadian-specific documentation additions to existing ISDA publications, in order to further service the Canadian derivatives market. In addition, we have focused on legislative developments in the area of OTC derivatives regulation and collateral law reform.

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On April 7, 2004 Ontario Superintendent of Financial Institutions released a ruling that affirms the right of banks, foreign bank branches and other federally incorporated financial institutions to engage directly in physically-settled commodity trading, subject to certain requirements. The Canada Steering Committee worked with the Canadian Bankers' Association, and various ISDA members from Canada, to submit a comment letter in support of the proposed ruling.

In May 2004, the Committee submitted a comment letter to the Canadian Securities Administrators on the consultation draft of the Uniform Securities Act --The Regulation of OTC Derivatives. The proposed legislation seeks to bring OTC derivatives within the regulatory jurisdiction of securities legislation, and then provide exemptions for transactions between "qualified parties." As a result, derivative transactions could be subject to prospectus and registration requirements unless exempted. There is no such comparable regulation in the United States and this approach could place OTC derivatives participants in certain Canadian provinces at a competitive disadvantage. ISDA's comment letter emphasized these points.

In June 2004, ISDA published a definition of "Force Majeure Event," for use with the 2002 ISDA Master Agreement, when such Master Agreement is governed by the law of a province of Canada (other than Quebec) or where there is a likelihood of having to litigate a force majeure issue in such a province. In February 2005, ISDA published Instructions and Additional Provisions for use with a Counterparty in Quebec to provide guidance on taking a non-

possessory security interest in certain forms of collateral, when a counterparty is located in Quebec. Also in June 2004, ISDA submitted a comment letter to Industry Canada regarding issues that ISDA members believe should be addressed in the next round of Canadian insolvency law reform; most significantly the operation of automatic stays against OTC market participants during insolvency proceedings.

In February 2005, ISDA submitted an amicus brief (or intervenor factum as it is called in Canada) in the Androscoggin Energy LLC case to the Court of Appeal for Ontario. ISDA's submissions to the court concerned whether "physical" v "financial" settlement is a proper basis for determining whether a contract is an "Eligible Financial Contract" under the Companies' Creditors Arrangement Act. The decision of the court, released February 18, upheld ISDA's submissions that "physical" vs. "financial" settlement is not a proper basis for determining whether a contract is an "Eligible Financial Contract" under the Companies' Creditors Arrangement Act. The decision goes on to uphold the reasoning applied by the Alberta Court of Appeal in Blue Range.

Looking ahead, the Committee will focus on increasing its work on collateral law reform and insolvency law reform, by expanding its efforts to encourage passage of the USTA by other provinces in addition to Ontario, and by encouraging Industry Canada to look at improvements to the various bankruptcy and insolvency statutes. ISDA will also aim to expand its educational seminar program in the region, notably in the area of accounting practice and policy.

## CENTRAL & EASTERN EUROPE / ISLAMIC LAW

ISDA's Central & Eastern Europe Committee focuses on the progress EU accession and candidate countries have made in implementing derivatives-relevant EU legislation, mainly the Collateral and Winding Up Directives and related legislation. The scope of this Committee also extends to other countries, including Islamic jurisdictions through the Islamic Finance Law Group.

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Upon EU accession, the Czech Republic adopted ISDA-endorsed netting provisions. Since Hungary and Poland adopted netting laws in 2002 and 2003, ISDA has published netting opinions for these jurisdictions. When Greece adopted a netting provision shortly after Hungary and Poland, ISDA published a Greek netting opinion as well. It is hoped that Slovakia will finalize netting legislation by the end of 2005.

In order to obtain more uniform netting across the EU, ISDA has submitted a proposal to the European Commission suggesting the adoption of a European netting directive aimed at harmonizing the netting regimes in the EU member states and the accession countries. ISDA is particularly monitoring the status of implementation of the EU Collateral Directive in accession, candidate countries and beyond. Russia remains a top priority for ISDA. Previously, ISDA had commented on various draft bills.

ISDA has approached the new financial markets regulator and is part of a new local working group that is discussing progress in financial legislation, especially derivatives. ISDA has also submitted comments on current legislative efforts in Israel. Issues of currency re-denomination in Turkey as of January 1, 2005 have also been addressed by the Association.

The Islamic Finance Law Group is discussing fundamental legal issues of Islamic law facing the derivatives business in jurisdictions of primary concern to ISDA members in the Gulf region (UAE, Bahrain, Saudi Arabia, Kuwait, Qatar) and Southeast Asia (Malaysia). Draft proposals for Shari'a law-compliant ISDA documentation are also being discussed. ISDA has approached regulators in the Gulf region and Malaysia on their views on key concepts of ISDA documentation.

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## LATIN AMERICA

The Latin America Committee recognizes that the region is an important emerging financial center and is working to promote financial law reform and growth in the OTC derivatives markets.

A review of the new Brazilian insolvency legislation may lead to the Association commissioning a new netting opinion for the

jurisdiction, though at the time of writing it appeared that this would not be needed. The Association has also commissioned a collateral opinion for Mexico.

At the time of writing, it also appeared likely that a netting opinion for Barbados will be commissioned some time during the spring.

## JAPAN

Over the past year, ISDA has continued to work toward the development and expansion of the activities in the privately negotiated derivatives markets through various committees and conferences. ISDA also continued its dialogues with Japan's regulators for a framework to be proportionate with region's market and risk management practices.

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ISDA continued its focus on risk management throughout 2004. Since its establishment in early 2004, the Japan Basel II Implementation Working Group has held proactive dialogues with Japan's Financial Services Agency (JFSA), collaborating with the Japanese Bankers Association on the revised framework of Basel Capital Accord and the implementation plan presented by JFSA. The focus of the Working Group was on the capital treatment of credit derivatives and collateralized OTC derivatives, including some of the issues debated under Basel Committee / International Organization of Securities Commissions Trading Book Working Group. Over the course of 2004, the Japan Equity Derivatives Committee worked on the standardization of confirmation terms of inter-dealer transactions relating to Japanese shares and indices. Careful discussions lead to the publication of confirmation templates in June 2004, followed by the Master Confirmation in February 2005.

In April 2004, the Japan Credit Derivatives Committee conducted a survey on the trading volume of various transaction types. Summary results were shared at a credit derivatives conference held in July, to allow broader market participants to analyze current activities and tell the future trend. Throughout the year, the Committee's subgroup, the Market Practice subcommittee, continued to serve as a forum to address local market issues. Discussions in 2004 included determination of Successors following the reorganization of JAL group and applicability of debt for an equity swap as a Restructuring Credit Event. In July 2004, ISDA established the Credit Derivatives Working Group as a subgroup to

the Japan Operations Committee. At its inauguration meeting, the new Working Group identified resolution of outstanding confirmations and automation of confirmation processes as its primary focus.

Another significant achievement in 2004 was the October release of Japanese guidelines to the 2002 ISDA Master Agreement. This booklet prepared by the Japan Documentation Committee was utilized as a text at the Conference held in February 2005, which was the first ISDA Documentation Conference conducted solely in Japanese.

In new products, the Japan Emission Trading Working Group finalized a proposal paper to the industry in June, which advocates the establishment of an OTC market and the importance of financial institutions to the development of an OTC emissions market in Japan. It also reveals issues that prevent the smooth development of an OTC market in the region based on legal and accounting analysis.

As a continuation of these activities, the Working Group met with Japan's Ministry of Environment for an information exchange in November. The Japan Commodity Definitions Working Group discussed the standard language for Japan Crude Cocktail (JCC) and agreed to include them in the 2005 ISDA Commodity Definitions.

In the coming year, ISDA will continue to provide forums for members to discuss issues relating to OTC derivatives, including traditional and new products, as well as furthering dialogue with national regulators.

## RESEARCH & EDUCATION

ISDA continues to believe that the industry benefits from increased understanding of derivatives by policymakers and by the public. In addition, ISDA continues to conduct surveys and other research activities that further the level of general understanding of its members, regulators and others.

Education: ISDA continued its derivatives training efforts in 2004, with its Fundamentals of Derivatives, Fundamentals of Credit Derivatives, and Operations Training seminars in New York and London. ISDA also conducted Fundamentals of Derivatives seminars in new locations in 2004, including Hong Kong, Singapore, Copenhagen, Paris, Vienna, Boston, Chicago, San Francisco, Stamford, and Washington. Credit Derivative Seminars were also held in Hong Kong and Tokyo. In the coming year, ISDA plans to offer Fundamentals of Derivatives Seminars in Johannesburg, Mumbai, Seoul and Taiwan.

New seminars are currently under development for 2005, including Fundamentals of Commodity Derivatives, to be held in London, Calgary and New York, and Fundamentals of Equity Derivatives, to be held in London and New York.

ISDA is also exploring interest in half-day seminars on specific topics such as Derivatives Documentation for Credit Managers, Pricing and Valuation and Bond Math for Derivatives.

Research: ISDA is acquiring and assembling historical data on the ISDAFIX Swap Rate Benchmark, which was established in 1998, and will make the data available at [www.isda.org](http://www.isda.org). The data cover swap fixed rates for six currencies: CHF, EUR (Euro Libor and Euribor), GBP, HKD, JPY, and USD (rates and spreads).

ISDA conducts its Margin Survey and Operations Benchmarking Surveys annually and its Market Survey semiannually. In

2004, the Market Survey and the Margin Survey were automated by moving the questionnaires to the Internet. In addition, the Operations Benchmarking Survey, while still conducted by means of spreadsheet distributed by email, has been simplified and shortened considerably.

Finally, the FpML Survey, which was previously a subset of Operations Benchmarking Survey questions, has been split off into a separate Internet-based survey. ISDA hopes to automate the Operations Survey in the coming year.

ISDA conducted two one-off surveys in 2004. The first was a survey of concentration of counterparty credit exposures among major dealers. Published at the AGM, the survey found that on average, a major dealer's five largest net interdealer exposures are about two percent of its entire derivatives exposure. The second was a survey of times required to negotiate an ISDA Master Agreement. Both surveys are available at [www.isda.org](http://www.isda.org).

Finally, ISDA and the International Association of Credit Portfolio Managers (IACPM) are jointly sponsoring a study of the Convergence of Credit Capital Models. The objective of the study, in which 31 financial institutions are participating, is to provide data to the Basel Committee on Banking Supervision that, it is hoped, will advance the case for allowing firms to use their credit portfolio models to determine capital adequacy. A by-product of study has been to provide new insights into the functioning of the major credit capital models. Final results are expected by mid-2005.

## MEMBERSHIP

ISDA's membership now totals over 625 financial institutions, government entities, corporations and professional service providers, spanning 47 countries across six continents. Since January 2004, 64 new members have joined the Association. ISDA continues to work through its active committees, working groups and educational efforts to address ongoing industry needs.

ISDA's members are classified into three categories according to the guidelines contained in its by-laws. Below is a description of each category as well as some of the benefits of membership.

### ***Primary Members – dealer firms***

According to the Association's by-laws, every investment, merchant or commercial bank or other corporation, partnership or other business organization that, directly or through an affiliate, as part of its business (whether for its own account or as agent), deals in derivatives shall be eligible for election to membership in the Association as a Primary Member, provided that no person or entity participates in derivatives transactions solely for the purpose of risk hedging or asset or liability management.

### ***Associate Members – service providers***

ISDA's Associate Membership category is designed for service providers -- brokers, law firms, accounting firms, consulting firms and software providers -- who are active in the privately negotiated derivatives business. Associate Membership provides a forum for these industry participants to stay abreast of and contribute to important developments and initiatives.

### ***Subscriber Members – end-users***

ISDA's Subscriber Membership category is designed for corporations, financial institutions, government entities and others who use privately negotiated derivatives to better manage financial risks. Subscriber Membership provides a forum for these industry participants to stay abreast of and contribute to important developments and initiatives.

Only ISDA members are entitled to receive the Association's legal opinions on the

enforceability of the netting provisions of the ISDA Master Agreements. ISDA has obtained netting opinions for 44 jurisdictions.

A netting opinion for the Czech Republic has been commissioned. In addition to the netting opinions, ISDA provides members with legal opinions on the ISDA Credit Support Documents from 34 different jurisdictions. A legal opinion for Mexico has been commissioned.

Only ISDA members are able to participate in the Association's numerous Committees, Working Groups and Task Forces, which serve to address issues in the rapidly evolving derivatives market. ISDA members exclusively receive the numerous policy papers, response letters, market survey data and communications on key business issues ISDA and its consultants generate.

ISDA members receive substantial discounts when ordering copies of the Master Agreement and supporting documents published by the Association and widely used to document privately negotiated derivatives transactions. Primary Contacts at member firms receive complimentary copies of all new publications upon their release.

Only ISDA members are eligible to attend the Association's Annual General Meeting, which is the industry's preeminent forum for the discussion of developments and issues in the privately negotiated derivatives business. In addition, a strong preference is given to enlisting speakers from ISDA member firms at the Association's numerous conferences and seminars.

Following is a list of the Association's members. *Firms shown in italics* are those that have joined since January 2004.

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## ISDA PRIMARY MEMBERS

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|--|---|
| ABAXBANK S.p.A.  | Caboto - Società di Intermediazione Mobiliare S.p.A.            |
| Abbey National Financial Products  | Caixa D'Estalvis de Catalunya                                   |
| ABN AMRO Bank N.V.   | Caixa Geral de Depositos, SA.                                   |
| ABSA Bank Ltd.   | Caja de Ahorros Y Monte de Piedad de Madrid                     |
| Accord Energy Limited  | Calyon Corporation  |
| AEP Energy Services, Inc.  | Capitalia Spa   |
| Agricultural Bank of China   | Cargill Financial Services Corporation                          |
| Allied Irish Banks, plc  | China Construction Bank   |
| American Express Company   | <i>Chinatrust Commercial Bank</i>                               |
| American International Group, Inc.   | Chuo Mitsui Trust & Banking Co. Ltd.                            |
| AmMerchant Bank Bhd.   | CIBC World Markets Inc.   |
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| Assured Guaranty Corp.   | Citigroup   |
| Australia and New Zealand Banking Group, Limited                             | Commerce International Merchant Bankers Berhad                  |
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| BANCA ALETTI & C. S.p.A. (Group Banco Popolare di Verona c Novara S.c.ar.I.) | Commonwealth Bank of Australia                                  |
| Banca del Gottardo   | Confederacion Espanola de Caja de Ahorros <i>ConocoPhillips</i> |
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| BRE BANK SA  | Industrial and Commercial Bank of China                         |
| <i>British Energy Power and Energy Trading Limited</i>                       |   |

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## **ISDA CONFERENCES 2004**

### **FUNDAMENTALS OF DERIVATIVES SEMINAR**

January 21 – New York  
February 23 – London  
February 25 – Vienna  
March 18 – Copenhagen  
April 28 – Paris  
June 9 – New York  
July 15 – Hong Kong

September 14 – Boston  
October 4 – Chicago  
October 6 – San Francisco  
October 25 – Singapore  
November 30 – Washington  
December 6 – Connecticut

### **UNDERSTANDING THE NEW ISDA DOCUMENTATION CONFERENCE**

January 22 – New York  
February 24 – London  
February 26 – Vienna  
February 27 – Frankfurt  
March 19 – Copenhagen  
April 29 – Paris

April 30 – Zurich  
June 10 – New York  
September 15 – Boston  
September 23 – London  
October 5 – Chicago  
October 7 – San Francisco

### **DOCUMENTING & CONFIRMING CREDIT DERIVATIVES TRANSACTIONS**

May 5 – New York  
May 12 – London

November 9 – New York  
November 17 – London

### **DOCUMENTING & CONFIRMING EQUITY DERIVATIVES TRANSACTIONS**

January 23 – New York  
June 11 – New York

September 24 – London

### **UNDERSTANDING COLLATERAL ARRANGEMENTS & THE ISDA CREDIT SUPPORT DOCUMENTS CONFERENCE**

May 6 – New York  
May 13 – London

November 10 – New York  
November 18 – London

### **OPERATIONS TRAINING COURSE**

March 16 & 17 – London  
April 20 & 21 – New York

October 14 & 15 – New York

### **FUNDAMENTALS OF ISDA DOCUMENTATION CONFERENCE**

February 9 – Mumbai  
March 11 – Seoul

July 27 - Bangkok

**LITIGATION IN THE OTC DERIVATIVES MARKET**

March 9 – New York

March 10 – London

**CREDIT DERIVATIVES CONFERENCE**

July 13 – Tokyo

July 16 – Hong Kong

**NEW PRODUCT DEVELOPMENTS FOR THE TRANSFER OF CREDIT RISK**

November 10 – London

November 18 – New York

**FUNDAMENTALS OF CREDIT DERIVATIVES SEMINAR**

May 4 – New York  
May 11 – London

November 8 – New York  
November 16 – London

**ISDA ENERGY, COMMODITIES & DEVELOPING PRODUCTS CONFERENCE**

April 22 – London

November 17 – New York

**FpML TRAINING COURSE**

June 17 – New York

December 8 – London

**2004 DOCUMENTATION INITIATIVES IN  
COLLATERAL, CREDIT & COMMODITY DERIVATIVES CONFERENCE**

July 27 – Toronto

**ISDA REGIONAL MEMBER CONFERENCE**

September 22 – London  
September 29 – New York  
October 21 – Sydney

October 26 – Singapore  
October 28 – Tokyo

**ISDA 19<sup>th</sup> AGM**

March 31 – April 2 – Chicago

**2004 ISDA FpML CONFERENCE**

December 9 – London

## ISDA RISK MANAGEMENT SEMINARS 2004

In 2004, 659 individuals from 232 companies attended ISDA's monthly risk management seminars, with an average attendance of 86 people.

### EUROPE

- |              |   |
|--------------|---|
| January 21   | An update on recent developments in Basel 2: distinguishing between expected and unexpected loss – Speaker: Paul Sharma                 |
| February 17  | ISDA Counterparty Risk Notes on "alpha" – Speaker: Juan Grana   |
| March 16     | Diversification Between Different Risk Types: Understanding the Importance & Examining the Latest Techniques – Speaker: Sebastian Fritz |
| April 13     | Reducing economic capital through securitization – Speaker: Michael Dickinson   |
| May 18       | Avoiding Default: New Techniques for Managing Credit Risk – Speaker: Jean-Martin Aussant  |
| June 15      | Management of credit risks within a trading environment – Speaker: Craig MacDougall   |
| July 13      | Achieving a Singular View of Trading Operations Worldwide – Speaker: Pascal Emile   |
| August 17    | Making Sense out of Metrics – Speaker: Michael Finlay   |
| September 14 | Translating Basel into Brussels – Speaker: Patrick Pearson  |
| October 13   | Risk Management - The view from Lloyds – Speaker: Andrew Gurney   |
| November 16  | The Market For Inflation Derivatives - Development And Application – Speaker: Julian Tams   |

### NORTH AMERICA

- |              |  |
|--------------|--|
| September 23 | The Role of Collateral in Risk Management: Dealer and Fund Manager Perspectives – Speakers: Michael Clarke & Ila Eckhoff |
| November 10  | Dealing With Operational Risk: A Global Firm Perspective – Speakers: Jay Newberry & Joe Sabatini                         |

