ISDA®

International Swaps and Derivatives Association, Inc.
24 Raffles Place
#22-00 Clifford Centre
Singapore 048621
Telephone: 65 6538 3879
email: isdaap@isda.org
website: www.isda.org

BY COURIER AND E-MAIL

December 15, 2009

Mr Salim Gangadharan
Chief General Manager-in-Charge
Foreign Exchange Department
Foreign Markets Division
Reserve Bank of India
Amar Building, 5th floor
P.M. Road, Fort
Mumbai – 400001
India
Email salimg@rbi.org.in

Dear Sir

Submission on Draft Comprehensive Guidelines on Foreign Exchange Derivatives and Hedging Commodity Price Risk and Freight Risk Overseas

The International Swaps and Derivatives Association, Inc. ("**ISDA**") is grateful for the opportunity to comment on the draft Comprehensive Guidelines on Foreign Exchange Derivatives and Hedging Commodity Price Risk and Freight Risk Overseas ("**Draft Guidelines**") released for public comment by the Reserve Bank of India ("**RBI**") on November 12, 2009.

By way of background, ISDA, which represents participants in the privately negotiated derivatives industry, is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has over 840 member institutions from 58 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

At the outset, we would like to place on record our appreciation for the initiatives taken by RBI in the arena of OTC derivatives. Market participants in general, and ISDA and its members specifically, have been following the policy initiatives taken by RBI and would like to take this opportunity to commend RBI on its proactive approach. ISDA values its relationship and on-going dialogue with RBI and is grateful that RBI has taken on board a number of the recommendations and submissions by ISDA in the past, for example, in relation to the Reserve Bank of India (Amendment) Act, 2006 and the Comprehensive Guidelines on Derivatives issued in April 2007.

At this stage, we would like to respectfully make a few "macro" level points on the Draft Guidelines.

1. Interaction with existing regulations

Currently, there are multiple regulations governing foreign exchange derivatives ("**FX Derivatives**") in India. While RBI's proposal to consolidate the existing regulations is laudable, it is unclear as to what would prevail in case the Draft Guidelines are divergent (which in some cases they seem to be) from the existing regulations[1].

Further, given that the Draft Guidelines cannot amend the Foreign Exchange Management Act, 1999 ("**FEMA**"), relevant circulars will still have to be issued under sections 10(4) and 11(1) of FEMA (the "**Circulars**"), along with amendments to the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000, where relevant. Also, as a matter of interpretation, the said Circulars are likely to prevail over the Draft Guidelines, in case of inconsistencies.

The Draft Guidelines also seem to co-exist with (and also reproduce) the existing guidelines/directions consolidated in the Master Circular on Risk Management and Inter-Bank Dealings dated July 1, 2009 ("**Master Circular**"). Given the reproduction, the Draft Guidelines could potentially create considerable confusion unless they are a substitute or replacement for the Master Circular. If the Draft Guidelines are not meant to be a substitute for the Master Circular, then RBI could consider cross-referring to each of the relevant portions of the existing regulations rather than reproducing them. This will also ensure that the Draft Guidelines take into consideration subsequent changes in the existing regulations.

We also note that the Draft Guidelines states that "the relevant provisions of comprehensive guidelines on Derivatives issued vide DBOD.No.BP.BC. 86/21.04.157/2006-07 dated April 20, 2007 are also applicable to forex derivatives." If the intention is to refer to certain specific provisions of the comprehensive guidelines on derivatives (probably 8.3 and 8.4) then it should accordingly be mentioned specifically.

2. Duties imposed on the Authorised Dealers ("**ADs**")

The Draft Guidelines lay down certain instructions to be followed by users and market makers. While some of these are a reiteration of existing compliance requirements, additional obligations are being introduced. In particular, the scope and extent of the due diligence and verification that needs to be undertaken by the ADs is significantly expanded (indeed to such an extent that ADs seem to be expected to be much more than just "watchdogs").

We would respectfully submit that enhancing the policing role of the ADs is inherently in conflict with their role as market makers and arm's length counterparty. When ADs deal on the basis of being an arm's length counterparty (which is the general norm worldwide), they assume no advisory duty and rely on the representations and warranties given by the counterparty. The Draft Guidelines essentially obliges the ADs to require proof to be provided by the counterparty of the existence of an underlying risk to be hedged and to verify that the transaction does hedge the underlying risk consistently with the

---

[1] The existing Regulations are:

(i) the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000;
(ii) the various circulars/notifications/orders issued by the RBI from time to time pursuant to Section 10(4) and Section 11(1) of the Foreign Exchange Management Act, 1999;
(iii) other circulars or orders not specifically stated to be issued pursuant to Section 10(4) and Section 11(1) of the FEMA; and
(iv) the Comprehensive Guidelines on Derivatives issued by the Department of Banking Operations and Development of RBI dated 20th April 2007;
(v) the Master Circular on Risk Management and Inter-Bank Dealings dated July 1, 2009.

counterparty's risk management policy. This will give (and has in the past given) rise to claims that the AD owes an advisory duty to the counterparty and is responsible for any losses that may be suffered by the counterparty - effectively, the AD is forced to underwrite such losses.

At the very least, we would urge RBI to (i) clarify the extent to which ADs can rely on representations and warranties by the user, (ii) state that the Draft Guidelines do not impose or give rise to the existence of an advisory or any other duty of care being owed by the ADs to the users, (iii) state that breach of the Draft Guidelines would not of itself render the contract void or voidable, and (iv) state that action would also be taken against corporate end-users who fail to comply with the Draft Guidelines. Consistent enforcement of the Draft Guidelines by RBI against both ADs and users would also help ensure compliance across-the-board.

3. Prohibition of cost reduction structures and zero cost structures

The Draft Guidelines prohibit the entry into cost reduction structures and zero cost structures. Structures that can currently be undertaken such as risk reversals/option spreads/seagulls allow users to structure their hedges in line with their underlying market view or risk management policy. We assume that RBI is primarily concerned with the use of leveraged products and the restructuring of out-of-the-money transactions. We would respectfully submit that these concerns can be dealt with in other ways (for example, by restricting leveraging) and that parties should still be allowed to enter into cost reduction structures and zero cost structures where appropriate. Our key concern with the prohibition of cost reduction structures is that corporate end-users may simply decide not to hedge as they view the option premium to be prohibitively expensive given their assessment of (i) the likelihood of rates moving against them, and (ii) the extent of an adverse rate move and the resulting expected loss they would suffer. This would expose them to potentially huge losses when they do get it wrong and rates do move against them significantly.

ISDA would be happy to clarify any points raised in this submission. Please do not hesitate to contact Mr Keith Noyes (knoyes@isda.org; +852 2200 5900) or Ms Jacqueline Low (jlow@isda.org, +65 6538 3879) of ISDA.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.

Keith Noyes
Regional Director, Asia Pacific

Jacqueline Low
Senior Counsel, Asia