

July 29, 2011

Svein Andresen
Financial Stability Board
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Svein,

In response to your letter of 10 June 2011, ISDA welcomes the opportunity to provide the FSB with an overview of industry achievements over the past year. This letter covers recent developments under the headings of clearing, standardisation, exchange and electronic trading, trade repositories and financial law reform. We have also included as an appendix details of various studies and resources published by ISDA over the past months, which provide some background to the marketplace and to ISDA's work.

We hope that it is clear from the material that follows that ISDA and its members have continued to make significant strides over the past months and years in the context of our commitment to safe and efficient markets. To list but a few examples by way of introduction:

- **Standardisation:** ISDA's 2011 Equity Derivative Definitions were published on 8 July 2011. These definitions provide a toolkit and framework to assist the industry build out of standard legal documentation for equity derivative products.
- **Clearing:** ISDA's analysis of year-end statistics published by the Bank for International Settlements (BIS) and LCH.Clearnet's SwapClear shows that the level of cleared interest rate swaps exceeded 50 percent of interest rate swap notional outstanding at the end of 2010, up from 21 percent at year-end 2007. Over the same time frame, the volume of uncleared interest rate swaps outstanding declined from \$201 trillion to \$116 trillion, a decrease of \$85 trillion or 42 percent.
- **Data standards:** A Legal Entity Identifier (LEI) solution for the whole financial industry is being developed by a broad group of firms and trade associations from around the globe. These trade associations have engaged global and regional market participants, as well as the regulatory community, to ensure the consideration of a broad set of views, practices and concerns.
- **Transparency:** ISDA has helped establish trade repositories for credit, interest rate and equity derivatives. Work is now well advanced to establish a repository for commodity derivatives. Trade repositories improve transparency by providing global regulators with significant visibility into risk exposures by firm and by counterparty.

There is further work to be done, and we are committed to maintaining a strong dialogue with regulators and policy makers around the globe in support of targeted and well-designed reform. As you are aware, the legislative and rulemaking processes are complex and ISDA continues to strive to overcome obstacles to the appropriate implementation of laws and rules that affect the OTC derivatives industry.

Following the adoption of Dodd-Frank into law in July 2010, rulemaking is under way. According to a Davis Polk & Wardwell LLP study, Dodd Frank requires some 243 rulemakings and 67 studies. The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions are likely to persist that will require consultation with the staffs of the various agencies involved. CFTC Chairman Gensler recently acknowledged that the CFTC were unlikely to meet the mid-July 2011 deadline for finalising the rulemakings. It now seems that rules will be introduced in phases with key definitions in summer 2011 and complex rules (such as collateral segregation and capital requirements) in autumn 2011. The proposed EU Regulation on OTC derivatives, central counterparties and trade repositories was first published in September 2010. It is currently passing through the EU legislative process, with the European Parliament and the European Council negotiating the text. On 5 July 2011, the European Parliament voted in plenary to adopt a number of amendments to the draft regulation. The Council has not yet arrived at a general approach, but continues its discussion on a number of issues. Adoption of the regulation had been expected mid-2011 but is now likely to be delayed and a second reading is possible. Given the global nature of the OTC derivatives market, international coordination between supra-national standard setters, national supervisors and industry is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. Of concern too are the potential unintended consequences of legislative extra-territorial application.

Clearing

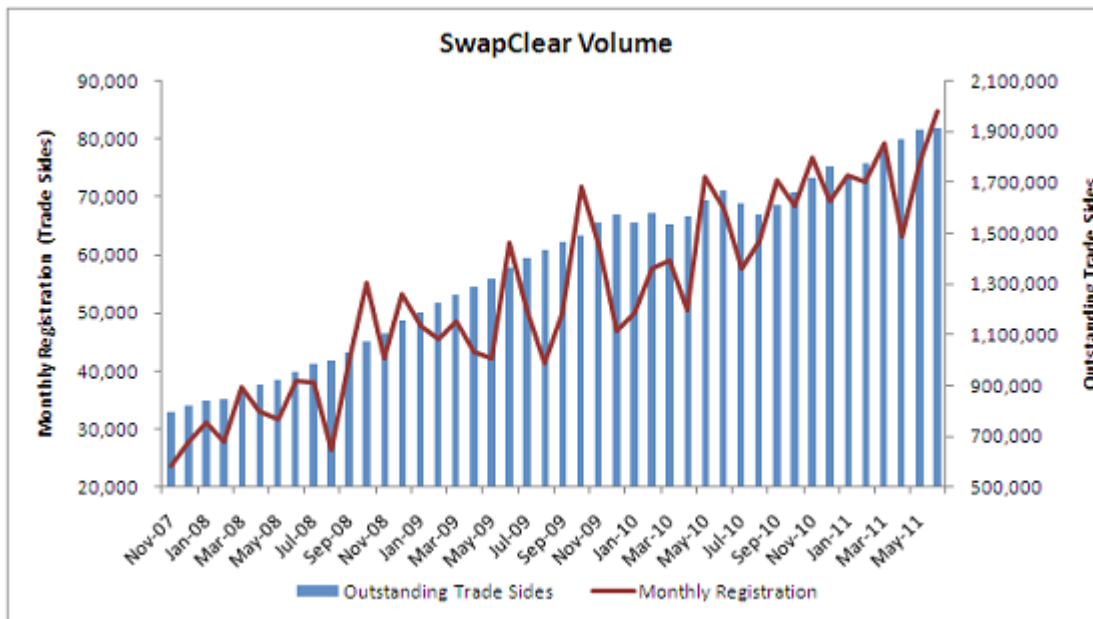
Increase in voluntary central clearing

Analysis published on 26 May 2011 shows that the level of cleared interest rate swaps exceeded 50 percent of notional outstanding at the end of 2010, up from 21 percent at year-end 2007. Over the same time frame, the volume of uncleared interest rate swaps outstanding declined from \$201 trillion to \$116 trillion, a decrease of \$85 trillion or 42 percent:

**BIS, Notional amounts
outstanding**

US\$ trillions	Dec.2007	Dec.2008	Dec.2009	Dec.2010
OTC Interest Rate Derivatives (including FRA, IRS, options)	393.1	432.1	449.9	465.3
Interest Rate Swaps (IRS)	309.6	341.1	349.3	364.4
LCH SwapClear volumes, adjusted for double-counting	54.4	75.8	107.7	124.3
IRS, adjusted for LCH cleared volumes	255.2	265.4	241.5	240.0
IRS volumes cleared, %	21.3	28.6	44.6	51.8
IRS, uncleared	200.7	189.6	133.8	115.7

The following chart produced by LCH.Clearnet further illustrates the significant growth in the volume of cleared interest rate swaps:



The role of central clearing is also increasingly significant in the CDS market. In January, the IntercontinentalExchange® announced that its CDS clearing houses surpassed \$15 trillion in cumulative gross notional value and 400,000 transactions during the week ending 21 January 2011. Together clearing and tear-ups have reduced the CDS market in excess of 75%.

International standards, mutual recognition and extra-territoriality

Given the global nature of the OTC derivatives market, such international coordination between industry, supra-national standard setters, national supervisors and infrastructure providers is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. ISDA has made numerous comments on the proposed capital treatment of bank exposures to CCPs produced by the BCBS in December 2010 and the global principles for “Financial Market Infrastructures” proposed by CPSS-IOSCO in March 2011.

The issues of mutual recognition and extra-territoriality between the US and EU proposals are still to be resolved. CFTC Chairman Gensler in a speech to the European Parliament in March 2011 noted the importance of the US and EU rules “converging” and pushed the EU to follow the CFTC focus on exchange traded and not just OTC transactions. Further progress on this is critical for all types of market participant.

Proliferation of CCPs

Singapore, India and Japan already have established clearing houses for OTC derivatives and Hong Kong, South Korea and China are working towards establishing clearing houses. Canada, Australia and Taiwan are contemplating developing a local CCP. This proliferation of clearing houses globally poses many concerns, including the potential introduction of legal, regulatory and financial arbitrage, and reduced netting opportunities and an overall reduction in trading activity as:

- Some global market participants may decide to limit their CCP memberships; and
- If regulators mandate market participants to clear their trades through a local clearing house, this may have the unintended consequence of curbing local market trading activity and may prevent financial institutions from accessing key markets.
- Differing eligible collateral requirements may increase the cost of funding.

CCP proliferation incurs the risk of fracturing currently singular bilateral netting “sets” across multiple CCPs. Such dispersion does not contribute to greater market safety and soundness. Potential clearing members have a finite pool of legal, credit and operations resources to draw upon to support clearing house developments. The risk is that resources will be spread too thinly, leading to the sub-optimal development of some clearing houses. Similarly, critical yet finite trading, legal, credit and operations resources will only be able to support a limited number of simultaneous clearing house member defaults, in a “worst case” scenario.

Standardisation

In May 2010 dealers contributed to a standardisation analysis across OTC Credit, Equity and Rates Derivatives. The analysis provided insight into the levels of standardisation for Trade Execution, Legal Documentation and Processing across each of the asset classes and was supported by a narrative which described the current state and future opportunities or next steps for each asset class. The dealers are in the process of refreshing the analysis at both the quantitative and qualitative levels with a scheduled completion date of 30 September 2011. Similar initiatives are currently being discussed for Commodities and FX although these will operate on a different timeline.

In addition to the standardisation analysis, industry is continuing efforts to increase standardisation across many products and post trade processing functions where appropriate. A number of specific enhancements to industry process and infrastructure have been delivered and many are on-going. Examples of recent delivery and current focus include, but are not limited to, the following:

- ISDA is proud of its long track record, stretching back to the 1980s, of producing OTC derivatives documentation whose usage is near-universal. The 2011 Equity Derivative Definitions were published on 8 July 2011. These definitions enable the further reach and extent of standard legal documentation for equity derivative products. Their publication was a landmark event for the industry, given the enormous amount of negotiation necessary to take account of the diversity of products, market participant types and geographical underlying issues inherent in the equity asset class. Implementation of the definitions will be a phased approach with an initial delivery of two products into a matrix form by 31 August 2011 ultimately extending to all equity derivative products thereby enabling their electronic confirmation;
- 2 new supplements to the 2006 ISDA Definitions have been published which provide standard legal definitions for 15 additional Floating Rate Options;
- New electronic templates have been established for confirming the following Credit Derivative products:
 - TRX.II Index;
 - iTraxx Australia, Asia Ex-Japan, Japan and Sovereign Swaptions;
 - Recovery lock CDS.
- Continued emphasis on development of electronic confirmations for Commodity Derivatives has seen electronic eligibility increase from 70% (March 2009) to approximately 90% in May 2011 for G14 vs non-G14 transactions, whilst inter G14 electronic eligibility is at a steady 95% of total volume.

- A roadmap for developing standard processing of Trade Lifecycle Events (including Corporate Actions) for Equity Derivative transactions was published on 30 June 2011.
- An important standardisation and risk reduction project is underway with respect to bilateral collateralisation. At its own initiative, the industry has commenced work on developing a standard ISDA Credit Support Annex, the primary objectives of this work are the standardisation of collateral practices and the closer alignment of bilateral and cleared OTC derivatives collateralisation methodologies.

Exchange and electronic trading

In September 2009, G20 leaders agreed in Pittsburgh that “all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate”.¹ It is difficult to comment in detail on industry progress against this commitment at this stage, given that policy makers are still in the process of putting in place the necessary legislation and rules to deliver on the commitment. However, it is worth noting that the OTC derivatives industry already has a long history of developing new ways to execute trades in response to client demand:

- In the credit derivatives area, executable market platforms exist for a small population of liquid index products (e.g. dealer pages on Bloomberg). Though these are available, they are not commonly used by end-users, but in the inter-dealer market electronic execution platforms see significant use. Request-For-Quotations facilities exist in platforms like Market Axess or Creditex where clients can obtain prices and execute electronically.
- In equities, exchanges have been active in listed derivatives for many years, as they are naturally incentivised to do as contracts become more liquid and commoditised (see B-Clear, FLEX Options and block-crossing mechanisms). Additional services are continuously added as client side demand dictates. Wholesale broker aggregation services also exist (BrokerHub, CScreen, Vectalis), with varying degrees of use.
- In interest rate derivatives, TradeWeb and Bloomberg are two of the major electronic platforms for multi-dealer execution for clients and provide access to tight bid/offer spreads, while single dealer platforms also allow for price discovery and trade execution.
- The FX market was an early pioneer of modern flexible electronic trading (Reuters Matching; ICAP EBS). In particular for FX spot (where there are a limited number of parameters), multiple competing electronic platforms exist that provide clients with a wide choice of execution methods including streaming prices (“click and deal”), request for quote (RFQ), single or blended liquidity, algorithmic trading, etc.
- The commodities market itself is diverse (such that each sector needs to be considered separately), but in general terms OTC trading can range from broker screens, to voice broking to bilateral trades for the most bespoke trades. Further, entities such as Platts and Argus provide price transparency services for certain products.

ISDA believes that the possibility of executing trades electronically, including via dealer platforms, is a positive development where it serves end user demand. We also believe that *mandating* or *incentivising* use of particular trading platforms for derivatives where such products are not suitable to their use will:(a) not reduce risk; (b) limit investor choice; and (c) potentially create new risks for investors, as mandating venues may not allow them to appropriately manage their own unique risks. In particular, mandating a given model for execution could adversely affect liquidity and thereby increase volatility.

¹ See www.pittsburghsummit.gov/mediacenter/129639.htm

We are therefore supportive of a regulatory approach that preserves the existing diversity of execution models (including dealer platforms) and allows for choice for end users.

Trade repository infrastructure - data standards

Three areas of work that will facilitate public and regulatory reporting and should help regulators with the analysis of the data provided by market participants are Unique Product Identifiers (UPI) and Taxonomies for OTC derivatives and Legal Entity Identifiers (LEI) for the broader financial industry.

ISDA published a white paper² on 14 April 2011 on the topic of UPI for OTC derivatives, and followed with an implementation plan to the regulators on 30 June 2011, outlining how the industry plans to provide both taxonomy for all the OTC derivatives asset classes and Unique Product Identifiers for standardized OTC derivatives. The industry, through various working groups, is currently detailing the taxonomy for the different asset classes and providing the specifications for UPI, which we expect to further enhance in collaboration with the regulators, during Q3 of 2011. The implementation process of the industry UPI infrastructure will start in Q4 of 2011, running into 2012.

A Legal Entity Identifier (LEI) solution for the whole financial industry is being developed by a broad global group of firms and trade associations, led by SIFMA. Engagement continues with global and regional market participants, as well the regulatory community, to ensure the consideration of a broad set of views, practices and concerns. On 8 April 2011 a letter was sent to the G20 Finance Ministers by ISDA and other trade associations, expressing support for a global LEI solution, and urging Finance Ministers to work towards a coordinated global solution. In early May 2011 a comprehensive set of requirements for establishing an LEI system to aid the monitoring of systemic risk was published.

A Solicitation of Interest (Sol) was subsequently released on 13 May 2011, to solicit responses from potential solution providers interested in delivering a LEI solution. The recommendation made in early July 2011 included the preferred standards body, issuing authority and database/facilities managers. The LEI implementation phase is expected to start in the fall and continue throughout 2012.

Financial law reform

Since 2009 ISDA has been in dialogue with the FSB and with the Basel Committee on Banking Supervision's Cross-Border Resolution Working Group (CBRG) on cross-border resolution of financial institutions, including: 1) the formulation of appropriate resolution powers and tools, 2) securities transfer, 3) partial property transfer powers and; 4) debt write-down (bail-in) powers and tools. ISDA has participated in broader industry discussions on these issues involving other financial market associations and stakeholder groups in various regions and has responded to public as well as informal consultations by the FSB and the CBRG on these issues.

In discussions with the European Commission and national authorities, ISDA has emphasised in its responses the need to protect private law property and contractual rights, to ensure legal certainty and to protect legitimate market expectations, all to ensure the safety and efficiency of the financial markets. In particular, we have emphasised the need to safeguard existing legal protections for close-out netting, financial collateral and other credit risk mitigation tools and techniques, which are crucial not only to private bilateral contractual arrangements but also to the integrity and

² <http://www2.isda.org/news/isda-releases-white-paper-on-product-representation-for-standardized-derivatives>



effectiveness of financial market infrastructure such as the organized markets and exchanges, trading platforms and clearing houses.

An important strand of ISDA's current financial law reform work focuses on strengthening existing legal regimes for close-out netting and providing guidance to jurisdictions and local markets where there is either no legal regime for close-out netting or an inadequate one. ISDA has been in dialogue with the European Commission regarding its proposed European instrument on close-out netting, a proposal for which is currently due to be published in early 2012. ISDA participates as an Observer in the UNIDROIT Study Group currently looking at developing an international instrument on core legal principles underlying close-out netting for financial contracts as part of the current UNIDROIT Work Programme.

Other ISDA financial law reform work focuses on: substantive legal and private international law aspects of intermediated securities, including the implementation of the Geneva Securities Convention and current consultations on a European Securities Law Directive; work at EU and international level through the Hague Conference on Private International Law on private international law issues affecting financial contracts, including governing law, jurisdiction and enforcement of foreign judgments; and dispute resolution in the financial sector including developing the use of mediation and arbitration for financial disputes.

We look forward to continuing our dialogue with you and naturally would be happy to respond to any questions relating to any of the foregoing.

Yours sincerely

A handwritten signature in black ink, appearing to read "Conrad P. Voldstad".

Conrad P. Voldstad
Chief Executive Officer

Additional Material

ISDA's 2011 Equity Derivatives Definitions

The Definitions represent a key development in the ongoing industry initiative to increase standardization and automation and further reduce risk across over-the-counter (OTC) derivatives markets

<http://www.isda.org/publications/pubguide.aspx>

ISDA's 2011 Operations Benchmarking Survey Results

The ISDA Operations Benchmarking Survey identifies and tracks operations processing trends in privately-negotiated OTC derivatives. The results provide individual firms with a benchmark against which to measure the promptness and accuracy of their trade data capture, confirmation, and settlement procedures, as well as the level of automation of their operational processes.

This year's survey reflects the increased automation in the OTC derivatives market over the past several years. 100 percent of eligible credit default swaps and 83 percent of eligible interest rate derivatives are now confirmed electronically.

<http://www2.isda.org/attachment/MzE3MA==/OBS%202011%20FINAL.pdf>

ISDA OTC Derivatives Market Analysis

According to ISDA's analysis, the level of cleared interest rate swaps exceeded 50 percent of interest rate swap notional outstanding at the end of 2010, up from 21 percent at year-end 2007. Over the same time frame, the volume of uncleared interest rate swaps outstanding declined from \$201 trillion to \$116 trillion, a decrease of \$85 trillion or 42 percent.

<http://www2.isda.org/attachment/MzE2OQ==/Ops%20Survey%202011%20G14.pdf>

ISDA Publishes "The Economics of Central Clearing: Theory and Practice," A Discussion Paper on Clearing Issues

The paper, "The Economics of Central Clearing: Theory and Practice" is authored by Craig Pirrong, Professor of Finance at the Bauer College of Business at the University of Houston.

The paper points out both the benefits and potential issues related to central counterparty clearing facilities (CCPs).

http://www2.isda.org/attachment/MzE0Ng==/ISDAdiscussion_CCP_Pirrong.pdf

ISDA Margin Survey 2011

The 2011 Margin Survey reveals that, among large dealers, 80 percent of all transactions are now executed with the support of a collateral agreement. The process of reconciling collateralized



portfolios shows steady advances in adoption. One hundred percent of large dealers and 73 percent of all survey respondents indicated that they pro-actively perform portfolio reconciliations.

<http://www2.isda.org/attachment/MzAyOQ==/ISDA%20Margin%20Survey%202011%20Final.pdf>

ISDA Transparency Studies

Over the past months, ISDA has conducted a series of studies on transparency in the OTC derivatives markets and made the results available on its website:

<http://www2.isda.org/newsroom/key-issues/improving-transparency>

ISDA's comment letter regarding the CPSS-ISOCO financial market infrastructure principles filed on 22 July 2011

http://www.isda.org/uploadfiles/_docs/CPSSISOCjuliO_FINAL_response_220711.pdf