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22 January 2007

Mr. Vijay Bhaskar **By Fax: 91 22 2215 0663**
Chief General Manager
Department of Banking Operations and Development
Reserve Bank of India
Central Office
Shahid Bhagat Singh Marg
Mumbai – 400 001
INDIA

Dear Sir,

Draft Comprehensive Guidelines on Derivatives

The International Swaps and Derivatives Association, Inc. ("**ISDA**") respectfully presents this letter of submission to the Reserve Bank of India ("**RBI**") in relation to the Draft Comprehensive Guidelines on Derivatives issued by the RBI on 11 December 2006 (the "**Guidelines**").

1. Introduction

ISDA is the global trade association representing participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has over 750 member institutions from 52 countries on six continents, including many banks from and active in India. Our 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.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Its work includes promoting sound risk management practices, securing recognition of the risk-reducing effects of netting in determining capital requirements and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives. Over the years, ISDA has worked with the RBI, including advising on the Guidelines on Forward Rate Agreements and Interest Rate Swaps, and has also worked closely with the Securities and Exchange Board of India on various derivatives-related issues.

ISDA strongly supports the prudential approach of the RBI in the Guidelines which clearly aims to establish a consistent and coherent regulatory framework for conducting derivative transactions and to provide comprehensive guidance on risk management in derivatives-related activities. This is an extremely important area for our members and the Guidelines have generated significant interest and attention of our members active in India.

ISDA applauds the policy objective of the proposed Guidelines. However, ISDA is concerned with certain of the provisions of the Guidelines. In particular, ISDA submits that:

- the approval criteria and process for a Market-maker may require further elaboration;
- some of the broad principles to be observed in conducting derivatives should be brought in-line with generally accepted market practices to be more practical and commercially reasonable;
- the RBI should clarify the extent to which the existing circulars issued by the RBI in relation to derivative transactions still apply after promulgation of the Guidelines;
- the approach in setting out a prescriptive list of permissible derivative instruments appears to be inflexible and may hamper market growth;
- certain steps currently contemplated in the risk management and corporate governance sections are out of line with similar international and regional standards and may be impractical or unduly onerous; and
- the provisions with regard to documentation should be amended further to reflect international and regional market practice.

The above issues are elaborated on more fully in our submissions below.

Unless the context otherwise requires, capitalised terms shall have the meaning given to them in the Guidelines.

2. Eligibility Criteria (Section 5)

The approval regime for Market-makers

We note that the RBI is proposing a new approval regime for entities currently engaged in market-making activities in derivative transactions. ISDA members currently undertaking market-making activities would like to ensure that they meet the required eligibility criteria, undertake the application process and obtain the approvals in the required time frame. Therefore, we would be grateful if the RBI could further elaborate on the eligibility criteria and the procedure (as applicable) for the purpose of obtaining approval as Market-makers.

From ISDA's experience in a number of countries in the region, it would also be extremely helpful to the market participants if the list of the approved Market-makers (which may be updated from time to time) is published by the RBI in due course.

Status of certain derivative transactions

Despite the best efforts of entities that are currently undertaking market-making activities, there is a possibility that they might be unable to obtain approval from the RBI to operate as Market-makers within the prescribed time-frame or at all. We would request the RBI to confirm in the Guidelines that derivative transactions undertaken by such entities during the transitional period of 6 months from the date of issue of the Guidelines will continue to be recognised and grandfathered.

3. Broad Principles (Section 6)

As these are principles that will broadly apply across the entire range of derivative transactions, it is essential that these broad principles are commercially reasonable, practical and in-line with sound and generally accepted market practices.

Mark-to-market accounting

ISDA appreciates that the Guidelines seek to achieve a standard well recognised by the international accounting standards that require all derivative transactions to be accounted for at fair value. There are various methods, including using observable market prices, which are widely accepted by the international accounting community as valid means of determining the fair value of a derivative contract. For example, many interest rate derivatives are valued using models based on observable market inputs, often in the form of rates rather than prices. Valuation methods using such models involve the careful application of judgment by the Market-maker in good faith. They are accepted market practice across the world, and are not considered inferior to valuation based on observable market prices.

These methods are particularly evident in the case of valuing illiquid derivative contracts. In practice, it may be very difficult for the Market-maker to obtain an observable market price for such contracts, and even if a market price can be obtained, such market prices may not be representative of the fair value. Accordingly, it is very important for the Market-maker to be permitted to use other valuation methods in order to determine the fair value of derivative contracts (in addition to marking-to-market based on observable market prices). Therefore we respectfully submit that the requirement to mark derivatives to market based on observable market prices should be replaced by fair value measurement requirements in line with internationally accepted accounting standards.

Second order derivatives

We would appreciate if the RBI could elaborate on the rationale for the blanket prohibition of second order derivatives such as swaptions, options on futures and compound options. Whilst certain of such products may indeed be complex, many of these products are extremely useful and common hedging and risk management tools. This is particularly the case in situations where it is not absolutely certain that the underlying exposure that the User may need to hedge will arise (such as a proposed foreign currency bond issue, where for example a swaption may be an appropriate hedging instrument, and foreign acquisitions). We would respectfully submit that these derivatives be allowed since there are sufficient safeguards in the Guidelines – the Guidelines permit Users to enter into derivative transactions only for hedging purposes and require Market-makers to obtain the RBI's approvals and comply with comprehensive risk management and suitability policies and corporate governance regulations.

Restructuring

We understand that the restriction of restructurings, novations or roll-overs of derivative transactions conducted in order to defer gains or losses might be the rationale for the provisions in the Guidelines requiring that all such restructurings, novations or roll-overs be undertaken at prevailing market rates and be cash-settled. Restrictions on the deferral of gains and losses for accounting or other purposes is of course a legitimate regulatory concern. However, prudent risk management practices internationally dictate that existing transactions be actively monitored and restructured in the light of changing market conditions. Often, such restructurings are effected at zero cost, where the amendments made to the transaction are such that the mark-to-market value of the transaction before and after the amendments are the same (except to the extent of any market spread charged by the Market-maker) and we would submit that they should not be prohibited or discouraged. However, the effect of the provisions in the Guidelines is that no amendments, roll-overs or restructurings will be permitted since all transactions will have to be terminated, cash-settled and new transactions with the new terms entered into. Even the simple restructuring by combining two existing and independent transactions into one transaction will not be permissible. Restricting such freedom of contract and business activities is uncommercial and may hamper the healthy development of the market. The undesirable deferment of gains or losses may be adequately addressed by the risk management policy that Market-makers will be required to adopt under the Guidelines (and many already do have such policies in place). In this regard, we note that paragraph 8.3(i) states that a Market-maker should avoid transactions which could result in acceleration/deferment of gains or losses.

Off-setting rupee transactions with subsidiaries/branches/group entities at offshore locations

We appreciate that the RBI may be concerned with offshore speculative activities in relation to the Rupee. However, we are concerned with the wide scope of this prohibition and the ability of global market participants to comply with it.

The prohibition appears to be extremely broad as many derivative transactions in one form or another will "involve the rupee" and the term "partially or fully offsets a similar but opposite risk position" is capable of wide interpretation. Accordingly, completely unrelated transactions might have the economic effect of partially offsetting a risk position even though the two transactions have no connection whatsoever.

In addition, it is virtually impossible for market participants with international and global operations to monitor all of the activities of its subsidiaries, branches and group entities and collate information about potentially off-setting risk positions taken by them. Global market participants, especially global financial intermediaries, are likely to have many branches, subsidiaries and group entities, and the transactions entered into by certain branches, subsidiaries or group entities may be separated by "Chinese walls" or "fire walls" for confidentiality and regulatory purposes. Therefore administrative compliance with this restriction will be extremely onerous and even impossible for large market participants.

Similarly, Users (including those based in India) may have group companies or branches outside of India. The existing systems of most Market-makers would not be designed to monitor transactions with different group entities of the User to ensure that they do not violate this prohibition. The cost of modifying the systems may prove prohibitive and would, in all likelihood, increase the cost of transacting which would then be passed on to the Users.

If there are particular types of transactions that the RBI aims to regulate or prohibit with this provision, we suggest that the prohibition be clearly defined and restricted to those types of transactions.

Cash margin and Liquid Collateral

As previously submitted to the RBI (please refer to our letter to you dated 14 March 2005 in response to the budget speech by the Hon. Finance Minister Mr. P. Chidambaram), we would welcome the introduction of legislation that will uphold the enforceability of close-out netting, collateral arrangements and the ability to net collateral on a cross-border basis. We would like to suggest that separate discussions on these topics are warranted.

4. Permissible derivatives instruments (Section 7)

We respectfully submit that the somewhat prescriptive approach of setting out the range of permissible derivative instruments is not advisable and may hamper the healthy development of the Indian derivatives market. Our experience internationally is that the development of various types of derivative products has been extremely rapid and it is extremely difficult (if not impossible) to set out exhaustively a prescriptive list of products since such list will be out-dated very quickly. Accordingly, we understand that number of countries in the region (including those with capital control regulations such as the People's Republic of China and Malaysia) do not set out a prescriptive list of permissible derivative products. Instead, their rules provide that so long as the Market-makers obtain the general regulatory approval and comply with the risk management and corporate governance regulations, they can undertake, for example, any interest rate derivatives, foreign currency derivatives and other types of derivatives without being restricted to a prescriptive list of permissible derivatives instruments.

In addition to the above submission, we would urge the RBI to reconsider the prohibition of any option features in interest rate derivatives, such as floors, caps and collars. These are internationally accepted and widely used hedging instruments. We also submit that "long term exposure" be defined to mean "exposure with residual maturity of one year or more" as the proposed three year maturity will leave entities exposed if their exposure is between one and three years. In this regard, we note that using a one-year maturity will be consistent with the prevalent accounting definitions of long-term exposure. Currently the forward markets are only active for exposures up to one year.

Last but not least, we would urge the RBI to consider the introduction of credit derivatives in India. As highlighted by the RBI in its recent report entitled "Trend and Progress of Banking in India" dated 14 November 2006 and the "Draft guidelines for introduction of Credit Derivatives in India", the use of credit derivatives will facilitate the distribution of credit risk across a broader group of investors and hence enhance financial stability within the banking system. To this end, we would also like to bring your attention to the Joint Forum report on credit risk transfer dated March 2005 by the Basel Committee on Banking Supervision (a copy of which can be obtained from http://www.bis.org/publ/joint13.pdf).

Should the RBI decide to retain the existing prescriptive approach in setting out the range for permissible products as in the current Guidelines, we respectfully suggest that the Guidelines should provide that the RBI may expand the list of permissible derivatives instruments from time to time without the need for a cumbersome legislative or administrative process to allow for greater flexibility in expanding the scope of permissible derivative products in the future.

5. Risk Management and Corporate Governance (Section 8)

We are highly supportive of the requirement for a prudent system of risk management through means of corporate governance, adequate supervision, internal controls, audit, reporting and a suitability and appropriateness policy. A robust and suitable regime of risk management is vital to ensure the stability of the financial markets.

High standard of responsibility imposed on the Market-maker

Firstly, the degree of responsibility imposed on Market-makers is far beyond the standard typically expected from a party conducting derivative transactions, which are usually effected on a "principal-to-principal" and "arm's length" basis. The standard of responsibility on Market-makers envisaged in the Guidelines is comparable to the responsibilities of an adviser or fiduciary and fraught with placing the Market-maker in an inherently conflicting position: that of a counterparty at arm's length and that of a fiduciary agent. We appreciate that it is prudent to have a stringent risk management requirement, but we respectfully submit that imposing such a high standard of responsibility would actually go against the prudential objective of the Guidelines of protecting the Market-maker against the credit, reputation and litigation risks since a Market-maker will be exposed to a much wider range of legal liability with such a high standard of duty.

Such a high standard of responsibility is also uncommercial and almost impossible for Market-makers to comply with. The increased risk of legal liability and the onerous requirements could also result in the Market-makers increasing the price that they would charge the Users to cover such increased legal risk and the increased costs of compliance. The increased pricing may deter Users from hedging their underlying exposure which may increase systemic risk of defaults.

For example, the requirement on the Market-makers in Section 8.3(a) of the Guideline to share the pricing, periodic valuation methodologies and dissection of products into its generic components is never imposed internationally. Such information is proprietary to Market-makers, and in practice is treated by each Market-maker with utmost confidence in a way akin to trade secrets. In any event, the pricing of bilateral and long-dated derivative transactions is not a function of central market place but based on factors subjective to each Market-maker including its particular appetite for the credit risk associated with the User and its own costs of hedging. In addition, the valuations of products by Market-makers are typically indicative, and not for transactional purposes, and in reality, the only relevant value may be the terminal value (as opposed to interim values). Therefore the information on pricing and periodic valuation may not be relevant for the User in understanding of the nature and risks of the derivative transactions.

The Users should, of course, satisfy themselves that the risk-reward profile of the instrument is suitable for their needs. But only the User is in an adequate position to determine what these needs are. To assist them, they may obtain comparative prices from other Market-makers in the market.

In this regard, we note that a similar requirement on Market-makers sharing pricing and valuation information with Users was proposed for the draft Risk Management Regulations in Korea in 2006. In the end however, the Financial Supervisory Service of Korea decided to drop such a proposal having taken into account these considerations.

Difficulty and impracticality in complying with the regulations

Secondly, we respectfully submit that some of the requirements are extremely difficult to implement practically and compliance with some of the provisions is difficult to verify objectively.

For example, despite best efforts, it is often not possible for Market-makers to confirm that Users have properly-documented risk management policies, follow prudent accounting and disclosure norms and have complied with any restrictions on use of certain types of derivatives. It is also extremely difficult in practice for a Market-maker to identify whether any proposed transactions are consistent with the User's policies and procedures with respect to derivative transactions. In this regard, we understand that corporate entities often treat their risk management policies and other internal policies as confidential and hence refused to share such information with Market-makers, or even to certify to Market-makers that such policies have been adopted. .

To the extent that such matters are not reasonably capable of verification by the Market-makers, Market-makers should be permitted to rely in good faith on appropriate representations made by the Users.

Recommendations

We respectfully submit that the RBI should consider adopting a high-level approach, rather than the current prescriptive approach, of imposing a requirement on Market-makers to put in place a suitability and appropriateness policy that would ensure that the Market-maker addresses the following key concerns:

- the Market-maker's assessment that the transaction is appropriate for the User given the User's disclosed purpose (and such purpose must not be an improper purpose such as the deferral of gains or losses for accounting reasons) and needs and its level of sophistication (including an escalation policy within both the Market-maker and the User, if the Market-maker's assessment is that the transaction is inappropriate);
- the Market-maker's assessment that the User understands and accepts the risks of the transaction; and
- the Market-maker's assessment that the User understands and accepts that the Market-maker is acting only as a counterparty at arm's length and not as an adviser to the User.

In addition, the policy should allow the Market-maker the flexibility to differentiate between different types of market participants depending on their sophistication so that different levels of due diligence regarding user appropriateness and suitability of products would be required for different types of market participants. For example, due diligence should not be applicable or that the level of due diligence required should be substantially lower in the case where the counterparty to the derivative transaction is a Market-maker or a sophisticated end-User.

From a legal liability standpoint, it may also be helpful for the Guidelines to explicitly state that any breach by the Market-maker would not in itself give rise to a cause of action by the Users against the Market-maker. Ultimately, the Users are responsible for the transactions they enter into by complying with their own set of risk management and corporate governance policies and it is not practical or appropriate for a Market-maker to assume that risk.

6. Documentation (Section 8.4)

We applaud the RBI for advising market participants to prioritise the documentation requirements of derivative contracts and that market participants may utilise the documentation that has been generated by ISDA. We note however that certain of the requirements imposed by the RBI may differ from accepted international and regional market practice in this area.

"Long-form" confirmations

It is not uncommon that derivative counterparties have not signed ISDA Master Agreements prior to undertaking derivatives business with each other. This is because negotiating and signing an ISDA Master Agreement together with the required Schedule may take several weeks or months, and the process typically is not started until a transaction is entered into. To address this situation, derivative counterparties instead execute a "long form confirmation", which provides that the confirmation in question is incorporated by reference into a "standard form" ISDA Master Agreement (without the Schedule, but with a few significant elections made), or otherwise incorporates by reference the ISDA Master Agreement. ISDA has been advised that this "incorporation by reference" of the ISDA Master Agreement is valid, binding and enforceable in India. The risk and credit committees of market participants are generally comfortable with this widespread practice. Accordingly, the Guidelines should allow for "long form" confirmations to be entered into between derivative counterparties. A sample of this form of wording is enclosed in the Annex to this letter for your reference.

References to the ISDA Master Agreement in confirmations

It is not always practicable to mention the applicable ISDA Master Agreement in the individual transaction confirmations. For example, it is very common for counterparties to document trades by certain "pre-set" format and confirmation through telex or electronic means which does not allow any information to be added (other than the trade details) and hence there are no fields to identify the applicable ISDA Master Agreement. However, it is still clear that the relevant ISDA Master Agreement will apply since certain specific language is included in the Schedule to the ISDA Master Agreement, which has the effect of "sweeping" the specified types of derivative transactions under the ISDA Master Agreement. The Guidelines should take account of this practice. A sample of this form of wording is enclosed in the Annex to this letter for your reference.

Physical Execution

Confirmations are increasingly exchanged by electronic means through systems that may not require execution of Confirmations. Thus Confirmations are not necessarily physically "signed". Market participants are comfortable with this position, which permits the more efficient processing of transactions.

7. Conclusion

ISDA would like to re-emphasise its positive assessment of the Guidelines and its support of the commitment of the RBI in laying down a consistent and coherent regulatory framework on derivative transactions. We hope that our comments are helpful to you during your considerations.

We respectfully submit to the RBI for consideration some more detailed initial comments on the text of the Guidelines which are set out in the Schedule to this letter. We have also raised some queries in the Schedule and would be grateful if the RBI could kindly respond to them.

ISDA would like to continue its dialogue with the RBI in relation to any further developments in relation to the Guidelines. In particular, ISDA would be pleased to receive draft changes on the Guidelines when they are available and to be given a further opportunity to comment on them (as appropriate) before they are finalised.

In the meantime, if you or your colleagues have any questions regarding our comments, please do not hesitate to contact Ms Angela Papesch (apapesch@isda.org; +65 6538 3879), Ms Jacqueline Low (jacquelinelow@dbs.com; +65 6878 4195) or Mr. H. Jayesh at Juris Corp (h_jayesh@jclex.com; +91 22 6633 8671).

Yours sincerely,

For the International Swaps and Derivatives Association, Inc.

Jacqueline Low
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Schedule

Section 1 - Definition of a Derivative

Section 1

- We note that you have provided two definitions for "derivative" in the introduction to the Guidelines, which do not appear to be used elsewhere in the Guidelines. Are these definitions intended to provide background information only or to also serve any other purposes under the Guidelines?

- Please note that a number of jurisdictions in the region (including the People's Republic of China, Malaysia, the Philippines and Singapore) have adopted a functional definition of derivative instrument in their risk management regulations similar to the one used in publications by the Basel Committee:

  "Broadly defined, a derivatives instrument is a financial contract whose value depends on the values of one or more underlying assets or indexes. Derivatives transactions include a wide assortment of financial contracts, including forwards, futures, swaps and options. In addition, other traded instruments incorporate derivatives characteristics, such as those with embedded options."

Section 1.2

- Several aspects of the existing Master Circular on Risk Management and Interbank Dealings dated 1st July 2006 (the "MC") covering areas such as hedging on the basis of past performance, contingent exposures hedging, hedging of contracts denominated in foreign currency though settling in INR, FDI and FII hedging, commodity hedging have not been covered in the Guidelines. Please specifically clarify in the Guidelines that they do not override the MC.

Section 3 - Participants

- Is it necessary for at least one party to a derivative transaction to be a Market-maker? This appears to be a deviation from the current practice of the RBI permitting intermediaries (who are not Market-makers) to trade derivatives provided they are entered into on a back-to back basis with a Market-maker.

- Please clarify what would constitute "continuous" bid and offer prices for the definition of Market-maker. We assume that any approved Market-maker pursuant to section 5 of the Guidelines will continue to be a Market-maker notwithstanding any (perceived) lack of continuity in the provision of bid and offer prices.

Section 4 - Purpose

- Please expand on the scope of hedging permitted to specifically include "portfolio hedging" in addition to asset or liability specific hedging. Broadly speaking portfolio hedging involves the party looking at a set of its assets and liabilities as a portfolio and setting limits and parameters for risks to be hedged on the basis of that portfolio rather than the individual assets and liabilities in it.

- Please clarify what is meant by "transformation of risk exposure". If "transformation of risk exposure" is performed for hedging purposes, this should already be covered by the first part of this section. We assume this means that a transaction entered into for the purpose of altering or unwinding a hedge under a previous transaction is permissible.

Section 5 - Eligibility Criteria:

Section 5(i)

- As discussed in the submission letter, please provide any further information which the RBI may have in relation to the application for approval to become a Market-maker. The further information may include:
  - the eligibility criteria for approval as a Market-maker;
  - the applicable materials required to be submitted for approval as a Market-maker;
  - the detailed approval process, including details of the approval procedure, to whom the application must be submitted, the time-frame, frequency of review and the appeal process.
- Please confirm in the Guidelines that derivative transactions undertaken by such entities during the transitional period will be recognised and grandfathered even though an approval was not subsequently obtained.
- Please provide more details with regard to the periodic review of the approval.
- We note that the Guidelines do not clearly state which provisions apply to which entity (for example, whether some provisions apply solely to Market-makers or to both Market-makers and Users) and hence this needs to be clarified.

Section 6 - Broad principles for undertaking derivative transactions

1st bullet point

- Please refer to our comments in the submission letter on mark-to-market and second order derivatives.

2nd bullet point

- It is unclear what is meant by a "net short options position".

3rd bullet point

- Please refer to our comments in the submission letter on restructuring.

4th bullet point

- Please amend this to become "All <u>material</u> risk arising from derivatives exposure should be analysed and documented."

7th bullet point

- Please refer to our comments in the submission letter on off-setting rupee transactions with subsidiaries/branches/group entities at offshore locations. If there are particular types of transactions that the RBI is concerned with regulating or prohibiting by this provision, we suggest that the prohibition be clearly defined and restricted to those types of transactions.

8th bullet point

- We understand that the maintenance of collateral is discretionary and not mandatory. We suggest that the word “may” be amended to “should have a discretion to”.

Section 7 - Permissible derivative instruments

- We reiterate our general comment in section 4 of our submission letter that it is not advisable to adopt a prescriptive approach of setting out the range of permissible derivative instruments. In particular, we would like to draw your attention to the points listed below.
- We note that the Guidelines modify the instructions contained in the extant guidelines issued by Foreign Exchange Department. It would appear that the list of permissible derivative instruments would consolidate and replace all other existing rules and circulars on permitted derivative transactions. Please clarify whether this is the case. Please also note our comment to section 1.2 above.
- We note that there are many references in this section to certain transactions being “as permitted” by the RBI. Is this a reference to a separate permission, and if so is it an existing approval process or a new requirement?

Section 7.1(b)

- It is unclear what is meant by “plain vanilla”. If this is a qualifying criterion for the FRAs/IRS, it should be set out more clearly to avoid confusion.

Section 7.1(d)

- Please consider expanding the list of Users under Section 7.1 (d) (Users) to include sole proprietors and partnerships.

Section 7.1(e)

- We note that the Guidelines provide for the purpose for Users for Rupee Interest Rate Derivatives, but the purpose for Market-makers is not provided. Please clarify by stating that there are no restrictions for Market-makers with regard to the purpose for this product.

Section 7.2

- We note that there are five different types of foreign exchange derivatives set out immediately under the heading of 7.2. However, the restrictions on “Participant” and “Purpose” are not set out for one of them (namely cross currency swaps). Could you please confirm whether any restrictions on participants or purpose apply to cross currency swaps?
- We suggest amending “cross currency swaps” to “non-rupee cross currency swaps” and amending “cross currency options” to “non-rupee cross currency options” to avoid ambiguity with “foreign currency rupee swaps” and “foreign currency rupee options”.
- Under “Products – ii Foreign Currency Rupee Swap”:
  - We understand that the reference here to residual positions that Market-makers can take is to the limit on unmatched FC-INR Swap positions of US$50 million currently stipulated by the RBI. We would request that the Guidelines elaborate on this to avoid any doubts in this regard.

- Under "Products – iii Cross Currency options":
  - We note that the purpose of the User is restricted to exposure arising out of current account transactions. Currently, corporates are permitted to access cross currency options for hedging their positions arising from foreign currency liability and not necessarily be a current account transaction. In fact, a substantial amount of cross currency options are used by corporates to hedge against positions arising from foreign currency liability. We would request your clarification that the extant regulatory provision allowing booking of foreign currency options against all kinds of foreign currency exposure including foreign currency loans will continue.

Section 8.1 – Corporate Governance

- Please make clear that the Chief Compliance Officer need not personally undertake the review and may delegate and rely on others as he reasonably sees fit.
- Please clarify the requirement for "intensive monitoring" for the first 6 months of introduction of all new products. For example, does this require a review of all transactions done in the first 6 months?
- Please also clarify the requirements for existing products to be reviewed in the light of the Guidelines "by the same mechanism and in a similar manner".

Section 8.2 – Board and senior management oversight

- We note that the policy framework that needs to be approved by the board is quite detailed under Section 8.2. As there could be differences between regulatory jurisdictions on the responsibilities of the board and senior management, this could be impracticable for banks not incorporated in India to comply with. In practice this is an area which may require cooperation between home and host country regulators. We suggest to include a preamble to state that where the bank's home country regulator has not issued guidelines on the role of the board and senior management in derivative transactions, the RBI would require that the board and senior management undertake the responsibilities listed in Section 8.2. For banks incorporated outside India, the RBI would work together with home country regulators to assess compliance in this area.

Section 8.3 - Suitability and Appropriateness Policy

- Please also refer to our comments in the submission letter with regard to the high standard of responsibility imposed on the Market-maker and the difficulty and impracticality in complying with the regulations.
- Alternatively, we suggest that the general approach to revision of section 8.3 would include the following:

  - Removing any requirement for the Market-maker to obtain internal documentation (for example, risk management policy, derivative transaction policy and procedures, board approval and so forth.). We suggest that the Market-maker should be entitled to rely on a one-off basis (rather than for each transaction) on a certificate issued by the User as evidence that the User has (i) complied with the relevant risk management requirements and (ii) obtained the requisite authorisations to enter into derivative transactions.
  - The obligation on Market-makers to carry out proper due diligence regarding user appropriateness and suitability of products should not apply to derivative transactions entered into with sophisticated market participants.
  - In particular, we note that a Market-maker dealing indirectly with an end-User through another Market-maker as an intermediary may have very little or no information or means of contact with the end-User to ensure compliance with the "Customer Appropriateness and Suitability". In any event, it should be sufficient, from the point of view of protection of the end-User and the Market-maker that the intermediary Market-maker is already subject to (and is following) the regulatory requirements ensuring the end-User's appropriateness and suitability required under the Guidelines.
- Please also clarify the extent to which the requirements in the existing RBI circulars, for example, paragraph A8 of the MC would continue to apply.
- Under section 8.3(h), please clarify the meaning of "significant" communications.

Section 8.4 - Documentation

Section 8.4 (i)

- The word "may" in the first sentence should be amended to "shall have the right to" to clarify that the use of ISDA documentation is not mandatory.

Section 8.4 (ii)

- Please consider deleting "duly signed by the authorised signatories" as it is extremely difficult in practice to obtain direct evidence regarding due capacity and authority of the counterparty.

Section 8.4 (iii)

- Please refer to our comment on "Reference to the ISDA Master Agreement in confirmations" in our submission letter.

Section 8.4 (v)

- Please refer to our comment on "Long-form confirmations" in our submission letter.
- Whilst we are or course in favour of the use of the ISDA Master Agreement, in practice, other industry or bespoke master agreements are still in use, particularly in relation to foreign exchange transactions. The Guidelines should allow some latitude for the use of other agreements, while encouraging the use of the ISDA Master

Agreement. We also note that ISDA Master Agreements are designed for use with over-the-counter derivative transactions and not for exchange-traded derivatives such as futures.

Section 8.5 – Identification of risk / Section 8.6 – Risk Management

- Please clarify that the steps taken on risk management do not all need to be done within India. In the context of global market participants, it is common for risk management functions to be carried on by offshore branches or group entities on a global or regional basis.

Under heading:- "Mark-to-market"

- Whilst clearly desirable, it is not always possible to obtain that the pricing factors for revaluations from a source which is independently verifiable.

Section 9 – Internal audit

- Please make clear that auditing work is not required to be performed only by an external party and may be done by internal departments.

Section 11 – Prudential limits on derivatives

- While PV01 based limits may be appropriate for individual derivative instruments or less sophisticated market participants, we believe that sophisticated market participants use value at risk ("VaR") based limits to monitor their market risk. These limits reflect offsetting positions and the correlation structure observed between the market risk factors driving the value of derivative transactions. Accordingly, we recommend that the RBI allows the use of VaR based limits for market participants who can develop more sophisticated VaR based risk measurements, subject to supervisory review of the model used by the RBI.
- In addition, we would suggest that a market participant can apply to the RBI for an approval to have a higher limit (more than 0.25 per cent net worth).

Miscellaneous / minor drafting comments

Section 5(i)

- Please clarify the meaning of "Scheduled Commercial Banks", "RRBs" and "Primary Dealers"

Section 7
1st Bullet Point

- "Interest rate derivatives" should be capitalised as it is a defined term.

Section 7.1(e)(iii)

- Please set out AFS (Available for Sale) and HFT (Held For Trading) in full.

Section 7.2

- The heading should be amended to "Foreign Currency Derivatives".
- Please clarify the meaning of "crystallized" and "genuine". These terms are ambiguous and may give rise to confusion.
- Under "Products – iii Cross Currency options";-
  - Please capitalise the word "options" in the heading.

	• Please set out CRAR (Capital-to-Risk-Weighted-Assets-Ratio) in full. • Under "v. Other Products" • Please set out ECB (External Commercial Borrowing) in full. • Please clarify the meaning of "transformation" – see our comments on "transformation of risk exposure" to Section 4 above.
Section 7.2(ii)(b)	• For the purpose of Users, the words " and vice versa" seem to have been omitted.
Section 8.3 (j)	• In the last sentence starting with "The forward contracts…" should be amended by:- • amending "are in use for long time" to "have been in use for a long time"; • "banks" should be replaced by "Market-makers"; and • "customers" should be replaced by "User".
Section 8.3 (j)	• The word "They" in the second sentence should be amended to read "Any dispute or complaint" and "at a regular interval" should be amended to read "within a reasonable time".

Annex

Sample wording used in "long-form" confirmations

"This Confirmation evidences a complete and binding agreement between you and us as to the terms of the Transaction to which this Confirmation relates. In addition, you and we agree to use all reasonable efforts promptly to negotiate, execute and deliver an agreement in the form of an ISDA Master Agreement, with such modifications as you and we will in good faith agree. Upon the execution by you and us of such an agreement, this Confirmation will supplement, form part of, and be subject to that agreement. All provisions contained in or incorporated by reference in that agreement upon its execution will govern this Confirmation except as expressly modified below. Until we execute and deliver that agreement, this Confirmation, together with all other documents referring to a 2002 ISDA Master Agreement (each a "Confirmation") confirming transactions (each a "Transaction") entered into between us (notwithstanding anything to the contrary in a Confirmation), shall supplement, form a part of, and be subject to, an agreement in the form of a 2002 ISDA Master Agreement as if we had executed an agreement in such form (but without any Schedule except for the election of [English Law][the laws of the State of New York] as the governing law and [specify currency] as the Termination Currency) on the Trade Date of the first such Transaction between us. In the event of any inconsistency between the provisions of that agreement and this Confirmation, this Confirmation will prevail for the purpose of this Transaction."

Sample of language having the effect of "sweeping" the specified types of derivative transactions under the ISDA Master Agreement

"Unless otherwise agreed in writing by the parties, each [FX Transaction] and [Currency Option Transaction] entered into between the parties before, on or after the date of this Agreement shall be a Transaction under this Agreement and shall be part of, subject to and governed by this Agreement. [FX Transactions] and [Currency Option Transactions] shall be part of, subject to and governed by this Agreement even if the Confirmation in respect thereof does not state that such [FX Transaction] or [Currency Option Transaction] is subject to or governed by this Agreement or does not otherwise reference this Agreement."