ISDA® Safe, Efficient Markets

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And

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Proposed Amendment to Financial Investment Services and Capital Markets Act (FISCMA) Relating to Central Counterparty

Dear Sirs,

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") to the Proposed Amendment to FISCMA Relating to Central Counterparty.

Since 1985, ISDA has worked to make the OTC derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, central counterparties ("CCPs") and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA is actively engaged with providing input on regulatory proposals in the United States, Canada, the European Union and in Asia. Our response is derived from these efforts and from consultation with ISDA members operating in Korea. Accordingly, our response draws on this international experience and dialogue in responding to the question of central clearing of OTC derivatives in Korea.

ISDA commends the FSC on the Proposed Amendments which would facilitate Korea meeting its G20 commitments to offer central clearing for standardized and liquid OTC derivatives by the end of 2012. ISDA notes, however, that the G20 commitment only applies to compelling systemically important financial institutions to clear. Whether to clear in Korea, or through a global CCP, is not mandated by the G20. The choice to establish a CCP in Korea will require significant expenditure that may not be justified given the size of the market and also risks causing market dislocation. These concerns will be elaborated on below.

Given the efforts being made to increase the use of CCPs, which will profoundly affect the role of the CCP in the broader financial infrastructure, effective CCP regulation, prudential supervision and oversight is critically important. If this is not achieved, CCPs will themselves become a major source of systemic risk. Thus, it is highly important that comprehensive analysis and consultation occurs on the design of the market structure and the implications for financial stability.

Global Markets, Regulatory Coordination and Timing

OTC derivatives are traded on global markets, the proposed reforms to the functioning of these markets are "significant" and "to a large extent" the proposed reforms are more relevant for Europe and the United States than for markets such as Korea that held up well during the financial crisis and in any case have significantly less OTC derivatives activity. Given that context, we strongly urge the FSC to gather the necessary information on the impact of the reforms in the U.S. and E.U. markets prior to embarking on comparable and substantial reforms in Korea. Without this information, we consider it is too early to determine what Korean derivative products would be viably centrally cleared. In that regard, it should be acknowledged that the implementation of key financial market reforms, due to their scale and complexity, is facing delay. At the date of this letter, the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") has been put back by approximately six months, after the Commodity Futures Trading Commission and the Securities and Exchange Commission agreed to delay implementation from a deadline set by the U.S. Congress of July 15 to the end of the year. Similarly, the European Parliament in early July 2011 postponed finalization of the European Market Infrastructure Regulation (EMIR), which contains similar provisions on clearing of OTC derivatives to Dodd-Frank.

In addition, we urge that regulators consider the global nature of the markets when creating regulations for OTC derivatives so that the regulation does not restrict the ability of Korean entities from continuing to participate and be competitive in the global derivatives market. To this end, it is vital that regulators seek to avoid mandating duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist. Regulators should consider which products a Korean CCP could clear that are not already cleared by a global CCP. For example, physically settled Korean Won trades may not be cleared by foreign CCPs, but non-deliverable FX forwards are, or will be, cleared by foreign CCPs.

Scope

It is unclear what would be a "Korean" derivative or market without first knowing the content of the Presidential Decree. We understand the FSC is considering regulation for derivatives with Korean counterparties but will the regulations only cover trades where both parties are acting in the domestic Korean market, or will it be sufficient for one party to be acting through an office in Korea to come under the regulatory regime? ISDA believes that it makes the most sense for mandatory clearing to apply narrowly to onshore, local-to-local physically settled trades, while carving out cross border trades from mandatory clearing for reasons that will be elaborated on later in this paper.

If the FSC decides to regulate cross border trades, how does it intend to coordinate with foreign regulators to ensure consistency of regulation? Given the global nature of the OTC derivatives market, such coordination is essential to effectively establish international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. Diverse and inconsistent requirements between different supervisors will increase costs and make it less likely that robust international standards can be developed. Close

international cooperation between various supervisory bodies including banks, CCPs, and systemic risk supervisors would mitigate these risks.

The FSC will need to clearly define the scope of the transactions, entities, trades and markets that are intended to be covered by the regulations in order for the industry to give meaningful comments on proposed rules.

ISDA also notes that the CCPs that have been built in Asia have generally taken longer than expected to achieve operational status and cautions that meeting an end 2012 deadline may cause stakeholders to rush Korea's CCP set up when it is imperative that each step in the building process is thoroughly deliberated and stress tested. Market safety must come before expediency.

Product Eligibility Considerations

CPSS/IOSCO papers have highlighted clearly that products eligible for clearing must be both highly standardized and liquid. "CCP clearing seems to be an effective way of reducing systemic risk and a safer way of mitigating counterparty risk. Counterparty risk can have a destroying effect on firms as was experienced during the recent crisis. In order to increase the usage of CCP clearing, regulators and market participants should jointly work on defining the products to be eligible for CCP clearing. On the other hand, there are some discussions around CCP clearing on whether to mandate the CCP clearing or not for the defined products. However, not all of the overall derivative market products have the same liquidity and due to the need for tailor-made products for hedging reasons, it is not possible to centrally clear all types of products."[1]

Article 166-3 of the Proposed Amendment, titled "Clearing Obligations of Over-the-Counter Transaction," appears to compel a CCP to accept an OTC derivative for clearing if so demanded by a financial firm. This could create a situation in which the CCP takes on risks that it cannot appropriately manage and the CCP itself becomes the source of systemic risk build up. The KRX should have the right to reject clearing any trade that it does not believe it can risk manage suitably.

Certain parameters for liquidity for each product are a minimum number of market makers, frequency of trading (daily) and depth of market (daily trading must be in sizes that are not insignificant). Some products may meet these requirements, or not, depending on tenor. For example, 5 year fixed income swaps may be traded daily in significant sizes but the same swap with a 30 year term may not trade frequently enough to be considered liquid. The CCP must have the power to refuse clearing any trades that do not meet these criteria and regulators must ensure that the CCP applies these product suitability criteria.

Cost Considerations

ISDA would like to point out that the considerable costs of building a CCP should not be ignored. Though the Singapore Exchange ("SGX") has not disclosed any number, the market estimates costs for the build out of SGX's clearing house are SGD40 – 50 million and do not include on going running costs. HKEx has budgeted HK$180 million for an information technology system and hiring staff for its new CCP clearing division to build out their clearing house, though it is too early to say whether actual costs will be greater or lower than this budget. Japan estimates on going running costs of over US$40 million just for the day-to-day operations of its OTC CCP.

[1] IOSCO Report, OTC Markets and Derivatives Trading in Emerging Markets, July 2010, Page 32

In its June 2010 Triennial Survey, the Bank for International Settlement (BIS) estimated that total interest rate derivatives turnover in the Korean market amounted to just under 0.4% of global volume. This begs the question of whether there is sufficient volume of clearing eligible transactions in the Korean market to justify a CCP. Unless the CCP will be offered as a subsidized utility, the costs of running the CCP will have to be allocated to the cleared trades. This could result in wider bid/offer spreads in the market, decreased liquidity and a real possibility that corporate end users and investors cease hedging their risks because the costs are too high (the cost of clearing would inevitably be passed from clearing members to end clients).

Also, the sizeable and on going cost of moving contracts to CCPs includes the initial margin plus guarantee fund contributions that depend on the amount of contracts cleared and should not be ignored. Globally, the direct incremental initial margin and guarantee fund contributions are estimated to be up to about $150 billion according to the analysis provided by the IMF[2]. Korean clearing members would bear a proportion of these costs and the question should be asked whether the sum total of credit losses in Korea the four years after and including the financial crisis justify these expenditures.

CPSS/IOSCO notes, "While jurisdictions that have relatively large and complex OTC markets should assess the use of CCP clearing for CCP eligible products, the jurisdictions which have relatively small and non-complex markets should not need to centrally clear the transactions, as it may impose a considerable cost in doing so."[3] Before deciding to build a domestic CCP, Korea will have studied the size and potential growth of the potentially clearable market closely. However, given the expensive investments that must be made to build the CCP, Korean officials may wish to consider requesting an internationally respected body such as the IMF, BIS or the Asian Development Bank, to analyze OTC market turnover in Korea in the context of when it would be optimal from a cost-benefit point of view for Korea to introduce OTC derivative clearing.

CCP Licensing and Governance Considerations

Article 323-3 lays out certain criteria for granting a license to operate a CCP in Korea. ISDA believes that requiring the CCP comply with CPSS-IOSCO standards[4] is an important additional criteria that should be imposed before granting a license. CPSS-IOSCO is the most authoritative voice on CCP standards and meeting these standards would ensure that Korea's CCP meets or exceeds international benchmarks for CCP management.

At the operational level, best practice CCP risk management starts with stringent requirements to become a clearing member ("CM") in terms of sufficient financial resources, robust operational capacity, and business expertise. We suggest that any CCP solution adopt CM requirements that are clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of CMs to the CCP.

CCPs typically seek to ensure that their CMs are creditworthy by establishing a set of financial requirements for membership. Usually CMs are required to meet, both initially and on an ongoing basis, minimum capital requirements, often stated as the larger of a fixed amount and a

[2] International Monetary Fund (2010) Global Financial Stability Report, available at http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf

[3] IOSCO Report, OTC Markets and Derivatives Trading in Emerging Markets, July 2010, Page 33,Reccomendation 6.

[4] CPSS-IOSCO consultative report, 'Principles for Financial Market Infrastructures' March 2011

variable amount that depends on some measure of the scale and riskiness of the CM's positions with the CCP and in other financial markets. In most cases, membership is restricted to regulated entities that meet regulatory minimum capital requirements. CMs that carry client accounts are often required to meet capital standards that are more stringent than regulatory minimum requirements. Clearing membership should be non-discriminatory: Foreign market participants should be allowed to be CMs if they meet the publicly stated CM criteria.

In addition to financial requirements, leading CCPs establish standards of operational reliability for CMs. CCPs typically impose tight deadlines for the submission of trade data and for completing various settlement obligations. The failure of a CM to meet these tight deadlines could significantly increase the CCP's risk exposures to that CM and possibly to other CMs as well. Compliance with operational deadlines is closely monitored on a day-to-day basis. Furthermore, in recent years many CCPs have been paying greater attention to the backup systems that CMs would have available if their primary operating systems were disrupted.

Korean regulation should require that a CCP legally separates its OTC derivative clearing activities from its other businesses. This prevents the commingling of default and guarantee funds across products. There may be limited circumstances where a combined entity should prevail, including where the entity covers both OTC and listed products with hedging properties, ensure that a CCP's OTC derivatives clearing activities are independently managed and there is no conflict of interest or exposure to these activities from its other businesses and that the CCP has dedicated resources to manage its OTC clearing activities, which is particularly important in the event of a default.

Second, CMs should only be able introduce risk commensurate with their capital position. Further, entities that become CMs of OTC derivatives CCPs must have the ability to participate in the CCP default management process including the ability to bid for the portfolios of other CMs of the CCP. If a CCP admitted a CM (or a group of CMs) that was unable to participate fully in default management of the product it clears, there could be significant negative repercussions for the CCP and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the CCP would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the CCP's risk management process would be effective. Moreover, for there to be the right level of incentives for active participation in default management, there needs to be enough 'skin in the game', which suggests not only that that the default fund needs to be allocated proportionally to risk introduced; but also that the default fund to initial margin ratio should reflect the estimated percentage of market risk remaining following the completion of the default management hedging phase.

Leveraging Global Technology Systems and Platforms

ISDA highly recommends mandating globally-tested vendor technology solutions for the CCP rather than developing bespoke applications. This includes both the CCP's risk management system and the middleware used for connecting CMs to the CCP.

All CCPs in existence globally have chosen from among a select few providers of risk management technology[5]. Confidence in a Korean CCP would be highest if it also selected a risk management system provider with a proven track record. Both the Singapore and Hong Kong stock exchanges concluded that the risk management systems they used for exchange-traded derivatives were inadequate for handling the complexities of OTC derivatives and chose to invest in new risk management systems developed by global vendors.

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[5] Murex, Calypso Technology and Razor Risk systems are most widely used in existing CCPs for OTC derivatives

Equally important is the middleware systems platform by which CMs connect to the CCP. Many Korean market participants participate as CMs in several CCPs globally and have already made significant investment in middleware systems. Recognizing this, CCPs in Japan and Singapore have also ensured that banks can connect to them via these platforms. We understand that Hong Kong's CCP will offer connectivity both via a global vendor solution and a bespoke local solution in order to provide a lower cost for local market participants who are not active in other markets. ISDA supports either of these approaches, but worries that a local market only solution would require internationally active CMs to make discreet local technology investments in bespoke systems that are incompatible with the systems they employ globally. This would lead to additional expenses that must also inevitably be passed on to end clients.

Portability and Segregation,

ISDA notes that the Amendments contain no provisions on portability or protection (segregation) of collateral. US and European regulators consider these a fundamental part of the client clearing model.

The Financial Institution Restructuring Law ("FIRL") permits the Financial Supervisory Service to transfer contracts/positions of an insolvent financial institution to another, solvent financial institution. Since most, if not all, CMs will be financial institutions subject to the FIRL, there may be no need for the Amendments to set out a separate portability regime, though market practice internationally is for end clients to pre-arrange for their portfolios to be ported to another CM in the event that the CM through whom they have cleared were to default.

There is a strong argument to be made for permitting market participants to contract on segregation and portability, as opposed to prescribing a method via regulation. One possibility would be to establish omnibus segregation as a default standard, but permit clearing members and their clients to negotiate to create individually segregated accounts to contract around the standard. This would permit those who value segregation more highly than it costs CMs to segregate, to negotiate mutually beneficial arrangements with CMs. Such contracts would reflect information available only to the contracting parties, but which regulators would not know when setting a one-size-fits-all standard. That said, end-users will need to be educated as to the trade off between highly segregated collateral and less segregation.

In addition, there are many different ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. This is critical in relation to whether customer positions and related margin are likely to be successfully ported. The impact from a Basel 3 point of view for banks that are clients of clearing members is substantial. A bank doing client clearing through a CM would only be able to enjoy the lowest CVA charge if:

> "(a) the CCP and/or the clearing member, as applicable (ie depending on who has control of the assets and collateral posted by the client) identifies and segregates the positions and assets belonging to the client from those of the CCP and the clearing member, and such segregation results in bankruptcy remoteness should the clearing member become insolvent; and
> (b) relevant law, regulation, rules and contractual arrangements ensure that the client's contracts with the defaulted or insolvent clearing member will be taken over by another

> clearing member, and thereby continue to be indirectly transacted through the CCP, should the clearing member default or become insolvent."[6]

With respect to segregation, under current law Korean securities would be provided as margin pursuant to a Korean law pledge, which does not involve a transfer of the pledged securities from the account of the pledgor to the account of the secured party. Rather, the pledged securities remain in the pledgor's account with a notation that they have been pledged, effectively immobilizing them. There thus would be no possibility that Korean securities provided as margin would be commingled; the existing law already provides an effective segregation mechanism for Korean securities.

Under current Korean law, cash margin may be posted in one of two ways: either as a pledge of a bank account or as an outright transfer to the secured party. The existing futures model relies on the outright transfer approach where cash margin is transferred to a customer account held by the exchange on a gross basis. Clarification is required as to whether the same approach would be followed in the context of a CCP for OTC derivatives since one variable in margin posting is whether a CCP collects margin from CMs on a gross basis (i.e. the CCP collects from each CM all margin posted by the CM's customers on account of CCP-imposed margin requirements) or on a net basis (i.e. the CCP collects from each CM a level of margin sufficient to account for the net risk to the CCP of the combined customers' positions, with offsetting customer positions resulting in a corresponding reduction in the aggregate margin requirement).

An important consideration in how margin is held is the degree to which the margin is commingled with other assets and where the margin is held. Customer assets may be comingled with the CM's proprietary assets or segregated from the CM's proprietary assets in an omnibus or on an individual client basis. Margin may be held at the CCP (in the client's name or in the CM's name), at the CM, or at a third-party custodian. In a situation where margin is posted by the client on a gross basis, but collected by the CCP on a net basis, it is possible that client margin is held at both the CCP and the CM.

Further clarity is required on CCP collateral management, including the mechanism for taking and holding collateral.

Margin and Default Fund Considerations

Article 323-14 (Clearing Margin Requirement) and Article 323-15 (Joint Compensation Fund for Damages) mentions only that" money, etc." shall be deposited by the CM to meet margin and Joint Compensation Fund requirements. ISDA suggests that greater clarity as to what constitutes eligible collateral under each article would be helpful. For example, can the CM use Korean government bonds? Korean corporate bonds above a certain rating? Are foreign government bonds acceptable? Will foreign currency cash or bonds be accepted? Will any maximum maturity or minimum liquidity constraints be imposed?

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[6] Capitalisation of bank exposures to central counterparties, Basel Committee on Banking Supervision, Page 11, 4 February 2011

Article 323-14 also makes no distinction between initial margin and variation margin? ISDA notes that the international norm is to accept either cash or eligible securities for initial margin, but that variation margin is always cash since it is a pass through item not held by the CCP.

ISDA also notes that Basel 3 proposes different CVAs for margin and Joint Compensation Fund contributions. If the CCP meets CPSS-IOSCO standards, the CVA for margin contributions is 2%, while it is 20% for Joint Compensation Fund contributions. This is one reason why industry participants prefer that a CCP protects itself through stringent initial margin requirements rather than higher compensation fund contributions.

The industry also highly recommends that the number of times that a CCP can call on a CM to replenish the compensation fund should be capped. Otherwise, CMs face potentially unlimited liability and may be restricted by home country regulators from becoming a CM of such a CCP. ISDA notes that foreign bank participation in Japan's CCP was held up until the issue of uncapped liability could be satisfactorily resolved.

Third Country Regulatory Considerations,

The Amendments do not mention a framework for recognizing third country CCPs. Derivative markets are global in nature and impediments to cross-border trading could be highly damaging. Consider the example of a Korean financial institution that is required to clear trades in Korea. If it were to enter into a cross border trade with another Asian bank that was also required to clear in its home jurisdiction, this trade could not take place as trades can only be cleared in one clearing house. Any rules that made it impossible for Korean financial institutions to execute such cross border trades would be bad for the Korean market.

ISDA submits that Korean regulation should detail conditions under which third country CCPs would be recognized for clearing and recommends that meeting CPSS-IOSCO benchmark standards is the appropriate criteria.

Also, the European Union's proposed standards for accrediting third-country CCPs are stringent. Regulatory powers have been given to the European Securities and Markets Authority ("ESMA"). ESMA may recognize a third country CCP if the European Commission has determined that:

(a) the third country's legal and supervisory arrangements ensure that its CCPs comply with legally binding requirements that are equivalent to the EU's;

(b) these CCPs are subject to effective supervision and enforcement in the third country on an on-going basis; and

(c) the third country's legal framework provides for effective reciprocal access of EU CCPs.

This could potentially lead to regulatory conflict. ISDA is not aware of any Korean Won denominated trades currently being cleared outside of Korea. However, if it were to be mandated that Korean Won trades must be cleared in Korea and a European-domiciled CCP also decided to offer Korean Won trade clearing, then not providing reciprocal access to that European-domiciled CCP could result in ESMA deciding not to recognize Korea's CCP for the purpose of clearing by European banks. In the extreme case, all of the liquidity that European banks provide to Korean OTC markets could disappear as a result.

Mandating that onshore swaps denominated in other currencies, such as Euros or US dollars, must be cleared in Korea, would immediately cause conflict with ESMA as European-based clearing houses already offer clearing of those products and reciprocal access would be expected.

It is worth noting that concerns also arise from the Dodd Frank Act. A potential Korean CCP might possibly gain blanket recognition from US regulators, though the criteria for that recognition is not clear at this moment. Instead, a Korean CCP may be required to register as a DCO in the US, subjecting the Korean CCP to potentially conflicting regulation between US and Korean regulators. Failure to register as a DCO would result in US banks not being able to clear through the Korean CCP. Instead, US banks could be required under the Dodd Frank Act to treat the CCP as a bilateral trading counterparty and require a Korean CCP to post margin to the US bank. Otherwise, US banks may not be permitted to trade with this counterparty. In the extreme case, all of the liquidity that American banks provide to Korean OTC markets could disappear as a result.

These issues can be addressed by convergence/alignment of rules, limited exemptions for cross-border business and (mutual) recognition arrangements, while still achieving the objectives of the Amendments. However, while solutions for these issues remain unresolved as between the United States, the European Union and other jurisdictions, it might be premature to implement any regulations that restrict Korea's ability to be flexible and require a long lead to time to change.

Local Law Legal Considerations (Requires input from Kim & Chang)

The existence of reasonable legal certainty is essential in the event of the insolvency of the relevant CCP or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property. ISDA believes that contingency plans for the wind up of a CCP in the event of an insolvency must exist from the outset and that their must be legal certainty in place.

Financial stability requires legal certainty of outcome in insolvency. This is essential to ensuring, that, upon insolvency, the assumptions on which credit support levels and default management procedures were structured are well founded and reliable. It is also essential in order to mitigate concerns that may deter participation in the market or in available clearing solutions. As mentioned earlier in this letter, confidence in the portability of customer accounts upon the insolvency of a clearing member is extremely important to market participants.

ISDA understands that Article 120(2) of the Debtor Rehabilitation and Bankruptcy Law ("DRBL") addresses CM insolvency, providing that upon the insolvency of a CM "the assumption of liability, netting, calculation of settlement amount, provision, disposition and application of margin and collateral and other matters relating to the clearance and settlement shall take effect as determined by the [CCP] and shall not be subjected to rescission, termination, cancellation or avoidance." Therefore, assuming the CCP's rules or the contractual arrangement between the CCP and its CMs permits the CCP to take such actions, Article 120(2) would protect actions taken by the CCP to close out the insolvent CM's contracts/positions.

CCP insolvency is not expressly addressed under current law, and it is unclear whether a CCP would be a "financial institution" for purposes of the FIRL (even if it is, because there likely will be only one CCP in Korea, the FSS would not be in a position to transfer contracts/positions away from the insolvent CCP). Nonetheless, Article 120(3) of the DRBL permits the enforcement of contractual netting provisions found in master agreements such as the ISDA Master Agreement. Thus, assuming the contractual arrangement between the CCP and its CMs is a "master agreement" for purposes of Article 120(3), a CM would be permitted to exercise any contractual netting remedies contained in that agreement in the event of the CCP's insolvency,

including the right to set off amounts owed to the CCP against the value of margin posted by the CM to the CCP. Nevertheless, pre-planning for the orderly unwinding of CM positions in the event of the CCP becoming insolvent, could reduce market volatility and expedite necessary risk management measures at a time when the financial system would likely be under a great deal of stress.

ISDA appreciates the opportunity to provide comments on the Proposed Amendments and looks forward to working with the FSC as it continues the regulatory process. Please feel free to contact any of the undersigned at your convenience.

Yours sincerely,

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