ISDA® Safe, Efficient Markets

BY COURIER & EMAIL

Intermediaries Supervision
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Dear Sirs and Madams,

Consultation Paper on (1) the OTC derivatives regime for Hong Kong – Proposed refinements to the scope of regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters; and (2) Proposed conduct requirements to address risks posed by group affiliates

The International Swaps and Derivatives Association, Inc. ("**ISDA**") [1] welcomes the opportunity to provide comments on the Consultation Paper on (1) the OTC derivatives regime for Hong Kong – Proposed refinements to the scope of regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters; and (2) Proposed conduct requirements to address risks posed by group affiliates (the "**Consultation Paper**") issued by the Securities and Futures Commission ("**SFC**") on 20 December 2017. Terms not defined herein have the same meanings given to them in the Consultation Paper and references to paragraphs are to the paragraphs in the Consultation Paper.

We set out our responses to the questions raised in the Consultation Paper. While our members have sought to form a consensus on such questions, there are certain issues on which individual members may have their own views. This response represents the majority view of the industry on the issues covered by the Consultation Paper, and certain members may provide their comments to the SFC independently.

A. Part II – Proposed refinements to the scope of regulated activities in response to market comments on the OTC derivatives licensing regime

Q1a. Do you have any comments or concerns about how we propose to carve out corporate treasury activities conducted within non-financial groups from the scope of OTC derivative products management (ie, Type 9 RA)?

Our members welcome the proposal to carve out corporate treasure activities.

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 891 member institutions from 67 countries. These members comprise of a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Q1b. Do you have any comments or concerns about how we propose to carve out corporate treasury activities conducted within non-financial groups from the scope of "dealing in OTC derivative products" (ie, the dealing limb of Type 11 RA)?

Our members welcome the proposal to carve out corporate treasury activities conducted within non-financial groups.

We note the SFC's considerations for not extending such carve-out to financial groups. However, we submit that the concerns summarised under paragraphs 13(a) and (b) in relation to corporate treasury activities of non-financial groups equally apply to such activities of financial groups. For example, it is equally unclear whether the "price taker carve-out" could be applied to an OTC derivative transaction entered into between affiliates of a financial group where both parties enter into the transaction merely for hedging or internal risk transfer purposes, with no intention of adding any remuneration or spread to the pricing, nor affecting or moving the market price. We submit that differentiating between financial groups and non-financial groups and providing different carve-outs would not reflect the SFC's policy intention to exclude end-users of OTC derivative transactions from the dealing limb of Type 11 RA. If the intra-group transactions are not intended to affect or move the market price, it should not matter whether the relevant affiliates belong to a financial group or a non-financial group. If, notwithstanding the foregoing, the SFC considers it important to differentiate between financial groups and non-financial groups, we propose that the SFC consider introducing a threshold (e.g. USD5 billion) so that the licensing requirements under Type 11 RA would only be triggered if the aggregate notional amount of OTC derivative transactions entered into in connection with corporate treasury activities of financial groups exceeds such threshold.

Q1c. Do you have any comments or concerns about how we propose to carve out corporate treasury activities conducted within non-financial groups from the scope of "advising on OTC derivative products" (ie, the advising limb of Type 11 RA)?

Our members do not have any comments on this part of the Consultation Paper.

Q1d. We do not propose to carve out corporate treasury activities from Type 12 RA because we believe that corporate treasury personnel do not typically provide client clearing services. Do you have any comments or concerns in this regard? Please provide detailed reasons and justification if you believe such a carve-out is necessary or useful.

Our members do not have any comments on this part of the Consultation Paper.

Q1e. The term "affiliate" is proposed to be defined by reference to the terms "group", and hence "subsidiary", as defined in Schedule 1 to the SFO. Among other things, the latter is defined by reference to: (i) control of the composition of the board of directors; (ii) control of more than 50% of the voting power at general meetings; or (iii) ownership of more than 50% of the issued capital (excluding capital which carries no right to participate beyond a specified amount on a distribution of profits or capital). Do you have any comments or concerns about defining "affiliate" in this way?

Our members do not have any comments on this part of the Consultation Paper.

Q1f. Do you have any comments or concerns about how we propose to define "financial group" and "financial services"?

Our members do not have any comments on this part of the Consultation Paper.

Q2a. Do you have any comments or concerns about our proposal to carve out multilateral portfolio compression services from both "dealing in OTC derivative products" and "advising on OTC derivative products"?

Our members welcome the proposal to carve out multilateral portfolio compression services. The carve-out would encourage more multilateral portfolio compression services providers to enter into the market in Hong Kong and provide more avenues for clients to reduce their risk exposures.

Q2b. Do you have any comments or concerns about how we propose to define "multilateral portfolio compression services"?

Our members do not have any comments on this part of the Consultation Paper.

Q2c. We do not propose to amend the definition of "automated trading services". If you disagree, please provide details of the amendment you consider to be necessary, together with supporting reasons and justification.

Our members do not have any comments on this part of the Consultation Paper.

Q2d. Other than portfolio compression services, are there other post-trade services which should also be carved out? If so, please provide detailed reasons and justifications.

Our members do not have any comments on this part of the Consultation Paper.

Q3a. Do you have any comments or concerns about how we propose to carve out the provision of compression services by CCPs from the scope of "advising on OTC derivative products"?

Our members welcome the proposal to carve out provision of compression services by CCPs.

Q3b. Do you have any comments or concerns about how we propose to amend the carve-out for CCPs from the scope of "dealing in OTC derivative products"?

Our members do not have any comments on this part of the Consultation Paper.

Q3c. Do you have any comments or concerns about how we propose to carve out persons licensed for Type 12 RA from the scope of "advising on OTC derivative products"?

Our members do not have any comments on this part of the Consultation Paper.

Q4a. Do you have any comments or concerns about how we propose to narrow the scope of Type 12 RA so as to align the position of overseas persons providing client clearing services irrespective of whether they do so as members of a local CCP or an overseas CCP?

Our members do not have any concerns about expanding the carve-out for Type 12 RA to cover overseas CCP.

With respect to the provision of client clearing services, we would like to urge the SFC to take a principles-based approach in determining which jurisdiction is a "comparable overseas

jurisdiction" under section 5 of Part 2A of Schedule 5 to the SFO. We note that this is consistent with the approach the SFC proposes under Part III.

In addition, we would like to request the SFC to consider further expanding the carve-out under Part 2 of Schedule 5 to the SFO to cover the provision of client clearing services by an entity, which may be located in Hong Kong, to its affiliates only. For administrative and operational ease, a group may only have one entity that is a clearing member of a particular CCP, and such entity would clear the trades on behalf of all its affiliates through such CCP. We submit that the proposed additional carve-out would encourage more trades to be cleared and support the policy intentions and implementation of mandatory clearing requirements and margin requirements of non-cleared OTC derivatives.

Q4b. Do you have any comments or concerns about our proposal to narrow the scope of Type 11 RA (both dealing and advising) so that activities carried out by acceptable participants which are not licensed for Type 12 RA are carved out?

Our members do not have any comments on this part of the Consultation Paper.

Q5a. Do you have any comments or concerns about how we propose to carve out clearing and settlement services provided by fund managers from the scope of Type 12 RA?

Our members do not have any comments on this part of the Consultation Paper.

Q5b. Do you have any comments or concerns about how we propose to refine the definition of Type 12 RA to exclude services that are essentially ancillary to the clearing and settlement process?

Our members do not have any comments on this part of the Consultation Paper.

Q6a. Do you have any comments or concerns about our proposal to expand the carve-out for professionals so that it covers all OTC derivative products?

Our members welcome the proposal to expand the carve-out for professionals.

Q6b. Do you have any comments or concerns about how we propose to carve out licensed fund managers' from Type 3 RA?

We support the SFC's proposal to carve out licensed fund managers from Type 3 RA. However, our members propose that the criteria set out under paragraph 41 be simplified. In particular, the criteria under paragraph 41(b) ("*the person provides a service of managing a portfolio of OTC derivative products for another person which the person is permitted to provide under that licence*") is already effectively covered by paragraphs 41(a) and 41(c) already. In addition, we suggest that the criteria under paragraph 41(d) be replaced by the criteria that the dealing in foreign exchange derivatives is solely for the purpose of managing funds.

B. Part III – Proposed risk mitigation requirements

Q7. Do you have any comments or concerns about the high-level, principles-based approach we propose to take in respect of applying the risk mitigation requirements, including the scope of application of our proposed requirements and the entities to whom our proposals apply? Are there specific challenges with respect to cross-border issues which may need to be taken into account under our proposed approach?

Substituted compliance

The industry is generally supportive of the high-level, principles-based approach to the risk mitigation requirements for licensed corporations. We note that the proposed requirements are based on the IOSCO RMS and that, under paragraph 55, registered institutions regulated by the HKMA are permitted to comply with the HKMA risk mitigation standards instead of the SFC requirements. We further note that substituted compliance is permissive under HKMA's risk mitigation standards.

We strongly urge the SFC to take the same approach to allow full substituted compliance with respect to overseas risk mitigation requirements that are comparable to the IOSCO RMS, especially existing requirements in the US and the EU. This is because licensed corporations trading with US or EU counterparties have already established systems and practices to comply with such overseas requirements for some time and it would be costly and burdensome if they have to make legal, operational, risk management or technological enhancements to implement the SFC requirements. Notwithstanding the flexibility of the SFC's high-level and principles-based approach, any slight difference in requirements could result in potential regulatory conflicts and thus impose a disproportionate burden on licensed corporations in implementation and compliance. This would run contrary to the express regulatory intent of the SFC. We thus request the SFC to allow licensed corporations to follow the requirements to which their counterparties are subject, provided that such requirements are comparable to the IOSCO RMS.

In assessing which requirements or jurisdictions are comparable, we urge the SFC to take an outcome-based approach rather than a granular or "element-by-element" approach. We submit that this is also consistent with the approach adopted by the HKMA under paragraph 2.3.6 of the Supervisory Policy Manual (SPM) CR-G-14.

We also suggest that the SFC take the approach of the HKMA under paragraph 2.3.2 of the SPM CR-G-14 and initially deem the risk mitigation standards of "WGMR member jurisdictions" (see footnote 24 therein) as comparable until a comparability assessment is completed by the SFC. In addition, we request that the European Union and the United Kingdom be listed separately and that the relevant regulators of a particular jurisdiction be listed separately (for example, the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission should be listed separately under the United States).

Further, we note that some licensed corporations that are part of a group only trade with their overseas affiliates and are thus subject to the overseas risk mitigation requirements to which their affiliates are subject. They follow certain internal group risk mitigation policies, which were put in place for the purpose of compliance with such overseas requirements. Compliance with such internal policies thus is a way to comply with the applicable overseas

risk mitigation requirements. We thus strongly request the SFC to permit such licensed corporations to follow their internal policies instead of the SFC requirements, provided the relevant risk mitigation requirements are deemed or assessed to be comparable by the SFC. Otherwise, the licensed corporations may become subject to duplicative requirements and a disproportionate compliance burden.

If substituted compliance is allowed, we also request the following confirmations from the SFC:

- licensed corporations can rely on their existing documentation that was put in place for the purpose of complying with the risk mitigation requirements of a comparable jurisdiction, without the need to enter into further documentation; and

- licensed corporations can delegate the implementation of the relevant risk mitigation requirements to its overseas affiliates. It is common for the operational aspects of risk mitigation requirements to be centrally carried out by a group entity that is already subject to risk mitigation requirements of its home regulator. Allowing such arrangement would avoid the need for firms to establish duplicative local operations.

Implementation timing

In order to avoid potential regulatory conflicts, we strongly request the SFC to phase in the risk mitigation requirements in a manner that is similar to that adopted by the HKMA.

We would also like to request that the SFC provide an indication of when the new OTC derivatives licensing regime is expected to commence.

Meaning of "execute" for Type 9 RA

We note that the proposed requirements apply to a corporation licensed for Type 9 RA that executes an OTC derivative transaction on behalf of a CIS managed by it, and would like to seek clarification from the SFC on what "execute on behalf of a CIS" would capture. It is common for an investment manager to sign an agreement or a confirmation in its capacity as an investment manager of a CIS, and to be named as such in the documentation. The transaction may however be entered into or executed by an employee of an overseas affiliate of the licensed corporation on behalf of the CIS. In the above scenario, would the mere signing of the confirmation be considered as "execute on behalf of a CIS"?

Overseas-incorporated licensed corporations

We note that the HKMA has made a distinction in the application of its risk mitigation standards to locally-incorporated authorised institutions and overseas-incorporated authorised institutions. In particular, with respect to an overseas-incorporated authorised institution, the HKMA requirements only apply to those transactions that are booked in its Hong Kong branch. We request the SFC to adopt a similar approach so that the proposed requirements only apply to those transactions that are booked in the Hong Kong branch of a licensed corporation incorporated outside of Hong Kong.

Q8. Do you have any comments on the proposed risk mitigation requirements, including trading relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression or dispute resolution?

In the case where a client has multiple accounts and where one of which is discretionary or is managed by another asset manager, a licensed corporation that manages the account of such client would not have knowledge of the transactions executed by other asset managers or the client itself. Accordingly, such licensed corporation may not be in a position to manage the risks to which the client is exposed by undertaking risk mitigation measures such as portfolio reconciliation or portfolio compression. We submit that the scope of the requirements applicable to a licensed corporation under the above circumstances should be narrowed accordingly.

Q9. Are any of the risk mitigation requirements inappropriate for a corporation licensed for Type 9 RA which carries out OTC derivative products management, in respect of non-centrally cleared OTC derivative transactions executed by the licensed corporation on behalf of any CIS managed by it? If so, how should the corresponding risk be mitigated?

We note that the last sentence of paragraph 52 provides that "*Where a licensed corporation manages a discretionary account instead of a CIS, we will leave it to the licensed corporation and its client to make the necessary arrangements between themselves.*" We request the SFC to clarify whether there are any requirements as to the form or content of such "arrangements". We also request clarification if this requirement applies to clients not regulated by the SFC and/or are domiciled outside Hong Kong.

We submit that it may not be practical to require all clients of a SFC-licensed asset manager to enter into formal written "arrangements", and that it should be sufficient if the SFC-licensed asset manager implements appropriate risk mitigation standards and provides notice to its clients of the relevant "arrangements".

Q10. Will any established industry practice be adversely affected in a material respect by the proposed risk mitigation requirements?

We note that it is common industry practice for the calculation of NAV to be done by a third party (such as a fund administrator or the trustee of a CIS) rather than by the asset manager. Such practice will be adversely affected in a material respect if an SFC-licensed asset manager is required to comply with valuation requirements and determine the official NAV. We however note that, under paragraph 52, the SFC does not intend to apply the proposed requirements to a licensed corporation managing a CIS if such requirements are handled by the governing body of the CIS or its delegate, such as the trustee or other operator of the CIS. We further note that paragraph 77 provides that an asset manager would not be subject to the proposed valuation model requirements if it does not have valuation responsibility. We suggest the SFC to make clear in its requirements that the above industry practice would not be adversely affected.

Q11. Is it appropriate to subject FX security conversion transactions only to the proposed risk mitigation requirements for trading relationship documentation and trade confirmation? If not, what are the reasons for exempting such transactions from these proposed requirements? How should the legal and operational risks of such transactions be mitigated?

We support the SFC's view that only certain risk mitigation requirements should apply to FX security conversion transactions.

Further to our response to Q9 above, we request clarification from the SFC that, in case of a discretionary account for which only FX security conversion transactions are traded, a SFC-licensed asset manager is only subject to the risk mitigation requirements for trading relationship documentation and trade confirmation.

C. Part IV – Proposed requirements on client clearing

Q12. Do you agree with our proposed segregation and portability requirements? Where both individual client segregation and omnibus client segregation are offered by a CCP, should a licensed corporation which is a clearing member of the CCP be required to offer its clients both account structures? As part of the proposed disclosure requirements in relation to the risks of different account structures, should licensed corporations also be required to explicitly flag to clearing clients the risk that clients themselves may be exposed to losses as part of CCP recovery and resolution, eg, via variation margin gains haircutting?

We are supportive of the SFC's view that clearing member firms should not be required to offer both individual and omnibus client segregation to clients for the reasons provided in the Consultation Paper.

We would like to seek confirmation that the proposed segregation requirements do not apply to the calculation of counterparty credit risk exposures and risk-weighted asset for regulatory capital purposes. For example, a licensed corporation is allowed to apply excess collateral posted by a client for cleared trades to reduce its exposure in relation to uncleared trades entered into with the same client.

Q13. Is it appropriate to prohibit the use of client assets for the benefit of the licensed corporation's affiliates? If so, is it appropriate to identify affiliates of a licensed corporation by reference to the concept of controlling-entity relationship as defined under the SFO?

Our members agree with the proposed requirements under the Consultation Paper.

Q14. Do you agree with our proposed notification and information disclosure requirements in relation to indirect clearing?

Our members agree with the proposed requirements under the Consultation Paper.

Q15. Do you agree with our proposed clearing confirmation requirements?

Our members agree with the proposed requirements under the Consultation Paper.

Q16. Are the proposed CMR and CSR requirements appropriate in the context of client clearing?

With respect to the scope of CMR and CSR requirements, we would like to confirm our understanding that these requirements will not apply to variation margin ("**VM**") and initial margin ("**IM**") in respect of non-centrally cleared OTC derivatives entered into between licensed corporations and its clients.

With respect to the CMR:

(a) the definition of "client money" under the SFO provides that such money must be "*received or held on behalf of a client of the licensed corporation or in which a client of the licensed corporation has a legal or equitable interest*";

(b) for VM, where cash collateral is provided by the client to the licensed corporation on a title transfer basis, it is our understanding that cash VM will not fall within the definition of "client money" under the SFO. In particular, the licensed corporation is not receiving or holding cash VM on behalf of its client, and the client does not retain any legal or equitable interest in the cash VM; and

(c) for IM, where cash collateral will generally be provided by the client to the licensed corporation pursuant to a security arrangement, it is our understanding that cash IM will be outside the scope of the CMR as the cash IM will be held by a third party custodian (where the account is opened in the name of the client).

With respect to the application of the CSR to VM, we note that Q1(c) of the CSR FAQs[2] expressly provides that securities provided on an outright transfer basis should not be treated as client securities or securities collateral. For IM, we understand that the CSR will not apply provided that securities provided by the client are held by a third party custodian (where the account is opened in the name of the client).

D. Part V – Proposed record keeping requirements

Q17. Is the requirement to retain trading relationship documentation, trade confirmations and valuation processes agreed with counterparties for a minimum of five years after the termination, maturity, novation or assignment of OTC derivative transactions appropriate? Should this requirement be extended to any other record?

Record-keeping in relation to collateral

While the proposed requirements are consistent with the IOSCO DMI report, we submit that it would be impractical to implement the requirement to maintain records relating to collateral for 5 years after maturity or termination of an OTC derivative transaction. This is because collateral is typically called for and collected on a net basis across multiple OTC derivatives transactions. As a result, it is impossible to allocate the collateral collected to individual OTC derivative transactions. For similar reasons, it is also difficult to identify what collateral has been rehypothecated in respect of a particular OTC derivative transaction. Further, it should be noted that most common law jurisdictions treat rehypothecation as title transfer, i.e. the collateral giver would lose all legal and beneficial interests to the collateral being rehypothecated and all title would be transferred to the collateral receiver. The collateral receiver would record such collateral as its own assets accordingly. In practice, this requirement would mean that licensed corporations would have to maintain collateral data in perpetuity. We thus request that this record-keeping requirement be amended such that

[2]http://www.sfc.hk/web/EN/faqs/intermediaries/supervision/client-securities-rules/2003-03-17.html

collateral information is retained only for 5 years from the date on which the relevant call or valuation was made.

Record-keeping in relation to "orders or instructions"

We request clarification from the SFC on what constitute "orders or instructions" under paragraph 113(a) and whether they would capture voice log.

Overriding the KRR

We note that, under paragraph 118, it is SFC's intention that "*where the SFO or other subsidiary legislation prescribes record retention periods which differ from the period provided for in the KRR, those more specific retention periods shall override any general period provided for in the KRR*". We request the SFC to provide examples on which retention periods would be considered specific and would override the general period provided for in the KRR.

E. Part VI – Proposed conduct requirements to address risks posed by group affiliates and other connected persons

Q18. Do you agree with our proposal to require licensed corporations to properly manage financial exposures to group affiliates and other connected persons according to the same risk management standards they would apply in respect of exposures to independent third parties undertaken by the licensed corporations on an arm's length basis in order to minimise interconnectedness risk? If not, what other conduct requirements should be introduced in order to minimise the impact of interconnectedness risk?

Scope of Part VI

We note that the proposed requirements under Appendix 8 apply to all licensed corporations and given the regulatory concerns of the SFC, we would like to seek clarification from the SFC on its rationale for subjecting corporations licensed for all different types of RA under the SFO to such requirements.

We also request confirmation from the SFC that the requirements under Part VI of the Consultation Paper will not apply to:

- registered institutions; nor
- inter-branch transactions (i.e. transactions between different branches of the same legal entity) and intra-branch transactions (i.e. transactions between different desks of the same branch). We note that this would be consistent with the approach adopted by the SFC and the HKMA with respect to implementation of the mandatory reporting and mandatory clearing requirements for OTC derivatives.

Management of financial exposures

We understand that licensed corporations do not have to apply "exactly the same monitoring and oversight procedures" to group affiliates and other connected persons, and note the

exceptions set out in paragraph 20.1 of Appendix 8. We would like to seek clarification from the SFC on what constitutes "financial exposure".

We also note that a licensed corporation that belongs to a large financial group may have access to the liquidity and capital positions of its affiliate, as well as those of the consolidated group. Such information provides such licensed corporation with a unique ability to assess the credit risk associated with its exposure to its affiliates or shareholders. The licensed corporation is unlikely to have access to information of the same level or quality for independent third parties, and thus is likely to assess the credit risk exposure against third parties to be higher. Further, as a result of the implementation of the SFC's Managers-In-Charge regime, managers of a licensed corporation have to act in its best interests and may take measures to mitigate the risk of return of liquidity or capital from the licensed corporation to its group when the group is under stress. It would therefore be impractical for a licensed corporation to manage its financial exposures to group affiliates and other connected persons according to the same risk management standards it deploys in respect of independent third parties in all circumstances. We thus request the SFC to provide an additional exception to the proposed requirement in paragraph 20.1 of Appendix 8 where a licensed corporation has access to liquidity and capital positions or other "insider information" of its affiliates or group.

Q19. Do you agree that licensed corporations should be allowed to i) solicit or recommend clients to enter into OTC derivative transactions with a group affiliate or ii) arrange for OTC derivative transactions to be entered into between its clients and a group affiliate only if the group affiliate is a licensed corporation, an authorized financial institution or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction subject to the exemption set out in paragraphs 136 and 139?

Comparable jurisdictions

We request clarifications from the SFC on the criteria to be used in making comparability assessments. It is noted that the G20 reforms on OTC derivatives have been implemented at a different pace in different jurisdictions (particularly in Asia). Some jurisdictions in Asia have experienced hurdles in implementing G20 reforms due to legacy regulatory framework or market infrastructure, e.g. netting enforceability remains uncertain in some Asian jurisdictions. On this basis, we would suggest that the determination of comparability be based not only on the status of implementation of G20 reforms, but also on considerations of the broader regulatory environment in which the CFA or the RBA operates (such as whether there are onshore restrictions that limit the amount of risk which the CFA or the RBA can take on).

In order to allow sufficient time for licensed corporations to effectively implement the new requirements, we suggest that the SFC make and issue its comparability assessments well in advance of the implementation of the requirements, and in any event, publish a list of deemed comparable jurisdictions as soon as the requirements are finalised. We suggest that the list of deemed comparable jurisdictions to include the "WGMR member jurisdictions" under footnote 24 of the HKMA Supervisory Policy Manual CR-G-14 and in particular, the European Union, Switzerland, the US, Canada, Japan, Singapore and Australia. We request that the European Union and the United Kingdom be listed separately and that the relevant regulators of a particular jurisdiction be listed separately (for example, the Federal Reserve,

the Securities and Exchange Commission and the Commodity Futures Trading Commission should be listed separately under the United States).

Similar to our response in Part III, we urge the SFC to take an outcome-based approach rather than a granular or "element-by-element" approach in assessing which requirements or jurisdictions are comparable.

Acting in the best interest of clients

We request clarifications from the SFC on how licensed corporations could meet the requirement to act in the clients' best interest and the additional protections such requirement could provide to clients. We further request clarification on whether compliance with the proposed requirements (such as those relating to group affiliate and risk disclosure) would be sufficient for this purpose.

We note that the requirement to act in the best interest of clients would give rise to a new "fiduciary" relationship between a licensed corporation and its clients. We submit that the interests of clients would be adequately protected by existing requirements (e.g. suitability checks and disclosure requirements in the Code of Conduct for Persons Licensed by or Registered with the SFC) and the proposed conduct requirements, without the imposition of a new "fiduciary duty".

Exemption in relation to CFAs

We note the SFC's concerns for the client where a CFA enters into back-to-back OTC derivative transactions with an RBA and the proposed requirement under paragraph 20.3(c) of Appendix 8.

We note that a CFA may enter into a back-to-back OTC derivative transaction with any affiliate (or RBA) or with an independent third party and that different requirements would become applicable to the relevant licensed corporation based on the identity of the hedging counterparty of the Qualified Person (as defined below). To illustrate the different outcomes, we make the following assumptions:

1. the CFA is a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction ("**Qualified Person**"); and

2. the relevant affiliate (or RBA) is not of a comparable jurisdiction.

Where the Qualified Person enters into a hedging transaction with its affiliate (or RBA), paragraph 20.3(c) applies and the licensed corporation would be subject to the proposed requirement under paragraph 20.4 of Appendix 8. Conversely, where the Qualified Person enters into a hedging transaction with an independent third party, paragraph 20.3(a) will apply instead and the licensed corporation will not be required to comply with paragraph 20.4.

We would like to seek clarifications from the SFC on the rationale for such outcomes. We submit that the requirement under paragraph 20.4 should not apply in both instances and the outcome should be the same irrespective of the identity of the hedging counterparty. This is because a CFA that is a Qualified Person will be subject to the risk mitigation standards of its

home regulator and it would be beyond the responsibilities of a licensed corporation to have oversight of, and monitor, the CFA's risk management measures.

We note the SFC's regulatory concerns under paragraph 121. Nonetheless, we submit that, in the above example, the CFA is already subject to certain legal or regulatory obligations imposed by the applicable regulator. Its risk management measures (e.g. collateral arrangements and risk mitigation programmes) would be subject to regulatory oversight, mitigating or eliminating any systemic risks that could be passed on to its counterparty (the client). It is also to be noted that if, as a result of the RBA's default, the CFA defaults in its obligations to its client, the client would seek recourse against the CFA as the contracting party, or the licensed corporation that induces the client to enter into the trade, and has no direct recourse against the hedging counterparty of the CFA. We thus submit that the proposed requirement under paragraph 20.4 does not afford additional protection for the client, nor effectively remove any financial and reputation risks to the CFA or the licensed corporation.

Exemption for clients that are professional investors

We understand the SFC's regulatory concern on the use of unlicensed CFAs or RBAs. However, it is submitted that the exemption provided under paragraph 136 be expanded so that it is also available when the client is an institutional professional investor[3] or an "experienced" corporate professional investor[4]. Licensed corporations generally deal with such clients on a principal-to-principal and arms' length basis, and we consider them to have sufficient knowledge of OTC derivatives and are in a position to assess the risks involved to make a decision on whether entering into a transaction with a CFA is in their best interest.

Exemption for clients that are special purpose vehicles

A licensed corporation often arranges for a special purpose vehicle to enter into OTC derivative transactions with an unlicensed CFA as part of a structured trade or structured note issuance. Under such circumstances, the SFC's regulatory concerns would not apply and we thus request the SFC to include such special purpose vehicles in the exemption provided under paragraph 136.

Group affiliate as an investment manager

We request confirmation from the SFC that the proposed conduct requirements do not apply where a licensed corporation recommends a client to sign an investment management agreement (or similar arrangement) with a group affiliate for the management of a portfolio that includes OTC derivatives. In this case, we submit that the regulatory concerns do not apply as the group affiliate is providing a service to the client and not the contracting party of the OTC derivatives transactions, i.e. not a CFA.

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[3] A client that falls under paragraphs (a) to (i) of the definition of "professional investor" in Section 1 of Part 1 of Schedule 1 of the Securities and Futures Ordinance.

[4] A client that falls under Section 3 of the Securities and Futures (Professional Investor) Rules and that has satisfied the assessment requirements under paragraph 15.3A of the SFC Code of Conduct.

To the extent that the proposed conduct requirements apply where a group affiliate is acting as an investment manager for the client, we would like to seek further clarity on whether the following would constitute a client solicitation or recommendation, or an arrangement made by a licensed corporation:

- a licensed corporation sends a client information or marketing materials about certain investment opportunities. The client then opens an account to invest in a portfolio that includes OTC derivatives and signs an investment management agreement with the group affiliate of the licensed corporation to manage such portfolio; and

- a client decides to appoint the group affiliate of a licensed corporation to be its portfolio manager and signs an investment management agreement with such affiliate. The licensed corporation provides certain client servicing functions to the client.

Q20. Do you agree with the proposed risk disclosure requirement for licensed corporations using unlicensed CFAs?

Provision of risk disclosure statement

We request confirmation from the SFC that the proposed risk disclosure statement can be provided on a one-off basis in the client agreement rather than included on a trade-by-trade basis.

Implementation timing

In order to effectively implement the requirements, a licensed corporation has to amend its existing client agreements. The industry considers a period of 6 months as the minimum time required for the amendment of client agreements. We thus request the SFC to take this into account when setting the implementation date of the requirements or to provide an appropriate transitional period.

Exemptions

We further request the SFC to introduce exemptions that are similar to those applicable to the requirement under paragraph 20.4 of Appendix 8 (see response to Q19 above) so that a licensed corporation will not be required to comply with paragraph 20.2(c) of Appendix 8 if any of the below condition is satisfied:

- the CFA is a Qualified Person; or

- the client is a Qualified Person, a professional investor or a special purpose vehicle.

Q21. Do you agree with the proposed risk management requirements for licensed corporations arranging for OTC derivative transactions to be booked in RBAs?

We would like to seek clarification from the SFC on the scope and contents of the "risk management program" referred to in paragraph 144(b). In particular, would the risk mitigation standards set out in Part III of the Consultation Paper be sufficient? To what extent RBAs have to meet the capital requirements applicable to licensed corporations?

F. Part VII – Proposed amendments to Securities and Futures (Fees) Rules (Cap 571AF), Securities and Futures (Insurance) Rules (Cap571AI), Guidelines on Competence and Guidelines on Continuous Professional Training

Q22. Are the proposed licensing fees in relation to the new RAs appropriate? Do you have any comment on the proposed extension of the fee waiver for Type 7 RA which is conducted incidentally to Type 3 or Type 11 RA?

Our members do not have any comments on this part of the Consultation Paper.

Q23. Is the proposed insured amount of "nil" for Type 10, Type 11 and Type 12 RAs appropriate? Please explain your views.

Our members do not have any comments on this part of the Consultation Paper.

Q24. Are the proposed amendments to the competence and CPT requirements appropriate? Please explain your views.

We request clarifications and further guidance from the SFC on what experience it would assess as relevant for the purposes of Type 11, Type 12 and expanded Type 9 RAs under Option 2 or Option 3 of the Test of Competence for Representative in Appendix B of the Guideline on Competence after the transition period, especially in the case where an individual has no direct prior involvement in such RAs.

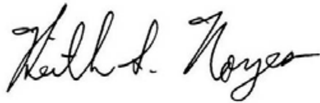
We note that, as with existing Type 7 RA, no specific competence requirements will be imposed in respect of expanded Type 7 RA. We would like to seek clarification from the SFC on whether an individual applying to be a responsible officer or a representative of Type 7 RA has to demonstrate competence in academic qualification, industry qualification or regulatory knowledge and if so, what those requirements are.

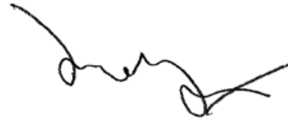
ISDA Safe, Efficient Markets

We look forward to continuing our dialogue with you. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific at (knoyes@isda.org, at +852 2200 5909) or Melody Ma, Assistant General Counsel, Asia at (mma@isda.org, at +852 2200 5908) if you have any questions.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.





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