

By E-mail

Consultation on Protected Arrangements Regulations
Financial Services Branch
Financial Services and the Treasury Bureau
24/F Central Government Offices
2 Tim Mei Avenue
Tamar, Hong Kong
E-mail: resolution@fstb.gov.hk

20 January 2017

Dear Sirs,

**Consultation on an Effective Resolution Regime for Financial Institutions in Hong Kong:
Regulations on Protected Arrangements**

Introduction

The International Swaps and Derivatives Association, Inc. ("**ISDA**")¹ and the Asia Securities Industry & Financial Markets Association ("**ASIFMA**"², and together with ISDA, the "**Associations**") welcome the opportunity to provide comments on the Consultation Paper on "*An Effective Resolution Regime for Financial Institutions in Hong Kong - Regulations on Protected Arrangements*" in relation to the Financial Institutions (Resolution) Ordinance (Cap. 628) ("**FIRO**") (the "**Consultation Paper**") issued by the Financial Services and the Treasury Bureau in conjunction with the Hong Kong Monetary Authority ("**HKMA**"), the Securities and Futures Commission and the Insurance Authority on 22 November 2016. The Associations are also grateful to the HKMA for providing us the opportunity to participate in a meeting on 22 December 2016 (the "**Meeting**") with other interested organizations to discuss the Consultation

¹ Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 66 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.

² ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

Paper. We find the dialogue with the HKMA extremely helpful and this submission is intended to continue our constructive dialogue and to highlight our concerns on legal uncertainty that will be created if the proposed resolution powers and related safeguards are not adequately defined and circumscribed in terms of their scope or effect.

All capitalized terms used but not defined in this letter have the meanings ascribed to such terms in the Consultation Paper.

While we welcome each of the categories of safeguards set out in the Consultation Paper, the majority of our comments relate to the consultation questions Q1 and Q4.

General

We note that the authorities intend to implement FIRO in the first half of 2017 and will publish a code of practice and further consultations on regulations under FIRO during 2017 and early 2018. ISDA submits that more clarity on the form and substance of future regulations under FIRO should be provided to the industry before FIRO becomes effective. ISDA further submits that an effective date within the first half of 2017 would not provide within scope entities with the legal certainty and understanding of the full impact of FIRO and any related subsidiary legislations for them to get ready for FIRO.

ISDA also requests the authorities to provide more clarity on the considerations a resolution authority would take into account when choosing which stabilization options (e.g. PPT or bail-in) to apply.

Q1. Do you agree with the proposed approach to protecting clearing and settlement systems arrangements in a PPT under the PARs?

As a general point, it is important to ensure consistency between FMI rules and procedures, and use of a resolution tool for FMI participants. This point is highlighted in Part II of Appendix II-Annex I (*Resolution of Financial Market Infrastructures (FMIs) and FMI Participants*) of the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board (“FSB”) on 15 October 2014. Paragraph 5 thereunder also puts emphasis on the provision of information on impending resolution of a participant by resolution authorities to FMIs, reinforcing the importance of the role FMIs play in the resolution of any of their participants and the objective to minimise disruption to the clearing and settlement functions provided by the FMIs. We also note that FSB has recently published a consultative document entitled “*Guidance on Continuity of Access to Financial Market Infrastructures (“FMIs”) for a Firm in Resolution*”³ and that international guidance on the interactions between FMI rules and procedures and resolution of FMI participants, and any cross-border issues is still at its formative stage. We urge the authorities to take international developments into account when finalizing and implementing the resolution regime in Hong Kong.

³ <http://www.fsb.org/2016/12/guidance-on-continuity-of-access-to-financial-market-infrastructures-fmis-for-a-firm-in-resolution/>

We welcome the proposed protection for clearing and settlement systems arrangements. ISDA notes that the proposed protection under paragraph 12 would only be available to arrangements with a clearing house recognized under the Securities and Futures Ordinance (Cap. 571) (“SFO”). We would like to seek clarifications from the authorities on how they intend a resolution authority to apply PPT with respect to clearing arrangements between a within scope entity that is under resolution and a clearing house that is not a recognized clearing house (e.g. LCH.Clearnet Limited) (“**Foreign CCP Clearing Arrangements**”). We further note that section 2(s) of Schedule 5 of FIRO does not cover liabilities owed to a clearing house that is not a recognized clearing house and would like to seek similar clarifications on how a resolution authority would make a bail-in provision with respect to Foreign CCP Clearing Arrangements.

We also note that section 45 of the SFO provides for proceedings of a recognized clearing house to take precedence over the law relating to distribution of the assets of a within scope entity on insolvency, bankruptcy or winding up, or on the appointment of a receiver over any of the assets of a within scope entity. We submit that it is not clear whether the initiation of resolution or application of stabilization options to a within scope entity under FIRO would fall within section 45 and thus would be overridden by the proceedings, including default rules under section 45(1)(e) of SFO, of a recognized clearing house. We note that in the UK, the operation and enforceability of the default rules of a recognised clearing house (as defined under the relevant UK statutory instrument) are given specific protection under a partial property transfer⁴. In the event that a clearing member enters into resolution, such protection would allow the default rules (e.g. porting) to operate so as not to compromise the safe and orderly operation of such clearing house. We would therefore welcome more clarity on the protections given to proceedings of a recognized clearing house in the PARs.

Q4. Do you agree with the proposed approach to protecting rights to set-off or net under set-off, netting and title transfer arrangements in a PPT under the PARs?

While we welcome the protections for set-off, netting and title transfer arrangements in the Consultation Paper, we have the following comments on the scope of the protection.

Standard set-off provisions under the ISDA Master Agreement

Paragraph 32 of the Consultation Paper states that assets, rights and liabilities that are linked to each other by virtue of bona fide financial arrangements such as the ISDA Master Agreement should be protected, while “catch-all” or “sweeper” provisions that provide for any and all rights and liabilities between the parties to be set-off or netted should not be protected. As mentioned in the Meeting, industry standard documents such as the ISDA Master Agreement typically contain set-off provisions which permit the parties to set off the close-out amount against other amounts owing between them under other agreements⁵. Similar to the close-out netting provisions, the object of a set-off provision is to reduce credit risk. ISDA welcomes confirmation that the

⁴ Please refer to paragraph 7(b) under the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (2009 No. 322).

⁵ Such set-off provisions appear as a standard provision (Section 6(f)) in the 2002 ISDA Master Agreement and are commonly added by the parties to the Schedule to the 1992 ISDA Master Agreement.

inclusion of a set-off provision will not affect the status of the ISDA Master Agreement as a protected arrangement.

Definition of “financial activity”

Paragraph 33 of the Consultation Paper contains a list of exclusions from the protection for set off, netting and title transfer arrangements. ISDA notes that these are broadly consistent with those in the UK, but note that with respect to sub-paragraphs (iv) and (v), “financial activity” is not defined. In the UK, such activity is defined by reference to activity related to financial instruments (including various derivative contracts), deposits, loans or other instruments that create or acknowledge indebtedness. We would thus welcome more clarity to the definition of “financial activity” in the PARs.

Condition precedents to payment obligations (“flawed asset” provision under the ISDA Master Agreement)

Paragraph 35 of the Consultation Paper states that clauses permitting the non-defaulting counterparty to make no (or limited) payments to the defaulting party should not be protected. As noted in the Meeting, the ISDA Master Agreement contains conditions precedent⁶ whereby a non-defaulting party’s obligations to make a payment or a delivery under a transaction is conditional upon the fact that no “event of default” or “potential event of default” has occurred with respect to the other party, or no “early termination date” with respect to the relevant transaction has been designated by the non-defaulting party. Accordingly, a party to an ISDA Master Agreement never has more than a conditional obligation to make a payment or a delivery under the ISDA Master Agreement. The “asset” represented by the conditional entitlement to receive a payment or a delivery may be said to be “flawed” as it is subject to the conditions precedent mentioned above.

This provision provides an important protection for the non-defaulting party in the initial period after its counterparty has defaulted, so that it is not required to make payments and increase its potential credit loss to a defaulting party or to close out prematurely. Such “flawed asset” provision is well recognized and distinct from “walkaway clauses” which entitle a non-defaulting counterparty to make no (or limited) payments to the defaulting party. ISDA would welcome clarifications that the “flawed asset” provision in the ISDA Master Agreement would not have an impact on the protections given to the ISDA Master Agreements under the PARs.

Written contractual agreements

Under paragraph 36 of the Consultation Paper, we note that the proposed approach for PARs is similar in principle to that adopted in the UK except that the proposed protection in Hong Kong would only apply to set-off and netting rights that have been created by written contractual agreements. Based on our discussions in the Meeting, we understand that such written contractual requirement stems from concerns that, without such requirement, the scope of protections would go beyond what is necessary to ensure certainty on credit risk mitigation and funding arrangements, and would disproportionately constrain the use of resolution tools. However,

⁶ Please refer to section 2(a)(iii) of the 1992 ISDA Master Agreement or the 2002 ISDA Master Agreement.

ISDA notes that the imposition of such requirement is not consistent with the approach in the EU and the UK where arrangements that “wholly or partially arise automatically as a matter of law” are protected under a partial property transfer⁷, and this may have an impact on how foreign regulators would give recognition to Hong Kong resolution actions (especially those that are exercised with respect to set-off and netting rights that arise by operation of law). ISDA requests that Hong Kong adopts an approach that is consistent with international standards.

Other comments: Information requirements

We understand from the Meeting that the authorities intend to engage with within scope entities on a bilateral basis to discuss the necessary information and reporting requirements. We would like to seek further clarifications and details on whether the information requests are intended to be made on an ad hoc basis (e.g., to facilitate the resolution authorities at or near a point of financial non-viability) or on a regular basis. If latter, within scope entities would need to time to develop capabilities to handle regular reporting to the resolution authorities. We also seek clarity on the timeframe for within scope entities to respond to such requests.

In relation to the detailed information and reporting requirements, we request the authorities to engage the industry on an open and transparent basis through a formal consultation process, and provide adequate time (and/or transition period) for market participants to develop the capabilities to implement such requirements.

⁷ Please refer to section 48(5) of the UK Banking Act 2009.

We look forward to continuing our dialogue with you. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific (knoyes@isda.org, +852 2200 5909), Jing Gu, Senior Counsel, Asia (jgu@isda.org, + 65 6653 4173) or Melody Ma, Assistant General Counsel, Asia (mma@isda.org, +852 2200 5908) for questions related to this response.

Yours faithfully,

On behalf of the **International Swaps and Derivatives Association, Inc.**



Keith Noyes
Regional Director, Asia Pacific

On behalf of the **Asia Securities Industry & Financial Markets Association**



Mark Austen
Chief Executive Officer