BY COURIER & EMAIL

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Dear Sirs and Madams,

Consultation Paper on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions

The International Swaps and Derivatives Association, Inc.[1] ("**ISDA**") welcomes the opportunity to provide comments on the Consultation Paper on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions (the "**Consultation Paper**") issued by the Securities and Futures Commission ("**SFC**") on 19 June 2018. 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.

General comments

Before turning to the specific questions raised in the Consultation Paper, we would like to highlight that many of our comments reiterate those we made in our letter dated 13 October 2017 as a response to the SFC's soft consultation on the proposed margin requirements issued in September 2017, and are directed at the importance of increasing harmonization between the margin requirements proposed by the SFC and other margin regimes that are already in effect, and particularly, the margin standards of the Hong Kong Monetary Authority ("**HKMA**") set out in its Supervisory Policy Manual CR-G-14 (the "**HKMA Rules**"). We are particularly concerned about the lack of harmonization between the SFC margin requirements and the HKMA Rules, which would significantly increase costs, compliance and operational

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 68 countries. These members comprise 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 website: www.isda.org. Follow us on Twitter @ISDA.

burdens for entities that have already built systems to comply with the HKMA Rules, e.g. an entity with both authorised institutions ("**AIs**") and licensed corporations ("**LCs**") in its group, or an AI that trades with an LC. Such inconsistency within Hong Kong would also create an un-level playing field between AIs and LCs, potentially putting LCs at a competitive disadvantage. Further, inconsistencies with existing foreign regimes could create market fragmentation and reduce liquidity for LCs when they conduct cross-border trades.

A. Part II – Overview of proposed margin requirements

Q1. Do you have any comments on the proposed scope of licensed corporations subject to the requirements and the types of counterparties constituting the covered entities? Is it appropriate to exclude transactions with a significant non-financial counterparty which engages in OTC derivatives predominantly for hedging? Would such an exclusion pose systemic risk concerns?

We do not have any comments on this part.

B. Part III – Instruments subject to the proposed margin requirements

Q2. Do you have any comments on the instruments excluded from the proposed margin requirements, or the application of the requirements to single-stock options, equity basket options and equity index options starting only from 1 March 2020?

We note that physically settled FX forwards, FX swaps and the "FX transaction" embedded in cross-currency swaps associated with the exchange of principal (the "**Relevant FX Derivatives**") are to be exempt from VM requirements, except for Relevant FX Derivatives entered into between (1) a licensed person and any of the following: an AI, an LC, or an entity that carries on a business outside Hong Kong and is engaged predominantly in banking activities, securities or derivatives business or asset management activities; and (2) two parties where each has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion. We further note that the SFC considers such approach to be consistent with those in the US and the EU.

As mentioned in the "General comments" section above, conflicting and duplicative rule sets would significantly increase costs, compliance and operational burdens on market participants, especially if they have to build separate systems to differentiate counterparty types and exchange VM on Relevant FX derivatives. We strongly urge the SFC to harmonize its requirements with all WGMR member jurisdictions (instead of with the EU, which is an outlier) and exempt Relevant FX Derivatives from VM requirements.

If, however, the SFC's preferred option is to adopt the EU approach and impose VM requirements on Relevant FX Derivatives, we would request the SFC to adhere to the risk-based approach taken by the US and EU, and design a framework that accounts for the unique risk characteristics of each firm, such as the nature and degree of potential systemic risks inherent in a firm's activities and operations. In the following, we consider whether the SFC proposed requirements are consistent with the US and EU approaches.

US approach

In relation to the US approach, we note that letter SR 13-24 issued by the US Federal Reserve on December 23, 2013 (the "**Fed Guidance**") applies to "large financial institutions" supervised by the US Federal Reserve, including the largest, most complex financial organizations that pose systemic risks to the US economy, or banking organizations with consolidated assets of $50 billion or more[2] ("**LFIs**"). The Fed Guidance applies to LFIs and is thus meant to only capture trades that give rise to systemic risks.

We thus submit that the SFC's proposed requirements for Relevant FX Derivatives are broader than the US approach as VM requirements may apply to Relevant FX Derivatives where none of the parties is a bank-like entity nor is an entity that poses systemic risks.

EU approach

The EU approach seeks to restrict the mandatory exchange of VM for physically settled FX forwards to transactions between "institutions" (as defined by the CRR) based on the legislative intent to capture "dealer-to-dealer transactions"[3] only, and to limit "risks of systemic contagion"[4]. We note that "institutions" (as defined by the CRR) means a "credit institution" or an "investment firm". The term "investment firm" (as defined by the CRR) refers to the same definition in MiFID, but excludes certain classes of firms (e.g. "local firms"). In other words, the CRR definition is a subset of those firms subject to the MiFID definition that, broadly speaking, captures non-bank entities that take balance sheet risk in association with their dealing, underwriting or otherwise placing of securities, or hold client money or assets, or operate certain trading platforms. The definition does not make reference to the size of a firm or its transaction exposures, and is meant to capture entities engaged in securities or derivatives activities that could present risks to the financial system or risks to clients. Given the risks such "investment firms" (as defined by the CRR) pose, the application of a more comprehensive prudential regime based on the Basel framework to such entities was considered to be justified.

The approaches adopted by both the US and the EU thus are meant to capture those entities that pose systemic risks and/or risks to their clients. Given the foregoing, we submit that the requirements to exchange VM for Relevant FX Derivatives should not indiscriminately apply to all types of LCs, and that the SFC should make a distinction between LCs that are systemic or "dealer-like" and smaller LCs that do not pose systemic risks or risks to their clients. We note that the SFC has already prescribed a threshold of HK$15 billion but submit that this is too low for the purpose of making such distinction, especially because the threshold could be applied to the group to which an LC belongs. We urge the SFC to consider: (i) raising the threshold to a level that reflects "dealer-like" activity levels which can pose systemic risks or risks to clients; (ii) applying such threshold at an entity level, i.e. only to the LC and not to its group; and/or (iii) providing for exclusions of certain types of LCs based on risk sensitivity, rather than types of authorised services or activities.

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[2] Letter SR12-17 / CA 12-14 issued by the US Federal Reserve, dated December 17, 2012 (see https://www.federalreserve.gov/supervisionreg/srletters/sr1217.htm)

[3] See paragraph 29 of the "Accompanying documents" section of in the ESA draft regulatory technical standards with regard to physically settled foreign exchange forwards dated 18 December 2017 (the "**Draft FX RTS**").

[4] See paragraph 32 of the "Views of the ESAs Stakeholders Groups" section of the Draft FX RTS.

C. Part IV – Proposed margin requirements

Q3. Do you have any comments or concerns on the proposed IM requirements, including the IM modelling standards, the IM threshold and the treatment of IM collected?

Approval for model approach

We note the SFC's considerations under paragraph 26 of the Consultation Paper. Nevertheless, we would like to reiterate our concerns set out in the "General comments" section above in relation to conflicting and duplicative rule sets. We urge the SFC to adopt an approach that is consistent with the HKMA rules by: (1) only requiring formal approval for use of an internally developed IM model or a third-party IM model that is not industry-wide (i.e. a model not developed by an industry association); (2) requiring only prior notification for use of an industry-wide IM model (i.e. a model developed by an industry association, including the ISDA SIMM™); or (3) requiring only prior notification for use of a model that has been approved by the home jurisdiction of a foreign counterparty if such jurisdiction is deemed comparable or assessed to be comparable by the SFC.

We would also like to make the SFC aware that ISDA is currently conducting some analyses on the compliance challenges associated with regulatory initial margin for phases 4 and 5, including industry concerns on the monitoring and approval requirements of the ISDA SIMM™, and will share the results with global regulators and other interested persons. We intend to share the same with the SFC once the analyses are finalised.

Rehypothecation

We note that the SFC proposed requirements permit rehypothecation of IM, and thus are inconsistent with the HKMA Rules which only permit rehypothecation of cash IM. We further note that rehypothecation of non-cash IM will be of limited use in practice given the various conditions and operational issues related to such arrangements.

Cash IM

We request the SFC to provide further clarity in paragraph 24 of draft Schedule 10 Part II of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Code of Conduct**") that IM collected in the form of cash and maintained by a third-party custodian may be placed on deposit with such custodian and recorded in an account in the name of the posting party that is subject to the terms of the applicable third-party custody arrangements.

Q4. Do you have any comments or concerns about the proposed VM requirements?

We do not have any comments on this part.

ISDA Safe, Efficient Markets

Q5. Do you have any comments on the proposed requirements for minimum transfer amounts, timing of the exchange of margin, assets eligible as margin or haircuts? Should any other assets be excluded from collateral eligibility? Since an external credit rating of a debt instrument is not a measure of the instrument's price volatility or liquidity during market stress, are the proposed haircuts for debt securities determined by reference to credit quality grades appropriately calibrated?

We note that there are discrepancies between the asset eligibility requirements and collateral haircuts proposed by the SFC and those under the HKMA Rules, and strongly urge the SFC to harmonize its requirements as much as possible with the HKMA Rules. Otherwise, LCs trading with AIs and covered entities that have already taken steps to implement margin requirements to which they are subject will be required to repaper their existing documentation and establish new collateral systems, thereby increasing their costs, compliance and operational burdens. Additionally, LCs will be put at a disadvantage as compared to their competitors that are not subject to the SFC's margin requirements and therefore would not need to change their existing operational and documentation arrangements.

Q6. In relation to the proposed requirements for the FX haircut, should onshore renminbi (CNY) and offshore renminbi (CNH) be considered as different currencies for the purpose of determining a currency mismatch between the contract currency and the collateral currency? If so, how should the FX haircut be calibrated? Is there any reason for not treating this as a currency mismatch for the purpose of the FX haircut?

We do not have any comments on this part.

D. Part V – Scope of applicability

Q7. Do you have any comments on the proposed exemptions for non-netting jurisdictions or intragroup transactions?

Intragroup transactions

We would be grateful if the SFC could confirm whether "*accounted for on a full basis*" in the context of the exemption for intragroup transactions means that both entities need to be 100 per cent. owned and controlled in the consolidated financial statements of the holding company.

Q8. Should substituted compliance be available? Do you have any comments on the proposed substituted compliance regime?

We are very supportive that the SFC makes substituted compliance available, which is critical to ensuring that market participants do not face conflicting or duplicative margin requirements on cross-border OTC derivative transactions.

We would like to request confirmation from the SFC that:

- where an LC trades with a counterparty which is subject to the margin requirements of a WGMR member jurisdiction, substituted compliance would be available so that the LC can follow the margin requirements of its counterparty; and

- where an LC trades with an AI, and the AI can avail itself of substituted compliance under the HKMA Rules to follow the margin requirements of its home jurisdiction instead of the

HKMA Rules, the LC would be in compliance with the SFC's margin requirements if it follows the margin requirements of the AI's home jurisdiction.

Further, we note that, under paragraph 63 of the Consultation Paper, the SFC considers the HKMA Rules to be comparable, except that margin collected by LCs should be subject to the asset eligibility requirements and collateral haircuts set by the SFC. To avoid uncertainty, we would request the SFC to explicitly provide for such comparability in draft Schedule 10 Part II of the Code of Conduct or publish a comparability assessment as soon as possible. We also seek confirmation that, pursuant to paragraph 51 of the draft Schedule 10 Part II of the Code of Conduct, an LC may follow the margin requirements of a WGMR member jurisdiction in their entirety (including asset eligibility requirements and collateral haircuts) instead of the SFC's margin requirements.

Finally, we note that some LCs are part of a group with a bank-like or dealer-like entity that is engaged in derivatives activities in a foreign jurisdiction. Such affiliates thus have already established systems to comply with margin requirements of their home jurisdictions. We request the SFC to permit such LCs to use the systems of their affiliates and follow the margin requirements of their affiliates instead, provided the relevant margin requirements are deemed or assessed to be comparable by the SFC. Otherwise, the LCs have to establish a separate and new system, and thus become subject to a disproportionate compliance burden and have to bear additional costs.

E. Part VI – When will the proposed requirements come into effect?

Q9. Do you have any comments on the proposed IM phase-in schedule or the effective date of the VM requirements?

We request the SFC to provide sufficient time for LCs and covered entities to implement the SFC proposed requirements, especially in relation to asset classes and collateral haircuts where full substituted compliance may not be available. We estimate that it would take at least 9 months for firms to adjust existing or build new collateral systems and/or IM models to comply with the SFC proposed requirements, and request the SFC to take this into account when setting the effective date.

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 Jing Gu, Senior Counsel, Asia at (jgu@isda.org, at +65 6653 4173) if you have any questions.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.

Keith L. Noyes

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