ISDA® Safe, Efficient Markets

BY E-MAIL

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16 October 2015

Dear Sirs and Madams,

Consultation Paper on Proposed Changes to the Securities and Futures (Financial Resources) Rules

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] welcomes the opportunity to provide comments on the Consultation Paper on Proposed Changes to the Securities and Futures (Financial Resources) Rules ("**Consultation Paper**") issued by the Securities and Futures Commission ("**SFC**") on 17 July 2015. Terms not defined herein have the same meanings given to them in the Consultation Paper.

ISDA commends the SFC for its careful consideration of the capital requirements in major financial centers to ensure that the capital regime in Hong Kong will be more aligned with relevant international standards. ISDA and its members strongly support a prudent and internationally consistent regime for capital requirements for OTC derivative activities to ensure that risks undertaken by market participants are commensurate with their capital and liquidity levels, thereby making markets safer and more efficient. ISDA is appreciative of the opportunity to respond to the Consultation Paper and hopes to have continued dialogue between the industry and the SFC to promote the adoption of more advanced risk management standards.

We set out our responses to certain specific questions raised in the Consultation Paper. While our members have sought to form a consensus on such questions, there are certain issues on which

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 68 countries. These members include a broad range of derivatives market participants such as 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, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on ISDA's web site: www.isda.org.

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. Answers to Consultation Paper Questions

Capital regime and minimum capital requirements for LCs engaging in OTCD activities

Question 1

Do you agree that RA11 dealers approved to use internal models should be subject to the proposed HK$156 million floor RLC and HK$2 billion tangible capital requirement?

We think that the HK$2 billion tangible capital requirement is too high. We understand that this is derived from the net asset requirement for issuers of structured products under the HKEx Listing Rules. We do not think this is a relevant reference point and submit that a tangible capital requirement of HK$1 billion would be more appropriate.

Question 2

Do you agree that RA11 dealers not using internal models should be subject to the proposed HK$156 million floor RLC and HK$1 billion tangible capital requirement?

We think that the HK$1 billion tangible capital requirement is too high. First, although extensive offsetting between related positions will be allowed, such offsetting will be subject to inherent inefficiency. Secondly, the proposed amount does not take into account the booking model that a LC may use to pass market risks to its affiliates. Under such model, the LC will still be subject to the tangible capital requirement notwithstanding its flat positions. We submit that a tangible capital requirement of HK$100-500 million would be more appropriate.

Question 3

Do you think that the proposed OTCD de minimus reduction is appropriate?

We do not think that the OTCD de minimus reduction is appropriate. However, our members have not formed a consensus on an appropriate level.

Question 4

Do you think that the proposed minimum capital requirements for RCCP-cleared RA11 dealers are appropriate?

In relation to paragraphs 159 and 160 of the Consultation Paper, we would like to express support for SFC's proposal to: (i) use the definition of "qualifying CCP" under the Basel Capital Accord as benchmark to define "Regulated CCP" for the purpose of the FRR; and (ii) grant approval to CCP based on PFMI or other established international standards. Many LCs transact with overseas CCPs, whether as a direct clearing participant or a clearing intermediary, and thus it is important that overseas CCPs would be approved by SFC as Regulated CCP, and such approval would be based on internationally recognized standards.

Question 8

a) Do you agree that the calculation of variable RLC should reflect the level of OTCD activities engaged in by LCs to ensure that capital is provided against residual risks and the leverage effects of OTCD transactions entered into or cleared by LCs?

b) Do you think that the proposed calculation methodology and the proposed capital charge percentages (i.e. 5% and 8%) used for calculating the margin-based components in paragraph 189 above are appropriate?

We agree that the calculation of variable RLC should reflect the level of OTCD activities engaged in by LCs.

However, we note that a much lower risk weighting has been adopted in other jurisdictions. In Singapore, the capital requirements are largely driven by margins and nostro balances placed with counterparties that are not approved exchanges or clearing houses. A capital risk weight of 0% is thus applied to approved exchanges or clearing houses to reflect the reduced counterparty risk[2]. Under Basel III, a risk weight of 2% is applied to a bank's trade exposure and any assets or collateral posted to a qualifying central counterparty.

In Hong Kong, CCPs are obliged to guarantee settlement of transactions effected by their clearing participants and meet the payment obligations of defaulted clearing members. Their risk management frameworks are designed to control credit, market and liquidity risks through, amongst others, its clearing membership requirements, margining requirements and default management process. Further, a clearing member is required to contribute to a guarantee fund, and such contribution represents a 100% deduction in a clearing member's capital. Given the foregoing, we think that the proposed capital charge percentages applicable to Regulated CCPs should be lower.

Capital treatments for market risks of OTCD and other proprietary trading positions

Question 12:

Do you agree that specific risk charge percentages for non-investment grade debt securities and unrated debt securities should be based on their initial issuance size?

We think it is preferable to follow the Basel's approach, which refers to the nature of the issuer and its capital structure. Basel's approach is a better proxy to determine specific risk charge percentages than the proposed approach, which refers to the issuer's initial issuance size.

Question 15:

Do you agree that a 100% specific risk charge should apply to the higher of the total long and total short position in non-marketable debt securities as proposed above?

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[2] See Fourth Schedule of Table 1 of the Securities and Futures (Financial and Margin Requirements for Holders of Capital Markets Services Licences) Regulations (http://www.mas.gov.sg/~/media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/SF%20FIN%20AND%20MARGIN%20REQMTS%20FOR%20HOLDERS%20OF%20CMSL%20REGS.pdf).

We agree that a 100% specific risk charge should apply, and would like to seek further clarification on how netting operates between the long and short positions. For example, will it be permissible to net between different long and short securities of the same issuer with different maturity profiles?

Question 16:

Do you have any comment on our proposal to modify the Basel shorthand method to calculate capital charges for foreign exchange risks?

Do you agree that net position in a controlled currency should be subject to capital charge at 8% independent of all other currency positions?

We request further clarification on the treatment of controlled currencies under the proposed foreign exchange risk framework and an example calculation in Appendix 4.

Question 19

Do you agree that the simplified approach and delta-plus approach are not appropriate for non-continuous options?

If yes, do you agree with our proposed approach for non-continuous options?

We submit that FRR's approach should be aligned with relevant international approaches. However, we note that the Trading Book Consultation is still ongoing, and suggest that SFC continue to monitor the development of such consultation. Further, we welcome the opportunity to be consulted on the conclusions of such consultation with the objective to make the FRR capital regime more aligned with international standards.

Question 20

a) Do you agree that the delta-plus approach is not appropriate for options on volatile stocks and short-dated at-the-money options?

b) If yes, what should the appropriate capital requirement for these options be and how should volatile stocks and short-dated at-the-money options be defined?

Similar to our response to question 19, we submit that FRR's approach should be aligned with relevant international approaches, and welcome the opportunity to be engaged in future dialogues with the SFC on the effects of new international standards.

Question 21

a) Do you have any comment on the proposed prudential and capital requirements for regulating the market risks on non-standard instruments?

b) Do you have any comment on the proposed capital charges for concentrated proprietary positions?

a) We disagree with paragraph 326 (a)(ii) which treats initial margin as a proxy for market risks. Initial margin reflects potential future exposure in case the counterparty defaults, and thus is more of a

counterparty risk measure than a market risk measure. Variation margin is a more appropriate proxy for assessing the size of the market risk.

b) We think it should be made clear that the concentration risk level should be measured against the higher of (i) the variable RLC and (ii) the floor RLC.

Question 22

a) Do you have any comment on the proposed treatment for opposite positions with the proceeds upon realization of one of the positions being subject to remittance control?

b) If netting of such positions were allowed in the calculation of capital charge for the market risk of the underlying, how should the liquidity mismatch risk arising from the remittance control be addressed in the FRR?

a) Given that net position in a controlled currency is already subject to a capital charge of 8%, there would be a double counting of capital charges if offsetting is not permitted. Therefore, we submit that offsetting of opposite positions should be allowed even if one of the positions is subject to remittance control.

b) We request SFC to provide an example calculation to illustrate how such positions would be treated if netting were to be allowed.

Capital treatments for counterparty credit risk arising form OTCD transactions

Question 26

Do you think that Approach Three is the most suitable for the FRR among the three suggested approaches?

We agree that Approach Three is the most suitable for the FRR on the basis that such approach would apply to each counterparty on a net basis, and that relevant legal documentation is in place for netting to operate between the relevant parties.

We also think that, for the purpose of defining uncollateralized exposure, the FRR should take into account evolving industry standards on initial and variation margin requirements under the global margining framework.

Question 27

Do you agree with the above use of initial margin requirements in the determination of the PFE for OTCD portfolios*?*

We agree with the use of initial margin requirements in the determination of the PFE and recommend the use of the Standard Initial Margin Model (SIMM)^{TM}, a common initial margin methodology currently developed by ISDA, as the adopted initial margin model.

Question 28

Do you agree with the use of CEM subject to the modifications as described in this paper instead of SA-CCR, to calculate the exposure amount under the SOCCRA?

We think that the SA-CCR is the preferred approach given its improved risk sensitivity. However, we are cognisant of SFC's view to refer to existing standards in designing the FRR at this stage. We note that SFC will monitor the development of the Basel Capital Accord and other international standards, and welcome the opportunity to be consulted on the effects of any new standards on the industry with a view to make the FRR's capital regime more aligned with international standards.

Question 31

Do you agree that the proposed Liquidity Adjustment and specified liquidity risk management measures can alleviate the impact on a LC's liquidity of the admission of uncollateralized receivables from counterparties in respect of current exposures of non-centrally-cleared OTCD transactions as liquid assets?

Given that the FRR capital regime is a "liquid capital" regime with a focus on liquidity in its design, we do not think it is necessary to impose specific liquidity risk management measures.

Counterparty Concentration Charge

With respect to the calculation of Counterparty Concentration Charge under paragraph 53 of Appendix 8, in order to avoid double counting, we think it should be calculated in the following manner: (i) the aggregate uncollateralized current exposure to the relevant counterparty, minus (ii) the applicable CCR Charge, minus (iii) the applicable Counterparty Concentration Threshold multiplied by the applicable concentration charge percentage.

With respect to the sliding scale of concentration charge percentages under paragraph 55 of Appendix 8, sub-paragraph (b) provides for a percentage of 20% to apply to a counterparty with a risk weight of greater than 20% but less than 50%. However, paragraph 36 of Appendix 8 does not provide for a risk weight to fall between 20% and 50%. Accordingly, paragraph 55(b) would never be applicable. We request SFC to provide clarification on how such sliding scale is intended to be applied.

Liquidity Adjustment

With respect to the calculation of Liquidity Adjustment under paragraph 56 of Appendix 8, in order to avoid double counting, we think it should be calculated in the following manner: (i) the sum of the aggregate uncollateralized current exposures to all relevant counterparties, minus (ii) the aggregate CCR Charges for such counterparties, minus (iii) the applicable Liquidity Adjustment Threshold.

Question 32

Regarding the specific liquidity risk management measures, how much time should be allowed for the LC to perform those measures after it has triggered the Counterparty Concentration Charge or Liquidity Adjustment?

In general, we think it is a good practice for LCs to establish their own liquidity risk management measures as part of their overall risk management framework. In case the Counterparty Concentration Charge or Liquidity Adjustment has been triggered, we think a timeframe of at least 3 months should be allowed for an LC to adopt the specific measures, with the option for such LC to apply for further extension based on its particular circumstances.

Question 34

Do you agree that uncollateralized receivables from affiliates in respect of current exposures of non-centrally-cleared OTCD transactions should be treated in the same way as for third party exposures in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment and the determination of the triggering event for imposing the proposed specified liquidity risk management measures?

We agree with the proposal to treat uncollateralized receivables from affiliates in the same way as third party exposures. However, we think consideration should be given to any credit risk mitigation techniques (such as collateral or guarantee) in relation to such uncollateralized receivables. We also propose that LCs be exempted from considering uncollateralized current exposures of non-centrally-cleared OTCD transactions with respect to a counterparty in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment if such counterparty meets certain criteria, such criteria being prescribed by SFC with reference to certain prudential liquidity standards.

Question 35

Should collateral posted for securing non-centrally-cleared OTCD transactions be included in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment and the determination of the triggering event for the proposed specified liquidity risk management measures?

We agree that collateral posted for securing non-centrally-cleared OTCD transactions should be included in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment framework, provided that it is not held by a custodian in a bankruptcy-remote manner.

Question 36

a) Do you agree that the BOCCRA can adequately address the counterparty credit risk arising from OTCD transactions?

b) In respect of the fixed rate haircut on the net uncollateralized exposure to clearing member of a Regulated CCP under the BOCCRA, should we further differentiate and set a lower haircut on exposures to clearing members which fulfils certain conditions on portability and protection of the open position and collateral posted?

a) We think that the BOCCRA approach cannot adequately address the counterparty credit risk as it only addresses the current exposure based on margin requirement and net collateral movement but not any potential future exposures.

b) The current proposed fixed rate haircut may not be sufficiently prudent as it ignores the credit quality of the clearing member or clearing intermediary. It assumes that all necessary legal opinions confirming segregation and portability of customers' positions and collateral provided to the CCP have been obtained. Without such confirmations, the counterparty risk of LCs may be underestimated as they may face double defaults.

Introduction of internal models approach

Question 40

a) Do you agree that a three-year clean record of FRR compliance is an appropriate requirement to indicate that applicants have effective FRR compliance monitoring controls?

b) Do you agree that a three-year clean record of FRR compliance is an integral part of the overall risk and control infrastructure and capability which applicants should demonstrate?

c) Should exception to the requirement discussed in Question 40(a) above be allowed and if so, what conditions should apply in that case?

Though indicative of the effectiveness of the applicant's FRR compliance monitoring controls to a certain extent, in our opinion, a three-year clean record of FRR compliance should not be made one of the eligibility requirements when applying for the use of an internal model. We do not think that it should be an integral part of the overall risk and control infrastructure and capability which applicants should demonstrate. This is because past compliance with the current FRR may not be relevant and is not a good indicator of the suitability of the use of an internal model under the proposed FRR. Furthermore, the requirements set out in Appendix 12 mirror standards under Basel III or other prudential supervisory approaches, and reflect industry practices. We think that such requirements are comprehensive and sufficient in determining the suitability of an applicant's use of an internal model.

If a three-year clean record of FRR compliance is to be made a requirement, we request clear and measurable criteria as to what constitute "clean record", including any quantitative requirements, to be published in advance of its implementation.

We also request clarification on what "proprietary investments" referred to in paragraph 460 comprise. For example, would "proprietary investments" cover investments arising from market-making and client facilitation activities?

Question 41:

Do you agree that a leverage ratio requirement should apply to LCs approved to use internal models in order to align with Basel capital standards?

We think a leverage ratio requirement should not apply to LCs approved to use internal models. First, the calculation of variable RLC already takes into account any leverage, which provides a good buffer over such exposure. Secondly, the risk of over-leverage stemming from entry into OTCD transactions is thought to be low as such transactions are mostly client-driven and are centrally cleared through Regulated CCPs. Thirdly, most uncleared derivatives will be subject to initial margin requirements under Basel. As a result, LCs will have to comply with such requirements to cover potential exposures, which will also be fully captured under the calculation of variable RLC. Finally, any leverage ratio requirement should apply universally to all LCs, not only to those approved to use internal models.

<u>Measures to address operational risks of LCs engaging in certain regulated OTCD activities and LCs opting into the standardized approaches</u>

Question 42

b) Do you have any comment on the contents of the draft Self-Assessment Return?

Responses to some of the questions in the Self-Assessment Return hinge on how one identifies the counterparty and its location. Many LCs use an offshore booking model where trades are executed by traders employed by the LCs or physically located in Hong Kong while the booking is done with an overseas affiliate. We thus request SFC to provide clear guidance on how such LCs should respond to the questions, including when to elect "No" and "N/A", to ensure a consistent approach in completing the self-assessments.

<u>Miscellaneous technical changes</u>

Question 44

Do you agree that there are risks for a LC placing excessive funds with its affiliated bank(s) and broker(s) and a LC should be subject to a cap on its aggregate uncollateralized receivables to affiliated banks and brokers as proposed?

We think that uncollateralized receivables from overseas financial institutions, which are neither AIs nor LCs, and are subject to equivalent local regulatory and prudential supervision, should also be excluded under paragraph 493. Exposure to such overseas financial institutions should be treated similarly to exposure to AIs or LCs. In addition, such exclusion would allow AIs and LCs, which are part of an international group, to manage their capital more efficiently and would ensure a level playing field for all affiliated banks, regardless of whether they are AIs, LCs or not.

We further propose that, in the event that the amount of uncollateralized receivables from affiliated banks or brokers exceeds 25% of the LC's shareholders' funds, such LC be given the option to exclude the amount of such excess from the calculation of its liquid capital. If, following the exclusion of such excess, a LC is able to meet its RLC, the LC will be deemed not to be in breach of the cap.

Question 45

Do you agree that margins held in bankruptcy remote manner with affiliated banks and brokers should not be subject to the proposed cap?

We agree that margins held in bankruptcy remote manner with affiliated banks and brokers should not be subject to the proposed cap.

Question 46

Do you have any comment on any of proposed technical changes in this Part?

We think the proposed technical changes should be separately reviewed and implemented as they have no obvious nexus to the changes to the capital requirements for OTCD, and conjoining the two could delay the implementation of the technical changes. For example, we consider the proposed reduction to the haircut percentage applicable to the Shanghai Stock Exchange to be an essential

market development, which could be implemented independently of the new capital requirements for OTCD.

Transitional arrangements

Question 47

Do you agree that pre-existing Non-RA11 OTCD dealers should be given a six-month transitional period to comply with minimum capital requirements as proposed in Section B of Part III, the SMRA and the SOCCRA?

We think that a twelve-month transitional period commencing from the effective date of the new FRR would be more appropriate given the significant due diligence and time required for system enhancements, business re-organisation, recapitalisation and communication to external stakeholders.

In addition, the new FRR requirement will trigger complex data processing requirements for some LCs. We recommend a testing period of at least six months prior to the effective date such that technical implementation details can be clarified and refined to the satisfaction of the SFC. This will also provide a good opportunity for the SFC to re-gauge the industry impact, taking into account possible additional business activities of the LCs.

B. Other Comments – Third-Party Clearing Arrangements

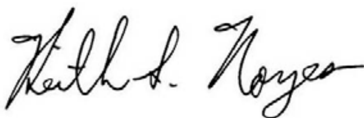
We would like to seek confirmation that amounts receivable from a Regulated CCP as part of a third-party clearing arrangement would be recognized as liquid assets.

Further, in order to facilitate the development of third-party clearing arrangements, we propose that amounts receivable from a non-clearing member, which are in turn receivable from a clearing member of a Regulated CCP, be recognized as liquid assets.

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, 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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