ISDA® Safe, Efficient Markets

BY E-MAIL & COURIER

Intermediaries Supervision, Intermediaries
Securities and Futures Commission
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24 August 2017

Dear Sirs and Madams,

Consultation Conclusions and Further Consultation 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 Conclusions and Further Consultation on Proposed Changes to the Securities and Futures (Financial Resources) Rules ("**Consultation Paper**") issued by the Securities and Futures Commission ("**SFC**") on 24 July 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.

ISDA commends the SFC for its careful consideration of the comments received on the Consultation Paper on Proposed Changes to the Securities and Futures (Financial Resources) Rules issued by the SFC on 17 July 2015. 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 to continue facilitating the dialogue between the industry and the SFC.

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.

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 875 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, 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.

A. Answers to Consultation Paper questions

Question 1

Do you agree that OTCD central dealing desk dealers should be subject to the proposed HK$30 million minimum paid-up share capital requirement and HK$15 million floor RLC?

We agree that OTCD central dealing desk dealers should be subject to lower capital requirements. We however note that there are other OTCD dealers (outside of the fund management industry) that bear similarities to the OTCD central dealing desk dealers and that meet most of the conditions under paragraph 38(a), such as those who induce or introduce clients to enter into OTCD transactions with a third party (including a group entity that is a locally incorporated bank or a branch of an overseas bank), without themselves carrying any positions on their books or becoming exposed to any market or counterparty credit risks in relation to the OTCD transactions so induced or introduced ("**Non-Risk Bearing OTCD Dealers**").

Given the business model and associated risks of the OTCD activities carried out by such Non-Risk Bearing OTCD Dealers, it would be highly disproportionate to apply the capital requirements of typical OTCD dealers to such dealers. Such an approach would effectively make introducing and other similar activities uneconomical and, if the third party (including a group entity) is subject to capital requirements to hold capital for the market and counterparty credit risks it bears, would result in duplicated capital being held by the third party or within the same group.

We acknowledge that Non-Risk Bearing OTCD Dealers have to face clients while OTCD central dealing desk dealers do not. However, we think that such a distinction in client interaction does not justify the huge difference in capital requirements between OTCD central dealing desk dealers and Non-Risk Bearing OTCD Dealers. We submit that, given that Non-Risk Bearing OTCD Dealers do not incur liabilities under the OTCD transactions, it would also be justifiable to subject Non-Risk Bearing OTCD Dealers to lower minimum capital requirements than ordinary OTCD dealers.

Question 2

Do you have any comments on the modified definition of "non-freely floating foreign currency"? Could you provide examples of such currencies and related products that may be traded in the OTC derivative market?

We support SFC's proposal to modify the definition of "controlled currency" to better reflect its focus on the free movement of exchange rates. We suggest the SFC to provide examples of "non-freely floating foreign currencies" (e.g. in an FAQ) to provide more clarity and guidance on how the currencies should be distinguished.

Based on our understanding of the Consultation Paper, examples of non-freely floating foreign currencies include Malaysian Ringgit (MYR) and Renminbi (CNY). An example of related products would be a non-deliverable forward contract.

Question 3

Do you agree that LCs which enter into a trading loss sharing arrangement should provide in a timely manner for a capital charge for the amounts of market risks of the proprietary transactions of their affiliates on which trading losses will be shared by the LCs?

We submit that the proposed imposition of a market risk capital charge on trading loss sharing arrangements would place a disproportionate cost and compliance burden on LCs, and urge the SFC to consider providing exemptions or relief subject to the satisfaction of certain conditions.

Definition of trading loss sharing agreement

We disagree with footnote 29, which is used to define "trading loss sharing arrangement". In our view, a distinction should be made between (X) an arrangement whereby trading profits are shared with an LC and are calculated on a financial year-to-date basis, but can be reversed within the same financial year after receipt should the overall profitability of the portfolio booked at the relevant RBA reduce, and (Y) an arrangement whereby trading losses are shared and borne by an LC.

Most LCs have trading profit/loss sharing arrangements that provide for them not to be directly exposed to the market risks associated with the financial instruments booked at the relevant RBAs. Instead, the LCs are entitled to share the profits, and are exposed at the most to the extent of their respective cost base and the likelihood that revenue (in this case the profits shared) will not cover such cost base. The exposure of an LC under such trading profit/loss sharing arrangements is fundamentally different from the gross risks incurred by an entity (the RBA) booking financial instruments in large volumes. This is also fundamentally different from an LC that is directly exposed to the market risks of the underlying financial instruments. As such, it would be unreasonable to require the LC that is subject to such trading profit/loss sharing arrangements to maintain market risk capital of the underlying financial positions booked at the RBA.

Although we acknowledge the concern that a clawback arrangement could subject an LC's income to fluctuation on a month-to-month basis, in our view, the proposed market risk capital charge would be a disproportionate measure to address such volatility as it imposes a 100% haircut on the interim profits and treats them as highly illiquid assets.

In the case of arrangement (X), an LC would recognize an intercompany receivable for the trading profits accrued, but the LC's liquid capital calculation would not take this into account as the intercompany receivable is considered an illiquid asset. Similarly, when an LC recognizes an intercompany payable (as the offset against the intercompany receivable previously recognised) for the reversal of trading profits, the LC's liquid capital calculation would not take into account a reduction arising from the inclusion of intercompany payable as a ranking liability. Given that the liquid assets would not be enhanced, it would impose a high cost for the LC to exercise the option to exclude interim profits shared from its liquid assets in lieu of undertaking the proposed market risk capital charges as proposed under paragraph 169 (the "**Exclusion Option**").

It is equally punitive for the LC to exclude interim profits from its liquid assets if the intercompany receivable for accrued trading profits has been cash-settled. Exclusion of interim profits from liquid assets does not take into account the probability of different degrees of clawback arrangements. In the case where full clawback is unlikely, it would be extremely punitive if the full amount of interim profits is excluded from liquid assets. It could also have temporary yet serious adverse impact on the liquidity and capital position of the LC.

For the above reasons, we submit that treating arrangement (X) in the same manner as arrangement (Y) would be unnecessarily punitive.

Finally, we would like to seek clarification on the distinction between the terms "trading loss sharing arrangement" and "trading profit/loss sharing arrangements".

Practical challenges in compliance

We further submit that the requirement under paragraph 166 for an LC to calculate market risk capital charges of within-scope transactions based on SMRA or BMRA presents practical concerns for compliance purposes.

Some trading profit/loss sharing arrangements provide for the use of parameters unrelated to market risks (for example, costs incurred by the affiliates for the within-scope transactions) for calculating the profit or loss shared by the LCs. The determination of such parameters may take time and is not within the control of the LCs. This places constraints on the LCs to calculate the impacts on its liquid capital in a timely manner, making compliance with the requirement under paragraph 166 extremely challenging in practice.

Further, it is typical that risk management of proprietary transactions is done on an aggregate and global basis and is overseen by a global team of risk management officers, including employees of the LC. It is practically difficult to isolate the transactions or the associated hedges traded by an employee of the LC and determine the market risks of the within-scope transactions. Moreover, the market risks of isolated transactions could be significantly overstated without taking into account the portfolio effect.

It is also typical that a portfolio of OTCD transactions and the associated hedges is managed on a dynamic basis. It would be impractical for LCs to track the realized and unrealized profits for the purpose of calculating the interim profit shared and excluding it from the liquid assets, rendering the exercise of the Exclusion Option impractical.

Appropriate exemptions

We submit that there could be circumstances where the imposition of a market risk capital charge on trading profit/loss sharing arrangements would place a disproportionate cost and burden on an LC and that appropriate exemptions would be justifiable.

In the case where the LC is part of a global financial institution and the relevant RBAs are subject to capital requirements in their home jurisdictions, the imposition of the market risk capital charge on the LC would subject the global financial institution to the cost of the same market risk twice. We note that the Basel capital framework does not provide for a market risk capital charge on trading profit/loss sharing arrangement, and the proposed requirement is inconsistent with international practices. We thus urge the SFC to give recognition to the capital requirements to which a RBA is subject and provide for appropriate exemptions, subject to SFC's assessment that such capital requirements are comparable to the relevant international standards.

Some trading profit/loss sharing arrangements provide for an LC to share the price spread between the OTCD transactions and the hedging instruments booked in its group companies. Such transactions have minimal exposure to market risks and trading losses will only arise under exceptional circumstances (such as dealing errors). If such transactions are treated as within-scope transactions, the LC will have to spend a lot of resources to calculate the market risk capital charges, the amounts of which would likely be insignificant. Given the nature of such transactions and the size of the associated market risk exposure, we propose that such transactions be excluded from the definition of within-scope transactions.

Exclusion Option

We would like to seek clarifications from the SFC on the conditions that LCs have to satisfy to avail themselves of the Exclusion Option, including the information required, the process and timeline for seeking approval from SFC in relation to the exercise of the Exclusion Option.

We submit that the definition of "trading profits" (or potential "at risk" amount) should be the net profit earned by the LC, taking into account both the transfer pricing revenue earned and expenses incurred by the LC for the relevant business.

Alternative proposals

In order to address the concerns SFC has on trading loss sharing arrangements with a clawback mechanism, in lieu of the Exclusion Option, ISDA proposes two options to be made available to LCs:

- we propose that, unless approval is otherwise obtained from the SFC, an LC is prohibited from repatriating interim profits that are earned through such sharing arrangement for the current year prior to the financial year end;

- some trading profit and loss sharing arrangements provide for the payment of a "risk of loss" fee by an LC to the relevant RBA to compensate the RBA for bearing market losses. Such fee is typically computed based on the probability of expected loss. We propose that the SFC provides for such probability to be applied to determine the appropriate level of interim profits to be clawed back and excluded from the liquid assets if the LC exercises the Exclusion Option, subject to agreement with the SFC on the probability factor.

Question 4

Do you agree that the above modified Basel comprehensive approach should be used to calculate the capital requirements for repo-style transactions by LCs using SOCCRA?

We welcome the flexibility provided by the SFC on capital requirement for repo-style transactions. We would like to seek clarification that this proposal is an alternative to sections 45 and 46 of the FRR referred to in paragraph 241, and not a compulsory requirement.

B. Other comments and requests for clarifications

1. OTCD de minimis reduction for introducing brokers

For an LC that acts as an introducing broker introducing or inducing investors to enter into OTCD transactions with its overseas affiliated entities that are RBAs or a third party, we would like to seek confirmation from the SFC that, for the purpose of calculating the OTCD activity level, such introducing broker is not deemed to have "entered into for the dealer's own or client account" an OTCD transaction under paragraphs 60(a), 60(b) or 60(c), and that such introducing broker can therefore exclude trades introduced to clients when calculating its OTCD activity level.

2. Investment in joint ventures/associates

We would like to seek SFC's confirmation that investment in joint ventures and investment in associates are not deducted from tangible capital.

3. *Unlisted stock options traded and cleared in Hong Kong*

According to section 2 of Part I of the draft amendments to the FRR (Appendix 1 of the Consultation), "unlisted options contract" means an options contract that is not listed securities.

We would like to seek clarification from the SFC as to whether unlisted stock options traded on HKEX and cleared through The SEHK Options Clearing House are considered "unlisted option contracts". If not, we would like to seek further clarification as to which sections of the FRR would apply to such options.

4. *RMB Cash and RMB-denominated assets held in Hong Kong*

We note that section 18(2) of the FRR will be removed and replaced by section 18(A) and as a result, the FAQ published by HKEX on the treatment of RMB and RMB-denominated assets under the FRR would require updating.

We would like to seek clarification from the SFC that RMB cash, RMB bank accounts and RMB deposits held in Hong Kong, and RMB-denominated assets listed in Hong Kong remain to be excluded from the definition of "controlled assets" under section 18(A) of the draft amendments to the FRR (Appendix 1 of the Consultation).

5. *Treatment of non-tenancy agreements*

We welcome the proposal relating to the treatment of tenancy agreements for business premises under paragraphs 321 to 323. In addition to tenancy agreements, an LC often has to enter into other lease or rental agreements with respect to other types of assets (e.g. fixed assets, software etc.) which would require recognition of the LC's rights and obligations as on-balance sheet assets and liabilities.

We thus request the SFC to consider treating such agreements in the same manner as tenancy agreements for business premises.

6. *Haircut percentages for zero coupon bonds*

According to Table 5 of Schedule 2 in the draft amendments to the FRR (Appendix 1 of the Consultation), "category 1 qualifying or special debt securities" does not include qualifying debt securities or special debt securities that have no maturity date or a remaining term to maturity exceeding 30 years. In the same table, "category 2 qualifying or special debt securities" means qualifying debt securities or special debt securities that do not fall within category 1 qualifying or special debt securities.

We would like to seek clarification from the SFC as to whether zero coupon bonds should be considered as "category 2 qualifying or special debt securities".

7. *Inclusion of Mainland Settlement Deposit and Mainland Security Deposit in liquid assets*

We support the proposal under paragraph 308 to include the amounts receivable by an LC from a GCP of a recognized clearing house in respect of securities sales cleared by the GCP that are not yet settled in its liquid assets. We agree that the proposal can facilitate third party clearing model by a GCP.

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We would like to urge SFC to consider including the Mainland Settlement Deposits ("**MSTD**") and Mainland Security Deposit ("**MSCD**") for the China Connect Market paid through a GCP to Hong Kong Securities Clearing Company Limited ("**HKSCC**") in liquid assets. According to section 28(1) of the FRR, MSTD and MSCD, when paid directly to HKSCC and reported as account receivables from HKSCC on balance sheet, could be treated as liquid assets. Under the third party clearing model, a GCP requires the LC to pay MSTD and MSCD in respect of the securities transaction of China Connect Market. Accordingly, such MSTD and MSCD cannot be included in liquid assets under section 28(1) of the FRR as they are paid to the GCP instead of to HKSCC directly. We are of the view that MSTD and MSCD paid through a GCP to HKSCC under a third party clearing model should be treated as if they were paid to HKSCC directly, and thus should be included in liquid assets.

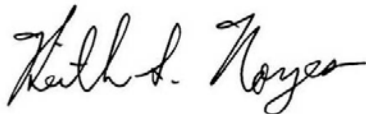
8. *Self-assessment requirement for OTCD central dealing desk dealers*

We note the SFC's proposal to apply to OTCD dealers the requirements to conduct a self-assessment of internal controls and risk management, and submit the results to the SFC under paragraph 272. We submit that most questions in the Self-Assessment Return do not apply to OTCD central dealing desk dealers nor Non-Risk Bearing OTCD Dealers. Given the business models and associated risks of the OTCD dealing carried out by OTCD central dealing desk dealers and Non-Risk Bearing OTCD Dealers, and taking into account the reasoning for applying lower minimum capital requirements to such dealers (including that discussed in Question 1), we request the SFC to exempt OTCD central dealing desk dealers and Non-Risk Bearing OTCD Dealers from the proposed requirement under paragraph 272.

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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