ISDA® Safe, Efficient Markets

BY EMAIL

24 June 2020

Hong Kong Monetary Authority ("**HKMA**")

55th Floor

Two International Finance Centre

8 Finance Street, Central, Hong Kong

Attention: Mr. Daryl Ho, Executive Director (Banking Policy)

Dear Mr. Daryl Ho,

ISDA comments on the Hong Kong Monetary Authority's consultation on revised SPM module CR-G-14 "Non-centrally Cleared OTC Derivatives Transactions - Margin and Other Risk Mitigation Standards" published 25 May 2020

The International Swaps and Derivatives Association, Inc. (ISDA)[1] is grateful for the opportunity to provide input to the Hong Kong Monetary Authority's consultation on the revised SPM module CR-G-14 "*Non-centrally Cleared OTC Derivatives Transactions - Margin and Other Risk Mitigation Standards*" (the "**Revised Module**"). Individual members of ISDA may have their own views on the Revised Module, and may therefore provide their comments to the HKMA directly.

ISDA and its members support the goals of strengthening resiliency in the non-centrally cleared derivatives market by the establishment of margin and other risk mitigation requirements. We further appreciate the HKMA's efforts to focus on the practical issues relating to the implementation of such requirements while reducing systemic risk as well as working on harmonization with other regulators to ensure a level playing field for Hong Kong authorized institutions ("**AIs**").

Because market participants are and will be subject to multiple rules related to margin and risk mitigation at any time, it is crucial that the authorities take a consistent approach in each of their respective final rules to reduce the compliance burden. In this regard, ISDA supports the HKMA's proposed amendments to the Revised Module and we have the following comments which we outline below.

All capitalized or italicized terms used but not defined in this letter have the meanings ascribed to such terms in the draft Revised Module.

[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 74 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.

1. Definition of Financial Counterparty (paragraph 1.1)

1.1 ***Alignment to ordinance definitions***: We wish to thank you for clarifying our understanding that the changes to the definitions of certain categories of financial counterparty in the Revised Module, in particular to sub-paragraphs (iii) (mandatory provident fund), (iv) (occupational retirement scheme), (v) (insurer) and (vi) (money service operator) are merely drafting changes to align to the current versions of the relevant ordinances and is not intended to change the counterparty scope as set out in these sub-paragraphs.

1.2 ***Foreign entities conducting derivatives business***: In respect of the other change to the definition of "*financial counterparty*" in sub-paragraph (xi) where it has been amended to include foreign entities that conduct "derivatives" (as well as securities) business, we note that this would be an expansion of the scope of this limb for financial counterparty.

We would be grateful if the HKMA could clarify that any such counterparties who were previously out-of-scope of the Revised Module, would only be included prospectively as within scope as of the effective date of the Revised Module.

2. Permanent exemption for single-stock equity options, equity basket options and equity index options (paragraph 2.1.2(v))

ISDA welcomes the HKMA's proposed amendments to the Revised Module to extend the temporary derogation of the deferred application of the margin requirements for single-stock equity options, equity basket options and equity index options, meaning that once the amendments come into effect these transactions would be out of scope of the Revised Module until 4 January 2021 which is consistent with the derogation under the draft Regulatory Technical Standards under Article 11(15) of Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories ("**EU Margin RTS**")[2] and Hong Kong Securities and Futures Commission.[3]

2.1 ***Avoiding market fragmentation:*** This temporary derogation was intended to assist in avoiding market fragmentation and ensure a level playing field for Hong Kong counterparties on a global level, acknowledging the fact that in some jurisdictions (e.g. the US) the exchange of VM and IM for single-stock options, equity basket options and equity index options were not subject to equivalent margin requirements.

However, as has been noted by European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority (together, the "**ESAs**") in their Final Report on the EU Margin RTS,[4] in the past three years, the reasons for deferring application of the margin requirements to such transactions have not materially changed.

2.2 ***Approach in other jurisdictions***: There are jurisdictions that, have not implemented margin requirements for single-stock options, equity basket options and equity index options, or are out of

[2] https://www.esma.europa.eu/sites/default/files/library/esas_2020_09_-_final_report_-_bilateral_margin_amendments.pdf
[3] https://www.sfc.hk/web/EN/files/SOM/OTC/Consultation Conclusion on OTCD Margin Dec 2019_Eng.pdf
[4] Paragraph 33 at https://www.esma.europa.eu/sites/default/files/library/esas_2020_09_-_final_report_-_bilateral_margin_amendments.pdf

scope of their relevant margin rules; or have also introduced temporary derogations or granted permanent exemptions for these transactions.

For example, in the United States of America ("**US**"), equity options and equity index options are not addressed within the scope of Dodd Frank Title VII, and regulatory margin requirements do not in practice apply to swap dealers under US regulation. Given that US is the largest market for equity options[5], alignment with the US in this regard will be important to avoid disruption of cross-border business. In particular, Hong Kong market participants will face a clear competitive disadvantage when dealing with its clients (including US insurers and hedge funds) who are likely to cease trading with them upon expiry of the exemption under the Revised Module.

Another example is in Singapore, the Monetary Authority of Singapore has released guidelines exempting equity options and equity index options from the scope of its margin rules entirely.[6]

2.3 ***Importance for smaller counterparties***: Equity options play a significant part in the real economy, and are used for multiple purposes aside from transactions between dealers, including hedging exposure to the purchase price in the context of an M&A transaction, use in share buy-backs by companies and use in private equity transactions as well as for stake building in preparation for takeover bids. Equity options may also be used to allow investors access to equity markets that are closed to direct investment from Hong Kong investors (e.g., emerging markets). Equity options also play a key role in supporting convertible bond issuance by Hong Kong corporates, but their usage in this context would no longer be viable if margin requirements were to be applied to them.

Imposing margin requirements in relation to equity options will have a disproportionate impact for smaller counterparties coming within the scope of the Revised Module, potentially leading entities that currently use equity options for hedging and risk mitigation to cease trading these products due to the cost increase, and incentivizing them to avoid dealing with Hong Kong AIs in equity options.

2.4 ***Request for permanent exemption***: As the situation globally has not materially changed and does not seem likely to change materially in the future, we would ask the HKMA to amend the Revised Module to exclude single-stock options, equity basket options and equity index options from the margin requirements permanently or, failing that, to extend the relief for these contracts in line with any further derogation the ESAs may agree to under the EU Margin RTS to avoid an unlevel playing field for Hong Kong market participants engaged in global derivatives markets.

3. Application of substituted compliance (paragraph 2.3.12)

We note the inclusion of the new paragraph 2.3.12 and in particular the inclusion of footnotes 29 and 30. Our understanding is that the HKMA fully supports the application of full substituted compliance as it avoids duplicative and conflicting margin rules and allows firms to establish a single system to comply with its obligations arising from multiple margin rule sets.

3.1 ***Reporting of material disputes (2.3.12(iii)):*** In this respect, we would like to ask if HKMA could clarify the footnote further in the case of where there is no specified *number* as the reporting threshold set out in the risk mitigation standards of the foreign jurisdiction adopted by the relevant

[5] https://stats.bis.org/statx/srs/table/d8?f=pdf

[6] Paragraph 4.2(f) at https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Fund-Management/Regulations-Guidance-and-Licensing/Guidelines/Guidelines-on-Margin-Requirements-for-NonCentrally-Cleared-OTC-Derivatives-Contracts-8-Apr-2020.pdf

AI under substituted compliance (its "**home jurisdiction**") (specifically, a member would like us to draw your attention to paragraph 95 of the prudential rules on margining of the Australian Prudential Regulation Authority ("**APRA**") where it only refers to "*disputes that are material either in dollar value or period of time outstanding*"). Given there is no specified threshold, it could imply that the AI would need to follow the specified threshold of HKD 100 million (or its equivalent in any other currency) set out in paragraph 4.6.2 of the Revised Module. However, the relevant AI may also be monitoring reporting thresholds according to another jurisdiction (that is not its home jurisdiction) but which is also considered comparable for substituted compliance e.g. the European Union ("**EU**") or the US. In such a case, we would be grateful if the HKMA could consider clarifying whether the AI could follow the equivalent rule in another comparable jurisdiction that it is already monitoring for, rather than needing to implement a new procedure to following the reporting threshold set out in paragraph 4.6.2 of the Revised Module.

3.2 ***Paragraphs 2.3.12(ii) and (vi):*** Further, it has been pointed out by a member that under the APRA prudential rules on margining,[7] there is no any similar requirement to:

(i) paragraph 2.3.12(ii) of the Revised Module (requiring maintaining records of transactions that are unconfirmed after 5 business days from the execute date of the transaction;[8] and

(ii) paragraph 2.3.12 (vi) of the Revised Module (requiring reporting to the HKMA), to report to APRA any material problems with the IM model after a validation.

As such, the member has requested that the HKMA consider removing the requirements under paragraphs 2.3.12 (ii) and (vi) of the Revised Module.

3.3 ***Substituted compliance***: In particular we draw the HKMA's attention to paragraphs 2.3.10 and 2.3.11 where it refers to the AI being able to comply with a comparable jurisdiction's margin standards and RMS (in their entirety) *in lieu* of the provisions set out in this module. If it is the HKMA's intention that paragraph 2.3.12 applies to a relevant AI as well as the comparable jurisdiction's margin standards and RMS, it would be helpful to state that paragraphs 2.3.10 and 2.3.11 are also subject to paragraph 2.3.12.

3.4 ***Effective date of application of paragraph 2.3.12***: Once paragraph 2.3.12 takes effect (such date, the "**Revised Module Effective Date**") we would be grateful if the HKMA could clarify that the intention is that it will only apply to:

(i) (in respect of sub-paragraph (ii)), transactions that are entered into after the Revised Module Effective Date; and

(ii) (in respect of sub-paragraph (vii), material problems that it becomes aware of after the Revised Module Effective Date,

or whether the intention that it applies to transactions and material problems, respectively, that are *outstanding* as of the Revised Module Effective Date.

---

[7] Prudential Standard CPS 226: "Margining and risk mitigation for non-centrally cleared derivatives" at https://www.apra.gov.au/sites/default/files/prudential_standard_cps_226_margining_and_risk_mitigation_for_non-centrally_cleared_derivatives.pdf

[8] Please see paragraph 77 of Prudential Standard CPS 226, which only requires recordkeeping of trading relationship documentation for a reasonable period of time after the maturity of any outstanding transactions with a covered counterparty; and paragraph 78, which only requires transactions to be "confirmed as soon as practicable after execution of the transaction".

4. Align thresholds for IM and RMS (paragraphs 2.4.2 and 2.4.3)

As mentioned above, we welcome the amendments to delay by one year Phase 4 for IM and RMS requirements and the new Phase 5 threshold of HKD375 billion.

However, as a result, for the period during 1 September 2021 to 31 August 2022, there is a different threshold (HKD 375 billion) for IM as set out in paragraph 2.4.2 of the Revised Module from the threshold for RMS (HKD 60 billion) as set out in paragraph 2.4.3. This creates practical difficulties for Hong Kong AIs to implement their client outreach as there would be multiple outreaches to the same client, first for RMS and then a year later, for IM.

Further, having a threshold of HKD 60 billion for RMS on 1 September 2021, will bring into scope a much larger pool of clients for outreach and negotiation, which will be required at the same time as negotiations and contractual changes are being executed for multiple other regulatory reforms (including for EU Central Securities Depository Regulation[9] settlement discipline regime, IM Phase 5 interest rate benchmark reforms, and complying with the Monetary Authority of Singapore's risk mitigation requirements). As result of Covid-19, there has been delays to global regulatory requirements which has meant AIs would need to undertake and manage negotiation and re-papering exercises for these reforms in parallel, and an increased scope of clients for HKMA RMS would only exacerbate this situation. The threshold of HKD 60 billion would bring into scope, smaller, less-sophisticated, corporate clients which may lead to additional demand on AIs with respect to client engagement and regulatory guidance, adding further to the resources required to execute.

To simplify the client outreach and negotiation process for these smaller counterparties who may require additional time to go through the negotiation process and to ease the workload for the AIs, we would be grateful if the HKMA would consider aligning the phase-in threshold schedule for IM and RMS resulting in a single pool of clients to be in-scope for both HKMA IM Phase 5 and RMS in September 2021.

5. Genuine and non-material amendments to legacy contracts to include all benchmark reforms and associated transitions from IBORs to alternative risk-free rates (paragraph 2.4.7)

5.1 We are grateful for the clarification in footnote 36 to clarify that genuine amendments to existing derivative contracts which are made to give effect to *interest rate benchmark reforms* will not be considered new contracts from perspective of the HKMA's margin requirements. This is consistent with the 5 March 2019 statement by the Basel Committee on Banking Supervision ("**BCBS**") and International Organization of Securities Commissions ("**IOSCO**") on the final implementation phases of the Margin requirements for non-centrally cleared derivatives released.[10]

5.2 ***IOSCO statement on the use of financial benchmarks***: On 5 January 2018, the IOSCO Board published a statement setting out matters for users of financial benchmarks to consider in selecting an appropriate benchmark and in contingency planning, particularly for scenarios in which a benchmark is no longer available.[11] The statement recommends that users should consider their contingency plans in the event a benchmark is no longer available or materially changes in order to mitigate the potential risks involved, and encourages users to produce and maintain clear,

[9] Regulation (EU) No 909/2014 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014R0909
[10] https://www.iosco.org/news/pdf/IOSCONEWS526.pdf
[11] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf

comprehensive and robust written policies and procedures on actions they would take in such an event. The statement provides that where feasible and appropriate, contingency plans for the cessation of a benchmark should include users' having sufficiently robust fallback provisions in their financial contracts and instruments, and puts forth that users should also seek to reflect their contingency plans in their contractual arrangements.

5.3 ***EU Benchmarks Regulation***: The EU has implemented the EU Benchmarks Regulation ("**EU BMR**")[12] which covers all indices which are made available to the public and used in financial instruments. The EU BMR's wide-ranging scope means that many domestic and foreign entities in the Hong Kong market are subject to its requirements. Benchmarks covered by the EU BMR would include a significant number of interest rates, equity indices, commodity indices, FX indices, credit indices and others (estimated by some to exceed 3 million indices in total).

Article 28(2) of the EU BMR provides:

"*Supervised entities…that use a benchmark shall produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided...and shall reflect them in the contractual relationship with clients.*"

As a result, the ISDA Benchmarks Supplement with generic fallbacks was published in response to Article 28(2) of the EU BMR to be used by market participants.

5.4 ***Amendments to existing derivative contracts to voluntarily replace IBORs with alternative reference rates***: In response to significant concerns regarding the reliability and robustness of interbank offered rates ("**IBORs**"), the Financial Stability Board ("**FSB**") called for the identification of alternative benchmarks to the IBORs and transition plans to support implementation.[13] In addition to amending existing derivative contracts to implement fallback arrangements to protect against any cessation of IBOR publication or determination that an IBOR is non-representative, market participants may choose to voluntarily convert IBOR-linked derivatives contracts to alternative reference rates prior to any such trigger event to ensure an orderly transition away from IBORs.

5.5 ***Approach in other jurisdictions***: The Australian Prudential Regulation Authority[14] has provided a broader clarification in its rules – explicitly stating that amendments made solely for the purpose of addressing benchmark reforms do not qualify as a new derivative transaction, specifically contemplating the need of market participants to comply with EU BMR.

Similarly, the ESA public statement[15] on "*The introduction of fallbacks in OTC derivative contracts and the requirement to exchange collateral*" shows that the ESAs are of the view that amendments made to outstanding uncleared OTC derivative contracts (legacy contracts) for the sole purpose of

[12] Regulation (EU) No 596/2014 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.171.01.0001.01.ENG&toc=OJ:L:2016:171:TOC

[13] https://www.fsb.org/2018/07/interest-rate-benchmark-reform-overnight-risk-free-rates-and-term-rates/

[14] https://www.apra.gov.au/sites/default/files/response_to_submissions_-_amendments_to_margin_requirements_-_v1.pdf; and Footnote 8 at https://www.apra.gov.au/sites/default/files/prudential_standard_cps_226_margining_and_risk_mitigation_for_non-centrally_cleared_derivatives.pdf

[15] https://www.esma.europa.eu/sites/default/files/library/esas_2019_19_statement_on_the_introduction_of_fallbacks_in_otc_derivative_contracts_to_increase_contract_robustness.pdf

introducing fallbacks should not create new obligations on these legacy contracts. In particular, it mentions that margining requirements should not apply to these legacy contracts where they were not subject to those requirements before the introduction of the fallbacks.

The US Commodity Futures Trading Commission ("**CFTC**") issued a no-action letter[16] that provided relief from CFTC uncleared swap margin requirements on amendments to an existing uncleared swap that references an "Impaired Reference Rate ("**IRR**")", including IBORs, solely to: (i) include new fallbacks to alternative reference rates triggered only by permanent discontinuation of an IRR or determination that an IRR is non-representative by the benchmark administrator or the relevant authority in a jurisdiction; or (ii) accommodate the replacement of an IRR.

5.6 ***Request to include amendments for all benchmarks and associated transitions from IBORs to alternative risk-free rates***: Greater certainty would be provided if the HKMA clarified that amendments to existing derivative contracts to (a) insert fallback provisions for all benchmarks, rather than being restricted to benchmarks for interest rates; or (b) voluntary transition[17] away from IBORs, in either case, would not constitute new contracts. This will remove any impediment market participants may otherwise perceive to ensuring that fallback provisions in their existing transactions (regardless of when these transactions were executed or the benchmarks they reference) are consistent with fallback provisions in their new transactions and as such, help to reduce basis risk across their portfolio of transactions to the fullest extent. Furthermore, such clarity would be helpful in facilitating efficient and cost-effective adoption of the IOSCO statement on the use of financial benchmarks as well as compliance with the EU BMR. Clarity on the treatment of voluntary transition away from IBORs in relation to HKMA margin requirements would ensure an orderly market-wide transition consistent with public sector expectations to transition away from IBORs.

6. Align calculation method for the average aggregate notional amount for Phase 4 IM with BCBS-IOSCO framework (paragraphs 2.4.9)

As mentioned, we welcome the amendments to delay Phase 5 for IM, in line with the BCBS-IOSCO framework.[18] However we would like to draw your attention to paragraph 8.7 of the BCBS-IOSCO framework which states that from for the period during 1 September 2019 to 31 August 2021, the aggregate month-end average notional amount of non-centrally cleared derivatives should be calculated by reference to March, April, and May of **2019**.

Paragraph 2.4.9 of the Revised Module currently refers to the March, April, and May preceding the 1 September starting date in a relevant year which would mean for Phase 4, there is a new aggregate month-end average notional amount period by reference to March, April, and May of **2020.**

To be consistent with the BCBS-IOSCO framework, we would suggest that paragraph 2.4.9 of the Revised Module be amended so that the Phase 4 threshold is calculated by reference to March, April, and May of **2019.**

---

[16] https://www.cftc.gov/csl/19-26/download

[17] As itemized in Annex 2 of the ARRC's letter to the US regulators, voluntary transition can take various forms including a portfolio compression. The ARRC's letter is available at: https://www.newyorkfed.org/medialibrary/Microsites/arrc/files/2019/ARRC_Letter_CFTC_Regulatory_Derivatives_Treatment_05132019.pdf.

[18] https://www.bis.org/bcbs/publ/d499.htm

ISDA

7. Clarification that the reporting threshold for VM and IM material disputes apply separately (paragraph 4.6.2)

It is most helpful that that footnote 57 has been inserted to clarify how to apply the HKD 100 million threshold in respect of the AI's disputes with its counterparty. Our understanding is that it is intended to clarify that the threshold applies to VM and IM disputes *separately*. However, there is a concern that it may also imply that the threshold applies to the aggregate of all VM and IM disputes. To avoid this uncertainty, we would be grateful if the HKMA would consider amending the footnote to explicitly state it applies on a separate basis, such as:

[57] *With respect to the exchange of margin, the HKD 100 million threshold is applied **separately** to the AI's disputes with its counterparty on VM and IM, respectively.*

We hope you find ISDA's comments and responses informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please do not hesitate to contact the undersigned.

Yours sincerely,

For the **International Swaps and Derivatives Association, Inc**.

Jing Gu

Jing Gu

Head of Legal, Asia Pacific

Monica

Monica Chiu

Senior Counsel, Asia Pacific

Hyelin Han

Hyelin Han

Director, Public Policy