

# Regulatory Framework for Sustainability-linked Derivatives: Hong Kong Analysis

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## EXECUTIVE SUMMARY

Interest in environmental, social and governance (ESG) issues has grown in Asia-Pacific, as companies transition to a green economy and enhance their social responsibility credentials. Sustainability-linked derivatives (SLDs) have emerged as one of the tools available to help firms meet their ESG objectives. However, it is necessary for users to understand how these instruments fit into existing regulatory regimes.

This whitepaper analyzes two categories of SLDs in the context of the derivatives regulatory framework in Hong Kong.

Specifically, it considers:

- Whether SLDs would be classified as over-the-counter (OTC) derivatives transactions or another type of regulated product, and how they are regulated; and
- Compliance issues for market participants to consider when executing SLDs.

## INTRODUCTION

Climate change and ESG-related issues have become increasingly prominent factors in financial markets and investments in Asia-Pacific. They have also become an area of focus for regulators in Hong Kong.

In May 2020, the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) set up the Green and Sustainable Finance Cross-Agency Steering Group to coordinate the management of climate and environmental risks for the financial sector and accelerate the growth of green and sustainable finance in Hong Kong<sup>1</sup>.

The Hong Kong government followed up with a Climate Action Plan 2050 in October 2021, which confirmed its target to achieve carbon neutrality by 2050 and committed to more aggressive medium-term targets<sup>2</sup>. Other regulatory initiatives include the launch of a Green and Sustainable Finance Grant Scheme<sup>3</sup>, publication of guidance for banks on managing climate-related risks<sup>4</sup> and distribution of a circular on sound practice supporting the transition to carbon neutrality<sup>5</sup>.

A number of ESG-related financial products, such as bonds, unit trusts, deposits and derivatives, have emerged locally in Hong Kong. ESG derivatives cover a broad spectrum of products, including futures, swaps and SLDs.

ISDA's December 2021 whitepaper, *Regulatory Considerations for Sustainability-linked Derivatives*<sup>6</sup>, explored regulatory issues for SLDs in the UK, EU and US. This paper takes the same approach for Hong Kong. The objective is to describe potential regulatory approaches to SLDs and provide market participants with information to develop their own assessments.

Two categories of SLDs are covered in this paper<sup>7</sup>:

- **Category 1 SLDs:** The key performance indicators (KPIs) that measure compliance with ESG targets and the related impact on cashflows are set out in the OTC derivatives transaction. An example of a Category 1 SLD is an interest rate swap (IRS) that provides additional or reduced payments if particular KPIs are met, or an IRS in which one party agrees to take certain actions (eg, a donation to a charity) if the other party meets certain KPIs; and

<sup>1</sup> The Green and Sustainable Finance Cross-Agency Steering Group recently published a preliminary feasibility assessment on carbon market opportunities for Hong Kong, suggesting carbon derivatives may potentially fall within the Securities and Futures Commission's (SFC) regulatory remit. See Carbon Market Opportunities for Hong Kong Preliminary Feasibility Assessment (March 2022), published by the Carbon Market Workstream of the Green and Sustainable Finance Cross-Agency Steering Group, [www.sfc.hk/-/media/EN/files/CEOO/CASGWS3PreliminaryCarbonFeasibilityAssessmentEnglish3032022.pdf](http://www.sfc.hk/-/media/EN/files/CEOO/CASGWS3PreliminaryCarbonFeasibilityAssessmentEnglish3032022.pdf)

<sup>2</sup> Hong Kong's Climate Action Plan 2050, October 2021, published by the Government of the Hong Kong Special Administrative Region, [www.climateready.gov.hk/files/pdf/CAP2050\\_booklet\\_en.pdf](http://www.climateready.gov.hk/files/pdf/CAP2050_booklet_en.pdf).

<sup>3</sup> The Green and Sustainable Finance Grant Scheme aims to support green and sustainable bond issuance and lending in Hong Kong. The scheme came into operation on May 10, 2021. See Guideline on the Green and Sustainable Finance Grant Scheme, published by the Hong Kong Monetary Authority (HKMA), May 2021, [www.hkma.gov.hk/media/eng/doc/key-information/press-release/2021/20210504e4a1.pdf](http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2021/20210504e4a1.pdf)

<sup>4</sup> Chapter GS-1 of the Supervisory Policy Manual (December 2021 version), published by the HKMA, [www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211230e2a1.pdf](http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211230e2a1.pdf)

<sup>5</sup> See HKMA circular on sound practices supporting the transition to carbon neutrality, December 8, 2021, [www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211208e1.pdf](http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211208e1.pdf), with annex, [www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211208e1a1.pdf](http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20211208e1a1.pdf)

<sup>6</sup> Regulatory Considerations for Sustainability-linked Derivatives, ISDA, December 2021, [www.isda.org/2021/12/01/regulatory-considerations-for-sustainability-linked-derivatives/](http://www.isda.org/2021/12/01/regulatory-considerations-for-sustainability-linked-derivatives/)

<sup>7</sup> There are likely to be other types of SLDs for which different regulatory issues may arise

- Category 2 SLDs: The KPIs and related cashflows are set out in a separate agreement that references the underlying (generally vanilla) OTC derivatives to set the KPI-linked cashflow. An example of a Category 2 SLD is an agreement to make a payment if a counterparty achieves its KPIs, with the payment calculated as a percentage of the notional amount of unrelated, separately documented derivatives transactions<sup>8</sup>. This KPI-linked payment could also be binary – for example, if the KPI is above a certain target, a specific payment is made. The terms (including pricing) of the underlying OTC derivatives would not generally be affected by the KPIs and cashflows in the separate agreement.

In general, this whitepaper focuses on SLDs that are OTC derivatives transactions rather than SLDs that are embedded in other products, such as loans or notes. It explores the regulatory aspects of SLDs rather than whether a particular party needs to be licensed to trade an SLD or how the product offering regime<sup>9</sup> impacts a particular transaction in an SLD. The whitepaper assumes the SLDs have been executed for commercial reasons and does not consider issues such as greenwashing or insider dealing.

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<sup>8</sup> For example, a percentage of the net aggregate notional amount of all foreign exchange forwards or swaps between the parties for the same currency pair, or a figure calculated by reference to the volume of all such transactions

<sup>9</sup> In Hong Kong, the product offering regime may generally apply to SLDs that are characterized as structured products, securities or regulated investment agreements

## REGULATORY CONSIDERATIONS FOR SLDs – HONG KONG ANALYSIS

### How OTC Derivatives Are Regulated

The Securities and Futures Ordinance (Cap. 571) (SFO) is the primary piece of legislation in Hong Kong setting out regulatory requirements for OTC derivatives<sup>10</sup>. The SFO uses the term ‘OTC derivative transaction’, which means a transaction in an OTC derivatives product. An ‘OTC derivative product’ is, in turn, defined in Schedule 1 to the SFO as a ‘structured product’<sup>11</sup>, subject to certain exceptions<sup>12</sup>.

Even before the term ‘OTC derivative transaction’ was introduced into the SFO in 2014, OTC derivatives were already regulated under the SFO if they fell into one of the existing classes of regulated product – notably, a security, futures contract or leveraged foreign exchange (FX) contract. An SLD may be categorized as an OTC derivatives transaction, but it could also be categorized as one of the existing types of regulated product.

### Categorization of Category 1 SLDs

Assuming the applicable Category 1 SLD falls into one of the classes of product regulated under the SFO (for example, a leveraged FX contract or an OTC derivatives transaction), the inclusion of cashflows linked to KPIs is unlikely to change this characterization.

### Categorization of Category 2 SLDs

Practically speaking, a Category 2 SLD is, by itself, unlikely to be categorized as a security, futures contract or leveraged FX contract. The question is therefore whether a Category 2 SLD is an OTC derivatives transaction.

The first part of the definition refers to an instrument that has some or all of the return or amount due determined by reference to “changes in the price, value or level (or a range within the price, value or level) of any type or combination of types of securities, commodity, index, property, interest rate, currency exchange rate or futures contract” (ie, part (i) of the structured product definition). It does not appear that a sustainability-linked KPI would fall within any of these categories of underlier, as the pay out on a Category 2 SLD does not directly relate to securities, indices or commodities<sup>13</sup>.

<sup>10</sup> Hong Kong legislation contains various definitions of ‘derivative’, ‘derivative contract’ and ‘derivative transaction’, other than those discussed in this whitepaper. Parties should check the definitions in the applicable legislation and determine whether SLDs are covered

<sup>11</sup> ‘Structured product’ is defined under section 1A of Schedule 1 to the Securities and Futures Ordinance (SFO). In this paper, references to parts of the ‘structured product’ definition are to those set out under section 1A(1)(a) of Schedule 1 to the SFO. These are as follows:

<sup>(a)</sup> an instrument under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to one or more of:

<sup>(i)</sup> changes in the price, value or level (or a range within the price, value or level) of any type or combination of types of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;

<sup>(ii)</sup> changes in the price, value or level (or a range within the price, value or level) of any basket of more than one type, or any combination of types, of securities, commodity, index, property, interest rate, currency exchange rate or futures contract; or

<sup>(iii)</sup> the occurrence or non-occurrence of any specified event or events (excluding an event or events relating only to the issuer or guarantor of the instrument or to both the issuer and the guarantor)

<sup>12</sup> For completeness, a ‘regulated investment agreement’ falls under the definition of a ‘structured product’ under section 1A(1)(b) of Schedule 1 to the SFO. A Category 2 SLD is probably not a ‘regulated investment agreement’ as there is no underlying ‘property’

<sup>13</sup> A key performance indicator may be structured by reference to a commodity. In addition, emission allowances may be categorized as property in some jurisdictions (for example, in England and Wales (see *Armstrong DLW GmbH v Winnington Network Ltd* [2012] EWHC 10 (Ch)) and in Australia (see section 103 of the Clean Energy Act 2011)), but there are no Hong Kong authorities on this yet

However, part (iii) of the structured product definition refers to instruments that have some or all of the return or amount due determined by reference to the occurrence or non-occurrence of specified events. A Category 2 SLD may contain an agreement to make a payment if the counterparty meets its KPIs. This appears to fall within part (iii), so a Category 2 SLD could potentially be an OTC derivatives transaction unless one of the other exemptions is available. The definition of 'structured product' is wide and so an institution may have to conduct further analysis to determine if a particular agreement or product falls within the definition.

Whether the KPI-linked cashflows are digital or variable based on whether the KPIs are met would not affect the analysis.

## LICENSING REGIME APPLICABLE TO SLDs

A firm that conducts business in a regulated activity in Hong Kong under the SFO must be licensed unless an exception applies. As previously noted, entering into an OTC derivatives transaction may fall into one of the existing categories of regulated activity. The types of regulated activity that are most relevant to the trading of OTC derivatives are dealing in securities, dealing in futures contracts and leveraged FX trading.

For example, an equity derivatives transaction may be a security and a firm will have to consider whether it has to obtain a license for dealing securities if an exception is not available. An FX derivative may be a leveraged FX contract and a dealer in such derivatives will have to consider whether it has to obtain a license for leveraged FX trading unless an exception is available. The introduction of sustainability-linked features into these derivatives transactions is unlikely to change this characterization.

Provisions to introduce the regulated activity of dealing in OTC derivatives products or advising on OTC derivatives products have been included in the SFO but are not yet in operation. When these provisions come into force, entities dealing in SLDs are likely to require a license to conduct this type of regulated activity in Hong Kong unless an exception is available.

## COMPLIANCE ISSUES IF CATEGORY 1 AND 2 SLDs ARE CONSIDERED OTC DERIVATIVES TRANSACTIONS

### Risk Management

Hong Kong generally requires banks<sup>14</sup> and licensed corporations<sup>15</sup> to have risk management procedures in place. In general, such risk management procedures would mean those entities need to identify any risks associated with KPI-linked cashflows<sup>16</sup>.

### Mandatory Margining and Risk Mitigation

If a Category 1 SLD or Category 2 SLD is an OTC derivatives transaction, trades between banks or licensed corporations and covered entities will be subject to mandatory margining under the applicable rules. Notional amounts of these SLDs will then count towards average aggregate notional amount calculations and the SLDs may be subject to mandatory exchange of initial and/or variation margin.

#### Regulatory Margin: Can a Category 1 SLD Be Used For Hedging Purposes?

For banks, the rules in Hong Kong governing the exchange of regulatory margin are contained in Chapter CR-G-14 of the Supervisory Policy Manual issued by the HKMA (CR-G-14). For licensed corporations, they can be found in Part III of Schedule 10 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, published by the SFC.

These rules specify that a bank or licensed corporation, as applicable, need not exchange margin with a significant non-financial counterparty that predominantly uses non-centrally cleared derivatives for hedging purposes. The bank or licensed corporation should obtain a declaration from the significant non-financial counterparty to this effect and may reasonably rely on this declaration. However, it must be considered whether it is reasonable for a bank or licensed corporation to rely on a declaration that an SLD has been executed predominantly for hedging purposes.

For example, parties to a cross-currency IRS may need to consider whether the non-financial counterparty is using a non-centrally cleared derivative to hedge or mitigate commercial risk if it has access to a more favorable exchange rate or a separate payment once it meets certain KPI targets, and whether this would mean the counterparty is no longer hedging, particularly if the payments under an SLD no longer match the underlying trade.

<sup>14</sup> In this whitepaper, references to banks are to 'authorized institutions' under the Banking Ordinance (Cap. 155)

<sup>15</sup> A licensed corporation is a corporation that is granted a license under section 116 or 117 of the SFO to carry out one or more regulated activities

<sup>16</sup> For banks, the board of directors and senior management should have sufficient knowledge and expertise to understand all material risks faced by the bank, including the risks associated with new or complex products and high-risk activities, and the interaction of these risks under stressed conditions. The responsibilities of a bank's risk management function include overseeing and approving risk assessment models and internal rating systems, and analyzing the risks of new products and services. New products should be subject to a careful review to ensure all relevant parties fully understand the risk characteristics, the underlying assumptions on business models, valuation and risk management practices, the potential risk exposure if those assumptions fail, and the possible difficulty in valuing the product involved, especially in times of stress. The bank should ensure there is adequate staffing, technology and resources (financial, risk management, compliance etc) to launch the product or service, as well as adequate internal tools and expertise to measure and manage the risks associated with it. See paragraphs 3.1.2, 4.3.3 and 5.1.3 of Chapter IC-1 of the Supervisory Policy Manual (October 2017 version), published by the HKMA, [www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/IC-1.pdf](http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/IC-1.pdf)

For licensed corporations, senior management should properly manage the risks associated with its business, including performing periodic evaluation of its risk management processes. Senior management should understand the nature of the business of the licensed or registered person, its internal control procedures and its policies on the assumption of risk. See paragraph 14.1 of the Code of Conduct, [www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code\\_of\\_conduct-Dec-2020\\_Eng.pdf](http://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct-Dec-2020_Eng.pdf)

Although SLDs are not generally used as hedging instruments, KPIs in Category 1 SLDs create or impact cashflows within conventional or vanilla derivatives, which may have been entered into for hedging purposes. In this situation, hedging of the original risk is likely to remain the objective of the overall transaction.

In the absence of unusual facts, it would still be reasonable to conclude that the non-centrally cleared derivative can continue to satisfy the requirement for the significant non-financial counterparty to enter the derivative predominantly for hedging purposes.

As such, counterparties may want to clarify that the addition of KPI-linked payment terms is not for speculative or investment purposes but is instead intended to enhance the sustainability of the non-financial entity's operations. A bank should also put in place appropriate internal limits and risk management policies and procedures, commensurate with its risk appetite, in order to monitor and control the risks of relevant exposures, even if it does not need to exchange margin with significant non-financial counterparties<sup>17</sup>.

#### Regulatory Margin: Could a Category 2 SLD Be Used For Hedging Purposes?

Counterparties may not execute a Category 2 SLD for hedging purposes but may instead want to meet specific sustainability goals. In some cases, payments may be made by one of the counterparties to a charitable or non-governmental organization. In light of this, it appears unlikely that a Category 2 SLD would satisfy the requirement for trades to be executed predominantly for hedging purposes.

#### Impact on Underlying Derivatives of Category 2 SLDs Classified as OTC Derivatives Products

In the context of the US regulatory regime, ISDA's *Regulatory Considerations for Sustainability-linked Derivatives* includes a discussion on whether structuring a Category 2 SLD to reference the notional amounts of separate, unrelated derivatives transactions could affect the classification of the underlying transactions, to the extent that those underlying transactions may lose the benefit of a regulatory exemption for physically settled FX forwards and FX swaps.

Similar issues do not arise under the Hong Kong margin regime. The potential characterization of a Category 2 SLD as a derivative would not affect any underlying transactions. That is because a Category 2 SLD would be assessed separately from any other related derivatives for Hong Kong purposes. Classification of one should therefore not affect the other or result in them being characterized as a single instrument<sup>18</sup>.

#### Risk Mitigation Standards

Where an SLD has been classified as an OTC derivatives transaction, certain risk mitigation requirements may also apply if a bank or licensed corporation executes these transactions with a covered entity under the applicable rules.

<sup>17</sup> Paragraph 3.2.9 of CR-G-14, [www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf](http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf)

<sup>18</sup> Assuming the Category 2 SLD does not directly amend the terms of those derivatives and the operation of those derivatives is unchanged following entry into the Category 2 SLD



These requirements include:

- Implementing policies and procedures to execute written trading relationship documentation;
- Requirements to ensure the material terms of transactions are confirmed as soon as practicable after the transactions are executed;
- Requirements to agree with counterparties how transactions are valued;
- Portfolio reconciliation;
- Portfolio compression; and
- Dispute resolution<sup>19</sup>.

## Mandatory Reporting

If SLDs are OTC derivatives transactions, then they must be reported to trade repositories<sup>20</sup>. However, there is a question over what asset class they should be reported under. The Hong Kong Trade Repository operated by the HKMA does not have specific guidance on SLDs. In the absence of guidance, it appears the SLD feature would not change the original asset class in which the OTC derivatives transaction should be reported. An SLD that is an IRS should therefore still be reported as being in the interest rate asset class<sup>21</sup>.

## Disclosure

Licensed corporations regulated by the SFC that wish to offer SLDs to retail investors as unlisted structured investment products must comply with the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. Every offering document for unlisted structured investment products must include a product key facts statement that enables investors to understand the main features and risks of the relevant structured investment product<sup>22</sup>. This would apply to SLDs offered as unlisted structured investment products by licensed corporations.

Banks may wish to offer SLDs that are currency-linked instruments or interest-rate-linked instruments to retail customers. If so, they are required to provide an important facts statement (IFS) to the retail customer for each transaction<sup>23</sup>. The IFS should include, among other things, the key features, risks and investment objectives of the product, described in a clear and concise way, as well as information that enables investors to understand the primary features and risks of the product<sup>24</sup>.

<sup>19</sup> Paragraph four of CR-G-14, [www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf](http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf); paragraph 4.3A, Part I and Part III of Schedule 10 to the Code of Conduct, [www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code\\_of\\_conduct-Dec-2020\\_Eng.pdf](http://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/Code_of_conduct-Dec-2020_Eng.pdf)

<sup>20</sup> Section 101B(1) of the SFO and the Securities and Futures (OTC Derivative Transactions—Reporting and Record Keeping Obligations) Rules (Cap. 571AL)

<sup>21</sup> According to regulatory guidance published by the SFC, if a transaction involves special product features that are not supported by the current reporting templates, it is acceptable to report information about the transaction only to the extent supported by the templates. Where there is key information relating to the core economic terms that materially affect the pricing of a transaction, but the current reporting templates do not have the relevant data field to capture such data, the reporting entity should report a 'Yes' value in the data field 'Special Terms Indicator', but no further details are required to be reported. However, the relevant regulator may, where appropriate or necessary, contact the reporting entity if it requires such details. Counterparties should consider whether the KPI-linked cashflows in SLDs should be reported on this basis. See Question 35 of Frequently Asked Questions on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (November 23, 2021), published by the SFC, [www.sfc.hk/-/media/EN/files/SOM/OTC/FAQs\\_Phase-2-Reporting\\_20211123.pdf](http://www.sfc.hk/-/media/EN/files/SOM/OTC/FAQs_Phase-2-Reporting_20211123.pdf)

<sup>22</sup> See paragraph 6 of Section I and paragraph 6.3 of Section IV of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (January 2019 edition), [www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/sfc-handbook-for-unit-trusts-and-mutual-funds/sfc-handbook-for-unit-trusts-and-mutual-funds.pdf](http://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/sfc-handbook-for-unit-trusts-and-mutual-funds/sfc-handbook-for-unit-trusts-and-mutual-funds.pdf)

<sup>23</sup> Unless the customer declines the important facts statement, in which case a proper audit trail of this should be maintained

<sup>24</sup> See circular on Important Facts Statement for Currency-Linked Instruments and Interest Rate-Linked Instruments Issued by Authorized Institutions (AIs) (April 18, 2011), published by the HKMA, [www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2011/20110418e1.pdf](http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2011/20110418e1.pdf)

In addition, licensed or registered corporations regulated by the SFC have general disclosure obligations under the Code of Conduct and should make adequate disclosure of relevant material information in their dealings with clients.

## Recovery and Resolution

The Hong Kong recovery and resolution regime should also be considered – in particular, whether SLDs fall within the protections for OTC derivatives transactions in the Financial Institutions (Resolution) Ordinance (Cap. 628) and its subsidiary legislation<sup>25</sup>. In addition, the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules require that a contractual recognition of the suspension of termination rights be included for certain financial contracts executed by specific covered entities<sup>26</sup> if the financial contract is not governed by Hong Kong law.

While a detailed analysis of the requirements under the stay rules is beyond the scope of this paper, it does briefly consider whether SLDs could be a financial contract for the purposes of the stay rules and if a suspension of termination rights provision should be included.

### Protected Arrangements

A resolution authority may take a number of actions with respect to a failing financial institution, including partial property transfers or a bail-in. In the context of OTC derivatives transactions, the Financial Institutions (Resolution) (Protected Arrangements) Regulation (Cap. 628A) (PAR) gives protection to set-off arrangements<sup>27</sup>, netting arrangements<sup>28</sup> and title transfer arrangements<sup>29</sup> if there is a partial property transfer or bail-in, among other things.

To qualify for the protection under the PAR, a set-off arrangement, netting arrangement or title transfer arrangement must fulfil certain conditions<sup>30</sup>. To the extent an SLD is a transaction under an ISDA Master Agreement, it would ordinarily fall within the scope of a set-off or netting arrangement and the protections should apply<sup>31</sup>. The categorization of an OTC derivatives transaction as an SLD should not change the treatment of the transaction if one of the parties enters into resolution. To the extent a Category 2 SLD is documented as a separate agreement, firms will need to consider whether it is protected as a set-off or netting arrangement, a secured arrangement or one of the other categories of protected arrangement.

<sup>25</sup> Including the Financial Institutions (Resolution) (Protected Arrangements) Regulation (Cap. 628A), the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements—Banking Sector) Rules (Cap. 628B) and the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights—Banking Sector) Rules (Cap. 628C)

<sup>26</sup> Covered entities are a Hong Kong-incorporated authorized institution, a Hong Kong-incorporated holding company of a Hong Kong-incorporated authorized institution, or a group company of a Hong Kong-incorporated authorized institution (but obligations of such a group company must be guaranteed or otherwise supported by a Hong Kong-incorporated authorized institution or its Hong Kong-incorporated holding company)

<sup>27</sup> A set-off arrangement is an arrangement under which two or more debts, claims or obligations can be set off against each other

<sup>28</sup> A netting arrangement is an arrangement under which a number of claims or obligations can be converted into a net claim or obligation

<sup>29</sup> A title transfer arrangement is an arrangement under which a person transfers assets to another person on terms providing for the other person to transfer assets if specified obligations are discharged and includes: (a) a repurchase or reverse repurchase transaction; and (b) a stock borrowing or lending arrangement

<sup>30</sup> See next page

<sup>31</sup> See next page

## Stay Rules

Certain covered entities, including Hong Kong-incorporated authorized institutions, will also need to consider whether an SLD that is not governed by Hong Kong law falls within the scope of the stay rules, meaning a suspension of termination rights provision should be included.

As it is an OTC derivative, a Category 1 SLD will already fall within the category of ‘financial contract’ and the introduction of sustainability-linked KPIs will not change that characterization. If it is determined that a Category 2 SLD is an OTC derivative, then it will be a derivatives contract (or a contract of a similar nature) and within scope of the stay rules. Depending on its categorization, it may also be a securities contract or a commodity contract, or a contract of a similar nature to those contracts.

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<sup>30</sup> The conditions are:

- Such an arrangement must be documented or otherwise arranged in writing;
- Either the party subject to the transfer or the other party is entitled to set off or net the rights or liabilities under the arrangement;
- The arrangement must not contain a provision permitting a non-defaulting counterparty to make no payments or limited payments to the defaulting party, even if the defaulting party is a net creditor; and
- The rights or liabilities arise out of the arrangement and are not specifically excluded.

Such excluded rights and liabilities are:

- (a) Rights and liabilities relating to a deposit made with the transferor;
- (b) Rights and liabilities relating to assets in the form of receivables owed to the transferor by depositors, other than receivables owed in relation to a financial contract;
- (c) Rights and liabilities relating to subordinated debt;
- (d) Rights and liabilities relating to transferable securities unless explicitly identified as the subject matter of a transaction under a set-off arrangement, netting arrangement or title transfer arrangement that is documented or otherwise evidenced in writing;
- (e) Rights and liabilities arising under a contract entered into by, or on behalf of, the transferor otherwise than in the course of undertaking financial activity; and
- (f) Rights and liabilities, arising in connection with the undertaking of financial activity, relating to a claim for damages, an award of damages or a claim under an indemnity

<sup>31</sup> The definition of derivative contracts (being one of the parts of the definition of financial contracts) in the Financial Institutions (Resolution) (Protected Arrangements) Regulation is different from the definition of structured product in the SFO. It does not include part (iii) of the definition of structured product that refers to instruments under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to the occurrence or non-occurrence of specified events. This distinction is only relevant to the definition of financial contracts. However, depending on the circumstances, a Category 2 SLD may be protected if it falls into the categories of set-off arrangement or netting arrangement or secured arrangement

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## ABOUT ISDA

Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 990 member institutions from 78 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](http://www.isda.org). Follow us on [Twitter](#), [LinkedIn](#), [Facebook](#) and [YouTube](#).