

BY EMAIL

6 September 2021

Consultation on Contractual Stays
Resolution Office
Hong Kong Monetary Authority (“**HKMA**”)
55th Floor
Two International Finance Centre
8 Finance Street, Central, Hong Kong

Ladies and Gentlemen

ISDA comments on the Hong Kong Monetary Authority’s consultation on Resolution Regime – Code of Practice ST-1 "Resolution Planning – Contractual Recognition of Suspension of Termination Rights"

The International Swaps and Derivatives Association, Inc. (ISDA)¹ would like to thank the HKMA for the opportunity to provide comments on the draft *Resolution Regime – Code of Practice ST-1 "Resolution Planning – Contractual Recognition of Suspension of Termination Rights"* (the “**Draft Code**”) and hope our comments in this letter will be useful.

Consistent with our mission, we are primarily concerned in this letter with the impact of the proposed Code on the safety and efficiency of the financial markets, by considering the direct impact of the proposals on the obligations of a market counterparty which is a “*covered entity*” (as defined in the Draft Code) with respect to its derivatives and other financial transactions that are “*covered contracts*” (as defined in in the Draft Code).

Our membership includes the leading global, regional and national financial institutions as well as leading end-users and many other important financial market participants. Our leading financial institution members are members of the other international financial trade associations, and their views on certain other issues will be represented to you through those associations.

All capitalized or italicized terms used but not defined in this letter have the meanings ascribed to such terms in the Draft Code (as may be further defined in the Financial Institutions (Resolution) Ordinance (Cap. 628) (“**FIRO**”) and the Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules) (“**Stay Rules**”).

¹ Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 960 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.

1. Illustrative examples of “support”

We welcome the illustrative examples of “support” provided in Section 2 of the Draft Code, in relation to the obligation of a related company under a financial contract that is guaranteed or otherwise supported by an AI incorporated in Hong Kong or an HK holding company in the same group as set out in Rule 2 of the Stay Rules.

We would like to make the following suggestions to provide additional clarity.

1.1 Provision of Collateral

We suggest that Paragraph 2.5(b) be amended to clarify that the “provision of collateral” by the AI incorporated in Hong Kong, or an HK holding company, that is in the same group of companies as a related company relates to “provision of collateral *on behalf of a related entity*”.

Such an amendment would make it clear that where there is provision of collateral in separate transactions between an AI and an affiliate under commercial terms which may occur at similar times as, or hedge exposures in respect of, transactions with other (non-affiliated) counterparties, are not in scope. For example, in the context where:

- (i) an AI enters into financial contract (“**Contract A**”) with a related entity who in turn enters in a financial contract with a counterparty (“**Contract B**”);
- (ii) under Contract A, AI provides collateral to the related entity (which may be an amount determined by the nature of the transaction as well as the credit risk of related entity); and
- (iii) under Contract B, the related entity also provides collateral to its counterparty (which may be an amount determined by the nature of the transaction as well as the credit risk of counterparty).

While there is a provision of collateral under Contract A, we would not have thought this would give rise to Contract B also being in scope. Accordingly, we would be grateful if this could be clarified in the Draft Code.

1.2 Cross-entity trigger provisions

We note that the HKMA has clarified in paragraphs 2.3 and 2.4 of the Draft Code that the “support” that is provided to the related company is in respect of an obligation of a related company under a financial contract and that generally such support would be “financial” in nature.

As such, it would appear that a *trigger* for a termination right under a financial contract between a related company and a counterparty relating to certain default events with respect to, an AI incorporated in Hong Kong, or an HK holding company, is not intended to fall within the scope of “support” that is provided by an AI incorporated in Hong Kong or an HK holding company in respect of an obligation of the related company.

An example, in the context of the ISDA Master Agreement between a related company and a counterparty, would be the Cross Default or Default under Specified Transactions

provisions, that could be triggered if there was a default by a “Specified Entity” (who may be an AI incorporated in Hong Kong, or an HK holding company) under another transaction or agreement. Cross-entity trigger provisions are often used in financial contracts.

If this is the HKMA’s policy intention, we request that the HKMA clarify in Section 2 of the Draft Code that cross-entity trigger provisions are not intended to be captured under the scope of “support” provided to a related company.

2. Record keeping

We thank the HKMA for providing examples in paragraph 4.9 of the Draft Code of records that a covered entity should keep to demonstrate compliance with the requirement to maintain adequate systems of control under Rule 8 of the Stay Rules.

However, concern has been expressed that the reference to “expected to keep” in this paragraph might imply that *all* data fields mentioned in paragraph 4.9 are mandatorily required. Given that the paragraph is prefaced with “by way of example”, it is suggested that the phrase “expected to keep” should be amended to refer to “may keep (if the covered entity considers relevant)” so as to make it clear that the covered entity may make its own assessment of what data fields should be kept based on the type of covered contract and counterparty.

3. Legal opinions

We refer to the detailed discussion in Section 5 of the Draft Code relating to legal opinions as set out in Rule 9 of Stay Rules and would like to make the following suggestions.

2.1 Policy intent

Paragraph 55 of the HKMA Consultation Conclusions published on 31 December 2020 (the “**Consultation Conclusions**”) on its Consultation on the Rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions under the Financial Institutions (Resolution) Ordinance (Chapter 628), states that the HKMA does not intend to routinely perform due diligence on the legal enforceability or the effectiveness of the contractual provisions for effecting suspension of termination rights, as the onus is on the covered entity to ensure its compliance with the Stay Rules.

Further, we understand that Section 5 of the Draft Code is intended to provide examples of what the HKMA may need to request a legal opinion in respect of, on a case-by-case basis, depending on the complexity of the issue and/or a particular covered contract.

However, our members have expressed concern that the way in which paragraphs 5.3 and 5.4 of the Draft Code are drafted (including the references to “constitutional documents of any party to the covered contract” and “due capacity and authority of the parties”) currently suggests that covered entities, may need to ensure each of the issues set out in paragraphs

5.3 and 5.4 should be covered by a legal opinion at the outset and at a counterparty level, which would be extremely onerous.

In line with the HKMA’s policy intent, we would suggest that it be clarified in paragraphs 5.3 and 5.4 of the Draft Code that the matters set out therein are merely examples of issues that may need further investigation by a legal opinion on a case-by-case basis, depending on the nature of the covered contract and covered entity. In particular, members would greatly welcome the clarification that the HKMA does not expect legal opinions to be required as a matter of course for each covered contract or covered entity upon entry of the relevant covered contract, nor necessarily at the outset.

This would be consistent with the Consultation Conclusions that it is up to the covered entities to ensure compliance with the Stay Rules and may rely on their own internal process to satisfy themselves of the elements that go to legal enforceability of the suspension of termination rights provision.

2.2 Relevant laws

In respect of the examples of issues that may need covered in a legal opinion where circumstances arise in respect of a particular covered contract, or counterparty as set out in Paragraph 5.3 of the Draft Code, we request that HKMA consider providing additional clarification by:

- (i) replacing the reference to “applicable laws” in Paragraph 5.3(b)(ii) of the Draft Code by identifying the relevant types of jurisdictions the HKMA is anticipating would be required, such as, “the laws applicable to the jurisdiction of the counterparty and the governing law”. If there are any other jurisdictions contemplated, we would be grateful if the HKMA would list these in this paragraph; and
- (ii) amending the reference to “parties’ chosen jurisdiction” in Paragraph 5.3(c) to the “parties’ chosen jurisdiction *for submission of disputes arising under the covered contract*” to make clear the intention of the HKMA and allow market participants to be better prepared.

4. Financial Contracts

We welcome the explanations set out in Section 6 of the Draft Code in relation to the definition of “financial contract” in the Stay Rules.

Further, in the Consultation Conclusions, we note the HKMA listed several agreements that may be in scope if they fulfilled the definition of “covered financial contract” including underwriting or subscription agreements, standalone guarantees, custody agreements, trust deeds, security or credit enhancements that supports a swap agreement. It would be helpful to market participants if such comments were consolidated from the Consultation Conclusions and included as examples in Paragraph 6 of the Draft Code.



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 faithfully,

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