

BY EMAIL

19 March 2020

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 paper (CP 20.01) on Rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions under the Financial Institutions (Resolution) Ordinance (Chapter 628) published 22 January 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 Paper (CP 20.01) on the implementation of the Rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions under the Financial Institutions (Resolution) Ordinance (Chapter 628), published 22 January 2020 (the “**Consultation Paper**”).

Consistent with our mission, we are primarily concerned in this letter with the impact of the proposed implementation 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 paragraph 3.4 of the Consultation Paper) with respect to its derivatives and other financial transactions that are “*within scope contracts*” (as defined in paragraph 3.2 of the Consultation Paper).

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.

Because market participants are and will be subject to multiple rules related to contractual stays on termination rights at any time, it is crucial that the authorities take a consistent approach in

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 73 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.

each of their respective final rules to reduce the compliance burden and uncertainty about parties' rights under derivatives contracts and other financial arrangements. In this regard, while we support the HKMA's proposed approach to implementation of requirements for contractual recognition of stay provisions, we have the following views 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 Consultation Paper.

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| Q1. Do you have any views on the scope of the covered entities to be subject to the Stay Rules? |
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We agree with the approach taken by the HKMA to focus the scope of the covered entities to a Hong Kong incorporated AI (and its holding company) and we consider it would be helpful to the market to provide certain limitations and clarifications as set out below.

1.1 To explicitly exclude non-HK entities unless those that specifically fall within limb (iii) of the definition of *covered entities*

It is our understanding that generally, non-HK incorporated entities (including the respective Hong Kong branch of such entities) are not *covered entities*, unless their obligations are guaranteed or otherwise supported by a HK incorporated AI or a Hong Kong incorporated holding company of an AI. Moreover, to the extent a non-HK entity provides a guarantee to any covered entity, our understanding is that such non-HK entity is not a covered entity. Expressly stating that generally, non-HK incorporated entities (including their respective Hong Kong branch) are not *covered entities* (unless falling in limb (iii)) would provide clarity to the scope of the covered entities.

1.2 Clarification to the term “guaranteed or otherwise supported”

Limb (iii) of the definition of *covered entities* includes a group company of a Hong Kong incorporated AI, if its obligations are “guaranteed or otherwise supported” by a Hong Kong AI (or its holding company).

The reference to “otherwise supported” is quite broad. For example, is a comfort letter in scope notwithstanding it does not constitute a legal obligation of the entity which issues the letter? We would recommend that the language of “otherwise supported” be deleted so it does not cause difficult interpretation issues during implementation of the Stay Rules. If HKMA intends to capture instruments in addition to legal guarantees, we would ask that an exhaustive list of examples be set out in the rules so AIs have clear understanding of the application scope of this proposal and for clarification that absent any such credit support relationship (by way of documentation), the entities would not be scope.

1.3 Clarify that entities that fall with limb (iii) of the definition of covered entities are only in scope if the covered financial contracts includes a relevant termination right

Limb (iii) of the definition of covered entities includes non-HK incorporated group companies to the extent that covered financial contracts entered into by that group company contains obligations that are guaranteed or otherwise supported by a Hong Kong AI (or its holding company). We would submit that the reference to covered financial contracts should be clarified to mean only if the group company has obligations under a

covered financial contract **which includes** termination rights that may be subject to a stay under the HK regime. For example, a group company who has obligations under a covered financial contract (which is guaranteed or otherwise supported by a Hong Kong AI or its holding company) that, does not have termination rights, or only has termination rights which are not related to the guarantor or credit support provider, should not be in scope as a *covered entity*.

Q2. Do you have any views on the scope of the covered financial contracts to be subject to the Stay Rules? Should other types of contracts also be included in your view?

We generally agree with the proposal by the HKMA for the definition of a “*within scope contract*”, however, we would seek clarity that the following are excluded from the definition:

2.1 Exclude overnight contracts from covered financial contracts

Any overnight contracts, such as overnight repurchase agreements, should be excluded from the scope since they present low risk. Those contracts will, by their nature, if entered into on the day of resolution, mature the business day following resolution and there may not be a practical difference between termination of such overnight contract and settlement of the trade. We submit that obtaining amendments to include contractual stay provisions to overnight contracts would be inefficient and be of limited (if any) benefit.

2.2 Exclude spot contracts

Paragraph 3.14D of Consultation Paper refers to “spot or other foreign exchange agreements; currency”. Several members have sought clarity on this phrase. It would be helpful if the HKMA could issue guidance that such reference only refers to swaps on foreign exchange or rates, but not to actual foreign exchange spot contracts (that are transacted only under SWIFT messages) or any other “spot contracts” under the Securities and Futures Ordinance (Cap 571).

In any event, similar to the reasons set out in Response 2.1, we would submit that spot contracts are low risk transactions with a short settlement cycle and there would be limited (if any) benefit to include contractual stay provisions as it would be inconsistent with the purpose and nature of these contracts for counterparties to trigger termination.

2.3 Clarify that exchange traded contracts are excluded

Under paragraph 3.14C of the Consultation Paper, there is a reference to “futures” contracts. While we understand that exchange traded futures contracts would be excluded as these are contracts with a financial market infrastructure, i.e. the exchange, clarity from the HKMA on this point would be helpful to exclude these types of contracts. Further, if the intention to “futures” is to refer to synthetic futures such as OTC contracts where the underlying reference security are futures contracts, this should be set out clearly.

2.4 Exclude cash equities transactions and related customer agreements and underwriting agreements from securities contracts

We would submit that that the definition of “*securities contracts*” in *covered financial contracts* includes a substantial number of financial contracts and transaction types that do not raise resolvability concerns. For example, with respect to contracts of cash equities of securities that settle within a single settlement cycle (which typically do not have

termination rights), if these were referred to in customer agreements as part of the services the covered entity provides and such agreement includes a right to terminate the customer agreement with notice or termination for illegality of performance, theoretically these contracts would be caught. However, such contracts do not raise concerns related to exercise of termination rights.

As such, we would urge that the HKMA to explicitly exclude the following types of contracts:

- (i) contracts in connection with transactions for the purchase and sale of securities that settle within a single settlement cycle and generally settled on a delivery versus payment basis;
- (ii) customer on-boarding documentation;
- (iii) dealer or distribution agreements;
- (iv) subscription or underwriting agreements; and
- (v) warrants and similar securities,

so as to allow covered entities to focus remediation efforts on the application of the Stay Rules to contracts that are of concern to resolvability.

2.5 Clarify the “termination right” feature of a within scope contract

As has been recognized by the HKMA, one of the lessons from the global financial crisis was that the resolution or insolvency of a covered entity could trigger disruptive terminations of contracts and consequently, destabilize the financial system. Accordingly, we would submit that the focus should be on, term transactions with termination rights related to resolvability against a covered entity, particularly, over-the-counter swaps, derivatives and securities finance transactions.

As such, we would ask that the HKMA limit the reference to a contract containing a “termination right” in the definition of a within scope contract, to be a reference to:

- (i) termination rights that are exercisable by the *non-covered entity* counterparty against the *covered entity* (such that if the contract only has termination rights exercisable by the *covered entity* against its counterparty, then that contract would be out of scope); and
- (ii) only if the right to terminate is triggered by events that go to resolvability such as failing financial condition, entry into resolution proceedings or the use of resolution powers (for example, a contract that only has a clause providing for termination by mutual agreement or upon 30 days’ notice by one party to the other has a “termination right” but one that is not relevant to resolution and therefore this contract should not be considered as having a “termination right” for purpose of any final requirements issued by HKMA).

Q3. Do you have any views on the counterparties proposed to be excluded from the Stay Rules?

In respect of the list of excluded counterparties, we would suggest the following clarification and additional exclusions:

3.1: Clarify definition of financial market infrastructure

The Prudential Regulation Authority (“PRA”), after consultation with the industry, expanded the definition of excluded persons from its contractual stay rules to cover all third-country financial market infrastructure which includes exchanges, trading facilities, payment systems, settlement system or other financial market utility or infrastructure.² The PRA recognized that, otherwise, UK firms would be unlikely to be able to obtain the relevant counterparty acknowledgement from the non-EEA financial market infrastructure providers and that adopting the rules without this expansion would prevent UK firms from accessing non-EEA markets. We submit that this equally applies to HK covered entities and accordingly, would suggest clarifying that the term “financial market infrastructure” (assuming it is used as defined in the Financial Institutions (Resolution) Ordinance Cap 628) includes those from a third country.

3.2 Exclude central banks, central governments and sovereign entities

While we understand the HKMA’s interest in encouraging a level-playing field as set out in paragraph of 3.19 of the Consultation Paper, we would submit to the HKMA that “central banks”, “central governments”, “sovereign entities” and “international financial institutions” (including multilateral development banks such as the Asian Development Bank), should each also be specified as an excluded counterparty.

In particular, we note that similar contractual stay rules in the United Kingdom, Germany and Switzerland exclude counterparties that are central banks and central governments (including their agency or branch thereof). Given the nature of these entities, we would expect that resolution authorities would work directly and closely with such entities in the event of a resolution of a covered entity.

Further, experience has shown that central banks, central governments, sovereign entities and international financial institutions are unlikely to accept any changes to their standard documents. As well, these entities have typically been excluded from post-financial crisis market reform legislation such as margin requirements, including that in Hong Kong. We further note that many of these entities are themselves sensitive to financial stability concerns and the goals of resolvability and may therefore not exhibit counterparty behavior that would undermine an orderly resolution.

3.3 Exclude transactions between a clearing member and its client

We agree that counterparties which are financial market infrastructures, including central counterparties should be excluded from the Stay Rules. Given the nature of cleared transactions where the transaction between the end client and a clearing member is intended to mirror the terms between the transaction between the clearing member and the central counterparty, significant legal and practical concerns would arise for

² Policy Statement (PS25/15) Contractual stays in financial contacts governed by third country law published by the Prudential Regulatory Authority in November 2015. As set out in Section 1.4 of the PRA Rulebook.

participants in the cleared derivatives market were there a mismatch between the different “legs” of a cleared derivatives transaction. Accordingly, we would submit that Customer Cleared Transactions (as defined below) should also be excluded from the Stay Rules as well as that involving the central counterparty. Such transactions were excluded from the contractual stay rules in Switzerland.

“**Customer Cleared Transaction**” means any transaction between a clearing member of a central counterparty (or any intermediate clearing firm) and its customer (including an intermediate clearing firm) in respect of which a clearing member has entered into a related cleared transaction with the central counterparty substantially contemporaneously with entry into the customer transaction.

3.4 **Limit to transactions with counterparties that affect the systemic risk of the Hong Kong financial market**

While we applaud the HKMA for taking in a similar approach to other jurisdictions that apply contractual stay requirements, we would like to highlight that Hong Kong faces a unique position in that most standard industry documentation is governed by English or New York law, rather than Hong Kong law. As such, contractual stay requirements would subject any Hong Kong incorporated AI (or its relevant holding company) to a heavier burden of amending agreements because most of its trading documentation that is based on industry standard documentation would need to be amended to include the Hong Kong contractual stay provisions.

Therefore, we propose that the HKMA consider limiting the counterparties to only those that truly pose a systemic risk to the stability and effective working of the Hong Kong financial system such as on a materiality level.

We would propose that this would most likely to be other covered entities or entities that are part of a G-SIB group and other financial institutions with material exposures (including foreign incorporated AIs, foreign banks) (such as, for example, on the basis of counterparties who trade covered financial contracts with covered entities over a certain threshold). Further, we would submit that corporate counterparties should be excluded.

However, if the HKMA deems it appropriate to include corporate counterparties, we submit that only significant corporate counterparties with an aggregate average notional amount of HK\$60 billion (similar to that use in the HKMA margin rules) should be included as only such counterparties could potentially pose risks to the Hong Kong financial market if they choose to terminate their respective covered financial contracts with a covered entity.

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| Q4. Do you have any questions or comments on the above operational matters in relation to the Stay Rules? |
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- 4.1 While we understand that the intention is that the Stay Rules would prohibit the entry into new obligations under a within scope contract, and any material amendments to any obligations under an existing within scope contract, we would seek clarification from the HKMA that it is not the HKMA’s intention that a lack of compliance with the Stay Rules would undermine the enforceability of the *within scope contract*. In other words, a *within scope contract* entered into by a *covered entity* that does not include the appropriate contractual stay provisions in a legally enforceable manner, would not be considered

unenforceable solely because of the lack of compliance with the Stay Rules. Allowing a counterparty to walk away from its obligations under the contract due to unenforceability would not advance any of the relevant objectives related to resolvability.

Q5. Do you have any views on the proposed approach to ‘material amendment’?

We generally agree with the proposed approach in respect of “material amendment”, however, our view is that clear guidance on what constitutes “material amendment” is key:

5.1 Providing examples of non-material amendments

In the Supervisory Statement SS42/15 “*Contractual Stays in financial contracts governed by third country law*” by the PRA issued in November 2015, guidance was issued to clarify that the following were examples of a non-exhaustive list of non-material amendments for the purposes of the contractual stay rules:

- (i) Changes that occur automatically by the terms of the contract without the need for any subsequent agreement by the parties, such as roll over or renewal of the contract; and
- (ii) Administrative changes such as changes to notification, confirmation or payment details, clarification of definitions, business day conventions, or other similar technical amendments.

We would be grateful if the HKMA could also issue guidance to this effect as this provides more certainty and clarity to the application of the Stay Rules.

5.2 Effect of Stay Rules with other regulatory changes

We would seek that the HKMA clarify that any changes to the documentation of *covered financial contracts* as a result of implementing the contractual stay provisions would not be considered amendments that trigger the application of the Hong Kong margining and clearing rules.

Further, as the HKMA is aware, there are several regulatory changes that are currently being finalised that may also affect covered financial contracts. We would like to reserve the opportunity to provide comment on the potential impact of such regulatory changes on the implementation of the Stay Rules in the future.

Q6. Do you agree with phasing in the implementation of the Stay Rules by counterparty types?

We generally agree with the proposed approach to phasing in the implementation of the Stay Rules, however, we have the following views in respect of the timing and types of counterparties:

6.1 Align implementation timetable with other Asian jurisdictions

As you may be aware, the Monetary Authority of Singapore (“**MAS**”) are also looking into implementing contractual stay provisions. To reduce the operational burden for the covered entities, we would strongly urge that the HKMA coordinate with the MAS to align their respective implementation timetables so that covered entities can remediate the relevant documentation at the same time.

6.2 Increase categories for phase-in implementation

We agree with the phasing of implementation of the stay rules as this will help to minimise business impact due to resource constraints.

We further agree with prioritizing efforts in the first stage to cover G-SIBs, which corresponds to important large providers of liquidity and are likely those to which a *covered entity* in resolution would have the largest exposure. We also agree with including AIs that are *covered entities* in the first phase as these entities will themselves be implementing this proposal.

However, we would submit that other foreign banks and AIs that are not covered entities (such as a foreign AI with a Hong Kong branch), be moved to a new second phase. Although they may be familiar with resolution matters generally, such entities would still be required to analyze the issues under Hong Kong's stay requirements and may require additional time and resources to do so.

The final phase would comprise all other remaining counterparties, other than excluded counterparties.

Accordingly, we suggest the HKMA adopt an approach similar to that applied for the US contractual stay rules, with a three stage implementation timetable:

- (i) **Phase 1:** counterparties that are also *covered entities* or entities that are part of a G-SIB group
- (ii) **Phase 2:** counterparties that are financial institutions who were not caught in Phase 1 (including foreign incorporated AIs, foreign banks)
- (iii) **Phase 3:** all other counterparties (except for excluded counterparties)

This will allow for more visibility to evaluate the progress of re-documentation as each phase is implemented.

6.3 Provide definitions for categories referred to in the different phases

To facilitate market understanding of which phases a counterparty would fall into, it would be helpful if the HKMA would be able to provide definitions for the categories of counterparties included within each phase, such as the term "foreign banks".

6.4 Longer time period for phase-in implementation

It has been raised as a concern that, if the scope of counterparties includes small to medium corporate counterparties, a longer time period for phase-in implementation would be required to facilitate the education of such counterparties who may not be familiar with the Key Attributes and the FSB principles and require additional explanation as to how their termination rights will be affected by the Stay Rules. Further, as we have referred to in response 3.4 above, trading documentation that is based on industry standard documentation used by the covered entities in Hong Kong are often governed by a foreign law such as English law or New York law rather than Hong Kong law, which will significantly increase the compliance burden for covered entities compared to the burden for entities covered by similar regulations in other jurisdictions.

As such, a longer time period for phase-in implementation would be appropriate to reduce the operational burden on the relevant covered entities. If the HKMA agrees to a three phase implementation as set out in Response 6.2, our members have suggested a timeline of 18 months for each of Phase 1, Phase 2 and Phase 3 as appropriate.

Q7. Do you have any views on the expectations on AIs' internal capabilities to support resolvability and the effective application of temporary stay in a resolution?

No comment.

Q8. Do you have any views on the periodic reporting and information requests in relation to the Stay Rules?

We have the following views in respect of reporting and information requests:

8.1 Requirement for legal opinions

We would like to draw the HKMA's attention to the approach taken by the PRA in respect of legal opinions in respect of enforceability. The PRA does not require legal opinions as a matter of course although the PRA does expect UK firms to satisfy themselves that they are in compliance with the rules.³

As such, our view is that the HKMA should only request sight of legal opinions as referred to in paragraph 4.12 of the Consultation Paper, to the extent these have been obtained; and if none, for covered entities to provide supporting documentation to demonstrate legal enforceability. While, as a matter of practice a covered entity may wish to obtain an opinion in order to demonstrate that the counterparty's agreement to the contractual stay provision is enforceable, if a firm has otherwise come to the conclusion that that the provisions are enforceable, we would submit that this should be an decision for the firm. This would appear to be consistent with the HKMA's view that the onus is on the AI to ensure its compliance with the Stay Rules.

8.2 Status reporting

The industry recognises that the HKMA would want to have visibility of the financial contracts of the covered entities in order to facilitate the monitoring of compliance with the Stay Rule. To this end, we would expect the main concern of the HKMA upon implementation would be to understand the level to which there are financial contracts not covered by the Stay Rules (whether due to out of scope, or non-compliance due to lack of engagement from counterparties) and the progress to which covered entities are achieving compliance.

As such, we would suggest that instead of periodic reporting, any reporting should be on ad hoc, upon request basis, providing the HKMA with an update from the covered entities as to the progress of documentation that are being covered by the contractual stay rules.

³ Policy Statement (PS25/15) Contractual stays in financial contracts governed by third country law published by the Prudential Regulatory Authority in November 2015 and section 3 of the Supervisory Statement SS42/15 "Contractual Stays in financial contracts governed by third country law" by the Prudential Regulation Authority issued in November 2015

This would reduce the operational burden on the covered entities and allow them to focus their resources on compliance with the Stay Rules.

8.3 **Development of reporting templates and implementation timing**

The industry would welcome a consultation on the requirements for status reporting to have clarity on the requirements. In respect of the key features listed in paragraph 4.15, additional guidance and discussion would be helpful to the market for example, some may be quite onerous, depending on the volume of in-scope documentation, and where there are bespoke or negotiated contracts. As such, further consultation would be helpful to understand the purpose and intention of the HKMA's requirements.

In addition, once the requirements for the templates have been finalised, sufficient time should be provided to allow covered entities to enhance their reporting systems to cater for such new reporting requirements.

Q9. Do you have any views on potentially extending the coverage of the Stay Rules so that relevant contracts may be bound by the ongoing stay provision, in addition to the temporary stay provision?

9.1 **No view on extending coverage**

While we note that certain regimes required their contractual stay provision to cover both the (equivalent of the) ongoing and temporary stay provision, we don't have any view as to whether such coverage should be extended.

9.2 **Align timing of implementation**

However, should the HKMA intend to extend the coverage of the contractual stay provision to cover the ongoing stay provision, our view is that any contractual temporary stay provision should be implemented together with any contractual ongoing stay provision. This would be similar to the approach taken in the United Kingdom and as such, the market only needs to undertake remediation once which reduces the operational burden on covered entities. Otherwise it may be quite onerous and costly for covered entities to undertake remediation on two separate occasions.

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.**