ISDA Safe, Efficient Markets

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By E-mail and Courier

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29 January 2016

Dear Sirs and Madams,

Consultation on Non-centrally Cleared OTC Derivatives Transactions - Margin and Other Risk Mitigation Standards

Introduction

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] and the Asia Securities Industry & Financial Markets Association ("**ASIFMA**" [2], and together with ISDA, the "**Associations**") welcome the opportunity to provide comments on the Consultation Paper (CP15.02) on Non-centrally Cleared OTC Derivatives Transactions - Margin and Other Risk Mitigation Standards ("**Consultation Paper**") issued by the Hong Kong Monetary Authority ("**HKMA**") on 3 December 2015. Individual members of the Associations may have their own views on the Consultation Paper, and may therefore provide their comments to the HKMA directly.

The Associations and their members strongly support the goals of strengthening resiliency in the non-centrally cleared derivatives market by establishing margin requirements. While the

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 850 member institutions from 67 countries. These members comprise of 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 web site: www.isda.org.

[2] ASIFMA is an independent, regional trade association with over 80 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

Consultation Paper is an important step forward for establishing a detailed set of requirements for the collection and protection of margin in the OTC derivatives market in Hong Kong, it is important that the HKMA continues to focus on the practical issues relating to the implementation of any rules and the overall purpose of reducing systemic risk. This submission is intended to continue the constructive ongoing dialogue between the HKMA and derivatives market participants and to focus on the practical concerns and risks surrounding the implementation of the margin rules, including the harmonisation of such rules with those of foreign regulators. We hope that our comments in this submission will assist the HKMA with its preparation of the new margin rules for non-centrally cleared OTC derivatives in Hong Kong ("**Margin Rules**").

We have divided this submission into 4 parts. Part 1 sets out our comments on the specific topics raised in relation to margin standards in the Consultation Paper. Part 2 sets out our further comments on margin standards as detailed in Sub-sections 1 to 3 (except Subsection 2.2) of the draft SPM module. Part 3 sets out our comments on the proposed risk mitigation standards outlined in Sub-sections 2.2, 4 and 5 of the draft SPM module. The final part 4 sets out our comments on the Appendices of the draft SPM module.

Part 1: Margin Standards – Specific Topics in Consultation Paper

In order to ensure the efficient functioning of the global derivatives market and to eliminate operational risks, we strongly support Hong Kong adopting rules that are harmonised and consistent across jurisdictions, and are broadly comparable to the final policy framework that establishes minimum standards for margin requirements for non-centrally cleared derivatives as proposed in the paper (the "**BCBS/IOSCO Paper**") issued in March 2015 by the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**"). Otherwise, the market will become increasingly fragmented and its liquidity impaired as counterparties struggle to meet inconsistent margin requirements of various international regulators. Moreover, for margin requirements, inconsistent rules will potentially be incompatible in practice. International consistency will also prevent regulatory arbitrage and lead to a more level playing field between competitors in different jurisdictions.

In this respect, we note that the HKMA has made a detailed consideration of the interaction between the draft SPM module and margin rules of other jurisdictions. We are grateful for the HKMA's approach and further note that the HKMA has tried to be largely consistent with the margin framework set out in the BCBS/IOSCO Paper.

a. Comparability assessments and guaranteed transactions

- **Outcome-based approach when conducting comparability assessments**

Outcome-based approach

We agree with the HKMA's outcome-based approach for comparability assessments and note that, under Sub-section 2.3.5, the HKMA intends to adopt an "element-by-element" approach in evaluating a jurisdiction's margin standards against the key principles set out in the BCBS-IOSCO margin framework. However, we also note that, under Sub-section 2.3.4, the assessment will be based on whether the outcomes of foreign margin standards are comparable to those sought under the Margin Rules. The aforementioned Sub-sections seem to be inconsistent as

foreign margin standards may be compliant with the BCBS-IOSCO margin framework and yet may have different rules with different product and entity coverage which are not comparable to the Hong Kong margin standards. Given the different approaches of national regulators in implementing their margin frameworks, it is submitted that the comparability assessment should be against the BCBS-IOSCO margin framework, and not against the draft SPM module.

We ask the HKMA to employ an open and transparent process in considering applications for comparability assessments.

Comparability assessments should be made available to all AIs and with sufficient notice prior to the implementation date

We note that the regulators in the US have issued the final margin rules and the EU, Japan, Canada, Switzerland and Singapore have proposed margin requirements based on the BCBS/IOSCO Paper, and other jurisdictions (e.g. Australia) are looking to issue similar rules in the near future. We recommend that, with respect to jurisdictions that adopt margin requirements that conform to the BCBS/IOSCO Paper ("**Interim Jurisdictions**"), the HKMA performs a comparability assessment and confirms that substituted compliance would be available to the applicable covered entities. Such treatment would be a fitting recognition of the extensive consultative process by which the BCBS/IOSCO Paper was developed. In addition, we suggest that such comparability assessments be made as soon as possible after the Margin Rules are finalised and before the phase-in dates of the Margin Rules. Finally, we suggest that HKMA publishes in advance a clear timeline for the projected comparability assessments that will be made. This will greatly facilitate the implementation of the Margin Rules.

After the rules are final, it will be necessary for market participants to have sufficient time to allow for the legal, operational, risk management and technological enhancements necessary to effectively and safely implement these new regulations. In particular, market participants will need time to build, test and receive approvals for IM models that are very new to the market. The regulators will also need time to formalise the regulatory approval processes for IM models across multiple jurisdictions. To the extent that market participants are proposing to outsource certain functions in relation to the margin requirements, such as the calculation of IM and the calling of IM, market participants may need to complete outsourcing applications/filings. They would need time to complete such applications or filings, and the regulators would need time to consider them. Moreover, the ability of the market to make the necessary enhancements will depend on the outcome of the comparability assessments, and this could further slow the implementation process.

In light of the above factors, if the HKMA is not able to make such a determination as soon as a jurisdiction issues final rules based on the BCBS/IOSCO Paper, and in any event before 1 June 2016, then we ask the HKMA to make a two-year transitional comparability determination during which the Margin Rules will not apply to in-scope derivatives transacted with covered entities of Interim Jurisdictions.

We also propose that the HKMA makes its comparability determinations and the considerations it takes into account in coming to such determinations publicly available so that they can be relied upon by all AIs, and that the HKMA maintains an updated list of comparable jurisdictions, rather

than requiring each AI to make a separate request (and to provide supporting information) for comparability.

HKMA not to have the ability to impose additional terms and conditions on comparability determinations (Sub-section 2.3.7)

We note that the draft SPM module gives the HKMA the ability to impose additional terms and conditions as the HKMA deems appropriate, even when a positive comparability determination has been made, to bring about outcomes sought under the Margin Rules. This will create bespoke margin requirements and unnecessarily add to the compliance burden. Given the tight implementation timeline we are facing and the complexity of implementing the margin requirements in cross-border transactions, we request that this be removed.

- **Introduction of partial compliance in addition to substituted compliance**

ISDA commends the HKMA for trying to find a solution for the cross-border issues. However, the industry is concerned that the partial compliance proposal will add another layer of complexity to the implementation of the proposed Margin Rules. Market participants need clarity and implementable rules and this is best achieved through substituted compliance. Therefore, ISDA strongly opposes the introduction of partial compliance, which is inconsistent with the BSBC-IOSCO framework. As a matter of principle, once a comparability assessment has been made for a jurisdiction, full (and not partial) substituted compliance should be made available. In this respect, we note that paragraph 7(b) of the BCBS/IOSCO Paper states that where a transaction is "*subject to two sets of rules (duplicative requirements), the home and the host regulators should endeavour to (1) harmonise the rules to the extent possible or (2) apply only one set of rules, by recognising the equivalence and comparability of their respective rules.*" ISDA members are of the view that partial compliance is too complex and would result in the posting and collecting of margin being subject to different regulatory regimes, which adds to the complexity of complying with margin requirements.

It is also not clear to us how the proposed partial compliance would work and whether it would be of any use in practice for overseas incorporated AIs. In this respect, we note that paragraph 2.1.6 of the draft SPM module does not tie in with paragraph 2.1.9 (i). For example, if the Hong Kong branch of an EU bank were facing a locally incorporated AI, the locally incorporated AI would be required to comply with the Margin Rules except that margin posted by the local AI may follow the requirements in the EU instead of the provisions set out in Sub-sections 3.7 to 3.9 of the draft SPM module (see paragraph 2.1.6), whereas the EU bank would be permitted to follow the EU margin requirements in all respects except it would need to post in accordance with Sub-section 3.7 to 3.9 of the draft SPM module (see paragraph 2.1.9). Therefore, even if the EU bank could apply the EU minimum transfer amount for posting to locally incorporated AI, the locally incorporated AI would not be able to accommodate such a request as it would be required to comply with Sub-section 3.6 (Minimum transfer amount) of the draft SPM module.

In addition, in relation to substituted compliance, ISDA requests that HKMA confirm our understanding of how substituted compliance would operate in the following examples:

(1) An overseas AI with its head office in the EU is required to follow the margin rules of its home jurisdiction and the HKMA has issued a comparability assessment in respect of that jurisdiction. The AI books its transactions in Hong Kong and transacts with a covered

entity that is a non-financial counterparty for the purposes of EU rules (an NFC-). The relevant transaction falls within scope of the Margin Rules. Under the EU margin rules, all trades with NFC-s are out of scope and the AI is not required to exchange margin in respect of such transaction. Accordingly, based on substituted compliance under Sub-section 2.1.10, the AI may follow the margin rules of its home jurisdiction (instead of those of Hong Kong) and need not exchange margin with such covered entity.

(2) An overseas AI with its head office in the US is required to follow the margin rules of the US and the HKMA has issued a comparability assessment in respect of the US. The AI books its transactions in Hong Kong and transacts with a covered entity that is an entity that qualifies for an exemption under the US interim final rule that exempts commercial end users and small banks from margin requirements (e.g. the covered entity is a small bank that uses swaps to hedge or mitigate commercial risks). The relevant transaction falls within scope of the Margin Rules. Under the US margin rules, all trades with such exempt counterparties are out of scope and the AI is not required to exchange margin in respect of such transaction. Accordingly, based on substituted compliance under Sub-section 2.1.10, the AI may follow the margin rules of the US (instead of those of Hong Kong) and need not exchange margin with such covered entity.

- **Application of the margin framework to guaranteed transactions; level of proposed threshold as specified in Sub-section 2.1.13(d) of the draft SPM module**

ISDA requests the HKMA to remove any margin requirements on guaranteed transactions under Sub-sections 2.1.12 to 2.1.15 in the draft SPM module. First, the guaranteed entity may not be an affiliate of the guaranteeing AI and in such a case, the guaranteeing AI is not in a position to "ensure" that the guaranteed entity follows the Margin Rules. In addition, if a party has already provided a guarantee as a credit support for its obligations, such guaranteed entity should not be requested to post margin to collateralise its exposure covered by the guarantee. Requiring a guaranteed covered entity to post margin in respect of guaranteed transactions according to the Margin Rules will lead to credit support being provided twice in respect of the same exposure, which is not economically viable.

We would like to clarify with HKMA the rationale of introducing these provisions. If the concern is that AIs may try to evade the margin requirements by booking their non-centrally cleared OTC derivatives transactions at a guaranteed offshore subsidiary, the policy objective will be best achieved by having the relevant overseas regulator of the subsidiary imposing margin requirements directly on the subsidiary. In this respect, we note that all major financial centres have proposed margin requirements. Imposing the Margin Rules on a covered guaranteed entity incorporated outside Hong Kong is extra-territorial, in particular when it comes to guarantees issued by an overseas-incorporated AI. Although Sub-section 2.1.13(c) makes it clear that this requirement only applies to guarantees booked in the Hong Kong branch of an overseas-incorporated AI, we believe that the home authority of the AI or the subsidiary is better placed to regulate the trading activities of the overseas subsidiary whose obligations are guaranteed by the AI.

If margin requirements were to be imposed on guaranteed transactions, ISDA requests that Sub-section 2.1.13(b) be extended to also refer to the situation where the guaranteed covered entity is already required to comply with the margin standards of the home jurisdiction of its counterparty.

In such a situation, the guaranteeing AI would not have to comply with the provisions of Sub-section 2.1.14.

b. Transactions with counterparties in non-netting jurisdictions

- **Calculation and exchange (VM) / collection (IM) on a gross basis (i.e. transaction-by-transaction)**

The proposed gross margining requirements are of significant concern for AIs in Hong Kong which frequently face covered entities incorporated in non-netting jurisdictions such as Mainland China.

The risk of an AI not getting back the VM it has posted in the event of a counterparty's default is the same as that applicable to IM, and the risk arising from "cherry picking" by an administrator applies to IM and VM equally. Therefore, the reasons that an AI should not post IM apply equally to why an AI should not post VM.

Requiring an AI to post VM on a gross or transaction-by-transaction basis would mean that the AI is always over-collateralising VM and hence increases counterparty risk. This has the effect of exposing the AI which is facing a covered entity in a non-netting jurisdiction to greater risk than an AI facing a covered entity in a netting jurisdiction. In addition, requiring each party to post gross VM exposes the counterparties to greater settlement risk and daylight (or Herstatt) risk when posting multiple currencies.

Further, imposing margin requirements on non-centrally cleared derivatives transactions with covered entities from non-netting jurisdictions would severely limit such transactions and cause significant disruptions in financial markets, preventing hedging and financial flows between Hong Kong and non-netting jurisdictions. Posting margin on a gross basis would also lead to severe liquidity issues.

As a practical concern, there are significant doubts as to whether counterparties from non-netting jurisdictions would ever agree to post IM on a gross basis (i.e., on a transaction-by-transaction basis) and especially when they are required to post IM on a gross basis but are not receiving any IM from AIs in Hong Kong.

In addition, ISDA requests the HKMA to clarify what is meant by calculating margin on a "gross basis" (or a "transaction-by-transaction basis") under Sub-section 3.2.2. We note that under the BCBS/IOSCO Paper and Sub-section 3.2.1 of the draft SPM module, IM is always calculated on a gross basis – there is no netting of IM amounts owed by the two parties. When an AI trades with a covered entity located in a non-netting jurisdiction, does the requirement to collect IM "on a gross basis with respect to the transactions with that covered entity, i.e., *on a transaction-by-transaction* basis" means that no offset (e.g., offsets within the same asset classes under B.3.4 of Appendix B) is permitted at all for AIs using an internal model to calculate the IM? What would it mean for AIs using Table A.1 in Appendix A to calculate the IM?

ISDA also requests HKMA to clarify what treatment would be given to the Hong Kong branch of an overseas-incorporated AI of which the home jurisdiction is a non-netting jurisdiction. In particular, when such branch faces an AI incorporated in Hong Kong, it would be required to exchange margin with the AI under the draft SPM module. However, the locally incorporated AI

would not need to post IM to a counterparty incorporated in a non-netting jurisdiction under Sub-sections 3.2.1.[3] This means that the AI incorporated in the non-netting jurisdiction would not be able to comply with the draft SPM module when it cannot collect IM from the locally incorporated AI. ISDA thus would be grateful if the HKMA could clarify how the proposed Margin Rules would operate in practice to an AI incorporated in a non-netting jurisdiction.

- **Any alternative approaches the HKMA should consider and why. Would the introduction of a *de minimis* threshold be appropriate? If so, what would be a sensible threshold level?**

De minimis threshold

ISDA requests the HKMA to consider a *de minimis* threshold of 5% below which no margin would be required in respect of trades with covered entities in a jurisdiction in which netting, collateral or third party custodian arrangement may not be legally enforceable ("**Threshold Jurisdiction**")[4]. We note that without enforceable netting arrangements, there is the risk that the administrator of an insolvent counterparty will "cherry-pick" from posted collateral to be returned in the event of insolvency and that an AI may not be able to effectively foreclose on the margin in the event of a counterparty default. Further, the lack of enforceable third party custodian arrangements would expose the posting party to the insolvency risk of the collecting party, and the lack of enforceable collateral arrangements would increase legal and operational risks without serving the purpose of reducing counterparty credit risk.

We recommend that the threshold be calculated as follows:

(i) the aggregate gross notional amount of non-centrally cleared derivatives entered into by an AI with covered entities in Threshold Jurisdictions that are subject to the Margin Rules, excluding those derivatives entered into prior to the entry into force of the relevant phase-in dates ("**Legacy Derivatives**"); divided by

(ii) the aggregate gross notional amount of non-centrally cleared derivatives entered into by the group to which such AI belongs (including entities that are not covered entities).

Such proposed threshold would: (i) exclude Legacy Derivatives and any new trades that are not subject to the Margin Rules, allowing firms to build up their exposure to counterparties from non-netting jurisdictions until the prescribed limit has been reached; (ii) be set at a level that is high

[3] We note that Sub-sections 3.2.1 uses the word "located" in a non-netting jurisdiction rather than "incorporated". However, we read "located" as referring to the place of incorporation because the "cherry picking" risk under insolvency laws discussed in paragraph 20 of the Consultation Paper equally applies to transactions with Hong Kong branch of an AI incorporated in a non-netting jurisdiction.

[4] Please note that the definition of "Threshold Jurisdiction" is not limited to jurisdictions where close-out netting is not enforceable. It also covers the jurisdictions where the industry standard collateral documentation is not enforceable or jurisdictions where parties have to use a local custodian to hold the collateral and the legal infrastructure does not support a custodian arrangement which would satisfy the Margin Rules in Hong Kong.

enough to accommodate the difference in the relative sizes of different banks' balance sheets, e.g. a bank's exposure to counterparties from non-netting jurisdictions may be relatively small due to its large balance sheets while still appearing "large" in absolute terms; (iii) be sensitive to market developments, e.g. when mandatory clearing is first implemented, the aggregate gross notional amount of non-centrally cleared derivatives may reduce, thereby making the non-netting exposures relatively larger; and (iv) be set with a buffer to accommodate short-term fluctuations.

In Hong Kong, AIs are more likely to face counterparties from non-netting jurisdictions and an appropriate threshold level should be set accordingly to take this into account. While these non-centrally cleared derivatives are important for individual AIs and covered entities, the 5% threshold would ensure that the exempted transactions are quantitatively immaterial to the AI.

We strongly encourage the HKMA to engage in discussions and consult with market participants on the manner in which the thresholds should be determined.

Non-netting counterparties

In certain jurisdictions, netting may generally be considered enforceable and yet certain types of entities may be subject to local insolvency or other regulatory regimes that would render netting against such entities unenforceable or subject to conditions. Conversely, netting may be legally enforceable against certain types of entities located in a non-netting jurisdiction. Some members thus request the HKMA take this into account and consider prescribing the margin requirements by reference to types of non-netting entities, rather than non-netting jurisdictions.

c. Transactions with counterparties not subject to margin standards

- **Exchange of VM and collection of IM when transaction with counterparties located in non-margin jurisdictions**

We agree with HKMA's analysis that counterparties not subject to margin requirements (or with a different implementation schedule for margin requirements) may not have the appropriate infrastructure in place to handle and segregate IM collateral properly and that an AI would be exposed to additional risk if it cannot be assured that posted collateral is sufficiently protected against the default of its counterparty. In addition, we also note that these counterparties, in particular smaller banks and non-bank financial institutions in Asian emerging markets often do not have infrastructure in place to calculate, exchange and manage VM. Imposing margin requirements on transactions with counterparties located in non-margin jurisdictions will not only expose AIs to additional risk but also severely limit such transactions and prevent hedging and financial flows between Hong Kong and those jurisdictions. We therefore strongly urge the HKMA to remove any margin requirements on transactions with counterparties in non-margin jurisdictions. In case the HKMA is concerned with AIs building up too much credit exposure to counterparties in non-margin jurisdictions if the Margin Rules are not imposed on those transactions, we would propose that those transactions be included in the 5% de minimis threshold discussed above. As mentioned above, the 5% threshold would ensure that the exempted transactions are quantitatively immaterial to the AIs.

Absent an exemption for counterparties from non-margin jurisdictions, the margin requirements will disrupt established trading relationships, skew competition in favour of local dealers or those

supervised by jurisdictions that do not impose their margin regulations in the affected jurisdictions, and curtail hedging and financial flows to those jurisdictions.

- **Exchange of margin when transacting with locally incorporated covered entities other than AIs that are not subject to margin standards (posting of IM would only be needed as long as the AI is confident that the counterparty's arrangement sufficiently protect the posting AI in the event that the collecting party enters insolvency)**

It is not entirely clear to us what scenarios this requirement is meant to cover. Practically speaking, it is burdensome for the AI to have to monitor on an on-going basis whether the covered entity's segregation arrangements adequately protect the posting AI in the event of insolvency of the covered entity. In addition, as a practical concern, there are significant doubts as to whether those covered entities would ever agree to post IM to AIs but are not receiving any IM from AIs. The potential asymmetry of this requirement would disrupt established trading relationships and potentially curtail hedging activities.

ISDA requests that the HKMA clarify what criteria an AI could use to determine whether its counterparty's arrangements sufficiently protect the posting AI in the event its counterparty enters insolvency. This requirement seems subjective and unclear. If the criteria are not sufficiently objective, there is a greater risk of disputes between an AI and its counterparties.

Given the practical concerns and uncertainty, we submit that AIs should not have to post or collect IM from local covered entities (other than AIs) that are not subject to margin standards.

d. Definition of financial counterparties

- **Any alternative definitions the HKMA should consider and why. Would the introduction of a threshold be appropriate? If so, what would be a sensible threshold level?**

As a general point applicable to the definitions of financial counterparty and significant non-financial counterparty, ISDA understands that AIs in Asia face a practical difficulty in obtaining representations from their counterparties as to their status whether by adhering to protocols or by returning representation letters. Very often, counterparties are slow to confirm their status or fail to respond, leading to a potential tradability issue. ISDA would encourage HKMA to harmonise the applicable definitions as far as possible with other jurisdictions and define the terms by reference to objectively available sources (e.g. globally significantly important bank or swap dealer pursuant to CFTC rules in the U.S.) such that existing outreaches can be leveraged upon.

Definition has wide extraterritorial effect

We encourage the HKMA to adopt an approach that limits the extra-territorial effect of the Margin Rules. Where both parties are incorporated overseas, margin requirements should only apply if both parties book their trade into their Hong Kong branch.

Structured finance vehicles

ISDA urges the HKMA to limit financial counterparties to regulated financial entities and specifically to exclude special purpose entities and remove limb (ix) of the definition of "financial counterparty".

Structured finance transactions in which the swap counterparty is either secured by a senior claim on pledged collateral held by a special purpose vehicle ("**SPV**") or is otherwise entitled to a senior priority claim on the assets of the SPV do not pose systemic risk to the broader market. Such credit support arrangements protect swap counterparties without use of VM or IM as required under the draft SPM module. Further, SPVs are established as bankruptcy-remote entities with a limited number of creditors so that a swap counterparty's position as a senior secured creditor should give the swap counterparty very strong rights with respect to the SPV's assets.

In addition, SPVs do not have ready access to liquid collateral that can be transferred back and forth to a counterparty in the manner generally required under the draft SPM module. SPVs would potentially be forced to exit the derivatives market entirely if they had to post or collect IM and VM in the manner contemplated by the draft SPM module and such a forced departure would impede structured finance transactions and cause significant harm to securitization and other financial markets.

End user exemption

ISDA would like to request that the HKMA include an end user exemption in the same way as Japan and the US. Such end users would include non-financial counterparties and smaller financial institutions with total assets under a certain threshold using swaps to hedge their risks. ISDA believes that such entities would not pose a systemic risk to the market and imposing margin requirements could disincentivize such entities using derivatives to hedge their risks.

Entity that carries on a business outside Hong Kong that requires authorization, license or registration if it were to carry on the same business in Hong Kong

ISDA requests that limb (viii) of the definition of "financial counterparty" be removed. AIs will have no way of knowing whether a covered entity fulfils such requirements and whether it would have been required to be licensed, authorized or registered if it had been carrying on business in Hong Kong. Ascertaining this point will require AIs and covered entities to undertake onerous legal due diligence. If this requirement is not removed, AIs should be able to rely in good faith on representations given to them by their counterparties, including in industry standard disclosure documents, as described in our comment on Sub-section 2.4.7 in Part 2(d) (*Thresholds*).

Meaning of 'sovereign'

ISDA requests that the HKMA clarify that such definition includes sovereign wealth funds.

Foreign incorporated subsidiaries of locally incorporated AIs (Sub-section 2.1.4)

The draft SPM module permits the HKMA to bring a foreign incorporated subsidiary of a locally incorporated AI into scope if it transacts in a significant amount of non-centrally cleared derivatives relative to the AI as a whole. While we acknowledge the concerns of the HKMA, we would like to submit that the ability of the HKMA to potentially bring a foreign incorporated

subsidiary of a locally incorporated AI into scope undermines the legal certainty of the exemption. In addition, a foreign incorporated subsidiary will be covered by the margin requirements in that foreign jurisdiction. Requiring a foreign subsidiary to comply with the Hong Kong Margin Rules is extra-territorial and would give rise to potential regulatory conflicts.

If the HKMA were to retain this provision, ISDA requests that the HKMA provide guidance as to what the "significant amount" threshold is and whether the HKMA would notify the applicable entity and AI once the threshold has been exceeded.

AIs incorporated outside Hong Kong (Sub-section 2.1.8 – 2.1.9)

An AI will not necessarily know whether its counterparty, if an AI, is booking a trade in Hong Kong. ISDA requests the HKMA to clarify that an AI may rely in good faith on representations made by its counterparty, including in industry-standard self-disclosure documents. In this respect, please see our comment on Sub-section 2.4.7 and footnote 19 in Part 2d. (*Thresholds*).

Investment Funds

HKMA should ensure the treatment of funds is aligned with other global regulators. Funds should be considered in-scope to the extent they are covered entities. Clear guidance should be provided on when different funds managed by a single investment advisor can be considered separately, so as not to improperly capture those funds as a single group for the purpose of applying the draft SPM module (e.g. for the application of the IM threshold to a "group").

<u>Part 2: Margin Standards – Draft SPM Module</u>

a. Broad product set should be permitted for margin calculation

ISDA has written to BCBS, IOSCO and the regulators in the US, EU and Japan ("Product Set Letter") addressing the need for ISDA members to have the flexibility to use a product set that is broader than the minimum product set required by applicable regulations. The Product Set Letter is attached as Appendix 2 to this submission.

The scope of products subject to proposed margin requirements is not consistent across jurisdictions. For cross-border OTC derivative transactions, if two parties have to use two different regulatory product sets to calculate margin, there will be two different margin determinations using the two sets of rules. Dealers would need to develop systems that could simultaneously run two sets of margin calculations based on two different product sets. These same issues also arise within one jurisdiction if two different sets of margin rules apply.

ISDA would like to request that its members have the option of using the broad product set in their implementation of applicable margin rules, including development of models and supporting systems. To the extent that substituted compliance does not apply to trades, ISDA and its members need the flexibility to adopt broad product sets that include the various definitions of derivatives that apply to each of their counterparties in their respective jurisdictions. This is necessary because it is very challenging, in the available time frame, to build systems that can determine margin based on a different product set for each party to a swap. In this respect, we note that the revised margin requirements in Japan allow out-of-scope OTC derivative

transactions to be included in the in-scope portfolio for the purpose of calculating the regulated VM and IM, as long as the in-scope entities consistently take such approach on an ongoing basis.

Under our proposal, for any counterparty pair, the parties may choose to use a broader product set than the set required by either party's applicable regulation. Netting within this broad product set will be permitted to the same extent, and under the same conditions, that would apply to netting of products subject to the Margin Rules. The broad product set will be used for VM and/or IM and will include derivatives as defined by the rules applicable to each counterparty in its respective jurisdiction.

Please refer to the Product Set Letter for our detailed discussions on this point.

b. Covered products – derivatives instruments

Physically-settled FX forwards and swaps

ISDA welcomes the exemption of physically-settled FX forwards and swaps from the IM requirements in the draft SPM module. However, the physically-settled FX swaps and forwards are within scope of the VM requirements under the draft SPM module. ISDA notes that physically-settled FX forwards and swaps are exempted from both the IM and VM requirements set out in the BCBS/IOSCO Paper and the final US margin rules as well as proposals in Canada, Singapore and Japan. ISDA requests that Hong Kong be consistent with the majority of the jurisdictions and exempt physically-settled FX forwards and swaps from the draft SPM module.[5] We note that a few members have expressed a preference for the Hong Kong rules to be aligned with the proposed EU margin rules.

Physically-settled commodity forwards should be exempt from the margin requirements

We request that the HKMA exempt physically-settled commodity forwards from the draft SPM module. We note that those trades are not subject to the final margin rules in the US and the proposed rules in Japan.

Amended trades, novations and new trades resulting from portfolio compressions should be exempt from margin requirements

The draft SPM module proposes that the IM and VM requirements shall only apply to new contracts entered into after the relevant phase-in dates, so that Legacy Derivatives are excluded. We note that, under footnote 17, genuine amendments to existing derivatives contracts will not

[5] We note BCBS/IOSCO Paper states that in developing variation margin standards for physically settled FX forwards and swaps, national supervisors should consider the recommendations in the 2013 *BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions* (the "**BCBS Supervisory Guidance**") which requires VM for physically-settled FX swaps and forwards. We do not oppose VM for physically-settled FX swaps and forwards. Rather, we intend to ask the HKMA to better align with the majority of jurisdictions (i.e., all but the EU) to exclude physically-settled FX forwards and swaps from the scope of the full set of VM requirements in the draft SPM module, and instead address VM for these products via adoption of the BCBS Supervisory Guidance.

qualify as a new derivatives contract. We seek the HKMA's confirmation that the following fall within Legacy Derivatives or are not subject to margin requirements:

(i) trades amended in a non-material manner (or arising from life-cycle events): so long as an amendment does not create any new significant exposure under the Legacy Derivative, the act of amending the derivative (or the occurrence of a life-cycle event) should not bring it within the scope of the draft SPM module;

(ii) trades created from novation: a novation of a Legacy Derivative that has all the same material terms as the Legacy Derivative (except the new counterparty) is a continuation of the Legacy Derivative, and should be exempt from the Margin Rules on the same grounds that Legacy Derivatives are exempt; and

(iii) new derivatives that result from portfolio compression: portfolio compression is designed to reduce complexity in the derivatives market and has been generally encouraged by regulators. However, if the result of portfolio compression of Legacy Derivatives would cause the resulting trades to be subject to margin requirements, it would severely reduce the incentives of market participants to run portfolio compression. In addition, excluding such new trades would be consistent with the HKMA's proposals, since the exposure with respect to the new derivatives would be materially similar to that under the Legacy Derivatives, which are excluded from the Margin Rules.

AIs should have right to include Legacy Derivatives in margin calculations and models.

Notwithstanding the above, we request that the HKMA confirm that AIs would have the discretion to include Legacy Derivatives in their margin calculations and models, provided such entity does not engage in "cherry picking" of particular trades. Parties should have the option to document their Legacy Derivatives under the same credit support annex (CSA) as new transactions entered into after the relevant phase-in dates, so that all of the transactions entered into under that CSA will be subject to the same margin rules.

Indirectly cleared derivatives (Sub-section 2.1.2(ii))

We wish to clarify whether the term "non-centrally cleared derivatives" includes indirectly cleared derivatives involving a clearing member, a non-member customer as well as such customer's own client. The Margin Rules should not be imposed on indirectly cleared derivatives. Transactions cleared indirectly through a clearing member of a CCP are still cleared transactions subject to the margin requirements of the CCP so the Margin Rules should not apply to those transactions.

c. Intragroup transactions *(Sub-sections 2.1.16-2.1.17)*

Requirements for intragroup exemption

In relation to intragroup transactions, ISDA wishes to clarify what "group wide supervision by the HKMA or supervisory authorities in other regions" in Sub-section 2.1.16(i) means. Bank groups are prudentially supervised but the applicable regulator does not directly subject subsidiaries to supervision. ISDA requests that the HKMA clarify that conventional regulation of bank groups would be sufficient to satisfy this requirement.

In addition, it is unclear what "group-wide integrated risk management function" in Sub-section 2.1.16(ii) means. Unless standards are clearly defined, there could be different approaches taken by entities. We suggest that this point be removed.

We also request HKMA clarify that transactions will not be subject to the SPM module retrospectively when HKMA decides to bring intragroup transactions in scope pursuant to Sub-section 2.1.17 of the SPM module.

Discretionary power to subject intragroup transactions to margin requirements

More importantly, the discretionary power of the HKMA to bring intragroup trades into scope of the Margin Rules greatly undermines legal certainty of the margin framework. It is well recognised that inter-affiliate swaps provide an important risk management role within corporate groups and that, rather than increasing risk, inter-affiliate swaps allow entities within a corporate group to transfer risk to the group entity best placed to handle it. [6] Further, the times that HKMA is likely to invoke this power is at times when the group is in financial distress. Any such action taken at this time would be inherently pro-cyclical and would require the group to fund liquidity at a time of market stress. ISDA believes this would have a counter-cyclical and counter-productive effect on the market.

Another fundamental point to note is that margining intragroup trades would significantly increase costs (as entities would have to set aside margin for the intragroup trade as well as the trade with third parties) without a corresponding benefit in the mitigation of contagion risk. Intragroup derivative transactions are generally not a factor for the transmission of systemic risk beyond a corporate group. They also typically do not increase group-wide leverage or systemic risk. However, if such transactions had to be margined, the group would suffer an extra liquidity burden.

The cost of funding this intragroup margin could discourage the management of risk through intragroup derivative transactions. Discouraging these transactions would increase group-wide credit risk by increasing the extent to which AIs must trade with third parties to hedge their market risk exposures, thus overall increasing the group's exposure to third parties.

As such, we would kindly request that the HKMA remove this discretionary power.

Finally, ISDA notes that the definition of "group" is defined as a group of companies for which consolidated financial statements are prepared. ISDA welcomes this definition and believes that it should be clarified to specify that entities should only be in a "group" if they are included (on a full basis) in a consolidation in accordance with generally accepted accounting principles applicable to such parent.

d. Thresholds

Thresholds should be harmonised in due course (Sub-section 2.4)

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[6] See, for example, statement of Commissioner J. Christopher Giancarlo regarding Final Rule on Margin Requirements for Uncleared Swaps, published by the CFTC on 16 December, 2015.

The HKMA has proposed that the thresholds by which a covered entity becomes subject to the IM requirements will be as set out in Sub-section 2.4 of the draft SPM module. We welcome HKMA's proposals and understand that the aim is to be consistent with the thresholds specified in the BCBS/IOSCO Paper and the numbers proposed in other financial centres. Global consistency is needed to keep Hong Kong market participants on an even footing with their peers and competitors. We further note that the HKMA intends to adjust the thresholds if there is a material change in the EUR/HKD exchange rate and seek confirmation from the HKMA that it would adjust the thresholds when the rules are finalised by reference to the then-prevailing rates.

Requirement for AI to substantiate information provided by counterparties on a best effort basis (Sub-section 2.4.7 and footnote 19)

Footnote 19 requires an AI to substantiate the information provided by its counterparty on a best effort basis. We request that the HKMA remove such requirement. The AI will not have any relevant knowledge relating to the derivatives business of its counterparty and this requirement will be in effect impossible for an AI to fulfil. In line with the requirement in the US, ISDA requests the HKMA to consider permitting an AI to rely in good faith on representations made by its counterparty including those made in industry-standard self-disclosure documents.

Intragroup trades to be exempt from calculation of average aggregate notional amount (Sub-section 2.4.6)

We request that the HKMA confirm that intragroup transactions would be exempt from the calculation of the aggregate average notional amount. As mentioned above, intragroup transactions should be excluded because they do not pose the same systemic risks as other transactions and do not transfer risks in or out of a corporate group. The HKMA has stated that the objective of the margin proposals is to prevent the "build up of uncollateralized exposure in the financial system" (paragraph 17 of the Consultation Paper). However, the volume of intragroup transactions is not a good indicator of systemic risk and should not be included in determinations as to whether a group is required to exchange or collect margin.

Change in status of AI's counterparty (Sub-section 2.4.3)

The draft SPM module makes it clear that where an AI's counterparty changes its status such that transactions with such counterparty becomes subject to IM requirements, such requirements to exchange IM only apply in a given 1 September – 31 August period. For the avoidance of doubt, we request that the Margin Rules make clear that where an AI's counterparty changes its status such that transactions with that covered entity become subject to stricter margin requirements, the AI should comply with the stricter margin requirements only for transactions entered into with that counterparty after the counterparty changes its status. Where an AI's counterparty changes its status such that transactions with such counterparty become subject to less strict margin requirements, the AI may comply with the less strict margin requirements for transactions entered into with that counterparty after the counterparty changes its status, as well as for any outstanding transactions entered into after the applicable compliance date set out in Sub-section 2.4.2 of the Consultation Paper and before the counterparty changes its status. We understand this is the

position set out in the final rule regarding margin and capital requirements for covered swap entities issued by the Prudential Regulators in the US (the "**PR Margin Rule**").[7]

e. Margin standards: Variation margin

Definition of variation margin (Sub-section 1.1.1)

We suggest amending the definition of "variation margin in Sub-section 1.1.1 by adding the words "or payment" behind "means the collateral" in the first line of the definition. This is to make it clear that VM is not subject to the same requirement for segregation as IM.

HKMA to recognise that methodology for calculating VM may need to take into account differences between counterparties (Sub-section 3.1.2)

The draft SPM module provides that the methodologies for calculating VM should be, amongst others, consistent across entities. This might not be achievable because the methodology for calculating VM may require slightly different approaches when dealing with different counterparties (i.e. valuation times might need to vary when dealing with a counterparty in Hong Kong versus a counterparty in the EU). ISDA requests HKMA to take this into consideration.

VM to be calculated and exchanged subject to a single, legally enforceable netting agreement (Sub-section 3.1.4)

Sub-section 3.1.4 proposes that VM be calculated and exchanged across all non-centrally cleared derivatives pursuant to a single, legally enforceable netting agreement. ISDA requests HKMA to confirm that the approach of having multiple credit support agreements under the same netting agreement is permissible and that parties would be able to use a new credit support arrangement (or other contractual arrangement) (and not a new master agreement) to distinguish between pre- and post- compliance date derivatives for the purposes of application of the Margin Rules. Thus, a single master agreement could have two credit support arrangements, one for pre-compliance date swaps and another for post-compliance date swaps.

f. Margin standards: Initial margin

Exemption from section 119A Banking Ordinance (Cap. 155)

While Sub-section 3.2 of the draft SPM module does not specify how IM is to be held, it is our understanding that this will be by way of security interest. For example, where Euroclear is used as triparty custodian, the security interest would take the form of a Belgian law pledge.

ISDA notes that section 119A(1) of the Banking Ordinance provides that, with respect to AIs incorporated in Hong Kong, such an AI may not, without approval of the HKMA, create a charge over its assets if the aggregate value of all charges existing over total assets is 5% or more of the value of those assets, or if such 5% threshold would be breached by reason of entering into the charge. This 5% threshold is a low threshold for margined non-centrally cleared derivatives and a

[7] See page 44 of the PR Margin Rule available at https://www.fdic.gov/news/board/2015/2015-10-22_notice_dis_a_fr_final-rule.pdf

locally incorporated AI may, when posting IM, inadvertently breach this threshold. Thus, ISDA requests that the HKMA exempt security interests over IM from the requirements of section 119A. Alternatively, ISDA requests that security interests over IM be included in the list of exempted charges in the Banking (Specification of Class of Exempted Charges) Notice (Cap. 155K).

Flexibility to be permitted in the use of standardised model approach and the internal model approach (Sub-section 3.2.5)

ISDA members have requested the flexibility of using both standardised and internal models within the same asset class where transactions are booked into a separate foreign branch (because it may not be worth implementing full margin infrastructure in a small branch with new derivatives business).

The HKMA should also make it clear that counterparties may apply different methodologies (e.g. internal model and standardized approach, or different internal models) to the same netting set under a single netting agreement. Counterparties may not be able to use the same internal model for all products in a netting set, and may need to use different approaches for one or more products. However, this should not result in the need for counterparties to split a single netting set into two or more netting sets in order to apply different methodologies to different products in one netting set. The creation of multiple netting sets is not desirable from a risk management or operational perspective Accordingly, ISDA requests that the HKMA confirm that the Al may use the standardized approach to calculate IM for one asset class (e.g. equity) while using the internal model approach for another asset class (e.g. credit), under the same netting set.

g. Treatment of IM collected

In general, both for VM and IM, ISDA requests that the HKMA confirm that such margin can be held offshore, for example, with custodians outside Hong Kong.

One time rehypothecation should be permitted (Sub-section 3.4.3)

For consistency with the BCBS/IOSCO Paper, we ask the HKMA to permit one time rehypothecation of IM collected. While ISDA recognises that there are many conditions around the one-time rehypothecation of IM, and hence that a one-time right to re-hypothecate collateral would be of very limited use, ISDA members would nevertheless like to have this option.

Collateral treatment requirements should not apply to margin that is not required to be collected under the Margin Rules

To the extent that the Margin Rules permit counterparties to exchange collateral greater than the minimum applicable requirements, we request that parties retain the discretion to determine whether the eligibility and other requirements should apply to the exchange of margin that is not required by the Margin Rules. We further request that the Margin Rules explicitly recognise that such principle applies in other cases where the Margin Rules permit parties not to exchange margin (if applicable).

Imposing eligibility criteria and other requirements on collateral posted voluntarily would have significant consequences for all collateral arrangements. Credit support arrangements with persons that are otherwise exempt from the Margin Rules, for example, would have to be

extensively re-negotiated. In many cases, it may not be feasible to maintain voluntary collateral in accordance with the Margin Rules, thereby restricting the ability of parties to negotiate additional protections where necessary to address credit risk in an appropriate way. Given the absence of discussion of this topic in the Consultation Paper, we request that the HKMA give our comments due consideration when finalizing the Margin Rules.

h. Segregation of IM

In general, we support the HKMA proposal that IM collected is to be held in such a way that it is readily available to the collecting party in case the posting party enters insolvency and is subject to arrangements that protect the posting party to the extent possible under applicable law in the event that the collecting party enters insolvency. As some entities lack the ability to create certain types of security interests, flexibility is required. Other entities may be limited by the nature of their assets. Structures other than the ones proposed in Sub-section 3.5 of the draft SPM module merit further consideration by the HKMA so long as they achieve the goal of significantly mitigating counterparty risks. For example, title transfer and charge back of margin is a structure that is commonly used in the market and provides protection to counterparties. The draft SPM module should permit flexible segregation arrangements as long as they sufficiently mitigate counterparty risk.

IM should be made available in a "timely manner" (Sub-section 3.5.2)

Sub-section 3.5.2 of the draft SPM module proposes that AIs be required to safe-keep the IM collected from counterparties in a manner such as to ensure that the IM collected is “immediately available” to the collecting party where the posting party enters insolvency.

We support the creation of robust segregation regimes, but the "immediately available" standard will not be possible to apply in practice and should instead be replaced with a requirement for IM to be provided in a "timely manner".

The HKMA has already acknowledged that stays or other restrictions on the availability of IM upon bankruptcy of the posting party may have an impact on when IM will be available. Where IM is held with an independent third party custodian, IM will only be available to the collecting party after the custodian goes through its required procedures. These procedures include the necessary operational steps for transferring the IM and may include verification of the legitimacy of the collecting party's claim for IM. Custodians may also insist on payment of their fees before releasing collateral from custodial liens. In addition, the parties may also agree that the posting party has a right to object to release of the collateral by the custodian if the posting party can claim that the demand is not appropriate. Such stays, restrictions or delays should not have an impact on the ability of AIs to enter into derivatives transactions with counterparties in jurisdictions that prevent immediate access to collateral upon a bankruptcy or to enter into arrangements with independent third party custodians.

Further, the bulk of collateral collected as initial margin is likely to be intermediated securities held in a clearing system requiring the collateral provider to deliver appropriate instructions and wait for delivery of the relevant securities in accordance with standard settlement cycles.

In this respect, we note that the revised margin rules proposed in the EU have replaced the "immediately available" standard with "available to the posting counterparty in a timely manner"

and believe that this would be a more appropriate standard.[8] We also note that in Hong Kong, rule 124 of the Banking (Capital) Rules also recognise these practical issues by providing that, for the purposes of calculating the risk weighted exposure of an AI, collateral is recognised where the legal mechanism by which such collateral is pledged or transferred ensures that the institution has the right to take possession of the collateral "in a timely manner".

Eligibility of custodian (Sub-section 3.5.4)

ISDA requests that HKMA clarify the criteria in the draft SPM module as to third party custodians. ISDA requests HKMA to outline what rating is needed for the custodian to be considered of "high credit quality" and to remove the requirement of "low probability of default" as this requirement is superfluous to the credit quality requirement.

Holding of cash IM (Sub-section 3.5.5) and re-investment of cash IM (Sub-section 3.4.4)

In respect of Sub-section 3.5.5, we request that the HKMA confirm that the segregation requirement does not exclude the holding of cash IM by an independent third party custodian in a deposit account.

Sub-section 3.4.4 of the draft Margin Rules helpfully provides the optionality for cash collateral to be invested in other eligible assets upon agreement of the counterparties. This provision is consistent with current market practice, and will allow counterparties to minimize their credit risk to the custodian or collecting counterparty whilst potentially earning higher returns than a deposit account. We note that a custodian would only do so at the direction of the swap counterparties, and not at its own discretion.

Omnibus account structure (Sub-section 3.5.6)

The draft SPM module provides that the IM collector is to provide the posting party with the option of individual segregation of the IM from other assets of the posting party. ISDA requests that HKMA confirm that an omnibus account structure can be used as long as the option of individual segregation is provided.

Independent legal review for IM arrangements (Sub-section 3.5.7)

Sub-section 3.5.7 of the draft SPM module proposes that the collateral arrangements be subject to independent legal review in order to verify that the IM collected or posted can be promptly returned to the surviving counterparty in the event of insolvency of the AI or its counterparty. While we support the requirement for obtaining proper legal advice with respect to collateral arrangements, we have the following comments and requests:

(i) Legal opinions/advice should only address segregation.

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[8] Paragraph 4 of Article 1 SEG provides that "The segregation arrangements shall ensure that the initial margins are available to the posting counterparty in a timely manner in case the other counterparty defaults. Available at https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf

Regarding the independent legal review requested under Sub-section 3.5.7, "promptly returned" is not a legal concept, but rather a determination made by counterparties after taking into account operational issues and any relevant risk tolerance. If a collecting party is obliged to legally segregate such assets but does not in practice do so, the posting counterparty's ability to trace its assets may be compromised. We thus propose that the opinions (or views, as discussed below) should address segregation directly and whether the IM will become part of the proprietary assets of the collecting party in the event of the insolvency of the collecting party.

(ii) Parties should be able to rely on industry-wide legal advice.

The draft SPM module should make it clear that counterparties may rely on standard industry-wide legal advice developed by market participants. Counterparties should not be required to obtain bespoke legal advice with respect to each new segregation arrangement, which could prove time-consuming and expensive. If industry-wide legal guidance is available with respect to certain standard segregation arrangements, such arrangements will be faster to implement and easier for both counterparties and regulators to analyze. ISDA currently works to provide derivatives markets with certain industry standard opinions, including netting opinions on insolvency, and similar standardized industry guidance will enhance the efficiency of the derivatives market with respect to segregation arrangements. In addition, counterparties should be able to rely on suitable opinions obtained by service providers such as custodians.

(iii) *Independent legal review to focus on IM posted.*

We would propose amending sub-section 3.5.7 as follows, to ease the operational burden on market participants:

"An AI should perform an independent legal review in order to verify that the IM ~~collected or~~ posted can be promptly returned to ~~the surviving counterparty~~ it in the event of the insolvency of ~~the AI or~~ its counterparty."

i. Timing for the exchange of margin *(Sub-section 3.7)*

Sub-section 3.7.2 of the draft SPM module proposes that margin should be called no later than the end of the following Hong Kong business day after the trade date in respect of VM and after either execution of a transaction or any of the prescribed events in respect of IM ("T+1"). Sub-section 3.7.3 provides that margin should be collected within two Hong Kong business days following the day when IM/VM has been called ("T+2"). We welcome HKMA's proposal of calling margin on T+1 basis and collecting margin on T+2 basis. However, to take into account the location of the parties' operational processes and types of collateral to be exchanged, we submit that the timing for margin delivery should refer to "Local Business Day" as defined in the relevant credit support documents between the parties, and not Hong Kong business day. We also request the HKMA to clarify that, where the two transaction parties are located in different time zones, the trade date or "T" shall refer to a day that is: (i) a business day of the later time zone; and (ii) a business day for both parties. This would allow for flexibility for the variety of factors impacting the call and settlement timelines, without allowing counterparties a longer time period than strictly required within their set of circumstances.

A few members express concern that the current T+1 proposal for calculation and call of margin does not take into account time zone issues and would pose operational challenges for transactions with a counterparty whose operational processes are located in the Asia Pacific region. They thus propose that calculation and call of margin be made within two business days (i.e. T+2) of the trade date.

We wish to note that other than the US, the margin rules proposed in other jurisdictions are still in draft form and may be subject to changes. In order to achieve global consistency and a more level playing field between competitors in different jurisdictions, it is submitted that the HKMA should engage in dialogues with other regulators to prevent regulatory arbitrage.

Regarding exchange of margin, we note that a posting party cannot deliver margin unless the counterparty is ready to receive it and has given appropriate instructions to its custodian or bank. Therefore, a posting party should be permitted to satisfy its posting obligation by delivering a notice, in accordance with the required timeframe, to its counterparty that the counterparty has the right to call for margin. A posting party will not have violated its posting obligations if the counterparty fails to accept the margin and the posting party delivers the notice in accordance with this paragraph.

j. Haircut

Cash collateral should not be subject to the 8% haircut (Sub-section 3.9.4)

We note that while HKMA does not request the FX-haircut apply to cash VM collateral, cash IM collateral is still subject to an 8% FX-haircut when the eligible collateral posted is denominated in a currency other than the current of settlement. The imposition of an 8% FX-haircut will lead to risks and inefficiencies and we request that the HKMA amend the draft SPM module such that the 8% FX-haircut does not apply to cash collateral, whether IM or VM.

The imposition of an 8% FX-haircut on cash IM collateral would not be consistent with the margin requirements proposed in the EU and could skew competition in favour of other such jurisdictions that do not mandate such a requirement. Cash funds denominated in all major currencies are liquid at the point of counterparty default, and there are robust markets in the major currencies that allow conversion or hedging to the currency of termination or transfer at a relatively low cost making the imposition of an FX haircut unnecessary.

"Currency of settlement" to be clarified in the context of the haircut (Sub-section 3.9.3)

The draft SPM module proposes that the 8% FX-haircut apply where collateral is denominated in a different currency from the "currency of settlement" agreed by the parties in the relevant contract. The currency of settlement is defined under Sub-section 3.9.3 as "any currencies agreed by the contracting parties in the relevant contract (individual derivatives contract, governing qualifying master netting agreement or the credit support annex)". We understand that this definition will cover the termination currency specified in an ISDA Master Agreement. We welcome the HKMA's proposal in Sub-section 3.9.3 which includes the termination currency in the definition of "currency of settlement" and allows parties to agree on two currencies of settlement (each party may choose one currency) for the purpose of exchanging IM collateral. However, the option to have two currencies of settlement is not applicable to VM non-cash

collateral under the draft SPM module. We request that in respect of the FX-haircut applicable to non-cash VM, parties should also be allowed to specify different currencies for each party.

The FX-haircut issue is discussed in detail in ISDA's responses to the European Supervisory Authorities on the Second Consultation Paper regarding draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP ("**July 2015 Responses**")[9]. Please refer to the July 2015 Responses for further information.

As the EU margin rules are still in draft form and the industry is also in the process of clarifying how the FX-haircut will be applied under the final margin rules in the US, for global consistency purposes, we request the HKMA to finalize its rules regarding the FX-haircut only after the publication of the EU margin rules and any further clarification from the US regulators regarding this issue.

Haircut for non-cash collateral (Sub-section 3.9.4 and Appendix C)

ISDA requests that, in addition to an external credit assessment institution, AIs can use an internal number for calculating credit rating.

Part 3: Risk Mitigation Standards

While ISDA welcomes the HKMA's efforts in implementing the IOSCO Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives, ISDA requests that the HKMA launch a separate detailed consultation on the risk mitigation standards which are set out in Sub-section 4 of the draft SPM module. In particular, ISDA requests that the HKMA de-couple the implementation of risk mitigation standards from the implementation of the margin requirements set out in the draft SPM module as the urgency to implement margin requirements is not present for other risk mitigation standards. This would enable the Hong Kong regulators and legislators to accelerate the process for the margin requirements in order to give market participants sufficient time to implement the rules before the scheduled go-live while giving the industry sufficient time to give detailed consideration to the risk mitigation standards proposed.

In order to ensure the efficient functioning of the global derivatives market and to eliminate operational risks, we strongly support Hong Kong to adopt rules that are harmonised and consistent across jurisdictions, and are broadly comparable to the Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives issued in January 2015 by IOSCO.

We set out our detailed comments below.

Scope of application (Sub-section 2.2.4)

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[9] ISDA letter to the European Securities and Markets Authority, the European Banking Authority and the European Insurance and the Occupational Pensions Authority re: Second Consultation Paper regarding draft regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP, dated 10 July 2015.

Please clarify that a foreign-incorporated AI should be able to comply with the risk mitigation standards of its home jurisdiction as well as the counterparty's jurisdiction, provided, in each case, that the applicable comparability assessment has been made.

Outsourcing of risk mitigation to third party service providers (Sub-section 2.2.5)

The draft SPM module permits an AI to employ a third party service provider to undertake risk mitigation processes. ISDA would like to clarify that this would include calculation of margin calls.

Trading relationship documentation (Sub-section 4.1)

We understand that it is industry practice (where not required under Dodd-Frank and related US regulation) to enter into documentary arrangements based on credit assessments and other requirements, including "long-form confirmations" and non-ISDA mini-master agreements. This involves trading with customers on a "deemed" master agreement basis where procedures are documented by internal written policies of the relevant AI. Counterparties are aware that the trades are done on the basis of a "deemed" master agreement but the documentation itself is executed in compliance with the timing requirements for the confirmation. ISDA requests that the HKMA permit industry participants to comply with the requirement for trading relationship documentation through "long-form confirmations". As it is not industry practice for long-form confirmations to be executed prior to the trade being executed, we propose that confirmations made in accordance with timely confirmation timelines be considered "contemporaneous execution" for the purposes of this requirement.

Trade confirmation (Sub-section 4.2)

In order to ensure global efficiency and reduce complexity for transaction parties (especially end users), we strongly encourage the HKMA to adopt trade confirmation rules that are consistent with the relevant rules in the EU and the US.

AIs to establish and implement procedures for trade confirmations (Sub-section 4.2.1)

Given that trade confirmations will not wholly be under the control of the AI, we suggest that the HKMA amend the requirement to be that "An AI should establish and implement policies and procedures designed to ensure the material terms…"

Form of trade confirmation (Sub-section 4.2.2); more time needed for trade confirmations (Sub-section 4.2.3)

All legally binding methods of trade confirmations should be permitted so long as they achieve a legally binding agreement and there should be no distinction between one way (negative affirmation) or two way confirmations depending on counterparty type. In this respect, we note that IOSCO standards[10] provide that negative affirmation may be used as long as not prohibited

[10] *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* published on 28 January 2015 by the Board of the International Organization of Securities Commissions.

under the applicable laws and regulations of a jurisdiction, and that Hong Kong laws contain no prohibition against negative affirmation.

ISDA requests that HKMA note that, as confirmations are bilateral, it is not appropriate to set hard deadlines as there could be a number of reasons why one party is non-compliant or why more time may be needed. In this respect, we propose that the HKMA require that an AI have appropriate procedures and arrangements in place to meet the confirmation deadlines instead of prescribing hard deadlines and that, if for legitimate reasons these deadlines are not achieved, the HKMA should examine those procedures and arrangements and determine whether the firm has made sufficient efforts to meet the deadlines.

In particular, in relation to counterparties that are not financial institutions, we request that negative affirmation (if pre-agreed between the parties as a legitimate confirmation method) be sufficient and that it be sufficient for the AI to provide a signed confirmation without requiring its counterparty to provide a signed or other form of return acknowledgement. Such counterparties are not subject to HKMA oversight and the AI may not be able to compel the counterparty to provide a timely confirmation. We request that the HKMA not penalise an AI that is unable to compel a counterparty, including a non-Hong Kong counterparty, to comply with these requirements.

As an alternative, ISDA requests the HKMA to provide more time for confirmations of trades to be executed. ISDA notes that the draft SPM module requires that two-way confirmations be executed on a T+1 basis for interest rate swaps and credit default swaps, and for other types of derivatives, by T+2 from 1 March 2017 until 31 August 2017. ISDA members note that for vanilla trades, a T+1 deadline is achievable assuming that AI's counterparties are banks. However, other counterparties such as corporates are likely to require more time.

For structured trades carrying a higher degree of complexity, ISDA members are of the view that a T+1 deadline is not achievable. For such trades, confirmations are manually drafted and do not follow industry standard templates. Industry experience is that such trades are typically confirmed on a T+5 basis or longer. We propose that the HKMA permit industry participants to comply with this requirement on a "best-effort basis" or provide a carve-out where the confirmation is manual or for bespoke transactions. We further propose that this requirement only applies to trades booked under an OTC derivatives intermediary and not where the OTC derivatives intermediary only acts as an agent without obligations to prepare or sign any confirmations.

We would be grateful if the HKMA could clarify the following:

(i) whether, in addition to the methods in Sub-section 4.2.2, the confirmations can be issued via electronic means (such as through e-platforms) as this would facilitate expedient confirmations;

(ii) whether the requirement for confirmations applies to intragroup transactions;

(iii) within which product type cross currency swaps fall; and

(iv) if it is proposed that a distinction be made between structured trades and other trades, how the industry should determine if a trade is "structured" given that not all firms use the same definition of "structured product".

Portfolio reconciliation (Sub-section 4.4)

ISDA requests the HKMA to clarify whether the portfolio reconciliation requirement applies to new trades entered into after 1 September 2016 or to all trades outstanding on 1 September 2016.

In addition, ISDA requests the HKMA to clarify whether the portfolio reconciliation requirement applies to intragroup transactions. Further, we urge the HKMA to consider introducing a de minimis threshold below which the parties would not be required to reconcile the discrepancies, e.g. CFTC adopts a de minimis threshold of 10%.

Portfolio reconciliation requires the co-operation of the counterparty. For this reason, when an AI faces a covered entity other than an AI or a licensed corporation as defined under limb (ii) of the definition of "financial counterparty", ISDA requests that the HKMA amend the requirement to bring it in line with the CFTC margin rules such that the AI is required to have policies and procedures in place to agree portfolio reconciliation with its counterparties, and not required to perform the reconciliation.

Portfolio compression (Sub-section 4.5.1)

The draft SPM module requires AIs to establish and implement policies and procedures to assess and engage in portfolio compression. We urge the HKMA to align this requirement with that in the EU where only financial counterparties and non-financial counterparties with 500 or more outstanding non-centrally cleared OTC derivative contracts are required to have in place procedures to regularly, and at least twice a year, analyse the possibility of conducting a portfolio reconciliation exercise.

Dispute resolution (Sub-section 4.6)

Sub-section 4.6 should make it clear that, in a dispute resolution scenario, the undisputed amounts of margin should be exchanged.

Supervisory approach (Sub-section 5.1.3)

The draft SPM module permits the HKMA to require AIs to submit its margin policies for non-centrally cleared OTC derivatives for review. AIs are expected to provide information promptly on request. We request the HKMA to replace "promptly" with "as soon as practicable".

Governance: group margin policies (Sub-sections 5.2.3 and 5.2.4)

ISDA requests HKMA to clarify when group margin policies must be in effect and whether this is by 1 September 2016.

<u>Part 4: Appendices</u>

Appendix A

"No/zero counterparty risk" (paragraph A.1.3)

The draft SPM module provides in A.1.3 that non-centrally cleared derivatives for which a firm faces no (i.e. zero) counterparty risk require no IM to be exchanged or collected and may be excluded from the IM calculation. We request that the HKMA provide further information and clarify how this relates to the threshold calculations and exemptions proposed by the HKMA.

Appendix B: Internal model approach

No requirement for HKMA approval for internal IM models (paragraph B.1.1)

Paragraph B.1.1 of the draft SPM module proposes that AIs seek formal approval from the HKMA before using an internal IM model even if that model is a third party model that is already in use by another AI. We query whether this requirement for pre-approval by the HKMA is necessary, particularly when bearing in mind the short period prior to implementation of the Margin Rules. To the extent that the HKMA requires that market participants make such approval applications, we request that the HKMA provide further information and clarification on the procedural aspects of how this would be done and the timeframe anticipated for the approval process. ISDA requests HKMA to clarify how long in advance should AIs submit models to HKMA for approval if the AI wishes to use the model on 1 September 2016.

We note that the industry has developed IM models, such as the ISDA SIMM Model, that could be used by market participants. In relation to such industry models, we request that the HKMA clarify if these would still be subject to HKMA' approval. In the event that the use of an IM model is also subject to the approval of another regulator, this could give rise to the situation where one regulator (such as the home regulator of a market participant) has approved the model but another regulator (such as the HKMA) has not.

Insofar as the HKMA intends to introduce the approval requirement, we request that the HKMA confirm that after an IM model has been approved by a home regulator or follows the ISDA SIMM Model, market participants that intend to use that model need only notify the HKMA and need not seek further approval from the HKMA. We further request that the HKMA confirm that such notification by a market participant need only be performed on a one-off basis in respect of all transactions that will use that model and in respect of the market participant's group.

Model changes should not require prior notification (Sub-paragraph B.1.4)

Sub-paragraph B.1.4 requires an AI to notify the HKMA at least 60 days in advance before making material changes to an approved model. ISDA is concerned that the requirement for prior approval will lead to delays where there are a large number of model approval requests and proposes there should be an interim process of "deemed approval" if the application has been done but review by HKMA not complete.

In addition, for recalibration of existing models, as AIs will be back testing the model, HKMA is requested to make it clear that a subsequent notification should be sufficient.

Modelling standards (Sub-paragraph B.2.3)

ISDA proposes a drafting change as follows: "The IM model should ~~calculate an extreme but plausible estimate of the potential future exposure of non centrally cleared derivatives,~~ reflect~~ing~~ a variation in value of the instrument that is based on a one-tailed 99% confidence interval over a 10-day horizon. The maturity of a derivative contract may be used instead of the 10-day

requirement if it is shorter than 10 days." ISDA understands that the "extreme but plausible" language has been taken from the capital context, but believes it is not appropriate in this context where certainty is paramount. The IM model should be based on purely objective, quantitative criteria and this is already reflected in the 99% confidence interval and 10-day horizon language. As a result, ISDA members are of the view that the "extreme but plausible" language creates uncertainty.

Description of asset classes (Sub-paragraph B.3.4)

ISDA requests that the HKMA clarify what the IM requirements would be if a non-centrally cleared derivative were to fall into more than one asset class (for example, an equity derivative with currency elements). Would such a derivative be classified under "others"?

Model performance (Sub-paragraph B.4.4)

ISDA notes that recalibration of an internal model is already required by Sub-paragraph B.4.2. Remediation of models should not be required because the interpretation of backtesting results is by nature subjective. The HKMA is requested to be consistent with the EU, which only requires recalibration of the model, and not remediation. In addition, market participants are moving towards the use of industry-standard models such as the ISDA SIMM model where recalibrations and model changes are agreed by a group of counterparties. Thus, Sub-paragraph B.4.4 should be amended to read: "An AI's policies and procedures should describe the methodologies used for back-testing and the results which would necessitate a ~~remediation~~ recalibration of the model."

Appendix D

In general, ISDA pro forma confirmations are widely used by industry participants and ISDA does not propose deviating from existing practices by introducing additional terms for trade confirmation in relation to information that is not already being collected. We also note that in Australia and the EU, the terms required to be included in a trade confirmation are not mandated. We propose that the HKMA consider that standard ISDA confirmations will fulfil the requirements for trade confirmations.

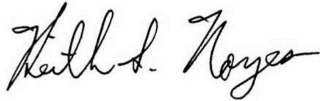
Possible material terms for trade confirmation (Appendix D)

Under "Asset class: credit/equity", we suggest the removal of "and currency" in "Notional amount and currency" as this is already covered by "Currency in which notional amount is expressed".

We look forward to continuing our dialogue with you. Please do not hesitate to contact Keith Noyes, Regional Director, Asia Pacific (knoyes@isda.org, +852 2200 5909), Jing Gu, Senior Counsel, Asia (jgu@isda.org, +65 6653 4173) or Melody Ma, Counsel, Asia (mma@isda.org, +852 2200 5908) for questions related to this response.

Yours faithfully,

For the International Swaps and Derivatives Association, Inc.



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