

## SECURITIES AND FUTURES ORDINANCE (Chapter 571)

Pursuant to sections 169 and 399 of the Securities and Futures Ordinance, the Securities and Futures Commission publishes the following amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct).

The amendments in Part I shall become effective upon Gazettal.

The amendments in Part II shall become effective on 1 September 2020.

The amendments in Part III shall become effective on the commencement date (as defined in section 1 of Part 1 of Schedule 11 to the Securities and Futures Ordinance as amended by section 55 of the Securities and Futures (Amendment) Ordinance 2014) for Type 12 regulated activity.

This notice supersedes Part III of G.N.9206 of 2018.

### Part I

In Part I of Schedule 10, in the definition of “financial counterparty” which follows paragraph 10—

1. Substitute paragraphs (c), (d), (e), (f) and (i):
  - “(c) a provident fund scheme registered under the Mandatory Provident Fund Schemes Ordinance (Cap 485) or its constituent fund as defined in section 2(1) of that Ordinance;
  - (d) an occupational retirement scheme as defined in section 2(1) of the Occupational Retirement Schemes Ordinance (Cap 426);
  - (e) an insurer authorised under the Insurance Ordinance (Cap 41);
  - (f) a licensed money service operator as defined in section 1 of Part 2 of Schedule 1 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap 615);
  - (i) a collective investment scheme as defined in section 1 of Part 1 of Schedule 1 to the SFO;”.
2. In paragraph (j):  
Delete footnote 2.

### Part II

1. Substitute paragraph 4.3A:

**“4.3A Risk mitigation requirements and margin requirements in relation to non-centrally cleared OTC derivative transactions**

A licensed person which enters into non-centrally cleared OTC derivative transactions should implement the risk mitigation requirements and margin requirements set out in Part I and Part III of Schedule 10 respectively.”

2. Substitute heading to Schedule 10:

**“Schedule 10 Risk mitigation requirements and margin requirements in relation to non-centrally**

## cleared OTC derivative transactions”

3. Insert new Part III of Schedule 10:

### “Part III Margin requirements

The margin requirements described in Part III of this Schedule apply to all licensed persons which are contracting parties to non-centrally cleared OTC derivative transactions entered into with a covered entity, subject to the relevant thresholds as set out below.

#### Terminology

##### Covered Entity

1. Covered entity means a financial counterparty, a significant non-financial counterparty or another entity designated by the SFC<sup>2</sup>, but excludes a sovereign<sup>3</sup>, public sector entity<sup>4</sup>, multilateral development bank<sup>5</sup> and the Bank for International Settlements. Any reference to “counterparty” below means covered entity, unless stated otherwise.

##### Financial Counterparty

2. Financial counterparty refers to any entity which falls within the definition of “financial counterparty” in Part I of this Schedule, with respect to a one-year period from 1 September each year to 31 August of the following year, if the entity itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion.

##### Significant Non-financial Counterparty

3. Significant non-financial counterparty refers to any entity other than a financial counterparty, with respect to a one-year period from 1 September each year to 31 August of the following year, if the entity itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion.

##### Average Aggregate Notional Amount

4. The average aggregate notional amount:

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<sup>2</sup> The SFC may designate any entity (or class of entities) as a covered entity if the SFC considers it reasonably necessary in order to ensure that the objectives of this Part are fulfilled or that its requirements are not circumvented, or the SFC is otherwise satisfied that it is appropriate to do so.

<sup>3</sup> Sovereign means (a) HKSAR; (b) the central government of a country; or (c) the central bank of a country.

<sup>4</sup> Public sector entity means any agency of HKSAR or of a central government that is incorporated or established for non-commercial purposes.

<sup>5</sup> As specified by the HKMA in the Banking (Specification of Multilateral Development Bank) Notice (Cap. 155N)

- (a) is calculated as the average of the total gross notional amount of month-end positions of non-centrally cleared OTC derivatives for March, April and May preceding the 1 September starting date in a relevant year. Month-end positions should be converted into Hong Kong Dollars using corresponding month-end spot rates, before calculating the average position;
- (b) includes the gross notional amount of all non-centrally cleared OTC derivatives, including non-centrally cleared OTC derivatives mentioned in paragraph 7(b), (c), (d) and (e) below;
- (c) is calculated on a consolidated group level<sup>6</sup> by including all non-centrally cleared OTC derivatives of all entities within the consolidated group<sup>7</sup>; and
- (d) includes all the non-centrally cleared OTC derivatives that entities within the group have entered into with each other, counting each of them once.

#### Consolidated Group

- 5. "Consolidated group" means a group of entities for which consolidated financial statements are prepared.

#### Netting Set

- 6. Netting set means a group of non-centrally cleared OTC derivative transactions between two counterparties that are subject to a legally enforceable bilateral netting agreement.

#### **Instruments subject to the requirements**

- 7. The margin requirements apply to all non-centrally cleared OTC derivatives except the following:
  - (a) OTC derivative transactions that are cleared by a clearing member on behalf of a non-member or a non-member's client where:
    - (i) the non-member and its client (as appropriate) are subject to the margin requirements of the central counterparty; or
    - (ii) the non-member and its client (as appropriate) provide margin consistent with the relevant corresponding central counterparty's margin requirements.
  - (b) physically settled FX forwards and FX swaps, and the "FX

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<sup>6</sup> An investment fund managed by an asset manager will be treated as an entity that is separate from the related group of funds for the purposes of applying the average aggregate notional amount as long as the fund is a distinct segregated pool of assets (i) that would be treated as such for the purposes of the fund's default or insolvency and upon the default or insolvency of the asset manager and (ii) that is not collateralised by or otherwise guaranteed or supported by any other investment fund managed by the asset manager or by the asset manager.

<sup>7</sup> To avoid doubt, non-centrally cleared OTC derivatives (i) for which a licensed person faces no counterparty risk; or (ii) that are entered into with a sovereign, public sector entity, multilateral development bank or the Bank for International Settlements should be included.

transactions" embedded in cross-currency swaps associated with the exchange of principal<sup>8</sup>, subject to paragraph 8;

(c) excluded currency contracts within the meaning of section 2 of Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules;

(d) physically settled commodity forwards; and

(e) on or before 3 January 2021, non-centrally cleared single-stock options, equity basket options and equity index options.

8. The instruments listed in paragraph 7(b) above are only subject to the variation margin requirements if:

(a) they are entered into by a licensed person with any of the following entities:

(i) an authorized institution as defined in section 2(1) of the Banking Ordinance (Cap 155);

(ii) a licensed corporation; or

(iii) an entity that carries on a business outside Hong Kong and is engaged predominantly in any one or more of the following activities:

- Banking;
- Securities or derivatives business; and
- Asset management<sup>9</sup>;

(b) In relation to both counterparties referred in (a) above, with respect to a one-year period from 1 September each year to 31 August of the following year, the entity itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion.

## Margin requirements

Initial margin ("IM") requirements

9. A licensed person should exchange (ie, post and collect) IM<sup>10</sup> on a gross basis with a covered entity which is a counterparty to non-centrally cleared OTC derivative transactions in a one-year period according to the following implementation schedule:

(a) from 1 September 2021 to 31 August 2022, where both the licensed

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<sup>8</sup> To avoid doubt, all other payments or cash flows that occur during the life of the cross-currency swap must be considered in the initial margin calculation, ie, the only payments that may be excluded from the calculation of initial margin are the fixed physically settled FX transactions associated with the exchange of principal.

<sup>9</sup> For the avoidance of doubt, this seeks to cover the asset manager, but not the funds managed by the manager.

<sup>10</sup> IM means the collateral that protects the parties to non-centrally cleared OTC derivatives from the potential future exposure that could arise from future changes in the mark-to-market value of the derivatives during the time it takes to close out and replace the position in the event of a counterparty default. The amount of IM reflects the size of the potential future exposure.

person and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives, calculated according to paragraph 4, exceeding HK\$375 billion;

(b) on a permanent basis from 1 September 2022 for each subsequent 12-month period, where both the licensed person and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives, calculated according to paragraph 4, exceeding HK\$60 billion.

10. The methodologies for calculating IM that serve as the baseline for margin collected from a counterparty should (i) reflect the potential future exposure associated with the relevant portfolio of non-centrally cleared OTC derivatives and (ii) ensure that all counterparty risk exposures are covered fully with a high degree of confidence.
11. No IM has to be collected in relation to non-centrally cleared OTC derivatives for which a licensed person faces no (ie, zero) counterparty risk and these may be excluded from the IM calculation<sup>11</sup>.
12. The required amount of IM may be calculated by reference to either (i) a standardised margin schedule ("standardised approach"); or (ii) a quantitative portfolio margin model ("model approach"). A licensed person may use the standardised approach to calculate IM for one asset class while using the model approach for another asset class.
13. The choice between the standardised approach and the model approach should be made consistently over time for non-centrally cleared OTC derivatives.
14. A licensed person should follow the steps set out in Annex A to calculate IM amounts under the standardised approach.
15. A licensed person should follow the steps set out in Annex B to calculate IM amounts under the model approach.
16. A licensed person may agree with its counterparty to include non-centrally cleared OTC derivatives that are otherwise out of scope (from the margin requirements to which the licensed person is subject) within the in-scope portfolio for the purpose of calculating IM, as long as this is done consistently and on an ongoing basis.
17. A licensed person may elect not to exchange IM with a significant non-financial counterparty provided that the licensed person has

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<sup>11</sup> As an example, consider a European call option on a single stock. Suppose that a licensed person agrees to sell a fixed number of shares to another party, the option buyer, at a predetermined price at some specific future date (the contract's expiry) if the option buyer wishes to do so. Suppose further that the option buyer makes a payment to the licensed person at the outset of the transaction that fully compensates the licensed person for the possibility that it will have to sell shares at contract expiry at the predetermined price. In this case, the licensed person faces zero counterparty risk while the option buyer faces counterparty risk. The licensed person has received the full value of the option at the outset of the transaction. The option buyer, on the other hand, faces counterparty risk since the licensed person may not be willing or able to sell shares to the option buyer at the predetermined price at the expiry of the contract. In this case, the licensed person would not be obliged to collect any IM from the option buyer and the call option could be excluded from the IM calculation. Since the option buyer faces counterparty risk, the option buyer needs to collect IM from the licensed person in a manner consistent with the standards herein.

obtained a declaration from the significant non-financial counterparty that it predominantly uses the non-centrally cleared OTC derivatives for hedging purposes.

#### IM threshold

18. A licensed person may agree with the counterparty not to exchange IM if the amount due is equal to or lower than a threshold of HK\$375 million ("IM threshold").
19. The IM threshold is applied at the level of the consolidated groups to which the licensed person and the counterparty belong and is based on all non-centrally cleared OTC derivatives outstanding between the two consolidated groups. A licensed person may agree with its counterparty on allocating the IM threshold at entity level.
20. If the total IM amount exceeds the IM threshold, the two consolidated groups need to exchange at least the difference between the total IM amount and the IM threshold.
21. A licensed person should have adequate and appropriate systems and controls in place to ensure that any allocated IM threshold is not exceeded.

#### Treatment of IM

22. When a licensed person is the party collecting IM, appropriate collateral arrangements, including credit support arrangements, should be in place which are legally effective in the event that the party posting IM defaults or becomes insolvent.
23. A licensed person as the party collecting IM should:
  - (a) ensure IM collected is held in such a way that it is available in a timely manner to the licensed person in case the party posting IM defaults or becomes insolvent; and
  - (b) provide the party posting IM with the option to have the IM that it posts segregated from the IM posted to the licensed person by other counterparties.
24. A licensed person as the party posting IM should ensure IM posted:
  - (a) is subject to arrangements that protect the licensed person to the extent possible under applicable law in the event that the party collecting IM defaults or becomes insolvent; and
  - (b) is segregated from the proprietary assets of the party collecting IM by either placing the IM with a third party custodian or through other legally effective arrangements to protect the IM from the default or insolvency of the party collecting IM.
25. If a third-party custodian is used, the licensed person should ensure that:

- (a) the custodian is not a consolidated group member of the counterparty collecting or posting IM; and
  - (b) the financial condition and credit standing of the custodian is regularly monitored.
26. IM collected from a counterparty may be re-hypothecated, re-pledged or reused (henceforth "re-hypothecated") with a third party only for the purpose of hedging the licensed person's derivative positions arising out of transactions with the counterparty for which IM was collected and must be subject to the following conditions:
- (a) The counterparty is not an entity that regularly holds itself out as making a market in derivatives, routinely quotes bid and offer prices on derivatives contracts and routinely responds to requests for bid or offer prices on derivatives contracts;
  - (b) The licensed person has:
    - (i) disclosed to the counterparty its right not to permit re-hypothecation and the risks associated with the nature of the counterparty's claim to the re-hypothecated collateral in the event of the default or insolvency of the licensed person or the third party; and
    - (ii) given the counterparty the option to individually segregate the collateral that it posts; and
    - (iii) the counterparty has given express consent in writing to the re-hypothecation of its collateral;
  - (c) Collateral collected as IM from the counterparty should be treated as a client asset segregated from the licensed person's proprietary assets until re-hypothecated. Once re-hypothecated, the third party should treat the collateral as a client asset, and segregate it from the third party's proprietary assets. Assets returned to the licensed person after re-hypothecation should also be treated as client assets and should be segregated from the licensed person's proprietary assets;
  - (d) The IM of counterparties which have consented to the re-hypothecation of their collateral should be segregated from that of counterparties which have not so consented;
  - (e) Where IM has been individually segregated, the collateral should only be re-hypothecated for the purpose of hedging the licensed person's derivative positions arising out of transactions with the counterparty in relation to which the collateral was provided;
  - (f) Where IM has been individually segregated and subsequently re-hypothecated, the licensed person should require the third party similarly to segregate the collateral from the assets of the third party's proprietary assets and the assets of any other person;

- (g) Protection is given to the counterparty from the risk of loss of IM in circumstances where either the licensed person or the third party defaults or becomes insolvent and where both the licensed person and the third party default or become insolvent;
- (h) Where the licensed person re-hypothecates IM, the agreement with the recipient of the collateral (ie, the third party) should prohibit the third party from further re-hypothecating the collateral;
- (i) Where collateral is re-hypothecated, the licensed person must notify the counterparty. Upon request by the counterparty and where the counterparty has opted for individual segregation, the licensed person should notify the counterparty of the amount of cash collateral and the value of non-cash collateral that has been re-hypothecated;
- (j) Collateral must only be re-hypothecated to, and held by, an entity that is regulated in a jurisdiction that meets all of the specific conditions contained in this paragraph and in which the specific conditions can be enforced by the licensed person;
- (k) The counterparty and the third party may not be within the same consolidated group; and
- (l) The licensed person and the third party should keep appropriate records to show that all the above conditions have been met.

#### Variation margin ("VM") requirements

- 27. A licensed person should exchange<sup>12</sup> VM<sup>13</sup> with a covered entity for non-centrally cleared OTC derivative transactions, from 1 September 2020, for a one-year period from 1 September each year to 31 August of the following year when the licensed person itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion, except that an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion applies to the instruments listed in paragraph 7(b). The VM amount exchanged should fully collateralise the current exposure of the non-centrally cleared OTC derivative transactions.
- 28. VM should be calculated and exchanged for non-centrally cleared OTC derivative transactions subject to a single, legally enforceable netting agreement.
- 29. A licensed person may agree with its counterparty to include non-centrally cleared OTC derivatives that are otherwise out of scope (from the margin requirements to which the licensed person is subject) within the in-scope portfolio for the purpose of calculating VM, as long as this is done consistently and on an ongoing basis.

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<sup>12</sup> Exchange of margin means the posting and collecting of margin between two covered entities.

<sup>13</sup> VM means the collateral which protects the parties to non-centrally cleared OTC derivatives from the current exposure that has already been incurred by one of the parties from changes in the mark-to-market value of the derivatives after the transaction has been executed. The amount of variation margin reflects the size of this current exposure, which can change over time depending on the mark-to-market value of the derivatives at any point in time.

30. A licensed person may elect not to exchange VM with a significant non-financial counterparty provided that the licensed person has obtained a declaration from the significant non-financial counterparty that it predominantly uses the non-centrally cleared OTC derivatives for hedging purposes.

#### Minimum transfer amount

31. A licensed person may agree with the counterparty not to exchange margin if the amount due (aggregate of IM and VM) since the last exchange of margin is equal to or lower than a specified minimum transfer amount not exceeding HK\$3.75 million (the "minimum transfer amount").
32. A licensed person and the counterparty need to transfer the full amount of margin if the minimum transfer amount is exceeded, ie, without deduction of the minimum transfer amount.

#### Timing for the exchange of margin

33. IM should be called at the earliest time possible after either execution of a transaction or upon changes in measured potential future exposure. The IM amount for a given counterparty has to be recalculated at least every ten business days.
34. IM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.
35. VM should be calculated at least on a daily basis and be called at the earliest time possible after the trade date and from time to time thereafter.
36. VM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.

#### Assets eligible as margin<sup>14</sup>

37. Subject to paragraphs 38 and 40, the following collateral instruments are eligible as margin (both IM and VM):
- (a) Cash in any currency;
  - (b) Marketable debt securities issued or fully guaranteed by a sovereign or a relevant international organisation<sup>15</sup>;
  - (c) Marketable debt securities issued or fully guaranteed by a multilateral development bank;
  - (d) Marketable debt securities issued or fully guaranteed by a public sector entity;

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<sup>14</sup> These asset eligibility requirements apply even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

<sup>15</sup> As defined in section 2 of Banking (Capital) Rules (Cap 155L).

- (e) Other marketable debt securities;
  - (f) Gold; or
  - (g) Listed shares which are subject to a haircut percentage of 15% under the Securities and Futures (Financial Resources) Rules ("FRR").
38. When a licensed person is the party collecting IM or VM, the following instruments are not eligible for IM or VM:
- (a) securities issued by the licensed person or an entity that is within the same consolidated group as the licensed person; and
  - (b) securities whose value exhibits a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared OTC derivative portfolio in such a way that would undermine the effectiveness of the protection offered by the margin ("wrong way risk").
39. A licensed person should ensure the collateral collected as IM or VM is not overly concentrated in terms of an individual issuer, issuer type and asset type.
40. Assets referred to in paragraph 37(b), (c), (d) and (e) are only eligible as margin if they are associated with a credit quality of investment grade. Notwithstanding the foregoing, the following assets are not eligible:
- (a) any special debt securities as defined under the FRR;
  - (b) any securities or any instrument acknowledging, evidencing or creating a subordinated loan or a debt due from a corporation within a group of companies of which the holder of the securities or instrument is a member;
  - (c) any structured product other than a bond that:
    - (i) has a coupon rate that has an inverse relationship to a money market or interbank reference interest rate that is widely quoted; or
    - (ii) has principal or coupon payments that are linked to an inflation rate;
  - (d) any securities or instrument the terms and conditions of which provide that, upon the occurrence of one or more events specified in the terms and conditions, one or both of the following must apply in relation to the principal value:
    - (i) the principal value is to be fully or partially converted into or exchanged for shares of the issuer or a related corporation of the issuer;
    - (ii) the principal value is to be fully or partially written down; or

- (e) listed securities that have been suspended from trading for at least 3 trading days or ceased trading on any exchange on which the securities were listed, except where the securities can continue to be traded on any other exchange on which the securities are listed.

#### Haircuts<sup>16</sup>

41. A licensed person should apply the haircuts set out in Annex C.
42. For the purpose of exchanging IM, each party may designate only one currency in the trading relationship documentation (such as a master agreement or credit support arrangement).
43. A currency mismatch arises whenever the eligible collateral posted (as either IM or VM) is denominated in a currency other than the currencies designated by the contracting parties in the trading relationship documentation.
44. In the case of a currency mismatch, an additive haircut ("FX Haircut") of 8% should be applied to the market value of any IM collateral (cash and non-cash IM collateral) and non-cash VM collateral, except for CNY-CNH, where the FX Haircut should be 1.5%.
45. If the trading relationship documentation does not identify relevant currencies as described in paragraphs 42 and 43 above, the FX Haircut would apply to the market value of all collateral for margin purposes, except cash VM collateral.

#### Scope of applicability

##### Netting

46. A licensed person need not exchange IM and VM in circumstances where there is reasonable doubt as to the enforceability of the netting agreement upon default or insolvency of the counterparty.
47. A licensed person need not exchange IM in circumstances where there is a reasonable doubt as to the enforceability of arrangements for the protection of posted collateral upon default or insolvency of a counterparty.
48. The licensed person should have a well-founded basis to justify its eligibility for exemption under paragraph 46 or 47 after undertaking an assessment of the enforceability of the netting agreement or the collateral arrangements (as the case may be). This should be supported by an external legal opinion<sup>17</sup> in writing with reference to the netting or collateral provisions in the contractual arrangements used by the licensed person. The licensed person should arrange for any such legal opinion to be updated on a regular basis as appropriate.

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<sup>16</sup> These haircut requirements apply even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

<sup>17</sup> Jurisdictional opinions obtained from external independent legal counsels by an industry association of which the licensed person (or any member of the licensed person's group of companies) is a member are acceptable.

## Intragroup transactions

49. The margin provisions in this Part do not apply to non-centrally cleared OTC derivative transactions between a licensed person and a covered entity which is in the consolidated group to which the licensed person belongs (ie, an affiliate), provided that,
- (a) the licensed person and the affiliate are accounted for on a full basis in the consolidated financial statements of the holding company of the consolidated group to which they belong, for the purpose of and in compliance with the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, the International Financial Reporting Standards issued by the International Accounting Standards Board, or the standards of accounting practices applicable to the holding company in the place in which it is incorporated; and
  - (b) the risk evaluation, measurement and control procedures applicable to the licensed person and the affiliate are centrally overseen and managed within the consolidated group to which they belong.

## Substituted compliance

50. A licensed person which enters into a non-centrally cleared OTC derivative transaction that is subject to the margin requirements set out in this Part (“SFC requirements”) with a counterparty which is subject to the margin requirements of another regulator or jurisdiction (“the counterparty’s margin requirements”) may, in respect of the transaction, elect to adhere to the counterparty’s margin requirements instead of SFC requirements subject to the following being satisfied<sup>18</sup>:
- (a) the licensed person must notify the SFC of its intention to adhere to the counterparty’s margin requirements before it begins to do so;
  - (b) either of the following apply:
    - (i) the counterparty’s margin requirements are of a WGMR<sup>19</sup> member jurisdiction or a regulator in such a jurisdiction and the SFC has deemed the counterparty’s margin requirements to be comparable to SFC requirements until a comparability determination in respect of the counterparty’s margin requirements is issued by the SFC or HMKA; or
    - (ii) a comparability determination in respect of the counterparty’s margin requirements has been issued by the SFC or HMKA; and

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<sup>18</sup> The SFC may specify conditions with which a licensed person must comply in adhering to the margin requirements of a jurisdiction or regulator, regardless of whether a comparability determination has been issued by the SFC or HKMA. The SFC will publish on its website the names of the jurisdictions or regulators whose margin requirements are referred to in paragraph (b) and any specified conditions referred to in paragraph (c).

<sup>19</sup> Working Group on Margining Requirements under the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

- (c) the licensed person must comply with all conditions specified by the SFC in respect of it adhering to the counterparty's margin requirements.

## Annex A - Calculating IM amounts by reference to a standardised margin schedule

- A.1 The total amount of IM required on a portfolio according to the standardised margin schedule should be computed by referencing the standardised margin rates in A.3 below and by adjusting the gross IM amount by an amount that relates to the net-to-gross ratio pertaining to all non-centrally cleared OTC derivatives in the legally enforceable netting set. The IM amount is calculated in two steps. First, the margin rate in the schedule set out in A.3 is multiplied by the gross notional size for each derivative contract, and then this calculation is repeated for each derivative contract to arrive at the gross IM. Second, the gross IM amount is adjusted by the ratio of the net current replacement cost to gross current replacement cost ("NGR"). This is expressed through the following formula:

$$\text{Net Standardised IM} = 0.4 * \text{Gross IM} + 0.6 * \text{NGR} * \text{Gross IM}$$

where NGR is defined as the level of net replacement cost over the level of gross replacement cost for transactions subject to legally enforceable netting agreements. Net replacement cost is the sum of positive and negative market values of all derivative contracts in the netting set. The value is set to zero if the sum is negative. Gross replacement cost is the sum of the positive market values of derivative contracts in the netting set.

- A.2 The total amount of IM required for a portfolio according to the standardised margin schedule is the net standardised IM amount.
- A.3 Standardised IM schedule

Asset class	IM requirement (% of notional exposure)
Interest rate <sup>20</sup> :	
0-2 year duration	1
2- 5 year duration	2
5+ year duration	4
Foreign exchange	6
Commodity <sup>21</sup>	15
Equity	15
Credit:	
0-2 year duration	2

<sup>20</sup> Inflation swaps, which transfer inflation risk between counterparties, are to be considered as part of the interest rate asset class.

<sup>21</sup> This includes gold and other precious metals such as silver and platinum.

2-5 year duration	5
5+ year duration	10
Other	15

## **Annex B - Calculating IM amounts by reference to a quantitative portfolio margin model**

### **B.1 Supervisory requirements**

B.1.1 A licensed person should obtain approval in writing from the SFC before using an internally developed or a third-party IM model<sup>22</sup>.

B.1.2 The applicant needs to demonstrate that the relevant IM model satisfies all of the criteria set out in this Annex and any other requirement as specified by the SFC on an ongoing basis.

B.1.3 Unless the SFC agrees otherwise, a licensed person should notify the SFC at least 60 days in advance before making any subsequent material changes to an approved model.

B.1.4 The SFC may consider that a licensed person using a model should collect a greater amount of IM than that determined by the licensed person's model if additional collateral is appropriate due to the structure, complexity or other features of the licensed person's non-centrally cleared OTC derivatives portfolio.

### **B.2 Modelling standards and calculation**

B.2.1 A licensed person's IM model should be conceptually sound and designed to calculate IM in an appropriately risk-sensitive manner.

B.2.2 The level of sophistication of the modelling approach should reflect the nature, scale and complexity of the risks inherent in the derivative contracts it is applied to.

B.2.3 The IM model should calculate a conservative estimate of the potential future exposure of non-centrally cleared OTC derivatives, reflecting 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<sup>23</sup>.

B.2.4 The IM model should be calibrated based on historical data in the most recent continuous period prior to the calibration date for no less than 3 years and no more than 5 years.

B.2.5 At least 25% of the data used for calibration should be representative of

<sup>22</sup> This requirement applies even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

<sup>23</sup> If VM is exchanged at less than a daily frequency, the number of days in between VM collection should be added to the 10-day horizon. If VM is exchanged at varying frequencies between the calculation of IM amounts, the number of days to be added to the 10-day horizon should be the maximum number of days in between VM collections within this period.

a period of significant financial stress, identified and applied separately at least for each asset class, which is appropriate to the derivatives to which the IM model is applied. If the most recent data period does not contain at least 25% stressed data, the least recent data in the time series should be replaced by data from a period of significant financial stress, until the overall proportion of stressed data is at least 25% of the overall data set.

B.2.6 The data within each of the identified periods should be equally weighted for calibration purposes.

B.2.7 Derivatives that are not subject to the same netting set should not be considered in the same IM model calculation.

### B.3 Model elements

B.3.1 The IM model should capture all relevant risk factors which materially influence the non-centrally cleared OTC derivative contracts in a netting set. As a minimum, risk factors should include foreign exchange or interest rate risk, equity risk, credit risk and commodity risk.

B.3.2 The model should appropriately assess other material risks arising from imperfect correlations, idiosyncratic risks for credit underlying, market liquidity and non-linear dependencies.

B.3.3 Risk-offsetting features should only be recognised within the same asset class and not across different asset classes.

### B.4 Model performance

B.4.1 A licensed person has to ensure that the data used in the model are subject to a process that ensures their quality.

B.4.2 The process should include recalibration, back testing and validation of the IM model.

B.4.3 The licensed person should ensure that the model:

- (a) Employs a methodology with an accepted economic or sound theoretical basis which incorporates all factors that counterparties would reasonably consider in calculating the IM;
- (b) Is appropriately calibrated and tested for validity;
- (c) Is subjected to independent model review, validation and approval periodically and when material changes are made; and
- (d) Outputs are subjected to regular independent review and verification.

The results of model calibration, testing, review and validation should be documented.

### B.5 Documentation

B.5.1 A licensed person should maintain adequate documentation in respect of the IM model.

B.5.2 The documentation should be sufficient to ensure that any

knowledgeable third-party would be able to understand the design and operational details of the IM model.

### Annex C - Standardised haircut schedule

The market value of eligible collateral (see paragraph 37) should be adjusted as follows:

*Adjusted value of collateral = value of collateral \* (1-applicable asset class haircut – applicable currency mismatch haircut)*

Asset class	Residual maturity	Haircut	Haircut credit quality grade 1	Haircut credit quality grades 2 & 3
	Year(s)	(%)		
Cash in same currency		0	-	-
Marketable debt securities associated with a credit quality of investment grade issued or fully guaranteed by:  (i) A multilateral development bank; or  (ii) A relevant international organization.	less than one	0.5	-	-
	between one and five	2	-	-
	greater than five	4	-	-
Marketable debt securities associated with a credit quality of investment grade issued or fully guaranteed by:  (i) A sovereign; or  (ii) A public sector entity.	less than one	-	0.5	1
	between one and five	-	2	3
	greater than five	-	4	6
Other marketable debt securities associated with a credit quality of investment grade that are publicly traded, subject to paragraph 38	less than one	-	1	2
	between one and five	-	4	6
	greater than five	-	8	12
Eligible equities <sup>24</sup>		15	-	-
Gold		15	-	-
Add-on FX haircut for currency mismatch, subject to paragraph 44		8	-	-

Where a debt security has two external credit ratings that map onto different credit quality grades, a licensed person should use the higher of the haircuts

<sup>24</sup> Please refer to paragraph 37(g) for details.

associated with the two credit quality grades. Where a debt security has three external credit ratings which map onto two or more different credit quality grades, a licensed person should use the higher of the two lowest associated haircuts.

Credit Quality Grades for Long-Term Exposures

Credit quality grade	Standard & Poor's Ratings Services	Moody's Investors Service	Fitch Ratings
1	AAA AA+ AA AA-	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-
2	A+ A A-	A1 A2 A3	A+ A A-
3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-

Credit Quality Grades for Short-Term Exposures

Credit quality grade	Standard & Poor's Ratings Services	Moody's Investors Service	Fitch Ratings
1	A-1+ A-1	P-1	F1+ F1
2	A-2	P-2	F2
3	A-3	P-3	F3

”

**Part III**

1. Substitute paragraph 4.3A:

**“4.3A Risk mitigation requirements and margin requirements in relation to non-centrally cleared OTC derivative transactions; Requirements for persons licensed for providing client**

## **clearing services for OTC derivative transactions**

A licensed person which enters into non-centrally cleared OTC derivative transactions should implement the risk mitigation requirements and margin requirements set out in Part I and Part III of Schedule 10 respectively. A licensed person which provides client clearing services for OTC derivative transactions should implement the requirements set out in Part II of Schedule 10.”

2. Substitute note to paragraph 6.2(i):

*“Note: “Financial product” has the meaning assigned to it under the SFO. For the avoidance of doubt, this requirement only applies to financial products in the context of regulated activities carried on by licensed or registered persons.”*

3. Substitute heading to Schedule 10:

### **“Schedule 10 Risk mitigation requirements and margin requirements in relation to non-centrally cleared OTC derivative transactions; Requirements for persons licensed for providing client clearing services for OTC derivative transactions”**

4. Insert new Schedule 10 Part II:

#### **“Part II Requirements for persons licensed for providing client clearing services for OTC derivative transactions**

The requirements set out in this Part of this Schedule apply to persons licensed for providing client clearing services for OTC derivative transactions in respect of their carrying on of that regulated activity. They do not apply to registered institutions.

##### *Segregation and portability*

1. If a licensed person offers to its client different methods of client asset segregation provided by a particular central counterparty, the licensed person should fully inform each client about the different methods. In respect of each method, the licensed person should explain the costs, risks and portability arrangements, including the legal implications and risk of loss mutualisation to which the client may be subject.
2. For cleared OTC derivative transactions, a licensed person should segregate collateral belonging to clients from the licensed person’s proprietary assets. No licensed person should apply any monies, securities or any other form of collateral that is standing to the credit of any client’s ledger account for the benefit of its own position accounts, accounts of its directors or employees or accounts of any corporations with which the licensed person is in a controlling entity relationship.
3. The client clearing agreement entered into between the licensed person and its client should provide for the transfer of the client’s positions and

collateral of the client's cleared transactions both in the normal course of business and (where the licensed person is also a clearing member of a central counterparty) following the licensed person's default, where permissible under the applicable legal framework and subject to any requirements of the relevant central counterparty.

*Indirect clearing*

4. If a licensed person provides client clearing services to its clients by submitting the client's OTC derivative transactions for clearing through one or more clearing intermediaries, the licensed person should notify each client of the names of each clearing intermediary (including the clearing member) and the central counterparty. The licensed person should also explain to each client the asset segregation arrangement between the licensed person and the clearing intermediaries in respect of the client's transactions, and the corresponding legal implications.

*Clearing confirmation to clients*

5. A licensed person should provide a clearing confirmation to its client no later than the end of the following business day after the client's OTC derivative transaction is accepted for clearing by the central counterparty."

11 June 2020

Julia LEUNG  
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