



**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會

Consultation Conclusions on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions

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Abbreviations and acronyms

AANA	Average aggregate notional amount
AI	Authorized institution
BCBS FX Supervisory Guidance	Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions issued by BCBS
BCBS-IOSCO Margin Requirements	Margin requirements for non-centrally cleared derivatives
CIS	Collective investment scheme
Code of Conduct	Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
FRR	Securities and Futures (Financial Resources) Rules
FSB	Financial Stability Board
FX	Foreign exchange
HKMA	Hong Kong Monetary Authority
IM	Initial margin
OTC	Over-the-counter
SEC	Securities and Exchange Commission
SFC	Securities and Futures Commission
VM	Variation margin
WGMR	Working Group on Margining Requirements

Executive summary

1. On 19 June 2018, the Securities and Futures Commission (SFC) issued the Consultation Paper on the over-the-counter (OTC) derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions (Consultation Paper). Public comments were invited on proposals to implement the margin requirements for non-centrally cleared OTC derivatives set out in *Margin requirements for non-centrally cleared derivatives* published by the Working Group on Margining Requirements (WGMR) with participation by members of the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) (BCBS-IOSCO Margin Requirements)¹.
2. The consultation ended on 20 August 2018. The SFC received 11 written submissions from various industry associations, market participants and other stakeholders. Two respondents requested that both their names and submissions be withheld from publication. A list of the respondents (other than those who requested anonymity) is set out in Appendix C.
3. Respondents generally agreed with the proposed requirements. Some respondents requested that the SFC harmonise its margin requirements with other WGMR member jurisdictions and exempt variation margin (VM) requirements for physically settled foreign exchange (FX) forwards, FX swaps and the “FX transactions” embedded in cross-currency swaps associated with the exchange of principal. Two respondents suggested that the SFC adopt a more risk-based approach. They considered that the HK\$15 billion average aggregate notional amount (AANA) threshold for non-centrally cleared OTC derivatives was too low when applied to physically settled FX derivatives and corresponding covered entities, bringing non-systemic transactions within scope and creating an undue burden on users with genuine hedging needs.
4. The exchange of VM is a sound prudential measure that mitigates licensed corporations’ firm-specific risks and limits the build-up of systemic risk. The SFC’s requirement is consistent with the policy expectation expressed in the BCBS-IOSCO Margin Requirements, the recommendations in the *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions* issued by BCBS (BCBS FX Supervisory Guidance), as well as the recommendation from the Financial Stability Board (FSB) in its report on the Peer Review of Hong Kong. Nevertheless, balancing the systemic risk reduction benefits against the economic needs of licensed corporations and covered entities to manage currency risk, and to reduce the operational burden on end-users of these FX hedges, we propose to narrow the scope of the VM exchange requirement for these instruments to authorized institutions (AI), licensed corporations and entities with similar business outside Hong Kong having an AANA of non-centrally cleared OTC derivatives exceeding HK\$60 billion. This higher AANA threshold for VM exchange will apply only to physically settled FX forwards, FX swaps and the FX transactions embedded in cross-currency swaps associated with the exchange of principal. For all other in-scope instruments, the proposed AANA threshold of HK\$15 billion for VM exchange will remain.
5. Two respondents asked the SFC to harmonise its asset eligibility requirements and collateral haircuts as much as possible with those of the Hong Kong Monetary Authority

¹ This publication was revised in July 2019, extending the final implementation of the margin requirements (available at www.bis.org/bcbs/publ/d475.htm). The original publication on which the CP is based can be downloaded at www.bis.org/bcbs/publ/d317.pdf.

(HKMA). Given that the SFC's asset eligibility requirements and collateral haircuts are in line with the BCBS-IOSCO Margin Requirements, and the divergence between the SFC's approach and the HKMA's requirements is mainly due to our alignment with the Securities and Futures (Financial Resources) Rules (FRR), the SFC will implement the proposals from the Consultation Paper with no amendment.

6. Two respondents requested that the SFC provide sufficient time for licensed corporations and covered entities to implement the SFC's proposed margin requirements, particularly when the SFC's margin requirements are different from the HKMA's. To ensure a smooth and orderly implementation of the margin requirements, the SFC will align with the revised BCBS-IOSCO initial margin (IM) implementation timetable.
7. For the reasons set out below, and having regard to the responses to the public consultation, the SFC has decided to adopt the proposals, with some amendments and clarifications of the regulatory intent as set out in this paper.
8. The major comments received and our responses are detailed in this paper.

Implementation

9. The final texts of the margin requirements in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) are set out in Appendix A (marked up to show amendments to the draft which was attached to the Consultation Paper).
10. The IM requirements will be phased in starting from 1 September 2020 while the VM requirements will become effective on 1 September 2020.
11. We would like to thank all respondents for their time and effort in reviewing the proposals and for their detailed and thoughtful comments.
12. The Consultation Paper, the responses (other than those from respondents who requested they be withheld from publication) and this paper are available on the SFC website at www.sfc.hk.

Comments received and the SFC's responses

I. Proposed scope of licensed corporations subject to the requirements and covered entities

Question raised in the Consultation Paper

Q1. Do you have any comments on the proposed scope of licensed corporations subject to the requirements and the types of counterparties constituting the covered entities? Is it appropriate to exclude transactions with a significant non-financial counterparty which engages in OTC derivatives predominantly for hedging? Would such an exclusion pose systemic risk concerns?

A. Transactions with a significant non-financial counterparty

Public comments

13. Respondents generally agreed with the proposed scope of licensed corporations subject to the requirements and the types of counterparties constituting the covered entities. However, respondents had diverse views on whether transactions with a significant non-financial counterparty which engages in non-centrally cleared OTC derivatives predominantly for hedging should be excluded from the margin requirements. One respondent supported the proposed approach that a licensed corporation may choose not to exchange margin with a significant non-financial counterparty which uses non-centrally cleared OTC derivatives predominantly for hedging. One respondent suggested that such transactions can be excluded, provided the volume of such transactions stayed below prescribed thresholds (without specifying what those thresholds should be) so as not to create undue systemic risk. Another respondent opposed the proposed exemption on the grounds that (i) these transactions, if significant, may still give rise to systemic risk; and (ii) it is difficult to determine whether a non-financial counterparty is genuinely engaged in non-centrally cleared OTC derivative transactions for hedging purposes.

The SFC's responses

14. As mentioned in the Consultation Paper, the SFC recognises that significant non-financial counterparties may actively engage in non-centrally cleared OTC derivative transactions for hedging purposes, and that hedging serves a legitimate purpose in managing risks related to commercial business in the real economy. Accordingly, we will implement our proposal that a licensed corporation may choose not to exchange margin with a significant non-financial counterparty which uses non-centrally cleared OTC derivatives predominantly for hedging. To address concerns that the cumulative volume of non-margined hedging by significant non-financial counterparties individually or collectively may give rise to systemic risk in the future, the SFC will monitor the accumulation of such risk and keep in view the appropriateness of this exemption, including whether it is necessary to impose a threshold.
15. To the comment that it may be difficult to determine whether a non-financial counterparty is genuinely engaged in non-centrally cleared OTC derivative transactions for hedging purposes, a licensed corporation may rely on a declaration from the

significant non-financial counterparty that it predominantly uses non-centrally cleared OTC derivatives for hedging, provided that the licensed corporation has exercised due skill, care and diligence in assessing whether such declaration is reasonable and consistent with its understanding of the significant non-financial counterparty's business.

B. Covered entity in the context of an umbrella trust

Public comments

16. One respondent sought clarification of whether (i) the term "covered entity", when applied to a collective investment scheme (CIS) as defined in Schedule 1 to the Securities and Futures Ordinance, referred to an individual fund within an umbrella trust or the entire umbrella trust (to which the fund belonged); and (ii) the application of the AANA threshold, IM threshold and minimum transfer amount was at the level of each individual fund or the umbrella trust as a whole.
17. The respondent also commented that (i) each fund typically enters into a non-centrally cleared OTC derivative transaction separate from other funds in the umbrella trust; (ii) the assets of each fund are separately held, managed, administered, valued, invested, distributed, audited, accounted for and otherwise dealt with as a separate entity pursuant to an umbrella trust's constitutional documents; and (iii) the assets and liabilities of each fund are also separate from the assets and liabilities of any other fund of the umbrella trust, and each fund's shares represent ownership in the property of that discrete fund, the assets of which can only be applied to discharge claims against the specific fund and not any other fund. The respondent therefore opined that each fund (as opposed to the umbrella trust) should be treated as the "covered entity" to which the AANA threshold, IM threshold and minimum transfer amount should be applied.

The SFC's responses

18. The SFC views that funds managed by an asset manager can be considered as separate entities as long as the funds are distinct segregated pools of assets (i) that would be treated as such for the purposes of the funds' default or insolvency and upon the default or insolvency of the asset manager and (ii) that are not collateralised by or are otherwise guaranteed or supported by other funds or the asset manager in the event of fund insolvency or bankruptcy. This is consistent with the BCBS-IOSCO Margin Requirements. This was mentioned in a footnote in the proposed requirements, and will be further clarified in the final text, as shown in Appendix A. Accordingly, where a CIS is a fund within an umbrella trust and it satisfies the conditions outlined above, then the individual fund (rather than the entire umbrella trust) can be treated as the covered entity to which the AANA threshold, IM threshold and minimum transfer amount should be applied.

II. Instruments subject to the proposed margin requirements

Question raised in the Consultation Paper

Q2. Do you have any comments on the instruments excluded from the proposed margin requirements, or the application of the requirements to single-stock options, equity basket options and equity index options starting only from 1 March 2020?

A. Physically settled FX forwards and FX swaps and the “FX transactions” embedded in cross-currency swaps associated with the exchange of principal

Public comments

19. Respondents generally agreed with the instruments excluded from the proposed margin requirements, and had no comments on the commencement date of the margin requirements for single-stock options, equity basket options and equity index options. However, several respondents requested that the SFC exempt all physically settled FX forwards, FX swaps and the “FX transactions” embedded in cross-currency swaps associated with the exchange of principal (Physically Settled FX Derivatives) from the VM requirements, including when they are entered into by a licensed person with (i) an AI; (ii) a licensed corporation; or (iii) an entity that carries on a business outside Hong Kong engaged in banking, securities, derivatives or asset management and both counterparties’ AANA of non-centrally cleared OTC derivatives exceeded a threshold of HK\$15 billion. The arguments advanced by various respondents to support their request included:
- (a) The desire to promote greater consistency in the treatment of Physically Settled FX Derivatives and to harmonise the margin requirements across all WGMR member jurisdictions, instead of adopting the prescriptive EU approach (which some respondents considered to be “an outlier”). Another respondent pointed out that since the HKMA’s margin rules already exempted the Physically Settled FX Derivatives from VM requirements, the difference in treatment between the SFC and the HKMA meant that different requirements would apply in Hong Kong and could cause market confusion;
 - (b) Compliance costs and the operational burden on market participants will increase as they would need to develop systems and infrastructure to accommodate the conflicting rules as well as source cash or other liquid assets as collateral to meet the VM requirements;
 - (c) Licensed corporations and covered entities may be challenged in managing their currency risk through the use of these instruments, and their counterparties who do not bear these VM obligations under their own regulatory framework may be deterred from trading with them; and
 - (d) The VM requirements associated with the Physically Settled FX Derivatives may deter counterparties who are not subject to such requirements under their own

regulatory framework from trading with licensed corporations, which would create an adverse impact on liquidity.

20. Two respondents suggested that the SFC adopt a more risk-based approach and only subject Physically Settled FX Derivatives to VM requirements when the counterparties to the transaction pose systemic risks. They also considered that the threshold of HK\$15 billion AANA of non-centrally cleared OTC derivatives was too low and may bring non-systemic transactions within the scope of the VM requirements. The respondents referred to the US Federal Reserve's implementation of the BCBS FX Supervisory Guidance² and highlighted that such guidance applied to large financial institutions supervised by the Federal Reserve, which covered the largest, most complex financial organisations considered to pose the greatest systemic risk to the US economy, as well as those banking organisations with assets of USD50 billion or more. The respondents also cited the EU's margin rules, which require VM on physically settled FX forwards transacted between "institutions" (as defined by the EU Capital Requirements Regulation, ie, credit institutions or investment firms) without reference to the size of the institution or its derivatives exposure.
21. The respondents emphasised that both the US and EU approaches intended to only capture those entities that posed systemic risk, or risks to their clients. One of the respondents suggested (i) raising the VM threshold to a level that reflects "dealer-like" activity levels which pose systemic risk; (ii) applying the VM threshold at an entity level (as opposed to a group level); or (iii) exempting certain types of licensed corporations from the requirement to exchange VM on Physically Settled FX Derivatives based on risk sensitivity. Another respondent stated that whether IM and VM should be exempted for Physically Settled FX Derivatives should depend on the price volatility of these instruments.
22. A respondent enquired how the SFC can oversee compliance with the requirement to exchange VM on Physically Settled FX Derivatives where the counterparty is an entity that carries on a business outside Hong Kong and is engaged in banking, securities, derivatives or asset management.
23. Another respondent sought clarification from the SFC that a CIS does not need to exchange VM for physically settled FX forwards and FX swaps.

The SFC's responses

24. The SFC's proposal is consistent with the policy expectation expressed in the BCBS-IOSCO Margin Requirements, which is in turn aligned with the BCBS FX Supervisory Guidance. Under the BCBS FX Supervisory Guidance, banks are expected to exchange VM of an amount necessary to fully collateralise the mark-to-market exposure to physically settled FX swaps and forwards with counterparties that are financial institutions and systemically important non-financial entities. In addition, the FSB in its report on the Peer Review of Hong Kong recommended that the regulatory authorities should consider applying VM requirements to physically settled FX forwards and swaps. The exchange of VM is a sound prudential measure that mitigates licensed corporations' firm-specific risks and limits the build-up of systemic risk. Accordingly, taking into account the policy expectation in BCBS-IOSCO Margin Requirements, the

² On 23 December 2013, the US Federal Reserve issued a letter (SR 13-24) (www.federalreserve.gov/supervisionreg/srletters/sr1324.htm) stating that large financial institutions should apply the seven guidelines published in the BCBS FX Supervisory Guidance to their foreign exchange activities.

BCBS FX Supervisory Guidance and the recommendations from the FSB's Peer Review of Hong Kong, the SFC does not consider it appropriate to exempt Physically Settled FX Derivatives from the VM requirements.

25. With regard to the comments concerning compliance costs and operational burden, as the respondents have noted, both the EU and the US have chosen to implement the VM requirements for physically settled FX forwards and FX swaps. Therefore, dealers which are licensed corporations or covered entities transacting with these EU or US entities will already need to (a) have in place the necessary systems and infrastructure; and (b) source the collateral to meet the requirement to exchange VM for physically settled FX forwards and FX swaps.
26. With regard to the comments concerning the scope of entities affected and the VM threshold, major overseas regulators adopt different approaches in setting the scope of the VM exchange requirement, for example by reference to the size of the group's consolidated assets, or by entity type without reference to the size of a firm or its transaction exposures. The SFC's proposed approach is already narrow in scope, as its application is limited to financial counterparties that are AIs, licensed corporations or entities with similar businesses outside Hong Kong, and in addition it applies an exposure size filter via the VM threshold. From a practical perspective, this is likely to limit the in-scope transactions mainly to "dealer like" activity which can pose systemic risk. Accordingly, the SFC's proposed approach does not appear unduly stringent compared to overseas approaches.
27. On the other hand, the SFC also recognises that licensed corporations and their counterparties may need to manage their currency risk through the use of these FX instruments, and covered entities which are not subject to VM obligations under their own regulatory regimes may be deterred from trading Physically Settled FX Derivatives with licensed corporations. As such, to encourage prudent management of currency risk, minimise the operational burden on the end-users of Physically Settled FX Derivatives and balance the benefits of systemic risk reduction with the need to manage currency risk, we propose to raise the VM threshold to an AANA of non-centrally cleared OTC derivatives exceeding HK\$60 billion.
28. This higher AANA threshold for VM exchange will apply only to Physically Settled FX Derivatives. For all other in-scope instruments, the proposed AANA threshold of HK\$15 billion for VM exchange will remain.
29. As to the comment on how the SFC can oversee compliance with the VM requirements when the counterparty is an entity that carries on a business outside Hong Kong, the SFC would like to emphasise that the margin requirements are applicable to licensed corporations which are contracting parties to non-centrally cleared OTC derivative transactions entered into with covered entities. In the course of the SFC's supervisory process, the SFC can check the licensed corporation's compliance with the VM requirements, including whether the licensed corporation has collected or posted VM as required.
30. Regarding the query on CIS, paragraph 15 of the Consultation Paper indicated that the VM requirements for Physically Settled FX Derivatives only applied to transactions between a licensed corporation and a covered entity that is an AI, a licensed corporation or an entity that carries on a business outside Hong Kong engaged in banking, securities, derivatives or asset management. Footnote 12 of the Consultation Paper further clarified that the requirement intended "to cover the asset manager, but

not the funds managed by the manager.” Given that it has always been the SFC’s intention to exempt CIS from the VM requirements on Physically Settled FX Derivatives, this will be clarified in paragraph 8(a)(iii) in Part III of Schedule 10 to the Code of Conduct by way of footnote.

III. Proposed margin requirements

Question raised in the Consultation Paper

Q3. Do you have any comments or concerns on the proposed IM requirements, including the IM modelling standards, the IM threshold and the treatment of IM collected?

A. Use of model approach to calculate IM

Public comments

31. Regarding the proposed requirement for the SFC’s prior approval before the use of an IM model, one respondent suggested that the SFC should promote harmonisation and adopt an approach that is consistent with the HKMA. Specifically, the respondent suggested that the SFC should only require prior notification instead of formal approval for the use of (i) an industry-wide IM model; or (ii) an IM model that has been approved by the foreign counterparty’s home jurisdiction, if such jurisdiction is deemed or assessed to be comparable by the SFC. The respondent opined that only internally developed or third-party IM models that have not been developed by an industry association should require formal approval from the SFC prior to their use.

The SFC’s responses

32. First, we would like to point out that the requirement to obtain regulatory approval for an IM model prior to its use is not unique to the SFC. Indeed, several other regulators such as the US regulators and APRA require pre-approval of IM models.
33. Second, as already explained in the Consultation Paper, the exchange of margin is important to mitigate both counterparty credit risk as well as systemic risk. Correctly calculating and collecting an appropriate amount of margin is therefore necessary for a licensed corporation to prudently manage its risk exposures, which will help maintain the integrity of the global financial system. This in turn is predicated upon the model used to calculate margin being (i) based on an appropriate modelling methodology; and (ii) subject to proper and effective controls. While there is less need for the SFC to validate an industry-developed modelling methodology which has been approved by major regulators overseas, it is necessary for the SFC to review and assess the robustness of a licensed corporation’s model governance framework as well as the adequacy of its model risk management controls.
34. As mentioned in paragraph 26 of the Consultation Paper, even if a licensed corporation adopts an industry-developed modelling methodology, each model user may (a) calculate risk factor sensitivities differently using its own system, model library, curves, volatility surfaces or market data sets; or (b) have different risk mappings for the same trade.

35. Additionally, a licensed corporation may face unique circumstances or peculiarities which its counterparties may not face. For example, a licensed corporation's non-centrally cleared OTC derivatives portfolio may (i) be predominantly exposed to risk factors that are not covered by the industry-wide IM modelling methodology; or (ii) be exposed to underlying assets or risk factors for which only sparse data exists, and the calibration of the model as specified in the industry-wide modelling methodology may not be suitable for it.
36. Hence, it is necessary for the SFC to review and assess how the licensed corporation manages risks not covered by the industry-wide IM modelling methodology as well as how it ensures that the application of the industry-wide IM modelling methodology, including its calibration and ongoing maintenance, is appropriate for the specific composition and risk profile of the licensed corporation's aggregate portfolio across its counterparties. The foregoing considerations also explain why it is not appropriate for the licensed corporation to use a foreign counterparty's IM model without our prior approval even though the IM model has been approved by a foreign regulator in a jurisdiction with a margin regime deemed or determined as comparable by the SFC.
37. Accordingly, the requirement for a licensed corporation to seek prior approval before it can use an internally-developed or third-party IM model will be implemented as proposed in the Consultation Paper. For the avoidance of doubt, where substituted compliance is available and a licensed corporation opts to comply with the margin requirements applicable to its counterparty, the licensed corporation is still required to obtain approval in writing from the SFC before using an IM model, regardless of whether the licensed corporation is using its counterparty's IM model or whether the IM model has been approved by the counterparty's regulator.
38. Lastly, licensed corporations which come into scope of the SFC's margin requirements and would like to adopt a model approach for calculating IM are encouraged to contact the SFC as soon as practicable regarding their application for IM model approval.

B. Transactions with no counterparty exposure

Public comments

39. A respondent sought clarification of whether the margin requirements apply to a fully funded equity swap where the licensed corporation as swap provider faces no counterparty risk during the life of the trade regardless of the price movement in the underlying reference asset.

The SFC's responses

40. In line with the BCBS-IOSCO Margin Requirements, the SFC's proposed margin regime seeks to ensure that counterparty risk exposures are fully covered with a high degree of confidence.
41. As already stated in the proposed requirements, no IM has to be collected in relation to OTC derivatives for which a licensed corporation faces no counterparty risk³.
42. If a licensed corporation has no counterparty exposure throughout the life of a swap, there should not be any mark-to-market amount in favour of the licensed corporation

³ Paragraph 11 of Part III of Schedule 10 to the Code of Conduct.

under the swap. On this basis, no VM amount should be owed to the licensed corporation under the swap, and as such the licensed corporation would not have a VM collecting obligation under the swap.

43. On the other hand, where the licensed corporation as swap provider has an obligation to pay the return of the reference asset to the counterparty according to the terms of the swap, its counterparty will be exposed to the risk of the licensed corporation's default⁴.
44. The scenario of a firm facing no counterparty risk is mentioned in the BCBS-IOSCO Margin Requirements, and such firm is not required to collect IM⁵. On the other hand, there is no VM exemption under the BCBS-IOSCO Margin Requirements. Accordingly, a licensed corporation with actual or contingent payment obligations under a swap should post VM to fully collateralise its obligation when a mark-to-market amount arises in favour of its counterparty.

C. IM threshold

45. The SFC noted that the BCBS-IOSCO published a statement on the final implementation phases of the margin requirements for non-centrally cleared OTC derivatives in March 2019⁶ (BCBS-IOSCO March 2019 Statement), which stated that the BCBS-IOSCO Margin Requirements did not "specify documentation, custodial or operational requirements if the bilateral initial margin amount does not exceed the framework's €50 million initial margin threshold".
46. The SFC takes this opportunity to clarify that it will follow the approach in the BCBS-IOSCO March 2019 Statement that documentation, custodial or operational arrangements need not be in place if the bilateral IM amount does not exceed the IM threshold of HK\$375 million. However, the SFC expects licensed corporations to act diligently when their exposures approach the threshold to ensure that the relevant arrangements are in place if the IM threshold is exceeded, and be aware of the volatility of the IM amount for their non-centrally cleared OTC derivative portfolios when monitoring the IM threshold. For example, licensed corporations should plan ahead and allow sufficient time to have in place the relevant agreements and documentation with trade counterparties, such as Credit Support Annexes and eligible collateral schedules, bearing in mind the time required to negotiate and agree on the terms of such items as well as their counterparties' capacity to handle concurrent requests for negotiation from multiple firms.
47. Similarly, when licensed corporations agree and sign custody agreements, account control agreements, collateral transfer agreements and security agreements (as the case may be) to ensure that the IM exchanged is appropriately segregated and safeguarded, licensed corporations will need to factor in the lead time for custodians to process and onboard the licensed corporations and their counterparties as part of the custodians' know-your-client, anti-money laundering and other due diligence checks.
48. Licensed corporations should also make the necessary operational preparations to ensure an effective and smooth implementation such that the margin requirements can

⁴ This position is consistent with the analogy of an option buyer being exposed to its counterparty's credit risk and needing to collect IM and VM, as stated in preamble (5) of the EU regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, accessible via this link: <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN>.

⁵ Paragraph 3.7 of the BCBS-IOSCO Margin Requirements.

⁶ Accessible via this link: <https://www.bis.org/press/p190305a.htm>.

be complied with once the IM threshold of HK\$375 million is exceeded. This entails establishing the processes, systems and infrastructure required to calculate and exchange the correct amount of margin on a timely basis and may involve (i) liaising with counterparties to reach a clear consensus on the population of in-scope transactions (ie, performing portfolio reconciliation); (ii) sourcing the relevant trade or market data for margin calculations; (iii) implementing and testing the margin calculations and, where an IM model is used, ensuring that it fulfils all the model-related requirements in Schedule 10 to the Code of Conduct when approaching the SFC for model approval, eg, that the model is subjected to robust model risk management controls and is appropriately calibrated, tested, independently validated and well documented; (iv) exchanging IM calculations with counterparties to reconcile any differences in IM model implementation and test the dispute resolution process; and (v) implementing and testing collateral management systems to ensure that margin calls can be handled effectively.

49. As our proposed requirements in the Consultation Paper are already consistent with the BCBS-IOSCO March 2019 Statement, no change to the proposed requirements needs to be made.

D. Treatment of IM collected

IM segregation

Public comments

50. One respondent stated that the segregation requirements⁷ can be dealt with by the use of ISDA Account Control Agreements.

The SFC's responses

51. It is not the SFC's practice to endorse any specific mode of account operation or industry-wide templates used by market participants. We do not prescribe any specific form of documents to be used by market participants to comply with the requirements for the safekeeping of collected IM. The contracting parties themselves are best placed to assess what account structure or custodial agreements, be they ISDA Account Control Agreements or otherwise, are appropriate for the parties' specific circumstances. Licensed corporations should note that the responsibility to ensure compliance with the corresponding IM safekeeping requirements lies with them and not with any industry association.

Cash collateral and use of bank deposits

Public comments

52. Some respondents sought clarification of whether the SFC prohibits the use of bank deposits for cash IM posted to segregated accounts with custody banks. They mentioned that cash received on deposit by the custody bank, like other deposit funding, is invested by the custody bank in suitable assets for the custody bank's own account and queried whether this would fall foul of the conditions governing re-hypothecation, re-pledging and reuse of IM in paragraph 26 of Part III of Schedule 10 to the Code of Conduct.

⁷ Set out in paragraphs 23(b) and 24 of Part III of Schedule 10 to the Code of Conduct.

The SFC's responses

53. Under paragraph 24 of Part III of Schedule 10 to the Code of Conduct, segregating posted IM from the proprietary assets of the party collecting IM can be implemented by either placing the posted 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” (emphasis added). This does not prevent a licensed corporation from posting cash IM to an account with a third-party custody bank in the name of the licensed corporation, and placing the posted cash IM on deposit with the custodian.
54. The restrictions against re-hypothecation set out in paragraph 26 of Part III of Schedule 10 to the Code of Conduct were intended to apply to the re-hypothecation, re-pledging or reuse (hereafter “re-hypothecation”) of IM collected by a licensed corporation to limit the risks arising from re-hypothecation. Throughout the proposed margin requirements, the “party collecting IM” refers to one of the parties to the OTC derivative trade, and does not refer to a third-party custody bank which is not a party to the trade. “IM collected” should be read correspondingly. A third-party custody bank is not directly subject to the requirements in paragraph 26.

Re-hypothecation

Public comments

55. One respondent commented that (i) the SFC's allowance of re-hypothecation of IM is inconsistent with the HKMA's margin requirements which only permit the re-hypothecation of cash IM; and (ii) the re-hypothecation of non-cash IM will be of limited use in practice given the various conditions and operational issues related to it.

The SFC's responses

56. Cash and non-cash IM collected from a counterparty may be 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, subject to the conditions detailed in paragraph 26 of Part III of Schedule 10 to the Code of Conduct. This is consistent with the BCBS-IOSCO Margin Requirements. It is open to a contracting party to restrict IM re-hypothecation by its counterparty through bilateral agreement. Accordingly, the SFC will implement the provisions pertaining to re-hypothecation as documented in the Consultation Paper with no amendment.

E. VM requirements

Question raised in the Consultation Paper

Q4. Do you have any comments or concerns about the proposed VM requirements?

Threshold for exchanging VM

Public comments

57. One respondent commented that whether the threshold for exchanging VM should be set at HK\$15 billion or lower could be further analysed to strike a balance between the operational burden to firms and the systemic risk reduction benefits.

The SFC's responses

58. The BCBS-IOSCO Margin Requirements do not set any threshold for subjecting covered entities to the VM requirements. As mentioned in paragraph 40 of the Consultation Paper, the SFC has already sought to balance the systemic risk reduction benefits versus the operational costs of implementing the margin requirements, particularly for smaller, less sophisticated counterparties who may have limited non-centrally cleared OTC derivative exposures, in setting the threshold for the exchange of VM at HK\$15 billion. Accordingly, the VM threshold will be implemented with no amendment, except for Physically Settled FX Derivatives as mentioned in paragraph 27 above. The SFC will keep the appropriateness of this threshold in view.

F. Requirements applicable to both IM and VM

Questions raised in the Consultation Paper

Q5. Do you have any comments on the proposed requirements for minimum transfer amounts, timing of the exchange of margin, assets eligible as margin or haircuts? Should any other assets be excluded from collateral eligibility? Since an external credit rating of a debt instrument is not a measure of the instrument's price volatility or liquidity during market stress, are the proposed haircuts for debt securities determined by reference to credit quality grades appropriately calibrated?

Q6. In relation to the proposed requirements for the FX haircut, should onshore renminbi (CNY) and offshore renminbi (CNH) be considered as different currencies for the purpose of determining a currency mismatch between the contract currency and the collateral currency? If so, how should the FX haircut be calibrated? Is there any reason for not treating this as a currency mismatch for the purpose of the FX haircut?

Minimum transfer amount

Public comments

59. One respondent suggested that the minimum transfer amount should be set at a higher level to reduce the administrative burden on smaller firms.

The SFC's responses

60. The minimum transfer amount permitted under the BCBS-IOSCO Margin Requirements is no higher than €500,000. Accordingly, our proposed minimum transfer amount of HK\$3.75 million is in line with the BCBS-IOSCO Margin Requirements.

Timing of the exchange of margin

Public comments

61. One respondent suggested recalculating the IM amount on a weekly basis instead of at least every ten business days since the current financial markets evolve quickly.

The SFC's responses

62. As mentioned in paragraph 46 of the Consultation Paper, the IM amount for a given counterparty has to be recalculated at least every ten business days. The choice of 10 business days was benchmarked against the requirement for an IM model to use a 10-day margin period of risk to estimate the potential future exposure of a non-centrally cleared OTC derivative, which reflects the variation in value of the instrument based upon a one-tailed 99% confidence interval over that 10-day horizon when calculating IM⁸. Recalculating the IM amount at least every ten business days is a minimum requirement, and it is always open to a licensed corporation to agree with its counterparty to recalculate the IM amount on a more frequent basis.

Harmonisation of assets eligible as margin and haircuts

Public comments

63. Two respondents requested that the SFC harmonise as much as possible its asset eligibility requirements and collateral haircuts with those of the HKMA (a) to reduce costs as well as compliance and operational burdens; and (b) to avoid putting licensed corporations at a disadvantage compared to competitors who are not subject to the SFC's margin requirements.

The SFC's responses

64. The SFC's asset eligibility requirements and collateral haircuts are in line with the BCBS-IO스코 Margin Requirements and largely consistent with the HKMA's margin regime.
65. A licensed corporation which trades with an AI may opt to comply with HKMA's standards, which we consider to be equivalent, except that certain less liquid assets are excluded from being eligible as margin in paragraph 40 of Part III of Schedule 10 to the Code of Conduct. These exclusions ensure consistency with our capital regime, because under the FRR, licensed corporations are not able to count these assets as liquid assets for the purposes of complying with their liquid capital requirements. In other words, it would be illogical to allow them for margining purposes when they cannot be considered as a licensed corporation's liquid capital.
66. In any case, we understand from the industry that counterparties typically enter into bilateral negotiations to arrive at an eligible collateral schedule tailored to suit their specific circumstances and preferences, instead of adopting an industry-wide, standardised eligible collateral schedule. A firm may prefer collateral which it finds relatively easier to source, cheaper to fund or better aligned with its existing investment or trading strategy. At the same time, the firm may be constrained by market factors, such as the ability of its custodian to process or support certain types of collateral, as

⁸ Paragraph B.2.3 of Annex B of Part III of Schedule 10 to the Code of Conduct.

well as its own internal risk management policies, which may restrict eligible collateral to a certain asset class, country or currency.

67. Well-designed collateral management systems typically build in the flexibility to cater for variations in margin requirements not only across jurisdictions, but also across counterparties. In addition, we note that licensed corporations may trade with global dealer counterparties which are not subject to the HKMA's margin requirements, and therefore need a collateral management infrastructure which can accommodate different margin regimes. We understand that vendor solutions from major providers also offer this flexibility. Accordingly, the SFC will not amend the asset eligibility requirements and collateral haircuts proposed in the Consultation Paper.

Use of credit ratings to determine eligible collateral haircuts

Public comments

68. One respondent commented that using credit ratings as a threshold criterion for determining the eligibility of debt securities as margin and collateral haircuts may:
- (a) Confuse the market as to what credit ratings are supposed to represent, namely a credit rating agency's opinion of the future credit risk of a debt security or issuer relative to other debt securities or issuers, which does not address other factors such as price or liquidity risks;
 - (b) Lead to undue reliance on credit ratings if they are widely incorporated into regulation, as this may disincentivise market participants from conducting their own credit analysis; and
 - (c) Result in a mechanistic use of credit ratings and a "cliff effect" if regulations require firms to dispose assets when the credit rating falls below a certain threshold, exacerbating market volatility in times of market stress.

Consequently, the respondent suggested that the SFC consider incorporating other credit risk measures or market-based indicators, such as market implied ratings and credit default spreads, as well as tools that measure risks other than credit risk, in determining collateral eligibility and haircuts. In addition, the respondent also suggested eliminating credit rating-based asset-disposal requirements or mitigating the potential impact of rating changes from the "cliff effect".

69. Another respondent suggested that the issue size of debt securities and their average weekly transaction volumes can be taken into account to calibrate the haircut levels.

The SFC's responses

70. The hard wiring of external credit ratings into regulatory requirements carries the risk of mechanistic reliance on ratings by market participants, when credit ratings are not necessarily good proxies for the liquidity risk or price volatility risk of a rated instrument. On the other hand, while market-based indicators such as credit spreads may reflect price volatility risk, calibrating collateral haircuts by reference to credit spreads could be difficult. These indicators may not be available or reliable because of the limited liquidity of bonds and credit default swaps referencing non-sovereign entities in certain markets, including Asia.

71. Further, the use of tools which measure risks other than credit risk may make it more complex and increase operational risk for licensed corporations implementing and operationalising them. For example, a wide variety of tools can be used to measure risks other than credit risk, but these tools may (i) require large amounts of input data (which may not be readily available for certain markets or instruments); (ii) involve computationally intensive calculations; or (iii) require a certain level of technical expertise to implement and maintain, and so may result in increased compliance costs and operational burdens for firms. Additionally, these tools may be implemented and calibrated differently across firms, and so their outputs may not be as transparent as a credit rating from an external rating agency, potentially resulting in disputes between counterparties about the appropriate haircut amount.
72. As already noted in paragraph 55 of the Consultation Paper, the SFC decided against the use of an Internal Ratings Based (IRB) approach for assessing the credit quality grade of collateral, as we believe that the use of a quantitative model-based approach such as the IRB increases complexity and risk for licensed corporations, and is comparatively less transparent than an external credit rating agency's credit rating.
73. As stated in the BCBS-IOSCO Margin Requirements, haircut levels should be risk-based and calibrated appropriately to reflect the underlying risks that affect the value of eligible collateral, such as market price volatility, liquidity, credit risk and FX volatility, during both normal and stressed market conditions. At the same time, this needs to be balanced against having haircut requirements which are transparent and easy to calculate, so as to facilitate payments between counterparties, avoid disputes and reduce overall operational risk.
74. As alluded to above, given the lack of standardised, universally well understood or accepted liquidity risk and price volatility risk indicators free from the operational issues highlighted above, as well as the need for minimum requirements that are transparent and simple to implement for all licensed corporations, we will maintain the collateral eligibility and haircut requirements as proposed. This will enable all market participants, including those which may be less sophisticated, to implement and operationalise the margin requirements in an efficient manner. Since these are minimum requirements, licensed corporations should make their own assessment in setting their asset eligibility criteria and haircuts, with a view to ensuring that the collateral they collect will maintain its value and can be readily disposed of in times of financial stress. Licensed corporations are also expected to review, on a periodic basis, whether the haircuts applied remain appropriate.
75. Regarding the comment on the "cliff effect", paragraph 51 of the Consultation Paper already stated that licensed corporations are "expected to have appropriate policies and procedures in place for cases where the credit quality of the collected collateral subsequently falls below investment grade", precisely to address and mitigate any potential adverse effects of credit rating downgrades on asset disposals. In addition, paragraph 53 of the Consultation Paper stated that license corporations are expected to have appropriate policies and procedures in place to monitor and manage the concentration risk of collateral.
76. Accordingly, the SFC believes that the criteria used to determine the asset eligibility requirements and collateral haircuts are appropriate and will implement the corresponding proposals in the Consultation Paper with no amendment.

Treatment of onshore renminbi (CNY) and offshore renminbi (CNH)

Public comments

77. For the purposes of the FX haircut, two respondents suggested that onshore renminbi (CNY) and offshore renminbi (CNH) should be treated differently. One respondent commented that CNY and CNH should be treated as different currencies because they are not yet freely convertible and believed that the haircut amount should be increased. The other respondent also viewed that a higher haircut level should be applied, given that historically CNH exhibited higher volatility and thinner liquidity than CNY.

The SFC's responses

78. The SFC has taken into account the comments received and decided not to treat CNY and CNH as the same currency for the purposes of the FX haircut. It has been observed that the CNY and CNH FX rates may deviate from each other from time to time. Therefore, we propose to apply an FX haircut of 1.5% to the market value of collateral to account for the basis risk observed in the market between CNY and CNH.

IV. Scope of applicability

Questions raised in the Consultation Paper

Q7. Do you have any comments on the proposed exemptions for non-netting jurisdictions or intragroup transactions?

Q8. Should substituted compliance be available? Do you have any comments on the proposed substituted compliance regime?

Exemption for non-netting jurisdictions

Public comments

79. One respondent stated that if netting laws are unclear and there are doubts concerning the enforceability of netting agreements, it would be inappropriate to expose market participants to additional counterparty risk by exempting counterparties from posting IM and VM.

The SFC's responses

80. Paragraph 58 of the Consultation Paper stated that a licensed corporation does not need to exchange IM and VM if there is reasonable doubt as to the enforceability of the netting agreement upon default or insolvency of the counterparty, as the SFC believes that requiring a licensed corporation to post margin under such circumstances exposes it to unnecessary legal and counterparty credit risks. However, paragraph 58 of the Consultation Paper also emphasised that a licensed corporation should still prudently manage the risks arising from such non-centrally cleared OTC derivative transactions

by, for example, imposing credit and country limits. We believe that such measures, if implemented appropriately, should be sufficient to mitigate the licensed corporation's counterparty risk.

Legal opinion for netting related exemptions

Public comments

81. One respondent suggested that although it is stated in paragraph 59 of the Consultation Paper that jurisdictional opinions obtained from external independent legal counsel by industry associations are acceptable, this should be stated in the text of the final rules in the Code of Conduct for the sake of clarity.
82. The respondent also suggested that instead of just accepting external independent legal opinions on the enforceability of netting agreements or collateral arrangements, the SFC should also permit legal opinions obtained from a firm's independent internal unit, to align with the HKMA.

The SFC's responses

83. For the sake of clarity, we will supplement paragraph 48 of Part III of Schedule 10 to the Code of Conduct to make it clearer that jurisdictional opinions obtained by industry associations from external independent legal counsel are acceptable.
84. As for the request that independent internal legal opinions be allowed, where the counterparty is outside Hong Kong, the enforceability of the netting agreement or the collateral arrangement typically involves cross-border legal issues. These issues potentially relate to legal regimes in multiple jurisdictions, for example, the jurisdiction of the incorporation of the counterparty, the jurisdiction of the counterparty's branch location (if the counterparty contracts through a branch), or the jurisdiction of the location of the collateral. The applicable netting regime in some jurisdictions may differ by counterparty type, for example, state-owned banks, privately owned banks and non-banks. The scope of transactions covered by netting law may also differ among jurisdictions⁹. Since a licensed corporation's internal legal assessment of netting and collateral enforceability may involve a complex analysis of multiple jurisdictions' insolvency laws, the SFC considers it prudent that it be supported by an external independent legal analysis.

Exemption for intragroup transactions

Public comments

85. One respondent sought clarification of whether "accounted for on a full basis" (in paragraph 61(a) of the Consultation Paper) means that both the licensed corporation and its affiliate need to be 100% owned and controlled in the consolidated financial statements of the holding company.

The SFC's responses

86. Paragraph 49(a) of Part III of Schedule 10 to the Code of Conduct sets out that the proposed margin requirements do not apply to non-centrally cleared OTC derivative

⁹ ISDA publication, *Regulatory Driven Market Fragmentation*, January 2019, page 11.

transactions between a licensed corporation and a covered entity which is in the consolidated group to which the licensed corporation belongs (ie, an affiliate), provided that, among others, the licensed corporation and the affiliate are accounted for on a full basis in the consolidated financial statements of the holding company of the group of companies to which they belong, for the purpose of and in compliance with the Hong Kong Financial Reporting Standards (HKFRS) 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.

87. The relevant accounting standards set out the requirements and basis for determining which entities are consolidated in the consolidated financial statements. According to the relevant accounting standards, it is not necessary for a parent to have 100% ownership and control of a subsidiary to establish a parent-subsidiary relationship and to include that subsidiary in the parent's consolidated financial statements. The phrase "accounted for on a full basis" is to be construed accordingly and does not require both the licensed corporation and its affiliate to be 100% owned and controlled in the consolidated financial statements of the holding company. In other words, the books and records of a subsidiary are to be fully consolidated in the consolidated financial statements of the holding company according to the accounting standards.

Scope of substituted compliance

Public comments

88. All the respondents were supportive of the SFC's proposals to make substituted compliance available. Two respondents sought clarification that if a licensed corporation trades with:
- (a) a counterparty which is subject to the margin requirements of a WGMR member jurisdiction, whether the licensed corporation can follow the margin requirements of such WGMR member jurisdiction; and
 - (b) an AI which avails itself of substituted compliance under the HKMA margin regime to follow the margin requirements of the AI's home jurisdiction, whether the licensed corporation can follow the margin requirements of the AI's home jurisdiction.
89. The respondents also enquired whether a licensed corporation may follow the margin requirements of a WGMR member jurisdiction in their entirety (including asset eligibility requirements and collateral haircuts) instead of the SFC's margin requirements.
90. The respondents also requested the SFC to permit licensed corporations to use the systems and follow the margin requirements of their affiliates, which have already established systems to comply with the margin requirements of their home jurisdictions.
91. Two respondents supported the availability of substituted compliance but expressed reservations about permitting substituted compliance involving non-WGMR member jurisdictions or other emerging market regimes and commented that the SFC should review whether their margin requirements are comparable.

The SFC's responses

92. When a licensed corporation enters into a non-centrally cleared OTC derivative transaction with a counterparty which is subject to the margin requirements of another regulator or jurisdiction deemed or determined to be comparable by the SFC or HKMA, substituted compliance will be available. Under these circumstances, the licensed corporation can elect to adhere to the margin requirements applicable to its counterparty, except that the margin collected by the licensed corporation should be subject to the asset eligibility requirements and collateral haircuts set by the SFC, and the licensed corporation is still required to obtain approval in writing from the SFC before using an IM model, as mentioned in paragraph 37. For the avoidance of doubt, the licensed corporation does not have discretion to elect to adhere to the comparable margin requirements of a WGMR member jurisdiction when its counterparty is not subject to those requirements. Substituted compliance may also be subject to additional conditions that the SFC may specify at its discretion.
93. Accordingly, when a licensed corporation trades with (i) a counterparty which is subject to the margin requirements of a WGMR member jurisdiction; or (ii) an AI which avails itself of substituted compliance under the HKMA margin regime to follow the margin requirements of the AI's home jurisdiction, the licensed corporation can elect to follow the margin requirements of the WGMR member jurisdiction or the AI's home jurisdiction respectively, provided that the licensed corporation follows the SFC's asset eligibility, collateral haircut and IM model approval requirements, as well as any other conditions that the SFC may specify.
94. As for the comment on allowing a licensed corporation to use an affiliate's systems and to follow the margin requirements to which the affiliate is subject, the SFC would like to point out that (i) there is nothing in the SFC's margin requirements that precludes a licensed corporation from using its affiliate's systems, as long as the SFC's margin requirements can be complied with; and (ii) substituted compliance only enables a licensed corporation to comply with the margin requirements applicable to its trade counterparty, not with the margin requirements applicable to its affiliate. A licensed corporation which chooses to transact on a cross-border basis or belongs to a group of companies which operate in multiple jurisdictions should already have the capability to cater for different jurisdictional requirements.

Substituted compliance – comparability determination

Public comments

95. One respondent asked the SFC to disclose its standards and parameters and explain the process for making its comparability determinations in order to provide consistency and transparency.
96. Two respondents noted that while paragraph 63 of the Consultation Paper stated that the HKMA's margin regime is comparable to the SFC's (with certain exceptions), they suggested that this point should be made clearer by explicitly providing for such comparability in Part III of Schedule 10 to the Code of Conduct or by publishing a comparability determination.

The SFC's responses

97. As explained in paragraph 63 of the Consultation Paper, the SFC plans to adopt an outcomes-based approach to the determination of comparability. Accordingly, when considering whether the margin requirements of another jurisdiction or regulator are comparable, regardless of whether it is a WGMR member jurisdiction, the SFC will critically review whether the requirements of the other jurisdiction or regulator achieve outcomes which are substantively similar to the SFC's margin requirements.
98. Regarding the HKMA's current margin requirements, they are deemed as comparable to the SFC's proposed requirements, except that the margin collected by licensed corporations should be subject to the asset eligibility requirements and collateral haircuts set by the SFC, and the licensed corporation is still required to obtain approval in writing from the SFC before using an IM model, regardless of whether the licensed corporation is using its counterparty's IM model or whether the IM model has been approved by the HKMA.
99. The list of jurisdictions (or regulators of such jurisdictions) whose margin regimes are determined or deemed as comparable, and the corresponding conditions specified by the SFC, will be published in a list of jurisdictions with comparable OTC Derivative (OTCD) margin requirements on the SFC's website.

Substituted compliance – WGMR member jurisdictions

100. The SFC also takes this opportunity to update the list of WGMR member jurisdictions whose margin requirements are deemed comparable¹⁰. The HKMA issued a circular dated 18 March 2019¹¹ which deemed the UK as comparable after its planned withdrawal from the EU as the UK's margin requirements are considered comparable irrespective of its EU membership status. As such, the list of WGMR member jurisdictions as set out in the list of jurisdictions with comparable OTCD margin requirements on the SFC's website as mentioned in paragraph 99 above will specifically cover (i) the UK as from the time it withdraws from the EU; and (ii) the current WGMR member jurisdictions.
101. Accordingly, the updated list of WGMR member jurisdictions comprises Australia, Brazil, Canada, the EU, Hong Kong, India, Japan, Republic of Korea, Russia, Singapore, Switzerland, the UK as from the time it withdraws from the EU and the US.
102. The margin requirements of the WGMR member jurisdictions (or the WGMR member regulators in such jurisdictions) as set out in paragraph 101 are deemed as comparable. A licensed corporation can elect to adhere to the margin requirements of any of these WGMR member jurisdictions which are applicable to its counterparty, subject to the following conditions:
- (a) the licensed corporation is required to obtain approval in writing from the SFC before using an IM model; and
 - (b) the margin collected by the licensed corporation should be subject to the asset eligibility requirements and collateral haircuts set out in paragraphs 37 to 45 of Part III of Schedule 10 to the Code of Conduct.

¹⁰ In footnote 22 of the Consultation Paper and footnote 16 of Appendix 1 to the Consultation Paper.

¹¹ Available at this link: <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2019/20190318e2.pdf>.

103. The SFC notes that in June 2019, the US Securities and Exchange Commission (SEC) adopted new rules and rule amendments to establish capital, margin and segregation requirements under Title VII of the Dodd-Frank Act¹². In particular, the SEC has established margin requirements for nonbank security-based swap dealers with respect to non-cleared security-based swaps. We note that under the SEC's margin regime, security-based swap dealers are not required to post IM, nor to collect VM or IM under certain circumstances. A licensed corporation which elects to adhere to the SEC's margin requirements which are applicable to its counterparty will be subject to the following specific conditions (in addition to the two general conditions in paragraph 102):
- (a) if the licensed corporation elects not to collect IM from a counterparty pursuant to an exception in the SEC's regime, the licensed corporation should deduct the full amount of the IM not collected from the counterparty from its liquid capital in calculating its liquid capital;
 - (b) if the licensed corporation collects IM, any re-hypothecation, reuse or re-pledge of the IM can only be undertaken under the conditions set out in paragraph 26 of Part III of Schedule 10 to the Code of Conduct. This condition applies up to the amount of IM required to be collected under the SEC's regime, including where the licensed corporation elects to collect IM instead of relying on an exception to the collecting obligation in the SEC's regime; and
 - (c) if the licensed corporation posts IM to a counterparty, the licensed corporation should ensure that it is properly segregated and protected against the risk of insolvency of the counterparty collecting initial margin in accordance with paragraph 24 of Part III of Schedule 10 to the Code of Conduct.

V. Implementation timetable

Question raised in the Consultation Paper

Q9. Do you have any comments on the proposed IM phase-in schedule or the effective date of the VM requirements?

Public comments

104. Two respondents requested that the SFC provide sufficient time for licensed corporations and covered entities to implement the SFC's proposed margin requirements, particularly when full substituted compliance may not be available and SFC's margin requirements are different from the HKMA's.
105. One respondent suggested that it would take at least nine months for firms to adjust or build new collateral systems and IM models to comply with the SFC's proposed margin requirements, while the other respondent suggested that 12 to 18 months may be needed.

¹² Available at this link: <https://www.sec.gov/rules/final/2019/34-86175.pdf>.

The SFC's responses

106. The SFC's proposed IM phase-in schedule is in line with the BCBS-IOSCO Margin Requirements. We also understand that some market participants have already been exchanging VM as their counterparties are global financial institutions which are already subject to the VM requirements of other jurisdictions or the HKMA.
107. To ensure a smooth and orderly implementation of the BCBS-IOSCO Margin Requirements and in view of the large number of covered entities which will be subject to the final phase of the IM requirements originally scheduled for 1 September 2020, in July 2019 the BCBS and IOSCO (i) extended the final implementation of the IM requirements by one year to 1 September 2021, at which point covered entities with an AANA of non-centrally cleared OTC derivatives greater than €8 billion will be subject to the margin requirements; and (ii) added one additional implementation phase whereby as of 1 September 2020 covered entities with an AANA of non-centrally cleared OTC derivatives greater than €50 billion will be subject to the margin requirements¹³.
108. Taking into account the industry's concerns about the implementation timetable and the revised BCBS-IOSCO IM phase-in schedule, the SFC will phase in the IM requirements as follows:

	Period	Threshold
Phase-in	1 September 2020 to 31 August 2021	HK\$375 billion
Permanent	On a permanent basis from 1 September 2021 for each subsequent 12-month period	HK\$60 billion

- (a) From 1 September 2020 to 31 August 2021, the exchange of IM by a licensed corporation is required in a one-year period where both the licensed corporation and the covered entity have an AANA of non-centrally cleared OTC derivatives exceeding HK\$375 billion on a group basis.
- (b) On a permanent basis starting from 1 September 2021 and for each subsequent 12-month period, the exchange of IM by a licensed corporation is required in a one-year period where both the licensed corporation and the covered entity have an AANA of non-centrally cleared OTC derivatives exceeding HK\$60 billion on a group basis.

In each case, the AANA is the average month-end aggregate notional amount of non-centrally cleared OTC derivatives for the months of March, April and May preceding the 1 September starting date in a given year.

109. VM requirements will become effective on 1 September 2020.

¹³ See the press release by BCBS and IOSCO: <https://www.bis.org/press/p190723.htm>.

110. The draft Regulatory Technical Standards published by the European Supervisory Authorities on 5 December 2019¹⁴ proposed several amendments to the EU margin regime for non-centrally cleared OTC derivatives, including one which defers the application of margin requirements for single-stock equity options and index options transactions until 4 January 2021. Given that some jurisdictions have not implemented margin requirements for these transactions, the European Supervisory Authorities considered that the amendment was appropriate to avoid market fragmentation and ensure a level playing field for market participants. The draft Regulatory Technical Standards are subject to endorsement by the European Commission and non-objection by the European Parliament and the Council.
111. To prevent regulatory arbitrage, the SFC plans to align the effective date of its margin requirements for non-centrally cleared single-stock options, equity basket options and equity index options with the EU's timeline. Accordingly, the margin requirements for these instruments under the SFC's regime will be deferred until 4 January 2021 or as otherwise specified in the finalised Regulatory Technical Standards. The deferred date is stated in paragraph 7(e) of Part III of Schedule 10 to the Code of Conduct, as set out in Appendix A. If the EU's timeline changes before the effective date of the SFC's margin requirements, this paragraph will be amended when the margin requirements are gazetted.
112. The SFC also takes this opportunity to clarify the interaction of the margin requirements with benchmark reforms. Paragraph 69 of the Consultation Paper mentioned the need for licensed corporations to have sufficiently robust fallback provisions in their financial contracts and instruments, as recommended in the IOSCO Statement on Matters to Consider in the Use of Financial Benchmarks (IOSCO Statement). Both paragraph 69 of the Consultation Paper and the IOSCO Statement are not limited to interest rate benchmarks, but instead cover all types of financial benchmarks. Accordingly, an amendment to an existing non-centrally cleared OTC derivative contract in response to the international benchmark reforms for the purposes of adopting fallback provisions for a reference benchmark, whether for interest rate or other types of benchmarks, would not, in itself, subject the amended contract to the proposed margin requirements¹⁵.

¹⁴ Final Report – EMIR RTS on various amendments to the bilateral margin requirements in view of the international framework: https://www.esma.europa.eu/sites/default/files/library/esas_2019_20_-_final_report_-_bilateral_margin_amendments.pdf.

¹⁵ Any necessary consequential changes to the contract attributable solely to the difference in the transaction's fair value due to such change of benchmark would also be considered a genuine amendment and would not, in itself, subject the amended contract to the proposed margin requirements.

Consequential amendment

113. With the introduction of the margin requirements, we propose to make a consequential amendment to paragraph 4.3A of the Code of Conduct by incorporating a reference to the margin requirements. Paragraph 4.3A was not shown in the Consultation Paper and so has now been presented in Appendix A of this paper for completeness.
114. We also propose to align the definition of financial counterparty for the margin requirements in Part III of Schedule 10 with that for the risk mitigation requirements in Part I of Schedule 10 to the Code of Conduct by making amendments to the definition proposed in the Consultation Paper in Part III of Schedule 10 to the Code of Conduct and consequential amendments to the definition in Part I of Schedule 10 to the Code of Conduct. The revised definition of financial counterparty is set out in Appendix B.

Appendix A Amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – paragraph 4.3A and new Part III of Schedule 10

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.

Substitute heading to Schedule 10

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

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 SFC¹, but excludes a sovereign², public sector entity³, multilateral development bank⁴, and the Bank for International Settlements. Any reference to “counterparty” below means covered entity, unless stated otherwise.

¹ 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 Schedule are fulfilled or that its requirements are not circumvented, or the SFC is otherwise satisfied that it is appropriate to do so.

² Sovereign means (a) HKSAR; (b) the central government of a country; or (c) the central bank of a country.

³ Public sector entity means any agency of HKSAR or of a central government that is incorporated or established for non-commercial purposes.

⁴ As specified by the HKMA in the Banking (Specification of Multilateral Development Bank) Notice (Cap. 155N) www.elegislation.gov.hk/hk/cap155N/en.pdf.

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, and means:
- ~~(a) an authorized institution as defined in section 2(1) of the Banking Ordinance (Cap 155);~~
 - ~~(b) a licensed corporation;~~
 - ~~(c) a mandatory provident fund scheme registered under the Mandatory Provident Fund Schemes Ordinance (Cap 485);~~
 - ~~(d) an occupational retirement scheme registered under the Occupational Retirement Schemes Ordinance (Cap 426);~~
 - ~~(e) a company authorised by the Insurance Authority to carry on any class of insurance business under the Insurance Companies Ordinance (Cap 41);~~
 - ~~(f) a money service operator (ie, remittance agents and money changers) licensed by the Commissioner of Customs & Excise under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap 615);~~
 - ~~(g) a money lender licensed under the Money Lenders Ordinance (Cap 163);~~
 - ~~(h) a special purpose vehicle or a securitisation vehicle, except where and to the extent that the special purpose vehicle enters into non-centrally cleared OTC derivative transactions for the sole purpose of hedging;~~
 - ~~(i) a collective investment scheme as defined in section 1, Part 1 of Schedule 1 of the SFO⁵;~~
 - ~~(j) an entity that carries on a business outside Hong Kong and is engaged predominantly in any one or more of the following activities:~~
 - ~~(i) Banking;~~
 - ~~(ii) Securities or derivatives business;~~
 - ~~(iii) Asset management;~~
 - ~~(iv) Insurance business;~~
 - ~~(v) Operation of a remittance or money changing service;~~
 - ~~(vi) Lending;~~
 - ~~(vii) Activities that are ancillary to the conduct of these activities.~~

⁵ For the avoidance of doubt, this would include (but is not limited to) hedge funds, mutual funds and pension funds.

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:
- (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 level⁶ by including all non-centrally cleared OTC derivatives of all entities within the consolidated group of companies⁷; 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.

Group of Companies Consolidated Group

5. Group of companies "Consolidated Group" means a group of entities for which consolidated financial statements are prepared ~~(consolidated group)~~.

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:

⁶ 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.

⁷ 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.

- (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 transactions" embedded in cross-currency swaps associated with the exchange of principal⁸, 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 ~~29 February 2020~~ 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 management⁹;
- (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\$15 billion~~ HK\$60 billion.

Margin requirements

Initial margin ("IM") requirements

⁸ 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.

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

9. A licensed person should exchange (ie, post and collect) IM¹⁰ 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 2020 to 31 August 2021, 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\$375 billion;
 - (b) on a permanent basis from 1 September 2021 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 billion¹⁴.
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 calculation¹².
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.

¹⁰ 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.

¹⁴ ~~IM requirements are phased in according to the schedule detailed in paragraph 65 of the Consultation Paper on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions, June 2018.~~

¹² 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.

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 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 groups⁴³. 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 collected

22. When a licensed person is the party collecting party of IM, appropriate collateral arrangements, including credit support arrangements, should be in place which are legally effective in the event that the party posting IM party defaults or becomes insolvent.
23. A licensed person as the party collecting IM party 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 party defaults or becomes insolvent; and
 - (b) provide the party posting IM party 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 party 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 party defaults or becomes insolvent; and

⁴³ An investment fund managed by an asset manager will be treated as an entity that is separate from the consolidated group for the purposes of applying the IM threshold 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.

(b) is segregated from the collecting party's 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 of companies; 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 exchange¹⁴ VM¹⁵ with a covered entity for non-centrally cleared OTC derivative transactions 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.

¹⁴ Exchange of margin means the posting and collecting of margin between two covered entities.

¹⁵ 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 margin¹⁶ 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 margin¹⁷

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 sovereign¹⁸ or a relevant international organisation¹⁹;
 - (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;
 - (e) Other marketable debt securities;

¹⁶ Exchange of margin means the posting and collecting of margin between two covered entities.

¹⁷ These asset eligibility requirements apply even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50

¹⁸ See footnote 2

¹⁹ As defined in section 2 of Banking (Capital) Rules (Cap 155L). www.elegislation.gov.hk/hk/cap155L/en-assist.pdf

- (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 ~~party of~~ 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 ~~of companies~~ 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.

Haircuts²⁰

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% (“FX Haircut”) 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 opinion²¹ 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.

Intragroup transactions

49. The margin provisions in ~~this Part III of this Schedule~~ 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,

²⁰ These haircut requirements apply even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

²¹ 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.

- (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 of companies 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 of companies to which they belong.

Substituted compliance-Comparability assessment

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 satisfied²²:

- (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 WGMR²³ 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 HKMA; or
 - (ii) a comparability determination in respect of the counterparty’s margin requirements has been issued by the SFC or HKMA; and
- (c) the licensed person must comply with all conditions specified by the SFC in respect of it adhering to the counterparty’s margin requirements.

Substituted compliance is available for those transactions in non-centrally cleared OTC derivatives if the SFC or HKMA has issued a comparability determination or the respective foreign jurisdiction is deemed comparable pursuant to paragraph 51. Comparability determination may be made on all or part of a foreign jurisdiction’s requirements, and may be subject to conditions. Where a comparability determination has been issued by HKMA in respect of a given jurisdiction’s requirements, licensed

²² 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).

²³ Working Group on Margining Requirements under the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

~~persons may elect to adhere to such requirements, subject to such modification or restriction as the SFC may specify at its discretion.~~

~~51. Where a licensed person notifies the SFC of their intention to comply with the margin requirements of WGMR member jurisdictions²⁴, such requirements are deemed as comparable from the day the respective standards have entered into force in such jurisdiction until the SFC or HKMA has completed a comparability assessment.~~

²⁴~~The WGMR member jurisdictions are Australia, Canada, the European Union, India, Japan, Republic of Korea, Mexico, Russia, Singapore, Switzerland and the United States.~~

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 derivatives in the legally enforceable netting set. The IM amount ~~is~~ would be calculated in two steps. First, the margin rate in the schedule set out in A.3 ~~is~~ would be multiplied by the gross notional size for each derivative contract, and then this calculation ~~is~~ would be 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 ²⁵ :	
0-2 year duration	1
2- 5 year duration	2
5+ year duration	4
Foreign exchange	6
Commodity ²⁶	15
Equity	15
Credit:	
0-2 year duration	2
2-5 year duration	5
5+ year duration	10
Other	15

²⁵ Inflation swaps, which transfer inflation risk between counterparties, are to be considered as part of the interest rate asset class.

²⁶ This includes gold and other precious metals such as silver and platinum.

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 model²⁷.
- 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 days²⁸.
- 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 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.

²⁷ This requirement applies even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

²⁸ 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 in case 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.

- 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 ²⁹		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 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 ~~associated with the applicable credit quality grades.~~

²⁹ Please refer to paragraph 37(g) for details.

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

Appendix B Consequential amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – Part I of Schedule 10

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

- (1) “financial counterparty” means:
- (a) an authorized institution (AI) as defined in section 2(1) of the Banking Ordinance (Cap 155);
 - (b) a licensed corporation;
 - (c) a ~~mandatory~~ 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~~ ~~the Mandatory Provident Fund Schemes (General) Regulation (Cap 485 sub. leg. A)~~;
 - (d) an occupational retirement scheme ~~registered under the Occupational Retirement Schemes Ordinance (Cap 426), or any scheme which is an offshore scheme~~ as defined in the section 2(1) of the Occupational Retirement Schemes Ordinance (Cap 426);
 - (e) an ~~insurer company~~ authorised by the Insurance Authority to carry on any ~~class of insurance business~~ under the Insurance Companies Ordinance (Cap 41);
 - (f) a ~~licensed~~ money service operator ~~(ie, remittance agents and money changers)~~ licensed by the Commissioner of Customs & Excise under ~~as defined in section 1 of Part 2 of Schedule 1 to the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap 615)~~;
 - (g) a money lender licensed under the Money Lenders Ordinance (Cap 163);
 - (h) a special purpose vehicle or a securitisation vehicle, except where and to the extent that the special purpose vehicle enters into non-centrally cleared OTC derivative transactions for the sole purpose of hedging;
 - (i) a collective investment scheme as defined in section 1, Part 1 of Schedule 1 ~~to of the SFO, or any scheme which is similarly constituted under the law of any place outside Hong Kong~~;
 - (j) an entity that carries on a business outside Hong Kong and is engaged predominantly in any one or more of the following activities³⁰:
 - Banking;
 - Securities or derivatives business;

³⁰ ~~For the avoidance of doubt, this would include (but is not limited to) hedge funds, pension funds and asset managers.~~

- Asset management;
- Insurance business;
- Operation of a remittance or money changing service;
- Lending;
- Activities that are ancillary to the conduct of these activities.

Appendix C List of respondents

(in alphabetical order)

1. Bank of New York Mellon, Northern Trust Company and State Street Bank and Trust Company
2. Complyport (HK) Limited
3. Global Financial Markets Association
4. ICI Global
5. International Swaps and Derivatives Association, Inc
6. Moody's Investors Service
7. The Hong Kong Society of Financial Analysts
8. The Japanese Bankers Association
9. The Law Society of Hong Kong