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TO:

Securities and Futures Commission
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August 17, 2018

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

Dear Securities and Futures Commission,

The Global Foreign Exchange Division ("GFXD") of the Global Financial Markets Association ("GFMA") welcomes the opportunity to provide comments to the SFC on its consultation paper published on June 19, 2018 "Proposed margin requirements for non-centrally cleared OTC derivative transactions" (the "CP").

The GFXD was formed in co-operation with the Association for Financial Markets in Europe (AFME), the Securities Industry and Financial Markets Association (SIFMA) and the Asia Securities Industry and Financial Markets Association (ASIFMA). Its members comprise 25 global foreign exchange (FX) market participants,[1] collectively representing around 80% of the FX inter-dealer market.[2] Both the GFXD and its members are committed to ensuring a robust, open and fair marketplace and welcome the opportunity for continued dialogue with global regulators.

The FX market is the world's largest financial market and effective and efficient exchange of currencies underpins the world's entire financial system. The FX market is also the basis of the global payments

[1] Bank of America Merrill Lynch, Bank of New York Mellon, Barclays, BNP Paribas, Citigroup, Crédit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds Bank, Mizuho, Morgan Stanley, MUFG Bank, Natwest Markets, Nomura, Royal Bank of Canada, Scotiabank, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

[2] According to Euromoney league tables.

system. The volume of transactions is therefore very high, and these transactions are often executed by market participants across geographical borders.

Many of the current legislative and regulatory reforms have had, and will continue to have, a significant impact upon the operation of the global FX market, and the GFXD wishes to emphasise the desire of its members for globally coordinated regulation, which we believe will be of benefit to both regulators and market participants alike.

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We support the SFC taking the initiative to implement G20 commitments to reform the OTC derivative markets and provide the following input in respect of questions raised in the CP:

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?

Physically-settled FX Forward and Swaps Transactions

We welcome and agree with the SFC's exemption of physically-settled FX forwards and swaps from initial margin ("IM") requirements. As indicated in the March 2015 Basel Committee on Banking Supervision and International Organization of Securities Commissions "Margin requirements for non-centrally cleared derivatives" (the "International Margin Framework"),[3] these products merit exclusion due to their unique characteristics.

However, in order to avoid undue costs and operational burdens being imposed on end-users of FX relying on these products to hedge their currency risk, and in order to promote greater consistency with the treatment of these products by the HKMA and under regulations in other global jurisdictions,[4] we urge the SFC to similarly exempt physically-settled FX forwards and swaps from the variation margin ("VM") provisions as well, for the reasons we explain below.

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[3] Available at http://www.bis.org/bcbs/publ/d317.htm.

[4] The HKMA and several other global regulators (United States, Japan, Canada, Singapore, Australia, Switzerland, Korea and Brazil) have explicitly excluded physically-settled FX forwards and swaps in respect of both IM and VM under their rules. VM is provided for in the EU, but may be limited to only transactions where both parties are "Institutions" as defined in the EU Capital Requirements Regulation (EU Regulation (EU) No 575/2013) – the "CRR"). See https://esas-joint-committee.europa.eu/Publications/Technical%20Standards/Joint%20Draft%20RTS%20on%20margin%20requirements%20for%20non-centrally%20cleared%20OTC%20derivatives%20(JC-2017-79).pdf (the "EU Margin RTS Amendment").

The proposed SFC rules apply VM obligations for physically-settled FX forwards and swaps where the relevant transactions are entered into by a licensed person with an: (i) AI, (ii) LC, or (iii) entity that carries on a business outside Hong Kong and is engaged predominantly in any one or more of these activities: banking, securities or derivatives business and asset management (where both parties exceed a HKD 15 billion threshold of OTC derivatives activity).

The SFC indicates it is seeking to appropriately balance systemic risk reduction benefits with operational costs of implementing margin requirements, particularly for smaller, less sophisticated counterparties who may have limited non-centrally cleared OTC derivative exposures. The SFC also indicates an intention to achieve consistency with the International Margin Framework and approaches taken in the EU and US. We are concerned, however, that the SFC's imposition of mandatory and prescriptive VM obligations on users of these FX hedging products may lead to substantial fragmentation of FX market liquidity within Hong Kong, potentially also having adverse consequences on the broader FX market.

In addition to the challenges which arise where regulatory approaches are not consistent as between regulatory bodies, implementing necessary capabilities for mandatory exchange of VM for physically-settled FX forwards and swaps requires significant cost, infrastructure build, creation of a counterparty classification/categorization system, as well as the commitment of cash or other liquid assets as collateral.[5] As recognized by the SFC,[6] it is therefore important to ensure that regulatory obligations take into account and reflect the nature and extent of the risks posed that are to be mitigated and minimize burdens on end-users. If the obligations are not commensurate with the risks posed, entities within scope of the SFC's margin rules may, due to the prescriptive VM requirements, be challenged in managing their currency risk through the use of physically-settled FX forwards and swaps, and their counterparties who do not themselves bear these obligations under their own regulatory framework may be deterred from trading with them, which could have adverse liquidity impacts.[7]

Furthermore, the focus of the International Framework, which forms the foundation for global uncleared margin rules, is to ensure margin requirements are implemented which (i) address the relevant risks posed,[8] and (ii) mitigate systemic risk.[9] Per the International Margin Framework, "[t]he

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[5] Also, some entities may have already built systems and set up documentation and operational processes in line with the HKMA Rules.

[6] See CP p.10 " . . . this should minimise the operational burden on end users."

[7] See International Margin Framework pp. 3,4: "The effectiveness of margin requirements could be undermined if the requirements were not consistent internationally. Activity could move to locations with lower margin requirements, raising two concerns: The effectiveness of the margin requirements could be undermined (ie. regulatory arbitrage). Financial institutions that operate in the low-margin locations could gain a competitive advantage (ie. unlevel playing field)."

[8] International Margin Framework, p.10: "All covered entities . . . must exchange initial and variation margin as appropriate to the counterparty risks posed by such transactions."

[9] International Margin Framework p.7, "The BCBS and IOSCO recognise that the exchange of variation margin is a prudent risk management tool that limits the build-up of systemic risk." and " . . . the BCBS and

BCBS and IOSCO believe that the margin requirements need not apply to non-centrally cleared derivatives to which non-financial entities that are not systemically important are a party, given that . . . such transactions are viewed as posing little or no systemic risk . . .”.[10]

Predominantly, regulators around the world, including the HKMA, have not imposed mandatory prescriptive VM requirements for physically-settled FX forwards and swaps. In the US, for example, physically-settled forward and swaps are excluded from margin rules, with the US Federal Reserve instead indicating its expectations regarding VM for these FX products - for large financial institutions supervised by the Federal Reserve - via adoption[11] of the 2013 “BCBS Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions” (the “FX Supervisory Guidance”).[12] These large financial institutions, however, consist of the largest, most complex US and foreign financial organizations subject to consolidated supervision by the Federal Reserve (because they are considered to pose the greatest systemic risk to the US economy), domestic US bank and savings and loan holding companies with consolidated assets of USD50 billion or more and foreign banking organizations with combined assets of US operations of USD50 billion or more. Furthermore, the FX Supervisory Guidance itself recommends VM for physically-settled FX only for firms that implicate systemic risk, recommending that banks exchange VM necessary to fully collateralise the mark-to-market exposure to physically settled FX swaps and forwards with counterparties that are financial institutions (interdealer) and “systemically important” non-financial entities.

In the EU, which itself is somewhat of an outlier,[13] it is clear as well that the purpose of the EU margin rules permitting the limitation of VM for physically-settled FX forwards and swaps to those where both counterparties are CRR “Institutions” (“credit institutions” and “investment firms”) is to avoid international regulatory divergence between the EU and other jurisdictions in respect of the mandatory exchange of VM on these products by applying VM to such transactions only between the most systemic counterparties, such as “dealer-to-dealer”.[14] The CRR’s “investment firms” definition is a

IOSCO have considered the extent to which potential approaches would capture all or substantially all systemic risk arising from non-centrally cleared derivatives, the risk of which is generally concentrated among the activities of the largest key market participants transacting in a significant amount of non-centrally cleared derivatives (eg. through dealing or other activities).”

[10] International Margin Framework, p.9. See also CP p.8.

[11] See https://www.federalreserve.gov/supervisionreg/srletters/sr1324.htm.

[12] Available at http://www.bis.org/publ/bcbs241.pdf (See Guideline 3).

[13] VM is provided for in the EU but may be limited to transactions only where both parties are “Institutions” as defined in the EU Capital Requirements Regulation (the “CRR”), comprising “credit institutions” and “investment firms” as defined thereunder.

[14] See EU Margin RTS Amendment, pp. 16 and 18: “Overall, the preferred option, as implemented in these amending RTS, would be to restrict the mandatory exchange of variation margins for physically settled FX forwards to transactions between institutions, as defined by the CRR, in a way similar to the US approach, which captures the dealer-to-dealer transactions.” and “ . . . it appropriately limits risks of systemic contagion, while limiting competitive distortion and ensuring that end-users can benefit from the appropriate exemptions.”

subset of those under the MiFID definition, with exclusions based on the assumption that some of the excluded firms are small and would pose a minimal risk to the financial system.[15] Thus, the CRR definition covers only those firms subject to the MiFID definition that, broadly speaking, means non-bank entities that take balance sheet risk in association with their dealing, underwriting or otherwise placing of securities, or hold client money or assets, or operate certain trading platforms. The definition does not refer to the size of a firm or its transaction exposures and is meant to capture entities engaged in securities or derivatives activities that could present risks to the financial system or risks to clients, to which the application of a more comprehensive prudential regime based on the Basel framework is considered to be justified.

In light of all this, we are concerned that, given HKD 15 billion is a relatively low threshold of derivatives activity, SFC licensed persons and transactions not considered "systemic" are brought within scope of prescriptive and mandatory VM requirements and that, as a result, these added obligations introduce regulatory divergence. Physically-settled FX forwards and swaps are relied upon by entities around the world to hedge currency risk exposures, so coordinated regulation in respect of these very straightforward, short-dated and fundamental FX products is vital.

We therefore urge the SFC to follow the approach taken by the HKMA and other global regulators and exempt physically-settled FX swaps and forwards from the mandatory and prescriptive VM requirements under the SFC rules. Rather than impose stringent VM requirements on physically-settled FX forward and swaps for the defined set of entity types, we suggest that the SFC take a more risk-based approach to VM for these FX products to ensure VM is limited in respect of physically-settled FX transactions to where it is deemed necessary and appropriate in light of the risks posed.[16] In our view, this would achieve closer and better alignment with the HKMA and other jurisdictions, whilst still enabling an approach that ensures the relevant risks are adequately addressed.

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[15] See https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-20+Report+on+investment+firms.pdf (p.13).

[16] Such as the approach taken by the Federal Reserve, as discussed. The HKMA in its January 2017 Supervisory Policy Manual on Margin and Other Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives Transactions states that physically-settled FX forwards and swaps are exempted from the margin requirements, but that in-scope entities are expected to appropriately manage the risks associated with non-centrally cleared FX transactions, referencing the FX Supervisory Guidance. See http://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-14.pdf. In Singapore the MAS in its October 2015 Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives states that physically-settled FX forwards and swaps are exempted from the margin requirements, but that entities are expected to appropriately manage the risks associated with such FX transactions, referencing the FX Supervisory Guidance. See http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Policy%20Consultation%20on%20Margin%20Requirements%20for%20NonCentrally%20Cleared%20OTC%20Derivatives%201Oct.pdf (Footnote 7).

Security Conversion Transactions

We agree with the points made in the CP regarding FX security conversion transactions being akin to FX spot transactions and fully support the exclusion of FX security conversion transactions from all margin requirements.

Other questions

In addition to the points made above regarding Question 2, we also wish to express our support for several points made by The International Swaps and Derivatives Association, Inc. (ISDA) in its letter dated August 17, 2018:

- **Question 5 (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?)**: Regarding the noted discrepancies between the asset eligibility requirements and collateral haircuts proposed by the SFC versus those under the HKMA Rules, we also urge the SFC to harmonize its requirements as far as possible with the HKMA Rules.

- **Question 8 (Should substituted compliance be available? Do you have any comments on the proposed substituted compliance regime?)**: Given the significant extent of cross-border activity in the FX market, we are also very supportive of substituted compliance being made available and reiterate the points raised by ISDA.

In respect of **Question 7** (**Do you have any comments on the proposed exemptions for non-netting jurisdictions or intragroup transactions?**), we suggest the SFC make clear in the final rule text that jurisdictional opinions obtained from external independent legal counsel by industry associations are acceptable (as indicated in the commentary on p.19 of the CP) and also request that a legal opinion obtained from the firm's independent internal unit be permitted. This would better align the SFC rules with the approach taken by the HKMA.

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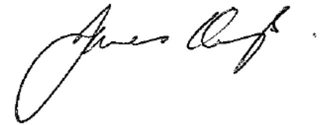
We greatly appreciate you giving us the opportunity to share our views on the draft margin regulations. Please do not hesitate to contact John Ball on+ 852 2531 6512, email jball@gfma.org or Victoria Cumings on +1 212 313 1141, email vcumings@gfma.org, should you wish to discuss the above.

Yours sincerely,



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