SECURITIES AND FUTURES COMMISSION

SFC

證監會

# Table of contents


Foreword 3

Personal information collection statement 4

Abbreviations and acronyms 6

I. Background 7

II. Overview of proposed margin requirements 8

III. Instruments subject to the proposed margin requirements 9

IV. Proposed margin requirements 11

Initial margin (IM) requirements 11

IM threshold 13

Treatment of IM collected 13

Variation margin (VM) requirements 14

Minimum transfer amount 15

Timing of the exchange of margin 15

Assets eligible as margin 16

Haircuts 17

V. Scope of applicability 18

Netting 18

Intragroup transactions 19

Comparability assessment 20

VI. When will the proposed requirements come into effect? 20

Appendix 1: Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ± Schedule 10 Part II 23

Part II Margin requirements 23

Terminology 23

Instruments subject to the requirements 25

Margin requirements 26

Scope of applicability 33

Annex A - Calculating IM amounts by reference to a standardised margin schedule 35

Annex B - Calculating IM amounts by reference to a quantitative portfolio margin model 36

Annex C - Standardised haircut schedule 38

## Personal information collection statement

1. This Personal Information Collection Statement (PICS) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data[1] will be used following collection, what you are agreeing to with respect to the SFC's use of your Personal Data under the Personal Data (Privacy) Ordinance (Cap. 486) (PDPO).

### Purpose of collection

2. The personal data provided in your submission to the SFC in response to this consultation paper may be used by the SFC for one or more of the following purposes:

   (a) To administer the relevant provisions[2] and codes and guidelines published pursuant to the powers vested in the SFC.

   (b) In performing its statutory functions under the relevant provisions.

   (c) For research and statistical purposes.

   (d) For other purposes permitted by law.

### Transfer of personal data

3. Personal data may be disclosed by the SFC to members of the public in Hong Kong and elsewhere as part of the public consultation on this consultation paper. The names of persons who submit comments on this consultation paper, together with the whole or any part of their submissions, may be disclosed to members of the public. This will be done by publishing this information on the SFC website and in documents to be published by the SFC during the consultation period or at its conclusion.

### Access to data

4. You have the right to request access to and correction of your personal data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your personal data provided in your submission on this consultation paper. The SFC has the right to charge a reasonable fee for processing any data access request.

### Retention

5. Personal data provided to the SFC in response to this consultation paper will be retained for such period as may be necessary for the proper

[1] Personal data means personal information as defined in the Personal Data (Privacy) Ordinance (Cap. 486).

[2]

## Enquiries

6. Any enquiries regarding the personal data provided in your submission on this consultation paper, requests for access to personal data or correction of personal data should be addressed in writing to:

The Data Privacy Officer

# I. Background

1. In September 2013, the SFC released consultation conclusions on the primary legislation for the regulation of OTC derivatives[3]. The Securities and Futures (Amendment) Ordinance 2014 was enacted in 2014.

2. In March 2015, the Working Group on Margining Requirements (WGMR), with participation by members of BCBS[4] and IOSCO[5], published the report Margin requirements for non-centrally cleared derivatives (BCBS-IOSCO Margin Requirements )[6]. This report sets out the standards for margin requirements for non-centrally cleared OTC derivatives.

3. The SFC is seeking comments from the public on proposals to implement margin requirements for non-centrally cleared OTC derivatives set out in the BCBS-IOSCO Margin Requirements.

4. The proposed variation margin (VM) requirements will apply to a licensed corporation which is a contracting party[7] to a non-centrally cleared OTC derivative transaction[8] entered into with a covered entity[9] (covered entity , described further in paragraph 8 below) when the licensed corporation itself or the group to which it belongs has an average aggregate notional amount[10] of non-centrally cleared OTC derivatives exceeding HK$15 billion[11]. These licensed corporations may also be subject to the proposed initial margin (IM) requirements if the average aggregate notional amount of non-centrally cleared OTC derivatives on a group basis exceeds HK$60 billion, as explained further in this consultation paper.

5. The proposed requirements would not apply to authorised institutions (AI), nor to approved money brokers (within the meaning of the Banking Ordinance). These entities would continue to be overseen and regulated by the HKMA.

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[3] Joint Supplemental Consultation Conclusions on the OTC Derivatives Regime in Hong Kong ±Proposed Scope of New/Expanded Regulated Activities and Regulatory Oversight of Systemically Important Participants (September 2013).

[4] Basel Committee on Banking Supervision.

[5] International Organization of Securities Commissions.

[6] Available at www.bis.org/bcbs/publ/d317.pdf.

[7] A contracting party refers to a party which enters into a non-centrally cleared OTC derivative transaction as principal, whether contracting directly or through an agent.

[8] Other than excluded transactions, see section III, Instruments subject to the proposed margin requirements below.

[9] See the terminology section of Appendix 1 for details.

[10] The average aggregate notional amount is calculated as the average of the total gross notional amount of month-end positions of non-centrally cleared OTC derivatives for the March, April and May preceding the 1 September starting date in the year when margin should start to be exchanged.

[11]

II. Overview of proposed margin r

## IV. Proposed margin requirements

Initial margin (I M)

calculated in an appropriately risk-sensitive manner using a sound methodology and that the model itself is well designed and correctly implemented.

34. To ensure IM posted by a licensed corporation is properly segregated and protected against the risk of insolvency of the collecting counterparty, we also propose that a licensed corporation as a posting party should ensure that IM posted:

(a) is subject to arrangements that protect the licensed corporation to the extent possible under applicable law in the event that the collecting party defaults or becomes insolvent; and

(b) is segregated from the collect L Q J S D U W \ ¶ V S U R S U L H W D U \ D I V H W V 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 collecting party.

35. In order to provide a similar level of protection to a counterparty which posts IM to a licensed corporation, we propose that a licensed corporation as the collecting party should provide the posting party with the option to have the IM that it posts segregated from the IM posted by other counterparties.

36. If a third-party custodian is used, we propose that the licensed corporation should ensure that:

(a) the custodian is not a group member of the collecting or posting party; and

(b) the financial condition and credit standing of the custodian is regularly monitored.

Rehypothecation, repledging and reuse of IM

37. Rehypothecating, repledging or reusing collected IM may result in the IM being comming( )-4(o)1y0( )-4(i)5(n)13( )-4(t)-4(he)14epledne IM beiwh

changes in the mark-to-market value of the contract after the transaction has been executed.

40. We propose that a licensed corporation should exchange VM with a covered entity for a non-centrally cleared OTC derivative transaction when the licensed corporation itself or the group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion. This seeks to balance the systemic risk reduction benefits versus the operational costs of implementing the margin requirements, particularly for smaller, less sophisticated counterparties who mal,ler, count4( 1 0 5(i)5(

46. We propose that 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. Examples of events that may result in changes in measured potential future exposure include:

(a) the relevant netting set changes (eg, new transactions are conducted, existing transactions are terminated or expire);

(b) for licensed corporations using the model approach, changes to the IM model are made which affect IM amounts; or

(c) for licensed corporations using the standardised approach, changes are made to the classification of an existing contract to a specific asset category outlined in Annex A to Appendix 1 of the consultation paper.

47. We propose that 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.

48. We propose that IM and VM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.

## Assets e ligible as margin

49. It is critical that assets collected as IM or VM by a licensed corporation hold their value. This is especially important in times of financial stress, when the counterparty may be at increased risk of default or insolvency and the licensed corporation may need to realise the value of the assets held as margin. Therefore, assets collected as margin should be highly liquid and should maintain their value in times of financial stress, even after applying appropriate haircuts. However, the benefits of protecting a licensed corporation I U R P I X U W K H U O R V V H V D J D L Q V W D F R X Q W H U S D U W \ ¶ V G H I D X exchange of liquid assets for margin need to be balanced against the liquidity strain that such a requirement will place on the wider financial system. Accordingly, restricting the assets eligible as margin to only the most liquid, high-quality assets such as cash or highly-rated sovereign bonds, may not be entirely appropriate.

50.

(g) Listed shares which are subject to a haircut percentage of 15% under Schedule 2 to the Securities and Futures (Financial Resources) Rules (FRR)[20], including:

(i) Shares which are listed on a recognized stock market: being a constituent of the Hang Seng Index;

(ii) Shares which are listed on a specified exchange in the United Kingdom other than shares which are listed on London Stock Exchange plc

arrangements for the protection of posted collateral are questionable or not legally enforceable upon the default or insolvency of the counterparty. However, this does not negate the need for a licensed corporation to prudently manage the risks arising from such non-centrally cleared OTC derivative transactions, such as imposing credit and country limits.

59. Additionally, to benefit from this exemption, the licensed corporation is expected to have undertaken an assessment of the enforceability of the netting agreement or the collateral arrangements, which should be supported by an external legal opinion in writing. Jurisdictional opinions obtained from external independent legal counsels by an industry association of which the licensed corporation (or its group) is a member are acceptable. All legal opinions should be updated regularly as appropriate, in particular where there are developments in the relevant law or practice. A licensed corporation which has made this election for a given non-netting jurisdiction should account for all transactions covered by such election on a gross basis instead of a net basis in its regulatory capital for counterparty risk exposure.

### Intragroup transactions

60. Non-centrally cleared OTC derivative transactions between a licensed corporation and a covered entity in the consolidated group to which the licensed corporation also belongs (ie, an affiliate) give rise to risks within the same group. Nevertheless, intragroup transactions may facilitate more effective risk management. Aggregating trades across group companies and managing the risks on a portfolio basis can create scale efficiencies and netting benefits. We do not wish to discourage licensed corporations and their affiliates from effectively and efficiently managing their risk exposures arising from non-centrally cleared OTC derivative transactions. The exchange of margin for intragroup transactions is not a universal requirement in other jurisdictions.

61. Having considered the benefits of requiring margin for intragroup transactions against the increased liquidity demand on the licensed corporation and the wider financial system, we propose that such transactions be exempt from the proposed margin requirements, subject to the conditions that:

(a) the licensed corporation and the affiliates are accounted for on a full basis in the group consolidated financial statements; and

(b) the risk evaluation, measurement and control procedures applicable to the licensed corporation and the affiliates are centrally overseen and managed within the group of companies to which they belong.

Comparability assessment

62. Given that the non-centrally cleared OTC derivatives market is global, it is likely that a transaction could be subject to the margin requirements of two or more regulators or jurisdictions. To avoid applying duplicative or conflicting margin requirements to the same non-centrally cleared OTC derivative transactions, we propose to allow substituted compliance for those transactions which are subject to the margin requirements of another regime:

(a)

| | Period | Threshold |
|---|---|---|

Appendix 1

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ±Schedule 10 Part I I

Schedule 10 Risk mitigation and margin requirements for non-centrally cleared OTC derivative transactions; Requirements for licensed persons providing client

(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 (i.e. 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 SFO[5];

(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.

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 group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$60 billion.

[5] For the avo

(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, 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 authorised institution as defined in section 2(1) of the Banking Ordinance (Cap 155);

(ii) a licensed corporation; or

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

- Banking;
- Securities or derivatives business; and
- Asset management;

(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 group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion.

## Margin requirements

### Initial margin (IM) requirements

9. A licensed person should exchange (i.e. post and collect) IM[8] on a gross basis with a covered entity to non-centrally cleared OTC derivative transactions where both the licensed person and the covered entity have an average aggregate notional amount of

[7] 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, i.e. 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.

[8] 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 initial margin reflects the size of the potential future exposure.

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 HK$ P L O O L R Q ³ , 0 W K U H V K R O G ´

19. The IM threshold is applied at the level of the consolidated groups to which the licensed person and the counterparty belong and is based on all non-centrally cleared OTC derivatives outstanding between the two consolidated groups[11]. 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 collecting party of IM, appropriate collateral arrangements, including credit support arrangements, should be in place which are legally effective in the event that the posting party defaults or becomes insolvent.

23. A licensed person as the collecting 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 posting party defaults or becomes insolvent; and

(b)

26. IM collected from a counterparty may be rehypothecated, repledged or reused (henceforth rehypothecated) with a third party only for the purpose of hedging the licensed p H U V R Q ¶ V G H U L Y D W L Y H S R V L W L R Q Wheddunterpaq J R X W R I V 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 rehypothecation and the risks D V V R F L D W H G Z L W K W K H Q D W X U H R I W K H F R X Q W H U S D U 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 rehypothecation of its collateral;

(c) Collateral collected as IM from the counterparty should be treated as a client asset V H J U H J D W H G I U R P W K H O L F H Q V H G nt Sehu\ Reaq\. S U R S U L H W Once rehypothecated, the third party should treat the collateral as a client asset, and V H J U H J D W H L W I U R P W K H W K L U G S D U W \ ¶ V S U R S U L H W D U \ person after rehypothecation should also be treated as client assets and should be V H J U H J D W H G I U R P W K H O L F H Q V H G S H U V R Q ¶ V S U R S U L H W

(d) The IM of counterparties which have consented to the rehypothecation 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 U H K \ S R W K H F D W H G I R U W K H S X U S R V H R I K H G J L Q J W K H O L 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 rehypothecated, the licensed person should require the third party similarly to segregate the collateral I U R P W K H D V V H W V R I W K H W K L U G S D U W \ ¶ V S U R S U L H W D U 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 rehypothecates IM, the agreement with the recipient of the collateral (i.e. the third party) should prohibit the third party from further rehypothecating the collateral;

(i) Where collateral is rehypothecated, the licensed person must notify the counterparty. Upon request by the counterparty and where the counterparty has opted for

32. A licensed person and the counterparty need to transfer the full amount of margin if the minimum transfer amount is exceeded, i.e. without deduction of the minimum transfer amount.

Timing for the exchange of margin

33. IM should be called at the earliest time possible after either execution of a transaction or upon changes in measured potential future exposure. The IM amount for a given counterparty has to be recalculated at least every ten business days.

34. IM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.

35. VM should be calculated at least on a daily basis and be called at the earliest time possible after the trade date and from time to time thereafter.

36. VM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.

Assets eligible as margin

37. Subject to paragraphs 38 and 40, the following collateral instruments are eligible as margin (both IM and VM):

    (a) Cash in any currency;

    (b) Marketable debt securities issued or fully guaranteed by a sovereign[14] or a relevant international organisation[15];

    (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;

    (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 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 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

[14] See footnote 2

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

45. If the trading relationship

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 jurisdictions[16], 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.

[16] 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 derivatives in the legally enforceable netting set. The IM amount would be calculated in two steps. First, the margin rate in the schedule set out in A.3 would be multiplied by the gross notional size for each derivative contract, and then this calculation 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:

Net Standardised IM = 0.4 * Gross IM + 0.6 * NGR * 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[17]: | |
| 0-2 year duration | 1 |
| 2- 5 year duration | 2 |
| 5+ year duration | 4 |
| Foreign exchange | 6 |
| Commodity[18] | 15 |
| Equity | 15 |
| Credit: | |
| 0-2 year duration | 2 |
| 2-5 year duration | 5 |
| 5+ year duration | 10 |
| Other | 15 |

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

[18] 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 model.

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

## 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:<br>(i) A multilateral development bank; or<br>(ii) A relevant international organization. | less than one | 0.5 | - | - |

Credit Quality Grade for Long-Term Exposures

| Credit quality grade | Standard & 3 R R U ¶ V 5 D W Services | 0 R R G \ ¶ V Investors Service | Fitch Ratings |
|---|---|---|---|
| 1 | AAA<br>AA+<br>AA<br>AA- | Aaa<br>Aa1<br>Aa2<br>Aa3 | AAA<br>AA+<br>AA<br>AA- |
| 2 | A+<br>A<br>A- | A1<br>A2<br>A3 | A+<br>A<br>A- |
| 3 | BBB+<br>BBB<br>BBB- | Baa1<br>Baa2<br>Baa3 | BBB+<br>BBB<br>BBB- |

Credit Quality Grade for Short-Term Exposures

Credit quality grade