



110 Bishopsgate
19th Floor, Suites 19-06 and 19-07
London EC2N 4AY, UK
+44 (0) 207 961 0830
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Suite 1200
Washington, DC 20005, USA
+001 202 326 5800
www.ici.org

20 August 2018

Submitted electronically to
otcmargin_consultation@sfc.hk

Ashley Alder
Chief Executive Officer
Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Re: Consultation Paper on Proposed Margin Requirements for Non-Centrally Cleared Over-the-Counter Derivative Transactions

Dear Mr. Alder:

ICI Global¹ appreciates the opportunity to provide comments on the Hong Kong Securities and Futures Commission's ("SFC") consultation paper on proposed margin requirements for non-centrally cleared over-the-counter ("OTC") derivative transactions.² We fully support the SFC's efforts to harmonize the margin requirements in Hong Kong with other major global marketplaces, as well as with the standards of the Basel Committee on Banking Supervision ("BCBS") and International Organization of Securities Commissions ("IOSCO").³

¹ [ICI Global](#) carries out the international work of the [Investment Company Institute](#), the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US\$29.6 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

² See SFC, *Consultation Paper on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions* (19 June 2018), available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=18CP5>. The proposed rules would supplement the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct").

³ See BCBS and Board of IOSCO, *Margin requirements for non-centrally cleared derivatives* (March 2015) ("International Margin Framework"), available at <https://www.bis.org/bcbs/publ/d317.pdf> (setting forth a standardized framework for margin requirements for non-centrally cleared over-the-counter derivative transactions).

Our members, both investment companies registered in the United States and other regulated funds around the world (collectively, “regulated funds”),⁴ support the goal of providing greater oversight of the derivatives markets through regulations that are coordinated and consistently applied across jurisdictions. As we have emphasized to other international regulators, the majority of OTC derivative transactions are conducted on a cross-border basis, which makes coordination of rules across jurisdictions so important.⁵ Consistent with that goal and to better synchronize Hong Kong’s regulations with requirements in other jurisdictions, we recommend that the SFC clarify the following aspects of the proposed regulations:

- Collective investment schemes (“CIS”), such as regulated funds, do not need to exchange variation margin when transacting with Hong Kong-licensed persons in physically-settled foreign-exchange (“FX”) forwards and swaps (altogether, “FX transactions”);⁶

⁴ For purposes of this letter, the term “regulated fund” refers to any fund that is organized or formed under the laws of a nation, is authorized for public sale in the country in which it is organized or formed, and is regulated as a public investment company under the laws of that country. Generally, such funds are regulated to make them eligible for sale to the retail public, even if a particular fund elects to limit its offering to institutional investors. These funds typically are subject to substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, investment restrictions (*e.g.*, leverage, types of investments or “eligible assets,” concentration limits and/or diversification standards). Examples of such funds include: US investment companies regulated under the Investment Company Act of 1940; European Union “Undertakings for Collective Investment in Transferable Securities” or “UCITS;” Canadian mutual funds; and Japanese investment trusts.

⁵ See, *e.g.*, Letter from Dan Waters, Managing Director, ICI Global, to Christopher Kirkpatrick, Secretary, US Commodity Futures Trading Commission (“CFTC”), dated September 14, 2015; Letter from Dan Waters, Managing Director, ICI Global, to Brent Fields, Secretary, US Securities and Exchange Commission (“SEC”), dated July 13, 2015; Letter from Dan Waters, Managing Director, ICI Global, to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, Barry F. Mardock, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, Alfred M. Pollard, General Counsel, Federal Housing Financing Agency, Legislative and Regulatory Activities Division, Office of Comptroller of the Currency, and Christopher Kirkpatrick, Secretary, CFTC, dated November 24, 2014; Letter from David W. Blass, General Counsel, ICI, to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, Barry F. Mardock, Deputy Director, Office of Regulatory Policy, Farm Credit Administration, Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation, Alfred M. Pollard, General Counsel, Federal Housing Financing Agency, Legislative and Regulatory Activities Division, Office of Comptroller of the Currency, and Christopher Kirkpatrick, Secretary, CFTC, dated November 24, 2014; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Elizabeth Murphy, Secretary, SEC, dated August 21, 2013; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, BCBS, Bank for International Settlements, and David Wright, Secretary General, IOSCO, dated March 14, 2013; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Melissa Jergens, Secretary, CFTC, dated February 6, 2013; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to Wayne Byres, Secretary General, BCBS, Bank for International Settlements, and David Wright, Secretary General, IOSCO, dated September 27, 2012; Letter from Karrie McMillan, General Counsel, ICI, and Dan Waters, Managing Director, ICI Global, to David Stawick, Secretary, CFTC, dated August 23, 2012.

⁶ “FX transactions” also include the FX portion embedded in cross-currency swaps associated with the exchange of principal.

- The minimum asset thresholds set forth in the rules apply to each regulated fund of an umbrella trust, not the entire umbrella trust; and
- The process by which the SFC will determine whether a foreign jurisdiction is deemed “comparable” for substituted compliance purposes.

Background

As the SFC recognizes, the non-centrally cleared derivatives market is global in nature and, accordingly, a particular non-centrally cleared OTC derivative transaction could be subject to the margin requirements of two or more regulators or jurisdictions.⁷ To avoid imposing, at best, duplicative and, at worst, conflicting regulatory requirements on counterparties, we have emphasized the importance of regulatory coordination with respect to application of derivatives regulations.⁸ Duplicative or conflicting regulatory requirements may lead to market uncertainty, increased operational and compliance burdens, and trading disruptions, which would increase systemic risk.

We therefore appreciate the SFC’s efforts to propose rules regarding margin for non-centrally cleared OTC derivative transactions that generally are consistent with the BCBS and IOSCO framework on margin requirements for non-centrally cleared OTC derivatives.⁹ These efforts of the SFC (and other regulators) to harmonize their margin rules should minimize the operational burdens on market participants.

We are, however, concerned about the potential for two separate margin regimes within Hong Kong that require funds to adhere to different margin standards for non-centrally cleared OTC derivative transactions depending on the funds’ counterparty. The SFC should work with the Hong Kong Monetary Authority (“HKMA”) to harmonize their margin requirements.

In addition, we urge the SFC to provide clarity and certainty around certain other issues that are critical to regulated funds. First, the SFC should confirm that regulated funds do not need to exchange variation margin for physically-settled OTC FX transactions. Second, the SFC should confirm that it will apply the minimum thresholds to umbrella trusts at the individual fund level rather than at the trust level. Finally, the SFC should provide more detail surrounding how the SFC would make its comparability determinations to allow licensed persons and their counterparties to rely on “substituted compliance.” We believe that our recommendations would facilitate cross-border transactions of derivatives, while at the same time meeting the SFC’s goals of providing appropriate oversight of OTC derivative transactions.

⁷ See, e.g., consultation paper at paragraph 62.

⁸ See, e.g., *supra* note 5.

⁹ See International Margin Framework, *supra* note 3.

Confirm that Collective Investment Schemes Need Not Exchange Variation Margin for FX Transactions

Subject to certain minimum thresholds, the proposed margin requirements would apply to all non-centrally cleared OTC derivative transactions between a licensed person, acting as principal, and a “covered entity,” except for certain specified transactions.¹⁰ Among the specified transactions, the SFC proposes to exempt non-centrally cleared, physically-settled FX forwards and swaps from the margin requirements (FX transactions), except that the variation margin requirements would apply for FX transactions when the covered entity is an authorized institution, a licensed corporation or “an entity that carries on a business outside Hong Kong engaged in banking, securities, derivatives or asset management.”¹¹ In further describing the requirement, the SFC adds a footnote stating that “[f]or the avoidance of doubt, this seeks to cover the asset manager, but not the funds managed by the manager.”¹²

We believe that the SFC intended to exclude CIS, including regulated funds, from the variation margin requirements for all FX transactions.¹³ The text of the proposed regulation and the accompanying footnote, however, do not make this intention clear.¹⁴ Certain CIS would be deemed to be “covered entities” under the proposed regulations.¹⁵ Because some of these CIS are entities that could be offered outside Hong Kong and may be deemed to be engaged in asset management, there is a concern that some CIS could “technically” come within the language described in the proposal and be required to meet the requirements to exchange variation margin. Although the footnote indicates that “. . . this seeks to cover the asset manager, but not the funds managed by the asset manager,” the same footnote and concept do not appear in Appendix 1, which provides the

¹⁰ See consultation paper at paragraphs 4 and 15. A “covered entity” is defined in Appendix 1, paragraphs 1 through 3.

¹¹ See consultation paper at paragraph 15. See also consultation paper at Appendix 1, paragraphs 7 and 8.

¹² See consultation paper at footnote 12.

¹³ One could interpret CIS to be outside the scope of the FX transaction variation margin requirements, as those apply to transactions with 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.” See consultation paper at Appendix 1, paragraph 8(a)(iii). This wording tracks the wording in Appendix 1, paragraph 2(j) designating those entities as one type of “financial counterparty.” CIS are listed as an entirely separate category of “financial counterparty.” See Appendix 1, paragraph 2(i). If CIS were intended to be required to exchange variation margin for FX transactions, like their treatment in the paragraphs setting forth “financial counterparties,” they would have been listed as a separate category in the variation margin requirements section. In any event, the SFC should affirmatively clarify that CIS are not required to exchange variation margin for FX transactions.

¹⁴ The SFC makes clear that it proposes to exclude FX security conversion transactions from all margin requirements, because the operational burden of setting up the margining infrastructure outweighs the limited risk reduction benefits of collateralizing such short-dated risks. See consultation paper at paragraph 17. We agree and fully support the exclusion of these transactions from all margin requirements.

¹⁵ See consultation paper at Appendix 1, paragraph 1 (defining “covered entity” to include “financial counterparty”) and paragraph 2(j) (defining “financial counterparty” to include the CIS, including mutual funds, that meet the HK \$15 billion threshold).

proposed amendments to the Code of Conduct. Further, it is unclear whether the footnote means that one should look toward whether the CIS's asset manager, not the CIS itself, is predominantly doing business outside Hong Kong or whether it means that the requirement only applies to transactions in which an asset manager, not a CIS, is acting as principal.

Excluding CIS from these requirements is consistent with the approach that other major global marketplaces currently take.¹⁶ To avoid any uncertainty, we recommend that the SFC specify in its Code of Conduct that CIS need not exchange variation margin for FX transactions.

Confirm that the Minimum Asset Thresholds Apply to Each Regulated Fund of an Umbrella Trust

The proposed rules would require both initial and variation margin to be exchanged when the licensed person and the covered entity (or the group to which they belong) meet certain minimum

¹⁶ In the United States, FX transactions are not subject to either the prudential regulators' or the CFTC's margin requirements for non-centrally cleared OTC derivative transactions. See *Margin and Capital Requirements for Covered Swap Entities*, 80 Fed. Reg. 74840 (Nov. 30, 2015) (final rule), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf> and 80 Fed. Reg. 74916 (Nov. 30, 2015) (interim final rule), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28670.pdf>; *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 81 Fed. Reg. 636 (Jan. 2, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf>. Likewise, in the European Union, legislative and regulatory efforts seek to ensure that regulated funds do not face variation margin requirements for these derivative transactions. See European Parliament, *Report on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivatives contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements of trade repositories* (May 25, 2018), available at <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A8-2018-0181&language=en#title1> (incorporating new recital 16a, which provides: "In order to avoid international regulatory divergence and bearing in mind the particular nature of the trade in such derivatives, the mandatory exchange of variation margins on physically settled foreign exchange forwards and physically settled foreign exchange swap derivatives should only apply to transactions between the most systemic counterparties, namely credit institutions and investment firms."); *Draft regulatory technical standards on amending Delegated Regulation (EU) 2016/2251 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 with regard to physically settled foreign exchange forwards* (Dec. 18, 2017), available at [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](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) (proposing to exempt most entities, including registered investment companies and UCITS, from the requirement to post variation margin for FX transactions). As a technical matter, the EU's margin requirements for non-centrally cleared OTC derivatives presently apply to FX transactions, but in light of the pending efforts to align these requirements with international standards, a number of EU national competent authorities have indicated they will forbear from enforcing these provisions. See also consultation paper at notes 15-16.

asset thresholds for their derivative transactions.¹⁷ Specifically, parties would have to exchange initial margin when both the licensed person and the covered entity (or the group to which they belong) have an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion.¹⁸ Parties would be required to exchange variation margin when the licensed person (or the group to which it belongs) has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion.¹⁹ The proposed rules also would permit a licensed person and a counterparty to agree not to exchange initial margin if the amount due (at the level of the consolidated groups to which the licensed person and the counterparty belong) is equal to or less than HK\$375 million.²⁰ In addition, the proposed rules would permit a licensed person and a counterparty to agree not to exchange margin if the amount of the margin due (aggregate of initial and variation margin) since the last exchange of margin is equal to or less than a specified minimum transfer amount not exceeding HK\$3.75 million.²¹

We recommend that the SFC confirm that the thresholds for a regulated fund that is a “covered entity” (*i.e.*, counterparty) would apply at the fund level of an umbrella trust, and not to the entire umbrella trust to which the fund belongs. Currently, the term “covered entity” includes CIS “as defined in section 1, Part 1 of Schedule 1 of the [Securities Futures Ordinance].” That section defines “CIS” to mean various pooled *arrangements* under which the participating persons do not have day-to-day control over the management of the property.²² It is unclear whether the term “arrangements” in that definition refers to a regulated fund of an umbrella trust or the entire umbrella trust as a whole. Accordingly, there is uncertainty regarding whether the minimum threshold requirements should apply at the regulated fund or umbrella trust level.

Because each regulated fund typically enters into a non-centrally cleared OTC derivative transaction separate and apart from the other funds in the umbrella trust, we believe that each regulated fund should be treated as the “covered entity” and counterparty.²³ Accordingly, we believe

¹⁷ The SFC clarifies that “group” for these purposes refers to a “group of entities for which consolidated financial statements are prepared.” *See* consultation paper at Appendix 1, paragraph 5.

¹⁸ *See* consultation paper at paragraph 4; Appendix 1, paragraph 9.

¹⁹ *See* consultation paper at paragraph 4; Appendix 1, paragraph 27. CIS (themselves or with the group to which they belong) also are required to have average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion. *See* consultation paper at Appendix 1, paragraph 2 (defining “financial counterparty” to include CIS (themselves or with the group to which they belong) that have at least HK\$15 billion in average aggregate notional amounts of non-centrally cleared OTC derivatives).

²⁰ *See* consultation paper at paragraph 31; Appendix 1, paragraphs 18 to 19.

²¹ *See* consultation paper at 44; Appendix 1, paragraph 31

²² *See* Securities and Futures Ordinance at Schedule 1, Part 1, Section 1 (emphasis added).

²³ As a general matter, 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. The assets and liabilities of each fund also are separate from the assets and liabilities of any other fund of the

that each individual fund should be subject to the covered entity and counterparty minimum threshold requirements.²⁴ To provide certainty in this area, the SFC should confirm the application of the thresholds for CIS in the Code of Conduct.

Clarify how the SFC will make Comparability Determinations

The SFC proposes to allow substituted compliance for those transactions that are subject to the margin requirements of another regime. In particular, it would permit licensed persons (and consequently their fund counterparties) to adhere to the requirements of a different jurisdiction for which the SFC or HKMA has issued a comparability determination.²⁵ In making these determinations, the SFC states that it plans to adopt an outcome-based approach to the comparability determinations and that the determinations may be subject to conditions.²⁶ In addition, it adds that comparability determinations may be made on all or part of a foreign jurisdiction's requirements.²⁷

We support this approach. We recommend, however, that the SFC and HKMA set forth clear standards to explain the process for making their comparability determinations. Publicizing these standards would allow interested parties to understand the objective basis for the determinations. It also would be consistent with other major marketplaces that have disclosed the parameters from which they will make their determinations.²⁸ We recommend that the SFC and HKMA take a similar approach to provide consistency and transparency in their comparability determinations.

* * * * *

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.

²⁴ The group to which the fund belongs only should include entities with the which the fund consolidates its financial statements. *See supra* note 17. Funds typically do not consolidate their financial statements with other funds of an umbrella trust.

²⁵ *See* consultation paper at paragraphs 62 and 63; Appendix 1, paragraph 50. The proposed rules also would permit margin requirements of Working Group on Margin Requirements jurisdictions to be deemed as comparable from the day they enter into force until the SFC or HKMA completes a comparability determination. *See* consultation paper at Appendix 1, paragraph 51.

²⁶ *See* consultation paper at paragraph 63.

²⁷ *See* consultation paper at Appendix 1, paragraph 50.

²⁸ *See, e.g., Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants – Cross Border Application of the Margin Requirements*, 81 Fed. Reg. 34855 (May 31, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-05-31/pdf/2016-12612.pdf> (providing the CFTC's parameters for allowing substituted compliance).

Letter to Ashley Alder, Chief Executive Officer
Securities and Futures Commission
20 August 2018
Page 8 of 8

We greatly appreciate the opportunity to respond to the consultation paper. If you have any questions, please contact Qiumei Yang, CEO, ICI Global Asia Pacific, at +852 2168 0881 or qiumei.yang@iciglobal.org or Jennifer Choi, Chief Counsel, ICI Global, at +1 (202) 326-5876 or jennifer.choi@iciglobal.org.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global