THE LAW SOCIETY OF HONG KONG
香港律師會

Consultation Paper on the OTC Derivatives Regime for Hong Kong – Proposed Margin Requirements for Non-centrally Cleared OTC Derivative Transactions

The Law Society's Submissions

The Securities and Futures Commission ("SFC") issued a consultation paper on 19 June 2018 on the OTC Derivatives Regime for Hong Kong - Proposed Margin Requirements for Non-centrally Cleared OTC Derivative Transactions ("Consultation Paper"). In response thereto, the Law Society provides the following submissions on the consultation questions posed.

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?

Law Society's response:

We agree with the approach taken in the Consultation Paper. We regard the hedging exemption for significant non-financial counterparties to be appropriate for the introduction of the regime to licensed corporations – rather than over-regulating from the start. This can be revisited at a later date in the context of systemic risk.

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?

Law Society's response:

We agree with the need to exclude short term (eg T+7) currency contracts. That exclusion reduces possible issues caused by imposing Variation margin ("VM") on physically settled Foreign exchange ("FX") forwards and FX swaps entered into by specified financial institutions.

We have no comment on the length of the grace period for single-stock options, equity basket options and equity index options.

Q3: Do you have any comments or concerns on the proposed Initial Margin ("IM") requirements, including the IM modelling standards, the IM threshold and the treatment of IM collected?

Law Society's response:

We have no comment on the IM thresholds in paragraph 65.

We expect the segregation referred to in paragraphs 34 and 35 to be dealt with by custodians putting in place ISDA-led Account Control Agreements. On that basis, we have no concerns on the treatment of IM collected.

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

Law Society's response:

No comment.

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?

Law Society's response:

No comment.

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?

Law Society's response:

No comment.

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

Law Society's response:

No comment.

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

Law Society's response:

Substituted compliance should be available.

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

Law Society's response:

No comment.

The Law Society of Hong Kong
24 July 2018