Submission to Consultation Paper Issued by Securities and Futures Commission on Proposed Changes on Securities and Futures (Financial Resources) Rules

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Introduction

The Securities and Futures Commission ("**SFC**") has issued a Consultation Paper on proposed changes to the Securities and Futures (Financial Resources) Rules ("**FRR**"), with the purpose of providing capital and other prudential requirements for activities involving over-the-counter derivatives ("**OTCD**"). The SFC has also proposed general changes in certain areas of the FRR to reflect market developments, including the reform of the OTCD market.

The submission is made in response to the SFC's Consultation Paper dated July 2015 and our comments and suggestions are set out below. Terms defined or given a particular construction in the Consultation Paper have the same meaning in this Response unless a contrary indication appears.

Consultation Questions

Question 1: Do you agree that RA11 dealers approved to use internal models should be subject to the proposed HK$156 million floor RLC and HK$2 billion tangible capital requirement?

We agree that RA11 dealers approved to use internal models should be subject to the proposed HK$156 million floor RLC, which is consistent with international standards. However, we are concerned that imposing a HK$2 billion tangible capital requirement will severely hinder the operations of RA11 dealers using internal models.

We consider the net asset requirement for issuers of listed structured products under the HKEx Listing Rules to be an inappropriate benchmark for determining the tangible capital requirement of RA11 dealers. According to the Listing Rules, an issuer of non-collateralized structured products must (1) meet a prescribed credit rating, or (2) be regulated by the HKMA or other recognized regulatory authority, or (3) be regulated by the SFC for the conduct of the business of dealing in securities (Type 1), or (4) be a government or state, or body which is backed by the full faith and credit of the government or state (Listing Rules 15A.13). In light of such requirements, listed structured products issuers are likely to be large public companies with the capacity to maintain substantial tangible capital. By contrast, the scale of business of RA11 dealers is not necessarily comparable. The high tangible capital requirement is likely to have an adverse effect on market entry for prospective RA11 dealers, thus impacting on the liquidity of the OTCD market in Hong Kong.

Furthermore, a HK$2 billion tangible capital requirement erodes the incentive of RA11 dealers to use internal models, given that the tangible capital requirement for RA11 dealers not using internal models is significantly lower (HK$1 billion). Thus the advantage of using internal models, namely that it recognizes more offsets between related positions, is not properly achieved. We are of the view that the 'model risks' arising from the wider range of OTC derivative products and counterparties can be adequately mitigated by supervision of internal models by RA11 dealers, rather than applying a high fixed-dollar baseline capital requirement. We also urge the SFC to provide more concrete guidance on the requirements of such 'internal models', and how SFC approval is to be obtained.

Question 2: Do you agree that RA11 dealers not using internal models should be subject to the proposed HK$156 million floor RLC and HK $1 billion tangible capital requirement?

We are of the view that there is insufficient justification for subjecting RA dealers not using internal models to a HK$1 billion tangible capital requirement. The MAS's $200 million (approximately HK$1.1 billion) group shareholders' funds requirement for Capital Markets Services (CMS) licence is not a suitable reference for regulating RA11 dealers, as it applies to dealing in unlisted derivatives with retail investors. By contrast, OTCD transactions are generally undertaken by institutional and professional investors.

Question 3: Do you think that the proposed OTCD de minimis reduction is appropriate?

We welcome the proposals to reduce the tangible capital requirements and floor RLC of RA11 dealers that engage in limited OTCD activities. However, we urge the SFC to consider granting greater flexibility to allow for a time period to acquire the required tangible requirement in the event that OTCD exceeds the de minimis thresholds. Furthermore, we foresee administrative difficulties in the categorization and calculation of the total value of (1) credit default swaps, (2) security based products and (3) other OTCD transactions.

We would also welcome greater elaboration regarding the decision not to apply the OTCD de minimis reduction to RA11 dealers using internal models. As mentioned above, the 'model risks' faced by such RA11 dealers may be mitigated by regulatory oversight of the calculation of internal models used.

Question 4: Do you think that the proposed minimum capital requirements for RCCP-cleared RA11 dealers are appropriate?

We agree that centrally cleared RA11 dealers should be subject to reduced minimum capital requirements, taking into account their lower counterparty credit risks and liquidity risks. Under central clearing, a CCP interposes itself between the buyer and seller of each transaction. A key benefit of central clearing stems from the multilateral netting of derivatives positions across counterparties which is available to clearing members. This reduces counterparty exposure, which reduces counterparty risk relative to OTCD transactions which are bilaterally cleared.

However, as products subject to central clearing tend to be standardized, the proposed minimum capital requirements may be disproportionate to the business and market risks faced by RCCP-cleared RA11 dealers. We would also welcome greater clarification on the concept of a 'CCP approved by the SFC', in particular, details regarding the implementation of the Principles for financial market infrastructures (PFMI).

Question 5: Do you agree that the minimum capital requirements for RA11 advisors should be the same as those applied to securities/ futures advisors (i.e. Type 4/ 5 RA)?

Yes, we agree.

Question 6: Do you think that the proposed minimum capital requirements for Type 12 RA are appropriate for the risks they undertake?

We agree, in principle, to subjecting LCs licensed to carry on Type 12 RA to higher capital requirements due to the increased credit risks they pose compared to Type RA11 dealers. However, we respectfully submit that the proposed HK$2 billion tangible capital requirement and HK$390 million floor RLC would severely limit the number of clearing agency services available. Due to the mandatory clearing obligations of standardized OTCD transactions through CCPs and stringent admission criteria of CCPs, market participants with lower capitalization levels may engage third parties to provide clearing agency services. The function of indirect clearing is likely to be impeded with the imposition of a floor RLC that is equal to the floor liquid requirement for OTC clearing members.

Question 7: Do you agree that an OTCD de minimis reduction should apply to the minimum capital requirements for Type 12 RA?

Yes, we agree. However, we are of the view that the specified thresholds should be revised to account for the higher levels of OTCD activity carried out by LCs engaged in Type 12 RA. This is crucial to the ability of CCPs to reduce systematic risks through multilateral netting of exposures, which requires a critical mass of OTC derivatives.

Question 8:

a) Do you agree that the calculation of variable RLC should reflect the level of OTCD activities engaged in by LCs to ensure that capital is provided against residual risks and the leverage effects of OTCD transactions entered into or cleared by LCs?

Yes, we agree.

b) Do you agree that the proposed calculation methodology and the proposed capital charge percentages (i.e. 5% and 8%) used for calculating the margin-based components in paragraph 189 above are appropriate?

Yes, we agree.

Question 9: Do you agree that an LFE Trader which would otherwise be classified as a Non-RA11 OTCD dealer for FRR purposes only because of its rolling forex trading should not be classified as such and subject to the minimum capital requirements proposed for Non-RA11 OTCD dealers?

Yes, we agree.

Question 10:

a) Do you agree that the minimum capital requirements for the new Type 7 activity should be the same as those for RA11 dealers/ Type 12 RA?

Yes, we agree.

b) If not, what do you think is the right level of minimum capital requirements for the new Type 7 activity and why?

We have no comment.

Question 11: Do you have any other comment or suggestion relating to the minimum capital requirements proposed in this Part?

No, we have no additional comments.

Question 12: Do you agree that specific risk charge percentages for non-investment grade debt securities and unrated debt securities should be based on their initial issuance size?

While we agree that non-investment grade debt securities and unrated debt securities may be subject to greater credit and liquidity risks, we are of the view that the specific risk charge percentage applied should be take into account the availability of public information about the issuer, in addition to the initial issuance size.

Question 13: Do you agree that a 100% specific risk charge should apply to unrated and non-investment grade securitization given their high market and liquidity risks?

We have no comment.

Question 14: Do you agree not to adopt the existing Basel treatment for correlation trading portfolios under the standardized interest rate risk framework?

We disagree with the decision not to adopt the existing Basel treatment for correlation trading portfolios, as this is not in line with international standards. Given that the Basel Capital Accord has been followed for treatment of credit default swaps and interest rate risk positions hedge by credit derivatives in Hong Kong, it is in the interests of consistency and coherency if Basel treatment was also adopted for correlation trading portfolios.

Question 15: Do you agree that a 100% specific risk charge should apply to the higher of the total long and total short position in non-marketable debt securities as proposed above?

We agree that a 100% specific risk charge should apply to non-marketable debt securities. This is consistent with the position taken by the SEC in Rule 15c3-1, the "net capital rule" (17 CFR 240.15c3-1(c)(2)(vii)). However, under Rule 15c3-1(c)(11)(ii), the definition of "marketable debt security" also covers 'securities which have been accepted as collateral for a loan by a bank … where the broker or dealer demonstrates to the SFC that such securities adequately secure such loans'. It is unclear as to whether the SFC intends to incorporate a similar limb in to the definition of 'non-marketable securities'. It is further emphasized that a clear definition of what constitutes 'non-marketable securities' under the FRR will be crucial to enabling OTCD dealers to meet the prescribed capital requirements and facilitate long-term planning.

Question 16:

a) Do you have any comment on our proposal to modify the Basel shorthand method to calculated capital charges for foreign exchange risks?

We generally agree to adopt the Basel shorthand method to calculate capital charges for foreign exchange risks. It can allow LCs that are taking cross currency position to be subject to a lower capital charge requirement then under the original FRR rules. It provides flexibility for LCs to use different foreign currency products in the portfolio.

b) Do you agree that net position in a controlled currency should be subject to capital charge at 8% independent of all other currency positions?

We agree that the calculation of capital charge for net position in a controlled currency should be independent of all other currency positions, as the volatility of controlled currencies are not in line with other currencies under the exchange control or intervention by local governments. Nonetheless, we are of the view that the proposed 8% capital charge is too high. The aim of exchange control is usually to lower the volatility of the currency and stabilize the exchange rate. Therefore, the risk exposure to positions in controlled currency is not substantial.

Question 17: Do you agree with this proposed treatment? (refer to page 78 of the Consultation Paper)

We agree to treat opposite positions in the onshore and offshore markets to be positions in the same underlying currency, which can be offset for foreign exchange risk charge purpose. The onshore and offshore exchange rates are usually highly correlated, as the government who imposed exchange control on currency will usually adjust the exchange rate with reference to

the offshore exchange rate, which reflects the real demand and supply in the market. Furthermore, Hong Kong is the largest offshore market of RMB. Many LCs engage in both transactions of CNH or its derivatives, and products of CNY. Adopting this treatment can alleviate the financial burden of such LCs.

Question 18: Do you have any comments on our proposal to adopt the Basel simplified approach (as modified) to calculate capital charges for commodity risk of tradable commodities?

We agree to adopt Basel simplified approach to calculate capital charges for commodity risk of tradable commodities. The new approach attaches different percentage to the net position and gross position of the commodity to calculate the required capital charge to cover directional risk and other residual risks respectively. Under this approach, it better reflects the market risk of holding commodities compared with the current FRR rules. Furthermore, we observe that many jurisdictions have adopted or proposed to adopt such approach, including HKMA, MAS, CA and CFTC. It strengthens the rationale for us to follow.

Meanwhile, we are a bit reserved towards the treatment for non-tradable commodity. A 100% haircut on gross position of the commodity is an overwhelmingly heavy burden to LCs engaging in such transactions.

Question 19:

a) Do you agree that the simplified approach and delta-plus approach are not appropriate for non-continuous options?

We do not agree to separate the calculation method of risk charge to cover risk exposure of continuous options and non-continuous options. Even though non-continuous options are subject to higher risk because of the higher fluctuations of price when there is price change of underlying assets, such risk should be able to be reflected by using the Delta-plus approach suggested. Such separation would complicate the calculation of capital charge as categorization of options is needed. Furthermore, we disagree to treat non-continuous options as non-standard instruments, as the latter has an uncommon structure, which require a higher capital charge for risk assessment, while the former is still under a common structure of options.

b) If yes, do you agree with our proposed approach for non-continuous options?

We do not agree, with reasons stipulated in Q19(a).

Question 20:

a) Do you agree that the delta-plus approach is not appropriate for options on volatile stocks and short-dated and at-the-money options?

We do not agree. Again we are of the view that delta-plus approach should be able to reflect the risk exposures of options. In particular, it would take the vega risk (volatility risk) into account such that to reflect the risk incurred over options on volatile stocks and short-dated and at-the-money options. Such separation would complicate the calculation of risk charge.

b) If yes, what should the appropriate capital requirement for these options be and how should volatile stocks and short-dated at-the-money options be defined?

Not applicable.

Question 21:

a) Do you have any comment on the proposed prudential and capital requirements for regulating market risks of non-standard instruments?

We are of the view that given the uncommon structure of the non-standard instruments, it is reasonable and prudent to impose a strict capital requirement. Therefore, we agree to impose a Margin-based Charge or Specified Market Risk Charge as the capital requirement. These charges proposed could reflect the maximum possible loss of the position by applying a 100% haircut.

Meanwhile, the calculation method of Specified Market Risk Charge is complicated. The Charge equals to the highest of several market risk indicators. LCs failing to consider any one of those indicators may result in non-compliance. Although LCs can opt out from this SMRA scheme, we still suggest the SFC to be in line with the UK, Australia and Singapore to use 100% of market value as the Specified Market Risk Charge for non-standard instruments, to alleviate the compliance challenge.

b) Do you have any comment on the proposed capital charges for concentrated proprietary positions?

We agree on the approach that imposing different concentration risk charge to investments of different quality. It is sensible that having a high concentration of net proprietary position of a common structure stock is having much less risk exposure compared with that of non-standard instrument with uncommon structures.

Question 22:

a) Do you have any comment on the proposed treatment for opposite positions with the proceeds upon realization of one of the positions being subject to remittance control?

We do not agree with such proposed treatment. The proposed treatment to prevent offsetting of opposite positions in calculation of market risk charge is in substance treating the proceeds upon realization of positions that are subject to remittance control as illiquid capital. Nonetheless, the value of proceeds under remittance control is not likely to depreciate and is easy to be realized. It is inappropriate to treat them as illiquid. Furthermore, it would greatly increase the capital requirement of many LCs, especially when the strategy of taking opposite positions is common in transactions of foreign exchange products, in which some of the jurisdictions involved are under remittance control, i.e. PRC etc.

b) If netting of such positions were allowed in the calculation of capital charge for the market risk of the underlying, how should the liquidity mismatch risk arising from the remittance control be addressed in the FRR?

We have no suggested proposal on this at the moment.

Question 23: Do you agree that the proposed capital charges for OTCD under the BMRA are sufficient for addressing the market risk of OTCD?

As a simpler approach to calculate market risk of OTCD, we agree that the requirements in BMRA are sufficient for addressing the market risk. Meanwhile, we are of the view that the proposed capital charges impose an overly strict capital requirement on LCs. Basically, it is in substance treating all OCTD derivatives as non-standard instruments, which require a 100% haircut. It is not proportional and the LCs would be overly burdened. Although LCs can freely opt in or opt out from this BMRA scheme, some smaller scale LCs without resources and expertise to adopt SMRA have to adopt BMRA and be overly burdened. We suggest that the

SFC considers whether there is any room to lower the capital requirement which at the same time addresses the market risk of OCTD.

Question 24: Do you agree that RA11 dealers, Non-RA11 OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA should be permitted to opt out of the SMRA and use the BMRA to calculate their market risk capital requirements if they have a low level of OTCD activity?

We agree that RA11 dealers, Non-RA11 OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA, whose OTCD activity level does not exceed the OTCD de minimis threshold, should be permitted to opt out of the SMRA and use the BMRA to calculate their market risk capital requirements. The new SMRA system involves significant changes in accounting system, and requires complex calculation, aggregation and netting of positions by risk class, hence more implementation costs will be incurred, as compared with the current FRR system. In light of this, it is plausible to allow LCs engaging in limited OTCD activities to opt out of the SMRA and to use BMRA, in order to reduce cost incurred in the calculation process of market risk capital requirements. Such flexibility can allow LCs to choose the most beneficial calculation method out of the two systems approved and provided by SFC.

However, the OTCD de minimis threshold is too low. LCs' OCTD activity level will easily exceed the threshold as discussed before. It would substantially limit the benefit and flexibility provided in this opt-out scheme.

Question 25: Do you agree that LCs that do not engage in regulated OTCD dealing/clearing/ATS activities should be permitted to adopt the proposed SMRA to calculate market risk capital requirements if they meet the same minimum capital requirements as a RA11 dealer with similar activity?

We agree, with similar reasons that are provided in Q24 above. It is always a good thing to provide flexibility for LCs to choose a more beneficial system to calculate market risk capital requirement out of 2 systems, where both are approved and provided by the SFC. Meanwhile, the minimum capital requirements proposed to opt in the SMRA are a bit arbitrary. In fact, there are no strong reasons to deter an LC to use SMRA just because of its capital size, if the LC considers SMRA is more beneficial.

Question 26: Do you think that Approach Three is the most suitable for the FRR among the three suggested approaches?

We are, in principle, among the three suggested approaches, in favor of Approach Three. Approach One is clearly inappropriate as not all LCs are involved in banking business. Approach Two would definitely highly increase the burden of LCs participating in OTCD transactions such that it contradicts with the original purpose of the current reform, which is to avoid creating significant capital burdens to such LCs. Approach Three is more reasonable among these three proposals. The liquidity adjustment proposed in this approach only target on LCs that include a large proportion of uncollateralized receivables in their investment portfolios. It is also in line with SEC's approach.
However, as Approach One and Two are obviously inferior and defective, it remains Approach Three as the only reasonable choice. We encourage SFC to provide more reasonable approaches on this aspect.

Furthermore, the details of Approach Three are still uncertain and not much information is provided. We expect the concentration charge and the concentration threshold will be reasonable if Approach Three is finally adopted.

Question 27: Do you agree with the above use of initial margin requirements in the determination of the PFE for OTCD portfolios?

In general, we agree with the use of initial margin requirements in the determination of the PFE for OTCD portfolios. In the calculation of initial margin, the CCP or the parties will take into account standardized haircuts stipulated in the FRR rules to assess future changes in the mark-to-market value of the contract during the time it takes to close out the position in the event that one or more counterparties default, hence to reflect the PFE. The estimation made by regulated CCP should be a reliable source to reflect the size of PFE. For portfolio of transactions, which are not cleared through regulated CCP, choosing the highest of the PFE calculated under proposed SOCCRA and the initial margin requirement imposed by the non-Regulated CCP, the parties to the transactions or clearing intermediaries as PFE is also, a reasonable and prudent approach to reflect the future risk incurred.

Question 28: Do you agree with the use of CEM subject to the modifications as described in this paper, instead of SA-CCR, to calculate the exposure amount under the SOCCRA?

We agree that at this moment, SA-CCR should not be used to calculate the exposure amount. SA-CCR is newly proposed by Basel and will only become effective starting from 1 January 2017. As an untested model to calculate capital requirement of counterparty credit risk, the effectiveness of SA-CCR and the potential problems that would arise in the implementation of this approach is yet to be seen.

Alternatively, CEM is simple and adopted by many jurisdictions, such as UK, US, Singapore and Australia. Although some components in the CEM are outdated or incompatible with the nature of LCs under SFC, the modifications proposed can somehow alleviate such problems. However, SFC should also be aware that Basel's standard is targeting to regulate banking services, many LCs in Hong Kong is not as resourceful as banks to meet certain capital requirements. SFC should take into account this factor when it evaluates the modifications needed.

Furthermore, we expect SFC to watch closely the implementation of SA-CCR and to assess whether the current proposed CCR calculation system should be further amended.

Question 29: Should we adopt similar treatment and assign the lower risk weights to exposures to a clearing intermediary which is a client of a clearing member of a Regulated CCP if equivalent conditions are met?

Yes, we think that a lower risk weight should also apply on clients of a clearing member of a qualifying CCP, provided that the offsetting transactions are identified by the CCP as client transactions and collateral to support them is held by the CCP, where the transactions would be indirectly transacted by the CCP when the clearing member is in default.

Question 30: Do you agree that it is appropriate to exclude only transactions with Regulated CCP from CVA Charge?

Similar to our stance in Question 29, we are of the view that treating transactions with Regulated CCP as the only exception from CVA Charge is somehow too stringent. For example, the SFC could consider excluding transactions with clearing members of a Regulated CCP from CVA Charge, provided that the offsetting transactions are identified by the CCP as client transactions and collateral to support them is held by the CCP, where the transactions would be indirectly transacted by the CCP when the clearing member is in default.

Question 31: Do you agree that the proposed Liquidity Adjustment and specified liquidity risk management measures can alleviate the impact on a LC's liquidity of the admission of uncollateralized receivables from counterparties in respect of current exposures of non-centrally-cleared OTCD transactions as liquid assets?

We agree that the proposed Liquidity Adjustment and specified liquidity risk management measures can achieve the aims stated above. It supports the FRR objective to ensure LCs have sufficient liquid assets to meet their liabilities. It balances the risk incurred in including current exposures of non-centrally-cleared OCTD transaction, which has a higher counterparty default risk, as liquid assets.

However, we are also concerned with the details of the specified liquidity risk management measures. We are of the view that the requirement of monthly checking would be demanding. We also expect SFC to provide guideline on the calculation of the liquid reserve and guideline on the preparation of emergency plan for relevant LCs to follow.

Question 32: Regarding the specified liquidity risk management measures, how much time should be allowed for the LC to perform those measures after it has triggered the Counterparty Concentration Charge or Liquidity Adjustment?

We suggest the relevant time period can be one month. This is to provide time for the LCs that have triggered the Counterparty Concentration Charge to perform liquidity stress testing and to find sources of fund to provide liquidity reserve.

Question 33: Apart from the triggers described in paragraph 438 above, do you agree that the proposed specified liquidity risk management measures should be applied to other LCs which have poor liquidity management?

We are of the view that despite maintaining sufficient liquidity is important, we could hardly comment on whether such risk management measures should be applied to LCs having "poor liquidity management" before SFC provides standards and definition of how will an LC would be categorized as having "poor liquidity management". We urge that the SFC clarifies on this point.

Question 34: Do you agree that uncollateralized receivables from affiliates in respect of current exposures of non-centrally-cleared OTCD transactions should be treated in the same way as for third party exposures in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment and the determination of the triggering event for imposing the proposed specified liquidity risk management measures?

We suggest that the threshold to trigger Counterparty Concentration Charge should be set higher for OTCD activities with affiliates. It is quite common for LCs to hedge OTCD activities back-to-back with affiliated companies in order to avoid risk, such as to hedge against currency fluctuation. In that case, imposing additional regulatory requirements and risk management measures to LCs when they have more than 5% exposures to affiliates would aversely affect the risk managing strategy available to LCs.

Question 35: Should collateral posted for securing non-centrally-cleared OTCD transactions be included in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment and the determination of the triggering event for the proposed specified liquidity risk management measures?

We do not agree including collateral posted for securing non-centrally-cleared OTCD transactions in the calculation. For non-centrally-cleared OTCD derivatives, there are certain margin requirements that the counterparties should exchange as imposed by regulatory body. Eligible collaterals are needed to be exchanged in order to comply with such requirements. Including collaterals posted in calculating Counterparty Concentration Charge and Liquidity Adjustment would discourage the margin exchange activities, as the LCs would try to prevent triggering event for the specified liquidity risk management measures to save costs.

Question 36:
a) Do you agree that the BOCCRA can adequately address the counterparty credit risk arising from OTCD transactions?

We, in general, agree that BOCCRA as a simpler approach to calculate counterparty credit risk, can more or less address the counterparty credit risk arising from OTCD transactions. However, some fixed haircut rate in BOCCRA is debatable. For example, we suspect that whether using 100% haircut rate for all exposures in respect of transactions which are centrally cleared through a non-regulated CCP or not centrally cleared, is truly reflecting the counterparty credit risk, or a deterrent to provide disincentive to LCs to enter into non-centrally cleared transaction. We suggest to lower this haircut rate.

b) In respect of the fixed rate haircut on the net uncollateralized exposure to clearing member of a Regulated CCP under the BOCCRA, should we further differentiate and set a lower haircut on exposures to clearing members which fulfills certain conditions on portability and protection of the open position and collateral posted?

We are of the view that the SFC should set a lower haircut rate on exposures to clearing members which fulfills certain conditions on portability and protection of the open position and collateral posted. It is sensible that with protected collaterals and open positions, the counterparty risk should be lower, as the loss from default can be claimed back from the collaterals. Furthermore, such differentiation should be easy to make and will not complicate the calculation method. Nonetheless, we are concerned about what would be the said conditions on portability and protection of open positions and collaterals posted. We hope to obtain more information regarding this aspect.

Question 37: Do you agree that RA11 dealers, Non-RA11 OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA should be permitted to opt out of the SOCCRA and use the BOCCRA to calculate their counterparty credit risk capital requirements if they only engage in a limited amount of OTCD activity?

We agree that RA11 dealers, Non-RA11 OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA, whose OTCD activity level does not exceed the OTCD de minimis threshold, should be permitted to opt out of the SOCCRA and use the BOCCRA to calculate their market risk capital requirements.

The new SOCCRA system involves significant changes in accounting system, hence more implementation costs will be incurred. In light of this, it is plausible to allow LCs engaging in limited OTCD activities to opt out of the SOCCRA and to use BOCCRA, in order to reduce cost incurred in the calculation process. Again, such flexibility can allow LCs to choose the most beneficial calculation method out of the two systems approved and provided by SFC.

Question 38: Do you agree that LCs that do not engage in regulated OTCD dealing/clearing activities should be permitted to adopt the proposed SOCCRA to calculate capital charges for counterpart credit risk arising from their OTCD transactions

if they meet the same minimum capital requirements as a RA11 dealer with a similar activity level?

Yes, we agree. Again, it is always a good thing to provide flexibility for LCs to choose a more beneficial system to calculate market risk capital requirement out of 2 systems, where both are approved and provided by the SFC. Using SOCCRA could help LCs to better reflect their risk exposure accurately, which is beneficial for risk management and internal risk evaluation. LCs can also achieve capital savings by using SOCCRA, compared with BOCCRA, if they consider such savings outweigh the implementation cost of the sophisticated SOCCRA.

Question 39: Do you agree that the FRR should be amended to allow the use of internal models for liquid capital computation purposes by individual LCs, subject to the SFC's approval?

We agree that FRR should be amended to allow the use of internal models for liquid capital computation purposes, subject to SFC's approval. By using internal models, approved LCs could have a main benefit of capital savings, as they can use a more risk-sensitive calculation methodology to calculate the capital requirement. Furthermore, the US and EU have already approved the use of internal models. Implementing such scheme in HK can let LCs, which are approved to use internal model to enjoy reputation benefit locally and internationally, as it demonstrates a recognized level of operational maturity.

Nonetheless, we are of the view that the HK$2 billion minimum tangible capital requirement is too high such the scope of this scheme would be very narrow.

Question 40:
a) Do you agree that a three-year clean record of FRR compliance is an appropriate requirement to indicate that applicants have effective FRR compliance monitoring controls?

We agree that a three-year clean record is an appropriate requirement. Strong operational supervision and monitoring are required in order to master a complex internal model for liquid capital computation. In light of this, a three-year clean record requirement is reasonable and proportional.

Nonetheless, we suggest the SFC to clarify the definition of "clean record" to the industry.

b) Do you agree that a three-year clean record of FRR compliance is an integral part of the overall risk and control infrastructure and capability which applicants should demonstrate?

We agree that it is one of the factors that should be considered to assess the eligibility of applicants applying to use internal models. There-year clean record is also a reasonable requirement as mentioned. However, we suggest on top of looking at the previous disciplinary records of applicants, to assess their eligibility, factors such as the availability of expertise, feasibility of their plans to implement internal models etc. can also be taken into account. The previous disciplinary record itself should not be decisive.

c) Should exception to the requirement discussed in Question 40(a) above be allowed and if so, what conditions should apply in that case?

We are of the view that some exceptions should be allowed. Some miscellaneous breaches such as minor delay in filing documents or in make notifications to SFC do not indicate that applicant does not have effective FRR compliance monitoring controls. SFC should assess

each application by a case-by-case approach with discretionary power to allow minor or minimal breaches, instead of adhering to the three-year clean record rule strictly.

Question 41: Do you agree that a leverage ratio requirement should apply to LCs approved to use internal models in order to align with Basel capital standards?

We do not agree to adopt the leverage ratio requirement. The Basel capital requirement is targeted to institutions providing banking services. Nonetheless, most of the LCs in Hong Kong do not provide banking services. Imposing significant leverage ratio requirement will substantially lower the profitability of the LCs.

Question 42:
a) Do you agree that RA11 dealers, Non-RA11 OTCD dealers, LCs licensed to carry on the new Type 7 activity or Type 12 RA, and LCs opting in the SMRA or SOCCRA should be required to conduct and report on an annual self-assessment of their internal control and risk management?

Yes, we agree. Given the risk exposure in OTCD activities and the complexity of SMRA and SOCCRA, it is reasonable to require the related parties as stated to file an annual report to indicate their internal control and operational risk management, especially when the required capital charge for operational risks will remain unchanged after the proposed changes of FRR rules. It can let SFC to assess how the new systems work in LCs and to spot any deficiencies in LCs' internal control or risk management, hence to take further actions. The SFC should consider issuing annual self-assessment template to the industry for this.

b) Do you have any comment on the contents of the draft Self-Assessment Return?

We have no comment on this.

Question 43: What is your view on the scope and nature of the proposed notification requirements?

We agree with the proposed changes and additions of notification requirements. We especially welcome the abolishment of the requirement for LCs to give 10 days' prior written notice to the SFC of their intention to enter into any OTCD with some exceptions.

Question 44: Do you agree that there are risks for a LC placing excessive funds with its affiliated bank(s) and broker(s) and a LC should be subject to a cap on its aggregate uncollateralized receivables to affiliated banks and brokers as proposed?

We understand the risk to place excessive funds with affiliated banks and brokers. However, we do not find imposing a cap on aggregate uncollateralized receivables to affiliated banks and brokers is of absolute necessity. Such measure would affect the internal asset management within a group company.

Even if a Cap is to be imposed, the threshold of 25% of the LCs' shareholder funds is too low.

Question 45: Do you agree that margins held in a bankruptcy remote manner with affiliated banks and brokers should not be subject to the proposed cap?

Yes, we agree. Any inclusion of margins held in a bankruptcy remote manner with affiliated banks and brokers in the calculation would be inconsistent with the purpose of setting up the Cap, which is to mitigate insolvency risk of the affiliated banks.

Question 46: Do you have any comment on any of the proposed technical changes in this Part?

For the proposed approach to determining haircut percentage for equity/debt securities basket or index, we are of the view that the proposed approach, which an index or basket position is treated as a single position for which the applicable haircut percentage is the highest of the hair cut percentages applicable to the constituents of the index or basket, cannot accurately reflect the risk exposure of the basket or index. The basket would be subject to a high haircut percentage whenever there is any constituents subjecting to high haircut percentage.

We propose options should be provided to let LCs to choose to calculate the haircut percentage of a basket or index by treating it as holding of a portfolio of the constituents, or use the proposed approach aforementioned, depending on the LC's preference.

Furthermore, we welcome the proposals to update the haircut percentage for investment funds and unspecified securities, as the current FRR scheme on this is obsolete. Nonetheless, we find that some revised haircut percentages are too high. For example, a 40% haircut for structured funds and funds investing in financial derivative instrument is too stringent. Similarly, the 100% haircut for unspecified securities is also debatable.

We have no comment on other parts.

Question 47: Do you agree that pre-existing Non-RA11 OTCD dealers should be given a six-month transitional period to comply with the minimum capital requirements as proposed in Section B of Part III, the SMRA and the SOCCRA?

We are of the view that the proposed six-month transitional period is not enough for implementation of the current change of capital requirements under FRR. To adopt SMRA and SOCCRA, the LCs have to make significant changes in accounting system and computation efforts. Furthermore, they have to get familiar with these proposed systems to decide whether to opt out or opt in the said schemes. Complicated calculation of counterparty risk, liquidity risk and relevant haircut is also involved. Given the complexity of the current proposed reform, we suggest that SFC gives a one-year transitional period for LCs to comply with the new minimum capital requirement.

During the one-year transitional period, we recommend that the SFC encourages LCs to submit draft FRRs in advance to seek comments from the SFC as a guiding support to the industry about this new measure.

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