

17 June 2016

To: Ms. Karen Kemp, Executive Director, Banking Policy
Dr. Martin Sprenger, Head Policy Research and Development
Hong Kong Monetary Authority
55th Floor, Two International Finance Centre
8 Finance Street, Central
Hong Kong

Via e-mail: kdkemp@hkma.gov.hk
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Dear Sir/Madam,

Re: Treatment of Security Conversion Transactions under Hong Kong OTC Derivatives Regulatory Regime

On behalf of the Asia Securities Industry and Financial Markets Association ("**ASIFMA**"¹) Asset Management Group ("**AAMG**") and the Securities Industry and Financial Markets Association Asset Management Group ("**SIFMA AMG**" or "**AMG**"²), together with the Alternative Investment Management Association ("**AIMA**"³), we wish to submit to you our comments on the treatment of Security Conversion Transactions (as defined below) under the OTC derivatives regulatory regime for Hong Kong (the "**Hong Kong Regulatory Regime**"), particularly as proposed in your Consultation Paper on *Non-centrally Cleared OTC Derivative Transactions – Margin and Other Risk Mitigation Standards* (CP 15.02) dated December 2015 (the "**Hong Kong Margin Rules**").

Our members respectfully request that Security Conversion Transactions not be subject to the requirements of the Hong Kong Regulatory Regime for the reasons set out in this letter.

¹ ASIFMA is an independent, regional trade association with over 90 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. It harnesses the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. AAMG was launched in 2014 to be the voice of the asset management industry across Asia.

² SIFMA AMG members represent U.S. asset management firms whose combined assets under management exceed \$34 trillion. The clients of AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, unit investment trusts and private funds such as hedge funds and private equity funds.

³ AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,600 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. AIMA's National Group in Hong Kong has 220 corporate members, comprising managers, prime brokers, fund administrators and legal, accounting and other professional services firms.

Background to Security Conversion Transactions

1. Many of our members are asset managers that manage portfolios of assets across a number of foreign financial markets. To facilitate their purchase and/or sale of securities denominated in different currencies and in different markets for those portfolios, asset managers will often enter into FX transactions in connection with the settlement of these securities transactions ("**Security Conversion Transactions**"). By way of example, when an asset manager wishes to purchase a Yen-denominated security, it will also arrange to enter into a FX transaction to ensure that it has sufficient Yen available to settle the acquisition of such Yen-denominated security. Such FX transaction will by necessity settle on the date the purchase of the security is settled.
2. It is important to note that while the settlement cycle for securities in Hong Kong is T+2, the settlement cycle for many securities denominated in another currency is a longer period of time. For example, in Asia, securities in Indonesia, Japan, Malaysia, Philippines, Singapore, Sri Lanka and Thailand are all settled on a T+3 basis. Japanese government bonds have an even longer settlement period (T+5). Therefore, any Security Conversion Transaction entered into by an asset manager for the purpose of settling the sale or purchase of such securities will have to match the settlement cycle of the underlying securities transaction.

Treatment of Security Conversion Transactions under Hong Kong Regulatory Regime

3. The asset management industry is concerned that under the Securities and Futures (Amendment) Ordinance 2014 (the "**SFAO**"), Security Conversion Transactions do not fall under any of the carve-outs from the definition of "OTC derivative product". Specifically, the definition of "spot contract" (which is one of the carve-outs) is generally restricted to FX transactions that settle within T+2.
4. As a result, any Security Conversion Transactions that do not settle within T+2 will fall under the definition of "OTC derivative product", resulting in the application of the various obligations imposed under the Hong Kong Regulatory Regime.
5. We note in particular that under paragraph 2.1.1 of the draft Supervisory Policy Manual contained in the Hong Kong Margin Rules, it is proposed that variation margin requirements will be applicable even to physically settled FX forwards and swaps, as well as FX transactions embedded in cross-currency swaps associated with the exchange of principal.
6. We respectfully submit that the treatment of Security Conversion Transactions like any other "OTC derivative product" under the Hong Kong Regulatory Regime would be contrary to their treatment in other international financial centres and would impose an undue burden on the asset management industry.

Treatment of Security Conversion Transactions in Various Jurisdictions

7. We would like to highlight that under the European Commission's Delegated Act⁴ published on 25 April 2016, an FX spot contract includes:

"a contract for the exchange of one currency against another currency....where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, [and delivery is scheduled to be made within] the period generally accepted in the market for the settlement of that transferable security or a unit in a collective investment undertaking is the standard delivery period or 5 trading days, whichever is shorter."

8. As a result of being treated as an FX spot contract under the Delegated Act, Security Conversion Transactions will not be considered a "financial instrument" for the purposes of the Markets in Financial Instruments Directive ("**MiFID**"). This means that Security Conversion Transactions are out-of-scope with respect to reporting, clearing and margining requirements introduced (or to be introduced) under the European Market Infrastructure Regulation.
9. Similarly, the Commodities Futures Trading Commission ("**CFTC**") considers that transactions for the sale or purchase of an amount of foreign currency to effect the actual delivery of a security by the relevant settlement date to be a bona fide spot FX transaction, and therefore outside of the definition of a "swap".⁵ As a result, the reporting, clearing and margining requirements introduced by the CFTC under the Dodd-Frank Act are not applicable to Security Conversion Transactions. For FX transactions that are within the definition of swap, the CFTC has an exception for Security Conversion Transactions subject to certain conditions⁶, for which SIFMA AMG is in the process of requesting conformance with the European Commission's Delegated Act.
10. With respect to Japan, it is our understanding that the definition for OTC derivatives under Article 2 paragraph 22 of the Financial Instruments and Exchange Act does not include physically settled FX forwards and swaps. This view has been confirmed by the Japan Financial Services Agency. Therefore, the requirements introduced under the OTC derivatives regulatory regime in Japan will not be applicable to Security Conversion Transactions.
11. By way of further example, although the definition of OTC derivatives in Singapore does not expressly exclude Security Conversion Transactions, we understand that the Monetary Authority of Singapore intends to exempt physically-settled FX forwards and swaps from both initial and variation margin requirements (as per the consultation paper published in November 2015).
12. As you will appreciate, the position adopted by the jurisdictions mentioned above is not surprising since the March 2015 paper on margin requirements for non-centrally cleared derivatives published by the Basel Committee on Banking Supervision and International

⁴ <http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2398-EN-F1-1.PDF>

⁵ <https://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf>

⁶ <https://www.federalregister.gov/articles/2012/08/13/2012-18003/further-definition-of-swap-security-based-swap-and-security-based-swap-agreement-mixed-swaps>

Organization of Securities Commissions⁷ clearly provides that Security Conversion Transactions merit certain exclusions from the scope of the margin requirements due to their unique characteristics.

Harmonization of Treatment of Security Conversion Transactions across Jurisdictions

13. If margin requirements apply to Security Conversion Transactions in Hong Kong, asset managers (who have many client accounts that do not trade OTC derivatives) will need to assist their clients to put in place the infrastructure to meet the requirements of the Hong Kong Margin Rules if they enter into Security Conversion Transactions that settle beyond T+2.
14. We submit that given that Security Conversion Transactions are short dated by nature and attract very low levels of risk, the perceived benefit of variation margin for such transactions are outweighed by the cost to investment funds and other clients of asset managers.
15. More important, we are of the view that Hong Kong's treatment of Security Conversion Transactions should be consistent with those in Europe, United States and Japan, which have all carved out Security Conversion Transactions from their definition of OTC derivatives. In the alternative, and in line with the approach being adopted in Singapore, we submit that the Hong Kong Regulatory Regime should exempt Security Conversion Transactions from reporting, clearing and margining requirements.
16. Finally, it is respectfully submitted that the imposition of margin requirements for Security Conversion Transactions that do not settle within T+2 may place financial institutions subject to the Hong Kong Margin Rules (such as Hong Kong banks and Hong Kong branches of overseas banks) at a competitive disadvantage in comparison with financial institutions subject to an OTC derivatives regulatory regime in comparable international financial centres.

Addressing Security Conversion Transactions under Hong Kong Regulatory Regime

17. We understand that the HKMA has already recognised that the inclusion of Security Conversion Transactions under mandatory reporting would be of minimal value and have excluded these Transactions from mandatory reporting under the joint HKMA/SFC Consultation conclusions and further consultation on introducing mandatory clearing and expanding mandatory reporting⁸ issued in February 2016 (the "**2016 Consultation**").
18. We support the definition of "excluded currency contract" as proposed in the 2016 Consultation and respectfully submit that a similar exclusion should be introduced for Security Conversion Transactions with respect to the clearing and margining obligations under the Hong Kong Regulatory Regime.

⁷ <http://www.bis.org/bcbs/publ/d317.htm>

⁸ <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=15CP4>

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Yours faithfully,



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