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Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Comments on the Consultation Paper on Proposed Changes to the Securities and Futures (Financial Resources) Rules

Dear Sirs,

Ernst & Young welcomes the opportunity to offer our views on the Consultation Paper on Proposed Changes to the Securities and Futures (Financial Resources) Rules dated 17 July 2015 (the "Consultation").

We recognize the difficulty facing the Securities and Futures Commission in reviewing numerous institutional responses within a short time frame. We have therefore attempted to be as specific and constructive as possible. Our key considerations reported below highlight the main aspects of the Consultation that we believe merit further review by the SFC before finalizing the rules. Abbreviations and acronyms used in this submission are those defined in the Consultation.

Proposed Capital Requirements

The adoption of the liquid capital regime for LCs engaging in OTCD activities appears to be suitable, but the requirements are in some circumstances overly prescriptive compared to similar jurisdictions (e.g. MAS requirements for Capital Market Service Licensees). Further consideration should be given to the combination of the tangible capital requirement, new component of variable Required Liquid Capital (RLC) with regard to OTCD transactions, liquidity measures and other capital charges, with the latter having a potential significant impact on LCs which engage in or hedge their OTCD activities back-to-back with affiliate companies.

When benchmarking Basel standards to design the new requirements, consideration should be given to the fact that Basel only requires banks to maintain 8% of the RWA, while the FRR rules require LCs to maintain 100% capital for the same capital charge.

Proposed Counterparty Credit Risk Requirements

In light of the forthcoming BCBS introduction of the new non-model based approach for measuring counterparty credit risk exposure of OTCD transactions (SA-CCR) and the Basel CCP rules that will take effect in January 2017, further consideration should be given to the proposed introduction of two additional approaches to measure counterparty credit risk.

While the basic approach (BOCCRA) would have less impact from an IT, organizational and operational perspective, the standardized approach (SOCCRA) is quite sophisticated and would require significant investments and updates to the current framework. How far these investments could be leveraged to implement the new SA-CCR (once formally adopted by the SFC) is still to be determined.

In essence, the potential issue that the LCs and the SFC could have in the future is that a range of new capabilities that built by the LCs, with significant investments in systems and resources, that may then need to undergo further changes and training respectively, in order to comply with the future SA-CCR approach.

Proposed Internal Model Approach

Given the inherent need for the industry to reach maturity before market risk internal models can be developed, which has also been recognized by the regulator since the earliest stage[1], and provided that the calibration of supervisory factors and single-systematic-factor correlations for the SA-CCR is also based on IMM models, we deem it appropriate and the right time to introduce a framework for the use of internal models for the calculation of the market and counterparty credit risk exposures.

Transitional Period

We would recommend a longer transitional period before commencement of the new regulatory framework, sufficient to allow Non-RA11 OTCD dealers to implement the new regime. The six-month transitional period after the regulated activities introduced/expanded by the SFAO come into effect (Commencement Date), has raised some concerns as follows:

- The time to expand the capital base, as captured in the Consultation, is a compounded challenge as all LCs will seek to make similar adjustments at the same time. Also, the increase is quite significant for some types of regulated activities and many corporations will wait until the regulation is finalized and capital requirements confirmed before raising new capital.
- Despite that some market participants are already undergoing some changes to align with the new requirements, the impact of the Consultation is very broad: from IT to operations/organization (e.g. establish/revise processes and policies and perhaps set up dedicated CVA desks to hedge CVA risk), and resources (e.g. hire and train staff).

Most of the additional resources required to implement the framework and comply with the new capital requirements may not be spent in the risk control departments, but rather in the financial reporting and IT systems areas, in order to generate the volume of data and reports required. Some of these implementation costs will be passed on to consumers and corporations, and along with increased capital requirements, may force LCs to review the efficiency of certain activities and to possibly exit some businesses.

Our responses to specific questions in the Consultation are set out in the Appendix to this letter.

We would be happy to discuss our views in detail or to discuss any new ideas that the SFC wishes to pursue. In this regard, please contact or

Yours faithfully,

[1] For example, since the 1997 Market Risk Amendment to the Basel Capital Accord, banks' market risk internal models have been formally incorporated into regulatory capital calculations.

Appendix - Responses to specific questions in the Consultation

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Appendix - Responses to specific questions in the Consultation

1. Proposed minimum capital requirements for LCs engaging in OTCD activities

1.1. Proposed Capital Requirements for RA11 Dealers in OTCD

Q1. 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 consider the capital requirements for RA11 dealers approved to use internal models are overly prudent. Capital requirements should be set at a level that is sufficiently prudent for the nature of the business but not overly excessive, with reference to both international practice and local market conditions (e.g. maturity, volumes, typology of derivatives traded).

When reviewing the benchmarking analysis we noticed that:

- The floor RLC for RA11 dealers has been benchmarked to the fixed-dollar amounts of the net capital requirement and adjusted net capital requirement proposed by the SEC and CFTC for registered standalone security-based swap dealers and registered swap dealers cum futures commission merchants respectively.
- The fixed-dollar baseline capital requirement for RA11 dealers approved to use internal models has been set at a higher level than the tentative net capital requirement proposed by the SEC for dealers approved to use internal models, to account for the fact that RA11 dealers can deal in a wider range of OTCD. The requirement is also benchmarked to the net asset requirement for issuers of listed structured products under the HKEx Listing Rules.
- The fixed-dollar baseline capital requirement for RA11 dealers not using internal models has been set arbitrarily to half the size of the tangible capital requirement of RA11 dealers using internal models, in the absence of any appropriate international benchmark; nonetheless the proposed amount is still higher than the tentative net capital requirement for SEC-registered standalone security-based swap dealers that use internal models.
- The OTCD de minimis reduction for RA11 dealers that engage in limited OTCD activities is benchmarked to only 50% of the US de minimis exception thresholds for registered security-based swap dealers/swap dealers.

Simply put, considerations applied to set up the fixed-dollar baseline capital requirement for RA11 dealers did not apply when setting up the OTCD de minimis reduction, given that the fixed-dollar baseline capital requirement and relief thresholds have been set respectively higher and lower than the benchmarked jurisdictions.

We suggest reconsidering the abovementioned requirements and thresholds. Model risk can be minimized by way of supervision and model validation, in line with the HKMA rules where no incremental charge is applied, for Authorized Institutions who are using internal models approach to calculate market risk.

Q2. 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?

See our response above.

In addition, the benchmark against MAS's S$200 million (approximately HK$1.1 billion) group shareholders' funds requirement for CMS licensees applying to deal in unlisted derivatives is only valid for CMS licensees dealing with retail investors; no such requirement is enforced for CMS licensees dealing with institutional investors or for entities engaged in intra-group derivative transactions. Accordingly, the room for regulatory arbitrage between the two markets could potentially still be relevant.

Furthermore, besides benchmarking to regulations in other jurisdictions we suggest conducting scenario analyses to validate the sufficiency of the HK$1 billion tangible capital requirement under abnormal/extreme events. An excessive capital requirement may discourage the growth of the OTCD industry in Hong Kong.

Q3. Do you think that the proposed OTCD de minimis threshold is appropriate?

Overall we agree with partially waiving capital requirements for LCs that engage in limited OTCD activities.

We also believe that the applicability of the abovementioned reduction should apply to RA11 dealers that use internal models, as the model risks that they face would be mitigated via other means (e.g. fixed-dollar baseline capital requirement, regulatory supervision and model validation) and, given the limited exposure, they would be exposed to lower risks and potentially generate lower systemic risk.

Q4. Do you think that the proposed minimum capital requirements for RCCP-cleared RA11 dealers are appropriate?

Type 3 seems to be a reasonable benchmark, although Type 2 could represent a good benchmark too, as futures are standardized contracts. Many LCs however may have a hybrid position at least initially, with certain derivatives being cleared through CCP while others are not.

1.2. Proposed Capital Requirements for Type 12 RA

Q6. Do you think that the proposed minimum capital requirements for Type 12 RA are appropriate for the risks they undertake?

The following points related to RA12 LCs seem to be overly prudent

- Even if LC licensed to carry on Type 12 RA clearing trades for clients with a CCP or another clearing intermediary may be exposed to higher settlement, counterparty and default risks than RA11 dealers (which clear for their own trades only), overall capital requirements, including OTC Clear's minimum capital requirements for clearing members, appear to be significantly higher than the reviewed jurisdictions in the benchmark. These include the proposed:
    - tangible capital requirement: HK$2 billion;
    - floor RLC: HK$390 million.

  The above are well above the major US/European OTCD CCPs' net capital requirements for clearing members, circa US$50 million.
- No tangible capital requirement differentiation is proposed for LCs licensed for Type 12 RA which use internal models (i.e. HK$2 billion), as it is considered already very substantial. This

does not completely tie with the requirements for RA11 dealers adopting internal models, where significant focus was posed on the necessity to cover model risk. Therefore, we suggest that either the HK$2 billion requirement for Type 12 RA LCs which do not use internal models be reconsidered, or the capital requirement for Type 12 RA LCs with approved internal models should be higher to include an even higher model risk.

Q7. Do you agree that an OTCD de minimis reduction should apply to the minimum capital requirements for Type 12 RA?

Yes, we agree. Even if it is not explicitly specified, we assume that the proposed OTCD de minimis reduction would be not applicable to RA12 LCs using internal models.

1.3. Proposed new component of variable RLC with regard to OTCD transactions

Q8a. 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?

As a stand-alone measure we welcome the introduction of such requirement; however concerns could arise when considering this in conjunction with the new concept of tangible capital, enhanced requirements for counterparty credit risk and market risk (including some additional prudential layers compared to the Basel framework), and liquidity measures. Effects could be exacerbated for LCs which engage in or hedge their OTCD activities back-to-back with affiliate companies that would be more likely to trigger further capital charges (i.e. Counterparty Concentration Charge and Liquidity Adjustment).

Q8b. Do you think 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 are appropriate?

We believe that transactions cleared through a Regulated CCP (being through OTC Clear or any others) should attract the same initial margin requirement (regardless of the percentage set), in line with the consistent treatment applied to RCCP under the counterparty risk framework (i.e. no further differentiation amongst RCCP).

1.4. Proposed minimum capital requirements for the new Type 7 activity

Q10a. 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?

We believe that capital requirements for New Type 7 Regulated Activity should be calibrated to the nature, extent and volume of each ATS activity, but also commensurate with the operational risk the provider faces. Factors such as the adequacy of the systems, including the reliability, security and contingency of the electronic trading system should be accounted for when assessing the capital requirements in line with international best practice, specifically for ATS that involves the novation of settlement obligations and provision of settlement guarantees.

Also, we would like to seek confirmation whether LCs providing ATS, excluding OTCD transactions, would need to comply or not with the proposed capital requirements.

Q10b. If not, what do you think is the right level of minimum capital requirements for the new Type 7 activity and why?

Please see our response above.

1.5. Measures to prevent overlap of paid-up share capital requirements and tangible capital requirements

Q11. Do you have any other comment or suggestion relating to the minimum capital requirements proposed in this Part?

Rather than differentiate tangible capital requirements for LCs adopting internal models or not, we foresee more significant benefits of tying model-derived capital requirements more closely to the requirements stemming from the standardized calculations through the use of floors (at least for a limited period of time). This would ensure capital requirements not to fall below a certain percentage of the LCs' capital requirements under the standardized approach.

The objectives of capital floors would include amongst others:

- preventing undue optimism in LC modelling practices, thereby ensuring that modelled capital requirements do not fall below a prudent level;
- mitigating model risk due to such factors as incorrect model specification, measurement error, data limitations and structural changes that may not be captured in historical data;
- allowing time for supervisors and LCs to rectify any implementation issues identified during the transitional period.

Furthermore, a more risk-based capital framework for LCs would ensure that licensees set aside capital more sensitive to the level of risks and commensurate with their size and scale of operations undertaken.

2. Capital treatments for market risks of OTCD and other proprietary trading positions

2.1. Proposed standardized interest rate risk framework

Q12. 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?

Specific risk is the risk of loss caused by adverse movements in the price of an individual debt security owing to factors specific to its issuer. However the correlation between the initial issuance size and the specific risk of its issuer is not evident.

2.2. Treatment for opposite positions where the proceeds upon realization of one of the positions are subject to remittance control

Q22a. 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?

Consideration should be given to certain non-deliverable products with the underlying currency subject to remittance control.

2.3. Opting into SMRA

Q25. 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?

Yes, capital rules should generally incentivize risk management innovation in those areas.

3. Capital treatments for counterparty credit risk arising from OTCD transactions

3.1. Calculation of exposure amount

Q28. 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?

As stated in the summary, we believe that the introduction of an interim sophisticated new standard approach (SOCCRA) before the adoption of the SA-CCR is not a cost-effective option. This is primarily true for smaller LCs dealing in OTCD that are not capable of or interested in modeling, and are keen to use a method that requires fewer resources than what are required for implementing and maintaining IMM. By switching the approaches twice within a few years (SOCCRA first and then SA-CCR), also in consideration of CEM being used for the past twenty years, LCs would be facing higher costs and an increased level of complexity for a prolonged time.

Therefore, we suggest implementing the BOCCRA as per the SFC proposal (BOCCRA also shares several components with SOCCRA), in order to strengthen the LCs' counterparty credit risk framework, and make it available to LCs engaging in Type 7 and Type 12 regulated activities, Type 11 dealers, and non-type 11 OTCD dealers, even if above the "OTCD de minimis threshold". On the other hand, we propose to put the SOCCRA on hold or make it discretionary, while waiting for the mandatory implementation of the SA-CCR, thus reducing the cost of compliance for market participants.

3.2. CVA Charge

Q30. Do you agree that it is appropriate to exclude only transactions with Regulated CCP from CVA Charge?

We suggest that transactions with all qualifying central counterparties (QCCPs) in jurisdictions that apply CPSS-IOSCO Principles be excluded from the CVA Charge, as QCCPs are permitted by the appropriate regulator/overseer to operate with respect to the products offered. This is subject to the provision that the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures[2].

The more favourable treatment for Regulated CCPs proposed in the Consultation is apparently justified by Regulated CCPs being more regulated than QCCPs; however in our opinion and based on the BCBS definition, no relevant distinction in the overall riskiness can be perceived between the two. In addition, the list of QCCPs is not readily available in the consultation.

3.3. Liquidity risk management measures

Q31. 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?

[2] BCBS Capital requirements for bank exposures to central counterparties, April 2014.

The Liquidity Adjustment and the specified liquidity risk management measures – the liquid buffer in particular – are in line with the objective to mitigate the admission of uncollateralized receivables as liquid assets. However, further consideration should be given on the joint effect of these measures on inter-company transactions, that are mainly uncollateralized and non-centrally-cleared and of the 25% cap of shareholders' funds for counting uncollateralized receivables from affiliates as liquid assets (ref. Section IX (A) of the consultation paper).

Q32. 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 believe that the proposed measures require extensive changes and time to be implemented, and the latter is not in line with the nature of liquidity risk. Therefore, we recommend establishing a base liquidity risk framework on top of the code of conduct and internal control guidelines issued by the SFC, regardless of the triggers and the framework, should be commensurate with the nature and complexity of the type of activity undertaken. For further comments, please refer to our response below.

Q33. Apart from the triggers described in paragraph 438, do you agree that the proposed specified liquidity risk management measures should be applied to other LCs which have poor liquidity management?

The specified liquidity risk management measures should be applied consistently across LCs as they are in line with principles for sound liquidity risk management and international best practice. In particular, in order to address potential liquidity issues that may manifest themselves in a very short time frame, even if only based on rumors or unforeseen events, it is important to have clear policies that govern a LC's access to liquidity.

In contrast, the proposed liquidity measures would only be triggered when the aggregate uncollateralized current exposures exceed 50% of the LC's last reported tangible capital. In addition, liquidity stress testing would be carried out only on a monthly basis (at a minimum). The time frame for a potential liquidity issue to manifest itself and the implementation of the containing measures is too wide considering the nature of liquidity stresses, i.e. of unpredictable low frequency, but extremely severe events.

In essence, stress testing represents the main tool in quantifying liquidity needs, and the liquid buffer is a vital cushion to keep the business viable within the survival time horizon. Furthermore the emergency funding plan is a key part of the overall governance and must be always ready and regularly updated; having said that, we suggest that these three measures should be set regardless of any triggers, and should be applicable to any LC, in line with the nature and complexity of the type of activity undertaken.

Q34. In the calculation of the Counterparty Concentration Charge and Liquidity Adjustment and the determination of the triggering event for imposing the specified liquidity risk management measures, all uncollateralized receivables in respect of current exposures of non-centrally-cleared OTCD transactions, irrespective of the counterparty's/clearing intermediary's relationship with the LC, must be considered. It follows that LCs which engage in or hedge their OTCD activities back-to-back with affiliated companies would be more likely to concentrate in non-centrally-cleared OTCD transactions entered into with their affiliated companies on a bilateral basis, and their counterparty exposures are more likely to concentrate in a single or a few affiliates, That said, it is prudent from a concentration risk stand point to treat concentrated exposures to affiliates in the same way as for third party exposures.

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?

In line with our responses to Q32 and Q33, we believe that liquidity risk measures should be enforced regardless of the triggers; nonetheless, if this route is not pursued, we believe that the SFC can consider to provide partial relief/exemption for uncollateralized receivables from affiliates as long as pre-defined conditions/agreements with affiliates and other limitations are met and also in consideration of the proposed cap on aggregate uncollateralized receivables from affiliated banks and brokers introduced in Section IX (A) of the Consultation.

Q35. Liquid assets posted by a LC as collateral for non-centrally-cleared OTCD transactions may not be available for meeting other payment obligations of the LC during the tenure of the contract due to the difficulty in terminating the contract. To address the impact of liquidity of liquid assets being posted as collateral for OTCD transactions, it would be prudent to include collateral 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. However, to do so may disincentivize LCs to exchange margins with their counterparties on non-centrally-cleared OTCD transactions, which is not desirable from a systemic risk perspective.

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 believe that collateral posted should not be included in the calculation of the proposed Counterparty Concentration Charge and Liquidity Adjustment. Several regulations (e.g. Dodd-Frank Act) are moving in the direction of strengthening margin requirements for OTCD transactions in order to reduce risk; hence penalizing LCs with additional requirements based on whether they post collateral would mean taking a step in the opposite direction.

Q36b. 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 fulfils certain conditions on portability and protection of the open position and collateral posted?

We agree with the introduction of a lower haircut in the abovementioned case, as it would be a risk-sensitive measure aligned with the counterparty's quality and also in line with the new Basel CCP rules.

3.4. Opting out of SOCCRA

Q37. 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?

Please refer to our response to Q28.

3.5. Opting into SOCCRA

Q38. 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 counterparty credit risk arising from their OTCD transactions if they meet the same minimum capital requirements as a RA11 dealer with a similar activity level?

Please refer to our response to Q28; but yes, advanced approaches should better allow quantifying the risks faced.

4. Internal models approach

4.1. Proposals

Q39. 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?

The overarching rationale for an internal models approach to capital requirements is to better tailor the required capital to the actual risks faced by specific institutions. In addition, across more advanced jurisdictions, institutions have always devoted many resources to developing internal risk models for the purpose of better quantifying the risks they face and allocating economic capital. These efforts have often been recognized and encouraged by regulators[3].

Also, as mentioned in the Consultation, it is common for securities firms engaging in complex trading activities, especially where OTCD trading is involved, to deploy internal risk measurement models to take advantage of the greater risk sensitivity to hedging and diversification of risks that internal models can offer.

Simply put, we consider the internal models approach is consistent with the increased emphasis on risk-sensitive capital requirements and the shift in supervisory interest from an exclusive focus on risk measurement to a more comprehensive evaluation of the LCs' overall risk management. The latter requires satisfying also specific qualitative standards in order to allow models for regulatory capital purposes, e.g. (refer also to Appendix XII of the SFC Consultation):

- establishment of an independent risk control unit in charge of gathering, processing and reporting directly to senior management;
- having an independent audit function in charge of reviewing at the onset and on an on-going basis any internal model;
- establishment of a risk management culture across the organization with well-defined lines of defense, responsibility and accountability at every level.

On the other hand, the SFC can always introduce quantitative constraints and criteria to address internal model shortcomings and to have a certain degree of standardization across firms in defining the capital requirements, such as:

- input data;
- standard parameters for the VaR percentile;
- holding period;
- backtesting and stress testing requirements.

With regards to internationally active securities firms that already have obtained approval from their home regulators to use internal models for regulatory capital calculation purposes and, as they expand the business into Hong Kong and become licensed by the SFC, wish to use the same or similar models to manage the risks of their local business in accordance with group risk management practices, we recommend that the SFC engage in a bilateral dialogue with those firms. This is because the same models being applied in different jurisdictions may produce different results.

[3] For example, since the 1997 Market Risk Amendment to the Basel Capital Accord, banks' market risk internal models have been formally incorporated into regulatory capital calculations.

Q40a. One of the proposed eligibility requirements for applying for approval to use internal models set out in the draft Guideline for the Use of Internal Models to Determine Capital Requirements (Appendix 12) is that the applicant should have a clean record of compliance with the FRR in the previous three years. Moreover, as mentioned above, only LCs which can demonstrate that they have sufficient risk and control infrastructure should be eligible to use internal models.

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?

See our response to Q40c.

Q40b. 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?

See our response to Q40c.

Q40c. Should exception to the requirement discussed in Q40a above be allowed and if so, what conditions should apply in that case?

As a matter of principle, we agree with the three-year clean record requirement; however we observe that the SFC could assess the gravity and the duration of any compliance breach which happened in the previous three years on a case-by-case basis, and, if depending on the facts and circumstances, allow internal model adoption on a discretionary basis.

The SFC may set additional and temporary conditions for the adoption of internal models for those LCs which may not have a three-year clean record. Such conditions could span from an increased frequency for the risk and control self-assessment return to an additional capital floor.

Q41. 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 consider beneficial the introduction of a non-risk-based leverage ratio as a backstop, alongside with the capital risk-based components of the new regulatory framework.

However, if the 3% requirement is a tout-court extension of the Basel framework requirement calibrated for banks, without appropriate testing for LCs and calibration alongside risk-based requirements, this may pose some concerns. In particular, if the leverage ratio is set higher relative to the risk-weighted requirement, it is likely to become the binding constraint, and the primary form of capital regulation. As a consequence, the level of risk-sensitivity introduced by the proposed framework will not be maintained.

If this is the case, we suggest considering a calibration or test period before introducing it as a mandatory requirement.

5. Measures to address operational risks of LCs engaging in OTCD activities

5.1. Proposals

Q42a. 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 in principle with the introduction of this new return. However it has to be clarified whether LCs conducting and reporting the annual self-assessment because they have opted in the SMRA or SOCCRA would still need to comply with this requirement in case they decide to opt out from any of the advanced approaches, as this may cause some regulatory arbitrage.

To overcome this point, and to preserve a level playing field between LCs engaging in/not engaging in OTCD activities; given also the importance of maintaining strong risk management and controls for all LCs, it is suggested that the same kind of self-assessment is performed across all LCs, commensurate with the nature and complexity of the type of activity undertaken.

In line with internationally accepted best practice and with the principles for the sound management of operational risk where RCSA forms an integral element of the overall operational risk framework, the SFC self-assessment will provide an excellent opportunity for LCs to integrate and co-ordinate the risk identification and risk management efforts and generally to improve the understanding, control and oversight of their risks.

Finally, the self-assessment should be enforced, other than on an annual basis, following any significant change in the LC's structure or in the external operating environment.

Q42b. Do you have any comment on the contents of the draft Self-assessment Return?

According to international best practice and regulators' recommendations, a risk and control self-assessment should start with the identification of the organization's key businesses, products, and processes, and the provision of a risk taxonomy based on the nature of the business activities undertaken. Business process mapping helps to identify and align risks and controls to key process steps, responsibilities, interdependencies and hand-offs.

The self-assessment should assist the business or functional area with the development of a comprehensive understanding of the risks it faces, the greatest areas of exposure and where appropriate focus and prioritization of activities should be in order to reduce exposure. However, the self-assessment needs to be carefully designed, planned and executed to provide the maximum opportunity for success and achievement of its full range of benefit potential.

In essence the assessment, as presented, might be treated as a "check the box activity", conducted at too high level. Furthermore, the assessment, as it stands, does not capture granular inherent risks (i.e. risks before controls are put in place) and residual risk (risks after existing controls have been applied) as an important part of the process. Understanding of the inherent risk profile is essential in order to identify improvements required to existing controls to manage the risk exposure to the desired level. Additionally, a single risk event may have multiple consequences: for example, unintentional transaction errors could result in both direct financial losses and subsequent dispute; hence it is of paramount importance to start the self-assessment by defining the risk taxonomy linked to the underlying business processes.

Therefore, it is recommended to re-consider the draft Self-assessment Return in light of the above considerations.

In order to achieve significant value from the self-assessment, the proposed regulation could also recommend, as best practice, the use of quality outputs, a challenge process, and comparative analysis by leveraging all sources of risk information, e.g. compliance and incident data, and internal audit reports etc., to fully understand the comprehensive 'risk profile' of the assessment area.

6. Miscellaneous technical changes

6.1. Cap on aggregate uncollateralized receivables from affiliated banks and brokers

Q44. Do you agree that there are risks for a LC placing excessive funds with its affiliate bank(s) and broker(s) and such LC should be subject to a cap on its aggregate uncollateralized receivables to affiliated banks and brokers as proposed?

We agree with the necessity to limit intercompany exposure; however further consideration should be given to the fact that this measure will add to the liquidity adjustment which, if triggered, will result in an overly conservative regime for LCs, and not be easily comparable with other jurisdictions. An alternative could be to introduce more stringent requirements on capital rather than having a cap.

Q45. 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. This is also in line with requirements related to collateral posted and held by a custodian in a bankruptcy-remote manner being not subject to credit risk capital charge.

We suggest further defining the following:

- Affiliated banks (but which is not an authorized institution)
- Bankruptcy remote manner

6.2. Proposed technical changes

Q46. Do you have any comment on any of the proposed technical changes in this Part?

It is not specified how to quantify the "low settlement risk" in exceptional situations that would allow LCs offsetting receivables and payables to General Clearing Participant of a recognized clearing house.