

## **Legislative Council Panel on Financial Affairs**

### **Latest Developments in the Regulation of the Over-the-Counter Derivatives Market**

#### **Purpose**

This paper briefs Members on the latest international developments in the regulation of the over-the-counter (OTC) derivatives market and the way forward for Hong Kong.

#### **International Developments**

2. The recent financial crisis has revealed the risks embedded in the OTC derivatives market. G-20 recommends that all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate<sup>1</sup>, and cleared through central counterparties (CCPs)<sup>2</sup> by end-2012 at the latest, and that all OTC derivatives contracts be required to be reported to trade repositories (TRs), and non-centrally cleared contracts be subject to higher capital charges.

3. The Financial Stability Board (FSB) has recently approved a report on Implementing OTC Derivatives Market Reforms (the Report) containing recommendations to promote consistent implementation of the G-20 commitments concerning –

- (a) Increasing the proportion of the market that is standardised;
- (b) Moving to central clearing of standardised OTC

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<sup>1</sup> Regarding the trading of OTC derivatives products on exchanges or electronic trading platforms, detailed rules and regulations in the US and EU have yet to be developed. We will closely monitor the international development in this aspect and consider how to implement the recommendation.

<sup>2</sup> A CCP stands between two counterparties, acting as buyer for the seller and seller for the buyer. It will be able to perform multilateral netting and facilitates the reduction of counterparty risks.

- derivatives by end 2012 –
- (i) implementing mandatory clearing requirements;
  - (ii) strengthening oversight and regulation of CCPs;
  - (iii) introducing robust risk management requirements for the remaining non-centrally cleared trades; and
- (c) Ensuring that OTC derivatives transactions, whether centrally cleared or not, are reported to TRs by end 2012.

4. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted on 21 July 2010 mandates central clearing and trade reporting of OTC derivatives. In Europe, revisions are being made to a number of directives, notably the Capital Requirements Directive, the Markets in Financial Instruments Directive (MiFID) and the Market Abuse Directive along with the new regulation proposed by the European Commission in September 2010 to mandate central clearing of standardised derivatives and reporting to TRs. In Japan, amendment to the Financial Instruments and Exchange Act was passed to make central clearing and trade reporting mandatory. Market players in all major markets are gearing up for the implementation of the new regulatory requirements.

### **Hong Kong's Position**

5. As a member of the FSB, Basel Committee and International Organization of Securities Commissions (IOSCO)<sup>3</sup> and in its role as an international financial centre, Hong Kong is committed to complying with, and contributing to the evolution of, international standards. According to the Report, there are certain conditions which regulators have to consider in determining which products should be subject to a mandatory clearing requirement, including the degree of standardisation of the product, market liquidity, availability of adequate pricing data and systemic relevance of the product. We have duly considered these factors when deciding the way forward for Hong Kong.

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<sup>3</sup> IOSCO is a forum for international cooperation among securities regulators. The Securities and Futures Commission is a member of the IOSCO.

6. Building on the current regulatory framework, we will take the necessary steps to implement G-20's commitments. In particular, we intend to require all financial institutions in Hong Kong to clear standardised and eligible OTC derivatives transactions at recognised CCPs and to report all OTC derivatives transactions to authorised TRs.

*Regulatory regime for reporting and central clearing of OTC derivatives*

7. The Government, the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) would work with relevant stakeholders to build a regulatory regime for the OTC derivatives markets, which would cover-

- (a) the reporting of OTC derivatives transactions, particularly those which are relevant to the Hong Kong market, to a local TR to be created by the HKMA;
- (b) the clearing of standardised OTC derivatives transactions through an authorized CCP.

8. At the initial stage, the reporting and clearing requirement will be applied to interest rate swaps and non-deliverable forwards. A breakdown of OTC derivatives trades generated in Hong Kong in 2009 is at **Annex**. After the initial roll out, consideration will be given to extending the requirement to other appropriate OTC derivatives asset classes, having regard to local and overseas market developments including any further guidance from international regulatory bodies.

*Market infrastructure*

9. The HKMA will build upon its existing Central Moneymarkets Unit (CMU)<sup>4</sup> infrastructure to develop a local TR in Hong Kong. A TR is a centralised registry that maintains an electronic database of OTC

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<sup>4</sup> The CMU provides computerised clearing and settlement facilities for Exchange Fund Bills and Notes, and other Hong Kong dollar and non-Hong Kong dollar debt securities. Since December 1994, the CMU has been linked with other regional and international systems.

derivatives transaction records. The objective is to improve market transparency for better systemic risk assessment. The database can enhance the market surveillance capacity of regulators and thereby contribute to the maintenance of financial market stability. The basic services of the TR include transaction data capture and maintenance; reporting to regulators and public disclosure. The CMU TR will also have the capability to pass eligible derivatives transactions to CCP for central clearing.

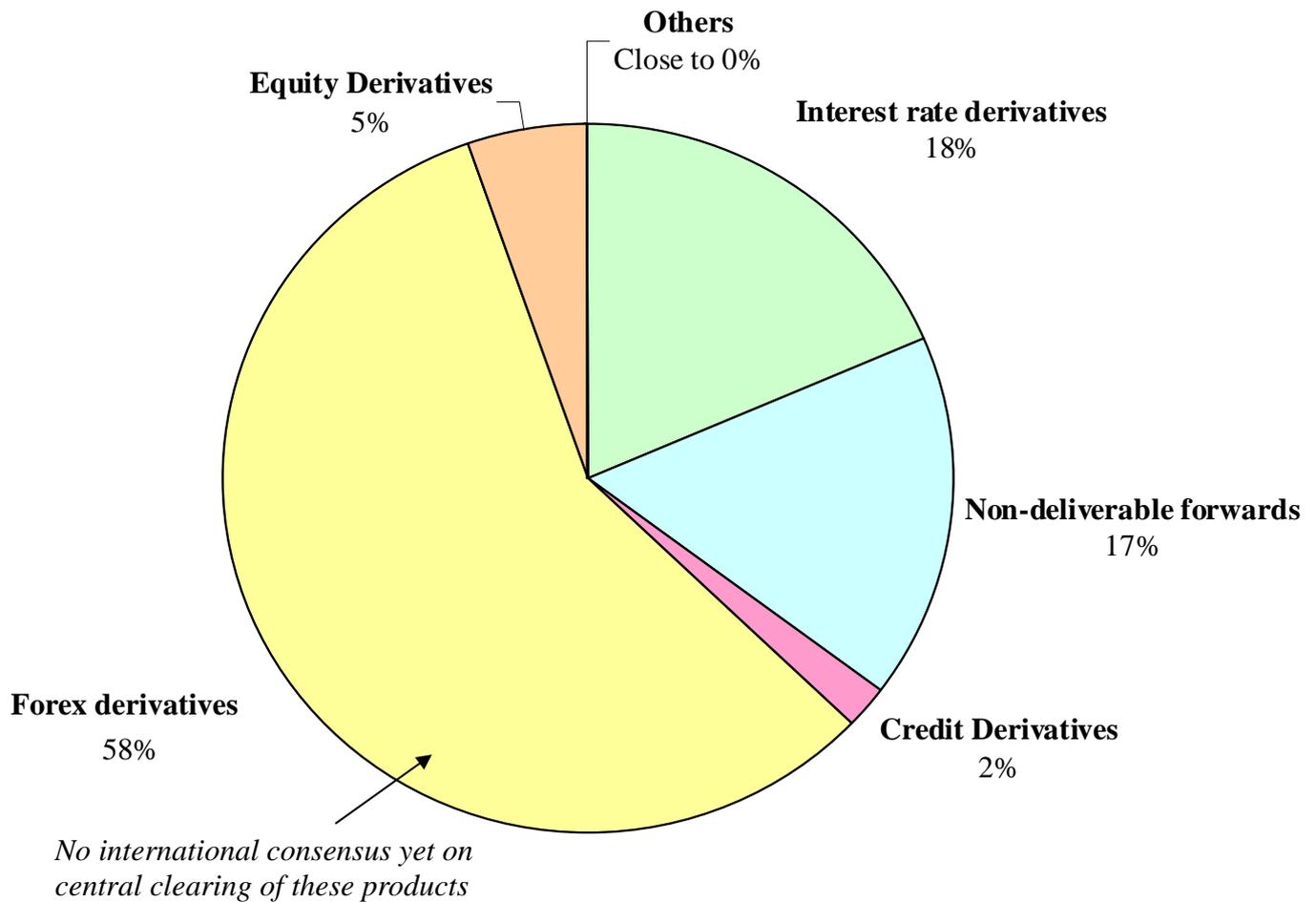
10. In connection with the introduction of mandatory clearing of standardised and eligible OTC derivatives at recognised CCPs, the Hong Kong Exchanges and Clearing Limited (HKEx) plans to establish a local CCP to provide central clearing services for the specified products. We welcome the establishment of a local CCP, as it would enable local players who do not have access to overseas CCPs to utilise the local facilities and enjoy the risk mitigation benefits.

## **Way Forward**

11. The HKMA and the SFC will work together to develop the regulatory framework, including the necessary legislative amendments, and ensure a level playing field for financial institutions in Hong Kong. The HKMA and the SFC aim to consult the market on the details of the regulatory requirements during the course of 2011.

**Financial Services and the Treasury Bureau  
Hong Kong Monetary Authority  
Securities and Futures Commission  
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**Breakdown of OTC derivative trades generated in Hong Kong during 2009 (by nominal amount)**



**Data obtained from a survey conducted with a list of major market participants**