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Legislative Council Panel on Financial Affairs

Progress in the Regulation of Over-the-counter Derivatives Market

Purpose

This paper updates Members on the progress in developing a full-fledged regulatory regime for the over-the-counter ("OTC") derivatives market and the need for introducing interim measures to facilitate voluntary clearing on OTC derivatives transactions to enhance our market competitiveness.

Background

2. We briefed Members at the Panel meeting on 3 January 2011 (vide paper CB(1)763/10-11(02)) on the international developments in the regulation of the OTC derivatives market and our plan to introduce a regulatory regime for the OTC derivatives market in Hong Kong[1].

Progress

3. In line with the G20 Leaders' commitment[2], the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") have been developing a regulatory regime for the OTC derivatives market in Hong Kong. To that end, a joint consultation paper was issued on 17 October 2011 which set out the HKMA and SFC's thinking on how the regime might be cast given the latest status of

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[1] The global financial crisis of late 2008 revealed structural deficiencies in the OTC derivatives market. The absence of regulation and the bilateral nature of OTC derivatives transactions rendered it difficult for regulators to assess OTC derivatives positions held by market players in order to monitor the build-up of exposures that might threaten the market or the wider economy. The global nature of the transactions also contributed to the interconnectedness of market players, thereby creating the potential for contagion risk.

[2] In September 2009, in the wake of the crisis, the G20 Leaders committed to reforms that would require (a) the mandatory reporting of certain OTC derivatives transactions to trade repositories; (b) the mandatory clearing of certain OTC derivatives transactions through central counterparties; (c) the mandatory trading of certain OTC derivatives transactions on exchanges or electronic trading platforms; and (d) the imposition of higher capital requirements in respect of OTC derivatives transactions not centrally cleared.

the global reform efforts, and invited industry feedback on specific issues that will help finalise key aspects of the local regime. The main proposals in the consultation paper are summarised at **Annex**.

4. The consultation period ended on 30 November 2011. The HKMA and SFC have received submissions from 33 respondents. They include financial institutions and industry bodies such as Hong Kong Association of Banks ("HKAB") and International Swaps and Derivatives Association, Inc. ("ISDA").

5. Respondents are generally supportive of the proposed regulatory regime and recognise the need for Hong Kong to develop and implement measures in line with G20 objectives in improving the surveillance of the OTC derivatives market. They support the proposed division of regulatory responsibilities between the HKMA and SFC as lead regulators of authorized institutions[3] ("AIs") and non-AIs in respect of their OTC derivatives market activities.

6. Respondents also support the proposed "two-tiered" legislative framework whereby the primary legislation will contain the high-level requirements in terms of the mandatory reporting, clearing and trading obligations and the subsidiary legislation, in the form of rules, will provide details for implementation. This approach would allow flexibility for the regulators to expand the scope of coverage of OTC derivatives transactions to be subject to the mandatory obligations in a phase-in manner, taking into consideration the evolving international regulatory development. There is also general support for not imposing the mandatory trading requirement at the outset but prioritising efforts on the mandatory reporting and clearing obligations at the initial stage.

7. The industry, however, has expressed concern about the following issues –

(a) the ambit of the term "OTC derivatives transactions" which would inappropriately also capture securities products and embedded derivatives;

(b) the need for clearer delineation of the new regulated activities and their overlap with existing regulated activities under the Securities and Futures Ordinance ("SFO");

[3] An AI refers to an institution that is licensed under the Banking Ordinance and regulated by the HKMA (i.e. banks, restricted licence banks, and deposit-taking companies).

(c) whether the mandatory requirements should cover transactions that AIs or licensed corporations[4] ("LCs") are not counterparty to but have only originated or executed;

(d) the extent to which the OTC derivatives transactions of foreign AIs might be caught (e.g. those with Hong Kong nexus) and the requirement for local AIs to comply on a group basis;

(e) the method for determination of the reporting and clearing thresholds;

(f) the absence of any exemption for end-users where their OTC derivatives activities are solely for commercial hedging purpose; and

(g) the potential conflict of law regarding client confidentiality in respect of the compliance of reporting obligation by an overseas AI and overseas branches of a local AI.

8. In response to the industry's comments, the HKMA and SFC will provide further clarification and/or refine the proposals, and aim to publish the consultation conclusions in the Second Quarter ("Q2") of 2012. Our plan is to introduce the relevant Bill into the Legislative Council in the Fourth Quarter ("Q4") of 2012 to provide for the regulatory framework for the OTC derivatives market in Hong Kong.

9. Given the global nature of the OTC derivatives markets, and the relatively small size of the OTC derivatives market in Hong Kong, it is important to ensure that the detailed requirements of the new OTC derivatives regime are in line with those adopted in other major international financial centres. In this regard, under our proposal, the detailed requirements of the new OTC derivatives regime will be set out in subsidiary legislation subject to negative vetting by the Legislative Council. The HKMA and SFC aim to conduct a public consultation on the draft subsidiary legislation in Q4 2012. We expect that by that time the relevant international standards as well as the progress of reform initiatives in the United States and European Union would be clearer.

Other infrastructure relating to the regulation

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4 A licensed corporation is a corporation which is licensed by the SFC under the SFO to carry on a regulated activity.

of the OTC derivatives market

10. As we briefed Members in January 2011, the HKMA would build upon its existing Central Moneymarkets Unit infrastructure to develop a local Trade Repository ("TR") in Hong Kong, and the Hong Kong Exchanges and Clearing Limited ("HKEx") would establish a local Central Counterparty ("CCP") to provide central clearing services for specified OTC derivatives products. These two projects are making good progress. The local TR will be ready to provide the necessary matching service to facilitate clearing by the local CCP by end 2012 and ready to receive information from users upon satisfactory testing of the system in Q2 2013. The HKEx aims to commence operation of the local CCP by end 2012.

Interim measure to facilitate voluntary central clearing

Market moving towards voluntary clearing

11. Notwithstanding that mandatory clearing has yet to be implemented, market participants are already moving towards clearing their OTC derivatives transactions through a regulated CCP on a voluntary basis. This is already the case in the United States, Europe and Singapore. Market participants recognize that the earlier they start central clearing, the more prepared they will be when the mandatory clearing obligation is implemented. They also recognize that centrally clearing their OTC derivatives transactions brings benefits and protection for both themselves and the market as a whole.

12. The laws of major markets already facilitate and support voluntary clearing of OTC derivatives transactions by providing insolvency override protection to such transactions cleared through a regulated CCP.

13. Insolvency override protection is a key concern for market participants, and critical to their choice of CCP for voluntary clearing of OTC derivatives transactions – if transactions cleared through a CCP do not enjoy insolvency override protection, it will raise concerns about the CCP's default management capability, and consequently defeat the objective of voluntary clearing (which is to better manage counterparty credit risk in the event of a default).

14. For Hong Kong, the existing insolvency override protection under the SFO does not apply to OTC derivatives transactions. It only

applies to “market contract”, which, as defined in Schedule 1 of the SFO), only covers transactions in securities or futures contracts, and only if –

(a) the transactions are subject to the rules of a recognized clearing house (“RCH”) and entered into by the RCH with a clearing participant pursuant to a novation, and

(b) the novation is for the purposes of clearing and settling transactions –

(i) effected on a stock or futures market operated by a recognized exchange company (“REC”), or

(ii) subject to the rules of an REC.

15. As a result, market participants in Hong Kong who wish to opt for voluntary clearing of OTC derivatives transactions will only be able to do so through overseas CCPs and will not have the option of clearing through a local CCP regulated by SFC at the moment. The latter, compared with clearing through overseas CCPs, will have a number of advantages. For example, this could facilitate communication since the CCP operates in the same time zone, and enable collateral to be held locally and thus be more readily accessible. In the event of default, the local regulator could more effectively assist local participants and monitor any potential systemic implications for the local market.

16. To support voluntary clearing of OTC derivatives transactions, pending the introduction of a full-fledged regulatory regime for the OTC derivatives market in Hong Kong, we plan to make use of the power for the Financial Secretary under section 392 of the SFO to prescribe, by way of a notice published in the Gazette, certain OTC derivatives transactions to be “futures contracts” for the purposes of particular provisions of the SFO, and hence enjoy the insolvency override protection. The relevant Gazette Notice is subsidiary legislation and subject to negative vetting by the Legislative Council. It will be repealed upon implementation of the full-fledged regulatory regime for the OTC derivatives market referred to in paragraphs 3 to 9 above.

17. The proposed measure to support voluntary clearing will facilitate implementation of the full-fledged regime for the OTC derivatives market in Hong Kong. Early recognition of a Hong Kong CCP will also give it the opportunity to build up experience and a track record before implementation of any mandatory clearing obligation. This

will provide added comfort to market participants who will then be obliged to clear through a CCP and would prefer to do so through a CCP in Hong Kong. An existing track record will also facilitate the recognition of the Hong Kong CCP by overseas jurisdictions, thus providing greater choice to market participants who may be subject to mandatory clearing obligations under both Hong Kong law and the laws of their home jurisdiction.

18. As some CCPs in other jurisdictions are already providing central clearing for HKD and RMB OTC derivatives products, the proposed measure will enable Hong Kong to compete with overseas markets and strengthen Hong Kong's position as an offshore RMB centre.

Market Engagement

19. The HKMA and SFC have consulted market participants on the proposal to introduce a section 392 Notice as discussed in paragraphs 16-18 above. Market participants are receptive to the idea as it will facilitate voluntary clearing in Hong Kong. As the scope of the notice is limited to extending the application of the insolvency override protection, its effect will be limited. In particular, the notice will not expand the existing licensing regime nor will it compel central clearing. They have not raised any objections or concerns on the proposal.

Way forward

20. We aim to table the relevant Gazette Notice on the interim measure at the Legislative Council for negative vetting in May 2012 to support voluntary clearing of OTC derivatives transactions.

21. Pending emergence of the international standards as discussed in paragraph 9 above, the Financial Services and the Treasury Bureau will continue to work with the HKMA and SFC on the legislative amendments for the introduction of a full-fledged regulatory regime for the OTC derivatives market in Hong Kong. Our aim is to introduce the relevant Bill into the Legislative Council in Q4 2012.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
April 2012

Annex

Joint Consultation by the HKMA and SFC on the Regulatory Regime for OTC Derivative Market in Hong Kong
Summary of Main Proposals

Legislative and Regulatory Framework

(a) The proposed regime will be set out in the Securities and Futures Ordinance ("SFO"). The broad framework for the regulation of the OTC derivatives market (including the obligation to comply with any mandatory clearing, reporting and trading requirements, and the penalties for breach of the requirements) will be set out in primary legislation while details (including the application of the mandatory requirements to authorized institutions ("AIs"), licensed corporations ("LCs") and other persons) will be set out in rules (subsidiary legislation) to be made by SFC with the consent of the HKMA.

(b) The proposed regime will be jointly overseen and regulated by the HKMA and SFC, with the HKMA overseeing and regulating the OTC derivatives activities of AIs[5] and the SFC overseeing and regulating such activities of LCs and other persons. Additionally, it is proposed that the relevant investigation and disciplinary powers under the SFO will be extended to the HKMA as appropriate to ensure that it is able to investigate and take action in respect of any breach of the mandatory requirements by AIs.

Reportable and Clearing Eligible Transactions

(c) Initially, the mandatory reporting and clearing obligations will apply only to certain interest rate swaps and non-deliverable forwards, but the current intention is to extend the obligations subsequently to cover other product classes (such as equity derivatives and other types of interest rate derivatives).

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[5] In the case of locally incorporated AIs, the HKMA's oversight will be in line with its current approach of "consolidated supervision", i.e. the supervision of a locally incorporated AI will take into account the activities of its local and overseas branches as well as any of its subsidiaries specified by the HKMA as appropriate so that the AI's group-wide activities (and resulting risk exposures) can be effectively monitored.

(d) The specific types of OTC derivatives transactions that will be subject to mandatory reporting or clearing (referred to in the consultation paper as reportable transactions and clearing eligible transactions respectively) will be determined jointly by the HKMA and SFC after public consultation.

Mandatory Reporting

(e) It is proposed that AIs, LCs and Hong Kong persons be required to report their relevant reportable transactions, irrespective of whether they are centrally cleared or not, to the Trade Repository ("TR") which is being set up by the HKMA ("the HKMA-TR"), and that such reporting be done either directly or indirectly (i.e. through an agent[6]).

(f) Given the global nature of the OTC derivatives market, the HKMA will endeavour to ensure that the reporting standards and specifications adopted by the HKMA-TR are in line with those set by international standard-setting bodies and major industry platforms. The HKMA will also work with other jurisdictions and TR operators to facilitate the sharing of data among themselves and with regulators.

(g) In light of their predominant role in the OTC derivatives market, AIs and LCs will be subject to more stringent mandatory reporting requirements than other persons. LCs and locally incorporated AIs will have to report all reportable transactions that they are counterparty to or that they have executed or originated. Overseas incorporated AIs will have to report reportable transactions that: (i) they are counterparty to, or have executed or originated, through their Hong Kong branch, or (ii) they are counterparty to and that have a Hong Kong nexus[7].

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6 The reporting agent may be a trade matching and confirmation platform or an overseas TR.

7 A reportable transaction has a Hong Kong nexus if its underlying asset, currency or rate is (or includes one that is) denominated in Hong Kong dollars, or in the case of credit or equity derivatives (if and when included), the underlying reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law. Such transactions are captured as they may have implications for the monetary and financial stability of Hong Kong.

(h) Other persons who are essentially based in, or operate from, Hong Kong (i.e. Hong Kong persons[8]) will have to report reportable transactions to which they are counterparties, but only if they have exceeded a specified reporting threshold[9] in respect of the product class to which the transactions belong. Also, in order to minimize the reporting burden on such persons, it is proposed that they be exempted from the reporting obligation if an AI or LC is also subject to a reporting obligation in respect of that transaction.

(i) Overseas persons (i.e. persons other than AIs, LCs and Hong Kong persons) will not be subject to any mandatory reporting obligation under Hong Kong law.

Mandatory Clearing

(j) It is proposed that AIs, LCs and Hong Kong persons be required to clear certain clearing eligible transactions through a designated CCP[10], and that this be done either directly (i.e. as a member of the designated CCP) or indirectly (i.e. through a third party that is a member of the designated CCP).

(k) The HKMA and SFC's current thinking is that only clearing houses recognised under the SFO, and providers of automated trading services authorised under Part III of the SFO, will be eligible for designation as CCPs under the proposed regime. A designated CCP may be a domestic or overseas clearing house.

(l) A mandatory clearing obligation will arise in respect of a clearing eligible transaction if both counterparties to the transaction have exceeded a specified clearing threshold[11] in

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8 Hong Kong persons include: (i) Hong Kong residents; (ii) the owners of any sole proprietorship or partnership based in, operated from or registered in Hong Kong; (iii) companies incorporated or registered in Hong Kong, (iv) funds managed in or from Hong Kong; and (v) any other entity established or registered under Hong Kong law.

9 The ambit and specific reporting threshold for each product class have yet to be determined. The HKMA and SFC are currently in the process of collecting data on the activities in the local OTC derivatives market, which will be used to determine appropriate thresholds for different product classes.

10 A designated CCP refers to a CCP that has been designated by the SFC (with the consent of the HKMA) for the purposes of the mandatory clearing requirement.

11 The ambit and specific clearing threshold for each product class have yet to be determined. The HKMA and SFC are currently in the process of collecting data on the activities in the local OTC derivatives market, which will be used to determine appropriate thresholds for different product classes.

respect of the product class to which the transaction belongs and either (i) an AI, LC or Hong Kong person is a counterparty to the transaction or (ii) an AI or LC has originated or executed the transaction. In the case of an overseas incorporated AI, such obligation will arise only if the transaction is done through its Hong Kong branch.

(m) Overseas persons will therefore be affected by the mandatory clearing obligation if an AI, LC or Hong Kong person is also involved in a clearing eligible transaction as aforesaid. Additionally, to reduce the compliance burden, a transaction will be exempted from mandatory clearing if both counterparties are overseas persons and the transaction has been cleared through a CCP in accordance with the laws of an acceptable overseas jurisdiction or is exempt from central clearing under those laws. .

Mandatory Trading

(n) Although we propose to amend the primary legislation to enable the SFC to impose the mandatory trading requirements, we do not intend to introduce any mandatory trading requirement at the outset. The size and liquidity of the OTC derivatives market in Hong Kong is relatively small. Further study is needed to assess the timing and manner for implementation of such a requirement in Hong Kong.

Regulation of Intermediaries and systemically important players

(o) AIs’ OTC derivatives activities are already subject to the HKMA’s regulatory oversight in respect of capital, liquidity and other relevant requirements and will remain so under the proposed regime. In order to bridge the regulatory gap that would otherwise exist, it is proposed that entities that are not AIs and that engage in dealing in (otherwise than as end users), advising on or providing clearing agency services in OTC derivatives as a business be required to be licensed by the SFC under the SFO, and that new regulated activities be introduced under the SFO for this purpose. We note that this is in line with international standards currently being discussed.

(p) It is also proposed to introduce provisions that will give the SFC a degree of regulatory oversight in respect of large players in the OTC derivatives market who are not otherwise regulated by the SFC or HKMA as intermediaries but whose positions raise concerns of potential systemic risk

Capital and Margin Requirements

(q) For OTC derivatives transactions that are not cleared through a designated CCP, the HKMA and SFC may apply higher capital requirements and margin requirements based on relevant international standards, including the Basel Committee on Banking Supervision capital requirements, and recommendations that may emerge from further work being conducted under the auspices of the Financial Stability Board in respect of the development of margining standards for non-centrally cleared OTC derivatives transactions.

Common Appeal Channels

(r) Relevant regulatory decisions made by the HKMA and SFC under the Amendment Legislation will be made appealable to the Securities and Futures Appeals Tribunal to ensure consistency in regulation and fair hearing.