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Bills Committee on Securities and Futures (Amendment) Bill 2013

Background brief

Purpose

This paper provides background information on the Securities and Futures (Amendment) Bill 2013 ("the Bill") which provides for a regulatory framework for the over-the-counter ("OTC") derivative market in Hong Kong and incorporates technical improvements to the regulation of the financial market. It also summarizes the discussion of related matters at meetings of the Panel on Financial Affairs ("FA Panel") on 3 January 2011, 2 April 2012 and 4 March 2013.

Background

2. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivative market, and the systemic risk it poses for the wider market and economy[1]. In the wake of the crisis, the Group of Twenty Leaders committed to reforms that would require –

(a) mandatory reporting of OTC derivative transactions to trade repositories ("TRs");

(b) mandatory clearing of standardized OTC derivative transactions through central counterparties ("CCPs");

(c) mandatory trading of standardized OTC derivative transactions on exchanges or electronic trading platforms; and

[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 of contagion risk.

(d) imposition of higher capital requirements in respect of OTC derivative transactions that are not centrally cleared[2].

3. These requirements aim to reduce counterparty risk, improve overall transparency, protect against market abuse, and ultimately enable regulators to better assess, mitigate and manage systemic risk in the OTC derivative market.

Public consultation on a regulatory regime for OTC derivatives market

4. In line with the G20 Leaders' commitment, the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") issued a joint consultation paper on 17 October 2011 to invite public views on the proposed regulatory regime on the OTC derivative market. A joint consultation conclusions paper was issued together with a supplemental public consultation on the proposed licensing regime for the new or expanded regulated activities and the oversight on systematically important participants ("SIPs") in July 2012 which ended in August 2012. According to the Administration, respondents generally supported the proposed regulatory regime and recognized the need for Hong Kong to develop and implement measures in line with G20 commitments of reforming the OTC derivative market. They supported the proposed division of regulatory responsibilities between HKMA and SFC. There was also general support for not imposing the mandatory trading requirement. The consultation paper and the consultation conclusions are hyperlinked in the **Appendix**.

The Bill

5. The Bill was published in the Gazette on 28 June 2013 and introduced into the Legislative Council ("LegCo") on 10 July 2013. At the House Committee meeting held on 12 July 2013, Members agreed to form a Bills Committee to study the Bill.

6. The key aspects of the proposed regulatory regime for the OTC derivative market set out in the Bill are highlighted as follows:

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2 For banks, higher capital requirements for OTC derivative transactions that are not cleared through a CCP have been introduced in January 2013 as part of Basel III implementation in Hong Kong. According to the Administration, it is closely monitoring the deliberation of the Basel Committee on Banking Supervision and the International Organization of Securities Commissions Joint Working Group on Margining Requirements on the guidance to develop margining requirements for non-centrally cleared OTC derivative transactions, upon finalization of which the Administration will take steps to develop legislation and a regulatory framework to implement the relevant requirements in Hong Kong in line with the recommended timeline.

<u>Legislative framework and persons covered</u>

(a) A broad regulatory framework for the regulation of the OTC derivative market is set out in the Securities and Futures Ordinance (Cap. 571) ("SFO"), with details prescribed in the rules (i.e. subsidiary legislation)[3] to be made by SFC with the consent of HKMA and after consultation with the Financial Secretary ("FS").

<u>Joint oversight by HKMA and SFC</u>

(Clauses 15 to 37 amend Part VIII and Part IX of SFO to ensure that both HKMA and SFC have the necessary investigatory and disciplinary powers to oversee and regulate activities in the OTC derivative market. Clause 40 adds a new Division 1A to Part XVI of SFO to impose a confidentiality requirement on HKMA and other persons involved in carrying out HKMA's functions under the proposed regime, and to create exceptions to the requirement in specified situations.)

(b) The new regime will be jointly overseen and regulated by HKMA and SFC, with HKMA regulating the OTC derivative activities of authorized institutions ("AIs") and approved money brokers ("AMBs"), and SFC regulating such activities of licensed corporations ("LCs") and other prescribed persons (such persons to be prescribed by subsidiary legislation)[4].

(c) HKMA will be given new powers under SFO to investigate breaches of mandatory obligations by AIs and AMBs, and to take disciplinary action against them for such breaches. SFC's existing investigation and disciplinary powers under SFO will also be extended as necessary so that they will cover breaches of the mandatory obligations by other persons, including LCs.

<u>Mandatory obligations and penalties</u>

(Clause 52 amends Schedule 1 to SFO to include a definition of OTC derivative product. Clause 9 adds a new Part IIIA (i.e. new sections 101A to W) to SFO on OTC derivative transactions and the obligations and requirements relating to them.)

(d) The Bill introduces mandatory reporting, clearing and trading obligations. These obligations apply to "prescribed persons", i.e. AIs, AMBs, LCs and others that are prescribed by subsidiary legislation; and in respect of those OTC derivative transactions

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3 HKMA and SFC aim to conduct a public consultation on the draft subsidiary legislation later in 2013 to take into account the relevant international standards as well as the progress of reform initiatives in other major jurisdictions like the United States and the European Union.

4 AIs refer to authorized institutions as defined in the Banking Ordinance (Cap. 155), and LCs refer to corporations licensed by SFC under SFO. AIs, AMBs and LCs are the main players in the OTC derivative markets and so they are referred to expressly in the Bill.

that are specified in subsidiary legislation. Mandatory trading obligation will not be implemented at the outset pending further study of local market conditions, in particular the liquidity level and number of trading venues in the market.

(e) The mandatory reporting and clearing obligations initially cover certain types of interest rate swaps ("IRSs") and non-deliverable forwards ("NDFs") specified in subsidiary legislation as they are the major types of OTC derivative transactions conducted in Hong Kong and are capable of standardization. The obligations will be extended in phases to cover other types of transactions and products to be determined by HKMA and SFC after public consultation and consultation with FS.

Mandatory reporting

(f) AIs, AMBs, LCs and other prescribed persons will be required to report certain OTC derivative transactions (as specified in the rules, "reportable transactions") to HKMA.

(g) The reporting obligation will apply irrespective of whether the reportable transaction is centrally cleared or not, and may be fulfilled either directly or indirectly, i.e. through an agent[5].

(h) AIs, AMBs and LCs will be subject to more stringent mandatory reporting requirements than other prescribed persons. In particular, the latter will only have to report if their OTC derivative positions exceed certain reporting thresholds (to be specified by SFC in subsidiary legislation), but no such thresholds will be applied to AIs, AMBs and LCs.

(i) Other prescribed persons will essentially cover persons other than AIs, AMBs and LCs that are based in or operate from Hong Kong. Overseas persons with no presence or operation here will not be subject to any mandatory reporting obligation under Hong Kong law.

(j) Only one TR, i.e. the one to be established by HKMA ("HKMA-TR"), will be designated for the purpose of mandatory reporting obligation on reportable transactions. The reporting standards and specifications adopted by the TR will be in line with those set by international standard-setting bodies and major industry platforms.

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

Mandatory clearing

(k) AIs, LCs, AMBs and other prescribed persons will be required to clear certain OTC derivative transactions (as specified in the rules, "clearing eligible transactions") through a designated CCP, and they may do this 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)[6].

(l) As with the reporting obligation, the clearing obligation will only apply to AIs, AMBs, LCs and other prescribed persons that are based in or operate from Hong Kong, i.e. it will not apply to overseas persons that have no presence or operation in Hong Kong. However, such persons may nevertheless be affected if they have entered into a clearing eligible transaction and their counterparty is an AI, AMB, LC or other prescribed person. This is because the clearing obligation can only be fulfilled if both counterparties clear through a designated CCP.

(m) New sections 101 K to N of SFO contain the rule-making powers relating to obligations and to designations. The rules may be made by SFC with the consent of HKMA and after consulting FS. New sections I and J of SFO empowers SFC to designate CCPs and trading platforms. SFC can make designations only with the consent of HKMA and after consulting FS.

Penalty for breaches of mandatory obligations

(n) Fines will be imposed for breaches of mandatory obligations. The Court of First Instance will be empowered to impose civil fines of up to $5 million on any person who breaches these obligations. For breaches by AIs, AMBs or LCs, HKMA and SFC will also be empowered to take disciplinary actions against them, including imposing disciplinary fines of up to an amount that is the greater of (i) $10 million or (ii) three times the amount of the profit gained, or loss avoided, by the person as a result of the contravention, making public or private reprimand and prohibiting them from carrying on OTC derivatives business.

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[6] For indirect clearing, the Administration intends to introduce amendments to SFO that will offer insolvency override protections for indirect clearing that are comparable to those provided for direct clearing, i.e. those contained in the existing SFO which essentially prevent transactions cleared through a CCP from being unraveled by the application of insolvency law in the event of a default by any members of the CCP.

<u>New regulated activities</u>
(Clause 53 amends Schedule 5 to SFO to include new types of regulated activities ("RAs"). Clause 55 adds a new Schedule 11 to SFO to provide transitional arrangements for the new and expanded RAs.)

(o) Two new RAs in relation to OTC derivatives will be introduced under Schedule 5 to SFO, namely (i) a new Type 11 RA to cover the activities of dealers and advisers, and (ii) a new Type 12 RA to cover the activities of clearing agents. The existing Type 9 RA (asset management) and Type 7 RA (provision of automated trading services) will be expanded to cover OTC derivative portfolios and transactions respectively.

(p) To minimize disruption to the market, transitional arrangements will be introduced for the new and expanded RAs, so that person who are already serving as intermediaries in the OTC derivative market may continue to do so for a limited period of time while their application to be licensed or registered for the new or expanded RAs is being considered[7].

<u>Regulation of systematically important participants</u>
(Clause 9: new sections 101O to W of SFO)

(q) The proposed regime will include regulation of SIPs, i.e. market participants which are not licensed or registered with either HKMA or SFC, but whose positions and activities in the OTC derivative market are so large that they may nevertheless raise concerns of potential systematic risks. These include commercial entities and financial institutions who do not act as intermediaries but who are essentially price takers and end users.

(r) Any person whose OTC derivative positions exceed certain specified thresholds ("SIP thresholds") should notify SFC. Failure to give such notification within a specified period, without reasonable excuse, will constitute a criminal offence and be subject to a fine up to $5 million and seven years' imprisonment. The SIP thresholds will be set at fairly high levels such that only a handful of market players, if any, may be caught.

(s) SFC will keep a register of persons who have notified SFC that they have exceeded any SIP thresholds, or whom HKMA/SFC has reasonable cause to believe have exceeded any SIP thresholds.

[7] For details of the transitional arrangements, please refer to footnote 7 of the Legislative Council Brief on the Bill (file ref.:SUB 12/2/7 (2013)) issued by the Financial Services and the Treasury Bureau on 26 June 2013.

The SIP register will be open for public inspection. HKMA and SFC will be empowered to require registered SIPs to provide information. SFC may require registered SIPs to take certain action in respect of their OTC derivative positions and transactions under certain circumstances.

Other technical improvements to the regulation of the financial market

(t) Other technical amendments to SFO and the Organized and Serious Crimes Ordinance (Cap. 455) ("OSCO") which have been incorporated into the Bill are –

(i) under clauses 61-64, to amend SFO to require notifications and reports under Part XV "Disclosure of Interests" of the Ordinance to be filed electronically with a view to improving the timeliness of publication of potentially market sensitive Disclosure of Interests notices; and

(ii) under clauses 65-68, to amend SFO and OSCO to enhance SFC's enforcement regime regarding market misconduct offences under SFO so that illegal gains from committing an offence can be recouped. Criminal courts will also be enabled to make disgorgement orders similar to the Market Misconduct Tribunal for the purpose of recouping illegal gains from committing a market misconduct offence.

Deliberations of the Panel on Financial Affairs

7. The major concerns expressed by members during the discussion at FA Panel meetings on 3 January 2011, 2 April 2012 and 4 March 2013 are summarized in the ensuing paragraphs.

General issues

8. There was doubt as to whether the Government and the relevant regulatory bodies had the expertise and competence for regulation of the OTC derivatives market. The Administration responded that at present, trading of OTC derivatives lacked transparency. The proposed regulatory regime would improve the transparency of the OTC derivatives market, thereby enhancing investor protection. The global financial markets would continue to make concerted efforts to establish and implement effective regulatory regimes for OTC derivative markets.

9. As to how the establishment of a local TR would help improve the assessment of the risk of OTC derivatives, HKMA explained that the TR

would enable the regulatory bodies to obtain information about the position held by individual financial institutions. Through the TR, market participants would also be able to obtain aggregate information on certain asset classes of OTC derivatives in order to assess and map out their risk management and investment strategies.

Coverage of the proposed regulatory regime

10. On the scope of products covered by the proposed regulatory regime, members sought information on the transaction volume and value of IRSs and NDFs in the Hong Kong market, and the situation of retail investors engaging in OTC derivative transaction vis-à-vis that of institutional/professional investors. There was a concern that if the mandatory reporting and clearing requirements would apply only to IRS and NDFs, the volume of OTC derivative transactions subject to regulation would be small. The Administration advised that, based on the findings of a previous survey, the notional value of OTC derivative transactions in Hong Kong had reached some US$16,000 billion, of which 18% and 17% were IRSs and NDFs respectively, whereas foreign exchange derivatives constituted the largest share, i.e. 58%. Credit derivatives (2%) and equity derivatives (5%) accounted for the remaining transactions. In terms of investor segments, 70% of the OTC derivative transactions were undertaken by AIs involving mainly institutional and professional investors, and 30% were end-users. The involvement by retail investors was small.

11. As regards members' concern that the proposed regulatory regime would not cover equity derivatives and foreign exchange derivatives at the initial stage, SFC and HKMA explained that it was difficult to achieve standardization, which was a prerequisite for centralized clearing, for equity derivatives. The OTC derivatives market in Hong Kong was similar to those in the United Kingdom, the United States and Singapore in that foreign exchange derivatives constituted the greatest share of the OTC derivatives market. However, the majority of the foreign exchange derivatives involved short-term foreign exchange swaps whose risk was relatively low. While it was the objective of the G20 Leaders to require mandatory clearing for all standardized OTC derivative trades through CCPs and mandatory reporting of all OTC derivative trades to trade repositories, the specific types of OTC derivative transactions to be included in the mandatory regulatory regime would be adjusted to cater for the unique circumstances and needs of respective jurisdictions. At the moment, there was no consensus among major jurisdictions towards subjecting short-dated foreign exchange derivatives to stringent regulation. Depending on the development in the international arena, Hong Kong might consider regulating OTC equity derivatives and some of the long-term OTC foreign exchange derivatives at a later stage.

12. Responding to the concern about the potential compliance burden arising from mandatory reporting and clearing of OTC transactions conducted between two companies only that did not involve banks or financial institutions, HKMA pointed out that the counterparties for non-financial institutions in OTC derivative transactions in Hong Kong or overseas were mainly banks or financial institutions, and very few of such transactions were conducted between non-financial institutions. To minimize reporting burden, non-financial institutions would have to report reportable transactions to which they were counterparties only if their positions exceeded the reporting threshold. If non-financial institutions' OTC derivative transactions involved an AI, LC or AMB, they would be exempted from the reporting obligation. Similarly, non-financial institutions that were counterparties to a clearing eligible transaction would be required to clear such transaction through a designated CCP if the transactions of both the non-financial institutions and their counterparties had exceeded the clearing threshold.

13. The Panel has considered whether a mechanism should be put in place to enable interference of regulatory bodies with the activities of insurance companies and large enterprises involved in transactions of foreign exchange derivatives having regard to their large transaction volumes. SFC advised that insurance companies and large enterprises were end-users rather than dealers in foreign exchange derivatives. The legislative proposals would include provisions whereby end-user was found to have acquired a large volume of OTC derivatives, SFC could exercise its power to request the end-user to provide details of the transactions, and if necessary, demand the end-user to reduce the size of OTC derivatives held by it. Companies, including insurance companies, if dealing in OTC derivative transactions, would be required to be licensed by SFC.

Financial arrangements and investor protection

14. Some members expressed concern about the financial arrangements for the establishment and operation of the CCP in Hong Kong. There was a suggestion that the expenditure of the CCP should be borne by market participants, and no subsidy should be made from the public purse. The OTC derivatives market in Hong Kong might be adversely affected if high levels of fees were charged for OTC derivative transactions.

15. The Administration advised that the Government would not provide financial support for the establishment and operation of the CCP. The Hong Kong Exchanges and Clearing Company Limited ("HKEx") advised that it would make an investment of about $180 million for setting up the CCP. A guarantee fund would be set up jointly between HKEx and the subscribers to the CCP. The CCP would charge a fee on the OTC derivative transactions for the services provided, and the fees would not be set at such a level as to hinder the development of the market. The fees would be set based on a

number of factors, including benchmarking with the fees charged in the global markets. SFC advised that the CCP would charge a fee on the OTC derivatives transactions based on "the user pay" principle and no levy would be imposed by SFC on transactions cleared by the CCP.

16. In the light of the Lehman Brothers incident, some members expressed concern about possible mis-selling of high-risk investment products, including derivatives, to investors and the extent of investor protection under the proposed regulatory regime for OTC derivative transactions. The Administration advised that the proposed regulatory regime would help monitor the build-up of exposures that might threaten the market, strengthen the stability of the financial system and reduce the potential of contagion risks affecting general investors arising from the global nature of OTC derivative transactions and interconnectedness of market players. The proposed regulatory regime would also enhance investor protection in the area of licensing of intermediaries relating to OTC derivative transactions.

17. In response to the enquiry about the need for setting up a compensation fund to protect the investors under the proposed regulatory regime for OTC derivatives market. SFC explained that as generally only institutional investors were involved in OTC derivatives transactions, it was not necessary to establish an investor compensation protection fund for OTC derivatives transactions.

Renminbi OTC derivatives

18. Regarding the impact of the proposed regulatory regime on the development of Renminbi ("RMB") OTC derivatives in Hong Kong, the Administration advised that Hong Kong enjoyed an edge over other financial markets in that it started the development of a RMB OTC derivatives market earlier than other places, e.g. a non-deliverable forwards market on RMB had already been established in Hong Kong. HKEx advised that while HKEx would not develop derivative products on its own, it would consider providing a platform for clearing of standardized OTC RMB derivative products.

Council Business Division 1
Legislative Council Secretariat
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Appendix

List of relevant papers

Date	Event	Paper/Minutes of meeting
3 January 2011	Meeting of the Panel on Financial Affairs ("FA Panel")	Discussion paper (LC Paper No. CB(1)763/10-11(02)) http://www.legco.gov.hk/yr10-11/english/panels/fa/papers/fa0103cb1-763-2-e.pdf Minutes (LC Paper No. CB(1)1336/10-11) http://www.legco.gov.hk/yr10-11/english/panels/fa/minutes/fa20110103.pdf
October 2011	Consultation paper jointly issued by the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") on the proposed regulatory regime for the over-the counter ("OTC") derivatives market in Hong Kong	Consultation paper http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2011/20111017e3a1.pdf
2 April 2012	Meeting of the FA Panel	Discussion paper (LC Paper No. CB(1)1411/11-12(05)) http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa0402cb1-1411-5-e.pdf Background brief (LC Paper No. CB(1)1410/11-12) http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa0402cb1-1410-e.pdf Minutes (LC Paper No. CB(1)2028/11-12) http://www.legco.gov.hk/yr11-12/english/panels/fa/minutes/fa20120402.pdf

Date	Event	Paper/Minutes of meeting
July 2012	Consultation conclusions jointly published by HKMA and SFC on the proposed regulatory regime for the OTC derivatives market in Hong Kong	Consultation conclusions http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2012/20120711e3a34.pdf
July 2012	Supplemental consultation paper jointly issued by HKMA and SFC on the OTC derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systematically important players	Supplemental consultation paper http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=12CP2
4 March 2013	Meeting of the FA Panel	Discussion paper (LC Paper No. CB(1)599/12-13(03)) http://www.legco.gov.hk/yr12-13/english/panels/fa/papers/fa0304cb1-599-3-e.pdf Updated background brief (LC Paper No. CB(1)599/12-13(04)) http://www.legco.gov.hk/yr12-13/english/panels/fa/papers/fa0304cb1-599-4-e.pdf Minutes (LC Paper No. CB(1)1131/12-13) http://www.legco.gov.hk/yr12-13/english/panels/fa/minutes/fa20130304.pdf

Date	Event	Paper/Minutes of meeting
10 July 2013	Introduction of the Securities and Futures (Amendment) Bill 2013 into the Legislative Council	The Bill http://www.legco.gov.hk/yr12-13/english/bills/b201306281.pdf Legislative Council Brief on Securities and Futures (Amendment) Bill 2013 (SUB 12/2/7 (2013)) http://www.legco.gov.hk/yr12-13/english/bills/brief/b21_brf.pdf Legal Service Division report on the Bill (LC Paper No. LS71/12-13) http://www.legco.gov.hk/yr12-13/english/hc/papers/hc0712ls-71-e.pdf