

Legislative Council Panel on Financial Affairs

Legislative Proposal on the Regulation of Over-the-counter Derivative Market

Purpose

This paper briefs Members on the legislative proposal to develop a regulatory regime for the over-the-counter (“OTC”) derivative market.

Background

2. We briefed Members at the Panel meeting on 3 January 2011 (vide paper CB(1)763/10-11(02)) and on 2 April 2012 (vide paper CB(1)1411/11-12(05)) on the international developments in the regulation of the OTC derivative market and our plan to introduce a regulatory regime for the OTC derivative market in Hong Kong¹.

Progress

3. Since the announcement of the Group of Twenty (“G20”) Commitments², we have taken active steps to prepare for local implementation in Hong Kong while monitoring international developments. This involves –

- (a) the making of subsidiary legislation in June 2012 to enable voluntary clearing of OTC derivative transactions and the setting up of a Central Counterparty (“CCP”) by the Hong Kong Exchanges and Clearing Limited (“HKEx”); and

¹ The global financial crisis of late 2008 revealed structural deficiencies in the OTC derivative market. The absence of regulation and the bilateral nature of OTC derivative transactions rendered it difficult for regulators to assess OTC derivative 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 in different jurisdictions, thereby creating the potential for contagion risk.

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

(b) a joint consultation on the key aspects of the regulatory proposal on the OTC derivative market by the Securities and Futures Commission (“SFC”) and the Hong Kong Monetary Authority (“HKMA”) in October 2011. 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 systemically important participants (“SIPs”) in July 2012. The supplemental consultation ended in August 2012 and the HKMA and SFC are finalising the supplemental consultation conclusions paper and will publish it soon.

4. Respondents to the October 2011 consultation 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 derivative market. They support the proposed division of regulatory responsibilities between the HKMA and SFC. 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.

5. Most of the responses to the supplemental consultation are in relation to clarification as to the ambit of, and possible exemptions available under the proposed licensing regime for new regulated activities, and also, how the proposed transitional arrangements for the new regime will work in practice.

6. Taking into consideration the feedback received from the two consultations, we are finalising the legislative amendments required to provide for the regulatory framework for the OTC derivative market in Hong Kong. The major proposals are set out below.

Legislative and Regulatory Framework

7. The proposed regime will be set out in the Securities and Futures Ordinance (“SFO”). The broad framework for the regulation of the OTC derivative market (including the obligation to comply with any mandatory clearing, reporting and trading requirements, and the penalties against breaches of the requirements) will be set out in primary legislation while details (including the application of the mandatory requirements to authorized institutions (“AIs”), approved money brokers (“AMBs”), licensed corporations (“LCs”) and other prescribed persons,

for instance, international investment houses) will be set out in rules (i.e. subsidiary legislation)³ to be made by the SFC with the consent of the HKMA, after consultation with the Financial Secretary.

8. The proposed regime will be jointly overseen and regulated by the HKMA and SFC, with the HKMA overseeing and regulating the OTC derivative activities of AIs⁴ and AMBs, and the SFC overseeing and regulating such activities of LCs and other prescribed persons. We propose to extend the relevant investigation and disciplinary powers under the SFO 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 and AMBs.

Mandatory Obligations

9. The Bill being prepared will enable the imposition of mandatory obligations on reporting, clearing and trading of specified OTC derivative transactions by AIs, AMBs, LCs and other prescribed persons. The application of these mandatory obligations will be determined by reference to a number of factors in relation to the product, transaction and party involved. For instance, LCs, AIs and AMBs will be required to report all specified categories of OTC derivative transactions (i.e. no threshold), while other prescribed persons will be subject to a reporting threshold and will be required to report their specified OTC derivative product transaction when the threshold is exceeded. As for the clearing obligation, LCs, AIs, AMBs and other prescribed persons will be required to clear their specified OTC derivative transactions through a designated CCP if the clearing threshold is exceeded. Further details are set out in paragraphs 12 and 13.

10. Concerning product coverage, the reporting and clearing requirements will initially be applied to interest rate swaps and non-deliverable forwards, because these are the major types of OTC derivative transactions, after foreign exchange derivatives⁵, in Hong

³ The HKMA and SFC aim to conduct a public consultation on the draft subsidiary legislation in summer 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 European Union.

⁴ 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.

⁵ We note that there is no consensus among major jurisdictions towards subjecting short-dated foreign exchange derivatives to stringent regulations.

Kong. The specific types of OTC derivative transactions that will be subject to mandatory reporting or clearing will be determined jointly by the HKMA and SFC after public consultation.

11. At the outset, we will implement the mandatory reporting and clearing obligations first and will conduct further studies to assess how best to implement the mandatory trading requirement in Hong Kong, taking into consideration the liquidity level and number of trading venues in our market.

Mandatory Reporting

12. The proposed regime regarding mandatory reporting is set out in further detail below.

- (a) AIs, AMBs, LCs and other prescribed Hong Kong persons will be required to report their relevant reportable transactions specified in the rules, irrespective of whether they are centrally cleared or not, to the trade repository (“TR”) which is being set up by the HKMA within its existing Central Moneymarkets Unit (“CMU”) infrastructure, and such reporting will be done either directly or indirectly, i.e. through an agent⁶.
- (b) In light of their predominant role in the OTC derivative market, AIs, AMBs and LCs will be subject to more stringent mandatory reporting requirements than other persons. LCs and locally incorporated AIs and AMBs will have to report all reportable transactions that they are counterparty to or that they have executed or originated and the transaction has a Hong Kong nexus⁷. Overseas incorporated AIs will have to report reportable transactions that –

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 –

- (a) in the case of equity derivatives and credit derivatives,
 - (i) that the underlying entity or the reference entity is listed in Hong Kong, and where there is more than one underlying entity or reference entity, a specified percentage of the entities are listed in Hong Kong, or
 - (ii) that the underlying is an index and a specified percentage of the underlying companies are listed in Hong Kong, or
 - (iii) that the reference entity is, or is wholly owned by, the Government of the Hong Kong Special Administrative Region, and

- (i) they are counterparty to, acting through their Hong Kong branch, or
 - (ii) they have executed or originated, acting through their Hong Kong branch, and that have a Hong Kong nexus.
- (c) Other persons who are essentially based in, or operate from, Hong Kong (i.e. Hong Kong persons⁸) will have to report reportable transactions to which they are counterparties, but only if they have exceeded a specified reporting threshold⁹ 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, AMB or LC is also subject to a reporting obligation in respect of that transaction.
- (d) Overseas persons (i.e. persons other than AIs, AMBs, LCs and Hong Kong persons) will not be subject to any mandatory reporting obligation under Hong Kong law.

Mandatory Clearing

13. The proposed regime regarding mandatory clearing is set out in further detail below.

- (a) AIs, AMBs, LCs and other prescribed persons will be required to clear certain clearing eligible transactions through a designated CCP¹⁰, and that this be done either directly (i.e. as a member of the designated CCP) or

(b) in the case of other derivatives, that the underlying asset, currency or rate is denominated in or related to (or includes an asset, currency or rate that is denominated in or related to) Hong Kong dollars or Renminbi.

Such transactions are captured as they may have implications for the monetary and financial stability of Hong Kong.

⁸ Hong Kong persons include: (a) Hong Kong residents; (b) the owners of any sole proprietorship or partnership based in, operated from or registered in Hong Kong; (c) companies incorporated or registered in Hong Kong; (d) funds domiciled in Hong Kong; and (e) any other entity established or registered under Hong Kong law.

⁹ The ambit and specific reporting threshold for each product class will be determined later. Further details on the reporting threshold, and its operation, will be provided when the HKMA and SFC consult the public on the detailed requirements.

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.

indirectly (i.e. through a third party that is a member of the designated CCP).

- (b) A mandatory clearing obligation will arise in respect of a clearing eligible transaction if both counterparties to the transaction have exceeded a specified clearing threshold¹¹ in respect of the product class to which the transaction belongs and an AI, AMB, LC or other Hong Kong person is a counterparty to the transaction. In the case of an overseas incorporated AI, such obligation will arise only if the transaction is booked in its Hong Kong branch.
- (c) Overseas persons will therefore be affected by the mandatory clearing obligation if an AI, AMB, LC or Hong Kong person is also involved in a clearing eligible transaction as aforesaid.
- (d) Regarding indirect clearing mentioned in paragraph (a) above, transactions cleared through a CCP may be cleared indirectly through, or as a client of, another person that is a member of the CCP. Such indirect clearing is referred to as “client clearing”. We propose to offer legal protections 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 unravelled by the application of insolvency law in the event of a default by any of the members of the CCP.

Penalty against Breaches of Mandatory Obligations

14. Fines will be imposed against breaches of the mandatory obligations. The Court of First Instance will be empowered to impose civil fines of up to \$5 million on any person who breaches such obligations and requirements. For breaches by AIs, AMBs or LCs, the HKMA and SFC will be empowered to take disciplinary actions against them, including imposing disciplinary fines of up to \$10 million and reprimand etc.

¹¹ The ambit and specific clearing threshold for each product class will be determined later. Further details on the clearing threshold, and its operation, will be provided when the HKMA and SFC consult the public on the detailed requirements.

Capital and Margin Requirements for Uncleared Transactions

15. For banks, higher capital requirements for OTC derivative transactions that are not cleared through a CCP have been introduced as part of Basel III implementation in Hong Kong. We are also 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 finalisation of which we will take steps to develop legislation and a regulatory framework to implement the relevant requirements in Hong Kong in line with the recommended timeline.

Regulation of Intermediaries

16. AIs and AMBs who serve as intermediaries in the OTC derivative market will continue to be overseen and regulated by the HKMA. Entities that are not AIs and AMBs and that engage in dealing in, advising on or providing clearing agency services in OTC derivatives as a business (other than as end users) will be required to be licensed by the SFC under the SFO, and new regulated activities will be introduced under the SFO for this purpose. We note that this is in line with international standards.

17. Two new regulated activities (“RAs”) in relation to OTC derivatives will be introduced under Schedule 5 to the SFO, namely (a) a new Type 11 RA to cover the activities of dealers and advisers, and (b) a new Type 12 RA to cover the activities of clearing agents. In addition, 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. As AIs and AMBs who serve as intermediaries in the OTC derivative market will continue to be overseen and regulated by the HKMA, they will not need to be licensed for the new Type 11 or Type 12 RAs. However, to the extent that their OTC derivative activities also constitute the carrying on of an existing RA (including the expanded Type 9 RA), they will continue to have to be licensed or registered (as the case may be) as they are today.

To minimise impact to the market, transitional arrangements¹² will be introduced for the new and expanded RAs. The HKMA will be enabled under the SFO to investigate breaches of the mandatory obligations by AIs and AMBs, and to take disciplinary action against them for such breaches. The SFC's existing investigation powers under the SFO will be expanded as necessary so that they cover breaches of the mandatory obligations by other persons, including LCs.

Regulation of Systemically Important Participants

18. While the major market players in the OTC derivative market in Hong Kong are expected to be persons licensed or registered with either the HKMA or SFC, to avoid any regulatory gap, the proposed regime will provide for the regulatory oversight of persons who are not licensed or registered with either the HKMA or SFC, but whose positions and activities in the OTC derivative market may raise concerns of potential systemic risks. Any person whose OTC derivative positions exceed a certain specified threshold¹³ should notify the SFC, and their names and information as to which threshold has been exceeded shall then be entered in a register of SIPs which shall be open for public inspection. Failure to give such notification to the SFC within a specified period, without a reasonable cause, will constitute a criminal offence liable to the penalty of a fine up to \$5 million and 7 years imprisonment. We expect that it is unlikely that there will be any SIPs at least in the initial stage of implementation of the proposed regime and it is expected that AIs, LCs or international investment houses will be the major players. We also expect that the possibility of an

¹² Transitional arrangements will be provided such that market participants who are already engaged in activities caught by the proposed new RAs and expanded RAs will be allowed to continue to do so for a limited period of time despite not being licensed for such RAs. This will give the SFC sufficient time to process licensing applications but with minimal disruption to the market. The transitional arrangements will comprise (a) an application period (which should last three months from the date of implementation of the new RAs and during which persons must submit their application to be licensed for the new RAs if they wish to benefit from the transitional arrangements) and (b) a no-action period (which should last six months from the date of implementation, and during which anyone may carry on the new RAs without being licensed to do so.) A person who submits an application to be licensed for any of the new RAs during the application period and meets certain criteria will be deemed to be licensed for the relevant new RAs with effect from the expiry of the no-action period. Similarly, persons seeking to be licensed/registered for the expanded Type 7/Type 9 RA, and who are not already licensed for such RAs will need to apply within the aforesaid 3-month application period and meet certain criteria in order to be deemed to be licensed/registered for the expanded RAs with respect to OTC derivatives. For persons who are already licensed/registered for Type 7 or Type 9 RA, and who wish to engage in the expanded Type 7/Type 9 RA, the transitional arrangements will be further simplified and they would only need to submit a notification and confirmation that they have fulfilled the relevant criteria to the SFC within the application period.

¹³ The threshold for SIPs' notification will be set at a level which is many times higher than the specified reporting and clearing thresholds in relation to the mandatory reporting and clearing obligations mentioned in paragraphs 12(c) and 13(b) above.

individual entering into an OTC derivative transaction and becoming an SIP to be very slim.

19. Additionally, in order to enable the HKMA and SFC to have some regulatory hold over SIPs, they will be empowered to require SIPs to provide information and take certain action in respect of their OTC derivative positions and transactions under certain circumstances. Persons who fail to comply with such requirements will be subject to disciplinary action by the SFC, and the sanctions that may be imposed will include reprimand and disciplinary fines of up to HK\$10 million.

20. The SFC will keep a register of SIPs and will enter in the register such details relating to these persons as specified in rules – basically, only the name of the SIP and the class of OTC derivative transactions in respect of which the SIP has exceeded the threshold will be included in the register. Such information will help alert market participants of the accumulation of positions with the SIP so that they may better manage risks arising from or associated with their OTC derivative positions, including risks arising from entering into transactions with an SIP. This kind of early alert would be particularly useful in non-standardized and non-centrally cleared OTC derivative contracts. The disclosure is in line with the purpose of the proposed regime to improve transparency, mitigate systemic risk, and prevent market abuse in OTC derivative markets thereby enhancing and promoting financial stability and meeting the regulatory reform requirements advocated by G20.

Regulation of Market Infrastructure

21. The proposed regime will also provide for the regulation of the market infrastructure through which any mandatory obligations must be fulfilled, i.e. the TR, CCPs and trading platforms.

22. The HKMA will develop a local TR in Hong Kong. Given the global nature of the OTC derivative market, the HKMA will endeavour to ensure that the reporting standards and specifications adopted by the 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 other TR operators to facilitate the sharing of data. The TR will also have the capability to pass eligible derivative transactions to the local CCP, which is being developed by HKEx, for central clearing (for details please refer to paragraphs 23 and 24 below). We propose to recognize only the TR developed by the HKMA for the purpose of the mandatory reporting obligation.

23. As for designating CCPs, for the purpose of the mandatory clearing obligation, both local and overseas CCPs may be designated. As a pre-requisite to such designation, they will first need to be either a recognized clearing house or an authorised ATS provider under the SFO. For designated trading platforms for the purpose of the mandatory trading obligation, the operator of the trading platform must be a recognized exchange company or an authorised ATS provider under the SFO. The SFC will be empowered to designate CCPs and trading platforms for the purpose of the mandatory clearing and trading obligations and to make rules to specify the requirements and procedures for such designation, with the consent of the HKMA and after consultation with the Financial Secretary.

24. The TR and CCP projects mentioned above are making good progress. The matching and confirmation functions of the local TR to support voluntary clearing at the CCP of HKEx were launched in December 2012. The reporting function of the local TR is targeted to be launched by mid-2013. HKEx has been discussing with financial institutions that are interested to join the new CCP as members and has started conducting system tests with potential clearing members. HKEx aims to commence operation of the local CCP by the second quarter of 2013, subject to the approval of the SFC after consultation with the Financial Secretary and market readiness.

Common Appeal Channels

25. Relevant regulatory decisions made by the HKMA and SFC under the proposed regime will be made appealable to the Securities and Futures Appeals Tribunal to ensure consistency in regulation and fair hearing.

Other Technical Improvements to the Regulation of the Financial Market

26. We will also incorporate other technical amendments to the SFO and the Organized and Serious Crimes Ordinance (“OSCO”) into the Amendment Bill with a view to improving the regulation of the financial market. Firstly, we will amend the 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. We will also amend the SFO and the OSCO to enhance SFC’s enforcement regime regarding market misconduct offences under the SFO so that illegal gains from committing an offence

can be recouped with a view to better complying with the recommendations on the effectiveness of the confiscation regime made by the Financial Action Task Force on Money Laundering, which is the international standard setter on anti-money laundering and counter financing of terrorism. 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 an offence.

Way Forward

27. We are finalising the Bill for introduction into the Legislative Council in the second quarter of 2013.

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