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Panel on Financial Affairs

Meeting on 4 March 2013

Updated background brief on regulation of over-the-counter derivatives market

Purpose

This paper provides background information on the proposal to establish a regulatory regime for the over-the-counter ("OTC") derivatives market, and summarizes the discussion of the subject at meetings of the Panel on Financial Affairs ("FA Panel") on 3 January 2011 and 2 April 2012.

Background

2. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivatives market, and the systemic risk it poses for the wider market and economy[1]. In the wake of the crisis, G20 Leaders committed to reforms that would require –

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

[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.

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

(c) mandatory trading of standardized OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate; and

(d) imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

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 derivatives 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") 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 to invite industry feedback on specific issues that would help finalize key aspects of the local regime. The consultation paper is hyperlinked in **Appendix I**.

5. In response to the industry's comments, HKMA and SFC have provided further clarification and/or refine the proposals, and published the consultation conclusions in July 2012 ("the Conclusions Paper" hyperlinked in **Appendix I**). According to the Administration, the feedbacks from respondents were generally positive. The Administration decided to proceed along the lines of the original proposals with some adjustments and refinements to address comments and concerns raised, including those in relation to the definition of "OTC derivatives transaction", the regulation of approved money brokers ("AMB") and market players, extra-territorial impact, confidentiality obligations under overseas laws.

Revised proposals after consultation

6. The key aspects of the proposed regime as revised after consultation are set out in the Conclusions Paper and highlighted as follows:

Legislative framework and persons covered

(a) The new OTC derivatives regulatory regime will be set out in the Securities and Futures Ordinance (Cap. 571) ("SFO"), with the main obligations set out in the primary legislation and the details set out in the subsidiary legislation to be made by SFC with the consent of HKMA.

(b) The new regime will provide for the introduction of mandatory obligations (i.e. mandatory reporting, clearing and trading, as appropriate), and the regulation and oversight of key players in the OTC derivatives market. The mandatory obligations will apply to authorized institutions ("AIs"), licensed corporations ("LCs"), AMBs and others who may be regarded as "Hong Kong persons"[2].

Joint oversight by HKMA and SFC

(c) The new regime will be jointly overseen and regulated by HKMA and SFC[3], with HKMA overseeing and regulating the OTC derivatives activities of AIs as well as AMBs, and the SFC overseeing and regulating the OTC derivatives activities of all other persons, including LCs.

Scope of the new regime

(d) The term "OTC derivatives transaction" will be defined by reference to the term "structured product" as defined in the SFO, but will incorporate appropriate exclusions[4], such as transactions in securities and futures contracts that are traded on a market operated by a recognized exchange company. For flexibility, the legislative proposal will include a power to enable specific transactions to be included within or excluded from the definition.

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2 Including funds which are domiciled in Hong Kong.

3 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 powers under SFO will also be extended as necessary so that they will cover breaches of the mandatory obligations by other persons, including LCs. SFC's disciplinary powers should not need expanding and will apply in respect of breaches by LCs only.

4 For details of the exclusions, please refer to paragraph 34 of the Conclusions Paper.

Products to be subject to mandatory reporting and clearing

(e) HKMA and SFC will jointly determine the specific types of OTC derivatives transactions to be mandated for reporting or clearing, i.e. the reportable transactions and clearing eligible transactions, and will do so only after public consultation. The mandatory reporting and clearing obligations will initially cover certain types of interest rate swaps and non-deliverable forwards, and will be extended in phases to cover other types of transactions and products subject to public consultation.

Mandatory reporting obligation

(f) Only one TR, i.e. the one to be established by HKMA ("HKMA-TR")[5], will be designated for the purposes of the mandatory reporting obligation on reportable transactions, irrespective of whether they are centrally cleared or not. The reporting standards and specifications will be in line with those set by international standard-setting bodies and major industry platforms;

(g) The reportable transactions of Hong Kong persons will have to be reported if their positions exceed a specified threshold (i.e. reporting threshold), which will be assessed based on the total amount of gross positions held. AIs, LCs and AMBs will not be subject to any reporting threshold in their reporting obligation.

(h) For LCs, AMBs and locally incorporated AIs, the reporting obligation will apply if they are a counterparty to the transaction or if they have originated or executed the transaction, and the transaction has a Hong Kong nexus[6].

(i) For overseas-incorporated AIs, the reporting obligation will apply if the AI, acting through its Hong Kong branch, has become a counterparty to the transaction, or originated or executed the transaction, and the transaction has a Hong Kong nexus[7]. The flow chart that summarizes when the mandatory reporting obligation will be triggered under the revised proposal is in

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5 The reporting function of the HKMA-TR is targeted to be launched by mid 2013.

6 Previously, the Administration did not propose that transactions originated or executed by locally-incorporated AIs, LCs or AMBs should have a Hong Kong nexus.

7 The original proposal is that all reportable transactions originated or executed by the Hong Kong branch of an overseas AI should be reported, and the requirement for a Hong Kong nexus was only relevant in respect of transactions to which the overseas-incorporated AI was a counterparty but not through its Hong Kong branch.

Appendix II. According to the Administration, the concepts of "originated or executed" and "Hong Kong nexus" will be tightened to reduce their extra-territorial reach.

Mandatory clearing obligation

(j) AIs, LCs, AMBs and Hong Kong persons that are counterparty to a clearing eligible transaction will be required to clear such transaction through a designated CCP if both they and their counterparty have exceeded a specified threshold (i.e. clearing threshold), and their counterparty is not exempted from the clearing obligation. The flow chart for the proposed mandatory clearing obligation is in **Appendix III**.

Mandatory trading obligation

(k) Mandatory trading requirement will not be imposed at the outset. The Administration will conduct further study to assess how best to implement such a requirement in Hong Kong.

Capital and margin requirements

(l) The Administration intends to impose higher capital requirements and margin requirements for non-centrally cleared OTC derivatives transactions, having regard to the margin requirements jointly issued by the International Organization of Securities Commissions and the Basel Committee for Banking Supervision ("BCBS") and the relevant capital requirements for banks issued by BCBS.

7. According to the Administration, its plan is to introduce the relevant bill into the Legislative Council ("LegCo") in the second quarter of 2013 to provide for the regulatory framework for the OTC derivatives market in Hong Kong.

Interim measure to facilitate voluntary central clearing

8. 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, the Financial Secretary has made the Securities and Futures (Futures Contracts) Notice 2012 ("the Notice") under SFO to prescribe that any structured product set out in the Schedule to the Notice is to

be regarded as a futures contract, so that if such a structured product is cleared and novated through a recognized clearing house, it may constitute a market contract, and thereby enjoy insolvency override protection. The Notice was tabled at LegCo on 9 May 2012 and has come into operation on 27 June 2012[8].

Deliberations of the Panel on Financial Affairs

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

General issues

10. A member expressed doubt on 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 establishment of a local CCP for the clearing of interest rate swaps and non-deliverable forwards, and a TR for the maintenance of transaction records of these OTC derivatives 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.

11. On a member's concern 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

12. Some members expressed concern that the proposed regulatory regime would not cover equity derivatives and foreign exchange derivatives at the initial stage, and enquired about the practices in other major financial markets in this regard. SFC and HKMA explained that it was difficult to achieve standardization, which was a prerequisite for centralized clearing, for equity

8 The Notice will be repealed and superseded when the new regime for OTC derivatives comes into effect.

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. Depending on the development in the international arena, Hong Kong might consider regulating OTC equity derivatives and some of the long-term foreign exchange derivatives at a later stage.

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 derivatives 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. A member enquired 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

17. A member enquired about the impact of the proposed regulatory regime on the development of Renminbi 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 Renminbi OTC derivatives market earlier than other places, e.g. a non-deliverable forwards market on Renminbi had already been established in Hong Kong. HKEx advised that while the HKEx would not develop derivative products on its own, it would consider providing a platform for clearing of standardized OTC Renminbi derivative products.

Recent development

18. The Administration will update the FA Panel at the meeting on 4 March 2013 on the legislative proposal to introduce a full-fledged regulatory regime for the OTC derivatives market in Hong Kong.

Council Business Division 1
Legislative Council Secretariat
27 February 2013

Appendix I

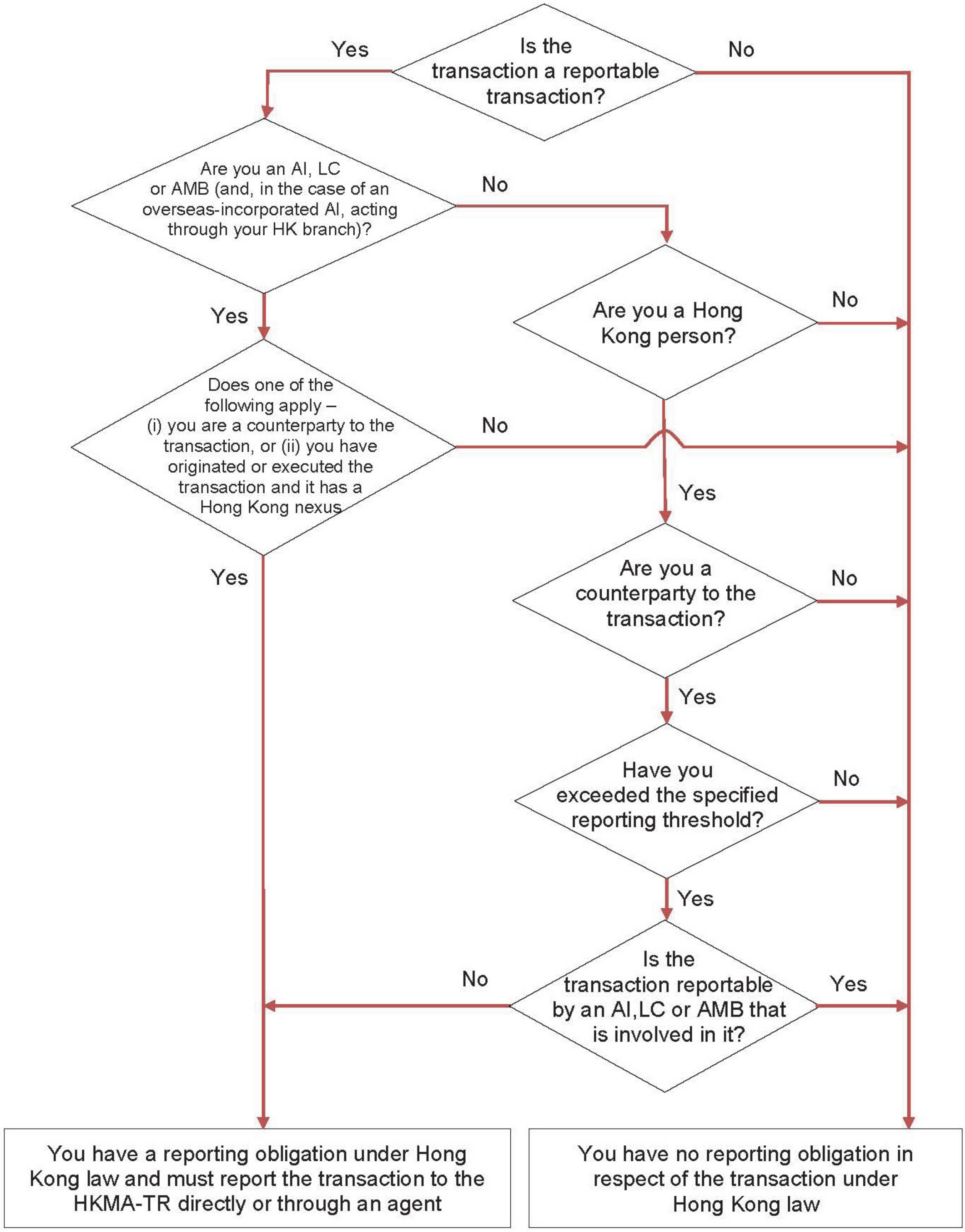
List of relevant papers

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 and Securities and Futures Commission 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	Joint consultation conclusions 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

Appendix II

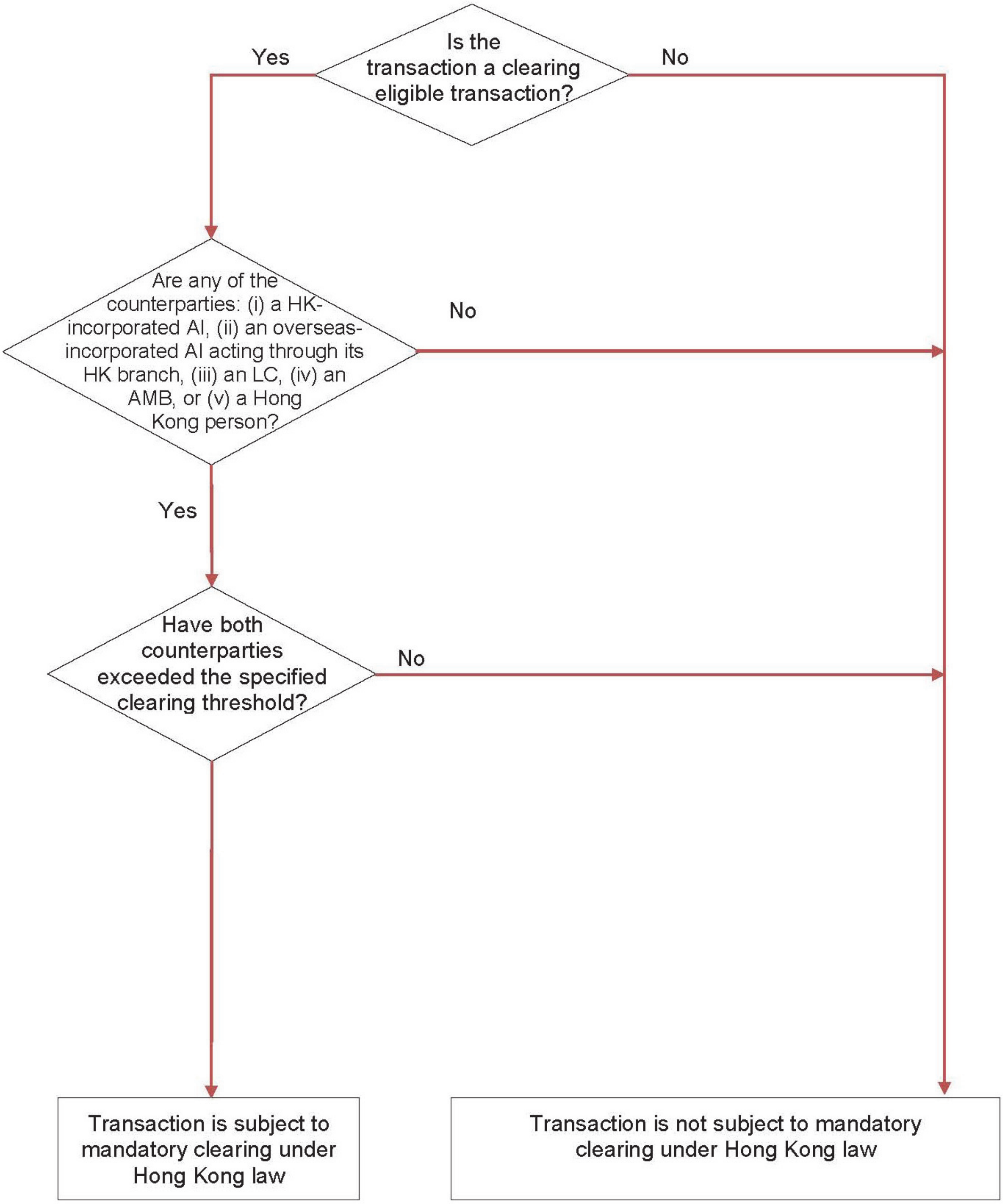
Flow chart for the proposed mandatory reporting obligation



(Source: Appendix 3 to the "Joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong")

Appendix III

Flow chart for the proposed mandatory clearing obligation



(Source: Appendix 4 to the "Joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong")