

*Legislative Council  
Panel on Financial Affairs*

**Progress in the Regulation of  
Over-the-counter Derivative Market**

*4 March 2013*



中華人民共和國香港特別行政區政府  
The Government of the Hong Kong Special Administrative Region  
of the People's Republic of China

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# 1. Background



## Background of International Reform

### G20 Commitment

In the wake of the financial crisis, the G20 leaders committed to reforms that would require -

- OTC derivative transactions to be reported to trade repositories (TRs)
- Standardised OTC derivative transactions to be centrally cleared through central counterparties (CCPs)
- Standardised OTC derivative transactions to be traded on exchanges or electronic trading platforms where appropriate
- Non-centrally cleared OTC derivative transactions to be subject to higher capital and margin requirements

### Objectives Of G20 Commitment

- **Reduce counterparty risk**
- **Improve overall transparency**
- **Enable regulators to better assess, mitigate and manage systemic risk in the OTC derivative market place**



## Significance of International Developments for HK

Nature  
Of  
OTC  
Derivative  
Market

The OTC derivative market is **inherently global** and primarily operates **cross-borders**



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Nature  
Of  
HK's  
Market

Characteristics of  
Hong Kong's  
OTC Derivative Market

Relatively  
Small

Open &  
International

Niche  
Market  
Products

**Hong Kong must actively monitor global developments, whilst considering its local conditions, and have the flexibility to adjust its regime to reflect international standards**



## 2. Progress Update



## Summary of Regulatory Developments

FSTB, HKMA and SFC have been working together in developing a regulatory regime for the OTC derivative market in Hong Kong

**October  
2011**

HKMA and SFC issued a joint public consultation paper on the proposed regulatory regime for the OTC derivative market

**June  
2012**

A subsidiary legislation has been made to enable voluntary clearing of OTC derivative transactions in Hong Kong

**July  
2012**

HKMA and SFC issued a joint consultation conclusions to respond to comments received from the first consultation, and issued at the same time a supplemental public consultation paper on the proposed licensing regime for the new/expanded regulated activities (RAs) and the oversight on systemically important participants (SIPs)

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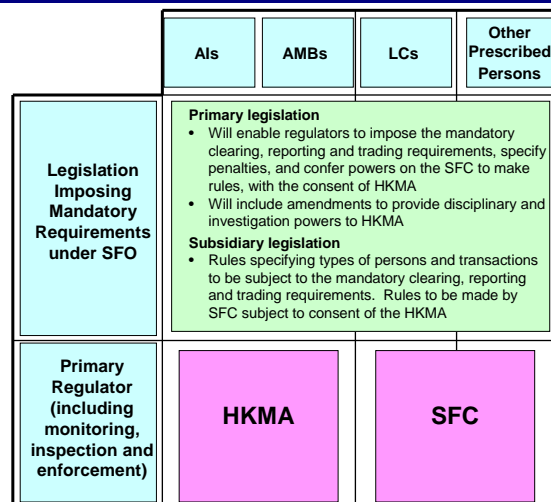
## Broad Regulatory Framework

- HKMA and SFC are working together to ensure a level playing field is established in the regulation of OTC derivative activities

- Primary legislation will enable the regulators to impose mandatory requirements on authorized institutions (AIs), approved money brokers (AMBs), licensed corporations (LCs) and other prescribed persons through the SFO

- HKMA will continue to regulate AIs and AMBs, including on a consolidated basis as appropriate, whilst SFC will regulate persons other than AIs and AMBs

- Through the new rulemaking powers granted by the SFO, HKMA and SFC will work together to jointly draft the relevant rules



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## Key Features of HK's Regime - Overview -

### Mandatory Requirements

- **At the initial stage, only clearing and reporting requirements will be introduced** as regulators continue to assess how best to introduce the trading requirement in HK

### Product Coverage

- The mandatory clearing and reporting requirements will only apply to certain types of **interest rate swaps** and **non-deliverable forwards** initially
- The scope of products covered will expand in phases to encompass all relevant OTC derivative asset classes

### Regulation of Intermediaries

- At present, OTC derivative activities already form a core and integral part of AIs' banking business and are already regulated by the HKMA in respect of capital, liquidity and other relevant requirements as part of its oversight of AIs
- To bridge the regulatory gap that will otherwise exist, there is a need to require entities (other than AIs and AMBs) that engage in OTC derivative activities (other than as end users) to be licensed for new RAs under the SFO. **Introduce** (i) a **new Type 11 RA** (which will capture the activities of dealers and advisers), and (ii) a **new Type 12 RA** (which will capture the activities of clearing agents)
- **Expand the existing Type 9 RA** (asset management) and **Type 7 RA** (provision of automated trading services) to cover OTC derivative portfolios and transactions, respectively

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## Key Features of HK's Regime - Overview -

### Oversight of SIPs

- Introduce provisions that will give SFC and HKMA a degree of **regulatory oversight in respect of HK players** that (i) are **not otherwise regulated by SFC or HKMA**, but (ii) whose positions or activities may nevertheless **raise concerns of potential systemic risk**

### Capital & Margin Requirements

- 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 HK
- We are closely monitoring the development of international standards on margin requirement 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 HK in line with the recommended timeline

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## Key Responses from Consultations

### Consultation in October 2011

- **Generally supportive of the proposed regulatory regime** and recognise the need for HK to develop and implement measures in line with G20 objectives to regulate the OTC derivative market
- **Support the proposed division of regulatory responsibilities between HKMA and SFC**
- **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

### Supplemental Consultation in July 2012

- Seeking clarification as to the ambit of, and possible exemptions available under the proposed licensing regime for new/expanded RAs
- How the transitional arrangements would work in practice
- Whether some of the criteria for benefiting from the transitional arrangements could be relaxed

Taking into account the feedbacks received, we have been working on the drafting of the necessary amendments to the SFO to provide for the regulatory framework for the OTC derivative market in HK

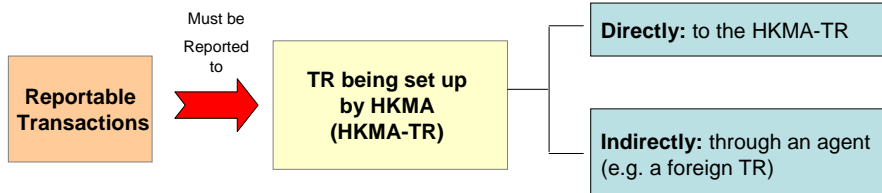
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## Proposed Mandatory Reporting Obligation

Proposed Mandatory Reporting Requirement

Channels



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## Proposed Mandatory Reporting Obligation

### For LCs, AMBs and Locally-incorporated AIs

- Reporting obligation will apply if –
  - (a) they are a counterparty to a reportable transaction, or
  - (b) they have originated or executed a reportable transaction, and the transaction has a Hong Kong nexus

### For Overseas-incorporated AIs

- Reporting obligation will apply if the AI, acting through its Hong Kong branch, has –
  - (a) become a counterparty to a reportable transaction, or
  - (b) originated or executed a reportable transaction, and the transaction has a Hong Kong nexus

### For Hong Kong persons

- They will have to report reportable transactions to which they are counterparties, but only if their positions exceed the reporting threshold
- To minimize reporting burden, they will be exempted from the reporting obligation if their transactions involve an AI, LC or AMB that has an obligation to report such transactions

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## Proposed Mandatory Reporting Obligation - Definition of “Hong Kong Nexus”-

- (1) In the case of equity derivatives and credit derivatives,
  - (a) 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
  - (b) that the underlying is an index and a specified percentage of the underlying companies are listed in Hong Kong, or
  - (c) that the reference entity is, or is wholly owned by, the Government of the Hong Kong Special Administrative Region, and
- (2) 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

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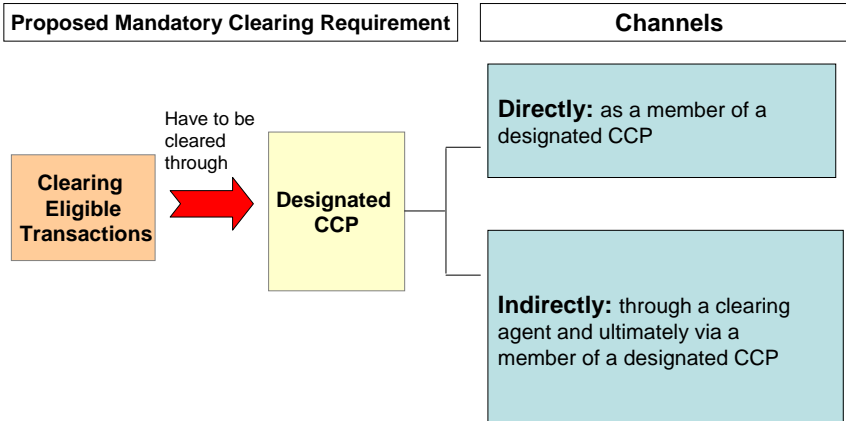
## Proposed Mandatory Clearing Obligation

- 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 the clearing threshold
- We will monitor international regulatory development and consider providing exemptions from the mandatory clearing obligation
- Only Recognised Clearing Houses (RCH) or authorised Automated Trading Services (ATS) providers could become designated CCPs

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## Proposed Mandatory Clearing Obligation



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## Proposed Regulations of Intermediaries – Type 11 RA (Dealing and Advising)

- **New Type 11 RA will encompass “dealing in and advising on OTC derivative transactions”**
  - will be defined along the lines of the existing dealing and advising definitions
  - will incorporate various carve-outs and exemptions
    - to exclude AIs and AMBs (as they will continue to be overseen and regulated by the HKMA)
    - to address overlaps with existing RAs to limit impact on market players
    - but exemption for proprietary trading with a professional investor under Type 1 RA will not be available under Type 11 RA

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## Proposed Regulations of Intermediaries – Type 12 RA (Clearing)

- **New Type 12 RA**
  - providing clearing agency services in respect of OTC derivative transactions, i.e. services for clearing OTC derivative transactions through a CCP on behalf of another person
  - Intermediaries that assist in the clearing and settlement process will need to be licensed for Type 12 RA if they handle client monies or assets
  - does not regulate clearing of proprietary trades
  - will incorporate various carve-outs and exemptions such as clearing agency activities of AIs and AMBs (as they will be overseen and regulated by the HKMA)

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## Proposed Expansion of Type 7 RA (ATS)

### ■ Expansion of Type 7 RA

- the definition of ATS will be expanded to cover OTC derivative transactions
- intermediaries who wish to provide ATS to facilitate trading in OTC derivatives will need to be licensed for the expanded Type 7 RA
- AIs or AMBs will be carved out if they provide ATS to facilitate the trading of OTC derivatives and the provision of such services is incidental to their activities of dealing in OTC derivatives. However, if the provision of ATS by an AI or AMB falls within the existing scope of Type 7 RA, it will still need to be licensed or registered for Type 7 RA as it is today

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## Proposed Expansion of Type 9 RA (Asset Management)

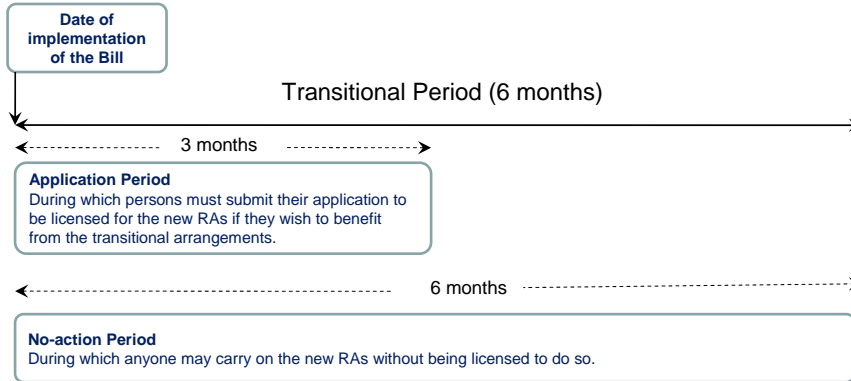
### ■ Expansion of Type 9 RA

- to also include “management of portfolios of OTC derivative transactions”
- will preserve existing carve-out so that where the asset management activity is wholly incidental to dealing in OTC derivatives, a license for Type 9 RA is not necessary

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## Proposed Transitional Arrangements



- A person who submits the relevant documentations during the application period and meets certain criteria will be deemed to be licensed for the relevant new/expanded RAs with effect from the expiry of the no-action period.

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## Proposals re Oversight of Systemically Important Participants

- **Regulatory oversight of SIPs – whose OTC derivative positions exceed a specified SIP threshold**
- **Need to capture Hong Kong persons whose possible failure (resulting from their activities in the OTC derivative market) could have significant impact for Hong Kong. Not envisaging any SIPs initially**
- **SIPs to notify SFC if their OTC derivative positions exceed an SIP threshold**
- **Names and the asset class on which the SIP has exceeded the threshold to be entered in a register of SIPs**
- **Regulators to have power to require SIPs to**
  - provide information about their OTC derivative activities, and
  - in extreme situations, take action in respect of their OTC derivative positions and transactions as specified (e.g. refrain from increasing its positions in any OTC derivative transactions)

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## Development of Infrastructure

	Local Initiatives	Target Launch Date
CCP	<ul style="list-style-type: none"><li>Local CCP developed by Hong Kong Exchanges and Clearing Limited (HKEx)</li></ul>	Q2 2013
TR	<ul style="list-style-type: none"><li>Local TR developed by the HKMA</li><li>Built upon existing Central Moneymarkets Unit (CMU) infrastructure</li></ul>	<i>Matching and Confirmation Functions:</i> Launched in December 2012  <i>Reporting Function:</i> Mid-2013

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## Development of Local OTC CCP

- HKEx is in the process of setting up a new OTC CCP as an RCH
- The new OTC CCP aims to commence operation in Q2 2013, subject to the approval of the SFC after consultation with the Financial Secretary and market readiness
- The new OTC CCP will have a separate guarantee fund and the clearing members of other HKEx's clearing houses will not need to contribute if they are not a clearing member of the new OTC CCP
- The new OTC CCP will conduct regular stress testing to ensure adequacy of its financial resources and have limited recourse wind down provisions (i.e. rules to cap the CCP's liability) under its rules to deal with a default situation where the loss exceeds its financial resources

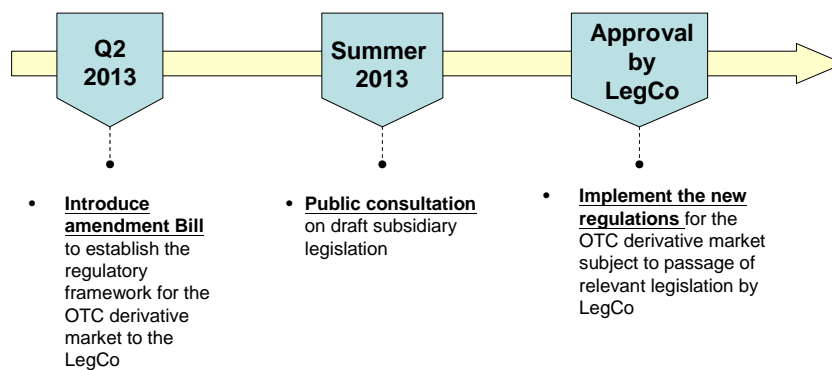
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### 3. Way Forward



### Timeline: Regulatory Developments





Thank You