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**Paper for the House Committee meeting on 26 June 2015**

**Report of the Subcommittee on  
Three Pieces of Subsidiary Legislation  
Relating to Over-the-counter Derivative Transactions**

**Purpose**

This paper reports on the deliberations of the Subcommittee on Three Pieces of Subsidiary Legislation Relating to Over-the-counter Derivative Transactions ("the Subcommittee").

**Background**

2. The Securities and Futures (Amendment) Ordinance 2014 ("the Amendment Ordinance") was passed on 26 March 2014 to provide for a regulatory framework for the over-the-counter ("OTC") derivatives market. The Amendment Ordinance has not yet come into operation as the details of implementation of the regulatory regime are to be prescribed in relevant subsidiary legislation.

3. According to the Administration, the new regulatory regime will be implemented in phases starting first with mandatory reporting and related record keeping obligations together with the general framework, followed by mandatory clearing and its related record keeping obligations in a later phase. The Amendment Ordinance will commence in phases in tandem with the making of the necessary subsidiary legislation.

4. The Administration has made the following three pieces of subsidiary legislation to implement the first phase of the new OTC derivatives regulatory regime –

- (a) Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015 ("Commencement Notice"), which appoints 10 July 2015 as the date on which certain provisions relating mainly to mandatory reporting and related record keeping obligations as well as the general framework of the regime will commence;
- (b) Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping Obligations) Rules ("Reporting Rules"), which sets out the details of the mandatory reporting and related record keeping obligations; and
- (c) Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice ("Prescription Notice"), which deals with the carve-out from the scope of the term "OTC derivatives product", which is introduced under the Amendment Ordinance.

5. Save that Rule 15 of the Reporting Rules on reporting by ATS-CCPs will come into operation on a day to be appointed by the Securities and Futures Commission ("SFC") by notice published in the Gazette, the three pieces of subsidiary legislation will come into operation on 10 July 2015.

### **The three pieces of subsidiary legislation**

#### Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015 (L.N. 95 of 2015)

6. The Commencement Notice seeks to bring into effect from 10 July 2015 the provisions of the Amendment Ordinance relating to the general framework of the OTC derivatives regulatory regime and the mandatory reporting and related record keeping obligations under the regime, as well as Part 3 (Amendments Relating to Protections under Part III of Securities and Futures Ordinance), Part 5 (Amendments Relating to Disgorgement Orders for Market Misconduct Offences) and Part 6 (Consequential Amendment) of the Amendment Ordinance.

Securities and Futures (OTC Derivative Transactions — Reporting and Record Keeping Obligations) Rules (L.N. 96 of 2015)

7. The main provisions of the Reporting Rules are as follows –
- (a) Part 1 contains definitions for the interpretation of the rules and includes –
    - (i) a provision that sets out the meaning of an "exempt person" (Rule 3);
    - (ii) a provision that sets out the circumstances in which a prescribed person is to be regarded as having "conducted a transaction in Hong Kong on behalf of an affiliate" (Rule 4);
    - (iii) provisions that specify who "prescribed persons" are for the purposes of the reporting and record keeping obligations (Rules 5 – 6); and
    - (iv) provisions that specify what "specified OTC derivative transactions" are for the purposes of the reporting and record keeping obligations (Rules 7 – 8);
  - (b) Part 2 describes the reporting obligation and how it must be fulfilled. It comprises 3 divisions, as follows -
    - (i) Division 1 (Rules 9 – 16) specifies when the reporting obligation arises, and elaborates on the difference in the obligation in respect of various reporting entities, namely, authorized institutions ("AIs"), approved money brokers ("AMBs"), licensed corporations ("LCs") and central counterparties. It incorporates provisions that require the reporting of new transactions, the backloading of historical transactions and the reporting of subsequent events;
    - (ii) Division 2 (Rules 17 – 18) specifies the circumstances in which the reporting obligation is taken to have been complied with, i.e. where the transaction, or subsequent event, is reported by an affiliate; and

- (iii) Division 3 (Rules 19 – 26) specifies how the reporting obligation must be complied with. In particular, it specifies the particular transaction information that must be reported (including the circumstances under which certain information may be masked and must subsequently be unmasked); the form and manner in which such information must be reported; and the time within which the information must be reported (including the circumstances in which any concession or grace period might apply);
- (c) Part 3 (Rules 27 – 30) describes the record keeping obligation. It specifies the records that must be kept to demonstrate compliance with the reporting obligation, the duration for which the records must be kept, and the manner in which they must be kept;
- (d) Part 4 (Rules 31 – 32) describes the reporting and record keeping obligations applicable to AIs incorporated in Hong Kong if their subsidiaries have been specified by the Hong Kong Monetary Authority ("HKMA");
- (e) Schedule 1 specifies the product classes and product types that are the subject of the reporting obligation. It also sets out in more details the specific transaction information that must be reported; and
- (f) Schedule 2 specifies the records relating to the specified OTC derivative transactions that must be kept for the purposes of the record keeping obligation under Rule 29.

Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice (L.N. 97 of 2015)

8. The Prescription Notice prescribes certain stock markets, futures markets and clearing houses for the purpose of excluding securities and futures contracts that are traded on these markets and cleared through these clearing houses from the definition of "OTC derivative product" under section 1B(2)(c) of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571). In other words, these securities and futures contracts will not be subject to the OTC derivatives regulatory regime.

## **The Subcommittee**

9. At the House Committee meeting held on 5 June 2015, members agreed to form a Subcommittee to study the three pieces of subsidiary legislation. The membership list of the Subcommittee is in the **Appendix**.

10. Under the chairmanship of Hon SIN Chung-kai, the Subcommittee has held two meetings with the Administration to scrutinize the three pieces of subsidiary legislation and has invited views from the industry and the public.

11. To allow sufficient time for the Subcommittee to study the three pieces of subsidiary legislation, a resolution was passed at the Council meeting of 10 June 2015 to extend the scrutiny period to 8 July 2015.

## **Deliberations of the Subcommittee**

12. The Subcommittee in general supports the three pieces of subsidiary legislation made for implementing the first phase of the new OTC derivatives regulatory regime. Members' deliberations are summarized in the ensuing paragraphs.

### Basis and scope of exemption from the Reporting Rules (Rule 3)

13. The Subcommittee notes that foreign exchange ("FX") derivatives (including non-deliverable forwards ("NDF")) and interest rate derivatives (many of which are interest rate swaps ("IRS")) account for over 90% of the OTC derivatives market in Hong Kong and that the mandatory reporting obligation set out in the Reporting Rules aims to initially cover only certain types of IRS and NDF (i.e. plain vanilla IRS (floating vs. fixed) and plain vanilla basis swap (floating vs. floating) in currencies and floating rate indices to be specified by the HKMA, and NDF in currencies to be specified by the HKMA) at this stage. Other derivatives will be covered at a later stage, and the Reporting Rules will be amended accordingly.

14. The Subcommittee further notes the Administration's response that under Rule 3(2) of the Reporting Rules, an AI, AMB or LC will be able to enjoy the "exempt person" relief if the sum of the notional amounts of all its OTC derivative transactions within a product class is below US\$30 million and it does not conduct any OTC derivative transactions in

that product class in Hong Kong on behalf of an affiliate or (in the case of an AI incorporated overseas) a branch outside Hong Kong (such transactions are referred to as transactions "conducted in Hong Kong" hereafter).

15. The Chairman has enquired about the basis for setting the above-mentioned ceiling at US\$30 million and sought clarification on whether there is a specific point of time or period, in respect of which the sum of the notional amount of the outstanding OTC derivative transactions is calculated for the purpose of qualifying for exemption for mandatory reporting.

16. The Administration has advised that the purpose of exemption is to reduce the compliance burden on small and inactive players and that the line of US\$30 million was drawn having taken into account the prevailing situations in the OTC derivatives market and the industry views. A prescribed person would be exempt from the mandatory reporting requirements so long as the sum of the notional amount of relevant OTC derivative transactions that are outstanding at any time does not exceed US\$30 million.

17. In order to assess the appropriateness of the ceiling being set at US\$30 million, the Subcommittee has sought information on the number and percentage of current market participants that would be exempt from the mandatory reporting requirements when it is set at this level.

18. The Administration has advised that there are 85 AIs or LCs with positions in IRS. Of these, the HKMA and the SFC expect that seven AIs (i.e. 8.2%) will enjoy the "exempt person" relief (i.e. they have IRS positions under US\$30 million and do not have any transactions in IRS "conducted in Hong Kong"). The total notional amount of the IRS transactions attributable to these seven AIs represents close to 0.003% of the total notional amount of IRS transactions attributable to the total population of 85 AIs or LCs with positions in IRS.

19. The Administration has also advised that there are 135 AIs or LCs with positions in FX forwards<sup>1</sup> (which include NDF). Of these, the HKMA and the SFC expect that two AIs (i.e. 1.5%) will enjoy the exempt person relief (i.e. they have NDF positions under US\$30 million and do not have any transactions in NDF "conducted in Hong Kong"). The total notional amount of NDF transactions attributable to these two AIs

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<sup>1</sup> According to the Administration, it does not currently have information to provide a breakdown between those positions which are in NDF and those which are in deliverable forwards.

represents 0.0014% of the total notional amount of FX forwards transactions attributable to the total population of 135 AIs or LCs with positions in FX forwards. According to the Administration, no AMBs have positions in IRS or NDF.

#### Concession period and grace period (Rule 19)

20. The Subcommittee has noted that while the reporting obligation should be fulfilled within two business days of a transaction, there will be an initial "concession period" of six months and a further period of three months thereafter (i.e. a "grace period" of a total of nine months). The Chairman sought clarification on the rationale and application of the concession period and grace period.

21. The Administration has advised that the purpose of the initial "concession period" is to ensure that reporting entities have enough time to set up the necessary system connection for reporting to the HKMA via the electronic reporting system operated by or on behalf of the HKMA. The "grace period" is to complete any backloading. This is to ensure reporting entities have sufficient time to sort out and report historical transactions that need to be reported. The Administration has further advised that a new concession period and a new grace period will apply every time a new type of product is made reportable. This is because new product types may have features that require system enhancements before they can be reported.

#### Reporting subsequent events (Rule 25)

22. The Subcommittee notes that apart from reporting reportable transactions entered into after the Reporting Rules come into effect (i.e. new transactions) and, backloading historical transactions that are still outstanding (i.e. those entered into before the Reporting Rules come into effect but which are still outstanding at that time), reporting entities should report any subsequent events relating to transactions that have been reported, e.g. changes in the terms of the transactions (e.g. notional amount), partial terminations, etc.

23. Mr NG Leung-sing has enquired whether the finance sector has a clear understanding about the interpretation of "subsequent event". Mr NG considers that the drafting of Rule 25(3) may somehow give the impression that when more than one subsequent event occurs on the same day, the reporting entity is only required to submit the transaction information once for that day and it is unclear which one of the events the reporting entity should report.

24. The Administration has advised that different OTC derivative transactions may have different situations which fall under the definition of "subsequent event". Specific details are usually set out in the agreement signed between the parties in a transaction. When more than one subsequent event occurs on the same day, the prescribed person is only required to submit the transaction information once for that day provided that the transaction information submitted incorporates all of the subsequent events that occurred on that day. The Administration has explained that the current drafting of Rule 25(3) aims to provide flexibility in reporting as some prescribed persons may report subsequent events one by one each day while others may report such events summarily once a day.

#### Submitting counterparty masking particulars (Rule 26)

25. The Subcommittee notes that under Rule 26(1), when reporting transaction information for a specified OTC derivative transaction, the reporting entity may submit counterparty masking particulars instead of counterparty identifying particulars in relation to a counterparty to the transaction if: (a) the submission of the counterparty identifying particulars is prohibited under the laws of, or by an authority or regulatory organization in, a jurisdiction; and (b) that jurisdiction has been designated by the SFC with the HKMA's consent. "Counterparty masking particulars" are defined as the particulars of a counterparty to a specified OTC derivative transaction which describe the counterparty in a way which prevents the ascertainment of the identity of the counterparty and "counterparty identifying particulars" are information of a reportable transaction of a specified OTC derivative transaction from which the identity of a counterparty to the transaction may be ascertained.

26. The Chairman has sought information on the jurisdictions which prohibit the submission of the counterparty identifying particulars. The Administration has advised that as designated by the SFC, 18 jurisdictions have data privacy laws which prohibit a prescribed person from revealing particulars of counterparties to specified OTC derivative transactions. Other jurisdictions such as Singapore, the United States and Australia also provide similar masking relief. Mr NG Leung-sing has raised concern about the situation in which a counterparty to a specified OTC derivative transaction claims that its jurisdiction prohibits the submission of the counterparty identifying particulars and the jurisdiction is not one of those so designated by the SFC.



27. The Administration has advised that if the jurisdiction of the counterparty concerned is not among the jurisdictions designated by the SFC with the HKMA's consent, the prescribed person might write to the SFC or the HKMA to state the reason, supported by legal opinion, why that particular jurisdiction should be so designated.

#### Phased implementation of the regulatory framework

28. The Subcommittee notes that the Administration will implement the regulatory framework for the OTC derivatives market in phases starting first with mandatory reporting and related record keeping obligations together with the general framework of the regime, as set out in the three pieces subsidiary legislation, followed by mandatory clearing and its related record keeping obligations in a later phase.

29. Mr Christopher CHEUNG has enquired whether the Administration would regularly report to the Legislative Council ("LegCo") the progress of the implementation of the mandatory reporting requirements proposed in the three pieces of subsidiary legislation and whether it has any plan to extend the mandatory reporting requirements to other derivatives transactions.

30. The Administration has advised that the reporting requirements will be extended to transactions in other derivatives products (such as credit, equity and commodity derivatives). LegCo Members will be updated of the progress of the implementation of the mandatory reporting requirements in the context of the upcoming public consultation for the legislative proposals on the next phase of the implementation of the regime. The Administration plans to conduct relevant public consultation in the second half of 2015 with a view to implementation in mid-2016.

#### Legal and drafting issues

31. The Subcommittee has examined the three pieces of subsidiary legislation clause by clause and finds no difficulties relating to the legal and drafting aspects of the subsidiary legislation. It has noted the enquiries raised by the Legal Adviser to Subcommittee<sup>2</sup> on certain drafting issues and the Administration's response on those issues<sup>3</sup>.

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<sup>2</sup> Issued vide LC Paper No. CB(1)975/14-15(01).

<sup>3</sup> Issued vide LC Paper No. CB(1)975/14-15(02).

**Recommendation**

32. The Subcommittee has raised no objection to the three pieces of subsidiary legislation. The Subcommittee will not propose any amendment.

**Advice sought**

33. Members are invited to note the deliberations of the Subcommittee as set out above.

Council Business Division 1  
Legislative Council Secretariat  
25 June 2015

**Subcommittee on Three Pieces of Subsidiary Legislation  
Relating to Over-the-counter Derivative Transactions**

**Membership list**

**Chairman** Hon SIN Chung-kai, SBS, JP

**Members** Hon NG Leung-sing, SBS, JP

Hon Christopher CHEUNG Wah-fung, SBS, JP

(Total : 3 members)

**Clerk** Mr Derek LO

**Legal Adviser** Miss Carrie WONG