For discussion
on 1 December 2014

Legislative Council Panel on Financial Affairs

First Phase of Implementation of the Over-the-counter Derivatives Regulatory Regime in Hong Kong

PURPOSE

This paper briefs Members on the first phase of implementation of the over-the-counter ("OTC") derivatives regulatory regime in Hong Kong.

BACKGROUND

2. The Legislative Council ("LegCo") enacted the Securities and Futures (Amendment) Ordinance 2014 ("Amendment Ordinance") on 26 March 2014 which provides for a regulatory framework for the OTC derivatives market in Hong Kong to meet the relevant commitments of the Group of Twenty. The framework enables the mandatory reporting, clearing and trading of OTC derivatives transactions, and introduces a record keeping obligation to supplement the implementation of the abovementioned obligations. It envisages that the precise ambit of these obligations, and their related details, will be set out in subsidiary legislation (i.e. rules) to be made by the Securities and Futures Commission ("SFC") with the Hong Kong Monetary Authority's ("HKMA") consent and after consultation with the Financial Secretary .

PHASED IMPLEMENTATION

3. We will implement the new regime in phases starting first with mandatory reporting and related record keeping obligations together with the general framework of the regime, 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 major proposals for mandatory reporting and related record

keeping obligations, which will be covered in the proposed Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules ("Reporting Rules"), are set out in the ensuing paragraphs.

MAIN PROPOSALS FOR MANDATORY REPORTING

Reportable transactions

5. The reporting obligation will only apply in respect of certain OTC derivatives transactions ("reportable transactions"). According to survey data on major market participants in the OTC derivatives market in Hong Kong, foreign exchange ("FX") derivatives, interest rate derivatives (many of which are interest rate swaps ("IRS")) and non-deliverable forwards ("NDF") account for over 90% of the OTC derivatives market in Hong Kong. We propose that the mandatory reporting obligation should initially cover only certain types of IRS and NDF, but not any FX derivatives at this stage because of the short-dated nature of most FX derivatives and their relatively less risky settlement method.[1]

6. The specific types of IRS and NDF that will be reportable at the initial stage are –

Product class	Product type
IRS	- plain vanilla IRS (floating vs. fixed) - plain vanilla basis swap (floating vs. floating) both in currencies and floating rate indices to be specified by the HKMA
NDF	- NDFs in currencies to be specified by the HKMA

Reporting entities

7. We propose that mandatory reporting should apply to authorized

1 Most FX derivatives transactions tend to be very short-dated and settled through the Continuous Linked Settlement system ("CLS system"). Short-dated transactions are less of a concern because the risk exposure is limited to a short period of time. In addition, settlement through the CLS system also reduces risk because it is on a payment versus payment basis which lowers settlement risk. We note that internationally, there is no push towards subjecting any FX derivatives to stringent OTC derivatives regulation.

institutions ("AIs"), approved money brokers ("AMBs"), licensed corporations ("LCs") and central counterparties ("CCPs") that provide clearing services to persons in Hong Kong.

8. We will focus on these entities in the initial phase because they are more likely to play a predominant role in the OTC derivatives market in Hong Kong, acting as counterparties or conducting transactions on behalf of affiliates.

Reporting obligation for AIs, AMBs and LCs

9. We propose that AIs, AMBs and LCs should report reportable transactions that –

(a) they are a counterparty to; or

(b) they have conducted in Hong Kong on behalf of an affiliate.[2]

10. The first reporting limb is a common requirement in overseas regulatory regimes. The second is also adopted by some jurisdictions. The reason for proposing the second reporting limb is that although such transactions may typically be booked with an overseas affiliate in the same group (i.e. the overseas affiliate rather than the local entity is a counterparty to the transaction), the local entity still plays a significant role in negotiating and finalizing the transactions. It is therefore necessary to capture these transactions as well if we are to obtain a full picture of OTC derivatives activities in Hong Kong.

Reporting obligation of CCPs

11. As far as CCPs are concerned, both recognized clearing houses ("RCHs") and providers of automated trading services ("ATS") authorized under Part III of the Securities and Futures Ordinance (Cap. 571) can act as CCPs to provide OTC derivatives clearing services to persons in Hong Kong. Although mandatory clearing is not yet in place, some market participants have voluntarily submitted their transactions to CCPs for clearing. In view of this, we propose that CCPs should also be subject to mandatory reporting as below –

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[2] For foreign AIs, paragraph 9(a) only applies to the counterparty transactions booked into the Hong Kong branch; and paragraph 9(b) is extended to cover the transactions conducted in the Hong Kong branch on behalf of the overseas offices/branches.

(a) an RCH should report all transactions that it has entered into as a counterparty (as part of the clearing process);[3] and

(b) persons authorized to provide ATS ("ATS-CCPs")[4] only have to report transactions where the other counterparty is a Hong Kong incorporated company.

Backloading and reporting of subsequent events

12. We propose that reporting entities should –

(a) report new transactions, i.e. reportable transactions entered into after the Reporting Rules come into effect;

(b) backload historical transactions that are still outstanding, i.e. reportable transactions entered into before the Reporting Rules come into effect but which are still outstanding at that time; and

(c) report any subsequent events relating to transactions that have been reported, e.g. changes in the terms of the transaction (e.g. notional amount), partial terminations, etc.

13. We also propose that the backloading obligation should only apply in respect of transactions to which the reporting entity is a counterparty, i.e. it should not apply to transactions that an AI, AMB or LC has conducted in Hong Kong on behalf of an affiliate. This is because the systems of an AI, AMB or LC normally do not have the capability to identify which of the past trades of its affiliate were conducted in Hong Kong, and it would be disproportionate to require all past trades to be reported.

Information to be reported

14. The specific types of information proposed to be reported are set out in the Reporting Rules. In particular, we propose that AIs, AMBs and LCs should report certain information relating to the daily valuation of their reportable transaction. However, as this will require system changes for both the electronic reporting system developed and operated

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[3] Currently, only OTC Clearing Hong Kong Limited is an RCH offering clearing services for OTC derivatives.

[4] We expect that overseas clearing houses may seek authorization from the SFC to become authorized providers of ATS.

by or on behalf of the HKMA (i.e. the Hong Kong Trade Repository ("HKTR")) and reporting entities, this aspect of the reporting obligation will be implemented at a later stage.

Exemptions

15. To reduce compliance burden and avoid conflicting requirements, exemptions and reliefs will be available. For example –

(a) we propose that AIs, AMBs and LCs will be taken to have complied with the reporting obligation in respect of a transaction that they have conducted in Hong Kong on behalf of an affiliate, if the affiliate has confirmed, in good faith, that it has reported the transaction; and

(b) we also propose an "exempt person" relief whereby AIs, AMBs and LCs that are small players and not active in the OTC derivatives market will be exempted from reporting transactions that they are counterparty to. The exemption will not however apply if they have conducted transactions in Hong Kong on behalf of an affiliate[5], as AIs, AMBs and LCs that engage in such activity are likely to be more active players.

Concession period and grace period

16. We propose that the reporting obligation should be fulfilled within 2 business days, subject to the following –

(a) there will be an initial "concession period" of 6 months. This is to ensure that reporting entities have enough time to set up the necessary system connection for reporting to the HKMA via the HKTR. A new concession 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; and

(b) there will be a further period of 3 months thereafter (i.e. a "grace period" of a total of 9 months) to complete any backloading. This is to ensure reporting entities have

[5] And in the case of an overseas incorporated AI, the exemption will not apply if they have conducted transactions in Hong Kong on behalf of an overseas branch.

sufficient time to sort out and upload historical transactions that need to be reported. Again, this period will apply every time a new type of product is made reportable.

Use and disclosure of data collected by the HKMA via the HKTR

17. We intend that data collected by the HKMA via the HKTR will be used for regulatory and market surveillance purposes. The data may be shared with other regulators and TRs to facilitate joint efforts in monitoring or regulating the OTC derivatives market, which comprises cross sector participants and is global in nature. We will strive to adhere to international standards when sharing data with overseas regulatory authorities and overseas TRs. Our current plan is for any public disclosure of such data to be made in summary form so as to prevent confidential and sensitive particulars from being ascertained.

Specified Subsidiaries of AIs

18. The Amendment Ordinance includes provisions that require locally-incorporated AIs to ensure their subsidiaries that are specified by the HKMA to report reportable transactions to the HKMA via the HKTR as well. The HKMA will specify subsidiaries taking into account their level of activities and other relevant factors.

MAIN PROPOSALS FOR MANDATORY RECORD KEEPING

19. In order for the HKMA and the SFC to effectively monitor and ascertain compliance with the mandatory reporting obligation, the mandatory reporting requirements will be supplemented by related record keeping requirements.

20. In general, we propose that reporting entities should be required to keep sufficient records to demonstrate compliance with their reporting obligations, and where applicable, to demonstrate that they are entitled to certain exemptions or reliefs. We propose that the record retention period should be 5 years from the date the transaction matures or is terminated.

MARKET ENGAGEMENT AND CONSULTATION

21. The HKMA and the SFC conducted a joint public consultation

on the draft Reporting Rules between July and August 2014. The above proposals have been formulated after taking into account market feedback received which mainly focused on the following areas –

(a) the timing for implementation of the Reporting Rules;

(b) the duration of the concession period (i.e. the period factored in for system setup);

(c) implementing reporting in phases (by the types of counterparties);

(d) extending the types of exemptions and reliefs;

(e) relaxing certain exemptions and reliefs;

(f) relaxing the record keeping requirements; and

(g) technical comments and clarifications.

LEGISLATIVE TIMETABLE

22. We are finalizing the first batch of subsidiary legislation[6] and aim to table them before LegCo for negative vetting in the first quarter of 2015.

ADVICE SOUGHT

23. Members are invited to note the proposed first phase of implementation of the OTC derivatives regulatory regime in Hong Kong and the legislative plan as set out in this paper.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
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6 The first batch of subsidiary legislation will consist of a commencement notice for commencing the relevant provisions of the Amendment Ordinance mainly for the implementation of the first phase of the OTC derivatives regulatory regime, the Reporting Rules and a notice to deal with carve-out from the scope of the term "OTC derivative product" under the Amendment Ordinance.