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Panel on Financial Affairs

Meeting on 1 December 2014

Background brief on the over-the-counter derivatives regulatory regime in Hong Kong

Purpose

This paper provides background information on the regulatory regime for the over-the-counter ("OTC") derivatives market in Hong Kong. It also summarizes the views and concerns expressed by Members when related matters were discussed by the committees of the Legislative Council ("LegCo") from 2011 to 2014.

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, the Group of Twenty Leaders ("G20") committed to reforms that would require mandatory reporting, clearing and trading in relation to OTC derivatives transactions. 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.

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[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 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 thereby creating the potential of contagion risk.

3. In line with the G20 Leaders' commitment, the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") issued a joint consultation paper on 17 October 2011 to invite public views on the proposed regulatory regime for the OTC derivatives market. The joint consultation conclusions paper was released in July 2012 together with a supplemental public consultation on the proposed licensing regime for the new or expanded regulated activities and the oversight on systematically important participants[2].

The Securities and Futures (Amendment) Bill 2013

4. The Securities and Futures (Amendment) Bill 2013, gazetted on 28 June 2013 and received its First Reading at LegCo on 10 July 2013, is to provide for a regulatory framework for the OTC derivatives market in Hong Kong. The Bill was passed at the Council meeting of 26 March 2014 and enacted as the Securities and Futures (Amendment) Ordinance 2014. The Ordinance has yet to come into operation as the details of implementation will need to be prescribed in the rules (i.e. subsidiary legislation) to be made by SFC with the consent of HKMA and after consultation with the Financial Secretary. Such subsidiary legislation is subject to the negative vetting procedure of LegCo.

5. The key aspects of the regulatory regime for the OTC derivatives market are highlighted in **Appendix I**.

Consultation on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping) Rules

6. According to the Administration, it is the plan of the regulators to implement the mandatory obligations in phases starting first with mandatory reporting and related record keeping obligations. In July 2014, HKMA and SFC launched a joint consultation on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping) Rules, covering proposals for reportable transactions, reporting entities and their obligations, as well as the time for reporting and backloading[3], exemptions and reliefs, the form, manner and contents of reports, use and disclosure of data collected by the trade repository established by HKMA ("HKTR") for the purpose of

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[2] Systematically important participants are market participants which are not licensed or registered with either HKMA or SFC but whose positions and activities in the OTC derivatives market are so large that they may nevertheless raise concerns of potential systemic risks.

[3] The reporting obligation will apply in respect of (a) new transactions, i.e. reportable transactions entered into from the day they become subject to reporting, and (b) historical transactions, i.e. reportable transactions entered into before that day, but which are still outstanding on that day – the reporting of such historical transactions is commonly referred to as "backloading".

mandatory reporting, and related record keeping requirements. The joint consultation also covered a draft of the proposed rules on the above matters. The consultation paper is hyperlinked in **Appendix II**. HKMA and SFC aim to finalize the draft rules and issue a consultation conclusions paper in the fourth quarter of 2014 with a view to introducing the final rules into LegCo for negative vetting in the first half of 2014-2015 session.

Concerns and views expressed by Members

7. The major concerns expressed by Members during discussion on matters relating to the OTC derivatives regulatory regime at the meetings of the Panel on Financial Affairs ("FA Panel") on 3 January 2011, 2 April 2012 and 4 March 2013, and at the meetings of the Bills Committee on Securities and Futures (Amendment) Bill 2013, are summarized in the ensuing paragraphs.

Legislative framework

8. Given that the details of the regulatory regime and the requirements will be set out in subsidiary legislation, Members considered it necessary for the Administration and the regulators to prepare the detailed rules for consultation with the stakeholders as soon as possible. With a view to avoiding potential conflicts with similar rules in other jurisdictions and adverse impact on the liquidity and efficiency of the OTC derivatives market in Hong Kong, as well as minimizing the risk of regulatory arbitrage and compliance cost on market participants, Members also stressed the need for the rules and requirements of the regulatory regime to align with the international standards.

9. HKMA and SFC pointed out that they were mindful of the need to strike a balance between strengthening regulation and reducing compliance burden on the industry, and would strive to facilitate a smooth implementation of the reform, including introducing appropriate transitional arrangements for the new licensing requirements. To this end, the regulators would continue to liaise with overseas regulatory bodies and engage the local financial services industry with a view to facilitating a smooth implementation of the new regulatory regime and minimizing conflicting requirements. In preparing the draft rules, HKMA and SFC would take into account the relevant international standards, regulations and rules of other major jurisdictions like the United States ("US") and the European Union.

Coverage of the proposed regulatory regime

10. Members expressed concern that if the mandatory reporting and clearing requirements initially would apply only to interest rate swaps ("IRSs") and non-deliverable forwards ("NDFs"), the volume of OTC derivatives transactions

subject to regulation would be small. The Administration advised that, based on the findings of a previous survey, the notional value of OTC derivatives transactions in Hong Kong had reached some US$16,000 billion, of which 18% and 17% were IRSs and NDFs respectively, whereas foreign exchange derivatives constituted the largest share, i.e. 58%. Credit derivatives (2%) and equity derivatives (5%) accounted for the remaining transactions. In terms of investor segments, 70% of the OTC derivatives transactions were undertaken by authorized institutions ("AIs")[4] involving mainly institutional and professional investors, and 30% were end-users. The involvement by retail investors was small.

11. As regards Members' concern that the proposed regulatory regime would not cover equity derivatives and foreign exchange derivatives at the initial stage, SFC and HKMA explained that it was difficult to achieve standardization, which was a prerequisite for centralized clearing. The OTC derivatives market in Hong Kong was similar to those in the United Kingdom, US 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. While it was the objective of the G20 Leaders to require mandatory clearing for all standardized OTC derivatives trades through central counterparties ("CCPs") and mandatory reporting of all OTC derivatives trades to TRs, the specific types of OTC derivatives transactions to be included in the mandatory regulatory regime would be adjusted to cater for the unique circumstances and needs of respective jurisdictions. At the moment, there was no consensus among major jurisdictions towards subjecting short-term foreign exchange derivatives to stringent regulation. Depending on the development in the international arena, Hong Kong might consider regulating OTC equity derivatives and some of the long-term OTC foreign exchange derivatives at a later stage.

<u>Concerns about multiple reporting</u>

12. Members expressed concern about multiple reporting on OTC derivatives transactions to regulators of various jurisdictions which would increase compliance costs on the industry. Members noted that some market participants suggested that besides allowing reporting to HKTR through third parties or agents, such as global TRs, HKMA should explore the feasibility of recognizing global TRs to mitigate the cost burden on the industry.

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[4] AIs refer to authorized institutions as defined in the Banking Ordinance (Cap. 155).

13. The Administration responded that it was necessary for HKMA and SFC to have effective and efficient access to OTC derivatives transaction information to ensure their effective surveillance and monitoring work. HKTR would facilitate the management of adequate amount of trade reports, instead of relying primarily on data sharing by overseas TRs or regulators. To address the concerns of reporting entities, there were linkages with major global TRs and regular dialogue with the industry so that they could readily entrust global TRs to file reports to HKMA on their behalf. To enhance efficiency in processing the outsourcing applications in relation to reporting, HKMA had been in close contact with reporting agents that were global TRs advising them the essential information and contributions required from them to support the outsourcing applications.

14. Responding to the concern about the potential compliance burden arising from mandatory reporting and clearing of OTC derivatives transactions conducted between two companies only that did not involve banks or financial institutions, HKMA pointed out that the counterparties for non-financial institutions in OTC derivatives transactions in Hong Kong or overseas were mainly banks or financial institutions, and very few of such transactions were conducted between non-financial institutions. To minimize reporting burden, non-financial institutions would have to report reportable transactions to which they were counterparties only if their positions exceeded the reporting threshold. If non-financial institutions' OTC derivatives transactions involved an AI, licensed corporation ("LC")[5] or approved money broker (i.e. prescribed persons to which mandatory obligations would be applicable), they would be exempted from the reporting obligation. Similarly, non-financial institutions that were counterparties to a clearing eligible transaction would be required to clear such transaction through a CCP if the transactions of both the non-financial institutions and their counterparties had exceeded the clearing threshold.

<u>Disclosure of information by HKMA to SFC and overseas regulators and sharing of information in HKTR</u>

15. On the sharing of information in HKTR, while Members supported the sharing of information on OTC derivate activities among market participants in a transparent and fair manner as such information was of valuable reference to the market, they were concerned about the protection of privacy of parties involved in OTC derivatives transactions, in particular HKMA might receive information on such transactions from reporting entities who were individuals. Members also sought information on the international standard and practice on the sharing of data stored in TRs among overseas regulators and TRs.

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[5] Licensed corporations refer to corporations licensed by SFC under the Securities and Futures Ordinance (Cap. 571).

16. HKMA pointed out that the data to be collected from mandatory reporting would be market sensitive and should be handled with care. Given that mainly institutional players (e.g. AIs, LCs, and funds) were involved in OTC derivatives transactions, information kept by TR would include data relating to individual OTC derivatives transactions conducted by these institutions, such as the types and amount of derivatives transactions, their economic terms, and the counterparties concerned, etc. The Administration added that to comply with the reporting obligation, a reporting entity would have to become a member of the HKTR and to sign an agreement with HKMA. The HKTR explicitly required that no personal data should be reported. In compliance with the Personal Data (Privacy) Ordinance (Cap. 486), HKTR set out its policies and practices with regard to personal data to be collected from the private individual in a personal information collection statement which would be available at HKTR's website.

17. Regarding international development in sharing of TR data, the Administration advised that there were already guidelines and standards on related aspects provided by international regulatory bodies. The Administration would monitor international discussions on TR data sharing and see if it was necessary to enter into an agreement for exchange of information or data sharing.

Investor protection

18. In view of the complexity of OTC derivatives products, Members stressed the importance for the proposed regulatory regime to offer adequate protection for investors of these products. The Administration reiterated that the regulatory framework for OTC derivatives transactions would enhance the transparency of these activities, enabling regulators to monitor build-up of exposures that might pose systemic risks to the market or the wider economy, thus reducing the contagion risk. While mainly institutional investors were involved in OTC derivatives transactions, if OTC derivatives products were offered to retail investors, they would be governed by the investor protection regime under SFO. In this regard, public offer of OTC derivatives products would continue to require SFC's authorization of the product documentation, and intermediaries involved in the sales process were subject to conduct regulation.

Latest development

19. The Administration will consult members of the FA Panel at the meeting to be held on 1 December 2014 on the first phase implementation of the Securities and Futures (Amendment) Ordinance 2014 and the legislative proposals for the proposed Securities and Futures (OTC Derivatives Transaction – Reporting and Record Keeping) Rules.

Relevant papers

20. A list of relevant papers is in **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
27 November 2014

Appendix I

Key aspects of the regulatory regime for the over-the-counter ("OTC") derivatives market

Legislative framework and persons covered

(a) A broad regulatory framework for the regulation of the OTC derivatives market is set out in the Securities and Futures Ordinance (Cap. 571) ("SFO"), with details prescribed in the rules (i.e. subsidiary legislation) to be made by the Securities and Futures Commission ("SFC") with the consent of the Hong Kong Monetary Authority ("HKMA") and after consultation with the Financial Secretary ("FS").

Joint oversight by HKMA and SFC

(b) The new regime will be jointly overseen and regulated by HKMA and SFC, with HKMA regulating the OTC derivatives activities of authorized institutions ("AIs") and approved money brokers ("AMBs"), and SFC regulating such activities of licensed corporations ("LCs") and other prescribed persons (such persons to be prescribed by subsidiary legislation)[1].

(c) 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 and disciplinary powers under SFO will also be extended as necessary so that they will cover breaches of the mandatory obligations by other persons, including LCs.

Mandatory obligations and penalties

(d) The regulatory framework covers mandatory reporting, clearing and trading obligations. These obligations apply to "prescribed persons", i.e. AIs, AMBs, LCs and others that are prescribed by subsidiary legislation; and in respect of those OTC derivatives transactions that are specified in subsidiary legislation. Mandatory trading obligation will not be implemented at the outset pending further study of local market conditions, in particular the liquidity level and number of trading venues in the market.

(e) The mandatory reporting and clearing obligations initially cover certain types of interest rate swaps and non-deliverable forwards specified in subsidiary legislation as they are the major types of OTC

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1 AIs refer to authorized institutions as defined in the Banking Ordinance (Cap. 155), and LCs refer to corporations licensed by SFC under SFO.

derivatives transactions conducted in Hong Kong and are capable of standardization. The obligations will be extended in phases to cover other types of transactions and products to be determined by HKMA and SFC after public consultation and consultation with FS.

Mandatory reporting

(f) AIs, AMBs, LCs and other prescribed persons will be required to report certain OTC derivatives transactions (as specified in the rules, "reportable transactions") to HKMA. The reporting obligation will apply irrespective of whether the reportable transaction is centrally cleared or not, and may be fulfilled either directly or indirectly, i.e. through an agent[2].

(g) AIs, AMBs and LCs will be subject to more stringent mandatory reporting requirements than other prescribed persons. In particular, the latter will only have to report if their OTC derivatives positions exceed certain reporting thresholds (to be specified by SFC in subsidiary legislation), but no such thresholds will be applied to AIs, AMBs and LCs.

(h) Other prescribed persons will essentially cover persons other than AIs, AMBs and LCs that are based in or operate from Hong Kong. Overseas persons with no presence or operation here will not be subject to any mandatory reporting obligation under Hong Kong law.

(i) Only one trade repository, i.e. the one established by HKMA ("HKTR")[3], will be designated for the purpose of mandatory reporting obligation on reportable transactions. The reporting standards and specifications adopted by the HKTR will be in line with those set by international standard-setting bodies and major industry platforms.

Mandatory clearing

(j) AIs, LCs, AMBs and other prescribed persons will be required to clear certain OTC derivatives transactions (as specified in the rules, "clearing eligible transactions") through a designated central counterparty ("CCP"), and they may do this either directly (i.e. as a member of the designated CCP) or indirectly (i.e. through a third party that is a member of the designated CCP)[4].

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[2] The reporting agent may be a trade matching and confirmation platform or an overseas trade repository.

[3] The reporting function of HKTR was launched in July 2013 and reporting from licensed banks under HKMA's regulatory requirement had begun since August 2013.

[4] For indirect clearing, amendments have been introduced to SFO to offer insolvency override protections for indirect clearing 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 unraveled by the application of insolvency law in the event of a default by any members of the CCP.

(k) As with the reporting obligation, the clearing obligation will only apply to AIs, AMBs, LCs and other prescribed persons that are based in or operate from Hong Kong, i.e. it will not apply to overseas persons that have no presence or operation in Hong Kong. However, such persons may nevertheless be affected if they have entered into a clearing eligible transaction and their counterparty is an AI, AMB, LC or other prescribed person. This is because the clearing obligation can only be fulfilled if both counterparties clear through a designated CCP.

Penalty for breaches of mandatory obligations

(l) Fines will be imposed for breaches of mandatory obligations. The Court of First Instance will be empowered to impose civil fines of up to $5 million on any person who breaches these obligations. For breaches by AIs, AMBs or LCs, HKMA and SFC will also be empowered to take disciplinary actions against them.

New regulated activities

(m) Two new types of regulated activities ("RAs") in relation to OTC derivatives will be introduced under Schedule 5 to SFO, namely (i) a new Type 11 RA to cover the activities of dealers and advisers, and (ii) a new Type 12 RA to cover the activities of clearing agents. The existing Type 9 RA (asset management) and Type 7 RA (provision of automated trading services) will be expanded to cover OTC derivatives portfolios and transactions respectively.

(n) To minimize disruption to the market, transitional arrangements will be introduced for the new and expanded RAs, so that person who are already serving as intermediaries in the OTC derivatives market may continue to do so for a limited period of time while their application to be licensed or registered for the new or expanded RAs is being considered[5].

Regulation of systematically important participants ("SIPs")

(o) The proposed regime will include regulation of SIPs, i.e. market participants which are not licensed or registered with either HKMA or SFC, but whose positions and activities in the OTC derivatives market are so large that they may nevertheless raise concerns of potential systemic risks. These include commercial entities and financial

[5] For details of the transitional arrangements, please refer to footnote 7 of the Legislative Council Brief on the Securities and Futures (Amendment) Bill 2013 (file ref.:SUB 12/2/7 (2013)) issued by the Financial Services and the Treasury Bureau on 26 June 2013, and hyperlinked in Appendix II.

institutions who do not act as intermediaries but who are essentially price takers and end users.

(p) Any person whose OTC derivatives positions exceed certain specified thresholds ("SIP thresholds") should notify SFC. Failure to give such notification within a specified period, without reasonable excuse, will constitute a criminal offence and be subject to a fine up to $5 million and seven years' imprisonment. The SIP thresholds will be set at fairly high levels such that only a handful of market players, if any, may be caught.

(q) SFC will keep a register of persons who have notified SFC that they have exceeded any SIP thresholds, or whom HKMA/SFC has reasonable cause to believe have exceeded any SIP thresholds. The SIP register will be open for public inspection. HKMA and SFC will be empowered to require registered SIPs to provide information or take certain action in respect of their OTC derivatives positions and transactions under certain circumstances.

[*Source*: Adapted from the Legislative Council Brief on Securities and Futures (Amendment) Bill 2013 issued by the Financial Services and the Treasury Bureau on 26 June 2013 (File Ref: SUB 12/2/7 (2013)).]

Appendix II

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)) Minutes (LC Paper No. CB(1)1336/10-11)
October 2011	Consultation paper jointly issued by the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") on the proposed regulatory regime for the over-the counter ("OTC") derivatives market in Hong Kong	Consultation paper
2 April 2012	Meeting of the FA Panel	Discussion paper (LC Paper No. CB(1)1411/11-12(05)) Background brief (LC Paper No. CB(1)1410/11-12) Minutes (LC Paper No. CB(1)2028/11-12)
July 2012	Consultation conclusions jointly published by HKMA and SFC on the proposed regulatory regime for the OTC derivatives market in Hong Kong	Consultation conclusions

Date	Event	Paper/Minutes of meeting
July 2012	HKMA and SFC issued a joint supplemental consultation paper on the OTC derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systematically important players	Joint supplemental consultation paper
September 2013	HKMA and SFC issued joint supplemental consultation conclusions on the OTC derivatives regime in Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systematically important players	Joint supplemental consultation conclusions
4 March 2013	Meeting of the FA Panel	Discussion paper (LC Paper No. CB(1)599/12-13(03)) Updated background brief (LC Paper No. CB(1)599/12-13(04)) Minutes (LC Paper No. CB(1)1131/12-13)
28 June and 10 July 2013	Gazettal of the Securities and Futures (Amendment) Bill 2013 and introduction of the Bill into the Legislative Council ("LegCo")	The Bill Legislative Council Brief on Securities and Futures (Amendment) Bill 2013 (SUB 12/2/7 (2013)) Legal Service Division report on the Bill (LC Paper No. LS71/12-13)

Date	Event	Paper/Minutes of meeting
July 2013 to February 2014	The Bills Committee on Securities and Futures (Amendment) Bill 2013 scrutinized the Bill	Background brief (LC Paper No. CB(1)1584/12-13(02)) Report of the Bills Committee (LC Paper No. CB(1)1112/13-14)
26 March 2014	LegCo passed the Securities and Futures (Amendment) Bill 2013	Hansard
July 2014	HKMA and SFC issued a joint consultation paper on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping) Rules	Consultation paper