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Subcommittee on Securities and Futures (Futures Contracts) Notice 2012

Background brief

Purpose

This paper provides background information on the Securities and Futures (Futures Contracts) Notice 2012 ("the Notice"), which was gazetted on 4 May 2012, and a summary of the relevant discussions at the Panel on Financial Affairs ("FA Panel") at its meetings on 3 January 2011 and 2 April 2012.

Proposed establishment of a regulatory regime for the OTC derivatives market in Hong Kong

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

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

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

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

(d) the 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.

4. In line with the G20 Leaders' commitment, the Hong Kong Monetary Authority ("HKMA"), the Securities and Futures Commission ("SFC") and the Hong Kong Exchanges and Clearing Limited ("HKEx") have been developing a regulatory regime for the OTC derivatives market in Hong Kong. The Administration's plan is to introduce the relevant Bill into the Legislative Council in 2012/2013 to provide for the regulatory framework for the OTC derivatives market in Hong Kong. Among other things, the new regime will introduce a mandatory clearing obligation whereby market participants will be obligated to centrally clear certain OTC derivatives through a designated CCP.

Interim measure to facilitate voluntary central clearing

Market moving towards voluntary clearing

5. Notwithstanding that mandatory clearing has yet to be implemented, market participants are already moving towards clearing their OTC derivatives transactions through a regulated CCP on a voluntary basis. This is already the case in the United States, Europe and Singapore. Market participants recognize that the earlier they start central clearing, the more prepared they will be when the mandatory clearing obligation is implemented. They also recognize that centrally clearing their OTC derivatives transactions brings benefits and protection for both themselves and the market as a whole.

6. A key consideration for market participants when deciding which CCP to use for voluntary clearing is whether the transactions cleared through that CCP enjoy insolvency override protection.[1] The insolvency override protection must be conferred by law. The laws of many major markets already confer such protection in respect of transactions cleared through CCPs in their jurisdictions. In the case of Hong Kong however, such protection is only conferred in respect of securities and futures contracts but not in respect of OTC derivatives transactions.

7. If the law remains unchanged, market participants in Hong Kong who wish to opt for voluntary clearing of OTC derivatives transactions will have no option but to clear through an overseas CCP, i.e. they will not have the option to clear through a local CCP regulated by SFC and enjoy the advantages of doing so.

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[1] Transactions that enjoy insolvency override protection are not susceptible to being undone pursuant to general insolvency law. Such protections have to be conferred by statute, and are typically conferred on transactions cleared through a registered CCP. The objective of such protection is to provide legal certainty of settlement finality for transactions cleared through the CCP.

Securities and Futures (Futures Contracts) Notice 2012

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 Notice under section 392 of the Securities and Futures Ordinance (Cap. 571) ("SFO") to prescribe that any structured products set out in the Schedule to the Notice is to be regarded as a futures contract for the purpose of certain provisions of the SFO. The overall effect is to –

(a) enable such a structured product to become a "market contract" if it is –

(i) cleared and novated through an RCH; and

(ii) either effected on, or subject to the rules of, an REC, and thereby

(b) enjoy the insolvency override protection conferred under Division 3 of Part III of SFO.

9. In the relevant Legislative Council Brief, the Administration advises that the proposed measure to support voluntary clearing will facilitate implementation of the full-fledged regime for the OTC derivatives market in Hong Kong. Early recognition of a Hong Kong CCP will also give it the opportunity to build up experience and a track record before implementation of any mandatory clearing obligation. As some CCPs in other jurisdictions are already providing central clearing for Hong Kong Dollar and Renminbi OTC derivatives products, the proposed measure will enable Hong Kong to compete with overseas markets and strengthen Hong Kong's position as an offshore RMB centre. The Administration also advises that the notice will not affect the existing licensing regime nor will it compel central clearing of OTC derivatives.

10. The Notice will come into operation on 27 June 2012.

Deliberations of the Panel on Financial Affairs

11. The Administration, HKMA and SFC briefed the FA Panel on the proposal to establish a regulatory regime for the OTC derivatives market in Hong Kong on 3 January 2011. On 2 April 2012, the Panel was briefed by the same parties on the progress of the work and the proposal of introducing interim measures to facilitate voluntary clearing of OTC derivatives transactions. The discussions are summarized in the ensuing paragraphs.

General issues

12. A member considered that the Government should have acted before the Lehman Brothers Minibonds Incident in regulating the OTC derivatives market, and 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.

13. 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

14. 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 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.

Financial arrangements

15. Some members expressed concern about the financial arrangements for the establishment and operation of the CCP in Hong Kong. A member opined that the expenditure of the CCP should be borne by market participants, and no

subsidy should be made from the public purse. Some members were concerned that the development of the OTC derivatives market in Hong Kong might be adversely affected if high levels of fees were charged for OTC derivative transactions.

16. The Administration advised that the Government would not provide financial support for the establishment and operation of the CCP. HKEx advised that it would make an investment of about $180 million for setting up the CCP, which was of strategic value for HKEx and Hong Kong's financial market. 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 "the user pays" principle, and benchmarking with the fees charged in the global markets. The CCP was expected to operate at a loss in the initial years.

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 to ensure parity of Hong Kong's regulatory arrangements with those of global financial markets, Hong Kong would maintain close liaison and exchange information with other major financial markets on the regulation of OTC derivatives. 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.

Non-centrally cleared OTC contracts

18. A member enquired what robust risk management requirements would be introduced for the regulation of the remaining non-centrally cleared OTC derivative trades. HKMA advised that given the higher risk involved in the trading of non-centrally cleared OTC derivatives, the contracts of such derivatives would be subject to higher capital requirements. The Basel Committee would review the capital requirement for financial institutions dealing with non-centrally cleared OTC derivatives.

Investor protection

19. A member asked whether a compensation fund would be established to protect the investors under the proposed regulatory regime for OTC derivatives transactions. The Administration advised that as generally speaking only institutional investors were involved in OTC derivatives transactions, SFC did not consider that the establishment of an investor compensation fund for such transactions was necessary.

Regulation of enterprises and insurance companies

20. A member was concerned that the OTC derivatives transactions of insurance companies and large enterprises might be of such a volume that posed systemic risks, and a mechanism should be established to enable interference of the regulatory bodies with such activities of insurance companies and large enterprises. The Administration advised that as a mechanism to handle systemic risks, if an end-user was found to have acquired a large volume of OTC derivatives, SFC would be empowered to request the end-user to reduce the size of OTC derivatives held by it. Companies, including insurance companies, involved in dealing in OTC derivatives transactions would be required to be licensed by SFC.

Relevant papers

21. The relevant papers are available at the following links:

Meeting of FA Panel on 3 January 2011	Administration's 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 Powerpoint presentation http://www.legco.gov.hk/yr10-11/english/panels/fa/papers/fa0103cb1-974-1-e.pdf Minutes (paragraphs 22 to 38) http://www.legco.gov.hk/yr10-11/english/panels/fa/minutes/fa20110103.pdf

Meeting of FA Panel on 2 April 2012	Administration's 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 Powerpoint presentation http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa0402cb1-1502-2-e.pdf
	The Notice http://www.legco.gov.hk/yr11-12/english/subleg/negative/ln081-12-e.pdf Legislative Council Brief http://www.legco.gov.hk/yr11-12/english/subleg/brief/81_brf.pdf Report of the Legal Service Division http://www.legco.gov.hk/yr11-12/english/hc/papers/hc0511ls-60-e.pdf

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