

Overview of the Regulation of Over-the-counter Derivative Market

July 2013



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

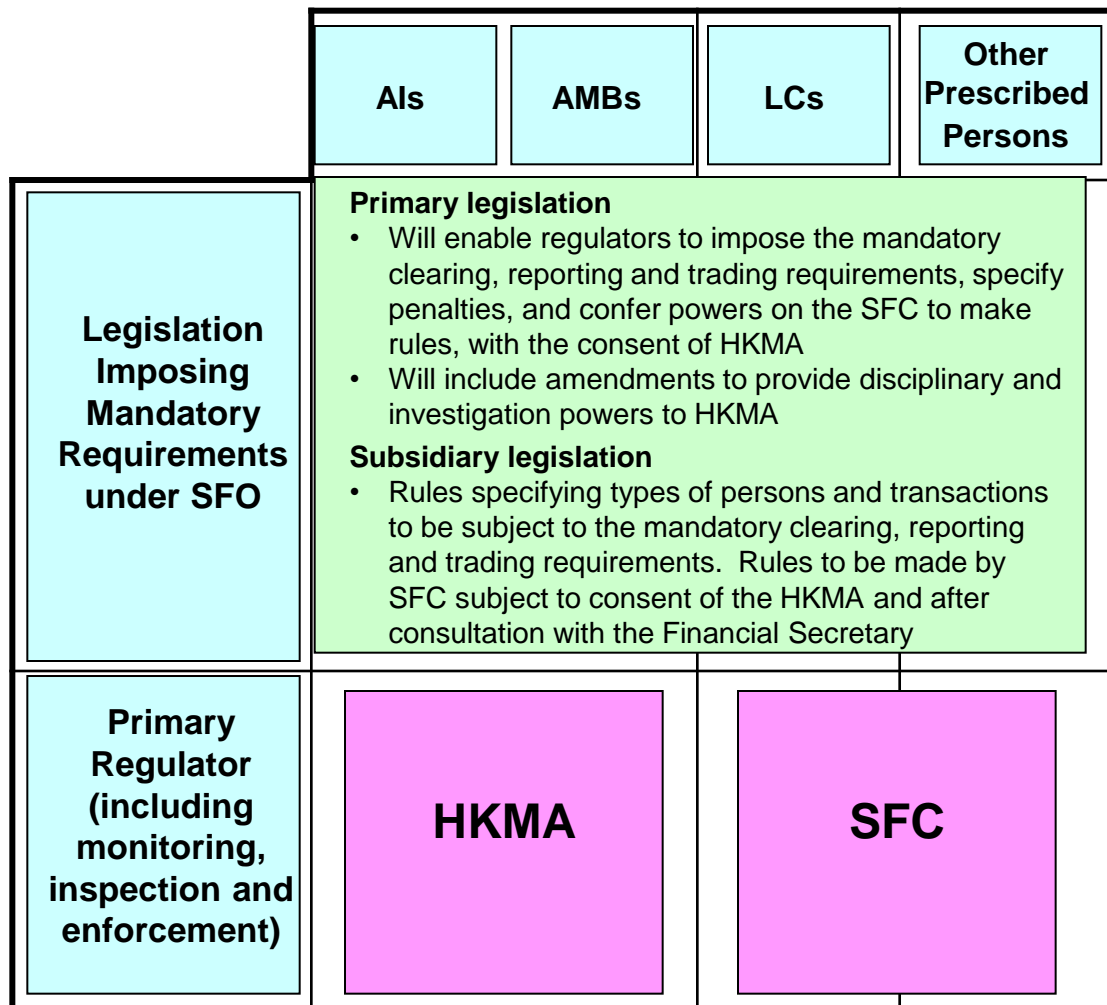
- Relatively Small
- Open & International
- Niche Market Products

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



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





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

- **OTC derivatives transaction** will be defined by reference to the definition of **structured product** under the SFO. The definition of OTC derivatives transaction could cover asset classes, such as foreign exchange, interest rate, credit, equity and commodity derivatives, and will incorporate appropriate exclusions in respect of certain transactions, such as transactions in securities and futures contracts that are traded on regulated markets, transactions in securitised products, embedded derivatives and spot contracts
- 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 may 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, 5 respectively



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

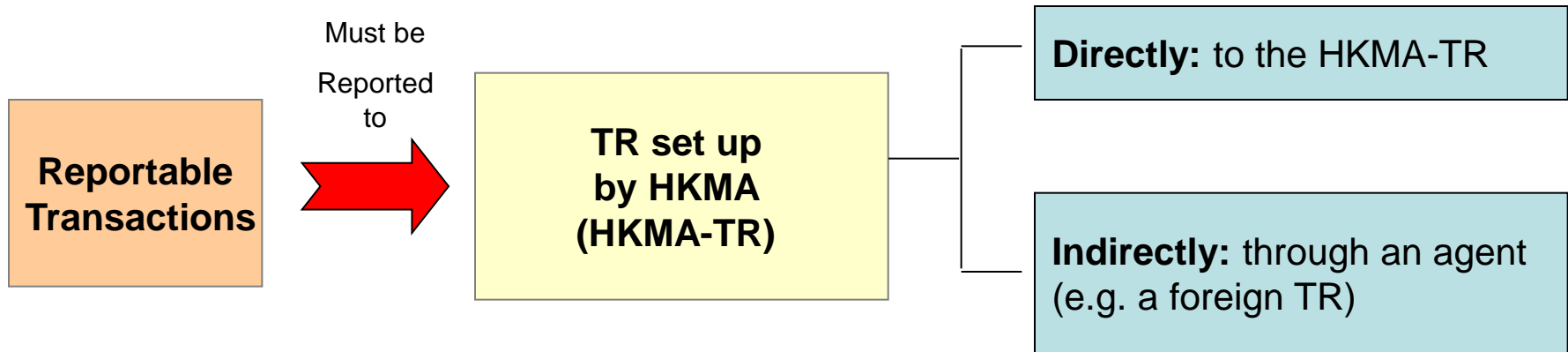
- For banks, higher capital requirements for OTC derivative transactions that are not cleared through a CCP have been introduced as part of Basel III implementation in HK
- We are closely monitoring the development of international standards on margin requirement for non-centrally cleared OTC derivative 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



Proposed Mandatory Reporting Obligation

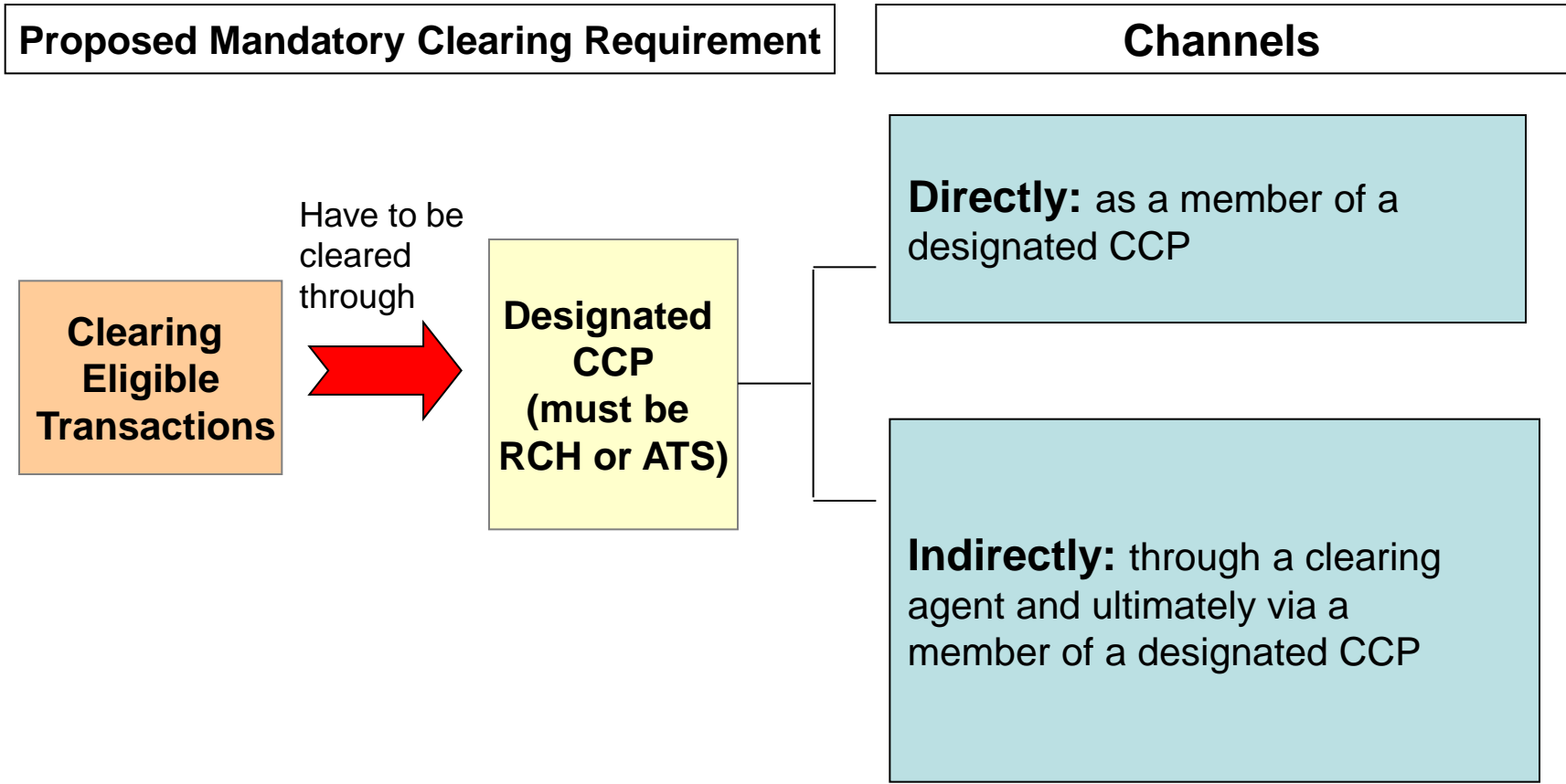
Proposed Mandatory Reporting Requirement

Channels





Proposed Mandatory Clearing Obligation



RCH – Recognized Clearing Houses
ATS – Authorized Automated Trading Services Providers



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

- **New Type 11 RA will encompass “dealing in OTC derivative products or advising on OTC derivative products”**
 - 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 be overseen and regulated by the HKMA)



Proposed Regulations of Intermediaries : Type 12 RA (Clearing Agency)

■ 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
- does not regulate clearing of proprietary trades



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

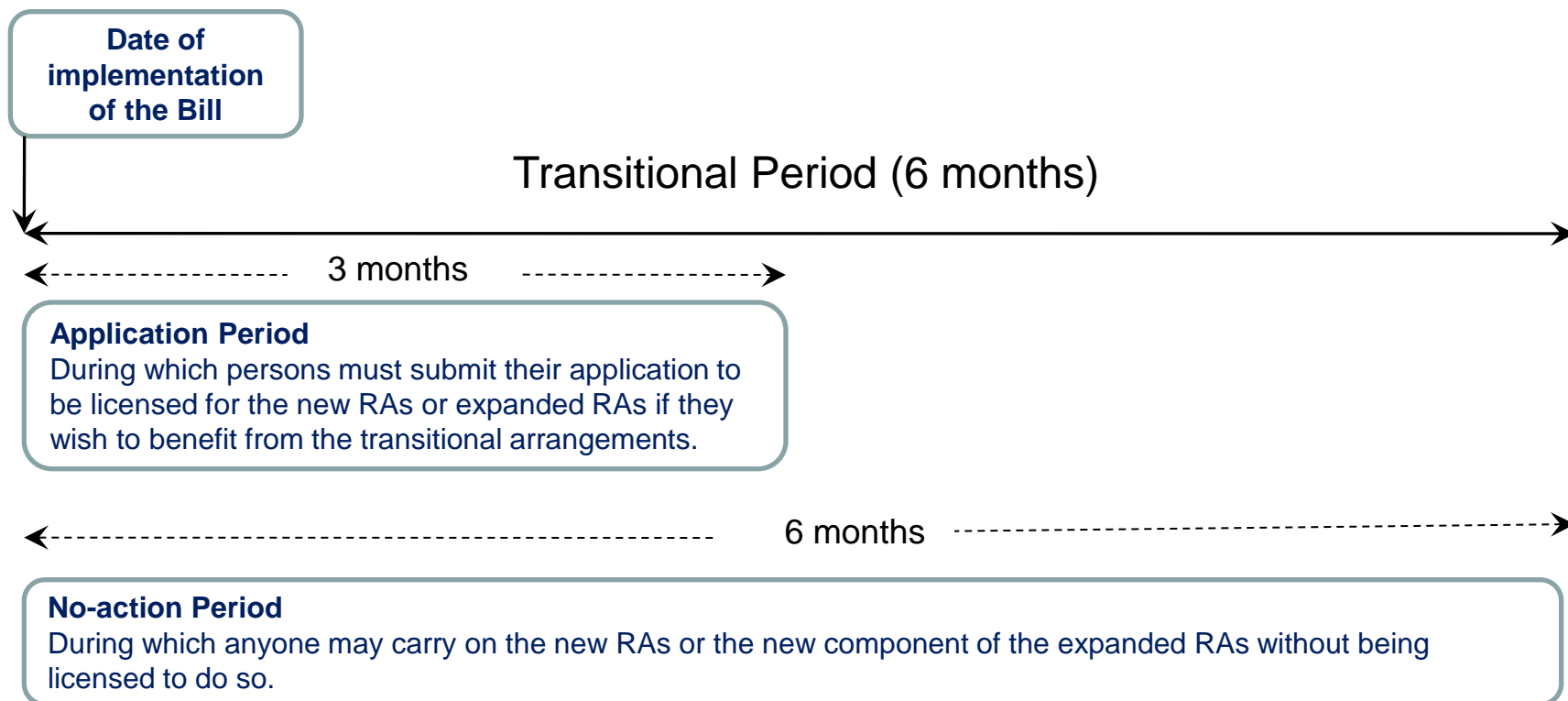


Proposed Expansion of Type 9 RA (Asset Management)

- **Expansion of Type 9 RA**
 - to also include “management of portfolios of OTC derivative transactions”



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.



Proposals re Oversight of Systemically Important Participants

- **Regulatory oversight of SIPs : whose OTC derivative positions exceed a specified 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**
- **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)
- **Not envisaging any SIPs initially**



Development of Infrastructure

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



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 later in 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

Other Technical Improvements

- 1. Electronic filing:** To amend the SFO to require notifications and reports under Part XV “Disclosure of Interests” of the Ordinance to be filed electronically with a view to improving the timeliness of publication of potentially market sensitive Disclosure of Interests notices (Clauses 63 and 64).
- 2. Court orders to recoup illegal gains from committing market misconduct offences:** To amend the SFO and the Organized and Serious Crimes Ordinance (“OSCO”) to empower courts to make orders for the purpose of recouping illegal gains from committing a market misconduct offence (Clauses 66 to 68).

Structure of the Bill

- **Mandatory reporting, clearing and trading obligations** and the relevant **rule-making powers** (Divisions 2 and 4 of the new Part IIIA of the SFO added under Clause 9).
- **Designations of CCPs and trading platforms** and the relevant **rule-making powers** (Divisions 3 and 4 of the new Part IIIA of SFO added under Clause 9).
- Provisions relating to **SIPs** (Division 5 of the new Part IIIA of SFO added under Clause 9)
- **New Type 11 RA and Type 12 RA** and the **expanded Type 7 RA and Type 9 RA** (Schedule 5 to the SFO amended under Clause 53).
- To provide **transitional arrangements** for the above new activities and new components (New schedule 11 to the SFO added under Clause 55).

Structure of the Bill

- **Necessary investigatory and disciplinary powers** for both the HKMA and SFC to oversee and regulate activities in the OTC derivative market (Part VIII and Part IX of the SFO amended under Clauses 15 to 37 and new Division 1A to Part XVI of the SFO added under Clause 40).
- **New definitions** pertaining to the regulation of OTC derivative transactions, including a definition of “OTC derivative product” (Schedule 1 to the SFO amended under Clause 52).

Thank You