CLIFFORD CHANCE

CLIFFORD CHANCE
高偉紳律師行
28TH FLOOR
JARDINE HOUSE
ONE CONNAUGHT PLACE
HONG KONG
TEL +852 2825 8888
FAX +852 2825 8800
INTERCHANGE DX-009005 CENTRAL 1
www.cliffordchance.com

By Fax and By Email

Hon CHAN Kam-lam, SBS, JP
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Email: slchan@legco.gov.hk

19 September 2013

Dear Sir

Submission on Securities and Futures (Amendment) Bill 2013

1. The Group would like to thank the Bills Committee for providing us the opportunity to make a written submission on the Securities and Futures (Amendment) Bill 2013 (the "**Bill**"). Our clients, whose names are set out in the Schedule to this letter (this working group is referred to in this letter as the "**Group**"), have prepared this letter as interested stakeholders in the Hong Kong financial markets.

2. We have been actively engaged with the Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**") since October 2011 commenting on the proposed reforms to the Hong Kong OTC derivatives market[1]. It is the Group's aim to provide assistance to the Bills Committee, the HKMA and the SFC in developing a functional, efficient and appropriate regulatory framework that will enhance the transparency, safety and stability of the Hong Kong OTC derivatives market.

---

[1] The HKMA and SFC published their joint consultation paper on the proposed regulatory regime for Hong Kong's OTC derivatives market on 17 October 2011.

3. Following the global financial crisis in 2008, the G20 committed to reforms[2] to address structural weaknesses in the OTC derivatives market. The Group welcomes the adoption of equivalent reforms in Hong Kong through the introduction of appropriate and proportionate mandatory reporting, clearing and trading requirements for OTC derivatives and considers this an important step in strengthening the financial markets in Hong Kong.

4. A strong, liquid and open OTC derivatives market is highly important to businesses operating in Hong Kong as well as Hong Kong's future as an international financial centre and as a premier offshore Renminbi ("**RMB**") business centre (see further paragraph 14(d) below). The new regulatory regime under the Bill must therefore achieve the twin goals of (i) managing systemic risk in the Hong Kong OTC derivatives market and (ii) ensuring financial institutions and end users in and outside Hong Kong can continue to access an efficient, liquid and robust OTC derivatives market in Hong Kong to risk manage their businesses without undue restrictions.

5. The Group was established in order for its members to collaborate and present their views on the mandatory obligations to be introduced in the Bill (specifically, mandatory reporting, clearing and trading of OTC derivatives). Therefore, we have not commented on the aspects of the Bill relating to reform of the Hong Kong licensing regime or amendments to the enforcement regime relating to market misconduct offences.

6. As international financial institutions, the Group has been engaged in consultations on and implementation of OTC derivatives reforms in several major jurisdictions. These include:

(a) the *Dodd–Frank Wall Street Reform and Consumer Protection Act* ("**Dodd Frank Act**") in the United States (which became effective on 21 July 2010);

(b) Regulation (EU) No 648/2012 (better known as the *European Market Infrastructure Regulation* ("**EMIR**")) in the European Union (which came into force on 16 August 2012);

(c) the *Securities and Futures (Amendment) Act 2012* ("**SFAA**") in Singapore (which was passed on 15 November 2012); and

---

[2] The G20 leaders declared at the Pittsburgh summit in 2009 that "*All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements*".

(d) the *Corporations Legislation Amendment (Derivatives Transactions) Act 2012* in Australia (which became effective on 3 January 2013).

7. Recognising the importance of the OTC derivatives market for Hong Kong, the Group strongly believes that it is crucial for Hong Kong to develop a regulatory regime for OTC derivatives which is aligned with international reform initiatives implementing the G20 committments and enhances Hong Kong's continued status as a leading offshore RMB market.

8. In this letter, the Group sets out its views on the Bill as well as the development of related subsidiary legislation detailing the mandatory obligations to be introduced to the OTC derivatives market in Hong Kong. We look forward to discussing these issues in further detail with the Bills Committee on 30 September 2013.

Framework Legislation

9. As set out in the Legislative Council Brief dated 26 June 2013 prepared by the Financial Services and the Treasury Bureau, the Bill serves as "*a broad regulatory framework*" for the regulation of the OTC derivatives market while details will be set out in subsidiary legislation to be made by the SFC with the consent of the HKMA, and after consultation with the Financial Secretary.

10. The Group supports this two stage process for implementing reforms to the OTC derivatives market, which is consistent with the approach adopted in various other jurisdictions, such as:

(a) the United States (where the Commodities Futures Trading Commission ("**CFTC**") and Securities Exchange Commission ("**SEC**") have been delegated powers under the Dodd Frank Act to make detailed rules in relation to swaps regulation);

(b) the European Union (where the European Securities and Markets Authority ("**ESMA**") is responsible for preparing the Regulatory and Implementing Technical Standards in relation to EMIR);

(c) Singapore (where the Monetary Authority of Singapore ("**MAS**") is developing the parameters for the mandatory obligations introduced in the SFAA); and

(d) Australia (where the Australian Securities and Investments Commission ("**ASIC**") is introducing further detail to the framework legislation that came into effect at the start of this year).

11. In principle, we believe the interests of the Hong Kong financial markets are best served by allowing the HKMA and SFC to develop the detailed rules for OTC derivatives regulation at the subsidiary legislation level, subject to the following considerations:

(a) *Reasonable implementation timelines and measured approach to mandatory trading*: While the Group recognises the importance of mandatory reporting and clearing of OTC derivatives to improve the stability and safety of the financial markets, it should be noted that experience with international reforms in this context shows that the implementation of such complex requirements involves a substantial amount of time, cost and resource for market participants. It is therefore important that the HKMA and SFC provide sufficient grace periods to affected institutions to allow them to comply with the mandatory obligations.

In this regard, the Group fully supports the HKMA and SFC's plans to conduct further studies on the potential impact of mandatory trading on local market liquidity before determining whether this would be appropriate and suitable to implement in Hong Kong, as was set out in the original joint consultation paper published in October 2011 and is consistent with many other jurisdictions[3];

(b) *Cost/benefit analysis*: It is important to note that the regulatory reforms introduced by the Bill will affect not only major financial institutions, but also funds, insurance companies and corporations in Hong Kong. Therefore, the development of sensible and proportionate exemptions from and a phasing in of requirements for mandatory obligations (particularly in relation to clearing of OTC derivatives) will be crucial in order to avoid imposing detrimental costs on "real economy" businesses that use OTC derivatives for hedging and other business activities.

The Group believes that the HKMA and SFC should carefully conduct a cost/benefit analysis in relation to the scope of all mandatory obligations and exercise their general powers to grant exemptions as provided under the Bill where it is appropriate. In particular, the clearing threshold, reporting threshold and the scope of the intra-group exemption must be set appropriately to balance the benefit of managing systemic risk against the cost of compliance and effect on the financial markets of Hong Kong; and

[3] See also page 14 of the Financial Stability Board's Fifth Progress Report on Implementation of OTC Derivatives Market Reforms.

(c) *Extraterritoriality*: The Group understands the motivation for developing a regulatory framework for OTC derivatives with extraterritorial reach given the international nature of the OTC derivatives market and the booking and business models adopted by many major financial institutions. However, it is crucial for such extraterritoriality to be carefully managed at the subsidiary legislation level in order to ensure that the requirements imposed on the Hong Kong OTC derivatives market are aligned with the requirements imposed in other jurisdictions and that any extraterritorial reach of the legislation is proportionate and appropriate for Hong Kong and allows for recognition of, or otherwise avoids unnecessary conflict with, equivalent requirements emanating from jurisdictions outside Hong Kong.

Importance of International Alignment

12. The Group strongly supports the active role played by the HKMA and SFC on international forums such as the Financial Stability Board, the Bank of International Settlements and the International Organization of Securities Commissions in relation to the development of regulatory reforms for OTC derivatives. The HKMA and SFC have regularly worked with the regulators of other jurisdictions in order to develop a globally aligned and consistent regulatory framework for OTC derivatives[4].

13. We agree with the emphasis placed by the HKMA and SFC on international alignment and harmonisation of OTC derivatives regulation and stress its importance to the Bills Committee. The G20 acknowledge that adoption of consistent, effective and practicable standards across jurisdictions is central to achieving the G20 regulatory reform objectives. For example, the July 2013 communiqué published following the G20 Meeting of Finance Ministers and Central Bank Governors states:

"*In particular, the recent EU-U.S. announcement on cross-border issues related to OTC derivatives reforms is a major constructive step forward, which paves the way for resolving remaining conflicts, inconsistencies, gaps and duplicative requirements globally.*"[5]

---

[4] See, for example, the SFC's participation in the Global Markets Advisory Committee Meeting hosted by the CFTC on 7 November 2012 that was also attended by representatives from the European Union, Singapore, Australia, Canada and Japan.

[5] See paragraph 24 of the communiqué following the G20 Meeting of Finance Ministers and Central Bank Governors in Moscow (19-20 July 2013).

14. International alignment is also crucial to Hong Kong's standing as an international financial centre for the following reasons:

(a) *Conflicting obligations*: It is important that the mandatory obligations to be introduced under the Bill do not conflict with similar rules being introduced in other jurisdictions. For example, if an OTC derivative entered into between a European institution and a Hong Kong institution were subject to mandatory clearing in both jurisdictions, the participants would not be able to conduct this trade if the rules of each jurisdiction conflicted with each other and did not, for example, allow both parties to clear at a venue which they could reasonably access. This could have serious ramifications for the liquidity and efficiency of the OTC derivatives market in both jurisdictions.

The potential for such conflicts to lead to market disruption and fragmentation is well recognised by many global regulatory authorities. In a report by the OTC Derivatives Regulators Group ("**ODRG**") (which includes as its members the HKMA, the CFTC, the SEC, ESMA, MAS and ASIC (among others)), it was agreed that:

"*absent appropriate co-ordination, our respective cross-border rules and implementation schedules could cause market disruption and fragmentation, reduced liquidity in certain markets, and the concentration of risks within certain jurisdictions*"[6];

It is essential that the risks associated with such conflicts are managed at the rule-making stage in three ways:

(i) appropriately managing the scope of obligations and in particular their extraterritorial impact;

(ii) providing for a mechanism whereby compliance with certain equivalent obligations imposed by overseas regulators is deemed to be sufficient for compliance with mandatory obligations in Hong Kong; and

(iii) implementing a fair and transparent process for the recognition of overseas CCPs and trading platforms such that access to the Hong Kong

---

[6] See page 2 of the OTC Derivatives Regulators Group Report on Agreed Understandings to Resolving Cross-border Conflicts, Inconsistencies, Gaps and Duplicative Requirements, 16 August 2013

market by overseas CCPs and trading platforms is facilitated provided they comply with international standards.

The initial recommendation from ESMA in connection with the European equivalence assessment mentioned in paragraph 14(c) below is that Hong Kong already has a legal framework that provides for an effective equivalent system for recognition of CCPs authorised under third-country legal regimes. However it is noted that considerable discretion still resides with the SFC to determine the authorisation criteria to be applied to any particular automated trading service. Reciprocal access and recognition will be a key element in ensuring the Hong Kong regime itself is deemed as equivalent pursuant to regulations in key overseas jurisdictions such as the European Union.

(b) *Risk of regulatory arbitrage and/or cost*: As highlighted above, even where the mandatory obligations of different jurisdictions do not conflict, any difference in the standards imposed by such jurisdictions may lead to two potential outcomes:

(i) relocation of OTC derivatives trading activity from jurisdictions with more onerous requirements to jurisdictions with less stringent rules, which decreases the OTC derivatives market volume for the former jurisdictions and increases the systemic risk for the latter jurisdictions; or

(ii) increase or even prohibitive compliance costs for market participants as they will be required to develop compliance and operational processes to comply with multiple standards set by various jurisdictions;

(c) *International equivalence and substituted compliance*: In the Group's opinion, it is crucial for Hong Kong to push forward with its intention to develop a comparable regulatory regime for OTC derivatives so that compliance with the requirements of the Hong Kong regime will be recognised as compliance with the rules of other major jurisdictions. This principle of mutual recognition of regulatory regimes is supported by the G20, which has stated that:

"*we agree that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially identically outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes*"[7].

---

[7] See paragraph 24 of the communiqué following the G20 Meeting of Finance Ministers and Central Bank Governors in Moscow (19-20 July 2013).

The Group would like to draw the Bills Committee's attention to the fact that this opportunity to develop co-operation with the European Union is continuing and ESMA is currently conducting an equivalence assessment for Hong Kong under EMIR. Similarly, the CFTC and SEC will also in due course be considering Hong Kong's suitability for substituted compliance under the Dodd Frank Act.

In respect of Europe, on 1 September 2013, ESMA released the first round of their technical advice to the European Commission on third country regulatory equivalence under EMIR for Hong Kong. The report states that, in relation to the regulation of central counterparties ("**CCPs**"), which plays a key infrastructure role for mandatory clearing:

"*there are a number of areas where the legally binding requirements which are applicable, at a jurisdictional level, to CCPs in Hong Kong are not broadly equivalent to the legally binding requirements for CCPs under EMIR*"[8].

The Group expresses concern that a failure by Hong Kong to obtain a favourable equivalence assessment from ESMA in connection with any key aspect of that regulation may have a detrimental effect on the ability for market participants which are subject to EMIR to operate in the Hong Kong OTC derivatives market. This could result in a deterioration of the liquidity and efficiency of the OTC derivatives market, with knock-on effects on its market participants; and

(d) *Detrimental effect on offshore RMB business in Hong Kong*: The Group understands that two of the key products which OTC Clear, the CCP established by the Stock Exchange of Hong Kong, will offer clearing services for are RMB denominated interest rate swaps and non-deliverable forwards. The central clearing of such offshore RMB OTC derivatives products in Hong Kong will play a very important role in the continued development of Hong Kong as a global premier offshore RMB business centre.

The success of OTC Clear could be affected if the Hong Kong regulatory regime for CCPs is not considered to be equivalent to the EMIR CCP requirements.

This is because (i) European banks will not be able to directly join any CCP in a jurisdiction not deemed equivalent under EMIR and (ii) the Capital Requirements Regulation (which forms part of the "**CRD IV**" package of reforms in Europe

[8] See paragraph 43 of the ESMA Final Report – Technical advice on third country regulatory equivalence under EMIR – Hong Kong, 1 September 2013

aimed at introducing Basel III regulatory capital requirements and which becomes effective on 1 January 2014) requires that any third-country CCP located in a jurisdiction that is not deemed equivalent under EMIR must also be treated as "non-Qualifying" for regulatory capital purposes. This means that if OTC Clear is unable to obtain recognition under EMIR, European banks (even where they are accessing OTC Clear through a non-European incorporated subsidiary) will face extremely unfavourable regulatory capital treatment if they clear derivatives transactions through OTC Clear[9] and will not be able to join the service as direct clearing members.

European financial institutions and their subsidiaries in Hong Kong represent a substantial portion of the market in offshore RMB derivatives products. The Group submits that if Hong Kong is not considered to have an equivalent regulatory regime for CCPs to EMIR or if OTC Clear otherwise fails to obtain recognition under EMIR, then this may impair Hong Kong's status as a leading offshore RMB centre. This is because entities subject to EMIR or CRD IV may be required to clear their offshore RMB derivatives products in another jurisdiction which is deemed equivalent under EMIR and where a CCP has managed to obtain recognition.

It should also be noted that the continued participation of European financial institutions and their subsidiaries as clearing members of the various clearing houses operated by the HK Exchange for exchange traded products such as futures and options and cash equities is also likely to depend on a positive outcome of Hong Kong's equivalence assessment under EMIR (which will include an assessment of their rules) due to the same regulatory capital concerns.

There are a number of requirements that need to be satisfied before any Hong Kong CCP will be recognised under EMIR (for example, the SFC will need to enter into a co-operation agreement with ESMA). This process for obtaining recognition would be supported if Hong Kong adopted the Bill, as the Bill contains provisions which will help Hong Kong satisfy the equivalence requirements set out under EMIR[10]. We would also respectfully urge the SFC to

[9] Specifically, CRD IV provides that entities subject to EU laws and regulations which are clearing transactions through a CCP will only benefit from the favourable 2% risk weighting for regulatory capital purposes if the CCP is recognized by ESMA as a qualifying CCP.

[10] See, for example, Section 101I(4) of the Bill which provides that a CCP established outside of Hong Kong can obtain recognition as a recognized clearing house from the SFC. This satisfies the requirement under EMIR

continue to support a favourable outcome of equivalence for Hong Kong (and EMIR recognition for HK CCPs) by following through on their commitment made in connection with the Bill to ensure that all CCPs in Hong Kong comply with CPSS-IOSCO Principles for Financial Market Infrastructures.

Requirement for Flexibility and Market Consultation

15. The recent Financial Stability Board's sixth progress report on implementation of OTC derivatives market reforms (dated 2 September 2013) notes that Hong Kong remains the only jurisdiction which has yet to adopt legislation on any of the mandatory obligations. This is of course a concern for the Group.

16. In order for Hong Kong to develop a regulatory regime for OTC derivatives in a timely manner and which is comparable to other major jurisdictions, the Group encourages the Bills Committee to adopt the Bill and allow sufficient flexibility to be retained at the subsidiary legislation level. However, this is subject to the Group's important requirement for the HKMA and SFC to always consult the market on subsidiary legislation proposals. It is submitted that the market participants can play a helpful and constructive role in developing the regulatory framework for OTC derivatives in Hong Kong and we welcome continuing the constructive dialogue we have had to date in this context.

17. We would like to highlight that although primary legislation for many jurisdictions has come into effect, for many of these jurisdictions the detailed rules are currently still under development. For example, the impact of EMIR on OTC derivatives conducted wholly outside of the EU has not been determined, and neither Singapore nor Australia have finalised detailed rules on the reporting of OTC derivatives which are booked offshore or rules relating to the clearing of OTC derivative transactions.

18. As a result, the Group considers that international alignment of the mandatory obligations imposed on OTC derivatives markets is ongoing and therefore a task which will need to be entrusted to the HKMA and SFC in the development of subsidiary legislation. This is because the HKMA and SFC will need flexibility to adapt and amend the scope of the mandatory obligations in Hong Kong in order to align and harmonise them with international developments and the rules of other major jurisdictions.

Article 25(6) which requires that the Hong Kong regulatory regime for CCPs must allow for recognition of European CCPs before OTC Clear can obtain recognition from ESMA.

19. In consideration for having this flexibility, the Group suggests that the HKMA and SFC should whenever possible conduct market consultation before implementing each set of detailed rules introduced as subsidiary legislation in order to allow industry feedback and preparation to be taken into account. It is submitted that this process will be highly beneficial in aligning the mandatory obligations in Hong Kong with other major jurisdictions and ensuring unnecessary costs and disruption for the Hong Kong market is avoided.

20. Based on the consultation conclusions published in July 2012, the Group believes that the HKMA and SFC have struck the right balance for Hong Kong between reducing systemic risk in the OTC derivatives market and managing the implementation impact on market participants. Therefore, the Group advocates that any detailed rules should be consistent with the position set out in the consultation conclusions.

Conclusion

21. The Group expresses its appreciation to the Bills Committee once more for its kind invitation to attend the meeting on 30 September 2013. Reform of the global OTC derivatives markets is a crucial element of the G20's response to the financial crisis, and it is the Group's belief that the Bill forms a key component in maintaining Hong Kong's position as a leading financial centre and reducing systemic risk in the financial markets. We reiterate the Group's keen support for the passage of the Bill and the Group's commitment to help develop a regulatory framework which enhances transparency and reduces systemic risk in the Hong Kong OTC derivatives market.

Yours faithfully

Clifford Chance

Clifford Chance

SCHEDULE

Barclays Bank PLC

BNP Paribas

Citibank, N.A.

Credit Suisse AG

Deutsche Bank AG

Goldman Sachs (Asia) LLC

The Hongkong and Shanghai Banking Corporation Limited

JPMorgan

Morgan Stanley

Standard Chartered Bank