

## Bills Committee

### Securities and Futures (Amendment) Bill 2013

#### Submission of Hong Kong Association of Banks

18 September 2013

#### Introduction

This paper sets out the views of The Hong Kong Association of Banks ("**HKAB**") in relation to the proposed introduction of the Securities and Futures (Amendment) Bill 2013 ("**Bill**"), particularly in relation to the provisions establishing a regulatory framework for the over-the-counter ("**OTC**") derivative market in Hong Kong.

Assisted by King & Wood Mallesons, HKAB has examined the legislative proposals set out in the Bill and in the explanatory materials and has identified a range of suggestions that we wish to raise with the Bills Committee.

Our previous work in relation to the proposed OTC derivatives regime during the previous consultation rounds has involved the following correspondence with the Hong Kong Monetary Authority ("**Monetary Authority**") and the Securities and Futures Commission ("**SFC**"):

- (a) on 30 November 2011 – our response to the proposals set out in the "Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong" ("**First Consultation Paper**") issued jointly by the HKMA and SFC in October 2011;
- (b) on 28 August 2012 – our response to the proposals set out in the "Joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong" ("**Conclusions Paper**") issued jointly by the HKMA and SFC in July 2012.

We would be pleased to engage in further discussions with the Bills Committee in relation to the proposed changes and to provide further industry input where necessary.

*Unless otherwise defined, terms used in our response have the meaning given to them in the Bill.*

#### Executive summary

HKAB welcomes the significant progress that has been made since the first proposals concerning these reforms were released in October 2011. We appreciate that many of HKAB's concerns have been taken on board and addressed in the revised proposals contained in the Bill.

We also fully support the proposed regulatory oversight of authorized financial institutions ("**AIs**") by the Monetary Authority and relevant exemptions from licensing.

We welcome this opportunity to make submissions to the Bills Committee in relation the Hong Kong derivatives regime and the Bill. In particular we consider that:

- (a) the scope of the regime; and
- (b) its interaction with similar requirements in other jurisdictions,

would benefit from clarification and some amendments to the Bill.

HKAB acknowledges that certain suggestions and concerns raised below relate to specific aspects of the proposed legislative regime which may be addressed in subsidiary legislation. It would be of great benefit to HKAB members for the details of this subsidiary legislation to be released as soon as

possible and HKAB requests that it be involved in the discussions that will shape the subsidiary legislation.

We welcome the opportunity to discuss these comments further.

## HKAB's response

### **A Approach to implementation**

#### **1 Consultation on further details**

1.1 We understand that many details are proposed to be addressed in subsidiary legislation and that a public consultation on that legislation is planned for later this year. However, we ask that:

- (a) relevant details to be contained in subsidiary legislation or other rules made under the Bill be released as soon as possible, with an adequate time for consultation and discussion with industry stakeholders;
- (b) all such details are finalised in tandem with the enactment of the Bill; and
- (c) sufficient time is provided for implementation (see the following paragraph 2).

#### **2 Grace periods**

2.1 HKAB commends the transitional arrangements set out in the Bill in relation to registration for the new regulated activities, in particular the inclusion of a six month no-action period for licensing and three month no-action period for necessary business closures.<sup>1</sup>

2.2 However, we note that the Bill does not provide for a grace period in relation to the reporting and clearing obligations.

2.3 We suggest that a minimum grace period of six months is required in order to implement the required changes and that a similar period for future changes in scope, such as the designation of new products to be subject to mandatory clearing or reporting, should be adopted pursuant to subsidiary legislation or rules. Given the extensive changes required, our members do not expect any lesser period will be sufficient however we recognise that any grace period needs to be balanced against potential impacts on regulatory capital requirements applying to AIs and other international regulatory requirements with which many HKAB members must comply. We suggest that flexibility be given to determine the scope of the applicable grace period in subsidiary legislation.

### **B Extraterritoriality**

#### **3 Extraterritoriality**

3.1 As currently proposed, the rule-making powers relating to reporting, clearing and trading allow the SFC to provide that an OTC derivative transaction is subject to those obligations:

- (a) even if a counterparty or more than one counterparty is a person outside Hong Kong;
- (b) except in certain cases, even if a person is not a counterparty to the transaction; or
- (c) even if the transaction is entered into or conducted wholly or partially outside Hong Kong.<sup>2</sup>

<sup>1</sup> Schedule 11 to the Bill.

<sup>2</sup> See sections 101K(3)(b), 101L(3)(b) and 101M(3)(b) of the Bill.

- 3.2 HKAB strongly suggests that these provisions be narrowed. Extraterritorial provisions are problematic in this area for a number of legal and practical reasons, including enforceability, client secrecy restrictions, compliance costs and, in relation to clearing, that OTC derivatives transactions can only be cleared once. As mandatory clearing will soon be a near-global requirement, extraterritorial provisions place market participants in difficult positions of legal conflict. Please also refer to our comments in paragraph 5 in relation to this issue.
- 3.3 From a policy perspective, we suggest that Hong Kong should adopt a restrained approach. This will also assist in retaining its status as an international financial centre, by avoiding an approach that potentially penalises the smallest connections to Hong Kong.
- 3.4 As a result, we recommend that the extraterritorial provisions be drafted more narrowly, to reflect a scope no greater than was contemplated by the Conclusions Paper. We will be pleased to provide further input on this. Alternatively, we recommend that the SFC be given the power to grant exemption relief in order to resolve the legal and practical difficulties highlighted in this paragraph 3.
- 3.5 Please also refer to our comments on extraterritoriality in relation to SIPs, in paragraph 14.

## **C Scope of OTC derivatives caught**

### **4 Definition of “OTC derivative product”**

- 4.1 In principle, HKAB supports the proposed scope of an “OTC derivative product” and, subject to our comment in paragraph 4.4, the proposed exclusion of exchange-traded products, spot contracts and products with embedded derivatives as set out in section 1B(2) of Part 1 of Schedule 1 to the Bill, which we believe recognises the nature of OTC derivatives transactions and existing regulatory structures.
- 4.2 However, as noted in our response to the First Consultation Paper, we are concerned about the complexity of the definition. While referring to an existing concept (“structured product”) in the SFO is convenient from a drafting perspective, conceptually, an OTC derivative product is not really a structured product. Structured products are financial instruments that use or rely on derivatives. The detailed proposed exclusions recognise this.
- 4.3 We therefore suggest that the definition be reconsidered: for example, by adopting an approach similar to that used in the Banking (Capital) Rules (Cap. 155L), which define more precisely “derivative contract”, “forward contract”, “option contract” and “swap contract”. This would reflect the approach taken in certain other jurisdictions, such as Singapore.<sup>3</sup>
- 4.4 However, if the existing approach is retained, we ask that the subsidiary legislation make these concepts clear.
- 4.5 We also ask that appropriate stock markets, futures markets and clearing houses are prescribed under section 392A as closely as possible with the enactment of the Bill, for the purposes of the exemption in paragraph (2)(c) of the definition. We understand from the Conclusions Paper that this category is intended to cover appropriate overseas exchanges.<sup>4</sup>

## **D Mandatory clearing obligation**

### **5 Resolving conflicting clearing obligations**

- 5.1 Ensuring that the OTC derivatives regime in Hong Kong applies without conflict with international obligations is key to the success of the new regime and upholding Hong Kong’s position as an international financial centre. The importance of resolving conflicts was discussed by the Financial Stability Board (“FSB”), in its recent report on OTC Derivatives Market Reforms:

<sup>3</sup> See section 3(h), Securities and Futures (Amendment) Bill.

<sup>4</sup> Paragraph 83(1), Conclusions Paper.

*“The large share of cross-border activity in many OTC derivatives markets means that clarity in how jurisdictions’ regulatory regimes interact is crucial for all stakeholders... The FSB continues to urge authorities to resolve regulatory conflicts, inconsistencies, duplication and gaps in order to provide certainty to stakeholders.”<sup>5</sup>*

5.2 The clearing obligation, as it is currently set out in the Bill,<sup>6</sup> does not specifically provide for a mechanism that resolves conflicts caused by overlapping clearing obligations imposed by overseas regulators.

5.3 We note that the rule-making powers do allow for the clearing rules to specify:

*“the circumstances in which the a specified OTC derivative transaction that is cleared otherwise than with a designated CCP is treated, for the purposes of the clearing obligation, as having been cleared with a designated CCP.”<sup>7</sup>*

5.4 We suggest that the drafting of this particular rule-making power be adjusted so that it is mandatory for the SFC to specify the circumstances in which overlapping clearing obligations will be treated as having been cleared with a designated CCP.

5.5 As expressed in our response to the Conclusions Paper, the reason this is essential is that an OTC derivatives transaction can only be centrally cleared once. This is because clearing involves the novation of the rights and obligations on each side of the transaction to a single CCP. This means, for example, that if a Hong Kong bank enters into a trade with a Singapore counterparty and each has a clearing obligation in its own jurisdiction, one of those entities will be in breach of its local laws - unless there is a mechanism to decide where the transaction can be cleared.

5.6 The ability of overseas CCPs to be designated in Hong Kong, alleviates, but does not resolve this difficulty because not all overseas CCPs will seek designation in Hong Kong.

## **E Mandatory reporting obligation**

### **6 Breach of confidentiality obligations**

We ask that section 101B include an express exemption from compliance with the reporting obligation where a transaction cannot be reported due to conflicting legal obligations under overseas laws. This was exemption was noted in the Conclusions Paper<sup>8</sup> and we suggest it should appear in the Bill, not in subsidiary legislation.

### **7 Resolving multiple reporting obligations**

7.1 As the Bills Committee is aware, in order to meet expectations of the FSB, HKMA has implemented interim reporting obligations applying to licensed banks in Hong Kong. While these obligations are set to apply until the Bill takes effect, HKAB members are keen to see that the Bill takes account of the FSB’s recommendations in relation to conflicts.

7.2 HKAB would welcome amendments to the Bill so that transactions are not the subject of multi-jurisdictional reporting obligations.

### **8 Global trade repositories**

8.1 As currently drafted, the reporting obligation requires reports to be made solely to the Monetary Authority. HKAB suggests the Bill should contemplate other repositories.

<sup>5</sup> Financial Services Board, “OTC Derivatives Market Reform, Sixth Progress Report on Implementation”, 2 September 2013, page 2.

<sup>6</sup> Section 101C of the Bill.

<sup>7</sup> Section 101L(6)(c) of the Bill.

<sup>8</sup> Paragraph 39(2), Conclusions Paper.

- 8.2 Helpfully, section 101K(8) permits the enactment of rules that allow reporting through third parties. The Background Brief also suggests that the reporting obligation may be fulfilled through an agent and the conclusions to the First Consultation Paper noted that:

*“market players [may be able] to appoint a third party for the purposes of the reporting obligations...[which] means they can, for example, report transactions via a global [trade repository].”<sup>9</sup>*

- 8.3 HKAB welcomes the in-principle ability to use third parties to assist in reporting, but we believe that global trade repositories should have a different status than any other third party that market players may use to assist them with reporting.
- 8.4 Specifically, the use of a global trade repository (that meets whatever reasonable criteria necessary) should be recognised as a distinct reporting channel, rather than being treated as a regular agent or as an outsourced function for which each individual AI must seek approval under the HKMA’s Supervisory Policy Manual.
- 8.5 We therefore ask that greater flexibility be added to the language in section 101B (and related provisions) of the Bill to contemplate the possibility of reporting to another appropriate repository as the primary reporting venue.

## **F Mandatory trading obligation**

### **9 Removal of trading obligation**

- 9.1 Given that the trading obligation in the Bill is not proposed to be implemented at this stage we ask that this obligation in section 101D of the Bill and related references be removed.
- 9.2 We note that this would reflect the approach taken in Singapore. In that jurisdiction, mandatory trading of OTC derivatives is not being pursued and there are no references to it in the Securities and Futures (Amendment) Act 2012, which was passed by the Singapore Parliament on 15 November 2012.

## **G Other issues relating to mandatory reporting, clearing and trading**

### **10 Penalties for non-compliance**

- 10.1 We suggest that an *ad valorem* penalty of:

*“3 times the amount of the profit gained, or loss avoided, by the person as a result of the contravention”*

should be removed as a potential penalty as, in the context of reporting, clearing and trading obligations, it would be very difficult to quantify any such profit or loss in this context. We suggest that other available penalties under the Bill provide real incentives for compliance and the removal of an *ad valorem* penalty would not detract from this.

### **11 Definition of “subsidiary”**

- 11.1 HKAB asks that Division 1 of Part IIIA include a specific definition of “subsidiary” for the purposes of the reporting, clearing and trading<sup>10</sup> obligations contained in Division 2 of that Part.
- 11.2 At this stage, “subsidiary” is broadly defined in section 1, Part I of Schedule 1 to the SFO and extends to a corporation’s indirect subsidiaries. That is, it includes:

*“a subsidiary of a corporation which is the other corporation’s subsidiary”<sup>11</sup>*

<sup>9</sup> Paragraph 103, Conclusions Paper.

<sup>10</sup> However, please refer to paragraph 9, in which we strongly advocate for the removal of the trading obligation from the Bill.

- 11.3 We understand that as a practical matter, this definition solely applies to the umbrella terms of the Bill and that the Monetary Authority has an express power to define its scope.<sup>12</sup> We express our support for this power to be relied upon and we ask that “subsidiary” be amended in such a way that it excludes paragraph (1)(b) of the definition of “subsidiary” in Part 1 of Schedule 1 to the SFO.

## **12 “Ensuring” compliance**

- 12.1 HKAB requests that the proposed obligation of an AI to “ensure” that its subsidiaries comply with the mandatory reporting, clearing and trading requirements in Division 2 of Part IIIA be adjusted to refer to an obligation to “take all reasonable steps” to ensure compliance.

We suggest that this more accurately reflects the AI’s role in its subsidiaries’ compliance. On its own, the word “ensure” suggests that the AI must guarantee the result, not only the aspects that are within its reasonable power and control. The subsidiary itself may be unable to comply for a variety of reasons, including local legal restrictions to which its operations are subject (as to which, see the following paragraph 13).

## **13 Legal restrictions on subsidiaries’ compliance**

- 13.1 We ask that Division 2 of Part IIIA provide an express exemption from mandatory reporting, clearing and trading in circumstances where the law of the jurisdiction in which a subsidiary of an AI carries on business:

- (a) does not permit compliance; or
- (b) makes it impracticable to comply,

with those requirements.

- 13.2 We suggest this protection is essential to avoid placing both the AI and the relevant subsidiary in conflict with relevant offshore restrictions. The reference to “impracticable” (or similar) is necessary to include not only formal laws, but also applicable regulatory restrictions and systemic considerations.

- 13.3 In this respect, we refer the Bills Committee to section 22(2) of Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615) (“AMLO”) by way of example. This provides fall-back provisions along the lines suggested paragraph 13.1.<sup>13</sup>

## **H Systemically important participants**

### **14 The need for a Hong Kong nexus**

- 14.1 In principle, HKAB understands the rationale for regulatory oversight over SIPs. However, HKAB asks that the rules relating to SIPs contain a Hong Kong nexus requirement - currently there are no parameters on the nature of the persons who may be caught by the obligations under section 101O of the Bill. HKAB also accepts there are differing views as to what should be the relevant nexus to Hong Kong (including, for example, whether a large Hong Kong dollar-denominated transaction has a relevant nexus).

- 14.2 We ask that Division 5 of Part IIIA be amended to:

- (a) specify an appropriate Hong Kong nexus (for example, local company or business registration); or

<sup>11</sup> Section 2(1)(b), Part I, Schedule 1, SFO.

<sup>12</sup> See sections 101B(5), 101C(5) and 101D(5) of the Bill.

<sup>13</sup> However, the approach is more restrictive in that case given the international regulatory context in which it was adopted (specifically, in connection with the recommendations of the Financial Action Task Force).

- (b) if that is not possible,<sup>14</sup> explain in general the scope of persons that may be prescribed by the SFC pursuant to its rule-making powers in section 101W of the Bill.

## **15 Scope of information to be made publicly available**

- 15.1 The Bill requires the SIP register to be made available to the public, including online.<sup>15</sup> HKAB asks that the scope of information that is available to the public be limited to:

- (a) the name of the SIP;
- (b) the specified class to which that person's registration as a SIP relates; and
- (c) the date on which the person became a SIP, in relation to each specified class.

- 15.2 We ask that section 101P(3)(b) of the Bill, which currently refers to "particulars of registration", be narrowed to reflect this scope. Our reason for this request is to limit the public disclosure of confidential or commercially-sensitive information. We believe the disclosure of any further information is unnecessary to achieve the underlying aim of allowing market participants to know if they are dealing with a SIP.

## **16 Scope of information collected**

- 16.1 HKAB is concerned about the scope of information that the SFC is authorised to collect under section 101T of the Bill. In particular, the SFC may require a registered SIP to provide information regarding:

*"the registered SIP's activities and transactions in OTC derivative products".<sup>16</sup>*

- 16.2 We accept that a registered SIP's transactions in OTC derivative products should fall within the purview of the SFC. However, we consider that reporting on "activities" is uncertain and is not necessary for the purposes of fulfilling the objectives of the Bill.
- 16.3 We therefore ask that the words "activities and" be deleted from section 101T(1)(a) and related provisions.<sup>17</sup>

# **I Regulation of AIs**

## **17 Oversight by the Monetary Authority**

HKAB welcomes the proposal that AIs will continue to be primarily regulated by the Monetary Authority in respect of the new OTC derivatives regime. Specifically, we believe that:

- (a) this is consistent with the supervision of AIs generally;
- (b) the Monetary Authority is experienced in supervising AIs and issues relating to multijurisdictional regulation (particularly, AIs incorporated overseas) and dealing with offshore home regulators; and
- (c) this approach is important in the context of the Basel III reforms, which tie into clearing and will apply only to AIs.

## **18 Licensing exemptions for AIs**

- 18.1 HKAB fully supports the proposal for AIs to be exempt from the proposed licensing requirements described in Parts 2 and 2A of Schedule 5 to the Bill.

<sup>14</sup> Although this is not our preferred option for the reasons set out in paragraph 3.

<sup>15</sup> Pursuant to sections 101P(3) and (6) of the Bill.

<sup>16</sup> Section 101T(1)(a) of the Bill.

<sup>17</sup> Such as sections 101T(2) and 101U(1) of the Bill.

## 19 Drafting of the exemptions

- 19.1 We ask the Bills Committee to adjust the drafting of the licensing exemptions for AIs.
- 19.2 Specifically, the exemptions for AIs and approved money brokers in relation to dealing and advising on, and providing clearing agency services for, OTC derivative products refer to acts that are:

*“carried out in the ordinary course of business”.*<sup>18</sup>

- 19.3 We suggest that these words are unnecessary and add uncertainty to the exemption. For example, we are not sure if this is intended to suggest that a one-off OTC derivative transaction or a new business line in certain OTC derivatives would attract licensing.
- 19.4 We also suggest that this drafting is inconsistent with other statutory exemptions available to AIs, such as in relation to licensing for leveraged foreign exchange trading,<sup>19</sup> money lending<sup>20</sup> and acting as a money service operator.<sup>21</sup>
- 19.5 HKAB recognises that the words are similar to those used by the Commodity Futures Trading Commission in the United States in respect of swaps and foreign branch transactions, but requests consideration be given to whether the words are necessary in the context of describing licensing exemptions for AIs.

## J Other comments

### 20 Regulatory secrecy requirements

- 20.1 The protection of secrecy of information provided to the SFC and Monetary Authority is paramount to the integrity of Hong Kong’s regulatory framework, its reputation as an international financial centre bound by the rule of law and the continued cooperation between regulators and those whom they regulate.

- 20.2 For this reason, HKAB is concerned about the proposal in:

- (a) section 381(2)(b) of the Bill, which adjusts the SFC’s existing power to disclosure information, as follows:

*“with a view to the institution of, or otherwise for the purposes of, any criminal proceedings, or any investigation carried out under the ~~laws of Hong Kong~~ relevant provisions or otherwise, in Hong Kong”; and*

- (b) section 381A(4)(b) of the Bill, which allows the Monetary Authority to disclose information:

*“with a view to the commencement of, or otherwise for the purposes of, an investigation carried out in Hong Kong **under a specified provision or otherwise**” (our emphasis).*

- 20.3 While we support the references to “relevant provisions” and “specified provisions”, which will ultimately be defined under the SFO by reference to certain Hong Kong laws,<sup>22</sup> we do not believe that the SFC or the Monetary Authority should be permitted to disclose information “otherwise” – that is pursuant to any other investigation, irrespective of whether or not it is carried out under the laws of Hong Kong.

- 20.4 The upshot is that information could be disclosed to any person, including an overseas regulatory authority, without sufficient protections. In this regard, we note that section 381(6)

<sup>18</sup> Sections 1(d), 2(f) and 4(b) or Part 2A of Schedule 5 to the Bill.

<sup>19</sup> See paragraph (xii) of the definition of “leveraged foreign exchange contract” in Schedule 5 to the SFO.

<sup>20</sup> See section 3 of the MLO.

<sup>21</sup> See section 25(a) of the AMLO.

<sup>22</sup> In Part 1 of Schedule 1 to the SFO (definition of “relevant provisions”) and the Bill (definition of “specified provision”).



of the SFO and the proposed 381F of the Bill already provide disclosure rights to overseas regulators, but with important conditions.

20.5 We therefore strongly recommend a revision to these provisions by either:

- (a) deleting “or otherwise” (our preference); or
- (b) reverting to the language currently used in section 381(2)(b) of the SFO, which refers to investigations “carried under the laws of Hong Kong”.

### **Next steps**

Thank you very much for the opportunity to provide feedback on the Bill.

HKAB and its members look forward to working with the Bills Committee and the SFC and Monetary Authority in relation to the development of the proposed Hong Kong OTC derivatives regulatory framework.

Please contact us if you have any queries in relation to the comments raised in this response.