

Submission from the Hong Kong Inter-Dealer Broker Association



Our reference: 1100558/RB
Your reference: CB1/BC/12/12

19 September 2013

By hand, fax (3529 2837) and email (slchan@legco.gov.hk)

Clerk to the Bills Committee
Legislative Council
Hong Kong

Attention: Chan Kam-lam (Chairman) and Angel Shek (for the Clerk)

Dear Sirs,

Re: Bills Committee on securities and Futures (Amendment) Ordinance Bill, 2013 ("Bill")

We refer to your letter of 2 August 2013 directed to the Hong Kong Interdealer Broker Association ("IDBA") seeking written submissions on the draft Bill.

We are instructed to act on behalf of the Hong Kong Inter-Dealer Broker Association (the "IDBA") in relation to your request for a response and to reply as follows.

Background

The IDBA's members are the major brokers undertaking the broking of OTC derivatives products between "dealers" who are predominately banks and AI's. The IDBA's members are licensed and regulated by the HKMA as "money brokers" under the Banking Ordinance, and in some instances also by the SFC for dealing in securities.

The IDBA and its members welcome the Bill and review process which has been put in place. As such we set out below as briefly as possible the main points the IDBA wish to raise at this stage by way of consultation and welcome the opportunity to discuss these issues with the Committee further and in more detail.

The IDBA wish to assist the Committee and the review process, and therefore wish to make the following general points by way of reply.

Mandatory Reporting and Mandatory Clearing

The IDBA agrees with and supports the need for enhanced reporting to regulators of transactions in relevant markets which may cause risk to market participants and the wider economy. This addresses, at a fundamental level the issues raised in paragraph 2 of the Legislative Council Brief (SUB 12/2/7 (2013) ("the Brief")

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"The absence of regulation and 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 wider economy."

The IDBA supports the introduction of mandatory reporting of reportable transactions to the HKMA as a Trade Repository. The IDBA also welcomes the proposal in para 38(5)(a) of Joint consultation conclusions of HKMA and SFC (July 2012) ("HKMA/SFC Conclusions") that in order to minimise duplication and the regulatory compliance burden, an Authorized Money Broker ("AMB") will be *"taken to have discharged its reporting obligation in respect of the transaction if the counterparty on whose behalf it is acting has confirmed to the ...AMB that the transaction has been reported to the TR"*

The IDBA also agrees with and supports the introduction of Mandatory Clearing under the proposed amendments in the Bill and the view that *"Central clearing through a CCP mitigates the counterparty risk exposure that players in the OTC derivatives market would otherwise face."* The IDBA are in general terms supportive of the introduction of central clearing of OTC derivatives and believe that the credit risk mitigation this will produce, in combination with the requirements for the mandatory reporting of reportable trades, addresses the fundamental concerns addressed in the above quote from the Brief. The introduction of clearing will address and mitigate much of the credit risk involved in bilateral but highly interlinked OTC derivative markets.

The IDBA welcomes the forthcoming opportunity to discuss these issues as well as future discussions on detailed terms of procedures and processes with the HKMA and SFC.

Mandatory Trading

The IDBA does not believe that there should be mandatory trading on exchanges or that legislation should be introduced relating to mandatory trading, even if the proposal is not to apply or to enforce that aspect of the Legislation initially. The IDBA agrees with the comments as to Hong Kong's position as a financial centre and these reforms in the original HKMA consultation Paper that:-

"Hence, our focus has been on developing a regime that is on a par with international standards but takes into account local market conditions and characteristics." and

"In considering how best to construct Hong Kong's OTC regime, we have kept in mind that it is not for Hong Kong to drive the reform initiatives given the relatively small size of our OTC derivatives market."

The IDBA also notes the position in the Brief that:-

"G20 Commitments

In September 2009, the Group of Twenty ("G20") Leaders committed to reforms that would require (a) the mandatory reporting of OTC derivative transactions to trade

repositories ("TRs"); (b) the mandatory clearing of standardised OTC derivative transactions through central counterparties ("CCPs"); (c) the mandatory trading of standardised OTC derivative transactions on exchanges or electronic trading platforms; and (d) the imposition of higher capital requirements in respect of OTC derivative transactions not centrally cleared. Given the global nature of the OTC derivative market, we need to ensure that our regime is in line with those of other major financial centres in order to facilitate compliance and avoid regulatory arbitrage"

However it is also noted that in its own terms in the Brief it is stated that the position of regimes in other financial centers is as follows (para 4 of the Brief):-

"International Developments

4. Market players in all major markets are gearing up for the implementation of the new regulatory requirements. In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act enacted on 21 July 2010 mandates central clearing and trade reporting of OTC derivatives. In Europe, the European Union ("EU") adopted the European Market Infrastructure Regulation, which is one of EU's key legislation for the OTC derivative reform, in July 2012, to mandate central clearing of standardised derivatives and reporting to TRs. In Japan, amendment to the Financial Instruments and Exchange Act was passed to make central clearing and trade reporting mandatory, and the relevant requirements have commenced in phases since November 2012. In Singapore, the enabling legislation on the regulation of the OTC derivative market was passed in November 2012. The Financial Stability Board ("FSB") has urged its member jurisdictions to complete the OTC reforms rapidly, accord higher priority to trade reporting and report progress to the FSB by July 2013. The FSB will report on the implementation to the G20." (Emphasis added)

The IDBA notes in para 41 of the HKMA/SFC Conclusions:-

"Mandatory trading obligation

41. As proposed in the Consultation Paper, we will not impose a mandatory trading requirement at the outset. Instead, we will first conduct further study to assess how best to implement such a requirement in Hong Kong."

In summary the IDBA's concerns are that:-

1. The legislative provisions for mandatory trading are included within the Bill.
2. There appears no clear statutory basis set out in the draft Bill for the potential deferral, or indefinite or permanent deferral of the introduction and commencement of those provisions on mandatory trading. Indeed the current section 1 of the Bill appears to suggest commencement of mandatory reporting, mandatory clearing and mandatory trading, at the same time.

3. There is no provision dealing with the criteria as to whether, when and how best to implement such.
4. The inclusion of such legislative provisions, even if deferred, render their later introduction a foregone conclusion, and add considerable momentum to the likelihood of later implementation when it is not clear at this stage:-
 - a. If in fact that is desirable
 - b. Whether that will place Hong Kong out of line with the regimes of other financial centers, to its detriment (see above quote).

In order to further explain the position and objection, the IDBA's reasons for opposing the introduction of mandatory trading of certain OTC Derivatives on exchanges are:-

- a. As outlined above, the principal concerns motivating and underlying the review of regulation relating to OTC derivatives are dealt with by the introduction of reporting and clearing. These mitigate the transparency and credit risk issues which might otherwise effect the market participants and the wider economy. In the view of the IDBA the introduction of mandatory trading of certain OTC derivatives on exchanges adds very little in terms of risk mitigation. Conversely there may be many adverse effects of taking this step.
- b. A large part of the OTC derivative market is in Non-deliverable Forwards ("NDF") and Interest Rate Swaps ("IRS"). The very nature and commercial purpose of NDF derivatives makes them unsuitable for trading on a public exchange, and certainly one which is one of Hong Kong's major financial institutions. NDF's are bilateral derivatives settled in cash, generally in US\$, but based on the notional price fluctuations of other underlying currencies. One of the primary reasons an NDF market exists and why certain currencies are the basis of such derivative transaction, is that the underlying currencies are almost invariably ones subject to currency controls and restrictions within their own jurisdiction. That is why the NDF market is an "offshore" market conducted in financial centers such as Hong Kong. It is for this reason that the trading of NDF derivatives on a public exchange and in such a public and open forum may be politically sensitivity (including with the Governments and Central Banks of the nation's issuing the relevant underlying currencies) as compared to a bilateral, private, derivative contract transaction (albeit subject to reporting and clearing).
- c. Most NDF and emerging market IRS derivatives are not currently traded on fully electronic platforms, but are intermediated, generally through a hybrid model. The number of currencies and variations and permutations in the products make these markets unsuitable to mandatory exchange based trading.
- d. An attempt to standardise such products in an attempt to achieve mandatory trading will greatly undermine the size of the market, the diversity of products available and the current market liquidity. This would be to the detriment of the

market the market participants and also to Hong Kong and the wider economy. Further the IDBA believes that an exchange traded market in such products will only operate efficiently and have liquidity if there is a sufficiently strong and highly liquid underlying market in Bonds and in Futures. The IDBA does not believe that this is currently the position in Hong Kong.

- e. Where the relevant market risk, can be effectively mitigated by other measures (mandatory reporting and clearing) the IDBA believes that additional regulation, market standardisation and intervention should generally be avoided especially where this may damage Hong Kong and its wider economy, in terms of market volume, product diversity, liquidity and also as a financial centre.

As stated above, the NDF market in particular is (because of its very nature) an offshore market which can potentially operate in any offshore financial centre.

If Hong Kong does introduce legislation on mandatory trading, which goes beyond that in other offshore financial centres its risks its position as a financial centre in those markets and therefore the wider economy of Hong Kong.

- f. The introduction of mandatory exchange based trading would be a radical and forced shift in the operation of those markets. As such this step should not be implemented and primary legislation should not put in place unless and until it is clear what tangible additional benefits would be achieved. This should involve a review the workings of mandatory reporting and mandatory clearing after a period of operation.
- g. If there are not strong and apparent reasons to introduce mandatory trading, legislation should not be enacted solely on the basis that mandatory trading may be implemented at a future stage. The IDBA believe that the introduction of legislation in that way increases the risk that mandatory trading would be implemented without a proper, objective assessment and review of the market, its effect on the market and whether it is necessary/beneficial in further mitigating market risk. The IDBA believe that reporting and clearing be introduced initially (as proposed) but that primary legislation relating to trading, only be introduced if and when appropriate. Introducing legislation prior to that and for "potential" use, increases the risk of regulation being implemented as a matter of course, and as the next stage in the process, when there is in fact no benefit or necessity for it. As stated by the HKMA and SFC (per above) "...we will first conduct further study to assess how best to implement such a requirement [for mandatory trading] in Hong Kong." No such study or assessment has been conducted.
- h. The IDBA believes that Hong Kong can effectively regulate OTC Derivative markets, mitigate the relevant risks, and implement international standards without the introduction of mandatory trading of OTC derivatives on exchanges, or taking legislative steps down that road.



We and the members of the IDBA look forward to meeting with you to further discuss the above issues and the Bill. If we can be of any further assistance to you in the meantime please let us know.

Yours faithfully

A handwritten signature in cursive script that reads "Tanner DeWitt".

Tanner De Witt

Enclosure