

立法會 *Legislative Council*

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Subcommittee on Three Pieces of Subsidiary Legislation Relating to Over-the-counter Derivative Transactions

Background brief

Purpose

This paper provides background information on the subsidiary legislation made under the Securities and Futures (Amendment) Ordinance ("Amendment Ordinance") to implement the first phase of the regulatory regime for the over-the-counter ("OTC") derivatives market in Hong Kong. It also summarizes the major views and concerns expressed by Members when related matters were discussed by the committees of the Legislative Council ("LegCo") from 2011 to 2015.

Background

2. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivatives market, and the systemic risk it poses for the wider market and economy¹. In the wake of the crisis, the Group of Twenty Leaders ("G20") committed to reforms that would require mandatory reporting, clearing and trading in relation to OTC derivatives transactions. 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.

3. In line with the G20 Leaders' commitment, the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC")

¹ The global financial crisis of late 2008 revealed structural deficiencies in the OTC derivatives market. The absence of regulation and the 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 the wider economy. The global nature of the transactions also contributed to the interconnectedness of market players thereby creating the potential of contagion risk.

issued a joint consultation paper on 17 October 2011 to invite public views on the proposed regulatory regime for the OTC derivatives market. The joint consultation conclusions paper was released in July 2012 together with a supplemental public consultation on the proposed licensing regime for the new or expanded regulated activities and the oversight on systematically important participants².

The Securities and Futures (Amendment) Bill 2013

4. The Securities and Futures (Amendment) Bill 2013, which sought to provide for a regulatory framework for OTC derivatives market, was passed at the Council meeting of 26 March 2014 and enacted as the Securities and Futures (Amendment) Ordinance 2014. The Ordinance has not yet come into operation as the details of implementation of the regulatory regime are to be prescribed in the rules (i.e. subsidiary legislation) to be made by SFC with the consent of HKMA and after consultation with the Financial Secretary. Such subsidiary legislation is subject to the negative vetting procedure of LegCo.

5. According to the Administration, the new regulatory regime will be implemented in phases starting first with mandatory reporting and related record keeping obligations together with the general framework, followed by mandatory clearing and its related record keeping obligations in a later phase. The Amendment Ordinance will commence in phases in tandem with the making of the necessary subsidiary legislation.

Consultation on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping) Rules

6. On 18 July 2014, HKMA and SFC launched a joint consultation on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping) Rules, and the consultation conclusions³ were released in November 2014 together with a further consultation on certain matters concerning mandatory reporting and related recording keeping obligations⁴. The conclusions on further consultation on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping Obligations) Rules were released in May 2015⁵.

² Systematically important participants are market participants which are not licensed or registered with either HKMA or SFC but whose positions and activities in the OTC derivatives market are so large that they may nevertheless raise concerns of potential systemic risks.

³ The consultation paper and consultation conclusions are hyperlinked in the Appendix.

⁴ In the consultation conclusions, HKMA and SFC took the opportunity to further consult on three matters – (a) reporting of valuation transaction information; (b) proposed list of jurisdictions to be designated by SFC for the purposes of the masking relief; and (c) proposed list of markets and clearing houses to be prescribed by FS for the purposes of the definition of "OTC derivatives product".

⁵ The consultation conclusions are hyperlinked in the Appendix.

Subsidiary legislation made under the Securities and Futures (Amendment) Ordinance

7. The following three pieces of subsidiary legislation were published in the Gazette on 15 May 2015 and tabled before LegCo at its sitting on 20 May 2015 –

- (a) *Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015* ("Commencement Notice")⁶ – to appoint 10 July 2015 as the date on which the provisions mainly relating to mandatory reporting and related record keeping obligations as well as the general framework of the regime will commence⁷.
- (b) *Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping Obligations) Rules* ("Reporting Rules")⁸ – to set out the details of the mandatory reporting and related record keeping obligations. The main proposals for mandatory reporting and mandatory record keeping are highlighted in paragraphs 5 to 19 of the Legislative Council Brief.
- (c) *Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice* ("Prescription Notice")⁹ – to set out the lists of prescribed stock and futures markets and clearing houses so as to exclude securities and futures contracts that are traded on these markets and cleared through these clearing houses from the scope of the term "OTC derivatives product".

8. The subsidiary legislation will come into operation on 10 July 2015.

⁶ Made by the Secretary for Financial Services and the Treasury pursuant to section 1(2) of the Amendment Ordinance.

⁷ The Commencement Notice also seeks to bring into effect from 10 July 2015 some other parts of the Amendment Ordinance (i.e. Part 3 (Amendments Relating to Protections under Part III of the Securities and Futures Ordinance), Part 5 (Amendments Relating to Disgorgement Orders for Market Misconduct Offences) and Part 6 (Consequential Amendment) of the Amendment Ordinance).

⁸ Made by SFC, with the consent of the Monetary Authority and after consultation with FS, by virtue of the new sections 101L and 101P of SFO.

⁹ Made by FS by virtue of the new section 392A of SFO.

Concerns and views expressed by Members

9. The major concerns expressed by Members during discussion on matters relating to the OTC derivatives regulatory regime at the meetings of the Panel on Financial Affairs ("FA Panel") on 3 January 2011, 2 April 2012, 4 March 2013 and 5 January 2015, and at the meetings of the Bills Committee on Securities and Futures (Amendment) Bill 2013, are summarized in the ensuing paragraphs.

General

10. Noting that the details of the regulatory regime would be set out in subsidiary legislation, Members stressed the need for the relevant rules and requirements to align with the international standards, with a view to avoiding potential conflicts with similar rules in other jurisdictions and adverse impact on the liquidity and efficiency of the OTC derivatives market in Hong Kong, as well as minimizing the risk of regulatory arbitrage and compliance cost on market participants.

11. HKMA and SFC pointed out that they were mindful of the need to strike a balance between strengthening regulation and reducing compliance burden on the industry, and would strive to facilitate a smooth implementation of the reform, including introducing appropriate transitional arrangements for the new licensing requirements. To this end, the regulators would continue to engage the local financial services industry to facilitate implementation of the new regulatory regime and minimize conflicting requirements. They would also take into account the relevant international standards, regulations and rules of other major jurisdictions.

Coverage of OTC derivatives transactions

12. Members expressed concern that if the mandatory reporting and clearing requirements initially would apply only to interest rate swaps ("IRSs") and non-deliverable forwards ("NDFs"), the volume of OTC derivatives transactions subject to regulation would be small. The Administration advised that other OTC derivatives such as equity derivatives and foreign exchange derivatives were not covered at the initial stage because it was difficult to achieve standardization, which was a prerequisite for centralized clearing. Besides, 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, the regulators would consider regulating OTC equity derivatives and some of the long-term OTC foreign exchange derivatives at a later stage.

Concerns about multiple reporting

13. Members expressed concern about multiple reporting on OTC derivatives transactions to regulators of various jurisdictions which would increase compliance costs on the industry. Members noted that some market participants suggested that besides allowing reporting to the Hong Kong Trade Repository ("HKTR") through third parties or agents, such as global TRs, HKMA should explore the feasibility of recognizing global TRs¹⁰ to mitigate the cost burden on the industry.

14. The Administration responded that it was necessary for HKMA and SFC to have effective and efficient access to OTC derivatives transaction information to ensure their effective surveillance and monitoring work. HKTR would facilitate the management of adequate amount of trade reports, instead of relying primarily on data sharing by overseas TRs or regulators. To address the concerns of reporting entities, there were linkages with major global TRs and regular dialogue with the industry so that they could readily entrust global TRs to file reports to HKMA on their behalf. To enhance efficiency of reporting entities in outsourcing their reporting obligation to agents, HKMA had been in close contact with reporting agents that were global TRs advising them the essential information and contributions required from them to support the outsourcing applications.

15. Some Members expressed concern about the compliance burden arising from mandatory reporting and clearing of OTC derivatives transactions conducted between two companies which did not involve banks or financial institutions. HKMA pointed out that the counterparties for non-financial institutions in OTC derivatives transactions in Hong Kong or overseas were mainly banks or financial institutions, and very few of such transactions were conducted between non-financial institutions. To minimize reporting burden, non-financial institutions would have to report reportable transactions to which they were counterparties only if their positions exceeded the reporting threshold. If non-financial institutions' OTC derivatives transactions involved an authorized institution ("AI"), licensed corporation ("LC")¹¹ or approved money broker (i.e. prescribed persons to which mandatory obligations would be applicable), they would be exempted from the reporting obligation. Similarly, non-financial institutions that were counterparties to a clearing eligible transaction would be required to clear such transaction through a central counterparty if the transactions of both the non-financial institutions and their counterparties had exceeded the clearing threshold.

¹⁰ If HKMA recognizes global TRs, parties required to report their OTC derivatives transactions can report to the global TRs and no longer needed to report to HKTR.

¹¹ Licensed corporations refer to corporations licensed by SFC under the Securities and Futures Ordinance (Cap. 571).

Disclosure of information by HKMA to SFC and overseas regulators and sharing of information in HKTR

16. On the sharing of information in HKTR, while Members supported the sharing of information on OTC derivative activities among market participants in a transparent and fair manner as such information was of valuable reference to the market, they were concerned about the protection of privacy of parties involved in OTC derivatives transactions, in particular HKMA might receive information on such transactions from reporting entities who were individuals. Members also sought information on the international standard and practice on the sharing of data stored in TRs among overseas regulators and TRs.

17. The Administration pointed out that HKMA would adhere to international standards whereby public disclosure of the data collected from mandatory reporting via TR would be made in summary form without showing the particulars of individual transactions, and the data would be handled with care. To comply with the reporting obligation, a reporting entity would have to become a member of the HKTR and to sign an agreement with HKMA. The HKTR explicitly required that no personal data should be reported. In compliance with the Personal Data (Privacy) Ordinance (Cap. 486), HKTR set out its policies and practices with regard to personal data to be collected from the private individual in a personal information collection statement which would be available at HKTR's website.

Exemptions and exclusions

18. Noting that AIs, AMBs and LCs which were small players and inactive in the OTC derivatives market would be exempted from the reporting transactions where they were a counterparty to (except if they had conducted transactions in Hong Kong on behalf of an affiliate), Members enquired about the definition of "small players", and raised concern that OTC derivatives transactions undertaken by small players might also give rise to systemic risks.

19. The Administration advised that an AI, AMB or LC would be considered a small player if the aggregate gross notional value of its outstanding OTC derivatives transactions did not exceed US\$30 million. Granting exemption for small players would strike a balance between ensuring regulatory oversight and smooth operation of the market, and avoiding unreasonable compliance costs on market participants if they only occasionally engaged in such transactions or the impact of the transactions was relatively insignificant. In response to a Member's request, the Administration has also provided written information¹² to explain why sovereign states were excluded from the mandatory reporting obligation.

¹² The Administration's paper is in LC Paper No. CB(1)476/14-15(02)).

Mandatory record keeping

20. Members noted that reporting entities of OTC derivatives transactions would be required to keep sufficient records to demonstrate compliance with their reporting obligations, and the proposed record retention period was five years from the date the transaction matured or was terminated. Some Members emphasized the need to minimize compliance costs on market participants, such as by simplifying the mandatory reporting process with increased use of information technology and reducing manual input. A Member enquired whether the Administration would align the record retention period with the usual requirement of seven years under other local legislation.

21. The Administration advised that when preparing the Reporting Rules, HKMA and SFC were mindful of the cost impact on the industry, and the need to strike a balance between enhancing regulation and keeping compliance costs at a reasonable level. Hong Kong was on a par with the practices among other major financial markets to require keeping of OTC derivatives transaction records for five years. Given the global nature of OTC derivatives market, it was necessary to align the record retention period with those of other major financial centres in order to facilitate compliance by market players.

Latest development

22. At the House Committee meeting on 5 June 2015, Members agreed to form a Subcommittee to study the three pieces of subsidiary legislation.

Relevant papers

23. A list of relevant papers is in the **Appendix**.

List of relevant papers

Date	Event	Paper/Minutes of meeting
3 January 2011	Meeting of the Panel on Financial Affairs ("FA Panel")	Discussion paper (LC Paper No. CB(1)763/10-11(02)) Minutes (LC Paper No. CB(1)1336/10-11)
October 2011	Consultation paper jointly issued by the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") on the proposed regulatory regime for the over-the counter ("OTC") derivatives market in Hong Kong	Consultation paper
2 April 2012	Meeting of the FA Panel	Discussion paper (LC Paper No. CB(1)1411/11-12(05)) Background brief (LC Paper No. CB(1)1410/11-12) Minutes (LC Paper No. CB(1)2028/11-12)
July 2012	Consultation conclusions jointly published by HKMA and SFC on the proposed regulatory regime for the OTC derivatives market in Hong Kong	Consultation conclusions

Date	Event	Paper/Minutes of meeting
July 2012	HKMA and SFC issued a joint supplemental consultation paper on the OTC derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systematically important players	<u>Joint supplemental consultation paper</u>
September 2013	HKMA and SFC issued joint supplemental consultation conclusions on the OTC derivatives regime in Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systematically important players	<u>Joint supplemental consultation conclusions</u>
4 March 2013	Meeting of the FA Panel	<u>Discussion paper</u> (LC Paper No. CB(1)599/12-13(03)) <u>Updated background brief</u> (LC Paper No. CB(1)599/12-13(04)) <u>Minutes</u> (LC Paper No. CB(1)1131/12-13)
28 June and 10 July 2013	Gazettal of the Securities and Futures (Amendment) Bill 2013 and introduction of the Bill into the Legislative Council ("LegCo")	<u>The Bill</u> <u>Legislative Council Brief on Securities and Futures (Amendment) Bill 2013</u> (SUB 12/2/7 (2013)) <u>Legal Service Division report on the Bill</u> (LC Paper No. LS71/12-13)

Date	Event	Paper/Minutes of meeting
July 2013 to February 2014	The Bills Committee on Securities and Futures (Amendment) Bill 2013 scrutinized the Bill	Background brief (LC Paper No. CB(1)1584/12-13(02)) Report of the Bills Committee (LC Paper No. CB(1)1112/13-14)
26 March 2014	LegCo passed the Securities and Futures (Amendment) Bill 2013 (i.e. enacted as the Securities and Futures (Amendment) Ordinance 2014 ("Amendment Ordinance"))	Hansard
July 2014	HKMA and SFC issued a joint consultation paper on the Securities and Futures (OTC Derivatives Transactions – Reporting and Record Keeping) Rules ("Reporting Rules")	Consultation paper
November 2014	HKMA and SFC issued consultation conclusions and further consultation paper on the Reporting Rules	Consultation conclusions (including the further consultation paper)
5 January 2015	Meeting of the FA Panel	Discussion paper (LC Paper No. CB(1)269/14-15(04)) Background brief (LC Paper No. CB(1)269/14-15(05)) Minutes (LC Paper No. CB(1)697/14-15) (paragraphs 9 to 24) Follow-up paper provided by the Administration (LC Paper No. CB(1)476/14-15(02))

Date	Event	Paper/Minutes of meeting
15 May 2015	HKMA and SFC issued conclusions on further consultation on the Reporting Rules	<u>Consultation conclusions</u>
20 May 2015	Introduction of the subsidiary legislation made under the Amendment Ordinance into LegCo	<u>Legislative Council Brief</u> (File Ref: SF&C/1/2/11/6C) Legal Service Division reports (<u>LC Paper No. LS66/14-15</u>) paragraphs 40 to 51) and (<u>LC Paper No. LS70/14-15</u>)