

立法會
Legislative Council

LC Paper No. CB(1)745/15-16

Ref. : CB1/SS/5/15

Paper for the House Committee meeting on 8 April 2016

**Report of the Subcommittee on Six Pieces of Subsidiary Legislation
Relating to Over-the-counter Derivative Transactions Gazetted on
5 February 2016**

Purpose

This paper reports on the deliberations of the Subcommittee on Six Pieces of Subsidiary Legislation Relating to Over-the-counter Derivative Transactions Gazetted on 5 February 2016 ("the Subcommittee").

Background

2. The global financial crisis of 2008 highlighted the structural deficiencies in the over-the-counter ("OTC") derivatives market and the systemic risk they pose for the wider market and economy. In the wake of the crisis, the Group of Twenty Leaders committed to reforms that would require, among others, mandatory reporting of OTC derivative transactions to trade repositories, mandatory clearing of standardized OTC derivative transactions through central counterparties ("CCPs"), and mandatory trading of standardized OTC derivative transactions on exchanges or electronic trading platforms.

3. The Legislative Council ("LegCo") passed the Securities and Futures (Amendment) Bill 2013 on 26 March 2014 which was gazetted as the Securities and Futures (Amendment) Ordinance 2014 ("Amendment Ordinance"). The Amendment Ordinance provides for a regulatory framework for the OTC derivatives market in Hong Kong which introduces mandatory reporting, clearing and trading obligations of OTC derivative transactions, as well as related record keeping requirements. The regulatory framework is to be implemented in stages with details to be prescribed in rules which are subsidiary legislation subject to the negative vetting procedure of LegCo.

Implementation of the first stage of the regulatory regime

4. The first stage of the OTC derivatives regulatory regime introduced mandatory reporting for certain interest rate swaps ("IRS") and non-deliverable forwards ("NDF") in Hong Kong, and related record keeping requirements ("phase 1 reporting"). Phase 1 reporting applies to authorized financial institutions ("AFIs"), approved money brokers ("AMBs"), licensed corporations ("LCs"), and CCPs that provide clearing services to persons in Hong Kong. Reporting entities need to report new transactions and backload historical transactions that are still outstanding when the reporting rules come into effect. They are also required to report any subsequent events relating to the transactions that have been reported, such as changes in the terms of the transaction, partial terminations, etc. As regards record keeping requirements, reporting entities are required to keep sufficient records to demonstrate compliance with their reporting obligation, and where applicable, to demonstrate that they are entitled to exemption or relief. The relevant records should be kept until no earlier than five years after the transaction has matured or been terminated. The first stage of the OTC derivatives regulatory regime commenced in July 2015 with the gazettal of the first batch of subsidiary legislation in May 2015.¹

Six pieces of subsidiary legislation made under the Securities and Futures Ordinance for implementing the next stage of the regulatory regime

5. To implement the next stage of the OTC derivatives regulatory regime covering mandatory clearing of dealer-to-dealer trades of certain IRS, designation of CCPs ("phase 1 clearing") as well as expanded mandatory reporting ("phase 2 reporting"), the Administration gazetted six pieces of subsidiary legislation made under the Securities and Futures Ordinance (Cap. 571) ("SFO") on 5 February 2016 which were tabled before LegCo on 17 February 2016. Details of the subsidiary legislation are set out below.

¹ The first batch of subsidiary legislation comprised:

- (a) the Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015 – to implement phase 1 reporting and the general framework of the regime;
- (b) the Securities and Futures (OTC Derivative Transactions — Reporting and Record Keeping Obligations) Rules – to implement phase 1 reporting; and
- (c) Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice – to provide for certain carve out from the scope of the term "OTC derivative product" under the Securities and Futures Ordinance (Cap. 571).

Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2016 ("Amendment Ordinance Commencement Notice")

6. The Amendment Ordinance Commencement Notice was made by the Secretary for Financial Services and the Treasury to appoint 1 September 2016 as the date on which the provisions in the Amendment Ordinance (including the new sections 101C, 101J, 101N and 101Q) relating to mandatory clearing and related record keeping obligations, as well as designation of CCPs, will commence.

Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules ("Clearing Rules")

7. The Clearing Rules were made by the Securities and Futures Commission ("SFC"), with the consent of the Monetary Authority ("MA") and after consultation with the Financial Secretary ("FS"), to set out the details of the mandatory clearing and related record keeping obligations as well as designation of CCPs (i.e. phase 1 clearing). The Clearing Rules, which will commence on 1 September 2016, prescribe the types of OTC derivative transactions subject to mandatory clearing, and the circumstances and timeframe for clearing the transactions, and the circumstances in which SFC may designate persons as CCPs under the new section 101J of SFO. The main provisions of the Clearing Rules are as follows:

- (a) Part 1 contains definitions for the interpretation of the rules and includes:
 - (i) a provision that specifies who "prescribed persons" are for the purposes of the clearing and record keeping obligations (Rule 2);
 - (ii) a provision that sets out the circumstances in which SFC may, with the consent of MA, designate any person as a "financial services provider" (Rule 3); and
 - (iii) provisions that set out the transactions that are specified OTC derivative transactions for the purposes of clearing and record keeping obligations (Rules 4 and 5).

- (b) Part 2 describes the clearing obligation and how it must be fulfilled, and it includes the following:
 - (i) a provision that specifies when the clearing obligation arises, including when a prescribed person is taken to have reached the clearing threshold or exited it (Rules 6 and 7);
 - (ii) provisions that specify the circumstances under which transactions will be exempted from the clearing obligation (Rules 8, 9 and 10); and
 - (iii) a provision that specifies the circumstances under which substituted compliance may be relied upon in relation to the compliance with the clearing obligation (Rule 11).
- (c) Part 3 (Rules 12 to 15) describes the record keeping obligation. It specifies that records must be kept to demonstrate compliance with the clearing obligation, the duration for which the records must be kept, and the manner in which they must be kept;
- (d) Part 4 (Rules 16 to 18) provides for matters relating to designation of CCPs and revocation of such designations;
- (e) Schedule 1 specifies the OTC derivative transactions that are to be subject to the clearing obligation; and
- (f) Schedule 2 specifies the calculation periods, and related clearing thresholds and prescribed days.

8. Under the Clearing Rules, mandatory clearing will apply to dealer-to-dealer transactions of certain IRS.² Mandatory clearing must be conducted through a designated CCP. Both local and overseas CCPs may apply to SFC to become designated CCPs. Pursuant to the new section 101J of SFO, any CCP seeking to become a designated CCP must either be a recognized clearing house or an authorized provider of automated trading services ("ATS-CCP"). A CCP may submit its application for ATS authorization and CCP designation together.

² The parties to the transaction must be an AFI, AMB, LC or a financial services provider and at least one party must be an AFI, AMB or LC and the AFI, AMB or LC must have outstanding OTC derivative positions that exceed certain stipulated thresholds.

Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (Commencement) Notice ("Reporting Rules Commencement Notice")

9. The Reporting Rules Commencement Notice was made by SFC to appoint 1 September 2016 as the starting date for reporting obligation for ATS-CCPs. Rule 15 of the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules ("Reporting Rules") (which commenced on 10 July 2015) provides that an ATS-CCP which is the counterparty to a specified OTC derivative transaction must report the transaction to MA if the other counterparty to the transaction is a company. Rule 15 was not commenced previously because the powers to enable SFC to confer ATS-CCP status were not yet effective. These powers will be effective when mandatory clearing is implemented on 1 September 2016. It is therefore proposed that Rule 15 be brought into effect at the same time.

Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) (Amendment) Rules 2016 ("Reporting Amendment Rules")

10. The Reporting Amendment Rules were made by SFC, with the consent of MA and after consultation with FS, to set out the details of the expanded scope of mandatory reporting and related record keeping obligations (i.e. phase 2 reporting). The Reporting Amendment Rules amend the Reporting Rules in the following manner:

- (a) amend Rule 2 to remove references to product classes and product types and other related references in the Reporting Rules and define grace period;
- (b) add a new Rule 2A and amend Schedule 1 to expand the scope of transaction information to be reported under phase 2 reporting;
- (c) amend Rule 3 to clarify that the US\$30 million criteria for the exempt person relief is to be assessed in respect of positions across all OTC derivative products collectively;
- (d) amend Rules 7 and 8 so that the reporting obligation applies to transactions in all OTC derivative products, and not only IRS and NDF;

- (e) provide for new Subrules 10(2A), 11(2A), 12(2A) and 13(2A) to clarify that the obligation to report transaction information within the expanded scope applies retrospectively to transactions reported under phase 1 reporting;
- (f) amend Rules 23 and 24, and repeal Rules 19 and 22 to provide for the removal of the concession period;
- (g) add a new Rule 25A to require the reporting of valuations on a daily basis;
- (h) add a new Rule 25B to provide modified arrangements for the reporting of transaction information within the expanded scope and the reporting of subsequent events in respect of transactions that were reported under phase 1 reporting; and
- (i) add a new Rule 33 to provide for transitional arrangements in respect of subsidiaries specified under phase 1 reporting.

11. The product scope under phase 2 reporting is expanded to cover all interest rate derivatives and foreign exchange derivatives not covered in phase 1 reporting, as well as other OTC derivative products, namely equity derivatives, credit derivatives and commodity derivatives. The scope of transaction information to be reported is also expanded to include such information as daily valuation of the transaction, information required for MA's administration of reporting transactions and information as to whether the transaction arises from portfolio compression exercise. The Reporting Amendment Rules will commence on 1 July 2017.

Securities and Futures (OTC Derivative Transactions Reporting Obligation – Fees) Rules ("TR Fees Rules")

12. The TR Fees Rules were made by the Chief Executive ("CE") in Council, after consultation with MA, to require the payment of a fee to MA for using the electronic system (i.e. the Hong Kong Trade Repository ("TR")) operated by or on behalf of MA for submitting and receiving reports on OTC derivative transactions under the regulatory regime. The fee is set at \$4.5 per transaction each month if the transaction is outstanding as at the last business day of that month. The TR Fees Rules will commence on 1 May 2016.

Securities and Futures (Fees) (Amendment) Rules 2016 ("CCP Fees Rules")

13. The CCP Fees Rules were made by CE in Council, after consultation with SFC, to provide for the application fee for CCP designation and annual fee

in respect of designated CCPs. The application fee and the annual fee for a designated CCP are both set at \$10,000. The CCP Fees Rules will commence on 1 September 2016.

The Subcommittee

14. At the House Committee meeting held on 26 February 2016, Members agreed to form a subcommittee to study the six pieces of subsidiary legislation. The membership list of the Subcommittee is in **Appendix**. Under the chairmanship of Hon Andrew LEUNG Kwan-yuen, the Subcommittee has held one meeting on 15 March 2016 to discuss with the Administration and SFC the six pieces of subsidiary legislation.

15. To allow more time for the Subcommittee to study the above subsidiary legislation, Hon Jeffrey LAM has given notice to move a resolution at the Council meeting of 16 March 2016 to extend the scrutiny period to the Council meeting of 13 April 2016. However, the agenda item on the proposed resolution was not reached when the said Council meeting was adjourned on 18 March 2016. As such, the scrutiny period for the subsidiary legislation was lapsed.

Deliberations of the Subcommittee

16. The Subcommittee does not object to the six pieces of subsidiary legislation. The major deliberations of the Subcommittee are set out in the ensuing paragraphs.

Phased implementation of the over-the-counter derivatives regulatory regime

17. Noting that the OTC derivatives regulatory regime is to be implemented in stages, members of the Subcommittee have enquired about the plans for implementing the remaining stages and the timetable.

18. Legal Adviser to the Subcommittee has pointed out that the provisions in the Amendment Ordinance which have not yet come into operation include those relating to the licensing of intermediaries for carrying out the regulated activities in relation to dealing in, advising on or providing client clearing services for OTC derivative transactions ("the OTC derivatives intermediaries licensing regime"), trading obligations imposed on prescribed persons, regulation of systemically important participants ("SIPs"), provision of trading services by ATS providers and transitional provisions. The Administration and SFC have advised that the uncommenced provisions will be implemented in

later stages in view of the complexity of the regulatory framework as well as the need to conduct relevant studies and ensure market readiness. Implementation of the OTC derivatives intermediaries licensing regime will also require the development of the relevant Financial Resources Rules ("FRRs"). SFC has completed a consultation on proposed amendments to FRRs in 2015 and is analysing the responses and finalizing the consultation conclusions. It is envisaged that the relevant licensing regime will be put in place in 2017-2018 the earliest. As regards implementation of the mandatory trading obligation and regulation of SIPs, the Administration and SFC will need time to examine OTC derivatives information collected from the market and the relevant international standards before formulating suitable proposals in Hong Kong. Having regard to the time required to work out the details and prepare the necessary subsidiary legislation, implementation of all remaining stages of the OTC derivatives regulatory regime is not expected to be completed until after 2018.

Exit arrangements from the clearing obligations

19. As provided in the Clearing Rules, if the average of the outstanding positions in specified OTC derivative transactions of an AFI, AMB or LC for a three-month calculation period exceed the stipulated clearing threshold of US\$20 billion, specified transactions entered into by the AFI, AMB or LC seven months after the calculation period will be subject to mandatory clearing. Once an AFI, AMB or LC has reached the clearing threshold for any calculation period, it will always be regarded as having reached the clearing threshold (even if its relevant positions fall below the threshold for a subsequent calculation period). The Clearing Rules provides for an exit mechanism from the clearing obligation under which the obligation will cease to apply if the AFI, AMB or LC's relevant positions (as at month end) have stayed below 70% of the clearing threshold (i.e. below US\$14 billion) for a period of 12 consecutive months, and it has notified MA or SFC (as applicable) of the situation.

20. Members of the Subcommittee are concerned that an AFI, AMB or LC may circumvent the clearing obligation or abuse the exit mechanism by deliberately keeping its positions of OTC derivative transactions below the relevant threshold at month end. The Administration has explained that as OTC derivative transactions were entered into between the AFI, AMB or LC with its counterparties, it will be necessary for the entity to seek co-operation from its counterparties in order to change its positions in OTC derivative transactions. Hence, it would be extremely difficult if not impossible for the AFI, AMB or LC to succeed in manipulating its month-end positions in OTC derivative transactions.

Deferred commencement of phase 2 reporting

21. The Subcommittee has enquired about the reasons for setting the commencement date of the Reporting Amendment Rules on 1 July 2017. The Administration has explained that, under phase 1 reporting, a one-off six-month "concession period" was built in to allow market participants sufficient time to set up or enhance their systems and systems connection for reporting transaction information to MA. During the consultation on proposals for phase 2 reporting, market participants have reiterated the need for sufficient time to make system arrangements for the new requirements. To simplify the rules for phase 2 reporting, the Reporting Amendment Rules remove the six-month concession period and simply defer the commencement date of the rules to 1 July 2017. Given a lead time of over 12 months from the expected enactment of the Reporting Amendment Rules to their commencement, it is envisaged that market participants should have enough time to make preparations for the new requirements.

Fees for reporting to the Trade Repository and for designation as central counterparties

22. The Subcommittee has sought details on how the proposed TR fees and CCP fees have been worked out.

23. In respect of the TR fees, the Hong Kong Monetary Authority has pointed out that according to its estimation, the annual recurring costs of operating TR would amount to about \$32 million and that approximately 600 000 transactions will have to be maintained daily after the full implementation of mandatory reporting obligation. The proposed fee of \$4.5 per transaction aims to achieve full recovery of the recurring costs. The Authority will review the fees periodically and propose any necessary adjustment in the future taking into account changes in market conditions.

24. As regards the CCP fees, SFC has responded that it will incur costs for processing applications of designated CCPs and regulation of designated CCPs. The proposed fee of \$10,000 each for the application of CCP designation and the annual renewal of designation have been set with reference to the same fee levels currently prescribed for ATS authorization and authorized ATS providers, which are the most comparable operations under SFO. Given that the proposed fees are relatively low, they will not cover SFC's relevant costs on a full cost recovery basis.

Advice sought

25. The Subcommittee did not propose any amendment to the six pieces of subsidiary legislation, neither did the Administration move any amendment to them.

26. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
6 April 2016

**Subcommittee on Six Pieces of Subsidiary Legislation Relating to
Over-the-counter Derivative Transactions Gazetted on 5 February 2016**

Membership list

Chairman	Hon Andrew LEUNG Kwan-yuen, GBS, JP
Members	Hon Jeffrey LAM Kin-fung, GBS, JP Hon Christopher CHEUNG Wah-fung, SBS, JP Hon SIN Chung-kai, SBS, JP
	(Total : 4 members)
Clerk	Ms Connie SZETO
Legal Adviser	Ms Vanessa CHENG