

**For discussion on
2 November 2015**

Legislative Council Panel on Financial Affairs

**Phase 1 Clearing and Phase 2 Reporting under
the Over-the-counter Derivatives Regulatory Regime in Hong Kong**

PURPOSE

This paper briefs Members on the next phase of implementation of the over-the-counter (“OTC”) derivatives regulatory regime in Hong Kong.

BACKGROUND

2. The Legislative Council (“LegCo”) enacted the Securities and Futures (Amendment) Ordinance 2014 (“Amendment Ordinance”) on 26 March 2014 which provides for a regulatory framework for the OTC derivatives market in Hong Kong to meet the relevant commitments of the Group of Twenty. Among other things, the framework introduces mandatory obligations that require the reporting, clearing and trading of OTC derivative transactions, and a record keeping obligation to supplement each of the abovementioned obligations. It is envisaged that the precise ambit of these obligations, and their related details, will be set out in subsidiary legislation (i.e. rules) which will be implemented in phases.

3. The first phase was implemented on 10 July 2015 when the first batch of subsidiary legislation came into effect. This introduced mandatory reporting for certain interest rate swaps (“IRS”) and non-deliverable forwards (“NDF”) in Hong Kong (“phase 1 reporting”).

4. The next goal is to introduce mandatory clearing (“phase 1 clearing”) and to expand the existing mandatory reporting obligation (“phase 2 reporting”). The relevant proposals are summarised in the paragraphs below.

MAIN PROPOSALS FOR PHASE 1 CLEARING

5. Under the new section 101C of the Securities and Futures Ordinance (Cap. 571) (“SFO”), transactions that are subject to mandatory clearing must be cleared through a designated central counterparty (“CCP”). As to which transactions will be subject to clearing, in what circumstances, and within what timeframe, we propose as follows.

Transactions to be subject to mandatory clearing

6. In considering which products should be covered under phase 1 clearing, we have taken into account the following –

- (a) whether the product is standardized enough;
- (b) whether there are acceptable pricing sources for the product;
- (c) the nature, depth and liquidity of the market for the product;
- (d) the level of systemic risk posed by the product;
- (e) the market impact of subjecting the product to central clearing;
- (f) whether the product is subject to mandatory clearing in other jurisdictions; and
- (g) whether any Hong Kong-authorized CCP provides services for clearing the product.

7. Having considered the above, we propose to require clearing for plain vanilla IRS that contain the features set out in the table at **Annex**.

8. Most major jurisdictions have mandated, or proposed to mandate, the clearing of IRS denominated in any of the G4 currencies (i.e. USD, EUR, GBP and JPY). We therefore consider it necessary to do likewise to prevent regulatory arbitrage. Additionally, we also propose to mandate clearing for HKD IRS because HKD is a systemically important currency for Hong Kong. As regards the other features described at **Annex**, our proposals are within the scope of those of the major jurisdictions.

Only dealer-to-dealer transactions to be covered in phase 1 clearing

9. We propose to only cover transactions between major dealers in phase 1 clearing. Major dealers are the most active participants in the OTC derivatives market. They also often trade among themselves, thus increasing their interconnectedness. Their transactions therefore potentially pose the greatest systemic risk.

10. Major dealers with a presence in Hong Kong are likely to be authorized institutions (“AIs”), approved money brokers (“AMBs”) or licensed corporations (“LCs”). Major dealers outside Hong Kong are likely to be similarly regulated in their home jurisdictions. Additionally, major dealers are likely to hold substantial outstanding positions in OTC derivative transactions. For these reasons, we propose to identify dealer-to-dealer transactions as follows –

- (a) the parties to the transaction must be an AI, AMB, LC or the overseas equivalent of an AI or LC, and at least one party must be an AI, AMB or LC; and
- (b) both parties to the transaction must have outstanding OTC derivative positions that exceed certain stipulated thresholds (“clearing thresholds”).

Clearing thresholds

11. We propose to have multiple thresholds (please refer to the next paragraph), each set by reference to a three-month calculation period, applicable to different categories of dealers. To determine if a person has crossed the threshold for a particular calculation period, its average positions during that period will be compared to the threshold stipulated for that calculation period. If the threshold is crossed, transactions (of the kind described at **Annex**) entered into seven months after the calculation period may be subject to mandatory clearing. The seven-month gap is to allow sufficient time for market participants to calculate and ascertain whether they have crossed the threshold, and if so, set up the necessary systems connection, and complete the documentation and on-boarding exercise, for accessing clearing facilities.

12. We propose the following clearing thresholds for phase 1 clearing.

Threshold for local AIs, AMBs or LCs	Threshold for overseas AIs, AMBs or LCs		Threshold for overseas equivalent of an AI or LC
	Positions booked in HK	Global positions	
US\$20 billion	US\$20 billion	US\$1 trillion	US\$1 trillion

Information collected from a recent survey conducted by the Monetary Authority (“MA”) of a group of 54 AIs in Hong Kong indicates that the lower threshold of US\$20 billion will capture institutions that accounted for approximately 96% of the positions of the surveyed institutions. As for the higher threshold of US\$1 trillion, this has been set by reference to publicly available information on the level of OTC derivative positions held by major global dealers. We believe that this level should bring most major global dealers within our mandatory clearing regime.

Timeframe for complying with the clearing obligation

13. We propose that a transaction which is subject to mandatory clearing must be cleared within one Hong Kong business day after the transaction is entered into. The one day lag should give market participants enough time to resolve any outstanding issues relating to the acceptance of the transaction for clearing. It should also provide some time allowance for persons clearing their transactions through a designated CCP located in a different time zone while ensuring timely mandatory clearing.

Proposed exemptions

14. We propose two exemptions to the mandatory clearing obligation – an intra-group exemption, and a jurisdiction-based exemption.

15. The intra-group exemption is intended to reduce the compliance burden by exempting transactions between affiliates within the same group. Such transactions pose limited risk, particularly where the risk management of the group is centralized. Regulators in other jurisdictions have also provided for similar exemptions. The proposed pre-requisites for this exemption are that –

- (a) the accounts of the two affiliates are consolidated in full by the holding company and the consolidated financial statements are prepared in accordance with certain recognized financial reporting standards;
- (b) the risk positions of the affiliates are centrally overseen and managed within the group; and
- (c) the identity of the affiliates have been notified in advance to the MA or the Securities and Futures Commission (“SFC”).

16. The jurisdiction-based exemption mainly aims to address concerns about conflicting obligations that may apply to market participants operating in closed markets where transactions may have to be cleared by a CCP located in that market but which is not a designated CCP under our regime. Basically, we propose that transactions booked by a person in one or more pre-identified overseas jurisdictions may be exempted from the clearing obligation if –

- (a) the person has notified the MA or SFC which jurisdictions it wishes to treat as “exempt jurisdictions”; and
- (b) the notional amount of the person’s OTC derivative positions booked in such exempt jurisdiction(s) must not exceed a certain portion of the person’s total OTC derivative portfolio (wherever booked), namely not more than 5% in respect of *each* exempt jurisdiction, and not more than 10% in respect of *all* exempt jurisdictions collectively.

Further relief proposed

17. We also propose to allow “substituted compliance” so that for a transaction that is subject to mandatory clearing under our regime *and* subject to mandatory clearing under the laws of a comparable overseas jurisdiction, the counterparties may opt to clear in accordance with our requirements or the requirements of the overseas jurisdiction. In either case, however, the transaction must be cleared through a designated CCP.

18. In allowing substituted compliance, we propose to adopt a “stricter rule” approach to avoid importing overseas exemption which may not be relevant for Hong Kong. If a transaction is subject to mandatory clearing under our regime but exempt from mandatory clearing under the laws of a comparable overseas jurisdiction, the counterparties must still clear in accordance with our requirements (as they are the stricter ones).

Designation and regulation of CCPs

19. We propose that both local and overseas CCPs may apply to be designated CCPs for the purposes of the mandatory clearing obligation. Pursuant to the new section 101J of the SFO, any CCP seeking to become designated CCPs must either be a recognized clearing house or an authorized automated trading services (“ATS”) provider. In the case of the latter, we propose that a CCP may submit its application for ATS authorization and CCP designation together.

MAIN PROPOSALS FOR PHASE 2 MANDATORY REPORTING

20. Our key proposals for phase 2 mandatory reporting are set out in the following paragraphs. They are largely in line with requirements introduced in other major jurisdictions.

Proposal to expand product scope

21. Currently, we only require the reporting of transactions in certain IRS and NDF. We propose that phase 2 reporting should require the reporting of transactions in *all* OTC derivative products, i.e. to add to the product scope all interest rate derivatives and foreign exchange derivatives not covered in phase 1, as well as all other OTC derivative products, such as equity derivatives, credit derivatives, commodity derivatives, etc. Most major jurisdictions (including the US, EU, and Australia) have already implemented mandatory reporting for substantively all OTC derivative products.

Proposal to expand scope of transaction information to be reported under phase 2

22. The mandatory reporting obligation requires the reporting of certain specific information and particulars relating to a transaction (“transaction information”). Under phase 2 reporting, we propose to

expand the scope of transaction information to be reported. The proposed expansion is necessary given the proposal to expand the product scope to cover all OTC derivative products, and taking into account reporting requirements imposed in other major markets. The wider scope will also better ensure the efficacy of data collected by the MA.

Impact on reliefs

23. We propose that reliefs under phase 1 reporting should generally apply under phase 2 reporting as well. However, two reliefs will operate differently under phase 2 as discussed below.

- (a) There is currently an “exempt person” relief under phase 1 reporting. This exempts small or inactive participants from our reporting regime. One criterion for this relief is that the person’s OTC derivative positions must be below US\$30 million. The existing regime sets this limit on a per product class basis, i.e. a person’s positions in *each* product class must not exceed US\$30 million. As the mandatory reporting obligation will be expanded to cover all OTC derivative products, the “exempt person” relief will need to be extended likewise to cover the whole spectrum of OTC derivative products. However, it may be confusing and administratively burdensome to market participants if this relief were to continue to apply on a product class basis.¹ We therefore propose that, under phase 2 reporting, the US\$30 million limit will apply across *all* product classes collectively, i.e. their positions in *all* product classes *collectively* must not exceed US\$30 million.
- (b) One of the two “masking reliefs”² available under phase 1 reporting is in respect of transactions that require counterparty consent, and this relief will not be extended further since this has always been intended as a short

¹ In particular, market participants would have to: (a) calculate their aggregate notional outstanding amount for each product class regularly; and (b) keep track of the product class(es) in respect of which they can or cannot enjoy the “exempt person” relief.

² Under rule 26 of the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (Cap. 571AL) (“Reporting Rules”), a prescribed person may submit counterparty masking particulars instead of counterparty identifying particulars for a transaction if: (a) the submission of the counterparty identifying particulars is prohibited under the laws of, or by an authority or regulatory organization in, a jurisdiction designated by the SFC with the consent of the MA; *or* (b) the transaction is entered into before 9 January 2016 and the person has been unable to obtain consent from the counterparty despite reasonable efforts.

term one-off relief which expires on 9 January 2016.³ However, masking relief based on legal or regulatory barriers will still be available for counterparties in a designated overseas jurisdiction.

Proposal to defer commencement of phase 2 reporting

24. Under phase 1 reporting, a one-off six-month “concession period” is built in to allow market participants sufficient time to set up or enhance their systems and systems connection for reporting transaction information to the MA.

25. Under phase 2 reporting, we propose to simplify the rules where possible. To this end, we propose to eliminate the six-month concession period and instead simply defer commencement of phase 2 reporting by six months (from the day the relevant rule amendments are enacted). This will ensure that market participants still have enough time to set up or enhance their systems and system connection.

SUBSIDIARY LEGISLATION

26. The OTC subsidiary legislation to be tabled before LegCo will comprise a commencement notice to commence the relevant provisions of the Amendment Ordinance required for mandatory clearing and related matters; the clearing rules to set out the details of the mandatory clearing and related record keeping obligations and the requirements for CCP designation; amendments to the Reporting Rules to expand the scope of the mandatory reporting and related record keeping obligations to cover all OTC derivative transactions; amendments to the Securities and Futures (Fees) Rules (Cap. 571AF) to provide for the application fee for CCP designation and annual fees in respect of designated CCPs⁴; and fee rules to require the payment of a fee to the MA for using the electronic

³ This means that for transactions entered into after 9 January 2016, a person reporting transaction information cannot mask its counterparty identifying information on the basis that it cannot obtain the required counterparty consent despite reasonable efforts.

⁴ We propose to set two fees in respect of CCP designation and designated CCPs - an application fee of HK\$10,000, and an annual fee of HK\$10,000 so long as the CCP remains designated. The proposed fee levels are the same as those in respect of ATS authorization and authorized ATS providers, the most comparable operations under the SFO.

system operated by or on behalf of the MA for submitting reports on OTC derivative transactions under the regulatory regime⁵.

LEGISLATIVE TIMETABLE

27. The MA and SFC launched a joint public consultation on the proposals for implementing phase 1 clearing and phase 2 reporting on 30 September 2015. They aim to issue their consultation conclusions on the same in early 2016, and finalize the relevant subsidiary legislation in time for them to be tabled before LegCo for negative vetting in the first quarter of 2016.

ADVICE SOUGHT

28. Members are invited to note the proposals for implementing phase 1 clearing and phase 2 reporting as set out in this paper.

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
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⁵ The electronic reporting system, the Hong Kong Trade Repository, is a new piece of financial infrastructure developed by the MA to support the implementation of the mandatory reporting obligation. To achieve a full recovery of the recurring costs, we propose a monthly fee of HK\$4.5 per transaction reported to the MA that is still outstanding on the last business day of the month, subject to a proposed cap of HK\$1 million per reporting entity per annum.

Transactions to be subject to mandatory clearing

	IRS that are fixed-to-floating swaps and basis swaps				
Currency	HKD	USD	EUR	GBP	JPY
Floating rate index	HIBOR	LIBOR	EURIBOR	LIBOR	LIBOR
Tenor	28 days to ten years				
Constant notional	Yes				
Optionality	No optionality that might affect the amount, timing or form of payments made under the IRS.				

	IRS that are overnight index swaps		
Currency	USD	EUR	GBP
Floating rate index	Federal funds	Euro Overnight Index Average	Sterling Overnight Interbank Average
Tenor	Seven days to two years		
Constant notional	Yes		
Optionality	No optionality that might affect the amount, timing or form of payments made under the IRS.		