

香港特別行政區政府
財經事務及庫務局
財經事務科
香港添馬添美道二號
政府總部二十四樓



FINANCIAL SERVICES BRANCH
FINANCIAL SERVICES AND
THE TREASURY BUREAU
GOVERNMENT OF THE HONG KONG
SPECIAL ADMINISTRATIVE REGION
24TH FLOOR
CENTRAL GOVERNMENT OFFICES
2 TIM MEI AVENUE
TAMAR
HONG KONG

電話 TEL.: 2810 2056

圖文傳真 FAX.: 2529 2075

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Ms Connie Szeto
Clerk to Panel on Financial Affairs
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

Dear Ms Szeto,

Panel on Financial Affairs

**Information Paper on the Prescription of Additional Markets and Clearing
Houses and Prescription of Delta One Warrants under the
Over-the-counter Derivatives Regulatory Regime in Hong Kong**

We enclose an information paper on the proposed adjustments to the scope of the term “OTC derivative product” under the over-the-counter derivatives regulatory regime in the Securities and Futures Ordinance for Panel members’ information.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'Ada Chan', written in a cursive style.

(Ms Ada Chan)

for Secretary for Financial Services and the Treasury

cc Securities and Futures Commission
cc Hong Kong Monetary Authority

(Attn: Mr Paul Yeung)
(Attn: Mr Kevin Cheng)

For information

Legislative Council Panel on Financial Affairs

Prescription of Additional Markets and Clearing Houses and Prescription of Delta One Warrants under the Over-the-counter Derivatives Regulatory Regime in Hong Kong

PURPOSE

This paper briefs Members on two proposed adjustments to the scope of the term “OTC derivative product” under the over-the-counter (“OTC”) derivatives regulatory regime in the Securities and Futures Ordinance (“SFO”). The adjustments involve the prescription of additional markets and clearing houses under section 392A(a) of the SFO and exclusion of Delta One Warrants from the term “OTC derivative products”.

BACKGROUND

2. The Legislative Council enacted the Securities and Futures (Amendment) Ordinance 2014 to provide 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. In line with other markets, the mandatory obligations are being implemented in phases. The first and second phases of mandatory reporting came into force on 10 July 2015 and 1 July 2017 respectively, and the first phase of mandatory clearing came into force on 1 September 2016.¹

3. In March 2017, market participants approached the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures

¹ The first phase of mandatory reporting covered transactions in certain interest rate swaps and non-deliverable forwards. The second phase of mandatory reporting has expanded the scope to cover all OTC derivative transactions in the five key asset classes (namely, interest rate, foreign exchange, equity, credit and commodity). The first phase of mandatory clearing covers transactions in certain interest rate derivatives between major dealers.

Commission (“SFC”) via an industry association² to request two adjustments to the scope of the term “OTC derivative product” under the SFO. They indicated that the adjustments were necessary to carve out certain products which were not typically regarded as OTC derivatives, and should therefore fall outside the OTC derivatives regulatory regime.

PROPOSALS

4. After public consultation, the HKMA and the SFC propose to prescribe the following adjustments to the scope of the term “OTC derivative product” under the SFO –

- (a) to prescribe additional markets and clearing houses under section 392A(a) of the SFO so as to exclude products traded on these markets and cleared through these clearing houses from the term “OTC derivative products”; and
- (b) to exclude Delta One Warrants³ from the term “OTC derivative products” pursuant to section 392(1)(b)(vii) of the SFO.

Prescription of additional markets and clearing houses

5. The OTC derivatives regulatory regime is not intended to encompass products that are traded on an exchange and cleared through a clearing house. Such exchange-traded products are already subject to adequate safeguards and protection. In the case of products traded on and cleared through exchanges and clearing houses in other jurisdictions, the exclusion only applies if the market on which they are traded and the clearing house through which they are cleared are prescribed under section 392A(a) of the SFO. The existing lists of stock markets, futures markets and clearing houses are prescribed in the Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice (Cap. 571AM).

² The request was made by the International Swaps and Derivatives Association, Inc. in a letter sent to the HKMA and the SFC on 31 March 2017 after consulting its members in the Asia Pacific region.

³ Delta One Warrants are warrants which give the holder the right to purchase the underlying asset(s) with a strike price set at zero or very close to zero. They are intended to enable holders to be exposed to the risk and return of the underlying asset(s), in particular, in closed or difficult-to-access markets, without actually investing directly in the underlying asset(s).

6. The HKMA and the SFC consider that markets and clearing houses for exchange-traded products should only be prescribed under section 392A(a) of the SFO if they meet all of the following criteria –

- (a) they operate in jurisdictions whose securities or futures regulator is a member of the International Organization of Securities Commissions;
- (b) they are regulated in their home jurisdictions by the relevant market regulator, banking regulator or government agency in that jurisdiction; and
- (c) their regulatory status is comparable to that of a recognized exchange company or a recognized clearing house (as the case may be) under the SFO. In the case of a market operator that operates several types of markets, only those markets that are traditional exchanges with a fairly established history should be prescribed.

7. The above criteria are intended to ensure that section 392A(a) is only used to exclude products that are – (a) genuinely exchange-traded rather than OTC in nature; and (b) traded on and cleared through adequately regulated exchanges and clearing houses.

8. Taking into account market feedback as well as the three criteria set out in paragraph 6 above, the HKMA and the SFC propose to prescribe additional markets and clearing houses as set out at **Annex**.

Prescription of Delta One Warrants

9. Section 392(1) of the SFO empowers the Financial Secretary to prescribe products so that they are specifically included in or excluded from the definition of “OTC derivative product”. This provides a degree of flexibility to refine the ambit of “OTC derivative product” over time as appropriate, and consequently adjust the scope of the OTC derivatives regulatory regime accordingly.

10. Market participants have requested that Delta One Warrants be specifically excluded from the definition of “OTC derivative product”. The rationale is that Delta One Warrants do not embody features commonly associated with OTC derivatives and therefore do not pose systemic risk in the way that other OTC derivative products might. In particular –

- (a) a Delta One Warrant has a simpler counterparty risk than most OTC derivatives. The warrant issuer is not exposed to the credit risk of the warrant holder since the latter has already paid the warrant price in full and will be under no further obligation to the issuer;
- (b) the strike price of a Delta One Warrant (i.e. the purchase price for the underlying asset(s) which the warrant holder must pay when exercising the warrant) is set at zero or close to zero. This means that the holder of the Delta One Warrant has effectively paid for the warrant's underlying asset(s) in full when acquiring the warrant. The warrant issuer therefore does not provide any leverage to the warrant holder. In contrast, most OTC derivatives typically involve some leveraged exposure; and
- (c) investing in a Delta One Warrant is very similar in risks and returns to investing in the warrant's underlying asset(s), except that – (i) there is no need to be concerned about the clearing and settlement of the underlying asset(s); and (ii) the holder of the warrant does not have the same rights as the holder of the underlying asset(s) in so far as it is not the legal owner of the underlying asset(s) (e.g. where the underlying asset(s) are shares in a company, a warrant holder is not entitled to vote in the shareholders' meetings).

11. Retaining Delta One Warrants within the ambit of “OTC derivative product” may unnecessarily hinder market development and create undue compliance burden. Consequently, it is proposed that a Delta One Warrant which meets all of the following criteria be prescribed under section 392(1)(b)(vii) of the SFO, and thus excluded from the definition of “OTC derivative product” –

- (a) it gives the holder the right to purchase the underlying subject matter;
- (b) it is either cash settled or physically settled;
- (c) if it is settled in a currency other than the currency or currencies in which the underlying subject matter is denominated, it is settled at the foreign exchange rate for the currencies involved prevailing at the time of settlement;

- (d) its strike price is specified as, or in effect set at, zero or close to zero;
- (e) there are no restrictions on its transfer (other than restrictions imposed solely for the purposes of complying with applicable legal or regulatory requirements); and
- (f) it is documented in the form of a warrant.

12. These criteria aim to define and restrict the scope of Delta One Warrants so that market participants cannot bypass the OTC derivatives regulatory regime by simply labelling or describing their products as Delta One Warrants.

PUBLIC CONSULTATION

13. The HKMA and the SFC conducted a joint public consultation on the proposed adjustments in April 2017. Respondents generally supported the proposed adjustments and some provided comments on the criteria for defining Delta One Warrants. The HKMA and the SFC have taken into account the responses in finalising the above proposals.

WAY FORWARD

14. We aim to table the relevant subsidiary legislation before the Legislative Council for negative vetting in the current legislative session.

15. Members are invited to note the content of this paper.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
23 November 2017

List of Proposed Additional Stock and Futures Markets to be Prescribed under Section 392A(a) of the SFO for the Purpose of Section 1B(2)(c) of Part 1 of Schedule 1 to the SFO

- (a) For the purpose of the definition of “OTC derivative product” under the SFO, we propose that all the markets operated by the following entities be prescribed under section 392A(a) of the SFO.

	<u>Market operator</u>
1.	Hanoi Stock Exchange
2.	HoChiMinh Stock Exchange
3.	Miami International Securities Exchange, LLC
4.	Pakistan Stock Exchange
5.	Taipei Exchange*
6.	Taiwan Stock Exchange Corporation

* “Taipei Exchange” is proposed to replace the currently prescribed “GreTai Securities Market”, which is the former name of Taipei Exchange.

- (b) For the purpose of the definition of “OTC derivative product” under the SFO, we propose that only the market identified below operated by the following entity be prescribed under section 392A(a) of the SFO.

	<u>Market operator</u>	<u>Market(s) proposed to be prescribed</u>
1.	The Irish Stock Exchange plc	Main Securities Market

**List of Proposed Additional Clearing Houses to be Prescribed under
Section 392A(a) of the SFO for the Purpose of Section 1B(2)(c) of
Part 1 to Schedule 1 to the SFO**

For the purpose of the definition of “OTC derivative product” under the SFO, we propose that the following clearing houses be prescribed under section 392A(a) of the SFO.

1.	Clearstream Banking S.A.
2.	Euroclear Bank S.A./N.V.
3.	National Clearing Company of Pakistan Limited
4.	Taipei Exchange*
5.	Taiwan Stock Exchange Corporation
6.	Vietnam Securities Depository

* “Taipei Exchange” is proposed to replace the currently prescribed “GreTai Securities Market”, which is the former name of Taipei Exchange.