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# SFC Begins Consultation On Proposed Regulatory Regime For OTC Derivatives Market

## Introduction

The Securities and Futures Commission (**SFC**) and the Hong Kong Monetary Authority (**HKMA**) have published a joint consultation paper (the **Consultation Paper**) to seek comments on a proposed regulatory regime for the over-the-counter (**OTC**) derivatives market in Hong Kong. At the G20 summit of 2009, world leaders committed to implement reforms in response to the global financial crisis of 2008. This consultation is part of the regulatory authorities’ reform efforts. The stated objectives of the proposed regulatory regime are to improve transparency, reduce interconnectedness of participants and reduce systemic risk in the financial system.

The Consultation Paper can be accessed on the [SFC’s website](https://www.sfc.hk/sfcConsultation/EN/sfcConsultFileServlet?name=otcreg&type=1&docno=1) ([see archive](openFile.pdf)) or on the [HKMA’s website](http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2011/20111017e3a1.pdf) ([see archive](20111017e3a1.pdf)).

Respondents should submit their comments no later than 30 November 2011.

## Background

G20 leaders in 2009 committed to reforms to require, by the end of 2012:

* mandatory reporting of OTC derivatives transactions to trade repositories;
* mandatory clearing of standardised OTC derivatives transactions through central counterparties (**CCPs**);
* mandatory trading of standardised OTC derivatives transactions on exchanges or electronic trading platforms (where appropriate); and
* higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

These commitments were reaffirmed in the G20 summit of 2010.

In accordance with these commitments, a trade repository and a new clearing house (to serve as a CCP) are being established in Hong Kong. The SFC and the HKMA have formed a working group to develop the legislative framework and requirements to regulate the OTC derivatives market. The proposed regulatory regime will be set out in the Securities and Futures Ordinance (**SFO**). The main obligation will be set out in primary legislation, but the details will be set out in subsidiary legislation.

## Main Proposals

These are the main proposals set out in the Consultation Paper:

* The proposed regulatory regime would be set out in the SFO, but would be overseen by both the SFC and the HKMA. The HKMA would oversee the OTC derivatives activities of institutions licensed under the Banking Ordinance, known as Authorised Institutions (**AIs**), while the SFC would oversee those of non-AI entities.
* Initially, only non-deliverable forwards (**NDFs**) and certain interest rate swaps (**IRSs**) must be reported to the trade repository, which would be set up by the HKMA. They must also be centrally cleared through a designated CCP designated by the SFC (**Designated CCP**). Eventually, these requirements would apply to transactions in other OTC derivative product classes as well, following further market consultation.
* Non-AI entities would be required to be licensed under the SFC in order to engage in OTC derivatives activities. A new Type 11 licence would be created for this purpose.
* Large participants not regulated by the HKMA or the SFC may be subject to other requirements, such as producing information regarding their OTC derivatives activities or even reducing their OTC derivatives positions.

Although the G20 commitments include requiring OTC derivatives transactions to be traded on an exchange or electronic trading platform by the end of 2012, that aspect of the reforms is not within the scope of the Consultation Paper, but may be discussed in a future consultation. Details of the proposals for the regulatory regime in Hong Kong are not yet finalised.

## Other Information About The Proposed Regulatory Regime

### The Legislative Framework

The SFC and the HKMA are currently working with the Government of Hong Kong to introduce the legislative amendments required for the proposed regulatory regime. The primary legislation would set out the following:

* the mandatory reporting, clearing and trading obligations;
* the penalties for failing to meet the obligations;
* the designation of CCPs;
* the designation of exchanges and other electronic trading platforms;
* the expanded scope of the legislation to cover OTC derivatives transactions; and
* the scope of oversight of the SFC and that of the HKMA.

The subsidiary legislation would set out details of the requirements set out in the primary legislation, such as how they apply, to whom they apply, detailed criteria of the requirements, procedures, etc. The purpose of setting out these details in subsidiary legislation, as opposed to primary legislation, is to allow regulators to introduce changes in time to keep up with market developments and global standards and practices. A consultation will be issued in 2012 in relation to the proposed subsidiary legislation.

Additionally, the SFO would be amended to reflect the respective areas of oversight of the SFC and the HKMA and to cover OTC derivatives transactions. The proposed definition of “OTC derivatives transactions” is “transactions in ‘structured products’ other than:

* transactions in securities and futures contracts that are traded on a recognised market (i.e. a market operated by a recognised exchange company);
* transactions in structured products that are offered to the public and the documentation for which is authorised under section 105 of the SFO; and
* transactions in currency-linked instruments, interest rate-linked instruments or currency and interest rate-linked instruments offered by AIs to the public and the documentation for which is exempted from the prohibition under section 103(1) of the SFO by virtue of section 103(3)(ea) of the SFO.”

The Consultation Paper also proposes to include in the SFO a power for regulators to expressly included (or exclude) specific transactions within (or from) the ambit of “OTC derivatives transactions”.

### Products Covered by the Mandatory Obligations

The SFC and the HKMA propose to take a phased approach to the mandatory obligations. The proposed regulatory regime would initially require only NDFs and certain IRSs to be reported to the HKMA’s trade repository and to be cleared through a Designated CCP. Other product classes (including interest rate, foreign exchange and equity derivatives) would be included eventually after further consultation. A list of OTC derivatives transactions that fall under these requirements would be published.

Currently, the Consultation Paper proposes only one trade repository. The information collected by it would be shared with the SFC. It is proposed that only a recognised clearing house or authorised automated trading services provider authorised under Part III of the SFO would be a Designated CCP.

### Mandatory Reporting Obligation

Locally-incorporated AIs and Licensed Corporations (**LCs**) would be required to report transactions to which they are a counter party, or have originated or executed (that is, to have negotiated, arranged, confirmed or committed to the transaction for itself or on behalf of any counterparty). Locally-incorporated AIs may in some cases have to report to the HKMA the positions of its subsidiaries in addition to its own positions. No exemption would be provided for AIs or LCs where another AI or LC is party to the transaction and must also meet the reporting requirement.

Overseas-incorporated AIs would be required to report transactions to which they are a counterparty if they conduct the transaction through their Hong Kong branch or if the transaction has a Hong Kong nexus. The transaction must be reported also if the overseas-incorporated AI originated or executed the transaction through their Hong Kong branch. A transaction has a Hong Kong nexus if the underlying entity or reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law (in the case of equity or credit derivatives) or if one of the underlying assets, currencies or rates is denominated in Hong Kong dollars (in the case of other derivatives).

Other Hong Kong entities, being neither AIs nor LCs, would be required to report transactions if they are a counterparty or if they have exceeded a specified reporting threshold. This threshold is not yet defined, but is proposed to be set in absolute dollar terms on a per product class basis. The SFC and the HKMA are currently collecting data for the purpose of establishing these thresholds. The ideal threshold would reduce the compliance burden for participants other than AIs and LCs. These thresholds would be reviewed every three years. OTC derivatives transactions that were entered into before the reporting requirement has come into effect would be included in determining whether the threshold has been exceeded, if it is part of a position that is still outstanding. Other Hong Kong entities would be exempt from the reporting requirement if an AI or LC is also subject to the reporting requirement in respect of the transaction.

Overseas entities that are not AIs or LCs would not be subject to any reporting requirement.

Transactions would be required to be reported by the end of the business day following the trading day. A grace period would be allowed for entities that are not already subject to the reporting obligation and also when a new product type is covered under the range of reportable transactions.

A flow chart summarising the mandatory reporting obligation is set out in Appendix C to the Consultation Paper.

### Mandatory Clearing Obligation

The mandatory clearing obligation must be met if:

* both counterparties to the transaction have exceeded the specified clearing threshold; and
* either:
  + an AI, LC or Hong Kong entity is a counterparty to the transaction;
  + an AI or LC originated or executed the transaction; or
  + an overseas-incorporated AI is a counterparty to, or originated or executed, the transaction through its Hong Kong branch.

As with the mandatory reporting obligation, AIs may have to meet the mandatory clearing obligation on a consolidated group basis. That is, the AI would have to take into account the positions of its subsidiaries when determining whether or not the specified clearing threshold was exceeded and procure that transactions entered into by its subsidiaries are centrally cleared through a Designated CCP. Unlike the mandatory reporting obligation, however, the mandatory clearing obligation is shared by parties on both sides of the transaction. The counterparties must ensure that this obligation is met. If an AI or LC originated or executed the transaction on behalf of one or both counterparties, it would be responsible for ensuring that this obligation is met unless it obtains confirmation from the counterparty that the transaction was centrally cleared through a Designated CCP.

Parties are exempted from the mandatory clearing requirement if:

* both counterparties to the transaction are overseas entities; and
* the transaction has been centrally cleared in accordance with (or is exempted from) mandatory clearing under the laws of an acceptable overseas jurisdiction (currently not yet specified or defined).

A 3-month grace period for clearing would be allowed, beginning when an entity first exceeds the specified clearing threshold and ending no earlier than six months after the mandatory clearing obligation is first implemented. The grace period is also available when a new product type is covered under the range of clearing eligible transactions.

A flow chart summarising the mandatory clearing obligation is set out in Appendix D to the Consultation Paper.

### Mandatory Trading Obligation

The Consultation Paper does not propose a mandatory trading obligation at this stage of the reforms, pending further study of local market conditions by the SFC and the HKMA.

### Penalties for Breaching Obligations

Following the international trend, the Consultation Paper proposes the imposition of civil or administrative fines for parties that breach the mandatory obligations, but does not propose any specific details of such fines. The penalty regime would not detract from the existing disciplinary regimes that apply to AIs and LCs.

### Designated CCPs

It is proposed that only a recognised clearing house or authorised automated trading services provider authorised under Part III of the SFO would be a Designated CCP. The Consultation Paper gives three reasons for this:

* The regulatory authorities can leverage on the existing provisions and frameworks that govern the regulation of CCPs.
* The existing regime for recognised clearing houses and authorised automated trading services providers is cast in broad terms, allowing the SFC to require that international standards for regulation of OTC derivatives clearing houses be met.
* The automated trading services regime is more flexible and can apply to overseas CCPs because they are primarily regulated in their home jurisdictions.

CCPs would not be required to be domestic CCPs in order to be designated by the SFC. Despite concerns of overseas CCPs clearing transactions in domestic products of systemic importance, the Consultation Paper proposes allowing overseas CCPs to be designated, as proliferation of CCPs may lead to fragmentation and reduce liquidity. The Consultation Paper suggests that restriction of Designated CCPs to domestic CCPs may imply costs for market participants that would need to become members of multiple CCPs. Furthermore, Designated CCPs would be allowed to accept overseas clearing members so that such members that fall under the mandatory clearing obligation would not have to clear the transaction through a local member (i.e. indirectly). Indirect clearing would be allowed, provided that the third party (a member of the Designated CCP) is an AI, an LC licensed to carry on Type 11 regulated activity (which is being proposed) or an overseas intermediary that is regulated in a recognised overseas jurisdiction.

### Capital Charges and Margin Requirements

The Consultation Paper suggests the imposition of margin requirements and higher capital margin requirements according to “international standards” for OTC derivatives transactions that are not cleared through a CCP, but does not go into detail.

### Regulation of Non-AI Entities

It is proposed that a new Type 11 regulated activity be introduced to Schedule 5 of the SFO in order to regulate non-AI entities who engage in OTC derivatives transactions. It is further proposed that the SFC have regulatory oversight over large players that may pose systemic risk, including entities that are closer to price-takers and end users than intermediaries.

The new Type 11 regulated activity would cover dealers, advisers and clearing agents in the OTC derivatives market. The definition of this regulated activity would be similar to those of Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities) and Type 5 (advising on futures contracts) regulated activities, but adapted for the OTC derivatives market (for example, OTC derivatives transactions are typically on a principal-to-principal basis).

The scope of the proposed Type 11 regulated activity would not be limited only to transactions that must meet the mandatory reporting obligation and mandatory clearing obligation. It may, however overlap with the scope of other regulated activities such as Types 1, 3 (leveraged foreign exchange trading) and 4. Therefore, it may be necessary to amend the scope of existing regulated activities.

The Consultation Paper proposes that quantitative and/or qualitative criteria be established to define “large players” who operate in Hong Kong’s OTC derivatives market. Any criteria that might be adopted to define “large players” would be high enough such that they would be required to meet the mandatory reporting obligation anyway (the mandatory clearing obligation may not arise if the counterparty does not exceed the specified clearing threshold). While there may be very few such players, their positions may raise concerns of potential systemic risk. Under the proposed regulatory regime, such players would not need to be licensed by or registered with the SFC, but may be required to produce information regarding their OTC derivatives transactions or take steps to reduce their positions in such transactions.

## How To Respond To The Consultation

Respondents must submit written comments on the proposals set out in the Consultation Paper no later than 30 November 2011 by one of the following methods:

By on-line submission at:

[http://www.sfc.hk/sfc/html/EN/speeches/consult/consult.html](http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/)

By email to:

[mdd@hkma.gov.hk](mailto:mdd@hkma.gov.hk) or [otcconsult@sfc.hk](mailto:otcconsult@sfc.hk)

By fax to:

1. 2878 7297 or (852) 2521 7917

* By post to one of the following:
* Market Development Division Hong Kong Monetary Authority 55th floor, Two International Finance Centre 8 Finance Street, Central Hong Kong
* Supervision of Markets Division Securities and Futures Commission 8th floor Chater House 8 Connaught Road, Central Hong Kong

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