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# SFC And HKMA Publish Consultation Conclusions And Supplemental Consultation On The Regulation Of OTC Derivatives

## Introduction

The global financial crisis in late 2008 highlighted the structural deficiencies in the over-the-counter (**OTC**) derivatives market, and the systemic risk it poses for the wider market and economy. In the wake of the crisis, G20 Leaders committed to reforms that would require:

1. the mandatory reporting of OTC derivatives transactions to trade repositories (**TR**s),
2. the mandatory clearing of standardised OTC derivatives transactions through central counterparties (**CCP**s),
3. the mandatory trading of standardised OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate, and
4. the imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

On 17 October 2011, the Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC** or **Commission**) issued a joint consultation paper (**Consultation Paper**) on the proposed regulatory regime for the OTC derivatives market. A Conclusion Paper on the Consultation Paper was released in July 2012, together with a **Supplemental Consultation**. A third consultation is expected to be launched during Q4 2012 (the **Q4 consultation**) to finalise details of the regime.

The reform will mainly introduce mandatory reporting, clearing and trading obligations in line with the G20 commitments and the establishment and regulation of the necessary infrastructures through which these "**Mandatory Obligations**" must be fulfilled. It should also provide for the regulation of key players in the OTC derivatives market, in particular authorised institutions (**AI**s), Approved Money Brokers (**AMB**s; which will be regulated by analogy to AIs), licensed corporations (**LC**s) and large players whose positions may pose systemic risk. This should cover most of the market for such products, as most of the main players are AIs.

This newsletter focuses on the elements of the proposed OTC derivatives reform suggested in the Conclusion Paper as well as the Supplemental Consultation. Topics covered are as follows

1. The general scope of the reform: "**OTC derivative transactions**" (Part I below). This concept defines the general scope of the reform, and is used to delimit some of its provisions.
2. The creation of "**Mandatory Obligations**" (Part II below). Mandatory Obligations will be created, and market participants will in certain circumstances be obliged to (a) report the transactions they are involved in to a Hong Kong Monetary Authority Trade Repository (HKMA-TR) (Part II.B below), and/or (b) clear their transactions through CCPs (Part II.C below). These propositions are well developed, and their details are described below. Further obligations are under consideration, namely (c) mandatory trading and (d) the imposition of higher capital requirements and margin requirements for non-cleared OTC derivatives transactions, but are yet to be the object of specific propositions. The mandatory reporting, clearing and trading obligations will be set out in broad terms in the primary legislation and the details will be set out in the subsidiary legislation.
3. The corresponding adjustment to **market infrastructure** framework. For their implementation, Mandatory Obligations will require corresponding market infrastructures, i.e. the creation of a local TR, the HKMA-TR (Part III.A below) as well as the enactment of a regime for designated CCPs (Part III.B below).
4. The licensing and regulation of **market players**. While Als and AMBs will see little change to their licensing and authorisation requirements, some activities will require a licence to be performed, i.e. some new Regulated Activities (RAs) will be created, and corresponding licensing requirements will be imposed. These will cover dealers and advisers under a new Type 11 RA, clearing agents under a New Type 12 RA, and the managers of portfolios of OTC derivatives transactions under an extension to the existing Type 9 RA. The Supplemental Consultation is in progress to assess these aspects, and the present state of the project is described in Part IV below.
5. Finally, **systemically important players** (**SIPs**), i.e. players that are not otherwise regulated but create systemic risk through the level of their exposures to OTC derivatives, will be subject to registration and regulation (Part V below).

## I. The Scope Of The Reform: "OTC Derivative Transactions"

The scope of the term "OTC derivative transaction" is key as it will effectively delineate the ambit of the new OTC derivatives regime. Ultimately, the objective is to only capture transactions that are (1) derivative in nature, (2) negotiated and entered into on a bilateral basis (as opposed to transactions that are offered on a "one-to-many" basis), and (3) not already regulated under existing laws and regulations.

This (broader) definition will apply to determining who needs to be licensed with the SFC for the proposed New Type 11 and Type 12 RAs as well as the extension of the Type 9 RA. However, the scope of the mandatory reporting, clearing and trading obligations will be narrower, as explained below. Subsidiary legislation will provide a power to enable specific transactions to be included within or excluded from the definition of "OTC derivatives transaction".

The term "OTC derivatives transaction" will be defined by reference to the term "structured product" found in the Securities and Futures Ordinance (**SFO**), but appropriate exclusions will be provided so as to avoid overlaps with other regulated products, in respect of:

1. transactions in securities and futures contracts that are traded on a market operated by a recognised exchange company (**REC**), or on such other overseas regulated markets as may be specified;
2. transactions in structured products that are offered to the public and the documentation for which is authorised under Section 105 of the SFO;
3. transactions in securitised products, embedded derivatives and similar products (i.e. products offered by a single issuer to a number of investors);
4. spot contracts; and
5. 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.

## II. Mandatory Obligations To Report And Clear Transactions

### A. Products covered by reporting and clearing Mandatory Obligations

The HKMA and SFC will jointly determine the specific types of OTC derivatives transactions to be mandated for reporting or clearing. The transactions mandated for reporting (**Reportable Transactions**) may differ from those mandated for clearing (**Clearing Eligible Transactions**), although there may be some overlap between the two (i.e. some transactions may be mandated for both reporting and clearing).

In any event, the mandatory reporting and clearing obligations will initially only cover certain types of interest rate swaps (**IRS**) and non-deliverable forwards (**NDF**), although this will subsequently be extended in phases to cover other types of transactions and products such as equity derivatives.

The Conclusion Paper differs inter alia from the Consultation Paper in that AMBs will be assimilated to Als and the extra-territorial effects of the regime will be limited.

### B. Mandatory reporting obligation

Transactions would be required to be reported by the end of the business day following the trading day. Data collected by the HKMA-TR will be used solely for regulatory and market surveillance purposes. Any public disclosure of such data will initially be on an aggregate basis only.

#### Scope of the obligation

Subject to a consultation on the detailed requirements in Q4 2012, the reporting obligations for Reportable Transactions are triggered in the cases described below:

1. Locally-incorporated Als, LCs and AMBs would be required to report transactions if:
   1. they are a counterparty to the transaction; or
   2. they have originated or executed the transaction, and the transaction has a Hong Kong nexus.
2. Overseas-incorporated Als have seen their reporting obligation narrowed following the consultation. They would be required to report transactions if the AI, acting through its Hong Kong branch, has:
   1. become a counterparty to the transaction, meaning the transaction is booked in the Hong Kong branch according to the accounting record, or
   2. originated or executed the transaction, and the transaction has a Hong Kong nexus.
3. Other Hong Kong entities, will have unchanged reporting obligations, i.e. their Reportable Transactions will have to be reported if their positions for a given product class exceeds a specified threshold (Reporting Threshold), which will be assessed based on the total amount of gross positions held (i.e. the average notional value of a person's outstanding positions for the previous six months based on his month-end position).
4. Overseas entities that are not Als or LCs would not be subject to any reporting requirement.

#### Comments on the scope of the obligation

A key change from the propositions of the Consultation Paper is that the mandatory reporting obligation will not apply to activities limited to pure broking in OTC derivatives for unrelated customers.

Fund managers acting on behalf of a fund would be subject to the reporting obligation under case 1.b above as an LC if they are licensed for Type 9 RA (i.e. investment manager of portfolios of OTC derivatives see below IV.C).

Only those funds that are domiciled in Hong Kong (i.e. established under Hong Kong law) should be regarded as "Hong Kong persons", and be subject to Mandatory Obligations under case 3 above. The Conclusion Paper suggested that the reporting obligation would rest with the legal owner, and be triggered at the fund level, or maybe at the sub-fund level for umbrella funds.

#### Exemptions when the other party also has to report

An AI, LC or AMB that has originated or executed a Reportable Transaction which has a Hong Kong nexus (cases 1.b and 2.b of the "scope of the obligation" above), will be taken to have discharged its reporting obligation in respect of that transaction if the counterparty on whose behalf it was acting has confirmed to the AI, LC or AMB that the transaction has been reported to the HKMA-TR.

Hong Kong persons that are not an AI, AMB or LC (case 3 above) will be exempted from having to report a transaction if it involves an AI, LC or AMB and the latter has an obligation to report it.

#### Impact of central clearing and CCPs exemptions

Some Reportable Transactions may also be cleared (whether or not the clearing is mandatory). CCPs performing the clearing would be exempted from reporting a transaction when they novate it, and on any subsequent change arising from life cycle events.

Only counterparties to the original transaction would have to report it, and provide details about the clearing.

#### Respect for overseas laws on confidentiality

The regulations should be tailored so as not to compel market players to breach confidentiality obligations under overseas laws. Accordingly, the reporting obligation should not apply in respect of transactions booked outside of Hong Kong if the reporting of such transaction to the HKMA-TR will violate any applicable legislation or regulation in the jurisdiction where the transaction is booked, and reasonable efforts to avoid such infringement have been unsuccessful.

### C. Mandatory clearing obligation

Indirect clearing (through an agent) will be available so as to satisfy the obligation (see below III.B and IV.B). Subject to a consultation on the detailed requirements in Q4 this year, the reporting obligations for Clearing Eligible Transactions are as follows.

#### Scope of the clearing obligation

LCs, AMBs, Hong Kong incorporated AIs, overseas incorporated AIs acting through their Hong Kong branch (i.e. the Clearing Eligible Transactions are booked in the Hong Kong branch of the AI according to the accounting records) and Hong Kong persons (including funds established under Hong Kong law) that are counterparty to a Clearing Eligible Transaction will be required to clear such transaction through a designated CCP if:

1. both they and their counterparty have exceeded a specified threshold (Clearing Threshold which will be assessed based on the total amount of gross positions held by the entities for the relevant product class); and
2. their counterparty is not exempted from the clearing obligation.

The scope of the obligation has been narrowed, and having « originated or executed » a transaction cannot trigger the clearing obligation any more, which should help reduce overlaps with mandatory clearing obligations from other jurisdictions.

#### Exemptions

1. Exemptions might be extended in respect of non-financial entities using OTC derivatives for commercial hedging purposes, and intra-group transactions.
2. Exemptions might also be extended to transactions involving "closed markets" (i.e. jurisdictions which have a material level of foreign exchange control, and/or other local regulatory restrictions that make it impractical to require clearing to take place in any jurisdiction other than its own jurisdiction).

### D. Common features of the Mandatory Obligations

#### Grace period

There should be grace periods so that persons who are not already subject to the reporting and/or clearing obligation have enough time to (i) set up their reporting and clearing channels (3 months), and (ii) complete any backloading (6 months, including the aforesaid 3 months) for reporting.

#### Public sector entities exemptions

Further exemptions will be provided to (i) central banks, (ii) monetary authorities or public bodies charged with the responsibility for the management of public debt and reserves and the maintenance of market stability, as well as (iii) certain global institutions such as the International Monetary Fund and the Bank for International Settlements. Reciprocity will be taken into account when appropriate.

#### Anti-circumvention clauses

For the purposes of effective supervision of a local banking group, a locally-incorporated AI may be expected to procure that any one or more of its subsidiaries comply with a Mandatory Obligation.

#### Penalties

Fines will be imposed for breach of the Mandatory Obligations. Where breaches are committed by AIs, AMBs or LCs, regulators should be able to take disciplinary action against them. To that end, the existing disciplinary regime under Part IX of the SFO would be expanded as appropriate.

The question whether breaches of the Mandatory Obligations should affect the validity and enforceability of transactions entered into by market participants is still under consideration, and will be further discussed during the next consultation.

#### Investigation powers

The SFC will have powers to investigate where it has reasonable cause to believe either that a Mandatory Obligation may have been breached by a non-AI or that a person may have engaged in defalcation, fraud, misfeasance or other misconduct in connection with any dealing in, clearing of, or advising on an OTC derivatives transaction, or the management of investments in any OTC derivatives transactions.

SFC will also be able to assist overseas regulators in connection with breaches relating to OTC derivatives transactions as well.

## III. Market Infrastructure Framework

### A. Establishment of HKMA-TR

The HKMA is in the process of establishing a local TR (i.e. the HKMA-TR) with the task of collecting data relating to OTC derivatives transactions and providing support in connection with the central clearing of OTC derivatives at any local CCP that may be established.

At first, only one TR, i.e. the HKMA-TR, would be designated for the purpose of the mandatory reporting obligation, in order to ensure the reliability of the information collected. In other words, reporting to global TRs will not suffice for the purposes of any mandatory reporting obligation under Hong Kong law.

Market players will be allowed to appoint a third party for the purposes of the reporting obligation, possibly a global TR. This should help reduce the compliance burden to a certain extent.

### B. Designated CCPs regime

Both local and overseas CCPs may become designated CCPs for the purposes of the mandatory clearing obligation. However, as a pre-requisite to such designation, they will first need to be either a recognised clearing house (**RCH**) or an automated trade services (**ATS**) provider. The suitability of a CCP to be designated should be assessed according to international standards.

#### Indirect clearing

Indirect clearing should be facilitated, since not every market player that is subject to the mandatory clearing obligation will be able to become a member of a designated CCP. This would be possible through an AI or an overseas clearing member (**Remote Participant**). Also, a New RA 12 will be created to this effect, and is described below (Part III.B).

#### Conditions to acceptance of Remote Participants by local CCPs

Local CCPs will be able to accept Remote Participants. However, such a person will be accepted as a Remote Participant only if such person's clearing activities are regulated under the laws of an "acceptable overseas jurisdiction". In determining whether a jurisdiction is an "**Acceptable Overseas Jurisdiction**", reference will be made to various factors, including:

1. whether the laws of that jurisdiction regulate the clearing activities of the overseas person to a level comparable to that in Hong Kong for the regulation of OTC derivatives market;
2. the enforceability of the local CCP's rules (in particular, rules relating to default management, and to reporting of margin and collateral, in the event of the overseas member's default) against the overseas member and any property of the overseas member provided as collateral; and
3. the adequacy of any MoUs or other regulatory cooperative arrangements with relevant regulators in that jurisdiction.

## IV. REGULATION OF OTC DERIVATIVES MARKET INTERMEDIARIES

### Introduction

#### New RAs

Persons who serve as intermediaries in the OTC derivatives market will be subject to licensing obligations. Two new RAs will be introduced under Schedule 5 to the Securities and Futures Ordinance: (i) a new Type 11 RA will capture the activities of dealers and advisers; and (ii) a new Type 12 RA will capture the activities of clearing agents. The existing Type 9 RA (asset management) will be expanded to cover the management of portfolios of OTC derivatives. The scope of the two new RAs and the expanded Type 9 RA will need to include a number of carve-outs, including carve-outs to address overlaps with existing RAs or the activities of such regulated players as Als or AMBs.

#### Overseas players

The licensing requirement for Type 11 RA and Type 12 RA will only apply to persons who carry on business in Hong Kong. However, for persons carrying on a business of dealing in, advising on or providing clearing agency services in respect of OTC derivatives outside Hong Kong, Section 115 of the SFO will continue to apply, i.e. so long as their dealing, advising or clearing agency services are not actively marketed to the Hong Kong public, they will not be regarded as carrying on Type 11 or Type 12 RAs. Special arrangements for Remote Participants of a Hong Kong CCP are contemplated (see above Part III.B).

#### Impact on AIs and AMBs

AIs and AMBs (within the meaning of the Banking Ordinance) who play a similar intermediary role should not need to be licensed for the new Type 11 or Type 12 RA. Their activities as OTC derivatives dealers, advisers and clearing agents will be overseen by the HKMA; the SFC will not have the power to register AIs that have activities encompassed by Type 11 and Type 12 RAs. On the other hand, to the extent that an AI or AMB's OTC derivatives activities overlap with any RA pre-existing the reform, or with the expanded Type 9 RA, the AI or AMB will need to be licensed (or registered) for such existing RA or the expanded Type 9 RA.

### A. New Type 11 RA

The initial ambit of the new Type 11 RA would be cast along the lines of the initial ambit of the existing dealing and advising definitions in the SFO, and would thus cover "dealing in and advising on OTC derivatives transactions", which includes:

1. entering into or offering to enter into an OTC derivatives transaction;
2. inducing or attempting to induce another person to enter into, or to offer to enter into, an OTC derivatives transaction; and
3. giving advice on, or issuing reports or analyses on whether, which, at which time, or the terms or conditions on which, OTC derivatives transactions should be entered into.

Carve-outs would be provided for the following, among others:

1. Als and AMBS;
2. end users for commercial hedging purposes;
3. some selected activities already licensed under or incidental to Types 1, 2, 3, 4, 5, 6, and 9 RAs will be carved out; and
4. some activities that would require a licence under existing Types 1, 2 and 3 RAs but for a specific exemption.

#### Implications for AIs of new Type 11 RAs vis-à-vis ATSs

The definition of ATS will need to be expanded as appropriate to cover OTC derivatives transactions as well. Under the SFO, providers of ATS must either be licensed/registered for Type 7 RA (i.e. essentially for persons who are primarily dealers, and bundle the Type 7 RA license with their Type 1 or 2 RA license) or authorised under Section 95 of the SFO.

Since AIs and AMBs will not need to be licensed/registered for the new Type 11 RA, and Type 7 RA is typically bundled, they should be allowed to provide the ATS to facilitate the trading of OTC derivatives under the supervision of the HKMA without being licensed/registered for Type 7 RA, nor authorised under Section 95 of the SFO, provided that the provision of such ATS is incidental to the AI's or AMB's activities of dealing in OTC derivatives.

### B. New Type 12 RA

The new Type 12 RA would cover the provision of clearing and settlement services where these are provided: (i) in respect of OTC derivatives transactions, (ii) through a CCP, and (iii) on behalf of another person. It should therefore encompass the activities of both:

1. members of a CCP; and
2. persons that intermediate between such member and a counterparty to the OTC derivatives transaction in respect of which the clearing agency services are provided.

The following activities would be excluded from the scope of the new Type 12 RA:

1. the activities of a CCP (whether in Hong Kong or overseas, and whether regulated or not) in its capacity as a CCP;
2. The clearing agency activities of an AI or an AMB; and
3. The clearing agency activities of an agent of a CCP member whose activities as agent do not include handling any client monies or client assets provided in connection with the clearing and settlement of OTC derivatives transactions (i.e. LCs providing marketing for a Remote Participant).

#### Special arrangements for Remote Participants of a Hong Kong CCP

Clearing agency activities of Remote Participants (i.e. a member of a local CCP from an Acceptable Overseas Jurisdiction, cf. above III.B), which may be regarded as carrying on their clearing agency business in Hong Kong, will also be exempted, provided that person:

1. does not have a place of business in Hong Kong, and
2. either (i) does not provide clearing agency services to persons in Hong Kong, or (ii) provides clearing agency services to persons in Hong Kong, but any marketing of such services (if any) is conducted by a person that is either an AI or an LC.

### C. Expanded Type 9 RA

The scope of Type 9 RA (management of portfolios of securities or futures contracts) should be expanded to cover the management of OTC derivatives portfolios.

It would be extended to all persons, including Als and AMBs, with an exception for activities falling within the scope of New Type 11 RA. In other words, Als, AMBs and persons licensed for Type 11 RA may manage portfolios of OTC derivatives transactions without a licence/registration for the expanded Type 9 RA if such management is incidental to their dealing in OTC derivatives, and is thus already regulated.

### D. Transitional period

A four to six weeks transitional period will be provided. An applicant who can confirm two years of operation in the field will be allowed to continue its operations pending the examination of their application for either the extension of licence under Type 9 RA, or the granting of a licence under Types 11 or 12 RAs.

## V. Regulation Of Systemically Important Players

Regulatory oversight in respect of SIPs, i.e. players in Hong Kong who are not already regulated but whose positions and activities may raise concerns of potential systemic risk. The objective of this proposal is precisely to enable regulators to have some oversight of the activities of end-users, price takers and others who are not already regulated by the HKMA or the SFC.

Market players will be required to notify the SFC if their OTC derivatives positions exceed a certain threshold (which threshold will be many times higher than both the Reporting and Clearing Thresholds) by reference to a person's aggregate holdings in all OTC derivatives transactions, and/or to holdings in a particular product class or transaction type.

Their names and details of their positions would then be entered in a register of SIPs to be kept and maintained by the SFC; the HKMA and the SFC would also be able to enter the name of a person in the register of SIPs at their own initiative where they have reason to believe that a person has exceeded the SIP threshold. It has not been decided yet if names of SIPs entered in the register would be disclosed to the public.

Regulators would have the power to require SIPs to provide such information regarding their OTC derivatives activities and transactions as may be specified, and take certain action in respect of their positions and any collateral provided or collected as may be specified if regulators have reasonable cause to believe that the SIP's activities or transactions in the OTC derivatives market pose systemic risk to the financial markets in Hong Kong.

SIPs who fail to provide information, or to take action as specified, would be subject to disciplinary action by the SFC under an amended Part IX of the SFO.

## Further Steps

The Supplemental Consultation was launched in July 2012, and covers the scope of the new RAs and expanded Type 9 RA, as well as the regulation of SIPs.

A third consultation is expected to be launched during Q4 2012 (the Q4 Consultation) to finalise details of the regime. It will elaborate on the precise ambit of the Mandatory Obligations, including matters such as:

1. definitions of some of the key concepts delineating the Mandatory Obligations (e.g. "originated or executed", "Hong Kong nexus", and "Hong Kong person");
2. which specific types of transactions will be subject to the Mandatory Obligations;
3. who will be subject to the Mandatory Obligations, and in what circumstances;
4. what the Reporting and Clearing Thresholds will be, and the circumstances in which they will apply;
5. which types of persons and transactions may be exempted from the Mandatory Obligations;
6. what information will have to be included when reporting a transaction to the HKMA-TR; and
7. details relating to grace periods, backloading etc.

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