



Hong Kong

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## HKMA AND SFC PUBLISH DRAFT RULES INTRODUCING MANDATORY CLEARING AND EXPANDING MANDATORY REPORTING FOR OTC DERIVATIVES

### Introduction

In February 2016, the Hong Kong Monetary Authority (**HKMA**) and Securities and Futures Commission (**SFC**) published conclusions to a joint consultation on introducing mandatory clearing and expanding mandatory reporting for the second stage of the over-the-counter (**OTC**) derivatives regulatory regime (the “**February 2016 Consultation Conclusions**”).<sup>1</sup>

The publication of the February 2016 Consultation Conclusions is part of a larger scheme among global financial regulators aiming to introduce global standards in relation to clearing and reporting of OTC derivatives to increase transparency and reduce counterparty risk.

The February 2016 Consultation Conclusions are the response to feedback and opinion on the joint consultation paper published in September 2015 (**September 2015 Consultation Paper**) by the regulatory bodies on revising the Hong Kong OTC derivative’s regime to introduce mandatory clearing and expanding mandatory reporting.<sup>2</sup>

### Background

In the September 2015 Consultation Paper, the HKMA and SFC’s proposals for the next step in the regulation of OTC derivative transactions related to:

- <sup>1</sup> <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=15CP4>
- <sup>2</sup> <http://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2015/20150930e7a1.pdf>

a) **Phase 1 Clearing**: the mandatory clearing of certain derivative trades; and

b) **Phase 2 Reporting**: an expansion of the existing mandatory reporting requirement to cover all OTC derivative products and require the reporting of a wider range of information and particulars about the transaction in question.

The first phase of mandatory reporting is already in place (**Phase 1 Reporting**). It applies only to certain interest rate swaps (**IRS**) and non-deliverable forwards (**NDFs**) and was implemented in July 2015 under the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (the “**Reporting Rules**”).<sup>3</sup>

The February 2016 Consultation Conclusions, therefore, indicate the regulatory bodies’ next steps.

### A. Phase 1 Clearing

The first phase of mandatory clearing (**Phase 1 Clearing**) aims to mandate the clearing of certain standardised interest rate swaps (**IRS**) between major dealers. The obligations are set out in the draft Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (**the Clearing Rules**) which are set out in Appendix B of the February 2016 Consultation Conclusions.

- <sup>3</sup> [http://www.legislation.gov.hk/blis\\_pdf.nsf/6799165D2FEE3FA94825755E0033E532/993676A01EFCF23948257E45005A0777/\\$FILE/CAP\\_571AL\\_e\\_b5.pdf](http://www.legislation.gov.hk/blis_pdf.nsf/6799165D2FEE3FA94825755E0033E532/993676A01EFCF23948257E45005A0777/$FILE/CAP_571AL_e_b5.pdf)

In the September 2015 Consultation Paper, the key proposals identified were:

1. the types of transactions that will be subject to mandatory clearing;
2. the persons who will be subject to the clearing obligation and in what circumstances;
3. the exemptions and reliefs that may apply; and
4. the process for designating central counterparties for the purposes of the clearing obligation.

#### **Types of transactions that will be subject to mandatory clearing**

In the September 2015 Consultation Paper, the HKMA and SFC proposed that Phase 1 Mandatory Clearing should only cover certain types of IRS and NDFs. Forward rate agreements (FRA) would not be covered.

Types of IRS which would be subject to mandatory clearing included plain vanilla fixed-to-floating swaps, basis swaps and overnight index swaps (OIS), specifically:

- basis swaps and fixed-to-floating swaps which are:
  - denominated in HKD, USD, EUR, JPY or GBP, and
  - with a tenor between 28 days and 10 years, and
- overnight index swaps which are:
  - denominated in USD, EUR, JPY or GBP, and
  - with a tenor between 7 days and 2 years.

#### **Persons who are subject to the clearing obligation**

In Phase 1 Clearing, only transactions between major dealers will be covered (**Dealer-to-Dealer Transactions**). These will likely be authorised institutions (**AIs**) or licensed corporations (**LCs**). They may also be approved money brokers (**AMBs**).

To fall within the “**dealer-to-dealer transaction**”, there will be a two stage test:

- The counterparties to the transaction must be an AI, AMB or LC or the overseas equivalent of an AI or LC. The Draft Clearing Rules refer to the former as “prescribed persons” and to the latter as “financial services providers”.
- Both counterparties to the transaction must have outstanding OTC derivative positions that exceed certain specified thresholds (**Clearing Threshold**).

In the February 2016 Consultation Conclusions, the regulatory bodies noted there may be difficulties in establishing if a party constitutes a “financial services provider”. Consequently, they will include a list of specific entities. A draft proposed list is set out in Appendix D of the February 2016 Consultation Conclusions.<sup>4</sup> A final full list will be published by notice in the Gazette.

#### **Clearing Threshold**

There are multiple Clearing Thresholds set out in the September 2015 Consultation Proposal.

Following consultation, details regarding the Clearing Threshold can be found in Schedule 2 of the draft Clearing Rules and set out in the table below.

Item	Calculation Period	Clearing Threshold	Prescribed Day
1	1 September 2016 to 30 November 2016	US \$20 Billion	1 July 2017
2	1 March 2017 to 31 May 2017	US \$20 Billion	1 January 2018
3	1 September 2017 to 30 November 2017	US \$20 Billion	1 July 2018
4	1 March 2018 to 31 May 2018	US \$20 Billion	1 January 2019

#### **Exemptions**

The Consultation Paper proposed two exemptions from the Phase 1 Clearing obligation which will both be adopted.

<sup>4</sup> See Appendix D of <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=15CP4>

- Exemption for intra-group transactions: the regulatory bodies are of that view that intra-group transactions pose little risk where risk management of the group is centralized, and that the intra-group transactions are entered into to facilitate such central risk management. They also note that regulators in other major jurisdictions have also provided exemptions for intra-group transactions.

To fall within the exemption, the intra-group transaction must meet the following conditions, as reflected in Rule 8 of the amended draft Clearing Rules<sup>5</sup>:

- Transaction is between a prescribed person and its affiliate;
  - Accounts of the prescribed person and the affiliate are consolidated in full by the holding company;
  - Consolidated financial statements are prepared in compliance with the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accounts, the International Financial Reporting Standards issued by the International Accounting Standards Board, or the accounting standards applicable to the holding company in its place of incorporation;
  - Both counterparties are subject to centralized risk evaluation, measurement and control procedures; and
  - The affiliate in question is an “exempt affiliate” – this means that the prescribed person must have notified the HKMA or the SFC that it should be regarded as an exempt affiliate and such notice must still be in force. A single notice can be sent in respect of multiple affiliates, but it must be signed by all prescribed persons who wish to rely on it.
- Exemption for transactions booked in exempt jurisdiction: this “jurisdiction-based exemption” addresses concerns about conflicting obligations which may apply to prescribed persons operating in closed markets.

To fall within the exemption, the transaction booked in one or more pre-identified overseas jurisdictions must meet the following conditions, as reflected in Rule 9 of the Amended Draft Clearing Rules:<sup>6</sup>

- the jurisdiction must be an “exempt jurisdiction” – i.e. the prescribed person must have notified the HKMA (in the case of an AI or AMB) or the SFC (in the case of an LC) that the jurisdiction is to be regarded as an exempt jurisdiction and that notice must still be in force;
- the prescribed person’s OTC derivative positions booked in each jurisdiction that is an exempt jurisdiction in relation to the person must not exceed 5% of the person’s total OTC positions (wherever booked); and
- the aggregate of the person’s OTC derivative positions that are booked in exempt jurisdictions must not exceed 10% of the person’s total OTC positions (wherever booked).

In response to comments received, a further exemption will be provided for transactions resulting from trade compression. The exemption will only be available where the original transactions were not subject to mandatory clearing. In addition, the exemption will only apply to multilateral trade compression cycles where the trade compression is conducted by a third party – bilateral trade compression is not covered. The new exemption is provided for under Rule 10 of the Amended Draft Clearing Rules.

### ***Designating Central Counterparties (CCPs)***

Both local and overseas CCPs may apply to be designated CCPs for the purposes of the Mandatory Clearing Obligation. CCPs who wish to become designated CCPs must be recognised clearing houses (**RCHs**) or authorised automated trading services (**ATS**) providers.

Prior to publishing the February 2016 Consultation Conclusion, concerns were raised to the HKMA and the SFC regarding whether a sufficient number of CCPs will be designated by the time Phase 1 Clearing is implemented.

<sup>5</sup> Please see Appendix B of the February 2016 Consultation Conclusions: <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=15CP4>

<sup>6</sup> *ibid*

## ***Delay of implementation***

In the February 2016 Consultation Conclusions, the HKMA and SFC have delayed the implementation of Phase 1 Clearing, deferring the commencement date from 1 July 2016 (as proposed in the September 2015 Consultation Paper) to 1 September 2016, subject to the legislative process.

While the regulatory bodies do not foresee a lack of designated CCPs, they are also mindful of the timeline for implementing Phase 1 clearing when processing applications for CCP designation. Consequently, the three-month deferment of the commencement date was implemented as an added measure.

## **B. Phase 2 Reporting**

As discussed above, Phase 1 Reporting began in July 2015.

The next phase (**Phase 2 Reporting**) comprises of an extended product scope. Key proposals under Phase 2 Reporting are: (1) expanding the product scope to include all OTC derivatives transactions, (2) expanding the scope of transaction information that is to be reported; and (3) to mandate the reporting of daily valuations. A draft of the revised Reporting Rules (**Expanded Reporting Rules**) is set out in Appendix C of the February 2016 Consultation Conclusions.

### ***Expanding product scope***

It was proposed that Phase 2 Reporting should include *all* OTC derivative products covered in Phase 1 Reporting, as well as *all other* OTC derivative products. These include, among others, equity derivatives, credit derivatives and commodity derivatives.

Following this expansion, the 'product type' and 'product class' classifications currently in use under Phase 1 reporting will be rendered obsolete.

### ***Expanding reporting entities***

The reporting entities will be expanded to include CCPs that are authorized ATS providers (**ATS-CCPs**), pursuant to Rule 15 of the draft Expanded Reporting Rules:

i) The SFC will require ATS-CCPs to provide information about their transactions with clearing members

incorporated in Hong Kong after they have been authorized. It will be inefficient to require ATS-CCPs to build a separate reporting system for that purpose.

ii) It will allow ATS-CCPs to ease into the reporting obligation more gradually as they will initially be subject to Phase 1 reporting only, under which the product scope and information scope are narrower. They will only be subject to the wider reporting obligation when Phase 2 reporting commences.

iii) Implementation by 1 September 2016 will still give CCPs who are intending to seek designated CCP status sufficient time to set up the necessary systems and system connection to the trade repository in Hong Kong (HKTR). In considering applications for CCP designation, one of the factors that will be considered is the CCP's readiness to comply with mandatory reporting obligations.

This rule will be implemented alongside Phase 1 Clearing (i.e. on 1 September 2016), while it is worth noting that the implementation of Phase 2 Reporting has been deferred until 1 July 2017 (as discussed below).

### ***Expanding transaction information to be reported under Phase 2 Reporting***

Phase 2 reporting will expand the information to be reported in respect of transactions. As the information to be reported is highly technical and fairly lengthy, the Reporting Rules will only set out the categories of information that have to be reported in broad terms. The specific data fields that have to be completed for each category will be published separately by notice in the Gazette. Responses to comments on the proposed data fields which were set out in Appendix D to the Consultation Paper will be set out in a separate conclusions paper in the near future.

### ***Reporting valuation information***

Daily valuation information will have to be reported within 2 days of the day of valuation. The information that will need to be reported is:

i) the basis on which the transaction is valued (i.e. valued by a CCP, mark-to-market or mark-to-model);

ii) the date and time of valuation;

- iii) the value of the transaction; and
- iv) the currency in which the value is denominated.

As to the valuations to be adopted:

- i) for transactions cleared through a CCP, the valuation determined by the CCP should be reported;
- ii) for non-centrally cleared transactions where the counterparties agreed to exchange margin, the valuation mutually agreed for the purposes of exchanging margin should be reported; and
- iii) for other non-centrally cleared transactions, internal valuations can be reported. This requirement will be subject to review depending on international developments in this area.

#### ***“Exempt Person” relief***

The “exempt person” relief will be extended to cover the whole spectrum of OTC derivative products and no longer apply on a product class basis. A person will only be entitled to this relief if the aggregate notional amount of its outstanding positions in all OTC derivative transactions does not exceed US\$30 million.

#### ***Backloading requirement for transactions reported under Phase 1 Reporting***

Reporting entities are required to backload historical transactions within a three month grace period. This requirement does not apply to transactions which mature within a year after the implementation of Phase 2 Reporting.

Rule 25B of the draft Expanded Reporting Rules governs this requirement. For the February 2016 Consultation Conclusions, the regulatory bodies have expanded the draft rule for better specificity and clarity.

Transactions are subject to the backloading requirement:

- i) If they are due to expire within one year of the implementation of Phase 2 reporting, reporting entities will not have to backload the expanded information scope. They will however have to continue reporting lifecycle events (on the basis of the narrower information scope required under Phase 1) on a T+2 basis. They will

also have to report daily valuation information within two business days once Phase 2 reporting comes into effect. This is now reflected in Rule 25B(3).

- ii) If they are not due to expire within one year of the implementation of Phase 2 reporting, reporting entities will have to backload the expanded information scope. This will have to be completed before the end of the grace period, and the information backloaded must reflect the position as at the day of reporting (or up to 2 days before that day), i.e. it must reflect the net effect of all life-cycle events occurring up to that day. Until the time of such backloading, they will have to continue reporting life-cycle events (on the basis of the narrower information scope required under Phase 1) on a T+2 basis. They will also have to report daily valuation information within two business days once Phase 2 reporting comes into effect. This is now reflected in Rule 25B(5).

- iii) For transactions that were originally intended to mature within a year of implementing Phase 2 reporting, but whose term was subsequently extended so that it matures beyond the one year period, reporting entities will also have to backload the expanded information scope. However, the deadline for completing this will be the later of: (a) the end of the grace period; and (b) 2 business days following the change in the maturity date. Again, the information backloaded must reflect the position as at the day of reporting (or up to 2 days before that day), i.e. it must reflect the net effect of all life-cycle events occurring up to that day. Until the time of such backloading, they will have to continue reporting life-cycle events (on the basis of the narrower information scope required under Phase 1) on a T+2 basis. They will also have to report daily valuation information within two business days once Phase 2 reporting comes into effect. This is now reflected in Rule 25B(7).

The regulatory bodies will also provide more detailed guidance in FAQs.

#### ***Backloading requirement for transactions not reported under Phase 1 Reporting***

Where the transaction was not reportable under Phase 1, there will be a 3-month grace period to complete all backloading and transactions maturing within the grace period will not need to be backloaded. When backloading a transaction, reporting entities will have to reflect its position as at the commencement of the grace period, and life-cycle events occurring after

commencement and up to the day of backloading must be reflected individually and chronologically. Additionally, after backloading is completed, life-cycle events and daily valuations will have to be reported within two business days of the event or valuation (as the case may be).

### ***Mandatory record keeping obligation***

Part 3 of the draft Expanded Reporting Rules focuses on the record keeping obligation for a prescribed person. Rule 27 provides “A prescribed person must, in relation to a specified OTC derivative transaction, keep the records specified in rule 29(1) in the manner specified in rule 30 until no earlier than 5 years after the transaction has matured or been terminated.”

In the February 2016 Consultation Conclusions, the regulatory bodies stress that such requirement must be complied with by all relevant parties, including ATS-CCPs.

### ***Delay of implementation***

The regulators also confirm that the implementation of Phase 2 Reporting will be deferred from 1 January 2017 (as proposed in the September 2015 Consultation Proposals) to 1 July 2017.

### **Next Steps**

Subject to the legislative process, the regulatory bodies aim for the next stage of the regime to be implemented as follows:

- i) The Clearing Rules to come into effect on 1 September 2016;
- ii) Rule 15 of the Reporting Rules to come into effect on 1 September 2016; and
- iii) The amendments to the Reporting Rules to implement Phase 2 Reporting to come into effect on 1 July 2017.

### **Conclusion**

The HKMA and SFC have received broad support for introducing mandatory clearing and expanding mandatory reporting for OTC derivatives.

They will identify and consolidate a set of Frequently Asked Questions to be published at a later stage to clarify complicated points for better transparency and reference.

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