

HKMA and SFC begin joint consultation process relating to the reporting, clearing and trading of OTC derivatives in Hong Kong

The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have on 17 October 2011 issued a joint consultation paper (the Consultation Paper) relating to the reporting, clearing and trading of OTC derivatives in Hong Kong. The Consultation Paper also outlines the regulators' current thinking in respect of regulating the OTC derivatives market through amendments to the Securities and Futures Ordinance (SFO) and the introduction of a new regulated activity.

Consultation process

The deadline by which comments should reach the HKMA or the SFC is **30 November 2011**. Clifford Chance has formed a team of lawyers, highly experienced in the sectors affected by these proposals (as detailed below), to respond to the Consultation Paper. We would be pleased to guide you through the response process and assist you with any questions you may have.

Initiatives contained in the Consultation Paper

This consultation has long been anticipated as part of global market reforms for strengthening financial stability coming out of the commitments made by the G-20 in Pittsburgh in September 2009. Following this, in October 2010, a report from the Financial Stability Board (FSB) to G-20 Finance Ministers and Central Bank Governors made 21 recommendations addressing practical issues that authorities may encounter in implementing the proposed market reforms. These recommendations included the following relating to OTC derivatives:

- increased standardisation of OTC products' contractual terms and operational processes;
- a requirement that all standardised derivatives contracts be centrally cleared through central counterparties (CCPs);
- a requirement that all standardised derivatives contracts be traded on exchanges or electronic trading platforms;
- a requirement that all OTC derivatives contracts (regardless of whether they are eventually centrally cleared) be reported to trade repositories (TRs); and
- increased capital and/or margin requirements in respect of derivatives contracts that are not centrally cleared.

The Consultation Paper sets out the current thinking of the HKMA and SFC on some of the key aspects of a new regulatory regime for the OTC derivatives market in Hong Kong arising out of the G-20 commitments.

Key Issues

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Although Hong Kong is not a member of the G-20, it is a member of the FSB and accordingly is committed to changing the Hong Kong legislative and regulatory framework to achieve the G-20 commitments in respect of OTC derivatives reform. To this end, the HKMA and the SFC are considering two key proposals in reforming the regulation of OTC derivatives in Hong Kong:

- (i) the introduction of mandatory reporting, clearing and trading (and the establishment of the necessary infrastructure (TRs, CCPs and trading platforms) in relation to this) (the Infrastructure Initiative); and
- (ii) a new regime for the regulation of "key players" in the OTC derivatives market (namely, authorised institutions (AIs), licensed corporations (LCs) and other large players who may pose a systemic risk to Hong Kong (the Regulatory Initiative).

A brief summary of some of the more important proposals set out in the Consultation Paper is set out below.

The Infrastructure Initiative

Reporting

It is proposed that a mandatory reporting obligation be introduced in Hong Kong in respect of specified OTC derivatives transactions (including single currency interest rate swaps, overnight index swaps, single currency basis swaps and non-deliverable forwards (together the reportable transactions)) which will affect the following market players in the following ways:

- LCs and locally-incorporated AIs must report all reportable transactions to which they are counterparty to or which they have originated or executed. In addition, locally-incorporated AIs may be required to report on both an entity and group basis;
- Overseas-incorporated AIs must report reportable transactions if:
 - they have become counterparty to, originated or executed the transaction through their Hong Kong branch; or
 - they are counterparty to a transaction and that transaction has a Hong Kong "nexus";
- Hong Kong persons who are not AIs or LCs should report reportable transactions if:
 - they are counterparty to the transaction; and
 - they have exceeded the (to be) specified threshold;
- A Hong Kong person will be exempt from the reporting obligation if an AI or LC is also subject to a reporting obligation in respect of the same transaction;
- There are no proposals to subject overseas persons to mandatory reporting obligations under Hong Kong law;
- The mandatory reporting obligation may be expanded in the future to cover a wider range of interest rate swaps, as well as certain foreign exchange derivative transactions and OTC derivative transactions over other asset classes (such as equity derivative transactions).

Reporting must be made by the end of the business day following the trading day, although grace periods will be available to permit market players to set up relevant systems and complete any backloading.

The HKMA is in the process of establishing a TR in Hong Kong for the purpose of collecting this data and in respect of which it is conducting its own consultation exercise.

Clearing

It is proposed that a mandatory clearing obligation be introduced in Hong Kong in respect of the clearing of specified OTC derivatives transactions (including certain interest rate swaps and non-deliverable forwards (together the clearing eligible transactions)) through a designated CCP.

The proposals for clearing eligible transactions differ from those for reportable transactions in that:

- The mandatory clearing obligation should apply to all clearing eligible transactions whenever:
 - an AI, LC or Hong Kong person is counterparty to the transaction or an AI or LC has originated or executed the transaction (and in the case of an overseas-incorporated AI, its involvement is through its Hong Kong branch); and
 - both counterparties to the transaction (whether or not an AI, LC or Hong Kong person) have exceeded the (to be) specified clearing threshold.
- Exemptions will be available if both counterparties are overseas persons and the transaction is subject to mandatory clearing obligations in an acceptable jurisdiction or otherwise exempt from mandatory clearing in that jurisdiction.
- The mandatory clearing obligation may be expanded in the future to cover a wider range of interest rate swaps, as well as certain foreign exchange derivative transactions and OTC derivative transactions over other asset classes (such as equity derivative transactions).

Hong Kong Exchanges and Clearing Limited is in the process of establishing a new clearing house to act as a CCP for the purpose of clearing OTC derivatives transactions in Hong Kong. Designated CCPs must be either a recognised clearing house or an authorised automated trading services provider.

There is much discussion regarding whether only local CCPs should be chosen for the mandatory clearing obligation in Hong Kong. Initially, the HKMA and the SFC were open to permitting overseas CCPs to clear "domestic" derivative transactions. However, concerns raised by the Australian Council of Financial Regulators (see "*Central Clearing of OTC Derivatives in Australia*" June 2011) and the Japanese approach to clearing credit derivative transactions referencing Japanese assets has led the HKMA and the SFC to consider whether to restrict designation to local CCPs only and they will therefore welcome input on this point.

Trading

There are no current proposals to introduce mandatory trading of OTC derivatives on exchanges or electronic platforms. This is subject to further study of local market conditions by the HKMA and the SFC.

The Regulatory Initiative

In order to ensure that certain entities which engage in OTC derivatives activities are properly regulated, a new Type 11 regulated activity will be introduced in order to bring such entities under the licensing regime of the SFC.

The new Type 11 regulated activity will be drafted in wide terms which may result in overlap with existing regulated activities and we understand the intention is to define the definition of Type 11 regulated activity broadly along the lines of the existing definitions of dealing in and advising on securities with appropriate amendments.

The HKMA and SFC are currently considering options to deal with overlaps in a practical way. One option suggested in the Consultation Paper is to incorporate appropriate carve outs such that if a person's OTC activities are limited to the scope of an existing regulated activity, then the person need not seek a license for the new Type 11 regulated activity. The alternate option is to amend the scope of existing regulated activities to exclude those activities that fall within the scope of the new Type 11 regulated activity.

The definition for OTC derivatives for the purposes of the new Type 11 regulated activity as proposed in the Consultation Paper is very broad as it will cover all structured products (as defined under the SFO), with certain exceptions. It is the intention of the HKMA and the SFC for this definition to be refined through subsidiary legislation (with consultation on such subsidiary legislation to take place around Q1 2012).

The Consultation Paper is silent as to how the broking of derivatives may be impacted by s.115 of the SFO and those overseas counterparts that actively market services or products to Hong Kong.

AIs

AIs, which are regulated by the HKMA, will not be required to be authorised to carry on Type 11 regulated activity. We presume the SFO will be amended to create an explicit carve out for AIs from the requirement to obtain a Type 11 licence, similar to the approach under the definitions of Type 3 (leveraged foreign exchange trading) and Type 8 (securities margin facilities) regulated activities.

Non-AIs

Non-AI entities engaging in derivatives activities (otherwise than as end-users) must be brought within the SFC's licensing regime by way of the new Type 11 regulated activity. This is aimed at those entities, other than AIs, carrying on business as dealers, advisers or clearing agents in the OTC derivatives market.

Funds

It is unclear from the Consultation Paper whether the proposed Type 11 licensing requirement will apply to fund managers who deal in OTC derivatives on behalf of the funds they manage, or whether such activity would be categorized as dealing as end-users and benefit from an exemption from the licensing requirement or added to Type 9 (asset management) regulated activity.

Large players

The regulation of "large players" is still under consideration. These players would include financial institutions, commercial entities and others that are essentially price takers or end-users in the OTC derivatives market whose positions may lead to concerns of potential systemic risk. In determining who will be considered a large player, quantitative and/or qualitative criteria will be proposed and it is anticipated that these will be significantly higher than any thresholds set for mandatory reporting or clearing.

The current intention is not to require licensing and/or registration of large players but to require them to provide to the SFC certain information regarding their OTC derivatives transactions and to take steps to reduce their positions if required by the SFC in specified circumstances.

Timetable

Significant legislative and regulatory amendments will be required to ensure compliance and the Consultation Paper outlines the following proposed timetable:

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| • Deadline for response to Consultation Paper | 30 November 2011 |
| • Consultation in respect of subsidiary legislation | Q1 2012 |
| • Final implementation | End of 2012 |

Significant impact on business

The proposed new regulatory regime on which views are now being sought will have a significant impact on the way in which market players conduct their business in the OTC derivatives market in Hong Kong.

It is important to remember that this is only part of a much larger global review of financial markets generally which will have far-reaching consequences on the conduct of cross-border business (see *CC briefing paper "OTC derivatives reforms – Impact on cross-border business – July 2011"*).

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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