

HKMA and SFC release joint consultation conclusions & supplemental consultation relating to the proposed regulatory regime for the OTC derivatives market in Hong Kong

Introduction

The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) launched a public consultation paper relating to the proposed regulatory regime for the OTC derivatives market in Hong Kong last year on 17 October 2011 (the **Consultation Paper**). The aim is to introduce a new regulatory regime in Hong Kong in line with the G-20's aims of reducing systemic risk in the global OTC derivatives market. For a discussion of the HKMA and SFC's proposals in the Consultation Paper, please see our client briefing entitled "[HKMA and SFC begin joint consultation process relating to the reporting, clearing and trading of OTC derivatives in Hong Kong](#)" (October 2011).

The Consultation Paper attracted responses from a wide variety of market participants, including, among others, a response prepared by Clifford Chance on behalf of ten major international dealers (the **Dealer Working Group Response**). The HKMA and SFC published joint consultation conclusions on 11 July 2012 (the **Consultation Conclusions**) with the intention of providing greater clarity and certainty on the scope and application of the new regulatory regime in Hong Kong.

The HKMA and SFC also published a supplemental consultation paper on 11 July 2012 on the proposed scope of the new regulated activities (Type 11 and Type 12) and regulatory oversight of systemically important players (SIPs) (the **Supplemental Consultation Paper**) in light of the feedback received on the Consultation Paper.

Consultation Conclusions

A summary of the main proposals contained in the Consultation Conclusions is set out below.

1. *Legislative framework and persons covered*

The reporting, clearing and trading obligations proposed under the Consultation Paper will be incorporated into the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong) (SFO) followed by supplementary rules and definitions in subsidiary legislation. The proposed timetable for the introduction of these obligations is set out at the end of this briefing note.

The HKMA and SFC will be given investigative and disciplinary powers (as appropriate) for the purpose of jointly overseeing and regulating the OTC derivatives activities carried out

Key issues

- Consultation Conclusions
- Supplemental Consultation Paper
- Conclusion

by certain "key players", namely authorized institutions (AIs), approved money brokers (which act as inter-dealer brokers) (AMBs), licensed corporations (LCs) and other Hong Kong persons (which are not AIs, AMBs or LCs, but operate from or have a connection with Hong Kong) (HKPs).

Given the important role that AMBs play in the OTC derivatives market, the HKMA and SFC propose introducing similar mandatory reporting and clearing obligations for AMBs in line with those for AIs and LCs.

The HKMA will act as the principal regulator for AIs and AMBs, and the SFC will regulate LCs and persons other than AIs and AMBs.

2. *Scope of proposed mandatory reporting, clearing and trading obligation*

The HKMA and SFC have made revisions to their original proposals contained in the Consultation Paper in

response to submissions from market participants who have encouraged an approach which strikes the right balance between strengthening oversight of the Hong Kong OTC derivatives market while managing the regulatory cost and compliance burden for market participants.

Products subject to mandatory reporting and clearing

The HKMA and SFC will determine the types of OTC derivatives transactions to be subject to mandatory reporting and/or clearing after conducting further public consultation. The mandatory reporting and clearing obligations will initially cover certain types of interest rate swaps (**IRS**) and non-deliverable forwards (**NDF**) only, but may be expanded to cover other types of transactions and products in the future.

Mandatory reporting obligation

The reporting obligation will only be imposed on:

- AIs, AMBs and LCs with trades that are "originated or executed" by them *and* which have a "Hong Kong nexus" (for example, a transaction involving an overseas-incorporated AI will only need to be reported if it involves the Hong Kong branch of such an entity).
- HKPs, if their positions in reportable transactions exceed a specified reporting threshold (to be assessed based on the total amount of gross positions held on a per product class basis).

AIs, AMBs and LCs will be regarded as having "originated or executed" trades if (i) they have agreed with the counterparty the "normal economic terms of the transactions" (whether directly or through an intermediary) and (ii) a related party of the AI, AMB or LC (other than the AI or LC itself) has been designated to be the final contracting party to the transaction.

The HKMA and SFC have clarified the meaning of having a "Hong Kong nexus" to cover the following:

- in respect of equity derivatives and credit derivatives, if –
 - (a) the underlying entity or the reference entity is Hong Kong listed (or if there is more than one underlying entity or reference entity, a specified percentage of the entities are Hong Kong listed);
 - (b) the underlying is an index and a specified percentage of the underlying companies are Hong Kong listed; or
 - (c) the reference entity is (or is wholly owned by) the Hong Kong Government.
- in respect of other derivatives transactions, if the underlying asset, currency or rate is denominated in or related to Hong Kong dollars or Renminbi.

The "specified percentage" as referred to above will be determined by the HKMA and SFC in due course.

If the reporting obligation applies to an AI, AMB or LC, it shall report details of the trade to the trade repository (which is to be established and operated by the HKMA) by the end of the second business day following the trading day (i.e. on a "T+2" basis), although market participants will receive grace periods for setting up their relevant systems (3 months from implementation) and completing any backloading of transactions entered into prior to the triggering of the reporting obligation (6 months from implementation). HKPs that have exceeded the reporting threshold will be exempt from their reporting obligation if they transact with an AI, AMB or LC who will be responsible for reporting the transaction.

Notably, given the growing importance of Hong Kong as a key offshore Renminbi business centre, it is proposed that the regulatory regime

in Hong Kong should cover Renminbi denominated transactions.

Mandatory clearing obligation

AIs, AMBs, LCs and HKPs that are a counterparty to a clearing eligible transaction will be required to clear such transaction through a designated central counterparty (**CCP**) if both they and their counterparty have exceeded a specified clearing threshold (to be assessed based on the total amount of gross positions held on a per product class basis). In other words, if either counterparty to a transaction does not cross the clearing threshold, such transaction will not be subject to mandatory clearing in Hong Kong.

To reduce the overlap with clearing requirements in other jurisdictions, the mandatory clearing obligations will not apply to any transactions that are booked overseas (i.e. outside of Hong Kong) even if such transaction is "originated or executed" by an AI, AMB or LC. Therefore, the mandatory clearing obligation will only apply if an AI, AMB, LC or HKP is one of the counterparties and the transaction is booked to them in Hong Kong.

In addition, the HKMA may require a locally-incorporated AI to take into account positions held by its subsidiary(ies) when assessing whether it has exceeded the clearing threshold and require that such clearing eligible transactions are centrally cleared through a designated CCP.

Mandatory trading obligation

The HKMA and SFC will not, at this stage, seek to introduce mandatory trading of OTC derivatives on exchanges or electronic platforms and will conduct further studies to assess how best to implement such a requirement locally.

Exemptions from mandatory reporting and clearing obligations

The HKMA and SFC will allow the following specific exemptions from mandatory reporting and clearing obligations:

- clearing exemption for (i) intra-group transactions; (ii) transactions of non-financial entities as end-users who use derivatives for hedging commercial risks; and (iii) transactions involving participants from "closed markets"; and
- clearing and reporting exemption for (i) central banks; (ii) monetary authorities or similar public bodies; (iii) certain global institutions (e.g. the International Monetary Fund and Bank for International Settlements), though this exemption may be subject to certain criteria such as reciprocity of treatment.

The clearing exemption for transactions involving participants from "closed markets" follows the suggestions raised by market participants in their consultation responses, including the Dealing Working Group Response, and is intended to cover trades involving participants from jurisdictions which have a material level of currency controls and/or other local regulatory restrictions that render it impractical to require clearing to take place in a jurisdiction outside the "closed market".

3. Consequences of breach

Fines (which will be set at levels comparable with other major

jurisdictions) will be imposed for any breach of the mandatory obligations imposed under the new regime. The HKMA and SFC will be granted powers within the existing disciplinary framework under Part IX of the SFO to take disciplinary action against AIs, AMBs or LCs if necessary.

At a global regulatory level, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions released a consultation paper on margin requirements for uncleared derivatives on 6 July 2012 (the **BCBS/IOSCO Paper**), which supports subjecting uncleared transactions between financial entities to initial and variation margin requirements across all OTC derivatives transactions and would not allow netting of initial margin amounts between the counterparties to a transaction. It might be expected that the HKMA and SFC will follow the approach in the BCBS/IOSCO Paper in imposing higher margin and capital requirements for uncleared OTC derivatives transactions.

The HKMA and SFC are further considering whether any breach of the mandatory obligations by relevant market participants would affect the validity and enforceability of the relevant OTC derivatives transactions.

4. Regulation of CCPs

Given the global nature of the OTC derivatives market, the HKMA and SFC do not plan to require designated CCPs to be located in Hong Kong. Both local and overseas CCPs may become designated CCPs under the new regime provided that the relevant CCP is a recognized clearing house (**RCH**) or an authorized automated trading services (**ATS**) provider, in each case approved as under the SFO.

Furthermore, local CCPs will be able to accept overseas clearing members (**remote members**) if such members' clearing activities are regulated under the laws of an "acceptable overseas jurisdiction" as determined by the HKMA and SFC.

The HKMA and SFC also propose to facilitate indirect clearing (i.e. client clearing) but will first consider how other jurisdictions implement client clearing under their regulatory regimes.

5. Definition of "OTC derivatives transactions"

The HKMA and SFC recognise the importance of the definition of "OTC derivatives transactions" as it effectively delineates the ambit of the new regulatory regime. The objective of the new definition of OTC derivatives transactions is only to capture transactions that are derivatives in nature, negotiated and entered into on a bilateral basis and that are not already regulated under existing laws or regulations.

The Consultation Conclusions propose adopting the SFO's definition of "structured product" as a starting point to defining "OTC derivatives transactions", with a number of further exclusions in response to the market's concerns about the wide definition of "structured products".

6. Regulation of intermediaries

The Consultation Conclusions propose the introduction of two new regulated activities, Type 11 (dealing and advising on OTC derivatives) and Type 12 (capturing activities of clearing agents) regulated activities. The existing regulated activities will be left intact with appropriate carve-outs to the scope of the new Type 11 regulated activity. This was the preferred approach of many respondents including the Dealer Working Group.

As mentioned, the HKMA and SFC have issued the Supplemental Consultation Paper setting out their current thinking and specific proposals in this regard (*see below*).

7. Application of s115 of the SFO

The Consultation Conclusions confirm that the offshore booking model will be available for the proposed new Type 11 regulated activity and Type 12 regulated activity provided there is

compliance with section 115 of the SFO (prohibition of active marketing).

Supplemental Consultation Paper

The HKMA and SFC maintain the view that AIs and AMBs do not need to be licensed (or registered) for the new Type 11 or Type 12 regulated activity as their activities will be overseen by the HKMA.

However, to the extent that OTC derivatives activities by AIs or AMBs overlap with any regulated activity other than Types 11 or 12, the AI or AMB would be required to be registered (or in the case of AMBs, licensed) for such other regulated activity.

1. Definition / scope of new proposed Type 11 regulated activity

Initial ambit of Type 11 regulated activity

The new Type 11 regulated activity (*dealing in and advising on OTC derivatives transactions*) will cover any of the following:

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

Proposed Carve-Outs

To address the regulatory overlap with existing regulated activities, a number of carve-outs have been proposed (details of which are set out in the Appendix to this briefing). Among the most important is that if a person's OTC derivatives activities are limited to activities that fall within

the scope of an existing regulated activity, for which that person is licensed or registered, then such person will be able to continue on the basis of its existing licence and will not need to apply for a separate Type 11 licence. However, any conduct requirements imposed on OTC derivatives market participants will be applied equally to such person.

However, this general rule is subject to an important exception: the HKMA and the SFC are of the view that an existing licence or registration for Type 1 (*dealing in securities*) regulated activity would not suffice to permit a person to carry on OTC derivatives dealings as principal (as opposed to on an agency basis). The regulators justify this view by saying that the Type 1 regulated activity does not cover principal-to-principal trading (since there exists an exception from the defined term "dealing in securities" for dealings as principal), while the proposed Type 11 will not contain such exception.

2. Type 9 Regulated Activity

The Supplemental Consultation Paper proposes to expand the current scope of Type 9 (*asset management*) regulated activity so that an asset manager dealing in a portfolio of OTC derivatives transactions would not be required to obtain a Type 11 licence.

Similarly, LCs licensed for Type 11 (*asset management*) regulated activity, AIs and AMBs will not be required to become licensed (or registered) for the expanded Type 9 regulated activity provided their management of a portfolio of OTC derivatives is incidental to the carrying on of dealing in OTC derivatives.

3. Type 12 Regulated Activity

Initial Ambit

The new Type 12 regulated activity is proposed to cover the provision of clearing and settlement services where these are provided:

- in respect of OTC derivatives transactions;
- through a CCP (whether local or overseas); and

- on behalf of another person.

It follows that the new Type 12 regulated activity should not catch the clearing and settlement activities of persons who clear their own (proprietary) trades.

As the objective is to cover persons that handle client assets in the course of providing clearing and settlement services of OTC derivatives transactions, the initial ambit catches activities of not only those persons who are members of a CCP but also those who intermediate between a CCP member and any counterparty to the transaction in question.

The Supplemental Consultation Paper makes it clear that if an overseas member of a Hong Kong CCP actively markets its provision of clearing agency services to the public in Hong Kong, then such member would be regarded as carrying on the new Type 12 regulated activity. This raises the question whether the SFC would be prepared to license such overseas member, which is currently not possible for the other types of licences.

Proposed carve-outs

The Supplemental Consultation Paper proposes a number of carve-outs from the new Type 12 regulated activity, for example for activities of a CCP (local or overseas), for clearing agency activities of an AI or an AMB, and for overseas members of a local CCP that do not provide or market their clearing agency services to persons in Hong Kong. Further details are set out in the Appendix.

4. Transitional Arrangements

A limited transitional period of four to six weeks from implementation is proposed before the two new regulated activities (Types 11 and 12) and the expanded Type 9 regulated activity are implemented.

Types 11 and 12 regulated activities

To cause minimal disruption, the Supplemental Consultation Paper proposes that persons that submit

their application for any of the new regulated activities during the transitional period and confirm in their application that they or their Responsible Officers have engaged in the relevant OTC derivatives activity in Hong Kong for a specified number of years (the current thinking is two years) immediately before the coming into effect of the new OTC derivatives regime, should be deemed to be licensed for the new relevant regulated activity until their application is determined.

Expanded Type 9 regulated activity

Similarly, LCs licensed or AIs registered for Type 9 regulated activities can apply to engage in the management of portfolios of OTC derivatives and will be deemed authorised to do so pending the determination of their application if they confirm in their applications that they, or their proposed Responsible Officers, have engaged in such activity for a specified number of years (the current thinking is two years). Technically, the application would be for a modification of the condition on their licence so that it permits the management of OTC derivatives portfolios. This seems to suggest that a condition not to engage in management of OTC derivatives portfolios would be imposed on all existing Type 9 licences/registrations.

5. Regulation of SIPs

It is proposed that the HKMA and SFC will have a degree of regulatory oversight (short of licensing) over systemically important players (**SIPs**).

Who is a SIP?

The HKMA and SFC propose a SIP threshold in determining whether a person should be regarded as a SIP. The SIP threshold may be set by reference to a person's aggregate holdings in all OTC derivatives transactions, or to holdings in a particular product class or transaction type (or a combination of the above). As the objective is to capture end-users (who would not otherwise be regulated as an AI, AMB or LC) but

whose possible failure as a result of their activities in the OTC derivatives market could have a significant impact on the financial stability of Hong Kong, the HKMA and SFC propose that the SIP threshold should be many times higher than the reporting and clearing thresholds. Consequently, only a handful of market players are expected to reach the SIP threshold.

Registration and Deregistration of SIP

The Supplemental Consultation Paper suggests that any registration should be relatively mechanical without involving any application or approval process.

Regulatory Powers in respect of Persons entered into as SIPs

If the HKMA or SFC has reasonable cause to believe that OTC derivatives activities or transactions of any such person may pose systemic risk to the securities, futures or OTC derivatives market in Hong Kong, the HKMA and SFC may require such person to:

- refrain from increasing its positions in any OTC derivatives transactions;
- reduce its positions in any OTC derivatives transactions;
- take such action in respect of any related collateral as specified; and
- take such other action as may be reasonably required.

There are, in addition, reporting requirements for SIPs and it is proposed that the HKMA and SFC be provided with various disciplinary powers over SIPs.

Timetable and next steps

Whilst the Consultation Conclusions mark an important milestone in the regulation of Hong Kong's OTC derivatives market, much remains to be done to implement the new regime (for example, determining appropriate thresholds for: (i) mandatory reporting,

(ii) mandatory clearing and (iii) qualifying as a SIP, determining further types of transactions which will be subject to mandatory obligations, amongst other things). The HKMA and SFC are closely observing

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current developments in other overseas jurisdictions to seek further improvements to the local regime.

The Consultation Conclusions provide the following timetable for further legislative and regulatory amendments to the proposed regime:

- Deadline for response to the Supplemental Consultation Paper: **31 August 2012**
- HKMA and SFC's public consultation addressing other detailed aspects of the current proposals: **Q4 2012**
- Introduction of the relevant Bill to the consultation into the Legislative Council (**LegCo**) and

simultaneous public consultation of the draft subsidiary legislation by the HKMA and SFC: **End of 2012**

- Final implementation (subject to passage of the relevant legislation by LegCo): **Mid-2013**

Conclusion

The proposed OTC derivatives regulatory regime will impact on how market players, particularly AIs, AMBs, LCs and HKPs, carry out their OTC derivatives transactions in Hong Kong. Market players should continue to maintain their awareness and understanding of the latest developments to the proposed regime, anticipate whether any mandatory reporting and/or clearing obligations or licensing obligations may arise, and if necessary, prepare to have the relevant reporting and/or clearing systems and capabilities in place before the mid-2013 targeted implementation.

APPENDIX

Type 11 regulated activity carve-outs

The proposed carve-outs to address the regulatory overlap between Type 11 regulated activity and the existing regulated activities are as follows:

- **Overlap with existing regulated activities:** Activities that also constitute an existing regulated activity and are conducted by a person who is appropriately licensed (or registered) to carry on such regulated activity will be excluded from the scope of the new Type 11 regulated activity. Corresponding carve-outs will also be introduced for the existing regulated activities so that persons licensed for Type 11 regulated activity would not be required to obtain a separate licence for an existing regulated activity to the extent that OTC derivatives also fall within the ambit of the latter. Note that this does not apply to AIs and AMBs who are exempt from the requirement to be registered or licensed for Type 11 regulated activity.
- **Dealing through a licensed dealer:** A person's activities that would also constitute a Type 1, 2 or 3 regulated activity but for relying on the "dealing through" with no remuneration exemption would be able to continue doing so without having to be licensed for the new Type 11 regulated activity or having to "deal through" an entity licensed for Type 11 regulated activity.
- **Communication of securities offers:** Persons licensed for Types 4 or 6 regulated activities who communicate offers of securities in compliance with the requirements of section 175 of the SFO (and hence are exempt from obtaining a Type 1 licence)

would be able to continue doing so without having to obtain the new Type 11 licence provided the communication complies with section 175 of the SFO.

- **Advising incidental to dealing:** Activities by a Type 1 licensed LC that would also constitute a Type 4 regulated activity or a Type 5 regulated activity but for the "wholly incidental" exemption would be excluded from the definition of Type 11 regulated activity.
- **Particular types of leveraged foreign exchange trading contracts:** Activities that would also constitute a Type 3 regulated activity but for carve-outs under paragraph (i), (iii) or (vi) of the definition of "leveraged foreign exchange trading" would be excluded from the ambit of Type 11 regulated activity.

In addition, the Supplemental Consultation Paper also proposes the following carve-outs from the ambit of Type 11 regulated activity (many of which are similar to the above):

- Activities of recognized clearing houses, recognized exchange companies and ATS providers authorized under section 95 of the SFO.
- Activities of AIs and AMBs.¹
- Dealing through an AI or a LC licensed for Type 11 regulated activity for no remuneration.
- Activities of price takers (i.e. end users).
- Activities of persons licensed or registered for Type 9 regulated activity (asset management) for the purposes of carrying on that regulated activity.
- Advice given to wholly owned subsidiaries, the holding company or other wholly owned subsidiaries of that holding company (intra-group exemption).
- Advisory activities of professional service providers, solicitors, accountants etc. where the

activities are wholly incidental to their practice or duty.

- Advisory activities conducted via published or broadcast media and made available to the public otherwise than on subscription.
- Any other activities excluded by subsidiary legislation.

Type 12 regulated activity carve-outs

The following activities will be excluded from the scope of the new Type 12 regulated activity:

- Activities of a CCP (whether in Hong Kong or overseas, and whether regulated or not) in its capacity as a CCP.
- The clearing agency activities of an AI or an AMB.
- The clearing agency activities of a person that:
 - (a) does not have a place of business in Hong Kong;
 - (b) is regulated under the laws of an "acceptable overseas jurisdiction" in respect of the provision of clearing agency services;
 - (c) provides clearing agency services as a member of a local CCP; and
 - (d) 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 is conducted by a person that is either an AI or LC.

- 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.

¹ This does not affect the obligation of AIs or AMBs to register or obtain a licence for any of the existing regulated activities to the extent that their OTC derivatives activities also constitute carrying on such existing regulated activities.

This publication 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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