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Hong Kong releases consultation paper on draft OTC derivatives mandatory reporting and record keeping rules

Following the enactment of the Securities and Futures (Amendment) Ordinance (the Amendment Ordinance) in April this year, the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have released a further public consultation paper (2014 Consultation Paper) containing draft rules to implement a mandatory reporting and record keeping regime for OTC derivatives. The consultation period will end on 18 August 2014. This new regime is expected to take effect at the earliest by the end of Q4 2014 or the beginning of 2015. The HKMA and SFC have indicated that the implementation of mandatory clearing and trading for OTC derivatives will come at a later stage.

The 2014 Consultation Paper is an important part of the OTC derivatives reform as it introduces the finer details relevant to mandatory reporting of OTC derivatives that will be set out in the subsidiary legislation. This client briefing highlights some key observations from the 2014 Consultation Paper and draws comparisons with the mandatory reporting regimes that have been introduced in other jurisdictions.

Outline of the 2014 Consultation Paper

The key developments introduced by the 2014 Consultation Paper include:

1. detailed rules on the scope of mandatory reporting of OTC derivatives which are "conducted in Hong Kong" by Authorised Institutions (AIs), Approved Money Brokers (AMBs) and Licensed Corporations (LCs);
2. the reporting requirements for funds and fund managers;
3. details on exemptions, thresholds and data masking relief for market participants; and
4. the imposition of reporting obligations on central counterparties (CCPs).

Overview of the 2014 Consultation Paper

List of OTC Derivative Product Classes to be Subject to Mandatory Reporting in Phase 1

Mandatory reporting will initially be limited to:

1. Non-deliverable forward transactions in ISO 4217 currencies (including some precious metals) to be specified by the HKMA;
2. Plain vanilla floating vs fixed interest rate swaps in ISO 4217 currencies and floating rate indices to be specified by the HKMA; and
3. Plain vanilla floating vs floating basis swaps in ISO 4217 currencies and floating rate indices to be specified by the HKMA,

(together, the Reportable Transactions).

Interestingly, overnight index swaps, which were an OTC derivatives product class specified to be reportable during the interim reporting regime, have been left out of the 2014 Consultation Paper.

The requirements will be extended subsequently, in phases, to cover other OTC derivatives products including other rates products and FX products, and also equity and credit derivatives.

Participants to be Subject to Mandatory Reporting in Phase 1

The scope of the mandatory reporting regime applies to the following entities where they are a counterparty to the relevant OTC derivatives transaction:

1. AIs;
2. AMBs;
3. LCs;
4. Hong Kong Persons (HKPs) (see below for further detail); and
5. CCPs that are recognized clearing houses, or are authorized under the Securities and Futures Ordinance (Cap. 571) to provide automated trading services,

(together, the Prescribed Entities).

Overseas-incorporated AIs with a Hong Kong branch will be captured by the mandatory reporting regime where (i) they are a counterparty to the relevant OTC derivatives transaction and the transaction to which they are a counterparty is recorded in the form of an entry in the books of the Hong Kong branch of the AI.

In addition, Hong Kong incorporated AIs may be required by the HKMA to procure that one or more of their subsidiaries (if specified by the HKMA) report on their Reportable Transactions. This obligation is separate from any reporting obligation of the relevant subsidiaries and is therefore not subject to any reporting threshold outlined below.

Who is a Hong Kong Person?

Broadly speaking, HKPs will include:

- residents in Hong Kong and entities established under Hong Kong law (including all partnerships, trusts, companies and other entities); and
- overseas companies registered or required to be registered under the Companies Ordinance (Cap. 622) (the Companies Ordinance) in Hong Kong.

An overseas company is required to be registered under the Companies Ordinance if it establishes a place of business in Hong Kong.

Mandatory Reporting of OTC Derivatives Transactions "conducted" in Hong Kong

An AI, AMB or LC will be required to report a Reportable Transaction if (a) a counterparty to the transaction is an affiliate of such AI, AMB or LC and (b) the Reportable Transaction was "conducted" in Hong Kong (such Reportable Transactions being Nexus Transactions). This limb of mandatory reporting replaces the initial "originate or execute" concept proposed by the Hong Kong regulators (see our previous client briefing *HKMA and SFC release joint consultation conclusions & supplemental consultation relating to the proposed regulatory regime for the OTC derivatives market in Hong Kong* for further details).

The requirement to report Nexus Transactions covers both OTC derivatives transactions conducted on behalf of an affiliate and those conducted by the Hong Kong branch of an overseas AI on behalf of the AI's head office or other non-Hong Kong branches.

While Nexus Transactions are booked outside of Hong Kong and therefore do not directly impact on the local balance sheet of the reporting AI, AMB or LC, the HKMA and SFC consider that it is important that they have oversight of activity taking place in the Hong Kong OTC derivatives market.

According to the 2014 Consultation Paper, an AI, AMB or LC will be considered to have conducted a Reportable Transaction in Hong Kong on behalf of an affiliate (and will therefore need to report that transaction) if the individual through whom the affiliate enters into the transaction (i) acts in his or her capacity as a trader, and (ii) is employed or engaged by the AI, AMB or LC to perform a substantial part of his or her duties in Hong Kong.

The Hong Kong regulators intend to let the term "trader" take on its ordinary meaning so that only persons who make the trading decision are captured by the "conducted in Hong Kong" test. Accordingly, persons who are acting solely in their capacity as salespersons will be excluded from the ambit of this test. In addition, the Hong Kong regulators have proposed that any transaction that is executed by a trader who is predominantly based in Hong Kong, regardless of the trader's physical location at the time of the transaction, is to be regarded as having been conducted in Hong Kong.

This is similar to the recent MAS proposals in Singapore[1]. Unlike in Singapore where the Monetary Authority of Singapore defined the concept of employment, the HKMA and SFC have not purported to define the terms "employed" or "engaged". Although some guidance is offered in the form of clarification that Hong Kong secondees will be caught by the reporting regime since they will need some form of employment or engagement letter with the AI, AMB or LC in Hong Kong, the precise meaning of the terms "employed" or "engaged" remains somewhat of an open question.

Reporting Requirements for Funds and Fund Managers

The 2014 Consultation Paper provides specific guidance to reporting of a fund's position. A fund's / managed account's position may become reportable under two potentially overlapping circumstances:

1. By virtue of being managed or sub-managed by an AI/LC licensed or registered to carry on a Type 9 regulated activity (*asset management*) and such AI or LC having entered into a reportable transaction on behalf of such fund. In this circumstance, the AI/LC will be caught under the proposed mandatory reporting regime.
2. If the fund itself is considered to be a HKP (i.e. by virtue of being domiciled in Hong Kong or domiciled overseas but structured in the form of a company and registered, or required to be registered, under the Companies Ordinance) and has exceeded the Proposed Reporting Threshold and does not fall below the Proposed Exit Threshold (see table below for details on the thresholds). In this circumstance, the fund will be caught under the proposed mandatory reporting regime.

[1] See MAS consultation paper on draft regulations for reporting of foreign exchange derivatives contracts.

There are several exemptions to this reporting requirement on funds which we discuss below. In the event that both circumstances above apply (i.e. both the fund and its fund manager are caught), the reporting obligation will rest on the Type 9 licenced/registered fund manager rather than on the fund. However, if only the second circumstance above applies (e.g. the fund is managed by an offshore fund manager that is not licensed or registered for Type 9 regulated activity), and the Reportable Transaction is not entered into with an AI, AMB or LC (see below exemption available for HKPs), the fund itself will have a reporting obligation.

While Hong Kong-based unit trusts will generally fall under both circumstances, most private fund vehicles (such as hedge funds) are not established or registered in Hong Kong but their transactions will still become reportable if they are managed by an AI or LC in Hong Kong.

Reporting Exemptions

1. Exemptions available to Hong Kong Persons

As a general rule, Hong Kong adopts two sided reporting. A notable exception to this rule, however, is where a HKP enters into a Reportable Transaction with an AI, AMB or LC (and such AI, AMB or LC is also subject to reporting in Hong Kong). In such circumstances, the HKP will be exempt from reporting and only the AI, AMB or LC will have an obligation to report the transaction.

Additionally, HKPs will not be subject to the mandatory reporting regime if, in respect of a particular product class, the level of their average gross notional outstanding positions for the previous six months (based on their month-end position) does not exceed the Proposed Reporting Threshold or falls below the Proposed Exit Threshold.

The proposed thresholds are as follows:

Asset Class	Proposed Reporting Threshold	Proposed Exit Threshold
IRS	USD3 billion	USD2.1 billion
NDF	USD1 billion	USD700 million

In calculating the Proposed Reporting Threshold and the Proposed Exit threshold, HKPs domiciled in Hong Kong should consider all their reportable transactions, while HKPs not domiciled in Hong Kong but registered, or required to be registered, in Hong Kong should only count their reportable transactions entered into in Hong Kong.

2. Exemptions available to AIs, AMBs and LCs

Reporting by an affiliate

With respect to transactions that become reportable by virtue of the "conducted in Hong Kong" test, the 2014 Consultation Paper sets out a proposal that would deem AIs, AMBs and LCs to be in compliance with their reporting obligations by virtue of receiving a confirmation from their affiliate, in good faith, that the affiliate has reported the relevant transaction to the Hong Kong Monetary Authority Trade Repository (HKMA-TR).

Exempt Person Relief

An AI, AMB or LC will also be exempted from reporting obligations if such AI, AMB or LC satisfies the Exempt Person Relief, i.e.:

- it does not conduct transactions in Hong Kong on behalf of an affiliate, or enter into transactions on behalf of another person in the course of managing such person's assets;
- it has no more than five outstanding OTC derivatives transactions in respect of a particular product class;
- it has less than US$30 million in aggregate gross notional value of outstanding OTC derivatives transactions of a particular product class;

- its counterparty to the relevant OTC derivatives transaction is not a HKP; and
- it has not already set up a connection with the HKMA-TR for reporting transactions in the product class for which they are claiming the exemption.

A particular point to highlight about the Exempt Person Relief is that once lost, it cannot be revived. In other words, once the AI, AMB or LC fails to meet any of the above criteria in respect of a particular product class, it will permanently cease to be entitled to this relief in respect of that class.

3. Privacy and Masking

Given there are certain jurisdictions where a counterparty's consent is insufficient to override local privacy and bank secrecy laws, the 2014 Consultation Paper allows for masking of counterparty particulars where:

(a) the laws of an overseas jurisdiction (which is designated by the SFC with the HKMA's consent), or an authority or regulatory organisation in that jurisdiction prohibit the disclosure of such information; or

(b) in the case of only historical transactions (i.e. transactions entered into before the rules first take effect), the person cannot disclose such information without the consent of the other counterparty, and despite reasonable efforts, such consent cannot be obtained.

Timing for Reporting and Grace Periods

Generally the reporting obligations must be fulfilled on a T+2 basis and entities will be given an additional two business days to report subsequent events relating to that transaction, including changes to the economic terms or counterparty of the contracts.

In terms of the initial lead time prior to the commencement of mandatory reporting, the 2014 Consultation Paper proposes that each time a new product becomes reportable:

(a) a period of up to 3 months will be given to reporting entities to set up their reporting channel to the HKMA-TR (Concession Period); and

(b) a period of up to 6 months (which runs concurrently with the 3 month Concession Period) will be given to reporting entities to complete any backloading, i.e. reporting of historical transactions (see below) (Grace Period).

The Concession Period and Grace Period will start running from the relevant reporting commencement date prescribed in the draft rules which will vary depending on the entity and product type involved. Such periods will not reset for entities that attain regulated status during or after the Concession Period or cease to be Exempt Persons during or after the Concession Period.

AIs that have reported their interbank transactions under the interim reporting requirements will not be subject to any backloading obligations and will have to continue to report new interbank transactions and subsequent events falling under the interim reporting requirement to the HKMA on a T+2 basis without regard to the Concession Period or Grace Period.

“Backloading” requirements

As a general rule, the reporting obligations will apply in respect of reportable transactions entered into before the day they become subject to reporting but which are still outstanding on that day. However, three limitations are imposed on this general rule:

(a) HKPs that are non-Hong Kong companies will only be subject to the backloading obligations for transactions they enter into before they reach the reporting threshold (discussed above) but after the relevant product specification day specified in the draft mandatory reporting and record keeping rules;

(b) AIs, AMBs and LCs will only need to backload transactions to which they are a counterparty. With respect to overseas AIs, this means that only transactions that are booked with the AI’s Hong Kong branch need to be backloaded; and

(c) Transactions that mature or are terminated before the expiry of the grace period allowed for backloading will not need to be backloaded.

Miscellaneous

1. **HKMA-TR Capabilities**

While mandatory reporting currently only extends to interest rate swaps and non-deliverable forwards, the HKMA is nevertheless expanding its trade repository capabilities. Previously the infrastructure could only cover interest rate swaps and non-deliverable forwards. By September 2014 it is estimated that data in respect of a further 15 product classes could be accepted (including equity derivatives).

The HKMA is also enhancing its reporting system to include fields that support the reporting of certain information relating to the valuation of transactions on a daily basis. This follows the proposed expansion of the mandatory reporting obligations so as to require AIs, AMBs, LCs and CCPs to provide, on a daily basis and for as long as transactions remain outstanding, a mark-to-market valuation of all transactions reported to the HKMA. However, the requirement to report this information daily will be implemented in the future, possibly in or after late 2015, according to the 2014 Consultation Paper.

2. **Record Keeping Obligations**

The 2014 Consultation Paper introduces record keeping requirements that will enable the HKMA and SFC to monitor compliance with the mandatory reporting regime. In particular, reporting entities must be able to demonstrate to the Hong Kong regulators through documentary evidence that they have reported transactions where required to do so, or have validly relied on one of the available exemptions. It is important to note that the record keeping requirements not only apply to regulated entities such as AIs, AMBs and LCs, but also to HKPs which are not otherwise regulated. Records must be kept for at least seven years after the transaction has reached maturity or has terminated.

3. **Agency Reporting**

The mandatory reporting obligations may be delegated to agents such as third party service providers or global trade repositories, subject to the agent fulfilling the relevant technical, logistical and documentation requirements necessary to obtain approval by the HKMA to conduct agency reporting. However, trade repository members reporting through an agent remain primarily responsible for the accuracy and timeliness of the reporting, and reporting through an agent may constitute an outsourcing arrangement requiring prior approval of the relevant supervisory authorities.

Looking Ahead and Next Steps

To prepare for the introduction of mandatory reporting of OTC derivatives transactions in Hong Kong, market participants should familiarise themselves with their reporting obligations and have the necessary infrastructure built to ensure their compliance with the regime is as streamlined as possible. Market participants should also subscribe to the HKMA-TR's trade reporting service with ample time in advance of the commencement of their reporting obligations.

Additionally, if an AI, AMB or LC wishes to rely on the Exempt Person Relief, it should monitor its positions very closely, noting that if it fails to meet any of the Exempt Person Relief criteria in respect of a particular product class, it will permanently cease to be entitled to the Exempt Person Relief in respect of that product class.

We will be responding to the 2014 Consultation Paper.

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