

# HKMA and SFC Consultation Conclusions pave way for mandatory reporting of OTC derivatives in Hong Kong in 2015

The Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**") released their consultation conclusions (the "**Consultation Conclusions**")<sup>1</sup> in relation to the proposed reporting and record keeping rules ("**Rules**") in respect of OTC derivative transactions.<sup>2</sup> In a welcome development for the fund management industry and end users, the HKMA and SFC have decided to adopt a phased approach to the introduction of mandatory reporting of OTC derivatives in Hong Kong, with dealers being the first category of market participants to be subject to the reporting requirements. The revised Rules applicable to dealers are expected to come into effect in the first quarter of 2015, with a six month grace period before mandatory reporting commences.

The regulators have made a number of amendments to the Rules after consideration of market feedback, such as an extension of the grace period, clarification of the product scope and broadening the availability of data masking. This client briefing sets out our main observations on the revised Rules contained in the Consultation Conclusions, and highlights the key developments that market participants should be aware of for 2015.

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<sup>1</sup> Consultation Conclusions and Further Consultation on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules of 28 November 2014  
A copy of the Consultation Conclusions can be found at

<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=14CP8>

<sup>2</sup> Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules

## Background

With the publication of the Consultation Conclusions to the consultation paper on the Rules dated 18 July 2014<sup>3</sup> (the "**Original Consultation Paper**"), market participants should expect mandatory reporting of OTC derivatives to be introduced in Hong Kong very soon.

This is a long-awaited development for Hong Kong that brings its regulatory regime for OTC derivatives in line with those of other major financial centres.

2015 is shaping up to be a very important year for OTC derivatives regulatory reform both in Hong Kong and the Asia Pacific region, with mandatory reporting commencing in multiple jurisdictions and consultations on detailed rules relating to mandatory clearing also scheduled for the first quarter of next year.

## Timing

It should be no surprise that Hong Kong is keen to expedite the introduction of the Rules given that mandatory reporting rules have been passed in other financial centres for some time already. With the revisions to the Rules made in the Consultation Conclusions, it is anticipated that such Rules will pass through negative vetting in the Legislative Council during the first quarter of 2015, and for the Rules to come into force soon after this.

We expect that market participants will be pleased that the regulators have agreed to increase the initial grace period for mandatory reporting from three months (as proposed in the Original Consultation Paper) to six months (as requested by many reporting entities). This has also increased the corresponding period for backloading of reportable transactions from six months to nine months. The additional three months provided by the HKMA and SFC will come as a relief for market participants that need to build operational systems for capturing trades that are reportable on the basis that they are "conducted in Hong Kong".

## Fund Managers and Hong Kong Persons

One of the most significant changes to the initial consultation is the delay of mandatory reporting for both fund managers and "Hong Kong Persons". The HKMA and SFC have agreed to implement mandatory reporting in phases, with authorized institutions and licensed corporations becoming subject to the obligation first.

The regulators recognised that for fund managers, there were significant difficulties with mandatory reporting which needed to be overcome. For example, due to operational burdens, most funds and fund managers may seek to rely on their dealers to report derivative transactions to trade repositories. However, many of the dealers are either overseas entities that are not subject to reporting under the proposed Rules and therefore will not set up the links required to report to the HKMA trade repository, or are otherwise not prepared to do delegated reporting. Additional time is required to find a solution to such problems.

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<sup>3</sup> For further information on the Original Consultation Paper, please see our client briefing at [http://www.cliffordchance.com/briefings/2014/07/hong\\_kong\\_releasesconsultationpaperondraf.html](http://www.cliffordchance.com/briefings/2014/07/hong_kong_releasesconsultationpaperondraf.html)

However, it is advisable for the fund management industry to use the additional time that has been provided by the HKMA and SFC to carefully consider the proposed reporting rules under the Original Consultation Paper and make submissions to the regulators on any difficult points. One example would be the proposal for fund managers regulated in Hong Kong to report OTC derivatives which they entered into on behalf of a fund as part of their asset management activities. There is some uncertainty as to the scope of this requirement and the fund industry should consider proposing a definition for this limb of reporting that appropriately meets the regulatory objectives and does not cause an undue operational burden for fund managers.

### Data Masking

The Consultation Conclusions introduced two important developments on data masking that will be helpful for reporting entities which are seeking to comply with their reporting obligations without breaching any bank secrecy and/or confidentiality requirements to counterparties.

#### *List of jurisdictions*

First, the SFC has (with the HKMA's consent) proposed a list of eighteen jurisdictions<sup>4</sup> for the purposes of data masking relief. This means that where a market participant is required to report an OTC derivatives transaction which involves counterparty identifying information belonging to one of the jurisdictions contained in such list, the market participant will be allowed to report on a masked basis.

As the regulators have ruled out the possibility for reporting entities to rely on a reasoned legal opinion to qualify for data masking relief, it will be important for market participants to assess all of their counterparties and seek to ensure that any "problematic" jurisdictions from a data privacy perspective are included in the list of jurisdictions that will be published by the regulators together with the final version of the Rules.

#### *Grace period to obtain consent*

Second, under the Original Consultation Paper, it was noted that where confidentiality issues could be overcome through counterparty consent, data masking would be available only for "historical" transactions that were entered into before the Rules came into effect. In other words, if a reporting entity had not obtained counterparty consent to report in Hong Kong, the reporting entity would need to stop trading with such counterparty after the Rules are implemented.

Market participants will welcome the changes proposed by the regulators under the Consultation Conclusions, under which a six month grace period has been introduced for "new" transactions where a reporting entity has used reasonable efforts to obtain consent from their counterparty but has not been able to do so by the date on which the Rules become effective. However, it is important to note that such reporting entities will need to demonstrate to the regulators that they have used reasonable efforts, including by providing documentary evidence.

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<sup>4</sup> Algeria, Argentina, Austria, Bahrain, Belgium, France, Hungary, India, Indonesia, Israel, Luxembourg, Pakistan, People's Republic of China, Samoa, Singapore, South Korea, Switzerland and Taiwan

## Further Consultation

Apart from consulting market participants on the list of jurisdictions for data masking purposes, the HKMA and SFC are also consulting on two further issues under the Consultation Conclusions, which are summarised below. The regulators have requested feedback on these three issues by 23 December 2014.

### 1. Reporting of valuation transaction information

Data relating to valuation transaction information is important to regulators seeking to assess systemic risk in the derivatives market of a jurisdiction. However, as recognised by many jurisdictions, the introduction of reporting of valuation transaction information imposes significant burdens on market participants and therefore the benefits must be weighed against the costs to reporting entities. Furthermore, additional time is needed to implement the systems necessary for valuation transaction reporting, and it will be interesting to see if market participants consider the timing proposed by the regulators (first quarter of 2016) to be sufficient.

One proposal of note in the Consultation Conclusions is the requirement that for non-centrally cleared transactions, the valuation should be based on methodology mutually agreed between the counterparties. A potential consideration for market participants is whether such mutual agreement will require the disclosure of proprietary information where mark-to-market is unavailable and a reporting entity is valuing on a marked-to-model basis.

### 2. List of stock/futures markets and clearing houses for the purposes of the definition of "OTC derivative product"

Under the definition of "OTC derivative product" in the Securities and Futures Ordinance, it is intended for products that are traded on a stock or futures market to be excluded as they will already be regulated transactions. To this end, the regulators have compiled a fairly comprehensive list of stock and futures exchanges as well as clearing houses which are set out as Appendix B in the Consultation Conclusions. The proposal is for products traded on such exchanges and clearing houses to be excluded from the definition of "OTC derivative product" under Hong Kong law.

While it is understood that the HKMA and SFC have conducted soft consultations with market participants on which exchanges and clearing houses to include in the list proposed in the Consultation Conclusions, market participants should nevertheless consider this list carefully and consider whether additions need to be made in order to ensure that none of their trades are inadvertently caught by the mandatory reporting, clearing and/or margining requirements to be introduced in Hong Kong.

## Looking ahead

The HKMA and SFC helpfully set out a proposed timetable for regulatory reform of OTC derivatives in Hong Kong for 2015. In particular, market participants should be aware that:

1. *Mandatory reporting:* Mandatory reporting of OTC derivatives will be expanded to cover fund managers and Hong Kong persons in the future when the regulators have resolved the various issues raised by concerned parties in response to the Original Consultation Paper; and

2. *Mandatory clearing*: The HKMA and SFC anticipate conducting a consultation on the detailed rules for mandatory clearing in the first quarter of 2015. This has been long expected since the publication of the consultation conclusions from July 2012<sup>5</sup> and the launch of OTC Clear in November 2013. Market participants will be interested in learning the regulators' views on key issues relating to mandatory clearing, such as (a) the proposed clearing threshold, (b) the proposed exemptions from mandatory clearing and (c) the interaction between the Hong Kong mandatory clearing obligation and that of other jurisdictions such as under Dodd Frank and EMIR.

Clifford Chance looks forward to assisting market participants and regulators in addressing the challenge of introducing the G20 measures designed to mitigate systemic risk while minimising disruption to the efficient functioning of the derivatives market.

## Conclusion

With the timetable proposed by the HKMA and SFC under the Consultation Conclusions, it is expected that 2015 will be an eventful year both for market participants that will become subject to mandatory reporting and clearing obligations in Hong Kong, and for any counterparties that trade with such entities.

As with the industry's experience in implementing requirements under the Dodd Frank Act and the European Market Infrastructure Regulation, it is expected that market participants will face a myriad of challenges (both anticipated and unanticipated) when mandatory reporting and clearing come live in Asian jurisdictions over the next two years or so.

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<sup>5</sup> For a copy of the consultation conclusions published in July 2012, please follow this link <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=11CP6>. For our client briefing on this paper, please follow this link [http://www.cliffordchance.com/briefings/2012/07/hkma\\_and\\_sfc\\_releasejointconsultatio.html](http://www.cliffordchance.com/briefings/2012/07/hkma_and_sfc_releasejointconsultatio.html)

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