THE LAW SOCIETY OF HONG KONG
香港律師會

SFC Consultation Paper on
The Proposed Regulatory Regime for the Over-the-Counter Derivatives Market in Hong Kong

We recognise the political, economic and regulatory significance of the proposed reforms for Hong Kong, not least in the context of Hong Kong implementing the G20 commitment to changes to the Over-the Counter derivatives (OTC) derivatives market in the wake of the 2008 global financial crisis. In developing a domestic central counterparty, Hong Kong needs to have a credible and effective regime in place to support in, in line with Hong Kong's position as an important international financial centre.

The tight deadline for implementation of the new regime by the end of 2012, consistent with the stated international timetable (subject of course to any general slippage there may be in terms of practical implementation internationally, which is to an extent alluded to in the Consultation Paper) leaves little room for manoeuvre and demands the incoming regime to be effective from day one, with no latitude for potentially damaging short term amendments or modifications following the commencement of operations.

In that regard, recognising the short time frame and the underlying drivers and imperatives, we have concentrated on what we consider to be some of the important legal issues arising out of the Consultation Paper. We have not responded to all of the consultation questions in detail, rather homing in on those substantive issues. We have accordingly not, for example, put forward any views in relation to the need for or desirability of a Hong Kong central counterparty (CCP), nor the degree to which its establishment may or may not assist in "improving" the OTC markets or managing effectively (rather than transforming) the nature of market risks in this area.

Joint regulation by the HKMA and SFC

Will there be a specific memorandum of understanding entered into between the HKMA and SFC to establish clearly defined regulation of the new regime seamlessly across the regulators and regulated transactions and entities? Or will the present arrangements between the regulators be modified to ensure that the consequences of the new regime are captured within their relationship for the sake of certainty in the market?

"OTC derivatives transactions"

We note that the current thinking is to define "OTC derivatives transactions" as a general concept as transactions in "structured products", subject to certain exemptions.

We appreciate why there is the desire to use the recently developed "structured products" definition in an effort to harmonise the terms used in the market. One of the consequences of the breadth of the definition is discussed below.

The exemptions from the definition of "structured products" for these purposes are as follows:

(1) transactions in securities and futures contracts that are traded on a recognized market (i.e. a market operated by a recognized exchange company,

(2) transactions in structured products that are offered to the public and the documentation for which is authorized under section 105 of the SFO, and

(3) transactions in currency-linked instruments, interest rate-linked instruments or currency and interest rate-linked instruments offered by authorized institutions to the public and the documentation for which is exempted from the prohibition under section 103(1) of the SFO by virtue of section 103(3)(ea) of the Securities and Futures Ordinance.

These exemptions are in our view sensible and appropriate. We do not understand why the exemptions are so limited. We do question for example why there is no additional exemption designed to accommodate hedging transactions of market participants. Also, the carve-out of securities and futures contracts traded on the HK exchanges seems to be too narrow (paragraph 38(1) of the Consultation Paper). What is the reason for not carving out securities and futures contracts traded on overseas exchanges?

We agree that it is appropriate to cater for market development in products by including a power that will allow specific transactions to be expressly included within, or excluded from, the ambit of "OTC derivatives transactions". We presume that exercise of such power would be subject to market consultation, so as to ensure reasonable certainty in the market.

As indicated in the Consultation Paper, a crucial issue is the degree to which OTC derivatives transactions (in non-deliverable forwards (NDFs) and interest rate swaps (IRS) to begin with) are sufficiently standardised and suitable for central clearing. Market participants will need clear definitions and guidance to allow them to accommodate the relevant contracts into their systems. The definitions will of course need to cater for the degree to which there can be variation in a particular contract before it becomes "bespoke" rather than "standard" and therefore falls outside the concept of mandatory clearing and reporting. Once it does so, as may be the case in relation to carefully designed and engineered derivatives to assist complex hedging arrangements for say large corporations, care needs to be taken not to penalise such legitimate market activity (by higher capital requirements and so on) in cases of bona fide hedging, where it could be argued that such arrangements are suitable and appropriate market strategies without the need to "punish" the relevant participants. This type of activity might be viewed in a similar vein in principle to the short term FX derivatives referred to in paragraph 54 of the Consultation Paper.

Finally in this regard, we note that in paragraph 59 of the Consultation Paper, reportable transactions will be limited to:

- single currency interest rate swaps
- overnight index swaps
- single currency basis swaps
- NDFs

Noting the above, where the first three bullets refer to IRS, we would point out that paragraph 97(1) says that "amortising swaps", even though not reportable, would need to be counted towards the threshold. We would have expected such transactions to amount to IRS and therefore caught, but this opens up the question of how to be clear about the different products for practical purposes.

The effect of this on the per product basis for thresholds is referred to below.

Who is caught by the regime?

Directly relevant to the impact of the incoming regime is the question of what type of person/entity falls within its scope.

Set out below is our understanding of how the regime is intended to work:

Who?

<table>
<tr><th>Type of entity</th><th>Reporting</th><th>Clearing</th><th>Trading</th></tr>
<tr><td>LC or local AI (on sole or consolidated basis)</td><td>If counterparty or O/E</td><td rowspan="4">If:
(a) local AI, LC or HK person is a counterparty or LC or local AI O/E or overseas AI counterparty O/E through HK branch
and
(b) both parties exceeded specified clearing threshold in same product class

NOT where both counterparties are overseas persons and the transaction must and has been cleared in acceptable jurisdiction (or is exempt in that jurisdiction)</td><td rowspan="4">N/A</td></tr>
<tr><td>Overseas AI</td><td>If:
(a) counterparty and O/E through HK branch
or
(b) counterparty and HK nexus</td></tr>
<tr><td>Other HK Persons</td><td>If counterparty and over specified reporting threshold in same product class (unless an AI or LC required to report)</td></tr>
<tr><td>Other overseas persons</td><td>N/A</td></tr>
</table>

AI – authorised institution
LC – licensed corporation
O/E – originated or executed (negotiate/arrange/confirm/commit)

We would like to highlight four points:

1. We realise that the regime would have little in the way of "teeth" if it were simply restricted to the counterparties to a transaction, given the way that most execution and booking arrangements are organised among international players in Hong Kong (agency/arranger/offshore booking structures).

Having said that, and presuming that the words "negotiate" (this is very broad indeed), "arrange", "confirm" (not clear what this means - presumably not in the ISDA confirmation sense) and "commit" (presumably execute) are destined to be used in the definition of "originated or executed", it is essential that these words are carefully defined to ensure a high degree of predictability in their application in the market. How involved would a Hong Kong branch need to be in a "negotiation" before it triggered a reporting/clearing requirement? "Arranging" has a relatively settled meaning in terms of taking distinct, material and positive steps to make a deal happen (and is for example a specific regulated activity in the UK); confirmations and commitment are probably the easier end of the spectrum to recognise in practice.

If there is intended to be a relatively "soft" and purposive definition for this overall concept, then it is incumbent on the SFC and HKMA to ensure that there is significant guidance to the market as to how the provisions will be applied, to avoid artificial debates about "how involved" a Hong Kong branch really had been in a trade and whether it had been sufficient to trigger the mandatory requirements.

2. Hong Kong "nexus" As drafted, an overseas authorized institution counterparty with no other connection than say a Hong Kong dollar-denominated rate or Hong Kong listed shares, could be treated as triggering the reporting requirement. That is calibrated as very much a "hair trigger" and in our view this needs to be re-considered as a mater of practicality (not least enforcement and information overload) and policy.

3. "Hong Kong" person: The proposed definition includes individuals who are HK residents (paragraph 77 of the Consultation Paper). Transactions effected by an individual in his personal capacity have not been expressly carved out. Why - and is it the regulatory intention to extend the regime to activities of individuals in their personal capacity?

4. We note that the specified thresholds for reporting (for Hong Kong persons) and clearing are currently envisaged to be set on a "per product class" basis. Clearly, there will need to be precise formulation of what is taken into account and disregarded for the purposes of determining what falls within a particular "bucket" of products for assessing whether a threshold has been reached. We agree that the thresholds need to be set at an appropriate level to avoid capture of non-material positions as far as possible, consistent with the concept of looking towards systemic stability and good order in the markets.

Where for example a local authorized institution, licensed corporation or Hong Kong person is a counterparty, there will other things being equal be a mandatory clearing requirement triggered where <u>both</u> parties exceeded the specified clearing threshold in the same product class. That would seem to create additional (and potentially burdensome) compliance/due diligence burdens on market players in determining the status of the <u>other</u> party in respect of its specified clearing threshold and whether it has been reached in the particular product class. This is because if the other party has not reached the threshold, then the clearing requirement would fall away.

We consider that the reporting and clearing requirements should be limited to those transactions which are subject to the mandatory requirements to reduce the overall heavy compliance burden for market participants and to reinforce the point that the targeted transactions are those of most immediate focus for the regulators and the market generally, and provide an, in theory, readily identifiable universe of transactions to quantify for the purposes of the thresholds. That avoids difficulties in identifying other types of transaction in terms of where they fall within particular product classes - if they are systemically important or otherwise of importance from a regulatory oversight perspective, then they should be incorporated into the regulated environment.

Mandatory reporting

Clearly, there is a need for the legislative reform, CCP infrastructure and trade repository to be dealt with as a whole by all relevant stakeholders, to ensure as far as possible a collective and integrated system which will be sufficiently robust to accommodate the incoming requirements.

The T+1 reporting requirement may make the exemption covering where the counterparty has confirmed that a transaction has been reported (paragraph 67 of the Consultation Paper) very difficult to apply in practice. Assuming that in order to benefit from the exemption an AI or LC is required to obtain confirmation on a case by case basis (instead of a "master" undertaking from a counterparty that it will report from time to time as required), it may be too late for the AI or LC to make its own report by the time the counterparty confirmed that it has not reported the transaction. AIs and LCs may decide reporting all transactions themselves as the risk of breaching the reporting obligation is not worth taking.

Regulation of OTC derivatives intermediaries

We question the logic of not aligning the new Type 11 licence requirement with the mandatory reporting, clearing and trading obligations. The regulatory net for the new Type 11 licence should not be unnecessarily wide and then leaving the actual application to be determined on a case by case basis at the regulators' discretion. The definition of the new Type 11 regulated activity should be sufficiently clear to allow the industry and the public to determine who are caught and who are not. We consider that the HKMA comparison (in paragraph 164 of the Consultation Paper) is not appropriate and the regulatory rationale can be distinguished.

Oversight of "large players"

This needs to be approached cautiously so as to ensure that only truly systemically important players are indeed caught within such requirements.

Approach to penalties

This seems the correct approach to us.

The Law Society of Hong Kong
Investment Products & Financial Services Committee
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