

# Consultation Conclusions & Supplemental Consultation on the Proposed Regulatory Regime for the OTC Derivatives Market in Hong Kong

## Background Information

### I. Introduction

- Following the public consultation on the proposed regulatory regime for the OTC derivatives market in October 2011, the HKMA and SFC published the consultation conclusions to respond to the comments received from the consultation and issued a supplemental consultation paper on the new Type 11 & Type 12 regulated activities (RAs), expanded Type 9 RA and the oversight of systemically important players (SIPs) on 11 July 2012, which will be closed on 31 August 2012.

### II. Broad Regulatory Framework

- The HKMA and SFC welcome support for the proposed mandatory obligations on central clearing, reporting and trading of OTC derivatives transactions to be effected under the Securities and Futures Ordinance (SFO).
- This would provide a level playing field among different types of players in the OTC derivatives markets regulated by the HKMA and SFC, i.e. authorized institutions (AIs), approved money brokers (AMBs)<sup>1</sup> and licensed corporations (LCs). HKMA will continue to be the principal regulator for AIs and AMBs whilst the SFC will regulate persons other than AIs and AMBs (including therefore LCs).

### III. Key Refinements to the Original Proposals

In light of the responses received from the consultation, the HKMA and SFC have refined some of the features of the proposed regulatory regime, mostly of a technical nature concerning the definition of some key terms as well as the scope of coverage of the new mandatory obligations:

#### Definition of "OTC derivatives transaction"

- The term "OTC derivatives transaction" will be appropriately narrowed to exclude transactions effected on certain overseas exchanges, spot contracts, securitised products, embedded derivatives and similar products offered by a single issuer to a number of investors.

#### Regulation of AMBs

- AMBs will be subject to the mandatory clearing and reporting obligations along similar lines as AIs and LCs. Nevertheless, given the nature of business of AMBs which typically does not involve taking of proprietary positions in OTC derivatives transactions, they should not be much affected by the proposed mandatory obligations.

#### Clearing Obligation

- The HKMA and SFC will refine the mandatory clearing obligation so that it does not apply in respect of transactions that are "originated or executed" by an AI, LC or AMB but are booked overseas. This would avoid potential conflict with clearing

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<sup>1</sup> AMBs act as inter-dealer brokers in the OTC derivatives market.

obligations imposed by relevant overseas regulatory authorities.

### Reporting Obligation

- Reporting obligation on AIs, LCs and AMBs will be refined so that :
  - Transactions that are “originated or executed” by AIs, LCs and AMBs will have to be reported only if those transactions also have a “Hong Kong nexus”.
  - For overseas-incorporated AIs, transactions in which the Hong Kong branch has no involvement at all will not have to be reported.

This would help reduce the reporting burden on such institutions, while still enabling regulators to obtain information to assess if their OTC derivatives activities might have a bearing on financial stability in Hong Kong.

- In this connection, the term “Hong Kong nexus” will also be tightened as follows for better clarity:
  - (1) Equity derivatives and credit derivatives will be regarded as having a Hong Kong nexus if –
    - (a) the underlying entity or the reference entity is listed in Hong Kong, (and where there is more than one underlying entity or reference entity, a specified percentage of the entities are listed in Hong Kong), or
    - (b) the underlying is an index and a specified percentage of the underlying companies are listed in Hong Kong, or
    - (c) the reference entity is, or is wholly owned by, the Government of the Hong Kong Special Administrative Region, and
  - (2) Other derivatives will be regarded as having a Hong Kong nexus if the underlying asset, currency or rate is denominated in or related to Hong Kong dollars or Renminbi. We propose that the scope for FX and interest rate derivatives should cover Renminbi denominated transactions because of the rapid growth of such products in Hong Kong given the growing importance of Hong Kong as a key offshore Renminbi business centre.

### Exemption

- The HKMA and SFC are prepared to consider providing the following specific exemptions from the mandatory clearing and reporting obligations:
  - Clearing exemption for (i) intra-group transactions, (ii) transactions of end-users who are non-financial entities and who are using derivatives to hedge commercial risks, and (iii) transactions involving participants from “closed markets”<sup>2</sup>
  - Clearing and reporting exemptions for (i) central banks, (ii) monetary authorities/ public bodies charged with responsibility for the management of public debt and reserves and the maintenance of market stability, and (iii) global institutions such as International Monetary Fund, Bank for International Settlements etc. Exemption to central banks, monetary authorities and public bodies may be subject to criteria such as reciprocity.
- Similar exemptions are also being contemplated in other jurisdictions. We will monitor the relevant overseas developments closely.

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<sup>2</sup> “Closed markets” refer to jurisdictions which have a material level of foreign exchange control, and/or other local regulatory restrictions that make it impractical to require clearing to take place in any jurisdiction other than its own jurisdiction.

#### New RA Type 11 & 12, Expanded Type 9 RA and Oversight of SIPs

- To bridge the regulatory gap that will otherwise exist, there is a need to require entities (other than AIs and AMBs) that engage in OTC derivatives activities (otherwise than as end users) to be licensed for new RAs under the SFO. We will introduce: (i) a new Type 11 RA, which will capture the activities of dealers and advisers, and (ii) a new Type 12 RA, which will capture the activities of clearing agents.
- Regulatory requirements applicable to AIs, LCs and AMBs will be aligned and consistently applied to ensure a level playing field among different market players
- The existing Type 9 RA (asset management) is also proposed to be expanded to cover the management of portfolios of OTC derivatives.
- We will introduce provisions that will give the SFC and HKMA a degree of regulatory oversight in respect of SIPs, i.e. Hong Kong players that (i) are not otherwise regulated by the SFC or HKMA, but (ii) whose positions or activities may nevertheless raise concerns of potential systemic risk. We expect it is highly unlikely that there is currently any player in Hong Kong who would qualify as an SIP. However, for completeness, the regime needs to provide the necessary enabling powers to the regulators to exercise oversight over any such entities in the future.
- Our detailed proposals on the above matters are set out in the Supplemental Consultation Paper. We welcome public comments in this regard. The consultation will end on 31 August 2012.

#### **IV. Next Step**

- Many of the detailed aspects of our proposals will be the subject of a separate consultation which we aim to issue in Q4 this year. This will include matters such as –
  - definitions of some of the key concepts delineating the mandatory obligations (e.g. “originated or executed”, “Hong Kong nexus”, and “Hong Kong person”),
  - which specific types of transactions will be subject to the mandatory obligations,
  - which types of persons and transactions may be exempted from the mandatory obligations,
  - thresholds for: (i) mandatory reporting, (ii) mandatory clearing and (iii) qualifying as an SIP.
- We also aim to introduce the relevant Bill into the Legislative Council by the end of 2012 and conduct a public consultation on the draft subsidiary legislation at about the same time. Subject to passage of the relevant legislation by the Legislative Council, the target is to implement the new regulatory regime around mid-2013.