



**Deacons**  
的近律師行

By e-mail otccconsult@sfc.hk

29 November 2011

Supervision of Markets Division  
Securities and Futures Commission  
8th Floor, Chater House  
8 Connaught Road Central  
Hong Kong

Dear Sir/Madam,

**Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong (the "Consultation Paper")**

Thank you for the opportunity to comment on the Consultation Paper. Our responses to the questions in the Consultation Paper are enclosed.

If you wish to discuss our responses in more detail, please feel free to contact

Yours sincerely

Deacons

Encl.

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**160**  
YEARS IN HONG KONG  
庆祝本行成立一百六十周年

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

**Question 1**

**Do you have any comments on the proposed scope of the regulatory regime for the OTC derivatives market in Hong Kong and how it is proposed to be set out?**

*Deacons response:*

We agree with the proposal to adopt a broad definition of "OTC derivatives transactions" and to define narrower reporting and clearing obligations in subsidiary legislation.

We note that, in contrast to proposals in Europe and the United States, the proposed scope does not contain any exclusion for non-financial entities that enter into OTC derivatives to hedge commercial risks. That may result in Hong Kong being out of line with, and more onerous than, other major financial centres.

**Question 2**

**Do you have any comments on the proposed division of regulatory responsibility between the HKMA and SFC?**

*Deacons response:*

We note the proposed division of regulatory responsibility is consistent with the current regulatory framework in Hong Kong, with the exception of regulation of large players by the SFC. See our response to question 14 below on the proposals for regulation of large players by the SFC.

**Question 3**

**Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?**

*Deacons response:*

No comment.

**Question 4**

**Do you have any comments on the proposal to initially limit the scope of any mandatory reporting and clearing obligations so that they apply in respect of certain IRS and NDF?**

*Deacons response:*

No comment.

### **Question 5**

**Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?**

*Deacons response:*

We note the proposed mandatory reporting obligation for AIs and LCs may result in duplicate reporting, which may unnecessarily increase the compliance burden on AIs and LCs.

We propose that, where 2 of the parties involved in the OTC derivatives transaction are AIs or LCs (whether as counterparties or as intermediaries in originating or executing the OTC derivatives transaction), it should be sufficient to discharge the reporting obligation if the parties agree that one of them will assume the obligation to report the OTC derivatives transaction. For example, where an investment manager arranges OTC derivatives transactions with an AI on behalf of its clients, the investment manager will discharge its obligation if it agrees with the AI that the AI is responsible for reporting the OTC derivatives transactions.

For Hong Kong persons that are not AIs or LCs:

1. It does not appear necessary to include "funds that are managed in or from Hong Kong" in the definition of "Hong Kong person".

For the fund to be managed in or from Hong Kong, the fund will need to appoint a manager in Hong Kong (either directly or indirectly). That manager will need to be licensed with the SFC and so will be subject to a reporting obligation in respect of OTC derivative transactions that it originates or executes. As noted in the proposal set out in paragraph 61(3) of the consultation, a Hong Kong person is exempt from the mandatory reporting obligation where an AI or LC is subject to a reporting obligation in respect of the relevant transaction. As a result, a fund that is managed in or from Hong Kong will be exempt from reporting.

2. The T+1 reporting obligation may be challenging for Hong Kong persons that are not AIs or LCs e.g. where a Hong Kong person has appointed an overseas asset manager to manage a discretionary portfolio and that asset manager enters into an OTC derivatives transaction on behalf of the Hong Kong person that is reportable.

### **Question 6**

**Do you have any comments on the proposal to adopt a specified reporting threshold for persons other than AIs and LCs, and how the threshold will apply?**

*Deacons response:*

We understand the purpose of the reporting threshold is to reduce the compliance burden on persons other than AIs and LCs. We support that purpose. However, the methodology proposed for calculating whether the threshold has been exceeded is complicated and is likely to result in an increased compliance burden and / or inadvertent failures to report. A simpler approach may be to set the threshold on a transaction basis for reportable transactions, with appropriate provisions to ensure a single transaction is not split into multiple transactions to avoid the reporting requirement.

**Question 7****Do you have any comments on the proposed grace periods and how they will apply?***Deacons response:*

We support the principle of grace periods to allow affected persons sufficient time to ensure the appropriate reporting channels are in place.

**Question 8****Do you have any comments on the proposed mandatory clearing obligation, and how it will apply to different persons?***Deacons response:*

It is important to avoid conflicting mandatory clearing obligations in Hong Kong and other jurisdictions, especially given the proposal to include OTC derivatives transactions that are originated or executed by an AI or LC under the Hong Kong requirements. We note the proposed exemption may need to be expanded. As presently proposed, it may give rise to conflicts with the requirements of other jurisdictions e.g. if only one counterparty is an overseas person but that counterparty is subject to a mandatory clearing obligation under the laws of another jurisdiction.

**Question 9****Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?***Deacons response:*

One of the key elements of the mandatory clearing obligation is that both counterparties exceed the specified clearing threshold. Whilst an entity can determine whether it exceeds the specified clearing threshold, it is not able to determine whether its counterparties to OTC derivative transactions do so, and so whether a particular OTC derivatives transaction is subject to the mandatory clearing obligation.

Investment managers that execute OTC derivatives transactions in managing discretionary portfolios for clients are not in a position to assess whether the client has exceeded the specified clearing threshold. The clients may use multiple investment managers, as well as executing OTC derivatives transactions themselves. As a result, it is not possible for an investment manager to ensure its clients comply with the mandatory clearing obligation.

Other AIs and LCs that originate or execute an OTC derivatives transaction on behalf of a counterparty face the same difficulty, as they do not necessarily have the information needed to calculate whether the specified clearing threshold is exceeded for either counterparty. It is not reasonable in this situation to require that the AI or LC be responsible for ensuring the counterparties comply with the mandatory clearing obligation.

**Question 10****Do you have any comments on the proposed grace periods and how they will apply?***Deacons response:*

We support the proposal to allow grace periods to implement the mandatory clearing obligation.

**Question 11**

**Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?**

*Deacons response:*

No comment.

**Question 12**

**Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?**

*Deacons response:*

No comment.

**Question 13**

**Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?**

*Deacons response:*

We believe it is preferable to draft the scope of the new Type 11 regulated activity to carve out activities that are permitted under existing regulated activities. That way, the need for licensed corporations to apply for an additional regulated activity, as well as the additional time and cost involved in doing so, is reduced. We note there is no adverse regulatory impact because the licensed corporations are already subject to the SFC's regulatory oversight.

It is common for investment managers to include OTC derivatives in the discretionary portfolios that they manage. We recommend that Type 9 regulated activity, "asset management" is amended to include OTC derivatives management i.e.

1. Paragraph (b) of the definition of "asset management" in Part 2 of Schedule 5 to the Securities and Futures Ordinance be replaced with:

"(b) securities, futures contracts or OTC derivatives management";

2. The definition of "securities or futures contract management" in Part 2 of Schedule 5 to the Securities and Futures Ordinance be amended to refer to OTC derivatives as follows:

"securities, ~~or~~ futures contracts or OTC derivatives management", in relation to a person, means providing a service of managing a portfolio of securities, ~~or~~ futures contracts or OTC derivatives transactions for another person by the person"

We recommend that the new Type 11 regulated activity include a carve out for asset management similar to that contained in the definition of "dealing in securities" i.e.

"(xiv) is licensed or registered for Type 9 regulated activity and performs the act solely for the purposes of carrying on that regulated activity"

We recommend that there is a transition period before commencement of the new regulatory framework sufficient to allow existing licensed corporations and other entities

to apply to the SFC to be licensed for Type 11 regulated activity. We propose a 6 month transition period.

**Question 14**

**Do you have any comments on the proposed regulatory oversight of large players?**

*Deacons response:*

We recommend that an entity should not be classified as a large player where it uses OTC derivatives to hedge commercial risks. Where there are genuine commercial risks that are being hedged, the use of OTC derivatives for this purpose is unlikely to give rise to any systemic concerns.

Where a large player is subject to prudential regulation by another regulator (such as insurance companies regulated by the Insurance Authority), it may be more appropriate for that regulator to take the lead role in relation to OTC derivatives holdings, with the SFC providing support to that regulator. The lead regulator will likely have more information about and a better understanding of the business of the relevant entity.

**Deacons  
29 November 2011**