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

Dear Sir/Madam,

**Re: HKMA and SFC's consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong**

On behalf of the Hong Kong Investment Funds Association ("HKIFA"), I would like to provide the following comments on the captioned proposal.

Based on the consultation paper ("CP"), we understand the context of the proposal is:

- to meet the G20 leaders' commitments on OTC derivatives ("OTCD") reforms,
- to meet a deadline that has been set, i.e. implementation by the end of 2012; and
- to come up with a framework that can ensure Hong Kong's financial markets' regulation is in line with international standards.

However, we believe that the approach, as it currently stands, has not factored in the unique characteristics of the Hong Kong market and the implications to investors and the market; and **we would exhort the authorities to revisit the whole approach.**

**Key considerations**

As stated in the CP, the OTCD markets are global in nature and there is a high degree of interconnectedness. In the global context, the size of Hong Kong OTC derivatives market is miniscule (less than 1% of the global outstanding). The CP rightly says that "it is not for Hong Kong to drive the reform initiatives in this area, though we cannot fall too far behind those of major markets". The paper also points out "that the key aspects of the OTC derivatives reform are still evolving in the global arena and certain proposals already put forward are still being debated".

**Proposal**

Against this backdrop, we believe that there should be a wholesale review of the Hong Kong approach to this G20 initiative.

- ***Two-phase implementation*** - What we would suggest is to propose to the relevant G20 working group to stagger implementation into two phases – i.e. all systematically important countries ("SIC"), i.e. which those which have a large market share of OTCD have to implement by 2012; and for the remaining countries/regions to implement by say, 2014. In fact, there should be a *de minimus* rule which exempts countries whose market share is below a certain threshold from the mandatory clearing and/or reporting requirements.

The rationale for putting forward such an approach is that as the CP concedes, "it is not for Hong Kong to drive the reform initiatives in this area... much will ultimately depend on the progress and timeline of reform initiatives in other major markets, including most notably the US and EU." Thus, there is a general acceptance that the standards and approaches adopted in the US, EU and other SIC will become the norm.

In regard to the CCP implementation progress in North America and Europe, the Financial Stability Board 's ("FSB") second progress report issued in Oct 2011 states that "the target of having all standardized OTC derivatives contracts centrally cleared will not be fully met by end-2012 in all FSB member jurisdictions..." Since the dust has not settled in the key markets, should markets such as HK jump the gun to develop their own models? Would it be more helpful to have the basic international frameworks in place first before we embark on ours so to ensure that we can dovetail with the international ones? Ultimately, this industry is by nature international and cross-border; and in designing the framework, we should position ourselves in the broader global context.

- ***Cost-benefit analysis ("CBA")*** - have the authorities performed any CBA on the proposal?

  On costs, there are both direct and indirect ones. The CP outlines the various set-ups that will be put in place: HKMA is to establish a TR and the HKEx will establish a new clearing house that may serve as a CCP for OTCD market here. We would expect that HKMA and SFC will have to employ additional resources to cope with all the new requirements. However, has there been any estimate of the costs involved (initial and on-going) and who will bear these? In view of the relatively small size of the Hong Kong OTCD market, will this result in a disproportionately high financial burden on the investors and market players? In the CP, there is no discussion whatsoever of this subject.

  Then, there are the indirect costs. Have the authorities factored these in, especially the implications to end investors? (In note A, we cite some examples to illustrate the indirect costs) It should be remembered that investors are not responsible for the GFC, but unfortunately they have to bear the brunt of this "tax".

  More importantly, it is questionable whether by implementing all the changes, the objectives of the G20 will be met. In fact, a paper released recently by the Committee on the Global Financial System (a division of the Bank of International Settlements) raises a concern that the requirement to clear OTC derivatives through CCPs will actually increase the concentration of risks in the small number of global dealers that have direct access to CCPs. This calls into question whether the exercise is really effective in achieving its original intent, in particular to reduce systematic risk.

If SFC and HKMA still maintain that they have to proceed according to the framework as outlined in the CP, we think there are a whole raft of issues that need to be addressed, for example the lack of clarity on the definition of terms, uncertainty as to who is responsible for what in regard to the clearing and reporting obligations, as well as possible duplication in licensing and the additional compliance burdens that all these will bring (for details on the comments made by our members, please refer to Appendix 1).

We welcome the opportunities to discuss and to work closely with the authorities to come up with a model that is proportionate and balanced.

Yours sincerely,

**Note A**

**Examples of the cost implications of the proposal (as provided by some HKIFA members)**

- A 30% collateral requirement for a 50% hedged international portfolios can tie 15% in the collaterals which are typically in cash for the Asian markets. Assuming everything is the same, this means an equity portfolio can only invest 85%. If the expected return is 3% pa, there will be 45bps opportunity loss and the accumulative impact in 40 years can be 10% less to portfolio value. It is a significant amount for the pension portfolio. The impact will be much higher during bull markets and the long term impact is much worse e.g. a 5% expected return (i.e. 75 bps opportunity loss because of collaterals) can trigger a 18% drop in under the same model.

- The proposed OTC derivatives requirements may affect the end-users as well. For example, for long-only funds which typically use FX derivatives (e.g. NDF) to hedge the currency risk, the collateral required (say 10-30% of the contract size) can be viewed as a 'tax' to the fund (hence, the returns to the investors) and the negative outcome to the end-investors can be the unintended consequence. Given the low yield environment in the recent years and the foreseeable future, the additional cost can eat away the performance.

- Besides, there are other unintended consequences of additional liquidity restriction on end-users/portfolios. For example, margin costs will increase as central counterparties ("CCP") are likely to be more conservative than bilateral counterparties have traditionally been, and that operational complexity will impose a significant start up cost which can force out some smaller players and raise the hurdle for new competitors.

(End)

# Hong Kong Investment Funds Association

**Appendix 1**

**HKIFA members' comments and queries re HKMA and SFC's consultation paper on the proposed regulatory regime for the over-the-counter ("OTC") derivatives market in Hong Kong**

- **Overall comments:**

Hong Kong's efforts to meet the G20 Leaders' commitments on OTC derivatives reforms are commendable. However, striking the right balance of regulatory oversight without hindering market development is of critical importance. There have been numerous cases where overly heavy regulated environments have caused business activities to move to more balance-regulated destinations. In the end, the overly heavy regulated countries lost out to the more balanced-regulated countries. This is particularly true for OTC derivatives as they can be traded cross borders. The practical way of striking the right balance is by learning from other countries' experiences. More importantly, the cost to the end-users must be assessed to ensure the new regulations can be largely covered by the benefits.

Some rough estimates on various new regulatory changes in Europe indicate that the potential direct costs to the investors can be 80 to 120bps pa. One example is the Financial Transaction Tax ("FTT") of European Union. A recent study on FTT conducted by a fund company suggests that "a prudent 40 year old investing €10,000 in this fund would pay nearly €1,000 of this original amount to an FTT by the time he/she were nearing retirement 20 years later. Were the same 40 year old to invest €10,000 in a global equity fund, an FTT would have eaten over €2,300 in expected returns by the time he/she reaches 60. More significantly, the same individual would lose nearly €15,000 investing in a more dynamically managed European equity fund over this timeframe. This is 50% more than what he/she originally invested".

Given the dynamic situations in the US and Europe (coupling with the debt crisis), it is important for Hong Kong as an international financial center to proceed with great caution and ensure the interests of investors are adequately protected. Comprehensive assessments/consultations should be conducted prior to the full implementation. It is vital to identify the true cost and benefit of new regulatory changes which can have long term impacts to investors, market developments and competitive advantages of the financial industry in Hong Kong. In addition, the effectiveness of the new regulations should be fully examined. For example, should the real money managers/end-users be excluded from the systemic risk institutions as long as the managers do not have significant trading positions? Should there be different implementation timeline for the Systemically Important Financial Institutions and other non-critical market participants such as traditional asset managers?

- **Oversight of derivatives market participants:**

In relation to the proposal on regulation of intermediaries, members believe that there is a need to put in place an incidental exemption rule such that any asset management companies (with Type 9 license) advising on or dealing in OTC derivatives which are incidental to their asset management activities would be exempted from the need to be licensed in the new regulated activity (Type 11). This is to apply the same incidental exemption for RA 1 (Dealing in securities) and RA 2 (Dealing in futures contracts) for fund managers that are licensed under RA 9 (Asset Management). Similar to dealing in securities and futures contracts, fund managers placing orders on OTC derivative instruments on behalf of clients are merely incidental to the discretionary management function.

- **Mandatory reporting obligation:**

Members point out that the types of persons that have to perform mandatory reporting of OTC derivatives need to be further clarified. It is not clear in the consultation paper whether a fiduciary (e.g. investment manager) would have to report OTC derivatives transactions executed on behalf of its client. In the case for investment managers, their counterparties (e.g. banks, brokers) will most likely be required to report the OTC derivatives transactions, thus reporting by investment managers will duplicate the works, which can be both confusing and costly.

If investment managers can be excluded from mandatory reporting, members wish to clarify whether investment managers who trade only with the authorized institutions ("AIs") or licensed corporations ("LCs") are subject to the reporting requirements.

If investment managers are required to perform mandatory reporting, members propose that the SFC can consider to apply a specific reporting threshold for investment managers. On one hand, the SFC thinks the AIs and LCs should be subject to a more stringent mandatory reporting obligation with no reporting threshold, while on the other hand, the SFC proposes that an AI or LC can discharge its reporting obligation if the reportable transaction has been reported to the HKMA trade repository ("TR") by its counterparty in order to reduce compliance burden as mentioned in paragraph 67 of the consultation paper. However, the AI or LC still needs to check whether its counterparty has reported the transactions or not to ensure compliance. If the counterparty applies a certain specific reporting threshold and does not report, or the counterparty is an "overseas person" who is not subject to the reporting obligation, the AI or LC still needs to report all those transactions. It seems this will defeat the purpose of reducing compliance burden. As such, members suggest SFC can apply a reporting threshold for investment managers for clear and easy monitoring.

Separately, re reporting obligation for persons other than AIs and LCs, the definition of "Hong Kong person" includes, inter alia, "funds that are managed in or from Hong Kong (irrespective of whether they are established as a company or trust)". If a sub-fund of a SICAV is managed in Hong Kong, would the sub-fund be considered a Hong Kong person or is the SICAV vehicle considered a Hong Kong person? Based on the considerations set out in the consultation paper, members believe, in the scenario set out above, the policy intent is not to capture the entire umbrella vehicle or SICAV as a "Hong Kong person". We would like to seek SFC's clarification on this.

- **The types of instruments that are subject to mandatory reporting:**

  Members opine that including IRS and NDF FX derivatives in the reporting regime can be very expensive requirements for plain vanilla instruments, which are the cause of the crisis.

- **Mandatory clearing obligation:**

  Members point out that apart from the cost and complexity in setting an efficient clearing agent, any new collateral requirement on highly liquid trades to the end-user (such as long only portfolios) can hurt the ultimate investors without bringing meaningful impact to the market stability. Members believe that the requirements should target at the systematic important operators only.

- **Higher capital requirements for OTC derivatives transactions:**

  SFC is contemplating to require higher capital requirements for OTC derivatives transactions that are not cleared through a CCP. Members would like to seek clarification whether this proposed change would have an impact on the Securities and Futures (Financial Resources) Rules.

- **Implementation issues:**

  Based on the CCP implementation progress in North America and Europe noted in Financial Stability Board 's ("FSB") second progress report in Oct 2011, "the target of having all standardized OTC derivatives contracts centrally cleared will not be fully met by end-2012 in all FSB member jurisdictions". For example, one of the potential issues that "the FSB has identified concerns the applicability of the G20 commitments to standardized derivatives that are moved onto exchanges or electronic trading platforms (and therefore no longer traded "OTC"). The report clarifies that in order to achieve the G20 objective of mitigating systemic risk, full implementation of the G20 commitments needs to cover these derivatives, irrespective of whether they continue to trade OTC or are moved onto organized platforms". Hence, it will not be a surprise to see practical issues during implementation while the major markets in the US and Europe are still resolving these issues.

(End)