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THE HONG KONG SOCIETY OF FINANCIAL ANALYSTS

30<sup>th</sup> November 2011

Sent by Email

Supervision of Markets Division  
Securities and Futures Commission  
8<sup>th</sup> Floor Chater House  
8 Connaught Road Central  
Hong Kong

Dear Sirs,

**Re: Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong**

The Hong Kong Society of Financial Analysts is pleased to comment on the consultation paper regarding the proposed regulatory regime for the over-the-counter (OTC) derivatives market in Hong Kong.

In our view, OTC derivatives typically are bilateral contracts between users of financial products. They play an important role in that they make management of financial risk possible, facilitate price discovery and make for efficient markets. Current problems surrounding OTC derivatives market include opacity of transactions, dissatisfactory price discovery, excessive speculation and disproportionate leverage. It is crucial that market participants and regulatory bodies continue their efforts to reform the derivatives market to improve transparency and reduce counterparty risk without reducing the room for product innovation.

In general, HKSFA is supportive of improving transparency in the OTC derivatives market to improve investor confidence, better assess and mitigate systemic risks and protect against market abuse. Accordingly, HKSFA advocates the initiatives to strengthen post-trading infrastructure through trade repositories (TRs). As clearing involves settlement and payment, which are trade specific, it will be helpful to know the specific rules for mandatory clearing obligation before one can access its impacts to individual business operation. In addition, in order to ensure that central clearing efforts are not impaired and with the understanding that central clearing will lead to significant concentration risks, CCPs need to be subject to stringent regulation and need to demonstrate high standards of risk management with rigorous default management processes, robust operational capacity and sufficient financial resources.

Based on our positions, we state our comments to the specific questions as set out in the Consultation Paper as follows:

### **III. Key aspects of the regime being considered**

#### **A. The broad framework**

**Q1. 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?**

In general, we support the proposal to require the mandatory reporting of OTC derivatives transactions to trade depositories. As for mandatory clearing, it will be helpful to know the specific rules for mandatory clearing obligation before one can access its impacts to individual business operation. We believe TR serves as an effective conduit for the electronic reporting of over-the-counter trades by providing an appropriate level of transparency for investors. Suffice to say, it is important to take note that consistency in implementation across jurisdictions is critical to the success of OTC derivatives market reform. We note that local market conditions and characteristics need to be taken into account; however, Hong Kong should also see what frameworks the major markets, notably the US and EU, put in place when developing our own regulatory framework.

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Nonetheless, in view of HK being an international financial center, the reporting burden could be onerous for global operation if it is required to report to multiple TRs for the same trade and it might also create double counting for regulatory purposes. It is important global regulators set out (1) clear objectives of the use of data and (2) a consistent reporting standards across different jurisdictions.

**Q2. Do you have any comments on the proposed division of regulatory responsibility between the HKMA and SFC?**

We agree with the proposed division of regulatory responsibility between the HKMA and SFC with the HKMA overseeing and regulating the OTC derivatives activities of authorized institutions and the SFC overseeing and regulating activities of licensed corporations. Since the HKMA acts as the primary supervisor and regulator of AIs to ensure market stability and integrity, it is logically and practical for the HKMA to continue to have the oversight of AIs' OTC derivatives activities. It is also recommended that there is a consistent reporting standard for institutions and their subsidiaries which are regulated separately by HKMA and SFC, as well as intra-group transactions including back-to-back transactions.

**B. Mandatory obligations and the products to be covered**

**Q3. Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?**

It is reasonable to take a phased approach to extending any mandatory reporting obligations. Not all products will be suitable for clearing depending on their complexity, standardization and liquidity. Hence, a dialogue should be open between the regulators and the designated TRs to come up with the type of transactions to be reported centrally. In the global arena, according to Financial Stability Board's progress report that the actual reporting of OTC derivatives contracts to TRs shows progress in the interest rate, credit, and equity derivatives asset classes but the infrastructure for the commodity and foreign exchange asset classes is still under construction. Hence, it is practicable to impose the mandatory reporting in phases beginning with product types that are widely traded in Hong Kong with the ultimate aims to include more product types over time to address concerns about systemic risk.

**Q4. 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?**

HK SFA is generally supportive of initially limiting the scope of mandatory reporting obligations to only interest rate derivatives and non-deliverable forwards which together roughly account for over 30% of OTC derivatives transactions generated in Hong Kong. It is also appropriate to increase standardization of OTC derivatives products to trade on exchanges to ensure fair market access and fair treatment of investors.

**C. Proposed mandatory reporting obligation**

**Q5. Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?**

**Q6. 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?**



Based on the information of this consultation paper, unlike in the US and EU, much of the OTC derivatives activity conducted by AIs and LCs in Hong Kong is not booked in Hong Kong. The Hong Kong arm is in the most cases the sales desk or trading desk rather than the client facing entity. Given this unique feature of Hong Kong's market, we agree that the proposed mandatory reporting obligation should also apply to AIs and LCs that originate or execute in the transaction. This has the added benefit of preventing AIs and LCs from circumventing the mandatory obligation by arranging an overseas affiliate to enter into the transaction on their behalf. For Hong Kong persons or entities (such as large listed or unlisted corporations and market players), given listed companies and their major shareholders have been reporting to the HK Exchanges and Clearing Limited, they should be included in the mandatory reporting regime to provide a comprehensive picture. It is recommended on the ground that the extra work for them is very limited as they will be required to report the same information to the TR. Although we do not believe it is appropriate to regulate large players, if the authorities have other reasons to believe so, then they should consider the following ways to carry out the policy:

We therefore propose a pragmatic and phased approach for mandatory reporting for these trades by:

- Data collection and analysis on the trade details (product class and complexity, counterparties profile, trade frequency, notional/marked-to-market position, risk, etc)
- Based on the results, segregate the reporting threshold (or extending to the overall and 'occasional participant' (less stringent)
- Allow a deferred formal implementation period as the regulator's aim of proposal formalization by 2012 (to keep pace with international effort) is time-aggressive. Meanwhile, the regulator could work with industry bodies to encourage voluntary reporting to help the data collection process as discussed earlier

On the other hand, the proposal suggests few consideration of the SRT setting referencing:

- (a) Absolute dollar terms of each product class - certain complex/creative OTC derivatives transactions may have multiple product features (whether reportable or not). It may not be a simplistic demarcation to arrive at the proper product classification, nor feasible for the regulator to provide an exhaustive product list. We suggest where a trade does not get classified into the regulator's product class, a sundry category should form the SRT calculation catching the notional value of the trade. Also, a combined 'top-down' and 'bottom-up' product identification approach is more favored, as the market evolves and new product rolls out while old products fade.
- (b) Exit threshold operational gap – the average notional value is based on the past 6 months reportable persons' month-end position, assuming a continuous trading position. The exit threshold may be subjected to circumvention and requires clear defining. For example, a reportable person satisfies this threshold, removed from reporting obligation but shortly after that transacted significant trade not captured under the regulator's radar. Does the 6-month notional value counting restart after exit?

We understand the reported data will accumulate in a trade repository with an ultimate goal to interface with other countries, which undergo similar OTC derivatives regulating initiatives. The regulator should be mindful of the SRT setting on an international scale. Also, the depth and breadth of data reported to trade repositories with some countries favoring a more limited data set while some opt for more substantial reporting.

**Q7. Do you have any comments on the proposed grace periods and how they will apply?**

The proposed grace periods should be determined based on the reasonable time to set up system infrastructure. We suggest having selective large corporations for pilot program and test run for industry readiness before full implementation of mandatory reporting.



**D. Proposed mandatory clearing obligation**

**Q8. Do you have any comments on the proposed mandatory clearing obligation, and how it will apply to different persons?**

**Q9. Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?**

**Q10. Do you have any comments on the proposed grace periods and how they will apply?**

Common and consistent reporting should be promoted by international authorities across jurisdictions to reduce the potential for CCPs competing on the basis of lower costs or reduced requirements. As clearing involves settlement and payment, which are trade specific, it will be helpful to know the specific rules for mandatory clearing obligation before one can access its impacts to individual business operation.

**E. Mandatory trading obligation**

**Q11. Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?**

In principle, we are supportive of exchange trading but at the early stage of market reform, the imposition of a mandatory trading obligation at the outset may not be desirable. We believe at this juncture as long as CCPs will conduct a thorough and regular analysis of risks, cost-effective of clearing and maintain operational reliability, trading can occur over multiple venues. Until there is increased standardization, the benefits of mandatory organized platform trading are not easily determined.

**F. Penalties for breaching mandatory reporting and clearing obligations**

**Q12. Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?**

We welcome the proposal to accept overseas CCPs as obtaining authorization as an ATS provider and providing clearing services in Hong Kong. Mutual CCP recognition across jurisdiction is important and can assist in resolving the potential cross-border conflicts discussed in Question 9 earlier on mandatory clearing obligations. The Hong Kong OTC derivatives market is relatively immature and fragmented, once it builds critical mass we support the premise of Japan and Australia's version of having domestic CCPs. Competition amongst CCPs may encourage innovative margin netting and pooling models which hopefully provide greater efficiency for OTC derivatives trading.

The SFC regulated RCH/ATS regime in our view has sufficient regulatory oversight and we expect the regulator to observe IOSCO's guidance on CCP qualification – e.g. financial resources, robust operational capacity to meet obligations arising from participation in the CCP, ongoing monitoring, default procedures and portability (extremely important when the proposal discussed 'indirect clearing').

**I. Regulation of OTC derivatives market players (other than AIs)**

**Q13. Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?**

We support an open scope approach for the new Type 11 intermediaries regulation, as mandatory reporting or clearing obligations may change in time (e.g. at commencement only 2 product classes). This is consistent with international standard and existing local supervisory arrangement for AIs, as long as the scope of activities the regulator aims to oversee is clearly set out. Whilst overlaps may exist for some existing regulated activities, we



prefer Option (1) contained in the proposal – i.e. incorporate carve-outs on OTC derivatives activities already regulated and hence refrain from seeking a new Type 11 license, over Option (2) on outright amendments on each existing regulated activity.

Option (2) is tidier but requires extensive rules redrafting and not an entirely efficient and a piecemeal approach as and when new regulated activities roll out. Most intermediaries in Hong Kong are likely to find their existing license(s) sufficient to cover the OTC derivatives activities the regulator at this stage wants to oversee, given the current size of the Hong Kong OTC derivatives market. We believe as the international OTC derivatives reforms gain momentum, the regulator could revisit and seek minor calibrations or overhaul to the intermediaries licensing arrangement as best suited under the circumstances.

**Q14. Do you have any comments on the proposed regulatory oversight of large players?**

Similar to our response to Q5, if the authorities have reasons to believe that large players should be regulated (though in the Hong Kong market context numbers should not be substantial), then we agree to the proposed non-licensing approach to regulate, via imposing specific obligations to these large players.

Large own account players are likely to transact genuine hedges to mitigate commercial risks in their ordinary course of business. Accordingly, balancing this reality and the premise of regulating large players systemic risks concerns, we suggest a higher reporting threshold and additional qualification criteria:

- (a) A higher absolute notional amount for each product class should be set than that in the mandatory reporting threshold. Data collection and industry survey (for common OTC derivative users) should help to uncover the optimal threshold. Likewise, whether it is a 6-month or any other time interval shall be considered further after more study.
- (b) Apply potential future exposures and uncollateralized exposures as additional benchmark. Some trades may have material notional amount but systemic risks are reduced by collateral or netting or product distribution probability.
- (c) Assess underlying positions to establish bona fide trade and business nature.
- (d) Apply test whether large players are highly leveraged and to having the necessary capital commitments to withstand losses/market fluctuations.
- (e) Explore the general definition of “material financial instability” and whether the large players are systemically important.

We are not in favor of mandatory clearing for large players at this stage; however, the regulator should retain the right to call for such large players or specific type of trades to clear through the designated CCPs.

Yours sincerely,  
For and on Behalf of  
The Hong Kong Society of Financial Analysts