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

Ladies and Gentlemen,

MarkitSERV<sup>1</sup> is pleased to submit the following comments to the Hong Kong Monetary Authority and the Securities and Futures Commission (together "**the Commissions**") in relation to the *Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong* (the "**Consultation Paper**") that was published by the Commissions.<sup>2</sup>

## Introduction

MarkitSERV views its role within the global derivatives markets as an independent facilitator, making it easier for derivatives market participants to interact with each other. To achieve this goal, MarkitSERV provides trade processing, confirmation, matching, and reconciliation services for OTC derivatives across all major regions and asset classes, as well as universal middleware connectivity for downstream processing such as clearing and reporting. Such services, which are also offered by various other providers, are widely used by participants in the OTC derivatives markets today and are recognized as tools to increase efficiency, reduce costs, and secure legal certainty. With over 2,200 firms currently using the MarkitSERV platform, including over 23,000 buy-side fund entities, MarkitSERV's legal, operational, and technological infrastructure plays an important role in supporting the global derivatives markets, including Hong Kong and other Asia-Pacific jurisdictions, Europe, and the Americas.

As a service and infrastructure provider, MarkitSERV supports the Commissions' objectives of increasing the transparency and efficiency of OTC derivatives markets in Hong Kong, of identifying any market abuse or manipulation, and of reducing both systemic and counterparty risk.

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<sup>1</sup> MarkitSERV, jointly owned by The Depository Trust & Clearing Corporation (DTCC) and Markit, provides a single gateway for OTC derivatives trade processing. By integrating electronic allocation, trade confirmation, and portfolio reconciliation, MarkitSERV provides end-to-end solutions for post-trade transaction management of OTC derivatives in multiple asset classes, including interest rate, FX, credit and equity derivatives. MarkitSERV also connects dealers and buy-side institutions to trade execution venues, central clearing counterparties, and trade repositories. In 2010, more than 19 million OTC derivatives transaction sides were processed using MarkitSERV. Please see [www.markitserv.com](http://www.markitserv.com) for additional information.

<sup>2</sup> Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong, dated October 2011.

## **Executive Summary**

We welcome the comprehensive and thoughtful approach that the Commissions have taken to develop an appropriate framework for the regulation of the OTC derivatives markets in Hong Kong. We believe, however, that the proposed regulatory framework can be further improved by addressing some concerns surrounding the proposed requirements to report information about OTC derivatives transactions to a Trade Repository ("**TR**") that would be based in Hong Kong (the "**HKMA-TR**").

Specifically, we believe that the Commissions should: (1) design any reporting regime for OTC derivatives in Hong Kong to avoid unnecessary duplication and data fragmentation; (2) make the following changes to the proposed local HKMA-TR regime: (a) create a robust verification regime similar to that proposed by other financial regulators in order to ensure the accuracy of TR data; (b) establish a two-pronged approach to determine what information has to be reported to the HKMA-TR; (c) explicitly require the confirmation of OTC derivatives transactions in order to provide legal certainty and facilitate timely reporting; and (3) provide for phased-in implementation to allow market participants sufficient time to meet compliance deadlines.

## **Comments**

### **1. Any Domestic Reporting Regime for OTC Derivatives Should Be Designed To Avoid Unnecessary Duplication and Data Fragmentation**

The OTC derivatives markets are international by their very nature. Counterparties to these transactions commonly cross through multiple regulatory jurisdictions, and multiple local regulatory authorities will need to have access to transaction information.

If reporting parties are required to report each transaction to multiple local TRs, the potential for over-reporting (because of duplication) and underreporting (because of lack of access to the regional TR) exists. We believe that data accuracy for cross-border transactions would be improved and the costs associated with reporting would be lower if the number of TRs was limited, ideally to one per asset class globally. This would avoid duplicative reporting because each trade would only be reported once to a single global TR entity and would also prevent data fragmentation because all data would be centrally located. As a result, OTC derivatives trade data would be more accurate and useful to regulators across the globe.

We are, however, aware of the myriad of regulatory and jurisdictional challenges surrounding the creation of and access to global TRs and understand some of the reasons why the Commissions might instead want to create a local TR such as the HKMA-TR. We believe that, if a local TR is established in Hong Kong, the Commissions should design the reporting regime as described below in order to maximize the accuracy and usefulness of reported data.

### **2. The Proposed Local Reporting Regime Should Be Modified to Minimize Duplication and Data Fragmentation**

We believe that the Commissions' reporting regime should have clear and specific rules in order to limit the potential for costly duplication and data fragmentation while at the same time allowing for a timely and cost-efficient implementation of the requirements. We therefore urge the Commissions, when crafting rules to mandate the reporting of all reportable transactions to the HKMA-TR, to implement the following measures.

a. Reporting Requirements Should be Designed to Secure Data Accuracy While Enabling Timely and Cost-Efficient Implementation

The Commissions expect the proposed requirements to result in some degree of double-reporting of transactions to the HKMA-TR; this double-reporting, they believe, can “help ensur[e] the accuracy of the data.”<sup>3</sup> While we agree that ensuring the accuracy of the data that is reported to the HKMA-TR is of crucial importance, we believe that the double-reporting of some transactions would only create confusion and require costly reconciliation. This is especially true for certain trade lifecycle events which may be included in the definition of “reportable transactions,” such as allocations or novations. We therefore urge the Commissions to avoid establishing requirements that would lead to the double-reporting of the same dataset to the HKMA-TR. Instead, we believe that the Commissions could ensure the accuracy of data, while reducing the cost of implementation, through use of the following means:

(i) *How to secure data accuracy*

We suggest that the Commissions establish a robust and streamlined *verification regime*. For instance, the regulatory framework should explicitly require that the data that is stored in the HKMA-TR has been verified by both counterparties to the transaction. To achieve this objective the Commissions should consider adopting the approach that was used by the CFTC in its final Swap Data Repository (“*SDR*”) rules for ensuring data accuracy:<sup>4</sup> if the counterparties decide to report the transaction data directly to the SDR, the SDR is required to confirm the accuracy of such data directly with both counterparties. However, the verification of transaction data accuracy is often facilitated by third-party platforms before the dataset is reported to the SDR. Therefore, in such instances where the data is reported by a third-party platform that has already facilitated the verification of the transaction record by both counterparties, the SDR will be permitted to rely on the accuracy of the data (assuming certain conditions are satisfied).<sup>5</sup> For the avoidance of doubt, we believe that this principle should also apply in situations where the platform that reports to the HKMA-TR has not performed the verification itself, but has received the verified record from a confirmation platform.<sup>6</sup>

(ii) *Ensuring timely and cost-efficient implementation*

Several provisions in the Consultation Paper are designed to reduce burdens on market participants. We support these measures, particularly the provisions which would permit the use of agents – including confirmation platforms or other service providers – for reporting to the HKMA-TR.<sup>7</sup> This approach mirrors current market practice, reduces the need to build costly additional infrastructure, and provides flexibility to develop a market-based architecture where various service providers might compete in the provision of reporting services in the future. We therefore urge the Commissions to permit market participants to use confirmation platforms for reporting purposes in the final Hong Kong regime.

We believe that the use of a reporting threshold, as proposed, might be helpful to reduce the reporting burden for market participants. However, the Commissions should avoid creating situations where counterparties are repeatedly being in and out of being required to report, as this could lead to significant administrative burden not only for the counterparties themselves but also for the relevant market infrastructures and for the Commissions. It would also increase the potential for set-up errors that could lead to erroneous reports, over-reporting, or failures to report. Therefore, in order for the use of a threshold to

<sup>3</sup> See Consultation Paper, Section C (published October 2011).

<sup>4</sup> The DFA requires SDRs to ensure the accuracy of the data that they receive. See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 Fed. Reg. 54538, 54546 (published 1 September, 2011).

<sup>5</sup> See Swap Data Repositories: Registration Standards, Duties and Core Principles, 76 Fed. Reg. at 54547.

<sup>6</sup> This could, for example, apply to some overseas TRs.

<sup>7</sup> See Consultation Paper, paragraph 47.

actually result in a reduced burden, the Commissions should ensure that the gap between the exit threshold and the reporting threshold is sufficiently wide.

Finally, we are concerned that some aspects of the proposed reporting requirements might create added burdens on market participants. For example, the proposals would effectively require double-reporting to the HKMA-TR in some instances;<sup>8</sup> in others, a participant would need to receive confirmation from its counterparty that the counterparty has reported the transaction to the TR in order to relieve itself from its own reporting obligation.<sup>9</sup> We are concerned that these ad hoc requirements could significantly increase the complexity of the regime as well as the cost of implementation. For example, Section C of the Consultation Paper refers to transactions originated or executed by local staff of an International authorized institution ("AI") but booked by the international arm of the AI. The rules seem to imply that the transaction would be reported by the International AI, the counterparty, and also by the local branch of the International AI.<sup>10</sup> In this scenario, the trade could be reported as many as three times, or "only" two times if the local staff verified that the transaction was reported.

We therefore urge the Commissions to ensure that counterparties can make use of efficient reporting arrangements across all specific situations, including the ones described above. Specifically, the Commissions should clarify that counterparties can satisfy their reporting obligations by having a confirmation platform submit a verified transaction record to the HKMA-TR. Importantly, this would ensure that accurate data is reported without the need for counterparties to double-report to the TR or receive a separate confirmation from their counterparty. To satisfy their reporting obligations, the counterparties should thus be permitted to agree to delegate the reporting of the transaction record that has been verified by both of them to the confirmation platform.

b. The Commissions Should use a Two-Pronged Approach to Determine What Information Has to be Reported to the HKMA-TR

The Consultation Paper does not specify which details of reportable OTC derivatives transactions should be reported to the HKMA-TR. We believe that, in order to create a workable reporting regime, the Commissions need to specify the relevant data elements and, as such, should pursue a simple but effective two-pronged approach to achieve their regulatory objectives while still allowing for timely and cost-efficient implementation:

- Every reportable transaction ought to be captured by the HKMA-TR through the utilization of electronic data fields. The best and easiest way for the Commissions to achieve this objective would be for them to define a limited set of data fields, or key economic terms, that could generally be applied across asset classes and products. Such a determination should be made in dialogue with industry and market participants, including third-party providers and existing TRs, so that market participants can set up their reporting arrangements appropriately and with global consistency.
- In order to effectively monitor systemic risk and investigate market abuse or manipulation, regulatory authorities will often need many additional details beyond the key economic terms that are relevant to all transactions. The HKMA-TR could most efficiently and effectively collect these additional details by requiring the reporting of transaction confirmations. To avoid any unnecessary burdens on reporting parties, the reporting of the transaction confirmation should occur in its existing format (i.e., it is likely to be the full set of electronic data fields for standardized transactions, while it may consist of scanned documents for more complex ones).

<sup>8</sup> See Consultation Paper, paragraph 75 ("It is entirely possible that a reportable transaction may involve more than one AI or LC . . . . In such cases . . . , the transaction would have to be reported by all AIs or LCs involved.")

<sup>9</sup> See *id.* at paragraph 107.

<sup>10</sup> See *id.* at paragraph 61.

We therefore believe that the Commissions should require the reporting of both (1) a standard set of key economic terms as well as (2) the confirmation of all reportable transactions to the HKMA-TR. Such a two-pronged approach would achieve the requisite regulatory objectives underlying the reporting proposals with minimal burden placed upon the parties, particularly when compared to the alternative of choosing specific sets of data fields which differ between asset classes and products.<sup>11</sup> It would also be consistent with requirements that have been proposed in other leading jurisdictions.<sup>12</sup>

Importantly, this two-pronged approach should not automatically require two separate submissions to the HKMA-TR. For example, for all standardized OTC derivatives transactions, the reporting parties would satisfy both requirements by a single submission of the full confirmation in electronic format.

c. The Commissions Should Explicitly Require Counterparties to Confirm OTC Derivatives Transactions in Order To Provide Legal Certainty and Facilitate Timely Reporting

We note that the Consultation Paper does not establish a requirement for counterparties to confirm their OTC derivatives transactions in a legally-binding manner. This stands in stark contrast with approaches pursued in many other jurisdictions where confirmation requirements serve as an integral part of legislation intended to reduce legal and systemic risk in the OTC derivatives markets.<sup>13</sup>

We believe that counterparties should be required to confirm their transactions and report confirmation data. This would provide the Commissions with complete transaction information and create a definitive record of the transaction in the event the terms of the parties agreement is later disputed. We wish to further highlight that if the Commissions require counterparties to *report* confirmations to the HKMA-TR, they should also be explicitly required to *execute* confirmations. Otherwise, it will be more difficult for counterparties to comply with proposed reporting obligations.

In this context, we believe that the Commissions should consider several additional aspects of the proposed regulations, and should aim to harmonize any specific requirements with those being established elsewhere:

- The confirmation of OTC derivatives transactions can be performed through various methods, including via the use of techniques such as "affirmation" or "matching." For the avoidance of doubt, then, we urge the Commissions to clarify that confirmation can be achieved through "matching, affirmation, or other methods that result in producing a legally binding agreement of the complete set of transaction details between the counterparties."
- In principle, the relevant details of an OTC derivative transaction at the time of its commencement and any lifecycle events thereafter such as novations, partial/full terminations, adjustments etc., should be confirmed between the original and/or new counterparties to the transaction, regardless of whether the transaction is destined to be centrally cleared or is bilateral in nature. The Commissions might, however, want to consider exempting counterparties from the requirement to legally confirm

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<sup>11</sup> This latter approach not only suffers from the complexity of having to determine appropriate fields for potentially hundreds of OTC derivatives products, but is also harder to implement and will be exposed to changes over time. Moreover, it will not necessarily satisfy the data needs of regulatory authorities.

<sup>12</sup> See, e.g., Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75208 (published 2 December 2010).

<sup>13</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010); Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 81519 (published 28 December 2010); Trade Acknowledgment and Verification of Security-Based Swap Transactions, 76 Fed. Reg. 3859 (published 21 January 2011); Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories, (published 20 October, 2011); Canadian Securities Administrators, "CSA Consultation Paper 91-402 – Derivatives: Trade Repositories" (23 June, 2011).

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all transaction details bilaterally in the event that the transaction is accepted for central clearing, and hence confirmed by a CCP, in a sufficiently timely fashion.<sup>14</sup>

### **3. The Implementation of the Various Requirements Should Be Phased-In to Allow Market Participants to Meet Compliance Deadlines**

We believe that the Commissions should provide sufficient time for market participants to establish the required reporting capabilities and procedures, and to allow for the backloading of any relevant existing contracts. The length of such periods should be agreed upon following dialogue between all relevant stakeholders (i.e., regulatory authorities, market participants and relevant infrastructure providers). This would not only ensure that the Commissions' rules are practical, but would also reduce the chances that the rules are inconsistent with other regulatory requirements or inefficient in light of such endeavors. For example, there is concern that the concept of an interim legal entity identifier regime may be a costly endeavor for industry participants if they and all relevant third-party service providers were required to incorporate it into their systems, and then subsequently an agreed global legal entity identification system is established.

We further believe that the Commissions should phase-in the implementation of reporting and clearing requirements by product category and underlying asset class based on the varying levels of standardization for such categories or classes.<sup>15</sup> We therefore welcome the approach that is envisioned by the Commissions of regulating the most relevant OTC derivatives products at the outset, while allowing for the separate application of implementation phase-in periods to additional products that might be covered in the future.<sup>16</sup>

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MarkitSERV appreciates the opportunity to comment on the Commissions' Consultation Paper. We would be happy to elaborate further or discuss any of the points addressed above in more detail.

In the event you may have any questions, please do not hesitate to contact the undersigned.

Yours sincerely,

MarkitSERV

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<sup>14</sup> See Letter from MarkitSERV to the CFTC (22 September, 2011), available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48191&SearchText=markitserv> (last visited 1 November, 2011).

<sup>15</sup> See Letter from MarkitSERV to the CFTC (4 November, 2011) available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=49962&SearchText=markit> (last visited 5 November, 2011).

<sup>16</sup> See Consultation Paper, paragraph 52.