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**A response from Standard Chartered Bank to
HKMA/SFC consultation on proposed regulatory regime
for OTC derivatives market**

November 2011

Dear Sir / Madam,

We are pleased to enclose our response to the HKMA/SFC consultation Paper on the proposed regulatory regime for OTC derivatives market in Hong Kong. The implementation of OTC regulations across the world incorporating increased trade reporting, central clearing and trading will have significant impact on the manner in which participants access these markets.

In our attached response, we highlight the questions and issues that we believe to be important when considering the implications for local market participants, global market participants and the position of Hong Kong with respect to its peer OTC market locations.

We believe that great care must be taken to address how these reforms are implemented such that, where appropriate, global standards are maintained in all jurisdictions. These standards are being promoted by the established OTC markets in the US and Europe as well as industry bodies (including ISDA), so that access to global derivatives markets can be managed alongside the need for local transparency and oversight.

In addition, we agree with your view that Hong Kong regulation initiatives should be aligned to the scope and timing of global reform.

We look forward to working with the HKMA and SFC in defining and implementing the right regulatory framework for the OTC derivatives market in Hong Kong.

Yours faithfully,

Broad Framework

- 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?**

SCB Response: The scope of the broad framework is in line at a high level with those being implemented in the US and EU, in terms of reporting, clearing and trading obligations. However, as per the questions and comments laid out below, further details and clarifications are required in order to understand the exact impact of the new OTC regulations.

The designation of “Authorised Institution, Licensed Corporation and Large Player whose positions may pose systemic risk” provides clarity on those participants that are active in the Hong Kong market. However, what regulatory oversight is intended for local corporate or small to medium size enterprises requiring financing or hedging activities through OTC derivatives contracts?

The application of “HK originated or executed” and “HK nexus” concepts in the consultation paper will (1) mean that transactions could be reportable in other (or multiple) jurisdictions, and (2) pose a challenge as to which CCP an AI or LC will be obligated to clear its trade.

In the case of reporting the paper states the need for the extended coverage (point 66), but also recognises that there will be a burden on AIs and LCs in relation to compliance (point 67). The paper sets out two scenarios under which an AI/LC would have discharged the reporting obligation, but this does not provide a full description of all potential reporting scenarios.

Under mandatory clearing as described, a HK trader booking a USD IRS in SCB London with a US counterpart would result in a significant challenge if the trade must be cleared via the HK CCP – specifically as it is highly likely the trade will be required to clear in SCB’s (and US counterparts) designated home country.

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

SCB Response: On reviewing the paper we would like to highlight the following queries -

Clearing:

- 1) How will the definition of “OTC derivatives transactions” impact the current Structured Products regime under the Securities and Futures Ordinance (SFO)? Our concern here is that the new definition of “OTC derivatives transactions” needs to be as clear as possible and should be separate from the current structured products regime under the SFO.

- 2) What are the licensing implications for AIs? How will this differ for Licensed Corporations? In particular, if there are going to be additional licensing requirements then the ramifications will need to be explained clearly. AIs and LCs will potentially need a grace period to deal with additional licensing requirements.
- 3) If the licensing or reporting requirements are overly burdensome for local corporate or SMEs, they may be effectively excluded from utilizing OTC product solutions for their genuine hedging/risk management needs. An unintended exclusion such as this, could have a major negative economic impact given the relative scale of these entities in the overall economy.
- 4) How will the membership for the new HKCCP be assessed by HKMA/SFC? Is the intention to follow membership criteria set by other central clearing venues (eg. LCH, ICE)? Full details on membership will be needed before being able to assess further.

Insolvency:

- 5) How will the new HK CCP operate within the existing insolvency laws of Hong Kong? Is the intention to update the HK insolvency laws? The concern here is that the insolvency regime needs to take into account the new proposed regulatory regime for OTC derivatives – this will avoid any complication in the event of the insolvency of a clearing or participating member of the HKCCP.

Governance:

- 6) How will the HKMA/SFC/HKEX govern the new HKCCP? Risk governance of the HKCCP will be the key.

Mandatory Obligation and Products to be covered

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

SCB Response: At this point, we consider the phased approach to be appropriate and aligned to feedback in peer market locations. We also consider the proposal to undertake market consultation to be very positive in determining which products must be reported and centrally cleared.

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?

SCB Response: Again SCB recognises this as a sensible approach, with the expectation that confirmation of the final product sets will be provided to market players in Hong Kong with sufficient lead time for such market players to comply.

Mandatory Reporting

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

SCB Response: Reporting will form a key aspect of the new regulations and to aid all market participants we would strongly support the use of global industry standards in terms of data formats, reporting contents and middleware standards.

For all market participants both local and global, reporting to different repositories, by location poses a huge infrastructure challenge both in terms of complexity, but also investment costs.

We strongly recommend the use of standard global trade repositories as the reporting mechanism and “golden source” of data to feed local repositories where required.

- 1) Any reporting errors committed by the trade repository/clearing agent will still be attributable to the AI concerned – there should be proper mechanisms for AIs to indemnify themselves from reporting errors committed by entities reporting on their behalf.
- 2) How will the “Hong Kong nexus” be established in order to trigger mandatory reporting obligations for AIs? The current definition of trades that are “originated and executed” in HK is broad and the definition of “Hong Kong persons” would require a large number of counterparties to report when in fact they trade with AIs.
- 3) What is the scope of reportable transactions and is the intention to align the content and format required to those specifications being used for other regulators (e.g. Dodd Frank)?
- 4) If mandatory reporting is implemented, the HKTR should ensure that data templates to be filled in by local AIs and LCs have minimal local specifications and should instead be in line with that provided by standard global TR’s. This will ensure further system development will not be required by AIs or LCs and to be in line with other regulations such as Dodd Frank.

- 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?**

SCB Response: Consideration will need to be given as to how the threshold will be defined and in identifying those persons required to report how this data can be collated and delivered in a controlled manner. From the consultation paper, we would support the reporting either coming from the AI/LC counterparty or be captured via an overseas, recognised regulator.

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

SCB Response: Operating a grace period should enable all local and global participants to identify how to comply with the requirement. As part of the regulation implementation, consultation with the Hong Kong market will enable an appropriate grace period to be agreed.

Mandatory clearing

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

SCB Response: In establishing mandatory clearing a number of key considerations for all participants are seen as priority - including the membership criteria, the default mechanism, the segregation of client assets and margin, portability of positions, product subject to clearing and efficient trade compression/de-clearing.

We believe the requirements to clear trades “originated or executed” by LCs or AIs will increase operational risk and cost for AIs or LCs without the benefit of mitigating systemic risk as majority of these trades will be booked offshore. This will also create situations whereby these trades will need to be cleared in multiple jurisdictions. There should also be recommendations on specific exemptions (ie. intragroup transactions) where applicable to AIs or LCs.

At this stage in the development of the regulations we would like to highlight the following: -

- 1) Clarity on the intended scope of “OTC derivatives transactions” that will be subject to mandatory clearing requirement, plus we would recommend that the timeline for implementation should be set after the CCP is deemed ‘operational’.
- 2) We believe a global CCP that is an RCH is the preferred method for mandatory clearing. If the domestic CCP is mandatory, clarity on currencies and product scope the domestic CCP will clear. This should be done with analysis on market volume and liquidity that the CCP can expect/sustain to ensure market depth. In addition, there should be clear guidelines on how domestic CCP deal with international insolvency issues (relating to counterparties).
- 3) Clarity on mechanism of trade portability.
- 4) Defined process on MTM calculation and the intended dispute resolution procedures.
- 5) Client Clearing as a service – how will this be implemented? We recommend this to be rolled out as subsequent phase to the initial launch.
- 6) Given the move to central clearing, how will smaller corporates address the need to provide and manage the daily margin process?

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

SCB Response: In establishing mandatory clearing, we would support clearing thresholds based on the analysis being undertaken to identify notional amounts plus the end users of the products.

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

SCB Response: Operating a grace period should enable all local and global participants to identify how to comply with the requirement. As part of the regulation implementation, consultation with the Hong Kong market will enable an appropriate grace period to be agreed.

Mandatory Trading

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

SCB Response: We would support the approach to focus current efforts on reporting and clearing. The implications of mandatory trading requirements can then be considered at a later stage.

CCP

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

In common with the industry we would prefer a commercially driven approach to CCPs which combines global regulatory drivers with an industry utility in line with the original intention of central clearing. We would request further clarification on the exact proposals and timings as they are developed.

Capital Charges and Margin

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

SCB Response: The outline proposal is in line with the regulations being adopted in the US and EU. Although the specifics of the new capital charges and margin requirements are being finalised under the Basel framework, we would highlight the following:

- 1) Clarity on the Capital treatment for qualifying transactions CCPs (i.e. 2%) versus that for bilateral trades – how will the latter be determined and at what level will this be set?
- 2) For large exposures, how will this be calculated given the potential high concentration to the CCP?
- 3) What will be the default fund requirement and the capital charge of AI's contribution? (We note that BCBS proposal is equivalent to dollar-to-dollar capital deduction)?
- 4) How will the margin requirement versus market risk capital required by HKMA be accounted for?
- 5) How will margin accounts operate; will these be fully segregated versus the omnibus/LSOC concept, or both?

- 6) How will the issue of trade portability be addressed?
- 7) What is the preferred default waterfall mechanism? Furthermore how will the risk management process and default management process work? Examples of the key considerations include, margin mechanism, collateral eligibility and haircuts, account structures, default procedures and netting.

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

SCB Response: In principle this is a good idea. However, it is important that AIs should not be subject to this regime.