Tanner De Witt solicitors

22 November 2011

By Hand and email

Market Development Division
Hong Kong Monetary Authority
55th floor Two International Finance Centre
8 Finance Street Central
Hong Kong

Attention: Pauline Chan and Abby Tse

Dear Sirs,

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

We are instructed to act on behalf of the Hong Kong Inter-Dealer Broker Association (the "IDBA") in relation to your request for a response to the "*Consultation paper on the proposed regulatory regime for over the counter derivatives market in Hong Kong*" ("the Paper").

The IDBA's members are the major brokers undertaking the broking of OTC derivatives products between "dealers" who are predominately banks and AI's. The IDBA's members are licensed and regulated by the HKMA as "money brokers" under the Banking Ordinance, and in some instances also by the SFC.

The IDBA and its members welcome the Paper and consultation process which has been put in place. As such we set out below as briefly as possible some of the main points the IDBA wish to raise at this stage by way of consultation and welcome the opportunity to discuss these issues with the HKMA further and in more detail. For the reasons set out below, this reply and the below points are only provisional at this stage.

Provisional Reply

Following a discussion with one or more of the members of the IDBA we note that a meeting has been arranged for Wednesday 23rd November in order to discuss the IDBA's views on the Paper. This is primarily as:-

1. The Role and position of Inter-dealer brokers (IDBs) and the role and function they perform in the OTC derivatives market is not fully addressed in the Paper.

2. The IDBA's view is that its members are involved in arranging, broking and analyzing the majority of OTC derivatives traded between banks and are in a unique position to add to the discussion on the proposals in the Paper in particular in the NDF and IRS markets addressed. In this respect the IDBA also consider that based on their market knowledge and position, many of

Tanner De Witt solicitors

the current assumptions and comments in the Paper concerning the OTC Derivative market, may not be entirely accurate or complete.

3. To date there has been no direct discussions with the IDBA or its members as to the OTC derivatives market and the facts and issues addressed in the Paper. We also understand that in light of this there has been some discussion as to the possibility of a further and revised Paper potentially addressing the position of IDB's and the input which it is hoped the IDBA can usefully have to the proposals set out in the Paper. We look forward to receiving any revised Paper which may be issued after discussion with the IDBA and to formally responding to it. In this respect we trust that if any revised Paper is issued that, sufficient time and consultation period will be available, and the cut-off date for replies to the current Paper, of 30 November, will be extended.

General Issues

As the role and position of IDBs, is not fully and directly addressed in the Paper, we do not think it would assist greatly to address the specific questions set out in the current Paper. However the IDBA wish to assist the HKMA and the consultation process, and therefore wished to make the following general points by way of reply and to assist the HKMA review.

1. The Paper makes no mention of any currency or as to any differentiation that may be drawn between IRS and NDF products in different currencies. However there are substantial differences in the relevant markets for IRS and NDF products depending upon the relevant currency.

   There is no HK$ market in NDF. Given the nature and commercial purpose of the NDF market, the NDF market is in currencies which, in general, are not freely traded and are subject to exchange and other controls in their home jurisdiction and/or by their issuing central banks. As such the NDF market is an "offshore market". It is not a Hong Kong or HK$ market. By reason of its very nature the NDF market is traded offshore from the currencies in which it is denominated. The main NDF currencies traded offshore, in Hong Kong are those such as NT$, RMB, KRW, IDR. However, the 3 main international centres for the NDF market are Hong Kong, Singapore and London. In that respect the IDBA does not consider it entirely appropriate for the Paper to refer to " ..*our OTC derivatives market*" (in relation to NDF). As sated the above the NDF market is not a Hong Kong or HK$ market. It is an offshore market which can and does operate in any financial centre which is outside the country in whose currency it is denominated.

   The IDBA therefore find some difficulty in commenting fully on the proposals set out in the Paper, as there is no mention or differentiation as to the applicable currencies. In the view of the IDBA that would be a key issue in considering the proper approach to the regulation of these markets.

   In addition, this issue is relevant to the approach to be taken by the HKMA to the extent it is relevant to its regulations and co-operation with other Central Banks, in particular those whose currencies are the subject of the main NDF markets.

2. The Paper and the proposals relating to the regulation of OTC Derivatives markets are primarily directed at IRS and NDF markets. The markets in NDF and IRS products are primarily linked to Foreign Exchange and foreign exchange markets.

However in the view of the IDBA there is little systemic risk (of the type these reforms appear intended to address) posed to the main participants in the OTC derivatives market by these products. This is borne out by the events underlying and causing the financial turmoil leading to and following the collapse of Lehman Bros. and the banking crisis.

In the view of the IDBA, the mains causes of the banking crisis and the risks it posed to the main participants in the market was primarily caused by other structured products, in particular, structured mortgaged backed securities and Credit Default Swaps.

Despite this, the proposed reforms appear focused solely on the IRS and NDF markets and not in any way on the other markets which experience would suggest pose a far greater systemic risk to the participants in the OTC derivatives markets.

3. The Paper appears to have been drawn up based on certain assumption and views as to the market which may not be entirely accurate or correct. As such the IDBA and keen to provide the benefit of their market position and knowledge to assist this process and regulators to gain a fuller understanding of the OTC derivatives market to which the proposed regulation relates. Many of the below general points address these issues and concerns and seek to correct perceived misconceptions as to the current nature and operation of the relevant OTC derivatives markets:-

a. In the view and experience of the IDBA the chart on page 14 of the Paper as to the breakdown of OTC derivatives transaction does not accurately and properly reflect the OTC derivative market in Hong Kong. In particular the IDBA doubt whether FX Derivatives make up such a large part of the OTC Derivative market and the relevant figures used may include FX transactions which are not OTC derivatives. Further the allocation of market share given to Equity derivatives (which is a substantial market) and other items further suggests that this chart is inaccurate.

b. Some of the contents of the Paper suggest that there may not be a full appreciation of the full scope and operation of the OTC Derivative market in Hong Kong. As stated above the IDBA considers that the vast majority of trades in the NDF market are undertaken via IDBs. Some of the matters addressed in the Paper which give rise to this concern are:-

c. Fundamentally and in essence there is no difference between NDF products (Non-Deliverable Forwards) and FX Derivatives. The NDF market is itself a market in FX derivatives. However these non-deliverable derivatives are generally in relation to currencies, where free and unrestricted trading of the deliverable underlying currency is not possible. Generally these will therefore settle in another currency (usually US$). This market operates in relation to a very broad range of offshore and restricted currencies.

d. The NDF market is, like the FX Derivatives market, primarily a short term market with most transactions being for periods of less than 1 year. This affects the potential for the NDF market to cause any inherent risk to the wider market. However the Paper does not give a detailed review of the NDF market, and yet proposes to exclude FX Derivatives from the initial scope of regulation on the basis that most of those transactions tend to be very short-dated and settled through CLS. (para 54).

e. The CLS system is mentioned in paragraph 54 where the Paper states "*However, because most of these transactions tend to be very short-dated and settled through the Continuous Linked Settlement system (**CLS system**), they are considered to be less of a concern.*" However the CLS system is predominantly used only for transactions in HK$ and US$ currencies A very wide range of NDF and FX Derivative are traded in and through Hong Kong in a wide range of other currencies, which form a significant part of that market.

f. The Paper seems to address the NDF market as some newer or different market. However the NDF market, in particular in certain offshore and restricted currencies (with domestic currency controls and restrictions) is a well-established and long standing OTC derivative market in Hong Kong.

g. Similarly with the market in Interest Rate Swaps (IRS), the Paper does not seem to be based on a full appreciation of the broad range of currencies and product variations utilised in the IRS market or other products such as NDIRS (non-deliverable IRS).

h. There are significant variations in the operation and workings of the markets in various IRS products, in part depending upon the currency they are denominated in. The Paper and the proposal appear to proceed on the basis of the product range being narrow and relatively standardized, or being amenable to standardization, whereas this is not the actual position in the OTC derivatives market for IRS.

i. At present and in part because of the wide range of product variations and currencies in the NDF and IRS markets, most of such trades are not currently traded on electronic platforms. And certainly as regards the proposal for mandatory trading this is relevant to paragraph 2(3) of the Paper which refers "*the mandatory trading of standardised OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate,*"

j. As stated the majority of the market in NDF and IRS OTC Derivatives is undertaken through IDBs and yet the Paper does not deal with IDBs, or address their involvement and role in the market. For example, in the proposal for reporting in Paragraph 7 and the licensing of intermediaries in paragraph 7(10) of the Paper which only addresses those providing "*dealing, advising and clearing agent services.*"

4. The IDBA agrees with the Paper as to the need for enhanced reporting to regulators of transactions in relevant markets which may cause risk to market participants and the wider economy. This addresses, at a fundamental level the issues raised in paragraph 1 of the Paper, i.e.

"The absence of regulation and bilateral nature of OTC derivatives transactions resulted in a market that was essentially opaque. This lack of transparency meant regulators did not have information on OTC derivatives positions held by market players, and therefore could not be alerted to the build-up of exposures that might threaten the market or wider economy."

There is already a considerable degree of reporting by IDBs of many categories of trade in OTC derivative products, to the major market participants. At present systems such as Markitwire and RTNS are utilised by banks and IDBs to report and record the vast majority of transactions in the IRS/NDF markets, to all of the major market participants. The IDBA believe that it would be able to greatly assist the HKMA in establishing the infrastructure and systems for reporting of the type envisaged, and believes that much of this is already being undertaken by market participants.

We are not able to comment in detail on the proposal as regards IDB's role in reporting as this is not set out or addressed in the current Paper. We await a more detailed revised Paper addressing these issues and will be able to respond in detail.

5. In general terms the IDBA agrees with the HKMA's view that "*Central clearing through a CCP mitigates the counterparty risk exposure that players in the OTC derivatives market would otherwise face.*" The IDBA are in general terms supportive of the introduction of central clearing of OTC derivatives and believe that the credit risk mitigation this will produce, in combination with the requirements for the reporting of trades, addresses the fundamental concerns addressed in paragraph 1 of the Paper. The introduction of clearing will address and mitigate much of the credit risk involved in bilateral but highly interlinked OTC derivative markets.

The potential structure of the clearing arrangements, the regulatory framework and there application to IDBs is not clear at this stage (for example paras 7(7) and 132 deal with AIs or LCs who originate or execute the relevant transaction without addressing the role of IDBs). The Paper does not address in detail the role of intermediaries arranging such transactions. The IDBA welcomes the forthcoming opportunity to discuss these issues with the HKMA.

However as regards the clearing arrangements, members of the IDBA would, in general, want to have the right and option to be involved in the the central clearing facility and to be consulted as to its procedures, processes and operations.

6. The IDBA does not believe that there should be mandatory trading on exchanges or that legislation should be introduced relating to mandatory trading, even if the proposal is not to apply or enforce that initially. The IDBA agrees with the comments in the Paper that:-

"*Hence, our focus has been on developing a regime that is on a par with international standards but takes into account local market conditions and characteristics.*" and

"*In considering how best to construct Hong Kong's OTC regime, we have kept in mind that it is not for Hong Kong to drive the reform initiatives given the relatively small size of our OTC derivatives market.*"

The IDBA's reasons for opposing the introduction of mandatory trading of certain OTC Derivatives on exchanges are:-

a. As outlined above, the principal concerns motivating and underlying the review of regulation relating to OTC derivatives are dealt with by the introduction of reporting and clearing. These mitigate the risks to the market participants and the wider economy identified in the Paper. In the view of the IDBA the introduction of mandatory trading of certain OTC derivatives on exchanges adds very little in terms of risk mitigation. Conversely there may be many adverse effects of taking this step.

b. The very nature and commercial purpose of NDF derivatives makes them unsuitable for trading on a public exchange, and certainly one which is one of Hong Kong's major financial institutions.

c. Most NDF and emerging market IRS derivatives are not currently traded on fully electronic platforms, but are intermediated, generally through a hybrid model. The number of currencies and variations in the products make these markets unsuitable to mandatory exchange based trading.

d. An attempt to standardise such products in an attempt to achieve mandatory trading will greatly undermine the size of the market, the diversity of products available and the current market liquidity. This would be to the detriment of the market the market participants and also to Hong Kong and the wider economy. Further the IDBA believes that an exchange traded market in such products will only operate efficiently and have liquidity if there is a sufficiently strong and highly liquid underlying market in Bonds and in Futures. The IDBA does not believe that this is currently the position in Hong Kong.

e. Where the relevant market risk, can be effectively mitigated by other measures (reporting and clearing) the IDBA believes that additional regulation, market standardisation and intervention should generally be avoided especially where this may damage Hong Kong and its wider economy, in terms of market volume, product diversity, liquidity and also as a financial centre.

   As stated above, the NDF market in particular is (because of its very nature) an offshore market which can potentially operate in any offshore financial centre.

   If (contrary to the approach set out in the Paper) Hong Kong does "..*drive the reform initiatives...*" and does not "...*take into account local market conditions and characteristics*" by introducing legislation on mandatory trading, which goes beyond that in other offshore financial centres (including these addressed in Appendix A of the Paper), its risks its position as a financial centre in those markets and therefore the wider economy of Hong Kong.

f. The introduction of mandatory exchange based trading would be a radical and forced shift in the operation of those markets. As such this step should not be implemented and primary legislation should not put in place unless and until it is clear what tangible additional benefits

Tanner De Witt solicitors

would be achieved. This should involve a review the workings of reporting and mandatory clearing after a period of operation.

g. If there are not strong and apparent reasons to introduce mandatory trading, legislation should not be enacted solely on the basis that mandatory trading may be implemented at a future stage. The IDBA believe that the introduction of legislation in that way increases the risk that mandatory trading would be implemented without there having been a proper, objective assessment and review of the market, its effect on the market and whether it is necessary/beneficial in further mitigating market risk. The IDBA believe that reporting and clearing be introduced initially (as proposed) but that primary legislation relating to trading only be introduced if and when appropriate. Introducing legislation prior to that and for "potential" use, increases the risk of regulation being implemented as a matter of course, and as the next stage in the process, when there is in fact no benefit or necessity for it.

h. Given the comments in the Paper, the IDBA believes that Hong Kong can effectively regulate OTC Derivative markets, mitigate the relevant risks, and implement international standards without the introduction of mandatory trading of OTC derivatives on exchanges, or taking legislative steps down that road.

7. As the members of the IDBA are licensed as money brokers under the Banking Ordinance and regulated by the HKMA, they believe that it is appropriate for the HKMA to regulate IDBs in relation to any new or additional licensing regime for reporting and/or clearing, including any possible Type 11 license.

   The IDBA welcomes the opportunity to discuss a revised Paper and the proposed licensing regime with the HKMA including as to issues such as individual licensing requirements, the potential "grandfathering" of current brokers in those markets and the operation of any individual licensing regime going forward.

We and the members of the IDBA look forward to meeting with you to further discuss the above issues, the Paper and the potential revisions to the Paper to address the functions and roles of IDBs. If we can be of any further assistance to you in the meantime please let us know.

Yours faithfully

Tanner De Witt