Ashurst Hong Kong
亞司特律師行 in association with
Jackson Woo & Associates
胡家驃律師事務所
16/F ICBC Tower
Citibank Plaza
3 Garden Road
Central, Hong Kong

Tel +852 2846 8989
Fax +852 2868 0898

www.ashurst.com

30 November 2011

BY FAX AND BY EMAIL

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

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

Dear Sirs

Consultation Paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

Ashurst Hong Kong is an affiliate of Ashurst LLP, an international law firm. We are very grateful for the opportunity to comment on the proposed reforms to the regulatory regime for over-the-counter ("OTC") derivatives. We set out each question in the consultation paper, and our response below. Our comments are intended as comments on legal issues only.

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?

We do not have any general comments on the proposed scope of the regulatory regime. However, we think there should be additional exceptions from the clearing requirement, particularly where exceptions have been made in the United States or Europe or where clearing is difficult to reconcile with market practice for other commitments. An example of this is an exception for hedging transactions. In fact, given the evolutionary nature of the derivatives markets, and the speed with which reform is being introduced, legal certainty would be significantly improved if the legislation contained a discretionary power to grant exemptions, temporary or permanent, from some or all requirements on an individual or market-wide basis. Powers to exempt should be retroactive, at least with respect to liabilities for breach.

We do not have any comments on the proposed split between primary and secondary legislation. We agree that the SFC and HKMA should have discretion to identify types of derivative that should be subject to clearing and reporting requirements. We suggest that, as well as a power to designate, the HKMA and SFC should have a power to de-designate (ie remove transaction types or sub-types from clearing and/or reporting requirements), particularly if a "bottom-up" approach may determine mandatory clearing requirements.

Adding a general definition of derivative transaction creates potential problems and may be unnecessary if there is a power for the SFC and HKMA to identify specific transactions or transaction types. A static list of transactions will be rendered out-of-date by innovation. A more generic description will be difficult to distinguish from most other contracts. In fact a general

definition is more likely to limit the discretion of the SFC and HKMA than enhance it. Defining an Elephant as a four-legged grey animal with a trunk is generally unnecessary; it will cause problems if, for some reason, an Elephant only has three legs or half a trunk.

If a definition is preferred, the definition of "structured products" under the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 is helpful in so far as it excludes ambiguity in some cases (such as insurance and gaming contracts). However as currently proposed the reforms will also create ambiguity for items that are structured products, but which would not normally be viewed as an OTC derivative. A better formulation would be that an OTC derivative must be a structured product, but not that all structured products (bar a specific few) must be OTC derivatives.

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

We don't have any comment in so far as the reforms apply to a person already regulated by the HKMA or SFC. However, dividing responsibility, but giving the SFC responsibility for regulating end-users also creates anomalies; both in terms of the SFC's mandate and in the nature of any sanctions the SFC may be able to impose for breaches. For example, in so far as the transparency or clearing requirements should be enforced on an insurance company, the appropriate authority may be the Office of the Commissioner of Insurance; in so far as they should be enforced on a Mandatory Provident Fund, the appropriate authority may be The Mandatory Provident Fund Schemes Authority.

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

A phased approach is better. The change of regime will require significant work putting in place new documentation.

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?

We think that IRS and NDF are very broad categories, and that the requirement should apply to a narrower field. Most clearing houses specify maturities, rate sources (such as HIBOR), amortisation profiles (or lack thereof) and similar matters when defining what they will accept for clearing. Many structured transactions (such as a perfect asset swap) would also qualify as interest rate swaps (IRS) but are not appropriate for clearing – both because of the exotic nature of the market risks and because of the circumstances in which they tend to be used.

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

The requirement to report transactions which are "negotiated, arranged, or confirmed" is very broad and will be onerous. It will be very difficult for counterparties to police, particularly for large or complex transactions where external advisers may be used. As currently drafted, law firms in Hong Kong could be faced with the need to prevent lawyers in Hong Kong working on international transactions with a derivative element, or risk creating a reporting requirement. The requirement for a Hong Kong nexus should also apply to reporting based on these pre-contract stages as well as any off-shore contracts. There is no benefit to requiring transactions with no Hong Kong nexus and no Hong Kong counterparties to be reported, simply because some of the persons involved in the work live in Hong Kong. The reference to parties "committing" to a transaction is legally ambiguous. There is no concept in Hong Kong law of a binding offer.

We agree with the suggested approach for persons other than authorised institutions and licensed corporations to be able to rely on disclosure by a counterparty. In fact, since the main purpose of the requirement is disclosure, the reporting requirement should be satisfied in any circumstances if

ever the HKMA-TR has all relevant information *de facto*. This would make transfer of information between trade repositories sufficient, but leave responsibility for compliance with counterparties.

When mandatory reporting applies, there should be adequate statutory protection for the confidentiality of information. There should also be adequate protection for a reporting counterparty from claims for breach of confidentiality or misuse of data, in particular, given that the regime potentially extends to derivative transactions with private individuals.

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?

The Consultation Paper assumes that legal title and the beneficial interest will always be the same. The reporting threshold should be calculated in a different manner for different types of entity. For example a corporate trustee (assuming not an AI or LC) should calculate compliance with respect to each trust individually. Similar issues apply for cell companies, umbrella companies, insurance companies (dealing through segregated funds), investment managers, and partnerships.

The threshold should not be a single threshold for all counterparties or transaction types. Different counterparties will have different needs and capabilities.

Any threshold should apply on a net basis. If a swap needs to be unwound it may be cheaper for a corporate, and require less cash up front, to enter into a reverse off-setting swap, than to terminate the original swap. The net effect will be to remove or reduce market risk, but applying the threshold on a gross basis would create a misleading reporting requirement.

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

A grace period for reporting should also apply to innocent mistakes and misinformation as well as applying on introduction of the regime. For example the same transaction may be reported more than once as different transactions by mistake. Equally certain trades may be disputed or set aside – for example "fat finger" transactions which sometimes occur on electronic execution facilities. It should be possible to correct these without penalty within a given time-frame.

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

It is very important that the regime does not impose an obligation to clear a transaction in Hong Kong at the same time as a foreign jurisdiction imposes an obligation to clear the same transaction in that (or another) jurisdiction. At the moment authorities globally are not paying enough attention to conflict of laws issues.

The Consultation Paper assumes that legal title and the beneficial interest will be the same. However where this not the case (for example, as with a trust), mandatory clearing should not prevent continued segregation of beneficial interests.

The Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**") in the United States contains an exemption for hedging by end-users in Title VII. The draft European Regulation on OTC derivative transactions, central counterparties and trade repositories ("**EMIR**"), includes a similar exemption in Article 5 for non-financial counterparties. We think an exemption for hedging is sensible and should apply irrespective of any clearing threshold.

Although we think a hedging exemption is desirable it can be difficult to define. We therefore think there should be a separate exemption for structured finance transactions where assets and liabilities are ring-fenced on a bankruptcy-remote basis (such as asset finance, project finance and securitisations). These structures are used to protect creditors and to minimise funding costs. Imposing a clearing obligation on any derivative transactions will prevent the structures from being bankruptcy-remote (since a clearing house will not accept a stay on its right to terminate on default) and the clearing house will be a preferential creditor above all other creditors. The need to

hold collateral which is eligible for delivery to a clearing house will increase funding costs, and make the structures less efficient. EMIR also exempts pension funds, for the time being. Again we recommend this approach.

The consultation proposes that the clearing requirement apply to transactions "originated or executed" in Hong Kong, and that this be defined in the same manner as the reporting requirement. This will mean that the clearing requirement will apply to transactions which are "negotiated, arranged, or confirmed, or committed to" in Hong Kong, even though there is no concept in Hong Kong law of a binding offer.

In practice, unlike reporting, there will be some form of Hong Kong nexus, since only a limited range of transactions will be eligible for clearing here, and those are likely to involve, for example, Hong Kong Dollars or local shares or debt obligations. However the requirement is still very broad and will be onerous. It will be very difficult for counterparties to police, particularly for large or complex transactions where external advisers (such as an international law firm) may be used. This approach will create particularly bizarre results if a clearing requirement also arises in another jurisdiction but that jurisdiction is not recognised in Hong Kong as "acceptable", particularly if the transaction was not actually executed in Hong Kong.

We agree with the proposal not to require back-loading of existing transactions for clearing purposes. It would be very disruptive if a counterparty were required to backload transactions and could involve extensive breaches of contract if the transaction were part of wider contractual arrangements (such as a securitisation or leveraged, project or asset finance transaction).

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

The clearing threshold should be calculated in a different manner for different types of entity. The Consultation Paper assumes that legal title and the beneficial interest will always be the same. This is not true. For example a corporate trustee should calculate compliance with respect to each trust individually. Similar issues apply for cell companies, insurance companies (dealing through segregated funds), investment managers, and partnerships. The same point would also apply to banks issuing covered bonds. Although there is no market for covered bonds in Hong Kong at the moment, it is increasingly popular as a financing technique – even with regulators.

The threshold should not necessarily be a single threshold for all counterparties or transaction types. Different types of counterparties will have different needs and different levels of excess cash available to provide funding for clearing.

Any threshold should apply on a net basis if netting is legally enforceable (ie where swaps are with the same counterparty). If a swap needs to be unwound it may be cheaper for a corporate, and require less cash up front, to enter into a reverse off-setting swap, than to terminate the original swap. The net effect will be to remove or reduce market risk. Requiring clearing based on the gross position would simply increase the costs for the counterparty without there having been any increase in market exposure.

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

No comment.

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

No comment.

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

A CCP needs to benefit from insolvency law and settlement finality protections. It also needs protection from any overseas insolvency proceedings. If a CCP is authorised an automated trading service this will not be the case. Unless the legislation is changed so that an automated trading service has the same privileges as a recognised clearing house, it will not be practicable for a CCP to be an automated trading service. In addition, even if a CCP is authorised as a recognised clearing house the current protections that apply to market contracts arguably would not apply to an OTC derivative transaction. The definition of market contract should be amended.

Given the above, although it is something which the consultation claims to leave open, the proposed approach would in fact have the effect of requiring a CCP to be local. Under the Securities and Futures Ordinance (Cap 571) a recognised clearing house must be a company formed in Hong Kong under the Companies Ordinance (Cap 32) or preceding legislation.

The protections for a recognised clearing house from insolvency laws and requirements for the perfection of security interests do not apply to indirect clearing, in the context of the contracts between a clearing member and its (non-clearing) counterparty. There are no substantive or conflicts of law rules on the legal nature of a holding of intermediated securities or on the taking of security over intermediated securities in Hong Kong. Portability and segregation are meaningless if there is no title to the securities. It would benefit the CCP, clearing members, and all intermediaries for these rules to be introduced before clearing becomes mandatory. This is also true if overseas counterparties are to be allowed to clear directly: there needs to be certainty that Hong Kong law will apply.

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

If the licensing requirement extends beyond transactions specifically identified for the clearing and reporting requirements it will be difficult to define OTC derivatives in a manner that is comprehensive enough, but not too wide. It will also be necessary to define "advice" narrowly enough to avoid unwanted side-effects.

Q12. Do you have any comments on the proposed regulatory oversight of large players?

Section 114 of the Securities and Futures Ordinance (Cap 571) prohibits a person carrying on business in a regulated activity without a licence or being exempt. The concept of "carrying on business" is a key feature of the regime and does not include being an end-user. It is important that any licensing regime for dealing in derivative transactions does not alter the definition of "carrying on business" for purposes of any other licensed activities.

Yours faithfully