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

Dear Sir / Madam,

CFA Institute [1] is pleased to comment on the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong.

CFA Institute, through its members' experience in international markets and different investment disciplines, represents the interests of investors and investment professionals to standard setters,

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1 With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of more than 110,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 137 countries, of whom more than 99,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

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regulatory authorities, and legislative bodies worldwide. CFA Institute promotes fair, open, and transparent global capital markets, and advocates for investors' protection.

In line with the G20 commitments, the Consultation proposes the establishment of a Trade Repository (HKMA –TR) for collection of data relating to OTC derivatives transactions and the process of establishing a new clearing house in Hong Kong that may serve as a Central Counter Party (CCP) for the OTC derivatives market in Hong Kong. The Consultation also provides an overview of the current environment, the uniqueness of the Hong Kong derivatives market, an assessment of what HKMA –TR and CCP entail, the phased approach of incorporating certain types of interest rate swaps (IRS) and non-deliverable forwards (NDF) to the mandatory reporting and clearing regime and how this will apply to Authorized Institutions (AIs), Licensed Corporations (LCs) and others who are Hong Kong persons.

In general, CFA Institute is supportive of both the introduction a reporting regime and a CCP for central clearing of OTC derivative contracts in Hong Kong, with an ultimate goal of greater use of exchange trading for derivatives.

In a survey of CFA Institute members in October 2009:

- 68 percent of members agreed that all standardized and standardizable derivative contracts that currently trade over-the-counter should be required to trade on a regulated exchange;
- 78 percent of members agreed that such contracts should have to clear centrally;
- 66 percent of members agreed that electronic reporting of over-the-counter trades would provide an appropriate level of transparency for all investors for those derivatives that continue to trade OTC.

The survey results are based on the responses of 755 CFA Institute members based in the United States. The results are available at http://www.cfainstitute.org/Survey/us_iwg_poll_report.pdf.

We appreciate the opportunity to comment on the proposals to introduce the legislative framework of reporting and clearing of over-the-counter (OTC) derivative contracts. These two elements have a significant impact on the structure of derivatives markets.

SPECIFIC COMMENTS:

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?

Hong Kong does not have an existing regulatory regime for the derivatives business, and the OTC derivatives market is relatively small. Hence the proposal is to leverage the existing SFO legislative framework instead of creating a new piece of legislation specifically to cater to OTC Derivatives. This will provide flexibility to react on a timely basis to market developments but will hopefully reduce legislative changes and help to meet the G20 objectives.

The new regime will be jointly overseen by the Hong Kong Markets Authority ("HKMA") and the Securities and Futures Commission ("SFC"). HKMA will oversee authorized institutions ("AIs") and SFC will oversee licensed corporations ("LCs"). There will be a primary and subsidiary legislation.

The primary legislation will set out the mandatory reporting, clearing and trading obligations for the eligible derivatives instruments. It will also include the penalties for any breach of the mandatory obligations. The designation of CCPs for the mandatory clearing and the designation of exchanges and other electronic trading platforms for the mandatory trading obligations will be set out in the primary legislation.

The detailed criteria and procedures for designation of CCPs and key definitions that will delineate the scope of mandatory reporting, clearing and trading obligations will be set out in the subsidiary legislation. This will include to whom the obligations apply, the types of OTC Derivatives transactions that are covered, the manner in which the obligations must be fulfilled, etc.

It appears that a better understanding of the scope and implications of the proposed regime will be derived after the second phase consultation to the subsidiary legislation is completed in Q1 2012.

For example, the term "OTC derivatives transactions" will be defined in the primary legislation but the scope of its application in relation to the mandatory obligations will be adjusted as appropriate in the subsidiary legislation. The HKMA and SFC do not propose to apply mandatory obligations to all OTC derivatives transactions but only to those specifically mentioned in the subsidiary legislation.

The Hong Kong regulatory regime has evolved over time. In April 2010, the Securities and Futures Commission (SFC) proposed and adopted a new definition of "structured products" which is broadly defined and potentially includes a number of derivative products.

The Consultation proposes to define OTC derivatives transactions using an existing definition of "structured products" and then exclude certain specific transactions. While the purpose behind this exclusion is to avoid overlapping regulation, the proposed definition will necessarily form the basis for a robust and practical derivatives regulatory regime and hence should be simple and leave no room for ambiguity.

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

The new regime will be jointly overseen and regulated by the HKMA and SFC with the HKMA overseeing and regulating the OTC derivatives activities of AIs and the SFC overseeing and regulating the OTC derivatives activities of the LCs and other persons.

It has been well identified that most of the main players in the OTC derivatives market in Hong Kong are all Authorized Institutions (AIs). They are already under the purview of HKMA as banking is the core and integral part of their business. Hence it is logical and practical for HKMA to continue the primary supervision and regulate the AIs.

It is proposed that non-Authorized Institutions in the OTC derivatives market will be overseen and regulated by the SFC because most of these LCs are international investment houses that are already licensed with the SFC in respect of securities and futures businesses. Those who operate as unregulated entities within a group will be brought under the SFC's purview by a new regulated activity.

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

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?

It is proposed that specified OTC derivatives transactions will be subject to mandatory reporting to Hong Kong Monetary Authority – Trade Repository (HKMA-TR) and mandatory clearing through a designated CCP. This will be subsequently extended in phases to cover other products and asset classes.

TRs are central databases that record the details of open OTC derivatives transactions. TRs thus serve a critical function in enhancing trade transparency in OTC derivatives markets and form a key component of post-trade infrastructure.

Based on the 2009 data included in the Consultation, (survey conducted with a list of major market participants), it is highlighted that although foreign exchange derivatives account for more than half of the OTC derivatives market in Hong Kong, they are short-dated transactions settled through the Continuous Linked Settlement system (CLS system) with less settlement risk exposure and no push internationally to subject them to stringent regulations.

This is consistent with the developments in the US and Europe on OTC derivatives regulatory proposals. While we understand the practical difficulties with regard to collateral and systems to include FX derivatives into reporting and clearing structure in the initial phase, CFA Institute is in favor of an exchange trading regime and central clearing of FX derivatives ultimately to ensure an appropriate level of transparency to investors, minimize risk and address the issues of liquidity and price discovery.

Since Interest Rate Swaps (IRS) and Non-Deliverable Forwards (NDF) are the next largest class of OTC derivatives traded in Hong Kong, it is proposed to include these types of transactions in the portfolio for mandatory reporting and mandatory clearing of OTC derivatives. We support the phased approach of extending the mandatory reporting and clearing obligations of these instruments.

Products that have very limited number of participants or where the liquidity and activity are generally low could be centrally cleared but given the relatively small size of these markets, the cost of clearing may outweigh the benefits to users. Hence testing the market first with NDF and IRS would be ideal given the scale of activity, and IRS and NDF appear to be systemically more important to the Hong Kong derivatives market.

Furthermore, in order to ensure a CCP does not face excessive risks clearing OTC derivatives, the derivative product or the underlying instrument that is subject to central clearing must be liquid, the exposure must be closed out in a timely manner and the derivative product must be accurately priced and margined. It is advisable to take a phased approach to ensure that there is sufficient liquidity in the product in question so that the CCP can safely and accurately establish the requisite margin and collateral. This will ensure a high level of integrity to the process.

It is proposed that logistical and technical arrangements for reportable transactions to HKMA-TR will be limited to transactions in the following types of products: Single currency interest rate swaps, overnight index swaps, single currency basis swaps, and non-deliverable forwards.

A derivative product in Hong Kong will be mandated for central clearing when it is classified as "eligible". The proposal includes two possible methods through which the classification can be assigned:

- Bottom-up Approach: A designated CCP can decide to clear a class of derivative and the regulator can authorize the clearing. Subsequently it will be made mandatory for that class of derivatives from a certain date.
- Top-Down Approach: The regulator mandates products suitable / eligible for clearing on a certain date.

We agree with this proposal as it is in line with what is being adopted internationally and it promotes prudent reform of the OTC derivatives markets in Hong Kong. TRs and central clearing counterparties would act as complementary post-trading infrastructure initiatives that would improve transparency and minimize risk. These are only two of the components necessary to strengthen the market infrastructure. CFA Institute members also support requiring all standardized and standardizable derivatives contracts to be traded on-exchange to address the separate trading issues of liquidity and price discovery.

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

CFA Institute advocates price transparency as one of the most important goals of financial markets and that investors should have access to relevant market information. Trade Repositories can help achieve these goals. CFA Institute has consistently called for a central data repository to enhance market transparency in general.

In line with the G20 recommendations, the Consultation proposes to introduce a mandatory reporting obligation which will require certain specified OTC derivatives transactions over a certain threshold to be reported to the HKMA-TR. The proposal is to recognize only one TR—i.e. the HKMA-TR—for the purpose of reporting either directly or indirectly through an agent. The information will facilitate both HKMA and SFC in their proposed joint oversight role of assessing, mitigating and managing any systemic risk created by the OTC derivatives market.

It is proposed that the mandatory reporting obligation will apply in different ways to LCs, AIs (both overseas incorporated and locally incorporated), and Hong Kong Persons.

LCs and locally incorporated AIs are required to report all reportable transactions to which they are counterparties or which they have originated and executed.

Unlike the US and EU, most of the OTC derivatives activity conducted by AIs and LCs in Hong Kong is not booked in Hong Kong. The Hong Kong arm in most cases is just the sales desk or trading desk rather than the client facing entity. The "originated and executed" extension would mean that the AIs and LCs cannot circumvent the mandatory obligations by booking through an overseas branch or entity. As long as the LCs or AIs negotiated, arranged, confirmed and committed to the transaction, they are subject to the mandatory reporting obligation.

Hong Kong persons are required to report a reportable transaction if they are counterparty to the transaction and if they have exceeded the specified reporting threshold. However, they will be exempted if an AI or LC is subject to reporting obligation to that transaction.

While we applaud the above proposal to ensure that there is no loophole given the unique nature of the Hong Kong OTC derivatives market, we are concerned about the effectiveness of identifying and ensuring Hong Kong persons report all transactions above a certain threshold. In particular, we are concerned about whether transactions will be reported when there is no AI or LC involved in the OTC derivatives transaction.

To remedy such concerns, we suggest that the Proposal require Hong Kong-based counterparties to adhere to the mandatory reporting requirements when neither an AI nor LC is involved.

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?

Hong Kong persons are required to report reportable transactions to which they are counterparty if the specified reporting threshold has been exceeded. It is important to note that the reporting threshold applied to Hong Kong persons only and not to LCs or AIs. The reporting threshold will be set separately for each product class and is proposed to be in absolute dollar terms by reference to the notional value (as opposed to market value) of the relevant transactions. The Consultation specifically identifies that if the market value were to be used instead; the value of the positions held would fluctuate more frequently, making calculation difficult. The average notional value of the relevant person's outstanding positions for the previous six months, based on month-end position will be taken into account to calculate the threshold.

To reduce the reporting burden on the Hong Kong persons, it is proposed to exempt them from mandatory reporting if an AI or LC is also subject to the reporting obligation in respect of such a transaction. There is no such exemption for AIs or LCs when more than one party has the obligation to report the transaction. This is to ensure checks and balances are in place.

The proposal of establishing a reporting threshold for persons other than AIs and LCs appears practical; however we are not able to comment on how the threshold should be calculated.

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

It is proposed that reporting obligations should be complied with by the end of the business day immediately following the trading day. The Consultation proposes a grace period when the reporting obligation comes into effect. Three months grace period is proposed for setting up a reporting channel to HKMA TR and six months for completing any back loading (i.e. reporting transactions already entered into but still outstanding).

CFA Institute recommends the regulatory body to enter into a dialogue with the market players in the industry to find out whether the proposed grace periods are appropriate. We have no comments to add in respect of the proposed grace periods.

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?

CFA Institute is of the opinion that all standardized and standardizable OTC contracts should be subject to central clearance. In a CFA survey conducted in the US in October 2009, 78% of the respondents expressed their support for this idea.

Under this type of system, TRs and CCPs would act as complementary post-trading infrastructure initiatives that would improve transparency and minimize risk respectively. In general, there should be very few exemptions from central clearing. Only transactions where a non-financial entity is specifically hedging a legitimate identifiable commercial risk, for example through the use of a bespoke contract transacted bilaterally with a bank, should be exempted from central clearing. Such a contract would be ill-suited to central clearing because of the difficulty of accurately margining the contract.

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

Although central clearing concentrates counterparty risk in an entity specifically chartered to handle it, it does not solve all problems associated with OTC trading. More notably central clearing does not provide price discovery, transparency or regulatory oversight. Consequently, CFA Institute promotes provisions requiring all standardized OTC derivatives to be traded on regulated exchanges. This position is supported by 68% of the respondents in our October 2009 member poll.

In combinations with exchange trading on standardized contracts, TRs and CCPs would enhance transparency and therefore permit investors to have a thorough understanding of the market trends, risks and pricing.

The results of the proposed mandatory reporting obligation will facilitate the assessment of the liquidity level and number of trading venues needed in the Hong Kong market. This assessment will then facilitate the imposition and implementation of a mandatory trading obligation. While we understand that there could be a delay in imposing a trading obligation, exchange trading is essential to underpin robust price discovery and market integrity and thereby enable investors, regulators and others to assess the accumulated positions and the risks within the marketplace.

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

It is proposed that all eligible transactions must be cleared through a designated CCP. Currently, only recognized clearing houses (RCH) or an authorized Automated trading service ("ATS") can be designated CCPs. It is believed that the existing provisions and frameworks can be extended to cover OTC derivative transactions and help to govern the regulation of CCPs. The ATS regime is particularly suited to overseas CCPs who wish to provide services to the Hong Kong market.

The Consultation recognizes that the existing regime for RCH and authorized ATS is broad to the extent that it allows the SFC to apply international standards for regulation of OTC derivatives clearing houses.

CFA Institute would like to reiterate that a well-founded, transparent and enforceable legal framework is of paramount importance to the effective operation of a CCP. It is important that the SFC should be empowered to apply international standards relating to governance structure, financial resources, membership criteria, risk management policies and procedures, margining requirements to approve a CCP.

With regard to the location of the CCP, the Consultation contemplates permitting overseas CCPs to clear transactions in domestic products that are of systemic importance as this has consequences for fragmentation and liquidity. References have been drawn to the Australian and Japanese discussion papers. Pros and cons of permitting an overseas membership to clear through a designated CCP directly are considered. It is proposed that market players should be allowed to perform any mandatory clearing obligation either directly (i.e. as a member of the designated CCP) or indirectly (i.e. through a third party that is a member of a designated CCP).

CFA Institute recommends the designation and regulation of CCPs to be consistent with international best practices as established by CPSS-IOSCO[2].

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[2] CPSS – Committee on Payment and Settlement Systems
IOSCO – The International Organization of Securities Commissions

CONCLUSION:

Standardization of derivatives currently traded OTC is a necessary step to facilitate greater trading transparency through the use of exchanges and other electronic trading venues, and to make CCP clearing safe and practicable. Trade repositories help further transparency and crucially enable regulators to monitor aggregate exposures and detect the build-up of risks. Exchange trading, CCP clearing and reporting to trade repositories collectively strengthen the functioning and resiliency of derivatives markets and thus bring benefits to both investors and regulators. CFA Institute is therefore supportive of efforts to begin the process of reforms by introducing a reporting regime and a platform for centralized clearing of OTC derivatives.

We note, however, that such post-trade infrastructure initiatives are not substitutes for on-exchange trading, which addresses the separate issues of trading transparency, liquidity, and price discovery.

Please do not hesitate to contact us should you wish to discuss any of the points raised.

Sincerely,