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By Post & Email: mdd@hkma.gov.hk

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

Dear Sirs

**Supplemental Consultation on the OTC Derivatives Regime for Hong Kong -  
Proposed Scope of New / Expanded Regulated Activities and Regulatory  
Oversight of Systemically Important Players**

We refer to the supplemental consultation by the Hong Kong Monetary Authority and the Securities and Futures Commission on the proposed regulatory regime for the OTC derivatives market in July 2012.

We have sought comments from all HKAB members and would like to enclose our submission in the appendix for your consideration.

For any questions, please contact

Yours faithfully

Enc.

*Chairman* The Hongkong and Shanghai Banking Corporation Ltd  
*Vice Chairmen* Bank of China (Hong Kong) Ltd  
Standard Chartered Bank (Hong Kong) Ltd  
*Secretary*

主席 香港上海滙豐銀行有限公司  
副主席 中國銀行(香港)有限公司  
渣打銀行(香港)有限公司  
秘書

**Hong Kong Monetary Authority and Securities and Futures Commission  
Proposed regulatory regime for the over-the-counter  
derivatives market in Hong Kong**

**Submission of The Hong Kong Association of Banks**

**28 August 2012**

**Introduction**

This paper sets out the views of The Hong Kong Association of Banks (“**HKAB**”) in relation to the revised proposals for Hong Kong’s regulatory regime for over-the-counter (“**OTC**”) derivatives, as set out in the “Joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong” (“**Conclusions Paper**”) issued jointly by the Hong Kong Monetary Authority (“**HKMA**”) and the Securities and Futures Commission (“**SFC**”) in July 2012.

Assisted by King & Wood Mallesons, we have examined the Conclusions Paper, including the supplemental consultation set out in Appendix 2 to that paper (“**Second Consultation Paper**”). We have also considered the extent to which HKAB’s comments in its submission dated 30 November 2011 (“**First Submission**”) have been addressed.

This submission sets out HKAB’s response to the Conclusions Paper and the Second Consultation Paper.

Our response is preliminary only, given that many critical details remain uncertain. HKAB looks forward to providing comprehensive comments on the detailed requirements when they are released later this year. We also ask that relevant aspects of our First Submission be taken into account in the drafting of those requirements.

We look forward to an ongoing dialogue with the HKMA and the SFC in relation to the proposed OTC derivatives regime.

*Capitalised terms that are defined in the Consultation Paper have the same meaning when used in our response.*

**Executive summary**

HKAB welcomes the significant progress that has been made since the first proposals were released in October 2011. We appreciate that many of HKAB’s concerns have been taken on board and addressed in the revised proposals contained in the Conclusions Paper.

We wish to express a small number of outstanding concerns arising from the Conclusions Paper (set out in **Part A**) and comments on the Second Consultation Paper (set out in **Part B**).

In summary, HKAB:

- (a) is concerned about the pace at which details of the new OTC derivatives regime are being released and requests that the consultation process for these details commence as soon as possible (see paragraph 1 of Part A);
- (b) asks that a uniform grace period of six months be adopted for clearing and reporting requirements, in recognition of the significant upgrades required to implement the new regime, the ongoing paucity of detail and the tight overall timeframe (see paragraph 2 of Part A);
- (c) requests that if adopted, the concept of “originated or executed” be supported by substantially more detail so that it is workable in practice (see paragraph 3 of Part A);

- (d) believes that the concept of "Hong Kong nexus" should be refined to remove (or substantially clarify) the reference to an underlying being "related to" a particular currency and that it should only refer to Hong Kong dollars ("HKD"), not Renminbi ("RMB") (see paragraph 4 of Part A);
- (e) asks that global TRs become a recognised reporting channel, rather than being treated as any other third party service provider (see paragraph 5 of Part A);
- (f) strongly urges the HKMA and the SFC to implement a specific regulatory mechanism to resolve conflicts caused by overlapping clearing obligations (see paragraph 6 of Part A);
- (g) suggests that further guidance be provided in relation to using counterparty declarations in relation to determining whether a "specified clearing threshold" has been met (see paragraph 7) and in connection with the proposed exemption for non-financial end-users that use derivatives to hedge commercial risks (see paragraph 8 of Part A);
- (h) emphasises the need for CCPs to be appropriately regulated and have robust governance, control and default management structures (see paragraph 9 of Part A);
- (i) urges the HKMA and the SFC to work with their overseas counterparts to ensure that when implementing any offshore substitute compliance mechanisms, any test of "comparability" or "equivalence" that is adopted is measured against the core G20 Pittsburgh commitments only and that it is not applied in a granular manner (see paragraph 10 of Part A); and
- (j) expresses its overall support for the proposed OTC derivatives-related licensing regime, but asks for some adjustments in connection with the transitional arrangements (see Part B).

We welcome the opportunity to discuss these comments further.

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## Part A – HKAB's response to the Conclusions Paper

The following submissions focus on issues raised in our First Submission that HKAB believes were not (or insufficiently) addressed in the Conclusions Paper and matters arising from further proposals raised in the Conclusions Paper.

### A Concerns about implementation

#### 1 Progress on detailed requirements

HKAB is concerned about the continuing lack of crucial details of the proposed new OTC derivatives regime, particularly given the tight consultation periods and overall implementation timeline.

Accordingly, we ask that the consultation process for the detailed provisions of the new regime commence as soon as possible, to give Hong Kong market players sufficient time to respond to the detailed proposals and in turn, to plan for and implement the new requirements.

The following paragraphs outline some of the key reasons for this request. Please also refer to our related comments in paragraph 2 concerning the proposed grace periods.

First, all market players need time to implement significant regulatory reforms – particularly in a previously unregulated (or minimally regulated) space that crosses borders.

Specifically, implementation of this new regime will involve:

- (a) understanding its precise scope, including the products involved;
- (b) strategic business planning, budgeting and resource allocation across multiple jurisdictions;
- (c) legal advice and extensive documentation reviews;

- (d) major policy development and procedural change;
- (e) new technological infrastructure and systems enhancements;
- (f) thorough testing before deployment;
- (g) building relationships with third party service providers;
- (h) staff training, in relation to new regulatory responsibilities and updates in internal policies, procedures, systems and documentation; and
- (i) client engagement at multiple levels, including obtaining necessary consents from HKAB member clients and those of their relevant subsidiaries.

No two firms are alike – each will need to tailor an approach that is appropriate to meet its needs and the needs of its clients.

Secondly, these implementation steps cannot begin in earnest without knowledge of the details.

HKAB acknowledges the significant work that has already been undertaken by the HKMA, the SFC and Hong Kong Exchanges and Clearing Limited. HKAB also appreciates the assurances given in the Conclusions Paper that the industry will be consulted on a wide range of matters in the coming months. HKAB also understands that the formulation of Hong Kong's regulatory regime for OTC derivatives is linked to developments overseas.

However, HKAB is concerned about the pace at which critical details of the new regime are being released. Examples include:

- (i) the specific products that will be the subject to mandatory clearing and/or reporting – for example, which currency NDFs will be required to be cleared;
- (ii) the types of subsidiaries of locally-incorporated AIs that may be required to report to the HKMA-TR, which is important for planning purposes and to ensure a transparent exercise of the HKMA's proposed power to require subsidiary reporting;<sup>1</sup>
- (iii) specific eligibility requirements for CCP membership (as part of the Type 12 licensing arrangements), including capital requirements; and
- (iv) the default management standards and arrangements that CCPs will be required to adopt, given their importance to the stability of Hong Kong's OTC derivatives market.

We ask that these (and other) details be released as soon as possible, with an adequate time for consultation and discussion with industry stakeholders.

Finally, in line with other recent major regulatory reforms, we ask that the HKMA and the SFC provide information sessions to market participants in relation to the detailed proposals for the OTC derivatives regime that are released later this year, and again before implementation.

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<sup>1</sup> Please refer to our comments in paragraph 5.5 of our First Submission.

## 2 Grace periods

Linked to our comments in paragraph 1 and in our First Submission, we ask again that the grace periods for reporting and clearing be extended to at least six months.

Our members strongly believe that three months are simply not enough to implement the degree of change required, given that numerous significant details remain outstanding and that pivotal systems, applications and middleware still need to be developed.

## B Mandatory reporting obligation

### 3 “Originated or executed”

HKAB appreciates the new guidance provided in the Conclusions Paper in relation to the meaning of “originated or executed” and the overall narrowing of this concept.<sup>2</sup>

However, we reiterate our overall objection to it and the specific concerns we expressed about its use in our First Submission. It exceeds the proposals in other major jurisdictions, including the United Kingdom, Singapore<sup>3</sup> and Australia. Despite the new guidance and adjustments set out in the Conclusions Paper, significant practical difficulties remain.

If it is adopted, we ask for substantially more guidance and examples to help make it workable in practice.

For example, paragraph 115(2) of the Consultation Paper explains that an AI,<sup>4</sup> LC or AMB will be regarded as having “originated or executed” an OTC derivatives transaction if it has agreed its “normal economic terms”, among other criteria. We have two queries about this:

- (a) First, there may be instances where only part of the transaction may have been agreed by that entity – how large or substantial must that part be to trigger the reporting requirement? Is there a materiality threshold?
- (b) Secondly, what do the HKMA and the SFC consider to be the “normal economic terms” of the transaction? Would periodic payment amounts be sufficient?

We acknowledge that prescriptive definitions and guidance could have the unintended result of encouraging regulatory arbitrage. However, sufficiently clear parameters are necessary for regulatory certainty, efficient implementation and consistent application across the industry. Vague regulation has significant cost implications and HKAB wishes to avoid unnecessary and duplicative reporting.

### 4 “Hong Kong nexus”

HKAB appreciates the steps that have been taken to fine-tune the concept of “Hong Kong nexus”. Our concern has always been that it should be defined by reference to objectively ascertainable criteria that can be discerned from key transaction details.

Bearing this in mind, HKAB wishes to express the following concerns in relation to paragraph 109(2) of the Conclusions Paper:

- (a) **“Related to”** - The concept of an underlying asset, currency or rate being “related to” HKD or RMB is unclear. Given that denomination in those currencies is separately

<sup>2</sup> From paragraph 113 of the Conclusions Paper.

<sup>3</sup> We are aware that in its latest consultation paper on the subject, the Monetary Authority of Singapore proposed to include derivatives “booked and traded” (our emphasis) in that jurisdiction within the ambit of the reporting requirement, with guidance to come on what “traded” means. While we also disagree with the use of this concept, we suggest it is materially narrower than “originated or executed”.

<sup>4</sup> That is, a locally-incorporated AI or the Hong Kong branch of an overseas-incorporated AI.

addressed, we are uncertain as to what else is contemplated. By way of example, our members have queried whether:

- (i) United States dollar (“USD”) products would be deemed to have a Hong Kong nexus, given that the HKD is pegged to the USD, and therefore the USD could be said to be “related to” HKD;
- (ii) for argument's sake, RMB is “related to” HKD by virtue of the political connection between the People's Republic of China and Hong Kong;
- (iii) HIBOR is a rate “related to” HKD; or
- (iv) rather, the intention is to capture products that derive their value from, or are otherwise linked to, fluctuations in the HKD or RMB, in the derivative sense?

We also suggest that going beyond denomination exceeds the proposals that have been canvassed so far in other jurisdictions.<sup>5</sup>

- (b) **Inclusion of RMB** – Secondly, we question why products denominated in, or related to, RMB are taken to have a Hong Kong nexus. Hong Kong is a financial hub for derivative products denominated in or linked to a wide range of currencies. It is also not the sole offshore RMB trading centre.

## 5 Global TRs

The Conclusions Paper suggests that:

*“market players [may be able] to appoint a third party for the purposes of the reporting obligations...[which] means they can, for example, report transactions via a global TR.”<sup>6</sup>*

HKAB welcomes the recognition of global TRs, but we believe that global TRs should have a different status than any other third party that market players may use to assist them with reporting.

Specifically, the use of a global TR (that meets whatever reasonable criteria necessary) should be recognised as a distinct reporting channel, rather than being treated as a regular outsourced function for which each individual AI must seek approval under the HKMA's Supervisory Policy Manual.

In this respect, we understand that the proposed OTC derivatives reporting rules in Europe and Singapore are intended to specifically recognise foreign TRs.

## C Mandatory clearing obligation

### 6 Resolving conflicting clearing obligations

The Conclusions Paper explains that no longer requiring trades merely originated or executed in Hong Kong to be centrally cleared in this jurisdiction would “help reduce overlap with clearing requirements imposed by overseas regulators”.<sup>7</sup>

We strongly urge the HKMA and the SFC to implement a specific regulatory mechanism that actually resolves – not only reduces – conflicts caused by overlapping clearing obligations.

<sup>5</sup> For example, see the Australian Treasury's consultation paper, “Implementation of a framework for Australia's G20 over-the-counter derivatives commitments”, dated April 2012.

<sup>6</sup> Paragraph 103, Conclusions Paper.

<sup>7</sup> Paragraph 160, Conclusions Paper.

The reason this is essential is that an OTC derivatives transaction can only be centrally cleared once. This is because clearing involves the novation of the rights and obligations on each side of the transaction to a single CCP. This means, for example, that if a Hong Kong bank enters into a trade with a Singapore counterparty and each has a clearing obligation in its own jurisdiction, one of those entities will be in breach of its local laws - unless there is a mechanism to decide where the transaction can be cleared.

The ability of overseas CCPs to be designated in Hong Kong, alleviates, but does not resolve this difficulty either because not all overseas CCPs will seek designation in Hong Kong.

HKAB understands that regulators in other key financial centres are grappling with this issue. We urge the HKMA and the SFC to draw upon their respective relationships with those regulators and engage with the Hong Kong financial services industry to devise a solution to this issue as a matter of priority.

Please also refer to our comments in paragraph 10 about offshore substitute compliance models.

## **7 Specified clearing threshold – using counterparty declarations**

HKAB welcomes the proposal to allow parties to rely on declarations given by their counterparties in relation to whether or not they are subject to clearing obligations.<sup>8</sup>

Certain HKAB members still have concerns about how the specified clearing threshold will work in practice, so we look forward to the detailed provisions that have been foreshadowed for the Q4 consultation. For example:

- (a) whether third party platforms (such as Markit Wire, which provides an electronic information exchange and trade confirmation service) can be used to facilitate the declaration process;
- (b) what other sources of information can be used to determine whether a counterparty has exceeded the specified clearing threshold; and
- (c) whether two parties can "opt in" to the clearing framework, even where one does not exceed the specified clearing threshold.

## **8 Commercial end-users**

HKAB fully supports the exemptions canvassed in paragraph 167 of the Conclusions Paper, including for (non-financial) end-users that use derivatives to hedge their commercial risks.

If adopted, we recommend that this exemption be supported by guidance that elaborates upon the supporting documents that can be used for audit purposes.

We also assume that if adopted, these exemptions will mean, for example, that if an AI trades with a non-financial entity to provide a hedge for its commercial risks, that transaction will not attract the capital charge and margining requirements that would otherwise apply to a non-cleared trade. We look forward to discussing capital and margining issues more generally with the HKMA as part of the consultation foreshadowed in paragraph 222 of the Conclusions Paper.

<sup>8</sup> Paragraph 163, Conclusions Paper.

## D CCPs

### 9 Designation and regulation of CCPs

HKAB fully supports the proposed reference to international standards, such as those set by CPSS-IOSCO, when assessing the suitability of a CCP to be designated.

We also wish to emphasise that CCPs must be appropriately regulated and have a robust governance structure, effective risk management controls and a sound default management protocol. Our specific suggestions were set out in Part G of our First Submission. We would be pleased to provide further input if needed.

## E Substitute compliance

### 10 Drafting of equivalence provisions and international cooperation

We are aware that other jurisdictions are considering rules to allow cross-border transactions to be cleared in accordance with overseas requirements.

For example, we understand that the Commodity Futures Trading Commission (“CFTC”) in the United States has proposed a mechanism to permit compliance with comparable regulatory requirements of a foreign jurisdiction as a substitute for compliance with the requirements of the Commodity Exchange Act (in certain circumstances). Under those proposals, substitute compliance would only be permitted where the foreign jurisdiction imposes “comparable and comprehensive” regulatory requirements to those under relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>9</sup>

While HKAB welcomes the proposed recognition of offshore substitute compliance, we are concerned that the test may be applied too narrowly in the jurisdictions in which it is offered (whether that be the United States, Hong Kong or elsewhere) and that G20 leaders may not be working “in a coordinated manner”, as pledged at the G20 Toronto Summit in June 2010.<sup>10</sup>

Substantial work has already been done and consensus reached by G20 leaders on the reform initiatives, to ensure that they are implemented consistently across all markets in a timely manner.

As a result, we strongly believe that any test of “comparability” or “equivalence” must be measured solely against the G20 Pittsburgh commitments,<sup>11</sup> which express international consensus - not against local requirements, bearing in mind that each jurisdiction will implement those commitments in such a way that is appropriate for its market, which should be respected as a matter of international comity. This also means that the test must not be applied in a granular manner.

For example, Hong Kong does not propose to mandate electronic or exchange trading of OTC derivatives.<sup>12</sup> Other jurisdictions, such as the United States and Europe, do. Similarly, each jurisdiction proposes to adopt its own concept and definition of “OTC derivatives” – it is already clear that these will not be identical.

<sup>9</sup> See, for example, CFTC press release dated 29 June 2012, available at [www.cftc.gov](http://www.cftc.gov).

<sup>10</sup> Paragraph 25, G20 Toronto Summit Declaration.

<sup>11</sup> That is, the following statement: “All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”

<sup>12</sup> Per paragraph 41, Conclusions Paper.



We therefore strongly urge that the HKMA and the SFC:

- (a) communicate with their respective counterparts in the United States, Europe and the Asia-Pacific and work cooperatively in formulating their domestic “comparability” or “equivalence” policies; and
- (b) pursue the following objectives, as a matter of priority:
  - (i) any “comparability” or “equivalence” criteria should refer to the core aspects of the G20 Pittsburgh commitment – that is:
    - (A) exchange / electronic trading, but only if it has been deemed appropriate for the local market;
    - (B) clearing through a CCP;
    - (C) reporting to trade repositories;
    - (D) capital charges for non-centrally cleared contracts; and
    - (E) regular reviews;
  - (ii) any comparisons should not be granular – that is, it should only be the major aspects of the regime that are compared, not every detail;
  - (iii) seek consensus with foreign regulators (including the CFTC) that where a jurisdiction is deemed comparable solely based on G20 Pittsburgh commitments, compliance with local requirements will be deemed compliance with the foreign requirements, whether at the entity or transactional level;
  - (iv) articulate to foreign regulators that the Hong Kong regime is a comparable jurisdiction in that its financial market regulation is on par with international standards and that in the context of the OTC derivatives specifically, its regime will be enhanced in accordance with G20 commitments, tracking the progress and timeline of reform initiatives in other major markets; and
  - (v) where a foreign jurisdiction, such as the United States, implements its reforms of the OTC derivatives market before the Hong Kong reforms are finalised and in force, seek dialogue with relevant foreign regulators to ensure that substitute compliance is permitted immediately, to the maximum extent possible, given Hong Kong’s regulatory position (per paragraph (iv)), even if the Hong Kong reforms are technically not yet fully finalised or in force.

These steps will have significant benefits for the Hong Kong OTC derivatives market.

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**Part B - HKAB's response to the Second Consultation Paper****1 Overall support**

Overall, HKAB supports the proposals in the Second Consultation Paper, including the proposed exemptions for AIs and the proposals to regulate SIPs. At this stage, we only have one comment concerning the transitional arrangements, as follows.

**Q5** *Do you have any comments or concerns about our proposed transitional arrangements for the new Type 11 and Type 12 RAs, and for the expanded Type 9 RA?*

**2 Transitional arrangements**

HKAB supports the proposed transitional arrangements. However, we suggest that a more appropriate transitional period would be three months, rather than four to six weeks.

The reason is that the preparation of a new application takes a substantial amount of time, particularly where numerous staff members also need to be accredited as licensed representatives and responsible officers. The application preparation process also involves significant updates to compliance manuals, policies and procedures, particularly for entities that previously operated in an unregulated space.

**Next steps**

Thank you very much for the opportunity to provide feedback on the Conclusions Paper and the Second Consultation Paper.

HKAB and its members look forward to working with the HKMA and SFC in relation to the development of the proposed Hong Kong OTC derivatives regulatory framework.

Please contact us if you have any queries in relation to the comments raised in this response.