Questions/comments from HKIFA members re the Consultation paper on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping) Rules (August 18, 2014)

<u>Questions as listed in the consultation paper</u>

Q4. Do you have any comments or concerns about how the terms "conducted in Hong Kong" and "affiliate" are proposed to be construed, or how this limb of the reporting obligation is cast? In particular, do you have concerns as to how this proposal might impact entities that keep a global book?

- We note that in the previous supplementary consultation conclusion, dealing activities by a HK licensed person in relation to transactions routed from an overseas affiliate on behalf of accounts managed by the overseas affiliate will be required to be licensed under RA11.

  (Extract from Supplementary Consultation Conclusion:
  "We have also received a suggestion that existing licensed persons who deal in OTC derivatives transactions - including executing OTC derivatives transactions for their affiliates / subsidiaries and portfolios managed by their affiliates or subsidiaries - should be exempted from Type 11 RA licence. It was suggested that this would facilitate international asset management companies to continue to use Hong Kong as their "central dealing hub" in Asia Pacific.

  We do not believe it is appropriate to exclude OTC derivatives market intermediaries which carry out dealing activities on behalf of their affiliates from our licensing requirement. Requiring them to be licensed under Type 11 RA is also consistent with the current requirement for them to be licensed under Type 1 and Type 2 RAs for acting as the "central dealing desks" for securities and futures contracts.")

  However, transactions under the same "order routing arrangement" are not subject to reporting as the transactions are not "recorded in the form of any entry in the books of the affiliate". There seems to be an inconsistency as dealings under the "order routing arrangement" will require licensing but the transactions resulting from such arrangement will not be subject to reporting. Please confirm if the above understanding of the licensing and reporting requirements is correct or not.

- Members believe that relief from requiring to report the OTC derivatives transactions should be provided for where the licensed asset management entities also operate a central dealing desk and execute trades on behalf of portfolios managed by group affiliates, and that these trades are in the book of the portfolios managed by the group affiliated asset managers as opposed to the book of the affiliates (i.e. the transactions are not recorded in the affiliates' own proprietary book). This relief/exemption to exclude from the definition of "conducted in Hong Kong" exemption is appropriate and should be explicitly stated in the Rules. The reason being affiliates and/or portfolios under their management would already be under similar obligation to report these transactions to a TR in their respective jurisdictions, or they would have been captured and reported by a LC/AI if executed via a Hong Kong counterparty under the 'counterparty' reporting limb.

- Rule 15 (transactions to be reported by Hong Kong persons) - Appreciate if there is clarification regarding whether the phrase "entered into the transaction in Hong Kong" under Rule 15(1) (f) of the Draft Rules has the same meaning as "conducted in Hong Kong"? If they are defined differently, what are the differences?

Q5. Do you have any comments or concerns about how we have cast the proposal that AIs and LCS that are registered/licensed for Type 9 RA must report transactions that they have entered into in their capacity as fund managers?

- Members propose that the Type 9 RA asset manager reporting limb should adopt the same threshold as the HK person limb. This will reduce the regulatory burdens posed to LCs. In any event, LCs are subject to regulatory oversight so that regulators will be able to request access to exposures and trades information of the LCs. Thus, only significant transactions should be subject to reporting.

- Members suggest that the SFC can consider extending the exempt person relief to Type 9 LCs as fund managers could be using FDIs intermittently or for hedging purposes. This would help ease the reporting burdens on fund managers who have small or limited exposures in OTC derivatives for hedging/EPM purposes only.

- Does the phrase "enters into the transaction" in Rule 9(1)(c)(iii) refer to the decision to enter into the derivative transaction or the execution of the transaction? If a Hong Kong LC makes the investment decisions, but delegates its trade execution function to an offshore affiliate, which is the entity that "enters into the transaction": is it the Hong Kong LC or the offshore affiliate?

Q6. Do you envisage any specific difficulties if this proposal were to be extended to also require an AI or LC that is registered/licensed for Type 9 RA to report transactions that it has advised a counterparty on, i.e., even though it has not entered into the transaction on behalf of that counterparty? If so, please provide details of the specific difficulties envisaged.

- Members believe that the reporting requirement should NOT be extended to trades where LCs are advisors only. Reporting "advised trades" will give rise to many practical issues/difficulties such as (i) trades may not be executed according to advice; (ii) a LC may not know whether the counterparty executes the trade or not; and generally the advisor may not have full information about the executed trades; and (iii) duplications with executed trades reported by the executing parties, etc.

Q8. Do you have any comments or concerns about the proposed approach to be taken in respect of the different types of Hong Kong persons?

- Members would like to have further clarifications on what is the meaning of "transactions that they have entered into on behalf of such persons". Does it refer only to transactions entered into by a RA9 asset manager as agent for the fund/client; and the fund/client is the principal to the trade and has the legal liability to settle? If the fund/client enters into the transaction as a direct

contractual party, then such transaction will not be regarded as being "entered into by an LC on behalf of such persons"? Please confirm if the above interpretation is correct or not.

Q9. Do you have any comments or concerns about how the reporting obligation will apply to funds? Do you envisage that funds may face practical difficulties in complying with this obligation? If so, please provide details of the specific difficulties envisaged.

- If a Hong Kong unit trust delegates trade execution to the overseas dealing desks/investment manager (not a SFC licensed person), will the trades executed or entered into by such overseas delegated dealing desks/investment manager on behalf of the HK unit trust give rise to any reporting obligation?

Q10. Do you have any comments or concerns about the proposed methodology for calculating if the reporting threshold or exit threshold has been reached?

- A Hong Kong Person may appoint a number of different asset managers to manage its assets and the asset managers may enter into IRS and NDF trades on behalf of the Hong Kong Person. We assume that a Hong Kong Person will have to aggregate the transactions that the different asset managers enter into in order to determine if the reporting threshold has been reached. If this understanding correct? Are the Hong Kong Persons such as Hong Kong statutory entities, pension funds, trustees etc aware of their obligations to monitor the gross outstanding notionals of IRS and NDF trades?

Q20. Do you have any comments or concerns about how the concession period and grace period are proposed to operate?

- In determining the start date, can the HK regulators take into account the regulations in the Region so as to facilitate a more streamlined approach in system enhancements. These include (i) ASIC Phase 3 reporting starting in April 2015 and (ii) reporting of additional data fields under the MAS regulations starting on 1 April 2015. Members propose phasing in the reporting requirements for different types of reporting entities e.g. AI and AMBs reporting first, LCs 3 months later and Hong Kong persons after that. This is in line with the implementation of the Singapore trade reporting regulations.

- Members believe that three months from the time of finalization of the rules is not sufficient for fund managers to prepare a solution for reporting, especially with MAS and ASIC developments also in parallel. It would be helpful if the final regulation can allow 180 days after the publication of final rules for firms to start reporting new trades, so as to provide participants sufficient time to do a complete build-and-test with due diligence. Also, 180 days is similar to the lead time that ESMA and MAS provide. Finalization of requirements is necessary before the industry embarks on any development work. Without the finalized requirements, it is very difficult for firms to start work. There would be added cost and effort of rollback/changes if the final regulations are different from the one under consultation. Any changes between now and the final rules might have a significant impact on the overall solution and delivery. Even when fund managers work with reporting agents like Unavista/DTCC to deliver the

requirements, they would ask for a caveat that in light of the rules not finalized, further analysis and rework might be required after the final rules are published. So far, all key jurisdictions have given sufficient lead time after the publication of final rules (at least 180 days) to allow firms to comply with the regulations. It would be helpful if HKMA/SFC could do the same.

Other questions/comments

1. Definitions – even though the following terms are commonly used in the market, it would be helpful if definitions are provided in the Rules (with illustrative examples) so as to ensure consistency and clarity in interpretations:
   - "counterparty" – this term is used throughout the draft Rules. For example, where a HK portfolio manager creates a specified OTC derivative order on behalf of a fund, forwards the order to an overseas affiliate, who executes the order with a broker/counterparty. In this case, the fund is the principal to the trade and has the legal liability to settle. It would be regarded as the counterparty to the trade. We would like to seek the SFC's confirmation if this understanding is correct and it would be helpful if a definition for "counterparty" is provided in the Rules.

   - The proposal is that all NDF transactions are reportable; but the term "spot" or "forward" is not defined. Common industry interpretation is that only transactions longer than a T+2 settlement are considered forward transactions with anything less being considered spot and not reportable. Please clarify the definition of NDF under varying settlement conditions.

   - HKTR will be enhanced to include "valuation transaction information" and there will be the requirement to include a reportable field that identifies whether a trade has been "marked to market" or "marked to model". It would be useful if these terms are defined; and also to illustrate under what conditions the valuation would move from mark to market to mark to model.

2. These is no express exemption for central banks in the consultation paper – Although these entities are unlikely to fall within any of the categories of persons who have reporting obligations, if these entities have assets that are managed by a LC, IRS trades that the LC enters into for the entity will have to be reported under Rule 9(1)(c)(iii). In contrast, if a Singapore CMSL holder manages assets for and enters into IRS trades as agent on behalf of an entity listed in the Fourth Schedule to the MAS regulations, the CMSL holder does not have to report the trades. Entities that have confidentiality concerns may prefer to appoint a Singapore asset manager over a Hong Kong asset manager for this reason.

3. The draft Hong Kong rules place the reporting obligation on the fund manager (which is a licensed corporation) rather than the Trustee. Would the HKMA/SFC consider adopting a similar approach as Singapore and require the Trustee rather than the Manager of a Hong Kong CIS to report derivative transactions entered into for the CIS? If the Trustee requires the Manager's assistance to report the transactions, this can be discussed between the Trustee and the Manager.

4. Do all reporting entities, including LCs and Hong Kong persons who have reporting obligations have to join HKTR as a TR Member in order to report to HKTR?

5. In a scenario where a Hong Kong person who has reached the reporting threshold appoints a foreign asset manager, the Hong Kong person will have a reporting obligation (as the foreign asset manager is not a LC). If the Hong Kong person wishes the asset manager to report OTC derivative trades on behalf of the Hong Kong person, should the Hong Kong person join HKTR as a TR member and appoint the asset manager as its agent?

   In Singapore, the MAS issues an identifier code to each legal entity. Using the above case as example, while the Hong Kong person has the obligation to report the trades, but that obligation would be discharged if these trades are reported by the asset managers or directly by the executing counterparty using that identifier code assigned to the Hong Kong person. It would be helpful if the SFC can explore similar arrangements to ease the reporting burden on Hong Kong persons.

6. What documentation is needed if a reporting entity appoints a series of agents e.g. a LC in Hong Kong => Unavista => DTCC => HKTR? In some other scenarios, Hong Kong person => a foreign asset manager => Unavista => DTCC => HKTR?

7. Is "over reporting" permitted? Rule 20 states that a Hong Kong person does not have to report a transaction if an authorized financial institution is required to report the transaction. A Hong Kong person may trade with a number of counterparties including banks domiciled in Hong Kong (which are authorized financial institutions) and foreign banks that do not have a reporting obligation under the Hong Kong regulations. In such cases, the Hong Kong person may find it operationally more efficient and more prudent to report all specified OTC derivative transactions instead of excluding transactions where the counterparty is an authorized financial institution. Is this permitted?

(End)