



35 New Broad Street
London EC2M 1NH, UK
+44 (0) 203 009 3100
www.iciglobal.org

Suite 1606-08, Chater House
8 Connaught Road
Central, Hong Kong
+852 2910 9224

1401 H Street, NW
Washington, DC 20005, USA
+1 202-326-5800
www.ici.org

August 27, 2014

Via email

Financial Stability Surveillance Division
Hong Kong Monetary Authority
55/F Two International Finance Centre
8 Finance Street, Central
Hong Kong

Supervision of Markets Division
The Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Dear Sir or Madam:

ICI Global¹ appreciates the opportunity to provide comments on the consultation paper issued by the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”) on the mandatory reporting and related recordkeeping requirements for OTC derivatives.² We applaud the HKMA and the SFC for developing a regulatory regime for the OTC derivatives market in Hong Kong in line with the commitments made by the G-20 countries. We fully support a phased approach to the implementation of these important reforms as well as proceeding with the implementation of the new regulatory regime in the follow order – mandatory reporting, mandatory clearing, and mandatory trading. With respect to mandatory reporting, which is the subject of the Consultation Paper, we have concerns with respect to how the proposed reporting requirements would affect non-Hong Kong (“HK”) funds.

¹ The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$18.8 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

² Consultation paper on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping) Rules (July 2014), available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=14CP6> (“Consultation Paper”).

Our members – US funds that are regulated under the Investment Company Act of 1940 (“ICA”) and non-US regulated funds publicly offered to investors (collectively, “Regulated Funds”) – use swaps and other derivatives in a variety of ways. Derivatives are a particularly useful portfolio management tool in that they offer Regulated Funds considerable flexibility in structuring their investment portfolios. Uses of swaps and other derivatives include, for example, hedging positions, equitizing cash that a Regulated Fund cannot immediately invest in direct equity holdings, managing a Regulated Fund’s cash positions more generally, adjusting the duration of a Regulated Fund’s portfolio, or managing a Regulated Fund’s portfolio in accordance with the investment objectives stated in a Regulated Fund’s prospectus. To employ derivatives in the best interests of fund investors, our members have a strong interest in ensuring that the derivatives markets are highly competitive and transparent.

ICI Global members, as market participants representing millions of investors, generally support the goal of providing greater oversight of the derivatives markets. Given that many derivatives transactions are conducted across multiple jurisdictions, we also support efforts for real and meaningful coordination among regulators on how the regulations will be applied to market participants that engage in cross-border transactions.

We have responded below to various parts of the Consultation Paper that are relevant to members of ICI Global.

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?

ICI Global fully supports the G-20 commitments to increase the transparency of the derivatives markets and providing regulators with data for more effective oversight of these markets. In this regard, Regulated Funds that engage in cross-border transactions are already subject (directly or indirectly) to mandatory reporting and recordkeeping requirements in many jurisdictions, including under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”) in the United States and the European Market Infrastructure Regulation (“EMIR”) in the European Union. To avoid imposing duplicative and overlapping reporting obligations on cross-border transactions, we have two specific recommendations.

First, although we broadly support the approach of the Consultation Paper to the extraterritorial application of reporting, we urge the HKMA and the SFC to tailor the rules appropriately to require reporting only by entities that are sufficiently connected to Hong Kong. The Consultation Paper limits reporting by entities (other than HK persons) to only those transactions that are “conducted in Hong Kong.” We understand that, for a transaction to be conducted in Hong Kong, one of the individuals making the decision to enter into the transaction must be a “trader” performing his or her functions substantially in Hong Kong. We note that the term “trader” is not defined in the Consultation Paper, and we are concerned that an overbroad reading of the term could include individuals who provide execution-only services on behalf of a non-HK fund manager. Such a definition of “trader” could

subject Type 9-licensed non-HK fund managers of Regulated Funds that are not HK persons (*e.g.*, UCITS and funds registered under the ICA) to the HK reporting rules if certain execution functions are performed by traders who are located in Hong Kong. In these instances, we do not believe the HK reporting rules should apply to such derivatives transactions because they do not have sufficient connection with Hong Kong. We recommend that the HKMA and the SFC confirm that the reporting obligation would not apply to non-HK fund managers if only execution functions related to derivatives contracts are carried out in Hong Kong. Similarly, we seek confirmation that where an HK fund manager delegates functions to an entity outside of Hong Kong and retains only execution functions (or no trading functions), the reporting obligation would not apply to the HK fund manager.

Second, we recommend that the HKMA and the SFC implement a “substituted compliance” or “equivalence” regime similar to those that may become available in the United States, European Union, and Singapore.³ Accordingly, if a counterparty to a transaction is required to report in another “equivalent” jurisdiction and has satisfied its reporting obligation, the HK reporting rules should deem a counterparty subject to the HK requirements to have complied with any reporting obligation under Hong Kong law as long as the HK authorities are able to obtain the data from the foreign jurisdiction. A substituted compliance or equivalence regime would appropriately limit the costs imposed on Regulated Funds and their investors and reduce duplicative requirements while providing global regulators with the necessary data to oversee and regulate effectively their derivatives markets.

We also urge the HKMA and the SFC to permit HK subadvisers of non-HK Regulated Funds to benefit from a substituted compliance regime. For example, transactions of Regulated Funds in the United States and European Union are already subject to comprehensive reporting and these funds and their non-HK advisers should be deemed to have complied with the reporting obligation under HK law (as requested above). Because the HKMA and the SFC will already be receiving the reporting data, the HK subadvisers to these funds also should benefit from the substituted compliance regime. Permitting HK subadvisers to benefit from a substituted compliance regime would eliminate duplicative reporting without impairing the ability of the HKMA and the SFC to review the data for oversight of the derivatives markets and regulation of licensed entities.

With respect to the mechanism for reporting, we request that the HKMA and the SFC permit reporting entities to report to any trade repository that could transmit data to the HKMA and the SFC. The Consultation Paper currently requires that all trades be reported to the HKTR. We note that foreign Regulated Funds and managers are less likely to have existing relationships with members of the HKTR or have established connections. Accordingly, foreign Regulated Funds and managers

³ For example, in the United States, substituted compliance for reporting may be available for certain regulated entities outside of the United States. To be eligible for substituted compliance, the counterparty to the transaction must be a non-U.S. person and the U.S. regulator must have direct electronic access to the reporting data held at the non-U.S. data repository. Similarly, under EMIR, legislators may declare that the legal, supervisory and enforcement regime of a non-EU country is equivalent to EMIR. Although final equivalence decisions are still pending, equivalence will allow counterparties to apply the rules of a non-EU country to an OTC transaction that would otherwise be subject to EMIR.

would be required to incur additional costs of establishing reporting links to the HKTR in addition to existing links to other trade repositories.

Q14. Do you have any comments or concerns about the proposed exemptions and reliefs, and the criteria for triggering them?

We support the proposed exemption in the Consultation Paper for HK persons for transactions that are reportable by their HK Authorized Institutions (“AIs”) counterparties. Under this proposed exemption, HK Regulated Funds that transact with AIs⁴ would be exempt from the reporting obligation although their managers would continue to have an obligation to report these transactions.

We recommend expanding the exemption to place a one-sided reporting obligation on AIs with respect to transactions to which AIs are a counterparty. We believe AIs (such as dealers) typically would have the capacity and scale to develop reporting systems and will likely have existing links to the HKTR or relationships with HKTR members to fulfill their reporting obligation. AIs that are dealers and engage in a substantial volume of derivatives transactions would be better situated to report their transactions than would Regulated Funds and their managers. Moreover, the proposed rules without this expanded exemption would likely increase costs for non-HK Regulated Funds and their foreign managers particularly because non-HK Regulated Funds generally would already be subject to reporting in another jurisdiction. In those situations where AIs are counterparties to Regulated Funds, we request that such AIs should have the sole reporting obligation with respect to any reportable transactions.

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

The Consultation Paper contains a reporting threshold (US\$3 billion for interest rate swaps and US\$1 billion for non-deliverable forwards average gross notional value over the preceding six months) that determines when an HK person becomes subject to mandatory reporting. We support the concept of a reporting threshold, which could appropriately minimize reporting costs for entities (such as HK Regulated Funds) that do not actively trade derivatives of sufficient value to justify reporting. We, however, are disappointed that the threshold, as currently proposed in the Consultation Paper, would not apply to trades of similarly situated Regulated Funds and their managers outside of Hong Kong. If the HKMA and the SFC determine that derivatives transactions below the threshold indicate a level of activity in the OTC derivatives market that would not require reporting, there is no reason why non-HK Regulated Funds and their managers should be required to report transactions below the threshold level. Non-HK Regulated Funds that only engage in the OTC derivatives markets below the threshold level should similarly not be subject to the reporting requirements either directly or indirectly via reporting obligations imposed on their foreign managers. Accordingly, a foreign fund manager should not be required to report trades for a non-HK Regulated Fund that falls under the same reporting thresholds available to HK persons. We urge the HKMA and the SFC not to treat similarly situated

⁴ The Consultation Paper also includes parallel exemptions for HK Regulated Funds whose trades are reportable by LCs or approved money brokers.

funds – non-HK Regulated Funds and HK Regulated Funds (HK persons) – differently for purposes of the reporting rules. Moreover, applying the thresholds differently could result in the HK regulators receiving a skewed impression of OTC trading in this segment of the OTC market, which seems unhelpful for informing policy decisions.

The Consultation Paper proposes a separate basis for calculating the reporting threshold for non-Hong Kong companies. For purposes of the above thresholds, only transactions that are entered into in Hong Kong are counted. We recommend that foreign managers that are LCs should be permitted to use the same thresholds and to count only transactions that are entered into in Hong Kong toward the thresholds. Although foreign managers are subject to regulation in Hong Kong to the extent that they conduct licensed activities, their foreign activities do not directly affect Hong Kong and should not be subject to HK regulation.

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

We support the inclusion of concession periods and grace periods in the Consultation Paper. Based on the experience of the fund industry with mandatory reporting under EMIR, we request that an adequate period of time be provided for foreign Regulated Funds and their managers to either develop systems to report via the HKTR or to contract with third parties (*e.g.*, their dealer counterparties) to report on their behalf. Similar to the regime proposed by the Consultation Paper, EMIR features a two-sided reporting obligation where both a fund and a fund's counterparty have a direct obligation to report OTC derivatives transactions. A significant portion of global derivatives trades are conducted in jurisdictions subject to EMIR, and European banking institutions were able to devote significant resources to the development of their own EMIR reporting capabilities. Because of the size of the potential market for reporting, platforms, such as DTCC, also made significant efforts to meet the needs of reporting entities under EMIR. Even with such efforts, the development of the reporting infrastructure was subject to delays and there was great deal of confusion in the market.

Although some ICI Global members subject to EMIR developed their own systems for reporting, many members did not have the capability to produce their own reporting systems and had to rely on their dealer counterparties or to engage a third-party service provider to report on their behalf. Our members faced significant difficulties in negotiating agreements with their dealer counterparties to report on their behalf because of dealer concerns regarding cost and liability. Moreover, platforms and agents for reporting were not ready to provide services as of various implementation dates.

In Hong Kong, Regulated Funds may face even greater hurdles in negotiating with their counterparties to report on their behalf. Most counterparties of Regulated Funds will not be subject to reporting in Hong Kong. Given their reluctance to report on behalf of Regulated Funds under EMIR (even when directly subject to identical reporting requirements themselves), such counterparties may be even less willing to provide delegated reporting services in Hong Kong.

Moreover, some Regulated Funds and managers may determine to develop their own reporting systems. We understand, however, that the process to establish reporting links to the HKTR is time-

consuming and the development of reporting systems is labor-intensive. We also note that few existing HKTR members are counterparties to foreign Regulated Funds or their managers. Therefore, these Regulated Funds and managers will need to develop new business relationships to comply with the reporting requirements.

Accordingly, we urge the HKMA and the SFC to provide all market participants (particularly foreign Regulated Funds and managers) sufficient time following the promulgation of final rules to implement reporting. Based on experiences in Europe and elsewhere, we request a minimum of one year for compliance with any new reporting rules.

* * *

We appreciate the opportunity to respond to the Consultation Paper. We fully support the efforts of the HKMA and the SFC to implement an effective regulatory framework for the oversight of the HK derivatives market. We urge the HKMA and the SFC, however, to modify the proposed rules to prevent imposing duplicative or overlapping reporting requirements on cross-border transactions and to avoid disparate impact on foreign Regulated Funds vis-à-vis HK funds. We also seek an adequate period of time after adoption of the reporting rules to allow market participants to develop systems or to put into place arrangements to comply with the new requirements. If you have any questions on our comment letter, please feel free to contact the undersigned,

Sincerely,

ICI Global