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Submission to OTC Derivative Transactions – Reporting and Record Keeping Rules Consultation Paper issued by Securities and Futures Commission

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For enquiries on this submission, please contact

CompliancePlus Consulting Limited understands and agrees that our name and/or submission may be published to the public.

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Introduction

The SFC issued the Consultation paper on proposals to introduce Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping) Rules, in a bid to bring the current local regulatory regime in line with the latest global efforts.

This submission is made in response to the SFC's Consultation paper dated July 2014 and our comments and suggestions are set out below.

Consultation Questions

Question 1: Do you have any comments or concerns about the proposed definition of "Hong Kong person," "RCH" and "ATS-CCP"?

We are, in principle, in favour of the proposed imposition of obligations on the above parties. It has been proposed that non-corporate entities established overseas but registered or having a presence here in Hong Kong will not be subject to mandatory reporting, with the exception of hedge funds.

Whilst we understand the rationales of the Commission for so proposing, we would like to draw your attention to the possibility of abuse of this exclusion as a loophole for circumvention of the reporting obligation.

The proposed design also has an underlying assumption that most offshore funds active in Hong Kong would be managed or sub-managed by a Hong Kong authorised institution; it begs the question whether, in the case of offshore hedge funds which do not engage a Hong Kong manager, these reportable transactions conducted by such funds will still be sufficiently covered by the proposed rules. Clarification from the SFC is needed and will be welcomed by the industry.

Question 2: Do you have any comments or concerns about the proposed types of IRS and NDF that will be subject to the mandatory reporting obligation in the initial phase of implementation?

Question 3: Do you have any comments or concerns as to how IRS and NDF are proposed to be defined in Part 1 of Schedule 1 to the Draft Rules, or how the reportable transactions, or the class to which they belong, have been described in Part 3 of Schedule 1?

We welcome the proposed amendment and see the proposal as both desirable and feasible. However, we note that it could create practical difficulties for financial professionals if the sole way of announcing the extension of reporting obligations to other classes or types of OTC derivatives in the future is by notice in the Gazette. We are of the view that for the benefits of enhancing effectiveness and promoting compliance, supplementary outlets of information, such as a readily accessible list specifying the types/classes of regulated OTC derivatives in the reporting portal, could make it more user-friendly.

We also recommend that consultation with the industry will be needed in the case of any extension of reporting to other classes or types of OTC derivatives in future so that the industry can express any operational difficulties or fine-tune the scope of reporting. If possible, grace periods or transitional periods of reasonable length should be provided to smoothen the transition process.

Question 4: Do you have 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?

The Commission's effort to consider the industry feedback as reflected in the drafting of Draft Rule 4 and 11 is well respected and appreciated. With all due respect, we observe one major ambiguity in the formulation of the concept of "conducted in Hong Kong". One of the major criteria for determining whether the transactions are

"conducted in Hong Kong" is whether the trader who "made the decision" performed his functions substantially in Hong Kong.

While we fully acknowledge the need for formulating the rules in such a way as to make the scheme flexible and inclusive, the phrase "made the decision" is arguably too ambiguous and not backed up with sufficient guidelines. Given the wide scope of interpretation for this criteria, and the fact that the decision-maker in most circumstances is difficult to trace or can only be traced at considerable costs, it is recommended that refining the definition is necessary to ensure effectiveness.

Question 5: 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?

Question 6 : 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.

We express concerns about the proposed extension of obligations to report transactions to advisory roles. An AI or LC that merely provides advice to a counterparty is not itself the decision maker, and hence such an entity does not assume a managerial role and it would be practically difficult for such an entity to confirm whether the advised party actually proceeded with the transactions as per the provided advice. Also, for the sake of coherence, the obligations to report on OTC derivatives transactions should be brought in line with other areas of rules, e.g. short position reporting (where only actual completed transactions are reportable). The coherence of rules is necessary to avoid conveying ambiguous information to the market participants. In this connection, we propose that the reporting obligations should only be imposed to the parties who made the investment decisions.

Question 7: Do you have any comments or concerns about how the reporting obligation in respect of CCPs has been cast?

We are in favour of the proposed imposition of obligations and agree with the definitions and scope thereof.

Question 8: Do you have any comments or concerns about the proposed approach to be taken in respect of the different types of Hong Kong persons?

We agree that it is necessary to see positions held in different capacities, even though by the same entity, as separate. It is also reasonable to require multinational corporations to report their local transactions only.

Question 9: 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.

The current proposal may not pose much practical difficulties to funds. However, it is submitted that given the increasing degree of complexity of the rules or regulations in respect of funds, the SFC should also expressly require a sufficient internal compliance control safeguard in place to ensure the fund manager is well aware of the whole regulatory framework over funds.

In addition, seminars conducted by SFC and HKMA are highly welcomed to promote compliance and to enhance regulatory knowledge on this reporting obligations applicable to fund managers in Hong Kong or overseas. To facilitate the setup of offshore funds in Hong Kong, such useful materials as FAQ or guidelines could be uploaded to the reporting portal as complements from time to time by the Commission.

Question 10: Do you have any comments or concerns about the proposed methodology for calculating if the reporting threshold or exit threshold has been reached?

Question 11: Do you have any comments or concerns about the proposed levels of the reporting threshold and exit threshold?

Question 12: Do you have any comments or concerns about the proposed reductions to the reporting threshold and exit threshold at a later stage?

The intention of an initial high threshold subject to a planned lowering for the sake of smoothing the transition is appreciated. However, this design is seen to be very inconsistent with other types of reporting obligations, for example short position reporting, which adopted a more stringent standard at the initial phase followed by a planned relaxation at a later stage. In the absence of good reasons, the proposition is worth revisiting to avoid unintended confusion among practitioners.

Question 13: Do you have any comments or concerns about the proposed application of the mandatory reporting obligation to cross-border transactions? If so, please provide specific details.

It is desirable to have consistent requirements in the context of cross border transactions. However, since the three limbs also share the concerns as described above, i.e. they could be easily circumvented by the relevant institutions at a low cost, it is submitted that the proposed three limbs might cast the net to so narrowly that they could not serve the purpose of including all transactions which are intended to be reportable.

In light of the trend of globalization of financial systems in large part due to advanced technology and the emergence of electronic trading, the formulation of rules as to cross border transactions requires review on a regular basis to keep abreast with the development of the financial system.

Question 14: Do you have any comments or concerns about the proposed exemptions and reliefs, and the criteria for triggering them?

We agree in principle with the proposal. Nevertheless, it is desirable to clearly set out in the rules the burden of proof as to the loss of relief. In addition, it is recommended that the SFC should, as a part of the framework or otherwise, explain how the relevant parties are monitored on a regular basis. For example, relevant entities are required to prove their status of being valid to the exemption at regular time intervals. Also, given the increasingly high volatility of the OTC derivatives, it might be very difficult for the SFC to prove that the parties intending to rely on the exemption had momentarily failed to meet the specified criteria.

On the other hand, it might not be necessary to report the same transactions which the CCP is already under an obligation to report. This kind of overlapping duties might not be commercially effective and should be removed.

Question 15: Do you have any comments or concerns about the proposal to exclude from the exempt person relief for IRS and NDF those licensed banks which have already reported to the HKMA via the HKTR under the interim reporting requirement and have outstanding reportable transactions on the commencement of the Draft Rules?

Question 16: With respect to the relief for AIs, AMBs and LCs that are less active in the OTC derivatives market, do you consider the proposed criteria of 5 transactions per product class, and aggregate gross notional value of US$30 million to be appropriate? If not, please provide specific details of why they may be inappropriate and what alternative criteria should be adopted.

We agree with the proposal to exclude from the exempt person relief for IRS and NDF those licensed banks which have already reported to the HKMA via the HKTR under the interim reporting requirement and have outstanding reportable transactions on the commencement of the Draft Rules.

With respect to the relief for AIs, AMBs and LCs that are less active in the OTC derivatives market, the criteria of 5 transactions per product class is somewhat redundant. The design of the whole scheme puts emphasis on the aggregate notional value of outstanding positions held by an entity. Given that the rationale is to oversee the OTC derivative transactions involving significant amount, this criteria is somewhat arbitrary and does not serve much practical purpose. Also, multiple small-scale outstanding positions should not pose systemic risks to the financial system. Lastly, the criteria of 5 transactions per product class is out of place compared with other reporting obligations and the regulatory regime overall. For instance, the number of outstanding transactions is not stipulated as one of the criteria for the purpose of exemptions in short position reporting. In this connection, the criteria of 5 transactions per product class should not be included as one of the relevant factors with respect of the relief.

Question 17: Do you have any comments or concerns about how the proposed backloading requirement will apply to transactions outstanding on the starting day? If so, please provide specific details.

We agree with the proposal.

Question 18: Do you have any comments or concerns about the proposal to have different starting days in respect of different types of reportable transactions? If so, please provide specific details.

The arrangement of having different starting days in respect of different types of reportable transactions is reasonable and we are in favour of the proposal.

Question 19: Do you have any comments or concerns about how the starting day might impact AIs, AMBs and LCs that previously qualified for the exempt person relief? If so, please provide specific details.

This arrangement is in line with the arrangements in other jurisdictions. We agree with the proposal.

Question 20: Do you have any comments or concerns about how the concession period and grace period are proposed to operate?

Question 21: Do you have any comments or concerns about how the grace periods will vary in respect of entities that become an AI, AMB or LC at a later date, or that cease to be an exempt person at a later date?

It is submitted that the grace periods and concession periods are too long to encourage prompt compliance and set up of reporting channel by the institutions, which may create backlog of reports. While we appreciate the rationale thereof, it is submitted that market surveys should be conducted in addition to obtain the progress in setting up of the communicating portal by each regulated entity. Accompanied by a renewed focus to facilitate the setup of reporting channel to reduce the time for transition, the two periods could each be shortened to 2 months to encourage reporting as soon as possible.

Question 22: Do you have any comments or concerns about the proposed types of transaction information required to be reported for the purposes of the reporting obligation, or as to how these have been expressed in Schedule 2?

The information required to be provided in the particulars is comprehensive.

Question 23: Do you have any comments or concerns about the proposal to require the reporting of valuation transaction information in the future?

We agree with the SFC that there is a need to report mart-to-market valuation transaction information. Also, since the infrastructure for such obligations might not be ready by 2014, therefore, it is submitted that the reporting obligations could commence on a daily basis in 2015 even for regulated entities.

Question 24: Do you have any comments or concerns about our proposals on how subsequent events are to be reported, and when they will cease to be reportable?

It is submitted that it is necessary to require subsequent events to be reported. However, we suggest that not every related subsequent event should be made reportable – only those that will materially affect the outstanding positions should be reported. This addition of element of materiality may also well reflect the intention, as evidenced in paragraph 126 of the consultation paper, that events affecting the value of the transactions should be reported. It is foreseeable that without the additional requirement, the currently proposed definitions might have very wide implications or unintended reports of insignificant events.

Question 25: Do you have any comments or concerns about the proposals on masking counterparty information under certain circumstances as a temporary measure?

We are in favour of the proposal.

Question 26: Do you have any comments or concerns about the proposals for subsequently reporting information when the pre-requisites for masking cease to exist?

We are of the view that the proposal is both desirable and feasible.

Question 27: Do you have any comments or concerns about the proposal that an AI's reporting obligations in respect of transactions entered into by its specified subsidiaries should be the same as its reporting obligations in respect of transactions to which it is counterparty itself?

We agree with the proposal that could prevent circumvention of the reporting obligations by entering into OTC derivative transactions through subsidiaries.

Question 28: Do you have any comments or concerns about the proposed record keeping requirements in relation to mandatory reporting?

Question 29: Do you have any comments or concerns about the types of records proposed to be kept, and the manner in which they are to be kept?

Question 30: Do you have any comments or concerns about the duration for which the records are proposed to be kept?

The record keeping requirements are in general clearly set out, save as regards the electronic storage of documents. In light of the emergence of cloud computing, many institutions would prefer cloud system as their data storage. Since "electronic system" as appeared in Draft Rule 36 is open for interpretation, we would like to hereby seek clarification from the Commission as to whether cloud storage system would fall within the definition of an "electronic system".

Conclusion

We agree in principle with the proposed introduction of the rules in relation to the mandatory reporting and record keeping of OTC derivatives as set out in the Consultation Paper. The ends and the philosophy of SFC to strike a balance from the regulators' perspective between monitoring the structured product markets and the systemic risks the OTC derivatives create and at the same time maintaining market efficacy and allowing reasonable uses of OTC derivatives for hedging or other legitimate purposes are appreciated. We hope that the proposed introduction of rules could facilitate prompt regulatory actions in future and constitute a good foundation for the subsequent introduction of other obligations in respect of OTC derivatives.

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