Alternative Investment Management Association

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Dear Sirs

AIMA response to the Further Consultation on the Securities and Futures (OTC Derivative Transactions - Reporting and Record Keeping) Rules

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to provide comments on the further consultation paper issued in November 2014 by the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) (together, the Authorities) and relating to the mandatory reporting and related record keeping obligations of the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong (the Consultation).

AIMA's Comments

AIMA members are active participants in the global derivatives markets, using derivatives for investment and hedging purposes. AIMA members (both those established domestically and outside of Hong Kong) are active in the Hong Kong market and support the Authorities' ongoing proposals to implement the G20 commitments.

We wish to acknowledge the Authorities' efforts to incorporate our feedback in the Consultation. In particular, we welcome the additional time provided to fund managers and Hong Kong persons to assess in more detail the impact of OTC reporting. Without the associated revisions to the proposed rules, LCs

[1] ***About the Alternative Investment Management Association***

The Alternative Investment Management Association (AIMA) is a global hedge fund association with over 1, 400 corporate members (with over 7,000 individual contacts) worldwide, based in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members manage a combined US$1.5 trillion in global assets (as of March 2014).

would have struggled to comply with reporting requirements as initially drafted, and we applaud the responsiveness of the Authorities to these challenges.

With respect to the current matters open for Consultation, we have substantive feedback regarding the implementation of valuation transaction reporting and the markets and clearing houses to be prescribed under section 392A of the SFO. In particular, we note several practical difficulties with respect to the proposals on valuation transaction reporting. We would urge an additional round of consultation. Secondly, we note that, whilst our members broadly support the list of markets and clearing houses included on Appendix B, we believe that other categories of markets should also be considered (principally, swap execution facilities).

Reporting of Valuation Transaction Information

We welcome the Authorities' solicitation of views on valuation. We appreciate that the reporting of valuation transaction information may facilitate systemic risk assessment consistent with regulatory requirements abroad. We also recognize that the Authorities appreciate the complexity associated with valuation.

In general, as with other OTC reporting requirements, we encourage that the rules associated with valuation be aligned with the rules in other jurisdictions including those in Europe and the United States. As we have noted previously, Hong Kong market participants are likely to be required to report in both Hong Kong and foreign jurisdictions; parity between Hong Kong and foreign rules will make valuation reporting less costly and potentially more useful as information obtained from different jurisdictions would be comparable.

As valuation is a complicated topic, we would encourage a further consult on valuation reporting prior to the adoption of rules. Since valuation methodology may differ among products, our comments are limited to the interest rate swaps and non-deliverable forwards that are the first set of products subject to reporting.

We encourage the Authorities to allow reporting entities to use internal valuations to fulfill the daily valuation transaction information requirement.

1. In relation to reportable transactions that are cleared through a CCP, our experiences in other jurisdictions indicate that CCP valuation methodologies do not always result in meaningful valuations. As a result, many market participants continue to value transactions internally based on internal valuation methodologies and not the CCP methodology. As a result, in order to report the CCP valuation, these market participants would be required to obtain CCP valuations that they do not use, resulting in an extra burden. In addition, it is not clear, from a practical perspective, that CCPs are able to send over valuation to fund managers in time to make a report on a T+2 basis. We would urge that reporting entities be allowed to use their own in-house valuations.

2. With respect to non-centrally cleared transactions with margin, counterparties do not necessarily agree on a valuation for each transaction. Often, each counterparty determines the value for margining for an entire portfolio of transactions, and their respective valuations can differ. Agreement may not be reached in time to complete reporting by T+2. In addition, margin is not always valued on a daily basis since margin is not necessarily exchanged daily. Finally, as noted above, many market participants (particularly those with prime brokerage relationships) have their counterparties determine margin on a

portfolio basis; such portfolio margining is not easily translated into margins for the individual transactions that make up the portfolio.

3. For other non-centrally cleared transactions, counterparties do not necessarily agree on a methodology. Requiring the two parties to agree to a common valuation for each transaction on a daily basis would be operationally burdensome and may result in parties being unable to report on a T+2 basis. As a result, we would suggest that each party be allowed to report their own internal valuation.

The differences in valuations described above can arise for various reasons. Counterparties may have different valuation points (*e.g.*, close of business in Asia compared to close of business in the United States) or they may use different curves and assumptions in their valuations. Counterparty valuations may lead to delays in reporting; investment banks have complex systems and delays in the receipt of valuations may occur. Where differences in valuations occur, investigation and resolution is required, which might have an impact on the timeliness, completeness and accuracy of any required reporting in the interim. All of these issues apply to CCP valuations as well to some extent.

Using internal valuations provides a direct solution to these practical difficulties. It would also result in the reporting of homogeneously-priced portfolios rather than portfolios priced on a piecemeal and inconsistent basis across counterparties. Internal valuations may also make information reported more useful to the Authorities: some OTC transactions are hedges for each other; using counterparty valuations captured using different assumptions would distort the nature of these hedges.

Prescription of jurisdictions for the masking relief

We broadly support the Authorities' proposal with respect to masking and the list of jurisdictions to be included on the initial list.

Prescription of markets and clearing houses

AIMA welcomes the opportunity to provide input on the markets and clearing houses that should be prescribed under section 392A of the SFO. In addition, AIMA requests consideration of whether an additional general category of markets, swap execution facilities ("SEFs"), should be included in Appendix B.

We agree with the Authorities that "OTC derivative product" should "encompass only products that are typically negotiated bilaterally between counterparties directly." We would expect, as noted in paragraph 132, that non-OTC markets should "provide a higher level of transparency than OTC markets", including both pre-trade and post-trade transparency, and "have an effective supervisory regime to safeguard market integrity and prevent abuse." As discussed in further detail below, we believe that SEFs meet these criteria. We note that, while electronic trading platforms had served primarily as execution facilities, SEFs are subject to an additional layer of regulation that requires a much greater degree of multi-lateral involvement and transparency that renders SEF transactions unlike traditional OTC transactions.

Paragraph 131 sets out three criteria for inclusion of a stock/futures market/clearing house in Appendix B:

"(a) They operate in jurisdictions whose securities or futures regulator is a member of the International Organization of Securities Commissions.

(b) They are regulated in their home jurisdictions, and their regulatory status is comparable to that of a recognized exchange company or recognized clearing house under the SFO. For example, they may be [...] "Designated Contract Markets" or "Derivatives Clearing Organizations" regulated by the CFTC in the US, etc.

(c) The markets and clearing houses are regulated by the relevant market regulator, banking regulator or government agency in that jurisdiction."

SEFs meet all three criteria. With respect to (a) and (c), SEFs are regulated by the CFTC (acknowledged in (b) as an appropriate regulator). The CFTC is a member of the International Organization of Securities Commissions. SEFs are directly subject to CFTC oversight.[2] With respect to criteria (b), SEFs and designated contract markets ("DCMs") are defined similarly and subject to similar regulation: under CFTC regulations, any person operating a trading system or platform in which more than one market participant has the ability to execute or trade swaps *with more than one other market participant* must register as either an SEF or a designated contract market.[3] The substantive requirements placed on SEFs and DCMs are broadly comparable (*e.g.*, both the public reporting and regulatory reporting requirements are identical). If the regulation of DCMs is viewed as comparable to a "recognized exchange company", then the regulation of SEFs should be as well.

SEFs provide a higher level of transparency than OTC markets, including both pre-trade and post-trade transparency. Pre-trade, SEF rules require that members request multiple quotes for any transaction; the requesting member would then be able to "observe or receive bids and offers entered by other market participants, and transact on such bids and offers".[4] Although currently, most SEF members continue to execute transactions using one of the multiple quotes they first request (*i.e.*, they use a "request-for-quote" system), SEFs are required to provide members with complete pre-transparency with respect to all equivalent transactions (*i.e.*, an "order book" system). This "order book" transparency is comparable to what DCMs provide. With respect to post-trade transparency, SEFs are required to provide real-time public reporting of transactions (the template for such information is the same as for DCMs).

SEFs are subject to an effective supervisory regime that safeguards market integrity and prevents abuse. In particular, the CFTC has authority to make binding regulation on SEFs and requires all SEFs to designate chief compliance officers.[5] The chief compliance officer is required to resolve conflicts that arise between business and compliance considerations and oversee requirements that SEFs provide fair, open and impartial access to members. SEF must have rule enforcement programs, operational risk analysis programs and adequate resources to detect, investigate and enforce rule violations.[6] SEFs are also required to maintain certain market infrastructure, including automated trade surveillance systems.[7] The relevant qualifications of SEF employees must be submitted to the CFTC for its review.[8]

In summary, the regulatory framework for SEFs is substantive and covers both transparency and market integrity. While SEF members have the option to transact with other members of their choosing, the involvement of the SEF ensures that such transactions are transparent and subject to third-party oversight. Subjecting such transactions to OTC reporting is unnecessary and would draw resources away

[2] Part 37 of the CFTC's regulations (Section 37.1) require compliance by all SEFs that are registered with the CFTC.
[3] 17 CFR Part 37, Section 37.3(a).
[4] 17 CFR Part 37, Section 37.3(a)(c).
[5] 17 CFR Part 37, Section 1501(d).
[6] 17 CFR Part 37, Section 203(a)-(c); Section 206(a), Section 1400.
[7] 17 CFR Part 37, Section 203(d).
[8] Form SEF, Exhibit E.

from surveillance of true OTC transactions that remain less transparent. Accordingly, we would encourage the Authorities to consider recommending the inclusion of SEFs in Appendix B.

We are grateful for the opportunity to provide our thoughts on this Consultation and would be pleased to discuss these comments in further detail.

Yours faithfully,

The Alternative Investment Management Association Ltd