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6 November 2015

By post and email: fss@hkma.gov.hk

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

Dear Sirs

Consultation Paper on Introducing Mandatory Clearing and Expanding Mandatory Reporting

The Hong Kong Association of Banks (“HKAB”) welcomes the opportunity to comment on the consultation paper on introducing mandatory clearing and expanding mandatory reporting (“**Consultation Paper**”).

As you are aware, we have made submissions on behalf of our members in relation to earlier consultations on OTC derivatives clearing in Hong Kong. Our membership maintains an active interest in this issue. As such, we appreciate the HKMA’s efforts in keeping us informed of developments in this area.

Assisted by King & Wood Mallesons, we have carefully considered the Consultation Paper and the included proposed rules. We have provided detailed responses to the questions set out in Consultation Paper. In summary, the proposed introduction of the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (“**Draft Clearing Rules**”), and the proposed amendments to the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (“**Draft Expanded Reporting Rules**”), will significantly affect our members’ businesses. We suggest that some alterations will be necessary to ensure the success of Hong Kong’s clearing regime.

Our suggestions can be summarised as follows:

Draft Clearing Rules

As the Draft Clearing Rules impose substantial obligations on HKAB’s members, we suggest that addressing the practicalities of clearing is key. As such, we have

Chairman The Hongkong and Shanghai Banking Corporation Ltd
Vice Chairmen Bank of China (Hong Kong) Ltd
Standard Chartered Bank (Hong Kong) Ltd
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渣打銀行（香港）有限公司
秘書



suggested a number of refinements where we felt that the practical aspects of clearing could be better reflected in the Draft Clearing Rules. In summary, HKAB:

- (a) is concerned about the currencies for which IRS clearing obligations are imposed, given the limited regional CCP support for particular currencies;
- (b) suggests that certain leading CCPs be designated before the clearing obligations come into effect;
- (c) proposes that the range of tenors used to identify IRS for mandatory clearing should match those proposed under EMIR;
- (d) suggests that methods other than written confirmation in respect of overseas counterparties should be adopted;
- (e) is concerned that the clearing threshold and calculation mechanisms are overly complex;
- (f) suggests that the global position threshold of US\$1 trillion be removed, and an additional product class threshold of US\$10 billion be included in respect of IRS for a prescribed person;
- (g) supports the proposal that only future transactions will be subject to mandatory clearing;
- (h) strongly prefers than an exit threshold (or a periodic assessment process) be included;
- (i) urges the HKMA and the SFC to implement longer time frames in regards to both clearing and following up on transactions that have been submitted for clearing;
- (j) emphasises the need for the concept of “business day” to accommodate global differences in time zones and public holidays;
- (k) suggests that standardised intra-group exemption notices be adopted;
- (l) believes that the jurisdiction-based exemption should apply to individual jurisdictions rather than collectively;
- (m) suggests that the proposal to not cover de-clearing and trade compression under the rules could have adverse effects on market participants;
- (n) is concerned that the “stricter rule” approach will do little to reduce market participants compliance burden;
- (o) supports a pro-active approach to assessing “comparable jurisdictions”; and



- (p) is concerned that that the record keeping obligations under rules 10 and 11 of the Draft Clearing Rules do not reflect the exemption available in rule 5(4).

Draft Expanded Reporting Rules

The Draft Expanded Reporting Rules impose further detailed reporting and record keeping obligations. Having regard to the experience of our members under the current reporting rules, we have made suggestions regarding:

- (a) the staging and timing of including all OTC derivative products in the next phase of mandatory reporting;
- (b) the timeframe for the commencement of phase 2 reporting;
- (c) potential notice and consultation requirements in respect of the proposal to set out information categories in subsidiary legislation;
- (d) the reporting of valuation transaction information in light of the absence of margin agreement frameworks across the industry; and
- (e) the time lags that arise in respect of transaction involving overseas currencies.

Next steps

We welcome the opportunity to discuss these comments further.

We also look forward to providing HKAB's response on Appendix D by 30 November 2015 as requested.

Yours faithfully

Enc.

Hong Kong Monetary Authority
Financial Stability Surveillance Division

Securities and Futures Commission
Supervision of Markets Division

**Securities and Futures (OTC Derivative Transactions –
Reporting and Record Keeping) Rules**

**Securities and Futures (OTC Derivative Transactions –
Clearing and Record Keeping Obligations and Designation of Central
Counterparties) Rules**

Submission of The Hong Kong Association of Banks

6 November 2015

Introduction

This paper sets out the views of The Hong Kong Association of Banks (“HKAB”) in relation to the proposed introduction of the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (“**Draft Clearing Rules**”), and to the proposed amendments to the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (“**Draft Expanded Reporting Rules**”).

Assisted by King & Wood Mallesons, HKAB has examined the proposals set out in the Draft Clearing Rules and the Draft Expanded Reporting Rules, and explained in the accompanying Consultation Paper dated September 2015 (“**Consultation Paper**”) issued by the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”). HKAB’s views are set out in the “HKAB’s response” section of this written submission, with our key suggestions summarised in the “Executive summary”.

We would be pleased to engage in further discussions with the HKMA and SFC in relation to the proposed changes and to provide further industry input where necessary.

Unless otherwise defined, terms used in our response have the meaning and construction given to them in the Draft Rules, the Draft Expanded Reporting Rules, and the Consultation Paper. The headings used below correspond to the headings used in the Consultation Paper.

Executive summary

HKAB acknowledges the important role that the Draft Clearing Rules and the Draft Expanded Reporting Rules will play in implementing the OTC derivatives regime, particularly given that the Amendment Ordinance established a high level framework for that regime, with further detail to be set out in subsidiary legislation.

Draft Clearing Rules

As the Draft Clearing Rules impose substantial obligations on HKAB’s members, we suggest that addressing the practicalities of clearing is key. As such, we have suggested a number of refinements where we felt that the practical aspects of clearing could be better reflected in the Draft Clearing Rules. In summary, HKAB:

- (a) is concerned about the currencies for which IRS clearing obligations are imposed, given the limited regional CCP support for particular currencies;
- (b) suggests that certain leading CCPs be designated before the clearing obligations come into effect;

- (c) proposes that the range of tenors used to identify IRS for mandatory clearing should match those proposed under EMIR;
- (d) suggests that methods other than written confirmation in respect of overseas counterparties should be adopted;
- (e) is concerned that the clearing threshold and calculation mechanisms are overly complex;
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- (m) suggests that the proposal to not cover de-clearing and trade compression under the rules could have adverse effects on market participants;
- (n) is concerned that the "stricter rule" approach will do little to reduce market participants compliance burden;
- (o) supports a pro-active approach to assessing "comparable jurisdictions"; and
- (p) is concerned that the record keeping obligations under rules 10 and 11 of the Draft Clearing Rules do not reflect the exemption available in rule 5(4).

Further details are set out in **Part I of "HKAB's response"** below.

Draft Expanded Reporting Rules

The Draft Expanded Reporting Rules impose further detailed reporting and record keeping obligations. Having regard to the experience of our members under the current reporting rules, we have made suggestions regarding:

- (a) the staging and timing of including all OTC derivative products in the next phase of mandatory reporting;
- (b) the timeframe for the commencement of phase 2 reporting;
- (c) potential notice and consultation requirements in respect of the proposal to set out information categories in subsidiary legislation;
- (d) the reporting of valuation transaction information in light of the absence of margin agreement frameworks across the industry; and
- (e) the time lags that arise in respect of transaction involving overseas currencies.

Further details are set out in **Part II of “HKAB’s response”** below.

Timeframe for implementation

Finally, timing is a key concern as global OTC derivative reforms are considered, implemented and expanded by market participants. We therefore request that sufficient time be allocated to enable the industry to build and implement the necessary technology, policies and processes to support the changes to the OTC derivatives regulatory regime in Hong Kong.

Next steps

We welcome the opportunity to discuss these comments further.

We also look forward to providing HKAB’s response on Appendix D by 30 November 2015 as requested.

HKAB's response

PART I - KEY PROPOSALS ON MANDATORY CLEARING

A Products to be subject to mandatory clearing

1 Do you have any comments or concerns regarding the proposed clearing determination process, or any of the factors included in that process?

HKAB supports the consultative approach that has been proposed as part of the clearing determination process, to ensure that further developments have appropriate levels of stakeholder input. We also support a staged approach to introducing clearing requirements for particular products. HKAB does not have any further comments at this stage on the overarching factors that have been proposed.

2 Do you have any comments or concerns about our proposals on the types of IRS that should be subject to mandatory clearing?

We support a limited and targeted approach to the types of IRS that should be subject to mandatory clearing, with a focus on products that have sufficient volume and standardisation to support clearing. Otherwise, HKAB has no comments at this stage on the specific types of IRS proposed for this first phase of mandatory clearing, except as specified in the following paragraphs.

3 Do you have any comments or concerns about our proposals to only include plain vanilla IRS with constant notional amounts and no optionality?

HKAB supports this proposal, subject to our comments in the following paragraphs.

4 Do you have any comments or concerns about our proposal to include IRS denominated in any of the G4 currencies under phase 1 clearing?

4.1 HKAB suggests that only USD should be included in phase 1 clearing.

4.2 Our specific comments and concerns are as follows:

- (a) **Liquidity of currencies** - First, we suggest that EUR, JPY and GBP do not have sufficient liquidity in Hong Kong to warrant inclusion in phase 1 clearing. Paragraph 62 of the Consultation Paper also acknowledges that these currencies are not "systemically important" to Hong Kong. We suggest that the fact or prospect of their mandatory clearing in other jurisdictions is not a compelling reason for imposing onerous local obligations in respect of these currencies.
- (b) **Lack of regional support** - Secondly, in our members' experience, JPY and GBP are rarely supported by CCPs in the region. We also note that OTC Clearing Hong Kong Limited currently only clears HKD, USD and EUR. It does not clear JPY or GBP. If there is a mismatch between what is mandated and what can actually be cleared in a practicable way, this will result in a challenging compliance burden and elevated costs. We suggest that, at minimum, each currency should be capable of being cleared through two CCPs.
- (c) **Timing issues** - HKAB recognises the significant effort that we understand that the HKMA and SFC have made in engaging with their regulatory counterparts in other jurisdictions in relation to OTC derivatives. We believe that this has helped develop important pragmatic solutions to challenging clearing and reporting-related issues. It also helps ensure that Hong Kong does not impose standards that make it unattractive as a financial services centre. For these reasons, we ask the HKMA and the SFC to engage with their regulatory counterparts in major jurisdictions such as the EU to ensure that timing is, as far as practicable, aligned and takes into account regulatory obligations and

clearing restrictions under their respective laws, including the European Market Infrastructure Regulations ("EMIR"). In particular, we understand that many internationally active dealers have structured their infrastructure developments around EMIR, and its proposed implementation dates.

- (d) ***Uncertainty of designation of overseas CCPs*** - We are concerned that there remains uncertainty as to whether leading overseas CCPs will be designated for Hong Kong clearing purposes. Key overseas CCPs of particular importance to HKAB members include:

- (i) LCH Clearnet Limited;
- (ii) CME Clearing Europe Limited;
- (iii) Eurex Clearing AG;
- (iv) Japan Securities Clearing Corporation; and
- (v) NASDAQ OMX Clearing AB.

If the clearing mandate has the effect of limiting major international dealers to clear certain swaps through a local CCP in Hong Kong only, then we suggest that this is likely to lead to the unintended consequences of reducing the volume of in-scope IRS that international dealers may choose to book locally in Hong Kong. Further, it will artificially split the existing swap market between swaps that are to be cleared through a local CCP and swaps that may be cleared through overseas CCPs. These foreign venues are likely attract larger volumes and greater volume related efficiencies in this circumstance.

5 Do you have any comments or concerns about our proposal to mandate HKD denominated IRS for clearing under phase 1 clearing?

- 5.1 We are concerned that accessibility issues may arise, as we understand that other CCPs in the region, such as those operating in Singapore, Japan, South Korea and Australia, do not support HKD IRS. Further, we note that no other jurisdiction has proposed nor mandated a clearing obligation in respect of HKD IRS.

- 5.2 We therefore respectfully suggest that no obligations should be imposed in respect of HKD IRS until a range of designated CCPs, both local and overseas, are actively clearing HKD IRS. This would:

- (a) ensure that there is sufficient liquidity in the market;
- (b) ensure that there is sufficient capacity amongst CCPs to clear HKD IRS;
- (c) prevent placing undue burden on market participants;
- (d) prevent a monopoly in the clearing of HKD IRS from arising; and
- (e) linked with paragraph (d), mitigate the potential systemic risks associated with a CCP failure.

6 Do you have any comments or concerns about our proposal to only cover IRS that feature the indexes set out in the two tables above?

At this stage we have no specific comments about this proposal.

7 Do you have any comments or concerns about our proposals on whether OIS should be covered under phase 1 clearing, and in what circumstances?

At this stage we have no specific comments about this proposal.

8 Do you have any comments or concerns about our proposal that mandatory clearing should apply to IRS that feature the range of tenors described above?

8.1 We are concerned that the range of tenors proposed does not accord with those employed in comparable jurisdictions, and will necessitate the development of multiple clearing systems to cater for Hong Kong and other jurisdictions.

8.2 We therefore respectfully suggest that the range of tenors be altered to match those proposed under EMIR. This would increase efficiency and interoperability between international financial centres, and reduce our members' compliance burden.

9 Do you have any comments or concerns about our proposal not to cover NDF transactions under phase 1 clearing?

In principle, we support a staged approach to implementing mandatory clearing. We believe that this will facilitate a smooth transition to mandatory clearing, and provide sufficient time for issues to be addressed. As a result, we support this proposal.

B Only dealer-to-dealer transactions to be subject to mandatory clearing in first phase

10 Do you have any comments or concerns about our proposal to restrict mandatory clearing to only dealer-to-dealer transactions in the first phase?

We agree that the Hong Kong mandate should be limited to dealer-to-dealer transactions. However, at the moment we suggest that the mandate may not achieve this in an efficient manner. Please see our general comments below with respect to financial service providers in response to questions 11 and 12.

11 Do you have any comments or concerns about our proposed criteria for scoping dealer-to-dealer transactions?

11.1 Under the current proposal, locally incorporated authorised institutions will be required to clear all in-scope transactions whether or not each transaction is booked in Hong Kong or elsewhere. This requirement raises practical difficulties for locally incorporated banks which may have branches operating in locations where they do not have access to a recognised CCP. However, under the current proposal, transactions must be cleared irrespective of their value.

11.2 HKAB therefore suggests that phase 1 clearing only apply to cleared transactions booked in Hong Kong. Alternatively, we suggest a *de minimise* threshold for transactions booked outside of Hong Kong so that this practical difficulty does not arise for small volume transactions.

11.3 To the extent that this is possible, we would also be grateful for further guidance from the HKMA and the SFC on the intended scope of transactions under phase 2 clearing.

12 Do you have any comments or concerns about our proposed scope for "prescribed persons" and "financial services providers"?

12.1 HKAB suggests that prescribed persons may have difficulties identifying and confirming whether they or not are dealing with "financial services providers" within the meaning of Hong Kong law. More specifically, we note the following:

(a) **Lack of counterparty understanding** - Non-Hong Kong counterparties may be unfamiliar with Hong Kong laws and their status under those laws. It may therefore be difficult to obtain accurate and timely confirmation of whether the Hong Kong clearing requirements will apply.

(b) **Practical difficulty obtaining written confirmation** - In light of the above, written confirmation from a financial services provider is likely to take significantly longer than written confirmation from a prescribed person.

- 12.2 As an alternative, we suggest that market participants be permitted to rely on a method such as:
- (a) confirming that the counterparty is on the relevant regulator's list of regulated financial institutions in the jurisdiction concerned;¹ or
 - (b) referring to other information that is already publically available or being collected by dealers under foreign clearing mandates such as EMIR and Dodd Frank.²
- 12.3 Without these kinds of clear avenues for confirming counterparty status, the compliance burden for satisfying the clearing obligations is significant and may prove impossible in practice.

C Clearing threshold and its calculation

13 Do you have any comments or concerns about our proposal to look at all OTC derivative transactions, other than deliverable FX forwards, when assessing if the clearing threshold has been crossed?

HKAB has concerns regarding the complexity of the clearing threshold and calculation mechanism and proposes the following refinements:

- (a) **Transactions in scope** - We suggest that only OTC derivatives that are mandated for clearing be included in the threshold calculation. We suggest that this is needed to rationally connect the threshold with the clearing requirements. By having transactions form part of the calculation that are not mandated for clearing, an entity with a large number of outstanding OTC derivatives in, for example, equity derivatives but only a handful of IRS will still be required to clear the IRS according to the mandate. In such circumstances, the relevant entity would have to put in place relevant systems, controls and documentation to centrally clear the small portfolio of IRS trades. Conversely, an entity could have a large number of IRS trades but a handful of other OTC derivatives, and yet it would not be caught by the clearing mandate, despite having a much larger portfolio of clearable trades.

Without limiting this request, HKAB recommends that, in any event:

- (i) all exchange traded derivatives be excluded from the calculations, irrespective of whether they are traded on a recognized futures market or a futures market prescribed under section 392A of the Securities and Futures Ordinance (Cap. 571);
 - (ii) intra-group and intra-company derivative transactions be excluded, given that the regulators are proposing to include an intra-group exemption from clearing;
 - (iii) transactions for hedging the commercial risks of end users be excluded;
 - (iv) all deliverable FX swaps also be excluded, as they are subject to the same unique settlement process as deliverable FX forwards.
- (b) **Confirmation of values to be used** – We would be grateful for confirmation that the clearing threshold will be calculated using gross notional values.

¹ Such as provided for under paragraph 4.10.7 of the HKMA Guideline on Anti-Money Laundering and Counter- Terrorist Financing (For Authorized Institutions)

² For example, we understand that Australia has linked its mandate to United States-registered Swap Dealers.

14 Do you have any comments or concerns about our proposal to set clearing thresholds by reference to a calculation period?

We have concerns about the complexity of calculating clearing thresholds. We would be pleased to engage with the HKMA and SFC to develop a simpler method for determining whether the clearing threshold has been crossed.

15 Do you have any comments or concerns about our proposal to use multiple calculation periods and multiple thresholds?

We suggest that the multiple calculation periods should be set at 12-month intervals. We believe that this period strikes the right balance between market realities and the need to prevent market participants from adjusting their positions simply to avoid mandatory clearing obligations.

16 Do you have any comments or concerns about our proposed threshold variations for different market participants?

16.1 We suggest that a single threshold should apply for AIs, AMBs and LCs that are incorporated outside of Hong Kong. We also suggest that this threshold be *lower*. This arrangement will help achieve the intent stated in paragraph 91 of the Consultation Paper but will not require the Hong Kong branch of the overseas entity to establish the infrastructure to support mandatory clearing if its relevant OTC derivative transactions are relatively small.

16.2 We also suggest that overseas entities should only be eligible to be treated as prescribed persons in respect of transactions that are booked in Hong Kong. For all other transactions, overseas entities should be required to meet the criteria of a financial services provider before they are required to clear.

17 Do you have any comments or concerns regarding our proposed formula for calculating the “average position”, i.e. the position that is to be measured against the clearing threshold?

Please refer to our comments in response to question 14.

18 Do you have any comments or concerns about the proposed threshold levels?

18.1 We understand that the clearing threshold for an overseas AI is either US\$20 billion, if booked in Hong Kong, or US\$1 trillion of global positions. We suggest that the latter global position threshold should be removed for two key reasons:

(a) the fact that an AI has large global positions does not mean that its relevant trades have a sufficient Hong Kong nexus. If an AI takes into account its global position, then only one HK IRS transaction is sufficient to trigger the clearing obligation. This may impose an unduly onerous burden on certain AI with limited Hong Kong book trades.

(b) AIs typically have different groups, desks and workflows: aggregating all such trades periodically all over the globe is an extensive exercise that places an additional burden on AIs.

18.2 We also suggest that an additional product class threshold of US\$10 billion be included in respect of IRS for a prescribed person. We note that the largest class of OTC derivatives traded in Hong Kong is FX derivatives. There are local AIs and overseas AIs who are major market participants for FX derivatives but not for interest rate derivatives. These AIs may be caught by the clearing mandate for IRS because of their significant position in FX derivatives even though their interest rate derivative position is small. As FX derivatives clearing is relatively new in all jurisdictions, these AIs may not already have infrastructure set up to support clearing through a CCP. A product class

threshold will allow these AIs to implement mandatory clearing at a later stage, once they have the necessary infrastructure and systems in place.

19 Do you have any comments or concerns about our proposal that only future transactions should be subject to mandatory clearing?

We support this proposal. Imposing retroactive mandatory clearing would involve onerous obligations for our members and regulators alike. The proposed approach also supports the general principle that laws should be prospective.

20 Do you have any comments or concerns about our proposal not to include an exit threshold?

20.1 We strongly prefer that an exit threshold (or a periodic assessment process) be included. Otherwise, once a person crosses the threshold for mandatory clearing for a particular calculation period, it will have to comply with the clearing obligation from the prescribed day and thereafter. We suggest that this is unreasonable: if a prescribed person changes its business model or trading profile and its derivatives volume drops to a level that it is no longer systemically important, it is not justifiable for it to keep complying with the mandatory clearing requirements. We also note that other regional jurisdictions, such as Australia, do have such a threshold which, if not met during any particular period, will not require the transactions of that entity to be cleared.

20.2 However, we appreciate the reasons stated in the Consultation Paper for not including an exit threshold and acknowledge that not including an exit threshold means that other parties do not have to constantly check whether a counterparty still meets the thresholds. We suggest that a potential solution is to include an exit threshold, but for the regulators to maintain an up-to-date list of entities that are subjected to the mandate. For example, the regulators could make it a requirement for prescribed persons to notify an appropriate regulator when they exceed the applicable clearing threshold, and when they fall below it. The regulators could then make this information publically available. This would provide consistency across the market as to how entities treat each other for the purposes of the clearing threshold and reduce the need for multiple bilateral communications between prescribed persons on an ongoing basis.

20.3 Alternatively, the periodic assessment approach taken or proposed in other jurisdictions such as Australia could be adopted. This would obviate the need for an “exit threshold” *per se*, but achieves the same overall intent.

D Complying with the clearing obligation

21 Do you have any comments or concerns regarding the matters to be checked by a prescribed person?

21.1 HKAB supports this proposal, if a pragmatic approach can be adopted for compliance.

21.2 More specifically, we are concerned that because a counterparty is under no obligation to disclose their average position, and because this position changes from time to time, that it will be unclear whether any written confirmation received from a counterparty will meet the standard stated in paragraph 108 of the Consultation Paper at (c). Further, we suggest that financial services providers who are not themselves subjected to any obligations in Hong Kong, they would be reluctant to expend resources and costs to assist their Hong Kong counterparties comply with Hong Kong laws and regulations. They may even prefer to deal with non-Hong Kong counterparties in order to avoid these regulatory burdens. In these circumstances, seeking confirmation from counterparties as to their regulatory status and derivative activity levels is extremely onerous and operationally challenging.

21.3 The regulator-maintained list proposed in paragraph 20.2 above is one potential solution to this issue. Employing a system of presumptions is another potential solution. For example, if a prescribed person has crossed the clearing threshold, it would be entitled to presume that its counterparties have fulfilled some of the conditions in

relation to which the regulators propose to seek written confirmation: for example, with respect to regulatory status and derivative activity levels.

22 Do you have any comments or concerns regarding a prescribed person's obligations vis-à-vis following up on transactions that have been submitted for clearing?

22.1 HKAB urges the HKMA and the SFC to adopt a longer time frame.

22.2 As it currently stands, paragraph 114(c) of the Consultation Paper proposes that uncleared transactions should be terminated within a T+1 timeframe. We are concerned that this timeframe is insufficient for the follow reasons:

- (a) termination of a transaction will typically require agreement from the counterparty, which will not always be forthcoming;
- (b) this timeframe does not account for technical issues arising, particular in respect of information technology; and
- (c) the high unwinding costs associated with terminating uncleared trades means that, in practice, uncleared trades are not always terminated.

22.3 As a result, HKAB suggests uncleared transactions should be exempt from this requirement, and that *at least* a T+2 timeframe would be preferable for all other transactions.

23 Do you have any comments or concerns about the proposed T + 1 timeframe for clearing, and our proposal to define "business day" to mean a business day in Hong Kong?

23.1 Aligned with our comments on question 22, we recommend a longer timeframe for clearing. We also suggest an adjustment to the concept of "business day". More specifically:

- (a) in relation to timing, we understand that paragraph 118 of the Consultation Paper proposes that compliance with the clearing obligation should occur within a T+1 timeframe. We are concerned that this is insufficient. It is our members' experience that clearing typically occurs within T+2, at the earliest, and more likely T+3, particularly in light of the issues acknowledged in paragraph 119 of the Consultation Paper;
- (b) in relation to "business day", paragraph 118 of the Consultation Paper proposes that "business day" will only refer to Hong Kong business days. We suggest that this will make clearing on overseas CCPs significantly more cumbersome given potential misalignments. We suggest that "business day" should be expanded to cover business days in the jurisdictions of the various designated CCPs, and to ultimately allow for a degree of flexibility to take into account differing time zones and public holidays. We would be pleased to assist in crafting suitable language.

24 Do you have any comments or concerns about our proposal not to cover specified subsidiaries of locally incorporated AIs under phase 1 clearing?

We support the proposal to not cover specified subsidiaries under phase 1 clearing.

E Exemptions from the clearing obligation

25 Do you have any comments or concerns regarding our proposed intra-group exemption or any aspect of it?

- 25.1 We agree with the proposed exemption for intra-group transactions. However, we request that this exemption also be reflected in the calculation of the clearing threshold, as noted in our response to question 13.
- 25.2 In general, we would also request more clarity in relation to the application of the intra-group exemption in practice. For example, we suggest that standard or suggested templates issued by the regulators for written exemption notices would be very useful, and would ease the administrative burden for the regulators (in assessing the notices) and market participants (in preparing them).
- 26 Do you have any comments or concerns regarding our proposed jurisdiction-based exemption or any aspect of it?**
- 26.1 In principle, we support a jurisdiction-based exemption. However, we are concerned that the requirements stated in paragraph 139(d) of the Consultation Paper impose a significant burden on prescribed persons and limit the effectiveness of the proposed jurisdiction-based exemption. We suggest that the application of the exemption to a given jurisdiction should only require the 5% limit to be fulfilled in that jurisdiction.

F Position on de-clearing

- 27 Do you have any comments or concerns regarding our proposal not to cover de-clearing and trade compression expressly under the rules?**
- 27.1 HKAB suggests a refinement to the approach to dealing with derivative transactions that are created as part of either a multilateral trade compression cycle or bilateral trade compression process.
- 27.2 Specifically, we suggest that new and amended derivative transactions that result from systemically risk-reducing processes such as compression should not be subjected to the clearing mandate if the original trades were themselves not subject to the clearing mandate. Otherwise, market participants are likely to be disincentivised from participating in such compression exercises, which could result in pricing risks for market participants. In addition it would have the effect of undermining the risk mitigation requirements that we understand apply under offshore rules in leading markets.

G Substituted compliance

- 28 Do you have any comments or concerns about our proposed substituted compliance framework, or any aspect of it?**
- 28.1 Overall, we support the implementation of substituted compliance and see this as a cornerstone of implementing the reforms in a global context. However, we respectfully suggest that the regulators' focus should be on the equivalence of the clearing requirements of the foreign jurisdictions, rather than apply the "stricter rule" overlay.
- 28.2 In particular, HKAB is concerned that adoption of the "stricter rule" approach will offer little help to prescribed persons in terms of reducing their compliance burden. In particular, we note that prescribed persons intending to rely on substituted compliance would still need to check whether every transaction covered by the Hong Kong clearing mandate is *in fact* cleared, requiring a case-by-case approach. This process would be complicated and costly to implement.
- 29 Do you have any comments or concerns about our proposed list of "comparable jurisdictions"?**

We support a proactive approach to including comparable jurisdictions that is responsive to regulatory developments outside of Hong Kong and includes all appropriate leading markets over time. We also suggest that the list be widely and publically disseminated by the regulators to ensure awareness and transparency.

H Clearing related record keeping requirements

30 Do you have any comments or concerns about our proposed record keeping requirements for demonstrating compliance with the clearing obligation?

- 30.1 We are concerned that the record keeping obligations under rules 10 and 11 of the Draft Clearing Rules do not reflect the exemption available in rule 5(4).
- 30.2 Specifically, rule 10 requires records to be kept by prescribed persons, which may include local and overseas AFIs and AMBs. Under rule 11, the record keeping obligation applies to specified OTC derivatives transactions even if the transaction is entered into wholly or partially outside Hong Kong.
- 30.3 However, rule 5(4) of the Draft Clearing Rules provides that the clearing obligation will not apply to an overseas AFI or an overseas AMB if the transaction is not recorded in the form of an entry in the books of the person in Hong Kong.
- 30.4 We suggest that rule 12 be amended to clarify that the record keeping obligations do not apply to any transactions that fall within rule 5(4).

I Designation and regulation of CCPs

31 Do you have any comments or concerns about our proposed processes for designating CCPs or for revoking a CCP designation?

- 31.1 As a general comment, we note that some overseas CCPs are essential to efficient international clearing operations.
- 31.2 Linked with our suggestions and observations in response to question 4, we urge the HKMA and the SFC to assist in minimising any operational disruption by contemplating the application process for overseas CCPs to be undertaken **before** mandatory clearing comes into force. We suggest that at least two CCPs should be authorised prior to the commencement of the mandatory clearing requirements, to ensure competition and prevent the concentration of risk. Should the approval process extend beyond the mandatory clearing timeframe, we suggest that a transitional period of 3 to 6 months be considered on the proviso that the relevant overseas CCPs have made a formal application.

32 Do you have any comments or concerns about our proposal to implement only the clearing leg of the extended definition of “ATS” at this stage?

In principle we support this proposal. A gradual introduction of the extended definition of ATS will assist in facilitating a smooth transition to the new regime. To this end we suggest that as explicit timeframe as possible is published in respect of introducing the extended ATS definition.

33 Do you have any comments or concerns about our proposal to defer implementation of the changes to the definition of “market contract” to cover CCPs that are authorized ATS providers and designated CCPs?

In principle we support this proposal, for the reasons given above in respect of question 32.

PART II - KEY PROPOSALS ON EXPANDING MANDATORY REPORTING

A Expanded product scope

34 Do you have any comments or concerns about our proposal to include all OTC derivative products in the next phase of mandatory reporting?

- 34.1 Our members' experience is that phase 1 reporting has already consumed significant time and resources. Further, we note that implementation complexity and risk increases significantly when multiple systems require enhancement or modification. We therefore ask that the remaining OTC products be rolled out across multiple phases.
- 34.2 We also suggest that further exemptions be granted in respect of particular products. For example, we suggest excluding spot foreign exchange contracts (that is, deliverable foreign exchange contracts with T+2 or shorter settlement periods) from the scope of phase 2 reporting. Such exclusions would be consistent with the approach that we understand has been taken by other Asian regulators, for example in Singapore³ and Australia.⁴

B Implications of removing "product class" and "product type"

- 35 Do you have any comments or concerns about our proposal that the "exempt person" relief should be extended to cover all OTC derivative products, but that it should no longer apply on a product class basis?**

At this stage we have no specific comments in relation to this proposal.

- 36 With respect to the criteria for triggering the "exempt person" relief, do you have any comments or concerns about our proposal that the limit on the aggregate notional amount should stay at US\$30 million?**

At this stage we have no specific comments in relation to this proposal.

C Transaction information to be reported under phase 2 reporting

- 37 Do you have any comments or concerns about our proposal to do away with the concession period and defer commencement of phase 2 reporting until 6 months after the rules are enacted?**

- 37.1 HKAB members' experience indicates that a deferment period of 6 months is unlikely to be sufficient, given the necessity for system enhancement and modifications, and for workflow change. This is particularly the case given that phase 2 is currently intended to include all remaining OTC products, and the high likelihood of various unmatched and unlinked transactions arising during the roll out period.

- 37.2 Based on member feedback we suggest that *at least* 12 months, and more likely 18 months, is required in order to give our members sufficient time to change their systems and resolve all unmatched and unlinked transactions.

- 38 Do you have any comments or concerns about our proposal to only set out the information categories in the subsidiary legislation, and separately publish, by way of a (non-statutory) Gazette notice, the specific data fields to be completed when reporting transaction information to the HKTR?**

- 38.1 In principle, we support including information categories in a non-statutory framework as we appreciate the onerous process of statutory reform. We also believe it is appropriate for more granular administrative issues. We also suggest that these categories be supported by FAQs or other supplemental guidance to enable to participants to deal with issues such as matching data fields required in Hong Kong with requirements in other jurisdictions.

- 38.2 We are concerned, however, that the requirements may be subject to change with little or no prior notice or consultation. We therefore suggest that any changes to these

³ Securities and Futures (Reporting of Derivatives Contracts) Regulations 2014, limb (b) of definition of "excluded currency contract" (Singapore).

⁴ ASIC Corporations (Derivative Transaction Reporting Exemption) Instrument 2015/844, Section 13 (Australia).

requirements follow extensive consultation with the industry, and also allow sufficient implementation time.

- 38.3 We will provide further details in respect of the data fields as part of the separate consultation.

D Reporting of valuation transaction information

- 39 Do you have any comments or concerns about the specific data fields set out in the tables at Appendix D? If you do, please provide specific details, including suggestions for alternative ways to capture the relevant information.**

We will be separately commenting on the data fields.

- 40 Do you have any comments or concerns about our revised proposal on the reporting of valuation transaction information?**

- 40.1 We suggest that valuation time as stated in paragraph 188(b) of the Consultation Paper should be excluded from the valuation transaction information. Valuation time is not recorded in all systems. Further, valuation time is not relevant if the market data for valuations are taken at a different time, as is common in the industry.

- 40.2 We also note that for non-centrally cleared transactions the absence of margin agreement frameworks across the industry means that most counterparties will continue to rely on internal valuation methods. We suggest that for these transactions, the regulators should consider providing an exemption in respect of paragraph 194(b) of the Consultation Paper until an industry-wide margin agreement framework is in place. We believe that the internal valuation by each party should be sufficient for market surveillance purposes.

- 40.3 Alternatively, for cleared trades the obligation to report valuations could be placed on the CCP itself rather than market participants.

- 41 In what circumstances do you envisage it will be necessary to submit the previous day's valuation figures, and why? Please provide specific details including the practices adopted and the particular difficulty encountered in view of such practices.**

For some transactions, the valuation figures may be provided by the counterparty rather than generated from the AI's systems. A time lag may therefore arise here before information is received. Further, if a trade involves an overseas currency, it may not be possible to source valuation data if it is a holiday in that overseas jurisdiction. Depending on the location of the counterparty, this time lag may exceed two days. We therefore suggest that AIs should be allowed to use the latest valuation figures available to them for their daily reporting.

E Mandatory record keeping obligation

- 42 Do you have any comments or concerns about our proposal to expand the mandatory record keeping obligation so that it applies in respect of the expanded product scope, but to leave the obligation otherwise unchanged?**

At this stage we have no specific comments on this proposal.

F Implications that proposed changes will have for different reporting entities

- 43 Do you have any comments or concerns about our proposal to have a single grace period under phase 2 that applies across all products and product types?**

Please see our response to question 44.

44 Do you have any comments or concerns about our proposals for how the single grace period under phase 2 will apply in respect of persons who are already reporting under phase 1?

- 44.1 We have concerns about the proposal under paragraph 203(e) in respect of back-loading. The identification of nexus trades is subject to ongoing system enhancements and enriched data capture at point of trade. Historically, the necessary data to determine nexus trades has not been available in all our members' systems. Therefore, it is highly problematic to include a back loading requirement with respect to nexus transactions. We suggest that any back-loading requirement with respect to phase 2 transactions outstanding as of the start of the phase 2 reporting obligation should be limited to transactions booked into Hong Kong.
- 44.2 We further suggest that if a back-loading window is included, then relevant back-loaded trades should be permitted to be reported masked or with redactions to the extent that any necessary consent has not been obtained from the counterparty for this historical activity. We consider that the ability to mask is critical to allow reporting entities to comply with their reporting obligations in Hong Kong without breaching confidentiality, privacy or data protection laws in other jurisdictions.
- 44.3 We would also appreciate clarifications of the grace periods that would apply to the back-loading requirements.

45 Do you have any comments or concerns about our proposals for how the single grace period under phase 2 will apply in respect of persons who became subject to mandatory reporting under phase 1 but whose grace period under phase 1 is still running when phase 2 reporting takes effect?

At this stage we have no specific comments on this proposal.

Next steps

Thank you very much for the opportunity to provide feedback on the Draft Clearing Rules and the Draft Expanded Reporting Rules. We would be delighted to discuss any aspect of our comments or to provide feedback on any further proposals.

We also look forward to providing HKAB's response on Appendix D by 30 November 2015 as requested.