

Joint consultation paper on the prescription of additional markets and clearing houses and prescription of Delta One Warrants under the OTC derivatives regulatory regime

April 2017



HONG KONG MONETARY AUTHORITY
香港金融管理局



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

TABLE OF CONTENTS

FOREWORD	iii
PERSONAL INFORMATION COLLECTION STATEMENT	iv
EXECUTIVE SUMMARY	1
INTRODUCTION	2
PRESCRIPTION OF ADDITIONAL MARKETS AND CLEARING HOUSES	2
PRESCRIPTION OF DELTA ONE WARRANTS	4
WAY FORWARD	6
APPENDIX A – LIST OF PROPOSED ADDITIONAL MARKETS AND CLEARING HOUSES TO BE PRESCRIBED	7

FOREWORD

In line with global efforts, the Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC**) have been working with the Hong Kong Government and stakeholders on implementing a regulatory regime for the over-the-counter (**OTC**) derivatives market in Hong Kong.

To date, we have implemented a degree of mandatory reporting and mandatory clearing. The next stage involves the expansion of mandatory reporting to cover a much wider range of products. This consultation focuses on issues raised by market participants in the context of this next stage.

Interested parties are invited to submit written comments on the two proposals in this consultation paper. Comments should reach either the HKMA or the SFC on or before **26 May 2017** and may be submitted by any of the following methods –

By online submission at: <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/>
By email to: fss@hkma.gov.hk or otcconsult@sfc.hk
By fax to: (852) 2878 7297 or (852) 2521 7917

By post to one of the following:

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

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

Any person wishing to submit comments on behalf of any organization should provide details of the organization whose views they represent.

Please note that the names of commentators and the contents of their submissions may be published by the HKMA and / or SFC on their respective websites and in other documents to be published by them. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

You may not wish your name and / or submission to be published by the HKMA and / or SFC. If this is the case, please state that you wish your name and / or submission to be withheld from publication when you make your submission.

April 2017

PERSONAL INFORMATION COLLECTION STATEMENT

1. This Personal Information Collection Statement (**PICS**) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection, what you are agreeing to with respect to the HKMA's and / or SFC's use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) (**PDPO**).

Purpose of collection

2. The personal data provided in your submission to the HKMA and / or SFC in response to this consultation paper may be used by the HKMA and SFC for one or more of the following purposes –
 - (a) to administer –
 - (i) in the case of the HKMA, the provisions of the Banking Ordinance (Cap. 155) and guidelines published pursuant to the powers vested in the HKMA; and
 - (ii) in the case of the SFC, the relevant provisions² and codes and guidelines published pursuant to the powers vested in the SFC;
 - (b) in performing –
 - (i) in the case of the HKMA, statutory functions under the provisions of the Banking Ordinance (Cap. 155) and the Securities and Futures Ordinance (Cap. 571); and
 - (ii) in the case of the SFC, its statutory functions under the relevant provisions;
 - (c) for research and statistical purposes; or
 - (d) for other purposes permitted by law.

Transfer of personal data

3. Personal data may be disclosed by the HKMA and / or SFC to members of the public in Hong Kong and elsewhere as part of the public consultation on this consultation paper. The names of persons who submit comments on this consultation paper, together with the whole or any part of their submissions, may be disclosed to members of the public. This will be done by publishing this information on the HKMA and / or SFC website and in documents to be published by the HKMA and / or SFC during the consultation period or at its conclusion.

¹ Personal data means personal information as defined in the Personal Data (Privacy) Ordinance (Cap. 486).

² The term "relevant provisions" is defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) and refers to the provisions of that Ordinance together with certain provisions in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Companies Ordinance (Cap. 622) and the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).

Access to data

4. You have the right to request access to and correction of your personal data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your personal data provided in your submission on this consultation paper. The HKMA and SFC have the right to charge a reasonable fee for processing any data access request.

Retention

5. Personal data provided to the HKMA and / or SFC in response to this consultation paper will be retained for such period as may be necessary for the proper discharge of the HKMA's and SFC's respective functions.

Enquiries

6. Any enquiries regarding the personal data provided in your submission on this consultation paper, or requests for access to personal data or correction of personal data, should be addressed in writing to –

In the case of the HKMA –

Personal Data Privacy Officer
Hong Kong Monetary Authority
55/F Two International Finance Centre
8 Finance Street
Central Hong Kong

In the case of the SFC –

The Data Privacy Officer
Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

7. A copy of the Privacy Policy Statement adopted by the HKMA and SFC is available upon request.

EXECUTIVE SUMMARY

1. In line with G20 commitments to reform the OTC derivatives market, the HKMA and the SFC have been working on implementing a regulatory regime for OTC derivatives in Hong Kong. The regime, which is now in place, provides for the introduction of mandatory reporting, clearing, trading and record keeping obligations in respect of OTC derivative transactions.
2. In line with other markets, mandatory obligations are being implemented in phases. To that end, the first phase of mandatory reporting (**Phase 1 Reporting**) came into force on 10 July 2015, and the first phase of mandatory clearing came into force on 1 September 2016. The next milestone will see implementation of the second phase of mandatory reporting (**Phase 2 Reporting**), which is scheduled to come into force on 1 July 2017.
3. This consultation focuses on two issues that market participants have recently raised in the context of the upcoming Phase 2 Reporting, both concerning the scope of the definition of “OTC derivative product”. Specifically, we have been asked to consider the following:
 - (a) Expanding the list of markets and clearing houses prescribed under section 392A of the Securities and Futures Ordinance (**SFO**) so that products traded on and cleared through them will not be “OTC derivative products” and hence will not be subject to mandatory reporting.
 - (b) Excluding from the definition of “OTC derivative product”, certain warrants with strike prices set at zero or near zero (**Delta One Warrants**), and which effectively serve as access products, since these are not generally regarded as OTC derivative products and therefore should not come within the regime.
4. The HKMA and SFC generally agree with the proposed changes, and accordingly propose:
 - (a) that the additional markets and clearing houses listed in **Appendix A** should be prescribed under section 392A of the SFO; and
 - (b) that Delta One Warrants bearing the features discussed under paragraph 20 below should be prescribed under section 392(1)(b)(vii) of the SFO and thereby excluded from the definition of “OTC derivative product” by virtue of section 1B(2)(i) of Part 1 of Schedule 1 to the SFO.
5. Amendments to subsidiary legislation will be needed to implement the above changes. The HKMA and SFC will work with the Department of Justice on the drafting of the relevant amendments as soon as practicable after completion of this consultation exercise. At this stage, we expect the earliest that the draft amendments can be completed and tabled before the legislature for negative vetting will be after the commencement of its new legislative session in October 2017. Market participants who anticipate difficulty in complying with Phase 2 Reporting before the amendments come into effect should contact their respective regulator.

INTRODUCTION

6. The HKMA and the SFC have been working on implementing an OTC derivatives regulatory regime in Hong Kong. Phase 1 Reporting came into effect on 10 July 2015. It requires the reporting of transactions in certain interest rate swaps and non-deliverable forwards. Phase 2 Reporting (which expands mandatory reporting to cover all OTC derivatives products in 5 key asset classes, namely, interest rate, foreign exchange, equity, credit and commodity) will commence on 1 July 2017.
7. As Phase 2 Reporting nears, we have been receiving market feedback to adjust the scope of the term “OTC derivative product”. Specifically, some market participants have requested the following via an industry association³:
 - (a) certain additions to the list of markets and clearing houses prescribed under section 392A of the SFO⁴; and
 - (b) the exclusion of certain warrants from the definition of “OTC derivative product” pursuant to section 392(1)(b)(vii) of the SFO.

PRESCRIPTION OF ADDITIONAL MARKETS AND CLEARING HOUSES

8. The OTC derivatives regime is not intended to encompass products that are traded on an exchange and cleared through a clearing house. They are therefore excluded from the definition of “OTC derivative product” by virtue of section 1B(2)(b) and (c) of Part 1 of Schedule 1 to the SFO. In the case of overseas products, the exclusion only applies if the market on which they are traded and the clearing house through which they are cleared are prescribed under section 392A of the SFO.
9. The existing lists of stock and futures markets and clearing houses prescribed under section 392A were gazetted on 15 May 2015.
10. Market participants have indicated that the existing lists are inadequate to carve out exchange traded products which may be caught under Phase 2 Reporting. We accordingly propose to add the markets and clearing houses set out at **Appendix A**.
11. In compiling the list at **Appendix A**, we have taken into account that the proposed markets and clearing houses meet the same three criteria that were adopted previously, i.e. –
 - (a) They operate in jurisdictions whose securities or futures regulator is a member of the International Organization of Securities Commissions.

³ The request was made by the International Swaps and Derivatives Association, Inc. (**ISDA**) in a letter sent to the SFC and the HKMA on 31 March 2017 after consulting its members in the Asia Pacific region.

⁴ Products traded and cleared through such prescribed markets and clearing houses are excluded from the definition of “OTC derivative products” by virtue of section 1B(2)(c) of Part 1 of Schedule 1 to the SFO. The current list of prescribed markets and clearing houses was gazetted on 15 May 2015.

- (b) They are regulated in their home jurisdictions, and their regulatory status is comparable to that of a recognized exchange company or a recognized clearing house under the SFO.
 - (c) They are regulated by the relevant market regulators, banking regulator or government agency in that jurisdiction.
12. Save for two exceptions, the list at **Appendix A** echoes the list of additional markets and clearing houses requested to be added. The two exceptions are the Shanghai Clearing House and The Irish Stock Exchange Plc. According to its PFMI disclosure, the Shanghai Clearing House provides clearing services for: (i) bonds; (ii) interest rate derivatives; (iii) foreign exchange and exchange rate products; and (iv) freight and commodity derivatives traded on inter-bank markets in China. It seems therefore that its services are for clearing OTC derivatives rather than exchange traded derivatives. We therefore do not agree that it should be prescribed under section 392A. As for the Irish Stock Exchange Plc, we understand that it operates three securities markets, two of which are regulated in the EU as multilateral trading facilities (**MTFs**). As noted in our 2014 Consultation Conclusions and Further Consultation, we believe MTFs in the EU are more commonly used for executing OTC derivatives. Accordingly, and in line with this approach, we only propose to prescribe the one securities market operated by the Irish Stock Exchange Plc that is not an MTF.

Q1: *Do you have any comments on the proposed list at **Appendix A**?*

Q2: *Do you believe any other markets or clearing houses should also be added to the list? If so, please specify all relevant information including: (i) the full legal name of the market or clearing house and its operator; (ii) in the case of a market, details of the clearing house through which products traded on the market must be cleared; (iii) a list of the jurisdiction(s) in which the market or clearing house is established and/or operates; (iv) its regulatory status in each such jurisdiction; and (v) the regulator or agency that oversees its activities in each such jurisdiction.*

13. It is noted that one of the markets in **Appendix A**, the Taipei Exchange, is proposed to be added to reflect the name change from the currently prescribed “GreTai Securities Market”. This illustrates the fact that maintaining the lists of prescribed markets and clearing houses, as we currently do, is not ideal as updates are needed from time to time in light of name changes, group or business restructuring, market development, etc.
14. The industry association also suggested excluding “futures contracts” from the definition of “OTC derivative product” to deal with exchange traded derivatives. However, this approach may not work as the definition of “futures contracts” in the SFO is linked to “futures market” which may potentially include certain type of trading platforms for OTC derivatives.

15. For the time being, we will continue with maintaining a list of markets and clearing houses to exclude overseas exchange traded derivatives from the definition of “OTC derivative product”. However, we will also look into alternative approaches, including (if necessary) recasting section 1B(2)(c) of Part 1 of Schedule 1 to the SFO. In any case, any change in approach will require consultation and may also involve amending primary legislation. It is therefore unlikely to be implemented in the near future.

PRESCRIPTION OF DELTA ONE WARRANTS

16. Section 392(1) of the SFO empowers the Financial Secretary to prescribe products so that they are specifically included in or excluded from the definition of “OTC derivative product”. This provision aims to ensure that there is a degree of flexibility to refine the ambit of “OTC derivative product” as appropriate. The section 392(1) power is intended to be used sparingly and in exceptional cases.
17. We have received a request from an industry association for Delta One Warrants to be specifically excluded from the definition of “OTC derivative product” by being prescribed pursuant to section 392(1)(b)(vii) of the SFO. In making this request, the industry association has provided suggested wording to describe Delta One Warrants as access products in the form of zero-strike or close to zero-strike call warrants and linked to any underlying asset(s). It has also noted the following:
 - (a) Delta One Warrants are call warrants that have a strike price that is set at zero or very close to zero and can be American style or European style. Its delta (option) value is normally 1 since the option is deep in the money at the time of issuance and remains that way unless the price of the underlying drops to near zero.
 - (b) Delta One Warrants are typically issued at a price which largely reflects the market price or level of the underlying asset(s) and the cost of carry. In other words, they are largely economically equivalent to the holder buying, or otherwise investing in, the underlying asset(s) (which might be stocks, a basket of stocks or an index) as the risk and reward profiles do not differ fundamentally.
 - (c) On exercising or reselling the warrant, the holder receives a settlement amount which is calculated by reference to, and largely reflects, the prevailing market price or level of the underlying asset (less certain costs to the issuer of the warrant).
 - (d) Such warrants simply replicate price fluctuations in the underlying asset(s) until the exercise date, and enable clients to gain synthetic exposure to assets in closed or difficult-to-access markets.
 - (e) Such warrants are not typically viewed as OTC derivatives by the industry, nor regarded as such under the laws of major jurisdictions such as the European Markets Infrastructure Regulation (**EMIR**) of the European Union.

18. We agree that Delta One Warrants are rather distinct from other OTC derivative products in that they do not contain features commonly associated with OTC derivatives. In particular –
- (a) A Delta One Warrant is fully funded and therefore the counterparty risk involved is simpler than most OTC derivatives. The holder of a Delta One Warrant is exposed to the credit risk of the warrant issuer in respect of the return on the warrant. On the other hand, the issuer is not exposed to the credit risk of the warrant holder since the latter has already paid the warrant price in full and will be under no further obligation to the issuer.
 - (b) As the strike price of a Delta One Warrant is zero or close to zero, the holder of the Delta One Warrant has effectively paid for the warrant's underlying asset(s) in full upfront. The warrant issuer is therefore not providing any leverage to the holder. In contrast, most OTC derivatives typically involve some leverage exposure.
 - (c) Investing in a Delta One Warrant is very similar in nature to investing in the warrant's underlying asset(s) during its lifetime, except that: (i) there is no need to be concerned about the clearing and settlement of the underlying asset(s); and (ii) the holder of the warrant does not have the same rights as the holder of the underlying asset(s) in so far as it is not the owner of the underlying asset(s).
 - (d) As mentioned above, Delta One Warrants themselves are not leveraged. Even if margin financing is arranged for a holder of these warrants, there are other existing regulations (extraneous to the OTC derivatives regulatory regime) that govern the monitoring of risks associated with such margin financing.
19. As a result of the above, we consider that Delta One Warrants do not pose systemic risk in the way that other OTC derivative products might. We note also that retaining these products within the ambit of "OTC derivative product" may unnecessarily hinder market development and create compliance burdens. For these reasons, we propose that they be prescribed under section 392(1)(b)(vii) of the SFO, and thus excluded from the definition of "OTC derivative product".
20. The precise language for describing Delta One Warrants will be subject to the drafting practice and approach adopted by the Department of Justice. However, our intention is that the language should be such as to embody any warrant that has the following features:
- (a) it gives the holder the right to purchase the underlying asset(s);
 - (b) its strike price is set as zero or close to zero;
 - (c) its underlying subject matter (as defined in section 101A of the SFO) may be anything;
 - (d) it is transferrable, and there is no restriction or limitation to the effect that the warrant can only be transferred or sold to the issuer; and

- (e) it is documented in the form of a warrant and not concluded by a confirmation made under an ISDA master agreement.
21. For completeness we note that we have considered whether all warrants, as a class, should be excluded from the definition of OTC derivative product. However, we do not believe this is appropriate as this might inadvertently provide a loophole for bilaterally negotiated OTC options to avoid the OTC derivatives regulatory regime by documenting in the form of warrants.

Q3: *Do you have any concerns or comments on the proposal to exclude Delta One Warrants, and how they should be described?*

WAY FORWARD

22. The proposals in this paper have been developed in response to market concerns and requests. We believe our proposals strike the right balance between ensuring a robust regime and addressing market concerns, but as always, we welcome market views on where the proposals may be insufficient or result in unintended consequences.
23. In view of the commencement of Phase 2 Reporting on 1 July 2017, we are minded to conclude this consultation and finalize our proposals before the end of June so that market participants will be aware of our regulatory intent prior to the commencement of Phase 2 Reporting. Drafting of the necessary legislative amendments can then begin as soon as possible thereafter, so as to initiate the legislative process after the next legislative session commences in October 2017. It follows therefore that it will not in any event be possible for the changes discussed in this paper to take effect before the scheduled commencement of Phase 2 Reporting on 1 July 2017. In view of this, market participants who envisage difficulty in complying with their Phase 2 Reporting obligations prior to any such changes taking effect, should contact their respective regulator as soon as possible.

APPENDIX A – LIST OF PROPOSED ADDITIONAL MARKETS AND CLEARING HOUSES TO BE PRESCRIBED

Proposed additional list of stock and futures markets

For the purposes of the definition of “OTC derivative product” under the SFO, we propose that all markets operated by the following entities be prescribed under section 392A of the SFO, except that where specific markets are identified below, we propose that only the specific markets identified below be prescribed.

	<u>Market operator</u>	<u>Market proposed to prescribed</u>
1.	Hanoi Stock Exchange	
2.	HoChiMinh Stock Exchange	
3.	Miami International Securities Exchange, LLC	
4.	Pakistan Stock Exchange	
5.	Taipei Exchange*	
6.	Taiwan Stock Exchange Corporation	
7.	The Irish Stock Exchange Plc	Main Securities Market

* “Taipei Exchange” is intended to replace the currently prescribed “GreTai Securities Market”, which is the former name of Taipei Exchange.

Proposed additional list of clearing houses

For the purposes of the definition of “OTC derivative product” under the SFO, we propose that the additional clearing houses also be prescribed under section 392A of the SFO.

1.	Clearstream Banking, S.A.
2.	Euroclear Bank S.A./N.V.
3.	National Clearing Company of Pakistan Limited
4.	Taiwan Stock Exchange Corporation
5.	Vietnam Securities Depository