

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

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HONG KONG MONETARY AUTHORITY
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**SECURITIES AND
FUTURES COMMISSION**
證券及期貨事務監察委員會

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INTRODUCTION

1. In April 2017, the Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC**) issued a joint consultation paper (**Consultation Paper**) proposing two adjustments to the scope of the term “OTC derivative product”, both in response to requests from market participants via the International Swaps and Derivatives Association, Inc (**ISDA**).
2. The proposed adjustments were as follows:
 - (a) to expand the list of markets and clearing houses prescribed under section 392A of the Securities and Futures Ordinance (**SFO**) to include those set out in Appendix A to the Consultation Paper; and
 - (b) to exclude Delta One Warrants from the definition of “OTC derivative product” pursuant to section 392(1)(b)(vii) of the SFO.
3. The deadline for submitting comments was 26 May 2017. We received written submissions from four respondents, including one from ISDA. A list of the respondents is set out at [Appendix A](#) and the full text of their comments can be viewed on the websites of the [HKMA](#) and the [SFC](#).
4. This Conclusions Paper summarises the comments received, our responses to them, and our conclusions. It should be read together with the Consultation Paper and the comments received.
5. We take this opportunity to thank everyone who took time and effort to submit comments. Your feedback has assisted in finalising these proposals.

PRESCRIPTION OF ADDITIONAL MARKETS AND CLEARING HOUSES

6. The specific markets and clearing houses proposed to be added were set out in Appendix A to the Consultation Paper. Respondents were generally supportive of this proposal. No concerns or adverse comments were raised. We will therefore proceed with initiating the process for expanding the list of markets and clearing houses accordingly.

PRESCRIPTION OF DELTA ONE WARRANTS

7. The Consultation Paper proposed to exclude Delta One Warrants from the definition of “OTC derivative product”. It also noted that while the definition of Delta One Warrants will be subject to the drafting practice and approach of the Department of Justice (**DoJ**), the intention was for the language to embody any warrant with 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 transferable, and there is no restriction or limitation to the effect that the warrant can only be transferred or sold to the issuer;
 - (e) it is documented in the form of a warrant and not concluded by a confirmation made under an ISDA master agreement.
8. We received a number of comments on the proposal to exclude Delta One Warrants, and the specific features for defining them. These are discussed below.

Gives holder the right to purchase the underlying asset(s)

9. One respondent noted that Delta One Warrants may be either call warrants or put warrants, and that the definition should not therefore be limited to call warrants only. The respondent further elaborated that these fully funded put warrants are equivalent to the holder selling the underlying but there is typically an early termination event before the underlying reaches two times the initial price to avoid the holder being out-of-money. As the holder of the put warrant has his downside risk capped under the structure, we do not agree that these put warrants are similar in nature as shorting the warrant's underlying asset during its lifetime. As a result, we do not propose to include put warrants in the definition.
10. Three respondents raised concerns that the requirement to give a "right to purchase the underlying" may imply the need for physical settlement. They noted that most Delta One Warrants are typically cash settled, and that physical settlement may in many cases not be possible – e.g. where the warrant is issued over an underlying asset in a closed market. One respondent suggested using the term "synthetic exposure" in the drafting as a possible solution. Although it was not our intention to imply the need for physical settlement, we do not believe it is appropriate to use the term "synthetic exposure" without defining it. We will work with DoJ to see how best to include a cash settlement feature to ensure there is no implication of physical settlement.
11. Two respondents requested that the definition expressly mention that the settlement currency of the warrant may be different from the currency of the underlying asset. We have no objection to doing this. However, as Delta One Warrants are essentially intended to be economically equivalent to holding the underlying asset, we would expect any settlement in a different currency to be at the then prevailing exchange rate for the currencies involved. Appropriate qualifications will therefore have to be included to make this clear as well.

Strike price is set as zero or near zero

12. One respondent noted that a Delta One Warrant may not always specify a zero strike price. They noted that the “Cash Settlement Amount” may simply be defined as “the Settlement Price” (less commission and/or fees), and that this is in effect the same as saying the Cash Settlement Amount is equal to the Settlement Price minus a strike price that is zero. We agree. We will work with DoJ to expand the description of the feature on zero strike price to provide for this.

Description of underlying subject matter

13. We received general support for the underlying subject matter to be anything. One respondent requested that the definition clarify that Delta One Warrants may be linked to a single underlying asset or a basket of underlying assets. We do not believe this is necessary if the definition refers to “underlying subject matter” (as defined in section 101A of the SFO). This is because the latter already embodies the concept of combinations and baskets. We will nevertheless keep this concern in mind when working with DoJ on the drafting so as to ensure there is no doubt or ambiguity on the matter.

No restriction on transfer

14. Two respondents noted that while Delta One Warrants are generally transferable securities, there may still be certain restrictions. For example, there may be restrictions on the offer, sale and delivery of warrants to domestic investors in certain closed or difficult-to-access markets or on the distribution of offer materials in certain jurisdictions. Warrant issuers may therefore include contractual restrictions such as requiring the issuers’ prior consent or subject to certain restrictions on the nationality of the prospective transferee. This allows them to complete appropriate know-your-client and/or anti-money laundering checks on the potential transferee.
15. We note the concerns raised and agree that some restrictions on transfer may be unavoidable as a result of applicable legal and regulatory restrictions. We will incorporate appropriate qualifications so that restrictions introduced by necessity so as to comply with legal and regulatory requirements are permitted.

Documented in the form of a warrant

16. One respondent queried whether it may be more appropriate for this feature to refer to “security” rather than “warrant”. We disagree. The term “security” is too general. The intention of this feature is to ensure that the products are in fact “warrants” and documented as such. It does not suffice therefore to require that the product be documented as a “security”.

Others

17. One respondent noted that Delta One Warrants are not issued only for the purposes of gaining synthetic exposure to assets in closed or difficult-to-access markets. They may be issued over underlying assets in open markets as well. We clarify that there is no limit in the definition of Delta One Warrants by reference to the rationale for their issue. The features discussed above also do not impose any such restriction. We will nevertheless keep this concern in view when working with DoJ on the precise language of the definition.
18. One respondent requested industry guidance from the HKMA to ensure that all banks receive consistent information on the expectations of the HKMA during the interim between commencement of phase 2 of mandatory reporting and implementation of the legislative amendments to exclude Delta One Warrants from the scope of “OTC derivative product”. We appreciate the concern raised and will work closely with the industry, including relevant industry bodies, in this regard. As mentioned in the Consultation Paper, market participants who envisage difficulty in complying with their reporting obligations under phase 2 should contact their respective regulator as soon as possible. This will also help regulators better assess whether and when to issue any additional guidance or circulars, and what these should cover.

WAY FORWARD

19. The above proposals will require amendments to subsidiary legislation.¹ The next step therefore will be for the HKMA and SFC to work with DoJ on the drafting of the relevant amendments.
20. A key aspect of the drafting work will be the definition of Delta One Warrant. We note that some respondents provided suggested wording in this regard, and this will be taken into account when working with DoJ. Additionally, since we have already consulted on the concept of excluding Delta One Warrants, and on the features that should be included when defining such products, we will not be exposing a draft of the definition for further public consultation. However, interested parties are welcome to contact us at any time if they wish to have an opportunity to comment on the draft when ready.
21. The proposed prescription to exclude Delta One Warrants is in response to market request. **We understand Delta One Warrants are mostly used for accessing equities, commodities, funds, debts and their related underlying assets and not for accessing pure currencies or interest rates.** In order to deal with risk of new types of Delta One Warrants which have not

¹ Specifically:

- the proposal to expand the list of markets and clearing houses prescribed under section 392A of the SFO will require amendments to the Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice; and
- the proposal to exclude Delta One Warrants from the definition of “OTC derivative product” pursuant to section 392(1)(b)(vii) of the SFO will likely require the making of new subsidiary legislation.

been anticipated, we will monitor market development closely and revisit the prescription as necessary.

22. The precise time-table for implementing the two proposals discussed above will depend on completion of the relevant legislative drafting work, and thereafter, the Legislative Council's negative vetting process. The HKMA and SFC will endeavour to initiate the process as quickly as possible. However, in light of the Legislative Council's summer recess, it may be that implementation is not possible till Q4 of 2017.
23. The regulatory intention is to exclude the following products from the definition of "OTC derivative product":
 - (a) products traded on and cleared through the list of new markets and clearing houses set out in Appendix A to the Consultation Paper; and
 - (b) Delta One Warrants which meet the features discussed above.
24. As a result, these products will not be reportable under the mandatory reporting regime. In the meantime before the new subsidiary legislation comes into effect, the HKMA and SFC will adopt a pragmatic approach in dealing with non-reporting of these products. We will continue to maintain close dialogue with the market as the next phase of implementation approaches.

APPENDIX A – List of Respondents

(in alphabetical order)

1. Bank of Communication Co Ltd, Hong Kong Branch
2. DTC Association, The
3. Hong Kong Association of Banks, The
4. International Swaps and Derivatives Association, Inc.