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Re: Joint Consultation Paper on enhancements to the OTC derivatives regime for Hong Kong

Dear Sirs, Mesdames

The Global Foreign Exchange Division ('GFXD') of the Global Financial Markets Association ('GFMA') welcomes the opportunity to provide comments to the HKMA and SFC ('the Agencies') on their joint consultation paper on enhancements to the OTC derivatives regime, ('the Consultation Paper'), published on 27 March 2018.

The GFXD was formed in co-operation with the Association for Financial Markets in Europe ('AFME'), the Securities Industry and Financial Markets Association ('SIFMA') and the Asia Securities Industry and Financial Markets Association ('ASIFMA'). Its members comprise 25

global FX market participants,¹ collectively representing over 80% of the FX inter-dealer market.²

Executive Summary

We are supportive of the approach outlined in the consultation paper, in particular the decision not to alter the definition of a Prescribed Person or Financial Services Provider for the clearing Phase 2, and that relevant developments introduced in other jurisdictions have been taken into account. Cross-border markets cannot operate in conflicting regulatory landscapes making it important that the definition of counterparties caught by the clearing obligation in different jurisdictions is as consistent as possible to avoid market fragmentation.

The GFXD's members recognise the benefits to be achieved from the use of LEIs in OTC trade reporting and worked extensively with their clients to ensure there was a minimum of disruption to the ability to trade with the recent Markets in Financial Instruments Directive ('MiFID II') implementation in Europe. However, issues were experienced with smaller clients, in particular those that would be categorised under Paragraph 28(f), highlighting the consequences of implementing jurisdiction specific regulation in international financial markets. We would recommend that the Agencies liaise with regional regulators to coordinate the roll out of this requirement.

There is concern over the potential impact of the 'No LEI, no trade' policy and the lack of transparency of the constituency of some of the categories of market participants for Phase 1, and our members have requested further clarity.

We would recommend that LEIs are only required for new trades and life-cycle events of trades entered into after the implementation dates due to the current design of the HKTR. The process to replace a counterparty identifier with an LEI for a legacy transaction could result in the cancellation of an existing position and its recreation via the lifecycle event, a process which is manually intensive and carries a degree of operational risk.

¹ Bank of America Merrill Lynch, Bank of New York Mellon, Barclays, BNP Paribas, Citi, Credit Agricole, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Lloyds, Mizuho, Morgan Stanley, MUFG Bank, NatWest Markets, Nomura, RBC, Scotiabank, Société Générale, Standard Chartered Bank, State Street, UBS, Wells Fargo and Westpac.

² According to Euromoney league tables.

We support the proposal not to include FX transactions in Phase 2 Clearing thereby continuing the global coordination of clearing mandates. We emphasise that, whilst clearing is designed to mitigate counterparty credit risk, the predominant risk associated with FX transactions is settlement risk.

As the Agencies consider the trading obligation for Hong Kong, we emphasise the importance of alignment with the trading obligation regimes in other jurisdictions. It is essential that jurisdictions introducing OTC derivatives reforms seek to address any conflicts and overlaps by introducing rules that clearly provide for a mechanism of substituted compliance, mutual recognition or equivalence. For a mandatory trading obligation, this approach is particularly important to avoid regulatory disparity, which can lead to market fragmentation, low trading liquidity, regulatory arbitrage, duplicative compliance requirements and ultimately increased risk.

Q1: Do you have any comments or concerns about how we propose to mandate the use of LEIs in OTC derivatives trade reporting? Where appropriate, please separate your comments and concerns for the two phases and the treatment of trades that have already been reported to the HKTR.

The GFXD fully supports the proposal to mandate the use of LEIs in OTC derivatives trade reporting in line with other FSB jurisdictions. This reinforces the position taken in our joint letter to regional regulatory authorities dated 30 August 2017 on the 'Implementation of an APAC Unique Transaction Identifier'³. We also endorse the staggered implementation approach that differentiates the small sized entities that may not be subject to any reporting obligations.

We are encouraged by the fact that, as of February 2018, approximately 90% of outstanding transactions reported by the HKTR can either be mapped to an LEI or were reported with an LEI and that these transactions can be linked to the entities listed in Paragraph 28 under groups (a) to (e).

However, our members have expressed concerns regarding the requirement to report the LEI of 'other entities that are transacting parties' (Paragraph 28(f)) given the dependency that will rest on LEIs being mandated in other jurisdictions. We note that there are a number of jurisdictions that have implemented a trade reporting regime but have not mandated the use

³ <http://www.gfma.org/correspondence/item.aspx?id=940>

of an LEI, and there are other jurisdictions that have not yet implemented a mandatory trade reporting obligation. Experience, based on the MiFID II implementation, has shown that this category of market participant is particularly disinclined to voluntarily register for an LEI. Consequently, we would strongly recommend that the Agencies engage with other regulators, particularly in the Asia Pacific region, to coordinate a similar requirement in other jurisdictions.

In addition, there is concern over the lack of transparency of the constituency of each group, in particular the identity of the 'providers of clearing services' in group (e). This lack of transparency will add an operational burden that will require reporting entities to check the status of each client they trade with prior to submitting a transaction report. This check will be required on an ongoing basis given that the status of a client may change over time.

Therefore, our members request that, until the implementation of Phase 2 in January 2020, the Agencies maintain a list that clearly identifies which entities are in groups (a) and (e) and thus belong to Phase 1. In the event that the Agencies do not wish to maintain such a list, our members request that the Agencies allow reporting parties to rely (in good faith) on appropriate representations, self-certification or any other information as may be provided by their clients to determine if they are required to have an LEI for Phase 1.

Further, our members seek clarification that the CCPs referenced in group (d) are those included in the list of prescribed clearing houses as of 10 July 2015 included as Annex 2 of the Frequently Asked Questions on the Securities and Futures (OTC Derivative Transactions Reporting and Record Keeping Obligations) Rules issued on 6 October 2017 ('the FAQs').

We note the FSB's recommendations calling for the removal of reporting barriers by June 2018 and masking relief by December 2018, but that the Agencies will review the continued appropriateness of the masking relief at a future date. However, we seek confirmation that, should the Phase 1 implementation date precede the FSB's recommended date for the removal of masking relief, transactions which are eligible for the masking relief provided under the list of jurisdictions for the purposes of masking relief in Annex 3 of the FAQs will not require the LEI of a counterparty and that such transactions can continue to be reported with an internal code.

The Consultation Paper introduces, with the implementation of Phase 2, the concept of the 'No LEI, No Trade' policy adopted in Europe under MiFID II. Our members request clarification on whether the No LEI, No Trade requirement applies to Phase 1 entities after the effective date of the Phase 1 implementation or if it only applies after the effective date of Phase 2 implementation.

We would also request the Agencies to provide relief to reporting parties where an entity has changed its LEI but has failed to notify the reporting party of this change.

Q2: Will you have any difficulties adopting the use of LEIs in OTC derivatives trade reporting according to the proposed timelines? If so, please provide details of your difficulties.

While the proposed timeline should be achievable for GFXD members (given existing LEI requirements in other major jurisdictions), we note that this may not be the case for all market participants, particularly local corporates and those that are not engaged in cross-border business. We suggest that the HKMA and SFC may need to conduct significant outreach to local institutions and end-users in the lead up to the requirement in order to ensure that it is fully understood.

Furthermore, we note that there may be scenarios in which further guidance may be required, in order to prevent disruption to end-users, for example where an underlying fund has yet to obtain a LEI, could the LEI of the fund manager be used as an interim identifier?

The GFXD supports the use of LEIs only in the reporting of new trades and life-cycle events that take place on or after the implementation dates. Due to the current design of the HKTR, the process to replace a counterparty identifier by an LEI for a legacy transaction in its life-cycle event reporting may require the cancellation of an existing position and reporting the life-cycle event as a backloaded transaction. This process is manually intensive and carries a degree of operational risk. Given this operational complexity, if one reporting party to the life-cycle event delays its reporting it will result in an unlinked and unmatched transaction report. Based on these concerns, we propose that inclusion of the LEI should not be mandatory when reporting life-cycle events of legacy trades.

Q3: Do you have any comments or concerns about our proposal to include the full range of IRS denominated in AUD under Phase 2 Clearing, i.e., fixed-to-floating swap, basis swap and OIS? If you do, please provide specific details.

The GFXD and its members support the proposal to include IRS denominated in AUD under the Phase 2 Clearing. We would appreciate confirmation of the expected timeline for Phase 2 Clearing.

Q4: Do you have any comments or concerns about our proposal not to introduce new products for Phase 2 Clearing other than IRS denominated in AUD? If so, please provide specific details.

For the same reasons as set forth in our letter to the Agencies⁴ in response to the September 2015 Consultation Paper on introducing mandatory clearing and expanding mandatory reporting, we concur with the proposal not to introduce new products for Phase 2 Clearing other than IRS denominated in AUD and, in particular, support not including FX within scope of clearing mandates being considered by the Agencies at this time.

In addition, we support the actions taken by the Agencies in the interest of global harmonisation by taking into account whether products have been mandated for clearing in other jurisdictions when determining what is appropriate for a clearing mandate.

Q5: Do you have any comments or concerns about our proposal to maintain the current scope of Prescribed Person? If you do, please provide specific

We agree with the HKMA's proposal to maintain the current scope of Prescribed Person.

Q6: Do you have any comments or concerns about our proposal to maintain the FSP criteria? If you do, please provide specific details.

The GFXD has no comments in response to this question.

Q7: Do you have any comments or concerns on our proposed revised FSP list? If you do, please provide specific details.

The GFXD emphasises the importance of ensuring that the international regulatory regime applied to the clearing obligation is consistent. Cross-border markets cannot operate in conflicting regulatory landscapes and the natural outcome, should this be the case, is unwanted fragmentation. Therefore, it is important that the definition of counterparties caught by the clearing obligation in different jurisdictions is as consistent as possible to avoid market fragmentation.

Given the very high coverage of IRS transactions reported to the HKTR based on the current FSP criteria, we support the decision of the Agencies to maintain these criteria. Furthermore, should the Agencies choose to expand the criteria at some date in the future, we strongly recommend that this does not extend the extraterritorial reach of the Hong Kong clearing mandate to include entities that are not required to clear in their home country. The

⁴ <http://www.gfma.org/correspondence/item.aspx?id=736>

consequence of such an action will lead to a bifurcation of the market resulting in reduced liquidity and an increase in transaction costs.

Q8: Do you have any comments or concerns about our approach to annually updating the FSP list and the exit mechanism from the FSP list? If you do, please provide specific details.

We refer to our response to Q7.

Q9: Do you have any comments or concerns regarding our proposal to maintain the Clearing Threshold and the calculation method of outstanding positions to be measured against the threshold? If you do, please provide specific details.

The GFXD has no comments in response to this question.

Q10: Do you have any comments or concerns regarding our proposal to maintain the current frequency of two Calculation Periods in a year and the length of three consecutive calendar months for each Calculation Period?

The GFXD has no comments in response to this question.

Q11: Do you have any comments or concerns regarding our proposal to add the eight additional Calculation Periods? If you do, please provide specific details.

The GFXD has no comments in response to this question.

Q12: Do you have any comments or concerns regarding our proposed trading determination process and criteria? If you do, please provide specific details.

The GFXD and its members are generally supportive of the proposed trading determination process and criteria. However, we would highlight the following issues for consideration -

As the Agencies determine the criteria for a trading obligation for Hong Kong, it is essential that jurisdictions introducing OTC derivatives reforms seek to address any conflicts and overlaps by introducing rules that clearly provide for a mechanism of substituted compliance, mutual recognition or equivalence. For a mandatory trading obligation, this approach is particularly important to avoid regulatory disparity, which can lead to market fragmentation, low trading liquidity, regulatory arbitrage, duplicative compliance requirements and ultimately increased risk.

Consequently, we emphasise the importance of alignment with the trading obligation regimes in other jurisdictions. The recent US-EU mutual recognition of derivatives trading venues put in place prior to the go-live date of MiFID II provides an excellent reference point.

As the Agencies seek to make substituted compliance, mutual recognition or equivalence determinations, they should do so using an outcomes-based approach instead of rule-by-rule analyses, consistent with the above-mentioned US-EU mutual recognition of derivatives trading venues.

Whilst recommending that the Agencies should consider the OTC derivative regimes in existence in other jurisdictions, there will be a need to take into account possible changes to the regimes in the US as the Commodity Futures Trading Commission (“CFTC”) undertakes a review of its rules and regulations under Project KISS, in Europe as the European Commission considers the updates to the European Market Infrastructure Regulation (“EMIR”) in the EMIR review process, and in the UK as it considers its regulatory framework post Brexit.

Prior to the commencement of the trading mandate, it is important that operators of OTC derivatives trading facilities which are likely to be used by market participants in Hong Kong are approved or recognised. Consideration should be given to how this approval/recognition process will operate as it will be necessary to ensure that there are sufficient venues for participants to satisfy the trading obligation.

We also recommend that consideration be given to where trades are booked rather than where they are traded. A trading obligation mandated on products that are “traded in” Hong Kong is likely to present significant challenges in implementation efforts as pre-trade checks will have to be conducted to determine if the transaction is subject to the trading obligation impacting the benefits of transparency as well as the speed and cost of execution.

It is important that market participants have the chance to comment on the details of the trading obligation regime in Hong Kong to make sure that it can be smoothly implemented. Therefore, we welcome the opportunity to provide feedback on the feasibility, scope and timing for implementing a platform trading obligation in Hong Kong.

We appreciate you giving us the opportunity to share our views. Please do not hesitate to contact should you wish to discuss the above.

Yours sincerely,

Managing Director
Global Foreign Exchange Division, GFMA