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Ladies and Gentlemen

Consultation response on HKMA & SFC Joint Consultation on Enhancements to the Over-the-Counter (OTC) Derivatives Regime for Hong Kong

Thank you for the opportunity to provide comments in response to the joint consultation paper on enhancements to the OTC derivatives regime for Hong Kong to (1) mandate the use of Legal Entity Identifiers for the reporting obligation, (2) expand the clearing obligation and (3) adopt a trading determination process for introducing a platform trading obligation (“**Consultation Paper**”).

The Hong Kong Association of Banks is pleased to provide its comments and queries, as enclosed.

For any enquiries, please do not hesitate to contact

Yours faithfully

Secretary

Enc.

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Vice Chairman Standard Chartered Bank (Hong Kong) Limited
Bank of China (Hong Kong) Limited
Secretary

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秘書

HKAB response to the HKMA and SFC Joint Consultation on Enhancements to the OTC Derivatives Regime for Hong Kong

27 April 2018

Introduction

This paper sets out the views of The Hong Kong Association of Banks (“HKAB”) in relation to the Joint consultation paper on enhancements to the OTC derivatives regime for Hong Kong to – (1) mandate the use of Legal Entity Identifiers (“LEI”) for the reporting obligation, (2) expand the clearing obligation and (3) adopt a trading determination process for introducing a platform trading obligation (“Consultation Paper”).

Assisted by King & Wood Mallesons, HKAB has examined the proposals set out in the Consultation Paper dated March 2018, issued by the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”). Our 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 Consultation Paper.

Executive summary

On the whole, HKAB supports the intent of the Consultation Paper and relevant proposals. In particular, we support the proposal to mandate the use of LEIs in OTC derivatives trade reporting. We agree that this would benefit the market and simplify operational aspects of identifying counterparties. It will also enhance Hong Kong’s position as an international participant, contributing to the standardisation of data reporting requirements on a global scale.

We have some recommendations to ensure that the proposals are ultimately practicable, relating to:

- (a) the implementation of mandatory LEIs and the integration of various identity-related initiatives – see paragraphs 1 and 2;
- (b) clarity on AUD IRS clearing channels and timing – see paragraph 3;
- (c) calculation periods – see paragraph 5; and
- (d) mandatory trading criteria and implementation – see paragraph 6.

Further details are set out in the “HKAB’s response” section below.

Please let us know if you have any questions.

HKAB’s response

1 Mandating the use of LEIs in OTC derivatives trade reporting

- 1.1 HKAB generally supports the provisions contained in the Consultation Paper. Nonetheless, we have highlighted some key suggestions which we believe will assist

in creating a realistically workable regime with regard to the mandatory use of LEIs in OTC derivatives trade reporting.

1.2 **Staging of mandatory LEIs based on jurisdictional considerations** – HKAB requests the HKMA and SFC to consider implementing mandatory LEIs on a further staged basis to differentiate between entities that already have an LEI in other jurisdictions and those who do not. This staged approach could be applied to the first tranche of entities that are proposed to be subject to the LEI requirement in the Consultation Paper, as well as the second. This is important to reflect:

- (a) essential updates to customer / counterparty onboarding arrangements; and
- (b) the fact that small market participants, including small and medium sized enterprises (“SMEs”), who do not have LEIs, may struggle to meet these requirements within a short time frame, particularly where they have no offshore obligations; and
- (c) the need to remain competitive internationally – if enough time is provided, this could reduce the risk that SMEs and others turn to other, less stringent jurisdictions.

Based on high level internal analysis conducted by certain HKAB members, it has been found that less than half of the existing transacting parties across the region have LEIs.

Specifically, HKAB:

- (i) recommends that the staging be split into:
 - (A) Hong Kong incorporated entities and entities incorporated in the European Union, United States and India, where local regulation requires LEI for in-scope trades; and
 - (B) transacting entities incorporated in locations other than those listed in (A); and
- (ii) expects that entities with no existing offshore LEI obligations would need approximately 6 months *longer* than other entities. We ask this be reflected in each tranche of the staged approach.

1.3 **Verification of counterparties’ LEI status** – With regards to the LEI annual renewal process, HKAB requests that the HKMA and SFC make clear whether reporting entities can rely on the information provided by counterparties without personally ensuring counterparties’ LEIs have been renewed annually.

1.4 **Optional LEIs in the case of life-cycle event reporting** – HKAB strongly urges the HKMA and SFC to ensure that LEIs are not mandatory for reporting life-cycle events of legacy trades. Under the current HKTR design, the process to replace a counterparty identifier by LEI in such case may require withdrawing an existing position and back loading the transaction, which is operationally difficult and requires manual process. Due to such operational difficulty, if a party to the legacy transaction delays in such life-cycle event reporting, because of the requirement to use LEI, an unlinked and unmatched reporting outcome will arise. To prevent such unintended consequence – that is, the legacy transaction which was previously matched becoming unmatched due to the new life-cycle event reporting with LEI requirement – we suggest ensuring that LEIs are not applicable to life-cycle event reporting.

For new trades, it is possible to impose controls in banks’ systems to prevent entering into new trades with clients without LEI. However, for existing trades, if the client wants

to unwind for example, from the contractual terms perspective, we believe that it is not appropriate for banks to refuse to unwind due to the lack of LEI on the client side.

- 1.5 **Scope of entities** – HKAB requests clarification on the broad description in paragraph 4 of the Consultation Paper which states that the HKMA and SFC “propose to mandate the use of LEIs in OTC derivatives trade reporting so that all entities contained in a transaction report to be submitted to the HKTR would eventually be identified by their LEIs”. We understand that this is only intended to refer to the entities listed in paragraph 28(a) to (f) themselves, rather than, say, parent companies.

Moreover, we also request clarification on how banks are expected to implement LEI to various groups in trade reporting. For example, for group (e), whether there is a manner in which banks should be able to determine if their trading counterparty is someone providing clearing services. It would add operational burden for financial institutions to check the status of each client they trade with and such status may change from time to time, consequently, requiring additional monitoring. Further guidance on determining which entities fall within which of sub-groups (a) to (e) would help achieve unified implementation in the market.

- 1.6 **Eligibility of natural persons to obtain LEIs** – HKAB requests that the HKMA and SFC confirm whether “natural persons” would be eligible to obtain and report LEIs under the trade reporting regime, even though it may not be mandatory for them to do so. If this is the case, then we request that the HKMA and SFC confirm the specific conditions that will be taken into account. In this respect, we note that although the position in respect of “natural persons” is set out at paragraphs 24 and 36 of the Consultation Paper, in paragraph 24 we note the caveat that under some conditions certain individuals acting in a business capacity are eligible to obtain LEIs.

- 1.7 **Including the concept of LEI into legislation** – Certain HKAB members suggested that compliance with the new requirements could be easier if the requirements in the Consultation Paper are given statutory effect. Without this, certain clients may resist subscribing for LEIs (with associated costs), for banks’ reporting purposes only. If this is not possible, we strongly recommend that the HKMA and SFC publish a clear fact sheet that can be provided to clients.

- 1.8 **Masking relief** – HKAB requests HKMA and SFC to confirm that in respect of transactions which are eligible for the masking relief provided under the relevant list of jurisdictions, in the FAQ published on 6 October 2017, banks do not need to report the LEI of the counterparty and can continue to report with internal codes (even after the LEI implementation date). We understand that this is the intent of paragraph 37 of the Consultation Paper, subject to later consideration.

- 1.9 **Collaboration with other regulators** – We suggest that the HKMA and SFC consider discussing with other key regulators in the APAC region (such as the Australian Securities and Investment Commission and the Monetary Authority of Singapore) to harmonise the implementation approach as well as the requirements and the implementation timeline of mandatory LEIs.

- 1.10 **Explanations published to all parties for clarity** – Aligned with our comments in paragraph 1.7, and similar to the implementation of the common reporting standard or Foreign Account Tax Compliance Act in the United States, we request that the HKMA and SFC provide a detailed background and instructions to all parties in order to:

- (a) explain the purpose of the LEI;
- (b) instruct all parties how to subscribe for an LEI and comply with updating requirements;

- (c) make timelines and stages clear;
- (d) describe how any expired LEIs will be dealt with; and
- (e) explain the consequences or limitations of not subscribing LEI.

We believe that this will be more effective and efficient for market participants, ensuring the reports are made in a timely manner.

1.11 **Effective date of implementation** – In relation to paragraph 38, HKAB requests that the HKMA and SFC clarify whether the:

- (a) “no LEI no trade” requirement will only apply after the effective date of phase 2 implementation (expected to be January 2020); **or**
- (b) “no LEI no trade” will apply to phase 1 entities after the effective date of phase 1 implementation and extend to phase 2 entities after the effective date of phase 2 implementation.

2 **Additional comments on the use of LEIs**

2.1 HKAB members also raised some practical implementation considerations for your awareness. On this basis, we also ask for an extension of the implementation period to 18 months at the earliest.

2.2 **Overall market familiarity** - LEI readiness in Asia is not directly referable to LEI readiness in the European Union or in other jurisdictions. On the contrary, our members’ experience has been that Asian OTC derivatives counterparties are not necessarily as familiar with this requirement (whether from a lack of press, different jurisdictional touchpoints or otherwise) and may therefore be less immediately willing to comply. Additional time would assist in ensuring an appropriate layering of information from regulators as well as from the banks themselves, plus enough time for compliance.

2.3 **Internal systems update and post-trade rectifications** – LEIs can be very difficult to implement where there is a lack of LEI information built into existing bank systems. This is because there needs to be a systematic control to block the trade. Currently, for some members, in-scope trades are reported on a real-time basis; should a trade be erroneously booked without the LEI information, the monitoring control process will pick this up *after* a trade is reported. As a result, HKAB strongly suggests that there be enough time for implementing new procedures. There should be a small window for reporting entities to take the appropriate steps to rectify the trade information without penalty.

2.4 **Valuation reporting** – HKAB understands that there is no requirement to add transacting parties’ LEI information as part of valuation reporting and there are no additional fields to be added to the valuation template. We request clarification on this because if our assumption is incorrect, IT development work will be required to banks’ existing models.

2.5 **Obtaining LEIs before implementation of the LEI requirements** – As it will become mandatory to use LEIs to identify HKTR members as part of the first phase, we would suggest the HKMA and SFC to require the HKTR to ensure all HKTR members have obtained their own LEIs before implementation of the LEI requirements, and that such information be published on the HKTR Information Page in the members’ area. We appreciate that this may take time and require consultation with HKTR members.

- 2.6 **Integration with other identification systems** – HKAB is aware that there are several initiatives in Hong Kong to identify persons (legal entities, natural persons etc). We strongly recommend that an appropriate review of these initiatives takes place, with strong dialogue between regulators and other stakeholders, to ensure that the initiatives are aligned, consistent and avoid unnecessary overlap.

3 Including a full range of IRS denominated in AUD under Phase 2 Clearing

- 3.1 **Alternative clearing channels** – Under the assumption that OTC Clear will not offer AUD IRS clearing service, in case AUD IRS is not clearable with OTC Clear when it becomes mandatory clearing product, we would need to establish alternative central clearing channels for newly in-scope transactions, to be cleared with an outside CCP that is designated by the SFC, via third party client clearing services.

- 3.2 **Timeline for Phase 2 clearing** – We would also like to confirm what the expected timeline is for such Phase 2 Clearing. We ask the HKMA and SFC to bear in mind that in the case of certain Mainland Chinese-incorporated banks, there is a certain extent of difficulty in acquiring client clearing services, because some service providers may consider Mainland China as non-netting jurisdiction. As a result, we would ask that sufficient time for implementation be provided. As a guide, we would appreciate, at least 12 months lead time from now for market participants to prepare.

4 FSP list and criteria

HKAB strongly agrees to maintain the FSP criteria. We also have no concerns around the proposed changes to the FSP list and reviewing the FSP list on an annual basis.

5 Additional Calculation Periods

- 5.1 **Clarification on calculation period table** – On the whole, we agree with the suggested calculation periods. However, referring to the table of proposed additional calculation periods on pages 16 to 17 of the Consultation Paper, we would like to clarify whether there is a calculation period for 1 September 2018 to 30 November 2018 where the prescribed day is 1 July 2019.

- 5.2 **Permanent calculation period** – We also ask the calculation periods be made permanent such that additional consultations for new calculation periods is not be required after 2022.

6 Trading determination process and criteria

- 6.1 **Alignment of trading obligation regimes in other jurisdictions** – HKAB is supportive of the proposed trading determination process and criteria. More specifically, we believe in the importance of alignment with the trading obligation regimes in other experienced jurisdictions and providing for mechanisms like substituted compliance, mutual recognition or equivalence, to avoid market fragmentation, low trading liquidity or regulatory arbitrage.

- 6.2 **Underlying purpose** – HKAB suggests the inclusion of a further criteria to ensure that designation for trading is actually needed. We expect that this would be an implicit part of the assessment anyway. However, certainty would be appreciated, given the significant resources involved in implementing new systems and procedures. The text for this criterion could be, for example:

“whether imposing a trading obligation in relation to the product is necessary and desirable in all the circumstances, having regard to the availability of less onerous regulatory requirements”

6.3 **Specified lists regarding factors contained in paragraph 72 of the Consultation Paper** – We suggest that HKMA and SFC provide a list of authorised trading platforms to market participants for cost evaluation, budget planning, necessary system setup and logistic arrangements.

6.4 **Future consultations** – Similar to the valuable consultative approach to date, we ask the HKMA and SFC to provide sufficient consultation room for industry's feedback in advance of finalising any rules for mandatory platform trading obligation. We strongly believe that it is important that market participants have the chance to comment on the details of the trading obligation regime in Hong Kong to ensure smooth implementation. Hence, HKAB welcomes the idea of consulting the market on the feasibility, scope and timing for implementing a platform trading obligation in Hong Kong.

We also ask the HKMA and SFC to consult the industry on the governance of the trading platform operator of in-scope products for financial institutions.

6.5 **Substituted compliance, venue equivalence and comparable jurisdictions** – We remind the HKMA and SFC to put in place a substituted compliance, venue equivalence and comparable jurisdictions mechanisms in advance of the platform trading obligation implementation.

6.6 **Factors to consider when detailing the platform trading obligation** – We suggest that the HKMA and SFC consider the following factors when detailing the platform trading obligation:

- (a) the time for market participants to evaluate the impact and implement the required trading platform;
- (b) the cost of such authorised trading platforms; and
- (c) the consequences of trading in-scope products on an unauthorised trading platform after the regulatory compliance date.

Specifically, in relation to paragraph (a), HKAB requests further clarification on whether there will be any grace period following the adoption of the trading determination process by June 2018. Generally, members have expressed that the expected timeframe to evaluate and implement the platform would need to be approximately 12 to 15 months.

Moreover, in relation to paragraph (c), we ask that this also be supported by specific guidance on the proposed consequences of trading in-scope products on an unauthorised platform after the specified date, in due course.

6.7 **Content of obligation documents** – We ask the HKMA and SFC to ensure that the following information is defined in the obligation documents:

- (a) the product scope;
- (b) persons to whom the requirements apply;
- (c) the implementation timeline; and
- (d) the recognised / approved trading platforms.

6.8 We believe that providing this information will ensure a well ordered and clear implementation, enhancing the overall OTC derivatives regime for Hong Kong. **Exemptions** – We request exemption for block trades, package trades, derivative contracts arising from trade compression, and swaps resulting from a swaption

exercise. We also ask the HKMA and SFC to which FX products would be in scope. HKAB may have further feedback in due course.

Next steps

Thank you very much for the opportunity to provide feedback on the Consultation Paper. We would be delighted to discuss any aspect of our comments or to provide feedback on any further proposals.