

Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

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HONG KONG MONETARY AUTHORITY
香港金融管理局



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Foreword

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

This paper sets out the HKMA and SFC's current thinking on some of the key aspects of such a regime. Market participants and interested parties are invited to submit written comments on the proposals discussed in this paper and on any related matters that may have a significant impact on these proposals.

Comments should be submitted in writing by one of the following means and should reach the HKMA or SFC by **no later than 30 November 2011**.

By on-line submission at: <http://www.sfc.hk/sfc/html/EN/speeches/consult/consult.html>

By email to: mdd@hkma.gov.hk or otcconsult@sfc.hk

By fax to: (852) 2878 7297 or (852) 2521 7917

By post to one of the following:

Market Development Division
Hong Kong Monetary Authority
55th floor Two International Finance Centre
8 Finance Street Central
Hong Kong

Supervision of Markets Division
Securities and Futures Commission
8th floor Chater House
8 Connaught 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.

17 October 2011

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 –
 - (1) to administer –
 - (a) 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
 - (b) in the case of the SFC, the relevant provisions² and codes and guidelines published pursuant to the powers vested in the SFC;
 - (2) in performing –
 - (a) in the case of the HKMA, statutory functions under the provisions of the Banking Ordinance and the Securities and Futures Ordinance;
 - (b) in the case of the SFC, its statutory functions under the relevant provisions;
 - (3) for research and statistical purposes; or
 - (4) 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 Defined in Schedule 1 of the Securities and Futures Ordinance (Cap. 571) (**SFO**) to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the Companies Ordinance (Cap. 32) so far as those Parts relate directly or indirectly, to the performance of functions relating to prospectuses; the purchase by a corporation of its own shares; a corporation giving financial assistance for the acquisition of its own shares etc.

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
55th floor Two International Finance Centre
8 Finance Street Central
Hong Kong

In the case of the SFC –

The Data Privacy Officer
The Securities and Futures Commission
8th floor Chater House
8 Connaught Road Central
Hong Kong

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

I. Executive summary

1. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivatives market, and the systemic risk it poses for the wider market and economy. The absence of regulation and bilateral nature of OTC derivatives transactions resulted in a market that was essentially opaque. This lack of transparency meant regulators did not have information on OTC derivatives positions held by market players, and therefore could not be alerted to the build-up of exposures that might threaten the market or wider economy. The opaque nature of the OTC derivatives market and increasing complexity of products also facilitated excessive leveraging and risk taking by market players. Moreover, the global nature of OTC derivatives transactions also contributed to the interconnectedness of market players, and thereby created potential for contagion risk.
2. Accordingly, in the wake of the crisis, G20 Leaders committed to reforms that would require –
 - (1) the mandatory reporting of OTC derivatives transactions to trade repositories (**TRs**),
 - (2) the mandatory clearing of standardised OTC derivatives transactions through central counterparties (**CCPs**),
 - (3) the mandatory trading of standardised OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate, and
 - (4) the imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.
3. These requirements aim to reduce counterparty risk, improve overall transparency, protect against market abuse, and ultimately enable regulators to better assess, mitigate and manage systemic risk in the OTC derivatives market.
4. Many major markets have initiated reform efforts to implement the G20 commitments. Hong Kong too has been working on developing a regulatory regime for its OTC derivatives market.
5. To that end –
 - (1) The HKMA is in the process of establishing a TR (**HKMA-TR**) for the collection of data relating to OTC derivatives transactions.
 - (2) Hong Kong Exchanges and Clearing Limited (**HKEx**) is in the process of establishing a new clearing house in Hong Kong that may serve as a CCP for the OTC derivatives market here.
 - (3) The HKMA and SFC have formed a working group to develop the legislative framework and detailed requirements for regulating the OTC derivatives market. In doing so, we have sought input from relevant stakeholders as well as the Government.
6. We are mindful that our OTC derivatives market is relatively small. Hence, our focus has been on developing a regime that is on a par with international standards but takes into account local market conditions and characteristics. However, because key aspects of the OTC derivatives reform are still evolving in the global arena, and certain proposals

already put forward are still being debated, the HKMA and SFC have not at this stage finalised details of the proposals for the Hong Kong regime. Nevertheless, we believe it is timely to issue a consultation paper that discusses our current thinking, and invites feedback on specific issues.

7. In brief, our current proposals for an OTC derivatives regime in Hong Kong are as follows.

- (1) Key aspects of the regime: We propose that the new OTC derivatives regime should comprise two key aspects, namely –
 - (a) First, it should not only introduce mandatory reporting, clearing and trading obligations in line with the G20 commitments where appropriate, but also provide for the establishment and regulation of the necessary infrastructure through which any mandatory obligations must be fulfilled, i.e. the TRs, CCPs and trading platforms.
 - (b) Secondly, it should provide for the regulation of key players in the OTC derivatives market – in particular authorized institutions (**AIs**), licensed corporations (**LCs**) and large players whose positions may pose systemic risk.
- (2) Regime to be set out in the SFO: We propose that the new OTC derivatives regime should be set out in the Securities and Futures Ordinance (**SFO**). Additionally, to provide for flexibility which is needed in view of the evolving global regulatory developments, we propose that the main obligations of the new regulatory regime should be set out in the primary legislation, but that the details – including some of the key definitions that will delineate the scope of any mandatory reporting, clearing and trading obligations – should be set out in subsidiary legislation.
- (3) Joint regulation by the HKMA and SFC: We propose that the new regime should be jointly overseen and regulated by the HKMA and SFC with –
 - (a) the HKMA overseeing and regulating the OTC derivatives activities of AIs,³ and
 - (b) the SFC overseeing and regulating the OTC derivatives activities of LCs and other persons.
- (4) Definition of “OTC derivatives transactions”: A key concept defining the scope of the new regime will be the term “OTC derivatives transactions”. We propose to define this term widely under the primary legislation, but to limit its application in the subsidiary legislation as appropriate. In particular, we propose to limit its application as appropriate for the purposes of any mandatory reporting, clearing and trading obligations so that such obligations only apply to certain OTC derivatives transactions. The wider definition may however apply to determining who needs to be licensed with the SFC for the proposed new Type 11 regulatory activity (discussed below).

³ With respect to locally-incorporated AIs, the HKMA’s oversight will be in line with its current approach of “consolidated supervision”, i.e. the supervision of a locally-incorporated AI will take into account activities of its local and overseas branches as well as any one or more of its subsidiaries as appropriate so that the AI’s group-wide activities (and resulting risk exposures) can be effectively monitored.

- (5) Reportable and clearing eligible transactions: We propose to introduce mandatory reporting and mandatory clearing obligations from the outset. However, we propose that these obligations should initially apply only to certain types of interest rate swaps (**IRS**) and non-deliverable forwards (**NDF**). The obligation will be extended subsequently, and in phases, to cover other interest rate derivatives and foreign exchange derivatives, as well as other asset classes, such as equity derivatives. The specific types of OTC derivatives transactions that will be subject to any mandatory reporting obligation or any mandatory clearing obligation (referred to in this paper, respectively, as **reportable transactions** and **clearing eligible transactions**) will be determined jointly by the HKMA and SFC after market consultation.
- (6) Mandatory reporting: We propose to require that reportable transactions be reported to the HKMA-TR. In this regard, our current thinking is that this obligation should apply only to AIs, LCs and others who are Hong Kong persons⁴ as follows –
- (a) LCs and locally-incorporated AIs should be required to report all reportable transactions that they are either counterparty to, or that they have originated or executed,⁵
 - (b) overseas-incorporated AIs should be required to report reportable transactions: (i) that they have become counterparty to, originated or executed, through their Hong Kong branch, or (ii) that have a Hong Kong nexus⁶ and that the overseas-incorporated AI is a counterparty to, and
 - (c) others who are Hong Kong persons should be required to report reportable transactions that they are a counterparty to, but only if such persons have exceeded a specified reporting threshold.

We further propose that the reporting obligation should be fulfilled by the end of the business day immediately following the trading day (i.e. T+1) but that certain grace periods should be allowed. We also propose that the reporting obligation should apply in respect of a reportable transaction irrespective of: (i) whether the transaction is centrally cleared or not, and (ii) if centrally cleared, where it is cleared. Additionally, to reduce the compliance burden, we propose that Hong Kong persons who have exceeded the specified reporting threshold should be exempted from the reporting obligation if their transactions involve an AI or LC that has an obligation to report such transactions.

- (7) Mandatory clearing: We propose to require that clearing eligible transactions be cleared through a designated CCP. However, our current thinking is that this mandatory clearing obligation should apply only if –
- (a) either –

⁴ Hong Kong persons essentially refer to persons (other than AIs and LCs) who are based in Hong Kong – see paragraphs 77 to 78 below.

⁵ A transaction is “originated and executed” by a person if he has negotiated, arranged, confirmed or committed to the transaction on behalf of himself or any of the counterparties – see paragraph 64 below.

⁶ A reportable transaction has a Hong Kong nexus if its underlying asset, currency or rate is (or includes one that is) denominated in Hong Kong dollars, or in the case of credit or equity derivatives (if and when included), the underlying reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law – see paragraph 71 below.

- (i) an AI, LC or Hong Kong person is a counterparty to the transaction, or
 - (ii) an AI or LC has originated or executed the transaction,
- (and, in the case of an overseas-incorporated AI, its involvement as a counterparty or the person originating or executing the transaction, must be through its Hong Kong branch), and
- (b) both counterparties have exceeded a specified clearing threshold.

Overseas persons⁷ will therefore be affected by the mandatory clearing obligation only if an AI, LC or Hong Kong person is also involved in the transaction as aforesaid (i.e. as described in sub-paragraph (a) above). Additionally, to reduce the compliance burden, a transaction will be exempted from mandatory clearing if: (i) both counterparties are overseas persons, and (ii) the transaction has been cleared through a CCP in accordance with the laws of an acceptable overseas jurisdiction⁸ or is exempt from central clearing under those laws.

- (8) *Mandatory trading*: We do not propose to impose a mandatory trading obligation at the outset, although the SFO will be amended to allow for such an obligation to be introduced in future if considered appropriate. We believe further study is needed first to assess how best to implement a mandatory trading obligation for the Hong Kong market.
- (9) *Regulation of CCPs*: As mentioned above, the proposed mandatory clearing obligation will require clearing eligible transactions to be cleared through designated CCPs. We propose that only CCPs that are either a recognized clearing house (**RCH**) or an authorized automated trading services (**ATS**)⁹ provider should be eligible to be designated for this purpose. We are also considering whether to impose a location requirement for certain products that are considered systemically important to the Hong Kong financial market, i.e. whether only local CCPs should be permitted to clear products that are regarded as being of systemic importance.
- (10) *Regulation of intermediaries*: We propose to require key players in the OTC derivatives market, other than AIs, to be licensed under the SFO if they serve as intermediaries. Our current thinking is to introduce a new Type 11 regulated activity which will bring into the SFC's regulatory net intermediaries in the OTC derivatives market that are active in providing dealing, advising and clearing agent services. We do not propose to require AIs to be licensed for the new Type 11 regulated activity because their OTC derivatives market activities are already subject to the prudential supervision of the HKMA, and will remain so under the proposed regime.
- (11) *Oversight of large players*: We also propose to introduce provisions that will give the SFC a degree of regulatory oversight in respect of large players in the OTC

⁷ In this paper, "overseas persons" refer to persons who are not AIs, LCs or Hong Kong persons.

⁸ The HKMA and SFC will identify which jurisdictions are to be regarded as "acceptable overseas jurisdictions" based on whether their laws on mandatory reporting, clearing and trading are on a par with international standards and practices – see paragraph 116 below.

⁹ Although the name "automated trading services" or "ATS" refers only to trading, it is defined under the SFO to cover not only trading facilities, but also clearing facilities.

derivatives market who are not otherwise regulated by the SFC or HKMA as intermediaries but whose positions raise concerns of potential systemic risk.

(12) *Capital and margin requirements*: We are thinking to require higher capital requirements for OTC derivatives transactions that are not cleared through a CCP. We are also considering whether such transactions should be subject to margin requirements. It is expected that global developments in this area will provide further guidance that will assist our formulation of an appropriate policy in this regard. In particular, the HKMA and SFC will draw reference to relevant international standards, including Basel capital requirements, and recommendations that may emerge from further work by standard setters on margining requirements for non-centrally cleared OTC derivatives transactions as has been encouraged by the Financial Stability Board (FSB) in July.

8. In terms of timing, the HKMA and SFC are currently working with the Government on the legislative amendments necessary to implement a regulatory regime for the OTC derivatives market in Hong Kong. Market comments in response to this consultation will be critical to finalising some of the key aspects of the regime and the legislative amendments.
9. As mentioned above, the detailed requirements will be set out in subsidiary legislation. In accordance with section 398 of the SFO, we will conduct a public consultation on such subsidiary legislation before it is introduced into the Legislative Council. Our current target is to conduct such consultation by Q1 of next year.
10. Given the relatively small size of Hong Kong's OTC derivatives market, we are mindful that it is not for Hong Kong to drive the reform initiatives in this area. Nevertheless, our reform efforts cannot fall too far behind those of major markets. To that end, we continue to work towards meeting the timeline set by the G20 commitments, i.e. implementation by end 2012. However, much will ultimately depend on the progress and timeline of reform initiatives in other major markets, including most notably the US and EU.

II. Background

A. The G20 commitments

11. The global financial crisis of late 2008 highlighted the structural deficiencies in the OTC derivatives market, and the systemic risk it poses for the wider market and economy. The absence of regulation and bilateral nature of transactions in the OTC derivatives market resulted in a market that was essentially opaque. This lack of transparency meant regulators did not have information on OTC derivatives positions held by market players, and therefore could not be alerted to the build-up of exposures that might threaten the market or wider economy. The opaque nature of the OTC derivatives market and increasing complexity of products also facilitated excessive leveraging and risk taking by market players. Moreover, the global nature of OTC derivatives transactions also contributed to the interconnectedness of market players, and thereby created potential for contagion risk.
12. In the wake of the global financial crisis, G20 Leaders agreed in Pittsburgh in September 2009 that:

All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.

13. These objectives were reaffirmed at the Toronto Summit in June 2010, when G20 Leaders also agreed to work in a coordinated manner to accelerate the implementation of OTC derivatives regulation and supervision, and to increase transparency and standardisation.
14. By committing to reform the OTC derivatives market, G20 Leaders acknowledged that the OTC derivatives market does bring benefits to financial markets and the wider economy, and that there is therefore a place for it in the global financial landscape. However, reforms are needed to rein in excessive risk taking, and to mitigate the potential for contagion arising from the interconnectedness of OTC derivatives market participants and from the limited transparency of counterparty relationships. To that end, the G20 commitments seek to reduce counterparty risk, improve overall transparency in the OTC derivatives market, protect against market abuse, and ultimately enable regulators to better assess, mitigate and manage systemic risk. Specifically –
 - (1) Central clearing through a CCP mitigates the counterparty risk exposure that players in the OTC derivatives market would otherwise face. This is achieved by the CCP becoming the buyer to every seller and the seller to every buyer. The CCP also monitors and manages counterparty and market risks through the imposition of stringent membership criteria, position limits, daily margin requirements, contributions to default fund, default procedures, etc.
 - (2) The reporting of trades to a TR provides increased transparency to the public on volumes and aggregate outstanding positions. This can help market participants to better assess market conditions, and, more importantly, enable regulators to more promptly identify potential risks arising from the build-up of exposures and take action to mitigate any threats to market stability. For regulators, trade level transparency helps to detect and deter market misconduct. Overall, transparency improves fairness, efficiency and competitiveness, which in turn helps to enhance investor confidence and participation.

B. International efforts

15. Many jurisdictions (including the US, the EU, Japan, Australia and Singapore) have initiated proposals to implement the G20 commitments. **Appendix A** highlights some of these implementation efforts.
16. Additionally, and given the global nature of OTC derivatives transactions, a number of working groups and task forces have been set up under the auspices of various international standard setting bodies (such as the Financial Stability Board (**FSB**), the Committee on Payment and Settlement Systems (**CPSS**) and the International Organization of Securities Commissions (**IOSCO**), etc) to provide guidance and thus help jurisdictions reach consensus on some of the key aspects of OTC derivatives regulation. Such consensus will be key to encouraging a generally consistent approach across jurisdictions and thereby discouraging regulatory arbitrage. The HKMA and SFC have actively participated in such international forums. **Appendix B** highlights some of these international initiatives.

17. As will be seen from Appendix B, the FSB has put forward 21 recommendations for implementing the G20 objectives. These recommendations, which were set out in FSB's October 2010 paper entitled *Implementing OTC Derivatives Market Reforms*, highlight some of the key issues that regulators need to focus on and address when developing regulatory regimes for their OTC derivatives market. They include specific recommendations for increasing standardisation, moving to central clearing, promoting trading on organised platforms, and the regulation and collection of data through TRs.

C. Hong Kong's efforts

18. Hong Kong too has been working towards meeting the G20 commitments. As an international financial centre, Hong Kong endeavours to ensure that its financial markets' regulation is on a par with international standards. In the context of the OTC derivatives market, given its global nature and the relatively small size of Hong Kong's OTC derivatives market¹⁰, we are mindful that our regime will need to be in alignment with other major markets while also taking into account local market conditions and characteristics.
19. Against this background, the HKMA, SFC and HKEx held a joint press conference in December 2010 at which the following was announced –
- (1) that the HKMA will establish and operate a TR for the collection of data relating to OTC derivatives transactions,
 - (2) that HKEx will set up a new clearing house to serve as a CCP for the OTC derivatives market, and
 - (3) that the two regulators will work with the Government and relevant stakeholders to build a regulatory regime for the OTC derivatives market in Hong Kong, which would cover the mandatory reporting and clearing of certain OTC derivatives transactions.
20. Work on each of these aspects has progressed steadily since then. In particular, the HKMA recently released a consultation paper on the logistical and technical arrangements for reporting OTC derivatives transactions to the HKMA-TR.
21. Meanwhile, the HKMA and SFC have set up a working group to draw up a possible framework and detailed requirements for regulating the OTC derivatives market in Hong Kong. In the process, the working group has met with market participants – including in particular both AIs and LCs – to better understand their current OTC operations and activities in Hong Kong, and their possible areas of concern. The working group has also been monitoring regulatory developments in the US, EU and other markets.
22. In considering how best to construct Hong Kong's OTC regime, we have kept in mind that it is not for Hong Kong to drive the reform initiatives given the relatively small size of our OTC derivatives market. Nevertheless, our reform efforts should not fall too far behind those of major markets such as the US and EU. In this regard, we note that key aspects of the OTC derivatives reform are still evolving in the global arena, and certain proposals already put forward have engendered considerable debate which is still continuing. In

¹⁰ Based on Bank of International Settlement figures, the notional amount of OTC derivatives held globally, as at December 2010 was about US\$600 trillion. In contrast, based on a survey of 197 AIs, their total notional amount of OTC derivatives outstanding as at the end of June 2010 stood at about HK\$40 trillion (i.e. about US\$5.2 trillion, or less than 1% of the global outstanding).

view of this, we have not at this stage finalised details of the proposed OTC derivatives regime for Hong Kong. However, given the timeline of the G20 commitments, and the current status of discussions in the international arena, we believe it is time to issue a consultation paper that discusses our current thinking on how Hong Kong's OTC derivatives regime might be cast. We also take this opportunity to invite feedback on specific issues and aspects that we feel may be of particular interest or concern to market participants and others.

23. In the paragraphs below, we discuss the key aspects of the regime being considered for Hong Kong. We also elaborate on some of the areas which we believe may be of particular interest or concern to market participants, and raise specific issues for comment and feedback.

III. Key aspects of the regime being considered

A. The broad framework

Two key aspects of the OTC derivatives regime proposed for Hong Kong

24. We believe there are two key aspects to implementing an effective and sound regulatory regime for OTC derivatives.
- (1) The first relates to setting up the appropriate market infrastructure to implement the reforms envisaged by the G20 commitments. Such infrastructure (i.e. the TRs, CCPs and trading platforms) must support any mandatory reporting, clearing and trading obligations that may be introduced, and be subject to adequate regulatory oversight so as to secure market confidence and achieve the objectives of the reform initiatives.
 - (2) The second relates to the regulation of financial intermediaries that play a key role in this market by subjecting them to appropriate prudential and conduct requirements. Appropriate oversight is also required in respect of large players whose positions may pose systemic risk.
25. These two aspects are also largely interconnected, and hence both are equally crucial to the effectiveness of any regime that is put in place.

Legislative framework

26. We propose that the new OTC derivatives regime should be set out in the SFO, with the main obligations set out in primary legislation and the details set out in subsidiary legislation.

What are the key amendments and where will they be reflected?

27. Specifically, we propose as follows –
- (1) The primary legislation should set out the mandatory reporting, clearing and trading obligations, but the details of the scope of such obligations and related matters should be set out in subsidiary legislation. Such details would include matters such

as: to whom the obligations apply, the types of OTC derivatives transactions that are covered, the manner in which the obligations must be fulfilled, etc.

- (2) The primary legislation should also set out the penalties for any breach of the mandatory obligations.
- (3) The framework for –
 - (a) the designation of CCPs for the purposes of any mandatory clearing obligation, and
 - (b) (when applicable) the designation of exchanges and other electronic trading platforms for the purposes of any mandatory trading obligation,

should also be set out in the primary legislation, while ancillary and related matters (such as any detailed criteria and procedures for designation) should be set out in subsidiary legislation. Amendments to primary legislation may also be needed to secure adequate protection for indirect clearing.¹¹

- (4) Additionally, amendments will be needed to various provisions in the primary legislation so as to expand its scope as appropriate to cover OTC derivatives transactions – e.g. provisions relating to RCH and ATS (which currently cover only securities and futures) will need to be expanded as appropriate to cover OTC derivatives transactions as well. Amendments will also be needed to reflect the HKMA and SFC's joint oversight and regulation of the OTC derivatives market.¹²

Why set out the details in subsidiary legislation?

28. By setting out the details of any mandatory obligations in subsidiary legislation (the legislative process for which is relatively simpler), regulators will have the flexibility to introduce changes as needed in a relatively timely manner to keep in step with market developments and evolving global regulatory standards and practices. This is particularly crucial given that the regulation of OTC derivatives markets is still relatively new, and many aspects of its regulation are still evolving.
29. We would note here that, in accordance with section 398 of the SFO, we will conduct a public consultation on the subsidiary legislation before commencing the legislative process. Our current target is to issue such a consultation in Q1 2012.

Joint oversight by the HKMA and SFC

30. We propose that the new regime should be jointly overseen and regulated by the HKMA and SFC, with –
 - (1) the HKMA overseeing and regulating the OTC derivatives activities of AIs, and

¹¹ Paragraphs 153 to 155 below discuss indirect clearing, and paragraph 155 in particular notes the possible areas that might need legislative amendment.

¹² The HKMA and SFC's joint oversight of the OTC derivatives market is discussed in paragraphs 30 to 36 below. See also paragraph 140 below.

- (2) the SFC overseeing and regulating the OTC derivatives activities of LCs and other persons.

Why should AIs' OTC derivatives activities be regulated by the HKMA?

31. At present, most of the main players in the OTC derivatives market in Hong Kong are AIs.
32. For many AIs their OTC derivatives activities form a core and integral part of their banking business which is subject to regulation by the HKMA. Regulating these activities is critical to the HKMA's prudential oversight of AIs. As such, they should continue to be overseen by the HKMA since the new OTC derivatives regime should not affect the HKMA's role as primary supervisor and regulator of AIs.

Why should non-AIs' OTC derivatives activities be regulated by the SFC?

33. As for the other players in the OTC derivatives market, we propose that their activities be overseen and regulated by the SFC. At present, many of the other players are international investment houses which conduct their OTC derivatives business in Hong Kong either through unregulated entities within the group, or through entities that are already licensed with the SFC in respect of their securities and futures businesses. We therefore propose that these non-AI intermediaries in the OTC derivatives market be regulated by the SFC. This will be done by introducing a new regulated activity under the SFO which will bring such intermediaries under the SFC's purview.

How will this joint regulation and oversight be reflected in the law?

34. As mentioned earlier, we propose that the details of the new OTC derivatives regime – including the precise ambit of any mandatory reporting, clearing and trading obligations that may be imposed – should largely be set out in subsidiary legislation to be made under the SFO.
35. The subsidiary legislation will be made by the SFC and will apply to all players in the OTC derivatives markets, i.e. to both AIs and non-AIs. However, because most of the main players in the OTC derivatives market are AIs, we propose that any subsidiary legislation proposed to be made by the SFC must first be consented to by the HKMA.
36. Additionally, we propose to introduce appropriate amendments to the SFO to ensure that –
 - (1) the HKMA is responsible for overseeing AIs' compliance with the mandatory obligations, and for investigating and taking action in respect of any breaches by AIs, and
 - (2) the SFC is responsible for overseeing non-AIs' compliance with the mandatory obligations, and for investigating and taking action in respect of any breaches by non-AIs.

Scope of the new regime – “OTC derivatives transactions”

37. If the new OTC derivatives regime is to be set out in the SFO, the scope of the SFO will need to be extended to cover “OTC derivatives transactions”. That term will also effectively delineate the ambit of the new regime.

38. Our current thinking is to define “OTC derivatives transactions” as transactions in “structured products”¹³ other than –
- (1) transactions in securities and futures contracts that are traded on a recognized market (i.e. a market operated by a recognized exchange company (**REC**)),
 - (2) transactions in structured products that are offered to the public and the documentation for which is authorized under section 105 of the SFO, and
 - (3) transactions in currency-linked instruments, interest rate-linked instruments or currency and interest rate-linked instruments offered by AIs to the public and the documentation for which is exempted from the prohibition under section 103(1) of the SFO by virtue of section 103(3)(ea) of the SFO.
39. To cater for market development in products, we also propose to include a power that will allow specific transactions to be expressly included within, or excluded from, the ambit of “OTC derivatives transactions”.

Why refer to “structured products”?

40. The reference to “structured products” is suggested because that term is cast widely under the SFO. It covers a very broad range of instruments that are essentially derivative in nature in that payment obligations under them are referenced to changes in the value of some underlying asset, rate, index, property, futures contract or by reference to the occurrence or non-occurrence of one or more events.

Why the proposed exclusions?

41. The proposed exclusions are essentially to avoid overlapping in regulation.
- (1) Securities and futures contracts traded on an REC are already subject to regulation under the SFO and rules of the relevant REC.
 - (2) Likewise, documentation relating to publicly offered non-listed structured products in most cases requires authorization under section 105 of the SFO. The SFC is therefore able to obtain further information from the issuer if necessary, including information relating to activities in such products.
 - (3) In the case of currency-linked instruments, interest rate-linked instruments or currency and interest rate-linked instruments offered to the public by AIs, these are already subject to HKMA’s regulatory oversight.

Why define “OTC derivatives transactions” so widely?

42. A point to highlight here is that the term “OTC derivatives transactions” will be defined in the primary legislation, but the scope of its application in relation to the mandatory obligations will be adjusted as appropriate in subsidiary legislation. In other words, we do not propose that the mandatory obligations should apply to all OTC derivatives transactions, but only to those OTC derivatives transactions specified in subsidiary

¹³ The term “structured products” was introduced under the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011.

legislation. (This is discussed in further detail in Section III.B below.¹⁴) A wide definition of “OTC derivatives transactions” in the primary legislation will essentially allow for greater flexibility when it comes to crafting the subsidiary legislation.

43. Additionally, as will be seen later, we propose to introduce a new Type 11 regulated activity that will require certain intermediaries in the OTC derivatives market to be licensed with the SFC. A broad definition of “OTC derivatives transactions” will also allow for greater flexibility when it comes to defining the class of intermediaries to be brought within the SFC’s regulatory net – this aspect is discussed further under Section III.I below.¹⁵

- Q1. Do you have any comments on the proposed scope of the regulatory regime for the OTC derivatives market in Hong Kong and how it is proposed to be set out?**
- Q2. Do you have any comments on the proposed division of regulatory responsibility between the HKMA and SFC?**

B. Mandatory obligations and the products to be covered

Proposal for Hong Kong

44. In line with the G20 commitments, we propose to introduce –
- (1) a mandatory reporting obligation which would require certain specified OTC derivatives transactions to be reported to the HKMA-TR, and
 - (2) a mandatory clearing obligation which would require certain specified OTC derivatives transactions to be cleared through a designated CCP.
45. We further propose that these obligations should initially be limited to only certain types of IRS and NDF, and subsequently extended, in phases, to cover other interest rate and foreign exchange derivatives products, as well as other asset classes such as equity derivatives.

The HKMA-TR and designated CCPs

What is the HKMA-TR?

46. The HKMA-TR refers to a TR to be established and operated by the HKMA.¹⁶
47. Our current thinking is to recognize only one TR, i.e. the HKMA-TR, for the purposes of the mandatory reporting obligation, and to permit reportable transactions to be reported to it either directly (i.e. by the person responsible for reporting) or indirectly (i.e. through an agent). Information collected by the HKMA-TR will be shared with the SFC, and used by

¹⁴ See paragraphs 52 to 60 below.

¹⁵ See paragraphs 157 to 172 below, and in particular paragraph 164.

¹⁶ In July 2011, the HKMA issued a consultation paper on the logistical and technical arrangements for reporting OTC derivatives transactions to the HKMA-TR. The consultation closed on 9 September 2011 and the HKMA is now studying the comments received.

both the HKMA and SFC to facilitate their joint oversight of the OTC derivatives market and the performance of their respective statutory functions. Information collected will also be shared with the market and public, but only on an aggregate level basis, i.e. transactional level details will not be disclosed.

Why not rely on global TRs instead of establishing a new TR in Hong Kong?

48. Since a key reason for the collection of information on OTC derivatives transaction is to enable regulators to better assess, mitigate and manage systemic risk in their own jurisdiction, we believe the better and more prudent approach is to provide for a mechanism that allows the regulators to obtain such information as quickly and directly as possible, thereby avoiding any uncertainties, delays or difficulties arising from overseas laws or considerations.
49. We appreciate however that the proposal to require reporting to the HKMA-TR rather than to a global TR may raise concerns given the global nature of the OTC derivatives market. In particular –
- (1) There may be concerns that certain transactions reported to the HKMA-TR may not be reported to global TRs and that global TRs may therefore have incomplete information.
 - (2) There may also be concerns about increased compliance costs for international groups that are required to report their OTC derivatives transactions to multiple TRs, as each may have different data or system requirements.
50. To help ease these concerns, the HKMA will endeavour to ensure that the reporting standards and specifications adopted by the HKMA-TR are in line with those set by international standard setting bodies and major industry platforms. The HKMA will also work with other jurisdictions and TR operators to facilitate the sharing of data. Additionally, and to reduce the compliance burden, the HKMA-TR will be able to accept reporting via agents that may be trade matching and confirmation platforms or overseas TRs.

What is a designated CCP?

51. A designated CCP simply refers to a CCP that is designated by the SFC for the purposes of the mandatory clearing obligation. Our current thinking is that only an RCH or an ATS provider authorized under Part III of the SFO will be designated as a CCP for this purpose. The designation and regulation of CCPs is discussed in greater detail below.¹⁷

Transactions proposed to be subject to mandatory obligations

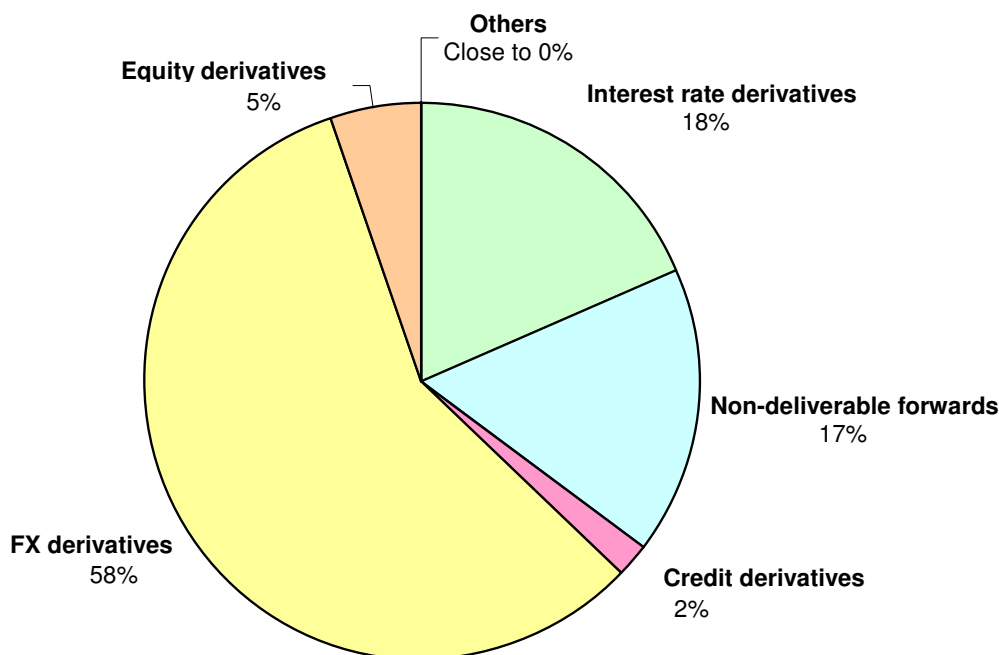
Why limit the obligations to certain types of OTC derivatives?

52. We propose to impose the mandatory reporting and clearing obligations in phases beginning with product types that are more widely traded in Hong Kong. We believe this is consistent with the spirit of the G20 commitments which ultimately aims to address concerns about systemic risk.

¹⁷ See Section III.G below.

Which types of OTC derivatives transactions are more widely traded in Hong Kong?

53. The chart below shows a breakdown (by notional value) of OTC derivatives transactions generated in Hong Kong during 2009¹⁸ –



Which types of OTC derivatives transactions should the mandatory obligations apply to?

54. As can be seen from the chart above, foreign exchange derivatives (other than NDF) account for more than half of the OTC derivatives market in Hong Kong. However, because most of these transactions tend to be very short-dated and settled through the Continuous Linked Settlement system (**CLS system**), they are considered to be less of a concern.¹⁹ We note also that internationally, there is no push towards subjecting short-dated foreign exchange derivatives to stringent regulations. Accordingly, we do not propose to mandate either the reporting or central clearing of foreign exchange derivatives (other than NDF) at this stage but we will keep in view international development in this area.
55. The next largest classes of OTC derivatives traded in Hong Kong are interest rate derivatives (many of which are IRS) and NDF.
56. We therefore propose to initially limit any mandatory reporting and clearing obligations to only IRS and NDF. Although equity derivatives comprise a smaller portion of the OTC

¹⁸ The chart under paragraph 53 is based on data obtained from a survey conducted with a list of major market participants who are active in the OTC derivatives market in Hong Kong.

¹⁹ Short-dated transactions are less of a concern because the risk exposure is limited to a very short period of time. Settlement through the CLS system also reduces risk because it is on a payment versus payment basis which lowers settlement risk.

derivatives market, we propose to focus on this category next since it will assist the SFC's monitoring of systemic risk in Hong Kong's stock market.

57. However, not all IRS and NDF will be subject to mandatory reporting and clearing at the initial stage. It will be necessary to also consider other factors such as –
- (1) for mandatory reporting, what types of IRS and NDF transactions can be reported to the HKMA-TR, and
 - (2) for mandatory clearing, what types of IRS and NDF transactions are standardised enough and suitable for central clearing, and whether any designated CCP offers services for clearing such IRS and NDF transactions.
58. The HKMA and SFC will jointly determine, after market consultation, which OTC derivatives transactions must be reported and centrally cleared, and a list of these will be published. For easy reference –
- (1) OTC derivatives transactions that will be subject to mandatory reporting in Hong Kong are referred to in this paper as **reportable transactions**, and
 - (2) OTC derivatives transactions that will be subject to mandatory clearing in Hong Kong are referred to in this paper as **clearing eligible transactions**.

Which specific transactions are likely to be subject to the mandatory obligations initially?

59. As indicated in the HKMA's consultation paper on the logistical and technical arrangements for reporting OTC derivatives transactions to the HKMA-TR, it is proposed that reportable transactions will at the outset be limited to transactions in the following types of products only –

Single currency interest rate swaps
Overnight index swaps
Single currency basis swaps
Non-deliverable forwards

60. As for clearing eligible transactions, a list of these has yet to be determined. Much will also depend on the CCPs that are designated and the types of transactions that they are able to clear. Accordingly, the HKMA and SFC propose to adopt both a top down and bottom up approach, i.e. taking into consideration what regulators consider as products suitable for central clearing as well as products proposed by designated CCPs for central clearing.

Q3. Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?

Q4. Do you have any comments on the proposal to initially limit the scope of any mandatory reporting and clearing obligations so that they apply in respect of certain IRS and NDF?

C. Proposed mandatory reporting obligation

Proposal for Hong Kong

61. As discussed in the previous section, we propose to introduce a mandatory reporting obligation in Hong Kong whereby certain specified OTC derivatives transactions (i.e. reportable transactions) must be reported to the HKMA-TR. We also propose that any such obligation should apply only to AIs, LCs and others who are Hong Kong persons. Specifically, we propose as follows –
- (1) In the case of LCs and locally-incorporated AIs, they should be required to report all reportable transactions that they are a counterparty to, or that they have originated or executed. Additionally, in the case of locally-incorporated AIs, we propose that the reporting obligation may in some cases apply on both an entity level and a group basis so as to facilitate the HKMA's consolidated supervision of AIs' activities. In other words, for the purposes of consolidated supervision, the HKMA may require a locally-incorporated AI to not only report its own positions but also to ensure that the positions of any one or more of its subsidiaries (as the HKMA may specify) are reported.
 - (2) In the case of overseas-incorporated AIs, they should be required to report their reportable transactions if: (i) they have become counterparty to, originated or executed the transaction and done so through their Hong Kong branch, or (ii) they are a counterparty to the transaction and the transaction has a Hong Kong nexus.
 - (3) In the case of others who are Hong Kong persons, they should be required to report a reportable transaction if –
 - (a) they are a counterparty to the transaction, and
 - (b) they have exceeded the specified reporting threshold.However, they will be exempted from the reporting obligation if an AI or LC is also subject to a reporting obligation in respect of that transaction.
 - (4) In the case of overseas persons (i.e. persons who are not AIs, LCs or Hong Kong persons), we do not propose that they be subject to any mandatory reporting obligation under Hong Kong law.
62. Additionally, in all cases, our current thinking is to require the reporting obligation to be complied with by the end of the business day immediately following the trading day, i.e. by T+1, although grace periods should be provided to give market players enough time to set up relevant system connections and complete any backloading.

Reporting obligation for AIs and LCs

Why subject AIs and LCs to more stringent reporting obligations?

63. We believe AIs and LCs should be subject to a more stringent mandatory reporting obligation given that they play a predominant role in the OTC derivatives market, including in particular as the key counterparties and intermediaries. We therefore do not propose that a reporting threshold should apply to them. Moreover, mandating AIs and LCs to report all of their reportable transactions allows regulators to have better information about

their OTC derivatives activities, thereby enhancing their ability to monitor the OTC derivatives exposure taken by such regulated entities.

What is meant by “originated or executed”?

64. By “originated or executed” we mean that the AI or LC has negotiated, arranged, confirmed or committed to a transaction on behalf of itself or any counterparty to the transaction, and in the case of an overseas-incorporated AI, that this has been done through its Hong Kong branch. It would therefore include the functions of a relevant sales desk or trading desk involved in the transaction.

Why cover transactions that are “originated or executed” by an AI or LC?

65. Unlike in the US and EU, much of the OTC derivatives activity conducted by AIs or LCs in Hong Kong is not booked in Hong Kong. The Hong Kong arm is in most cases the sales desk or trading desk rather than the client facing entity. Its role is therefore to negotiate, arrange, confirm or commit to a transaction on behalf of the group client facing entity, rather than to enter into the transaction as counterparty itself.
66. Given this unique feature of Hong Kong’s market, we do not believe any mandatory obligation would be effective if it were imposed only on counterparties to the transaction. We therefore propose extending it so that it also covers others who are involved in making the transaction happen. Hence the proposal that the mandatory reporting obligation should also apply to AIs and LCs that originate or execute the transaction. This has the added benefit of preventing AIs and LCs from circumventing the mandatory obligation by arranging an overseas affiliate to enter into the transaction on their behalf.
67. However, to reduce the compliance burden, we propose that an AI or LC will be taken to have discharged its reporting obligation in respect of a reportable transaction that it has originated or executed if –
- (1) it has originated or executed that transaction on behalf of one of the counterparties, and
 - (2) that counterparty has confirmed to the AI or LC that the transaction has been reported to the HKMA-TR.
68. A subtle point to note here is that we are not proposing that an AI or LC should not be subject to a reporting obligation in the circumstances discussed in paragraph 67 above, but rather that it should be taken to have discharged such obligation in those circumstances.

Will the reporting obligation apply similarly to locally-incorporated and overseas-incorporated AIs?

69. Our current thinking is that the mandatory reporting obligation should apply differently to locally-incorporated AIs and overseas-incorporated AIs. Specifically –
- (1) In the case of an overseas-incorporated AI, the mandatory reporting obligation should only apply in respect of reportable transactions: (i) that the overseas-incorporated AI has become counterparty to, originated or executed, through its Hong Kong branch, or (ii) that have a Hong Kong nexus and that the overseas-incorporated AI is a counterparty to. In other words, an overseas-incorporated AI should not be subject to mandatory reporting in Hong Kong, unless: (i) its Hong

Kong branch is involved in the transaction, or (ii) the transaction itself has a Hong Kong nexus (discussed in paragraph 71 below) and the AI is a counterparty to it.

- (2) However, in the case of a locally-incorporated AI, the mandatory reporting obligation should apply in respect of all reportable transactions to which the locally-incorporated AI is a counterparty or which it has originated or executed, i.e. irrespective of whether the AI has conducted such activities through its Hong Kong office or through an overseas branch. Additionally, for the purposes of consolidated supervision, the HKMA may require a locally-incorporated AI to report positions on a group basis, i.e. to not only report its own positions but also to ensure that its Hong Kong and overseas subsidiaries' positions are reported. For this purpose, the HKMA will specify which subsidiaries' positions should be reported.

70. The above is essentially to reflect international protocol on banking regulation, whereby –

- (1) the host regulator mainly regulates the activities of the domestic branch of an overseas bank (i.e. the branch that operates in the host regulator's jurisdiction),
- (2) the home regulator exercises consolidated supervision over the bank's group as a whole (including therefore all of its subsidiaries and overseas branches), and
- (3) there are cooperative arrangements between the home and host regulators to ensure that a cross-border banking group is effectively supervised.

(As there is no equivalent protocol among securities or futures market regulators, a similar distinction is not proposed in the case of LCs. Accordingly, the mandatory reporting obligation will apply in respect of all OTC derivatives activities of an LC irrespective of where they are conducted.)

What is meant by "Hong Kong nexus" and why introduce such a concept?

71. By "Hong Kong nexus" we mean that –

- (1) in the case of equity derivatives and credit derivatives, the underlying entity or the reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law, and
- (2) in the case of other derivatives, the underlying asset, currency or rate is denominated in (or includes one that is denominated in) Hong Kong dollars.

72. In the light of the international protocol on banking regulation by home and host regulators as mentioned above, we do not believe it is appropriate to require overseas-incorporated AIs to report all their reportable transactions, particularly if such transactions are conducted from outside Hong Kong. However, transactions with a Hong Kong nexus may have an implication for the monetary and financial stability of Hong Kong. We therefore propose to require overseas-incorporated AIs to report transactions with a Hong Kong nexus, but only if they are a counterparty.

Why require locally-incorporated AIs to report on group basis?

73. The HKMA has responsibility for supervising locally-incorporated AIs on a consolidated basis, where appropriate. It therefore needs to be able to monitor such AIs' OTC

derivatives market activities on a group basis so as to prevent them from circumventing the mandatory obligations (e.g. by booking transactions through different subsidiaries).

74. A point to note here is that if a locally-incorporated AI is required to report on a group basis, the reporting obligation will remain with the AI and not shift to the subsidiaries. The subsidiaries will only be subject to the reporting obligation if they themselves fulfil the relevant criteria described in paragraph 61 above.

Why is there no exemption for cases involving more than one AI or LC?

75. It is entirely possible that a reportable transaction may involve more than one AI or LC (e.g. both counterparties may be AIs or LCs, or one counterparty may be an AI or LC and another AI or LC may have originated or executed the transaction on behalf of the other counterparty). In such cases, based on our current thinking as reflected above, the transaction would have to be reported by all AIs or LCs involved, with the result that the HKMA-TR would receive more than one report of the same transaction.
76. We have considered whether an exemption should be provided in such cases. Our current thinking is that it should not because reporting by both sides will provide a useful check and balance. Moreover, if an exemption were to be allowed, a mechanism would need to be incorporated to determine which party is responsible for reporting, and what checks or confirmations the non-reporting party needs to have done or obtained. This may introduce unnecessary complexity and confusion, and in turn increase the likelihood of reporting failures. On balance therefore, we believe it may be simpler and more straightforward for AIs and LCs to have a clear obligation to report all reportable transactions, rather than having to check which transactions they need to report and which they can rely on their counterparty to report.

Reporting obligation for persons other than AIs and LCs

Who are “Hong Kong persons” and “overseas persons”?

77. The reference to Hong Kong persons is essentially intended to cover persons (other than AIs and LCs) who operate from Hong Kong, or who otherwise have a connection with Hong Kong. Accordingly, we propose that the term should refer to the following –
- (1) individuals who are Hong Kong residents,
 - (2) the owners of any sole proprietorship or partnership that is based in, operated from, or registered in Hong Kong,
 - (3) companies that are incorporated or registered in Hong Kong,
 - (4) funds that are managed in or from Hong Kong (irrespective of whether they are established as a company or a trust), and
 - (5) any other entity that is established or registered under Hong Kong law.
78. The above will therefore catch non-AI and non-LC financial institutions, commercial entities and high net worth individuals based in Hong Kong, as well as funds managed from Hong Kong, and irrespective of whether they enter into OTC derivatives transactions to hedge their commercial activities or as part of an investment portfolio.

79. Persons who are not AIs, LCs or Hong Kong persons are referred to in this paper as overseas persons.

Why are Hong Kong persons exempted if an AI or LC is involved?

80. As mentioned earlier, our current thinking is to require AIs and LCs to report all of their reportable transactions. This should, we believe, capture most of the OTC derivatives activity in Hong Kong since most OTC derivatives transactions in Hong Kong are likely to involve an AI or LC (either as a counterparty, or as a person originating or executing the transaction).
81. In view of the above, we believe it is possible to take a more pragmatic approach by exempting Hong Kong persons from the reporting obligation if an AI or LC is subject to a reporting obligation in respect of the transaction. This can help reduce the reporting burden without compromising the objectives of the reporting obligation, which is essentially to enhance transparency for both the market and regulators.
82. A further point to note is that because this proposed exemption is limited to transactions that an AI or LC is required to report, it follows that –
- (1) if a Hong Kong person enters into a reportable transaction directly with an overseas person or with another Hong Kong person, then the exemption will not apply, and
 - (2) similarly, if a Hong Kong person enters into a reportable transaction with an overseas-incorporated AI but: (i) the AI's involvement is not through its Hong Kong branch, and (ii) the transaction does not have a Hong Kong nexus, then the exemption will not apply,

and such transactions will have to be reported if the Hong Kong person meets the other prerequisites (i.e. it is a counterparty to the transaction and has exceeded the specified reporting threshold).

Is there concern if overseas persons are not subject to mandatory reporting in Hong Kong?

83. We are not currently inclined to impose any reporting obligation on overseas persons.
84. We acknowledge that an overseas person's holdings or activities in OTC derivatives transactions could potentially raise concerns about systemic risk for Hong Kong – e.g. an overseas person might hold significant positions in equity derivatives with Hong Kong underlying. However –
- (1) Transactions of overseas persons that involve an AI or LC may in any event have to be reported to the HKMA-TR by the AI or LC concerned.
 - (2) Overseas persons are likely to be subject to a mandatory reporting obligation in their home jurisdiction. Even if they are not, their counterparty may be subject to a reporting obligation. As a result, their transactions are likely to be reported to a TR somewhere.
 - (3) Regulators in different jurisdictions are working towards putting in place information sharing arrangements whereby information collected through TRs in their own jurisdiction will be shared with overseas regulators. This will enable regulators to better identify and manage risks relating to their own markets.

85. In view of the above, we believe the HKMA and SFC should be able to obtain information on transactions by overseas persons where these have the potential to pose risks to our market. We therefore do not propose to impose any reporting obligation on overseas persons for now. However, we will revisit this issue if it appears that information collected from overseas TRs and regulators does not suffice.
86. We appreciate that the above will not catch OTC derivatives transactions where both counterparties are overseas persons, and both have no reporting obligation in their home jurisdiction. However, we expect that such cases may be extremely rare. In any event, we will revisit the need to impose reporting obligations on overseas persons if it appears necessary to do so.

Specified reporting threshold

What is it and how will it be fixed?

87. To reduce the compliance burden for market players who are neither AIs nor LCs, we propose to introduce a reporting threshold such that only those players who hold positions beyond the threshold will be subject to the reporting obligation. Our current thinking on how the reporting threshold should be cast is as follows.
88. First, we are thinking to set the reporting threshold in absolute dollar terms (i.e. as opposed to a percentage figure) and by reference to the notional value. We also propose to set the reporting threshold on a per product class basis, i.e. the threshold will apply separately and independently in respect of different product classes and may also be different for each product class. Hence, for example, we may adopt a threshold of HK\$X for IRS and a threshold of HK\$Y for NDF, and a person who only exceeds the threshold for IRS but not the threshold for NDF would only need to report his IRS (if they are reportable transactions) but not his NDF (even if they are reportable transactions).
89. Furthermore, a product class may cover a single product type or a group of product types. Hence, for example, we may define a product class to include all equity derivatives (in which case a single aggregate threshold would apply in respect of all of them), or we may define separate product classes for equity options, equity swaps, etc (in which case, different thresholds would apply in respect of each of these product types). In considering which product types should fall within the same product class (and hence share a common threshold), we propose to take into account relevant factors such as the size of the market for the relevant product type(s) in Hong Kong.
90. Secondly, we propose to set the reporting threshold at a suitable level which allows us to reduce the compliance burden for market players other than AIs or LCs, while permitting information on the OTC derivatives market to be adequately captured. For this to be effective, the threshold must be set high enough so as to exclude small players and others who only occasionally participate in that market.
91. The ambit and specific reporting threshold for each product class have yet to be determined. The HKMA and SFC are currently in the process of collecting data on the activities in our OTC derivatives market. This data will be used to determine appropriate thresholds for different product classes. The specified reporting thresholds will also be reviewed every three years and amended as appropriate to ensure it is in step with market development and changes.

How would a person determine if he has exceeded the specified reporting threshold?

92. In determining whether a person has exceeded the reporting threshold, our current thinking is to refer to the average notional value of his relevant outstanding positions for the previous six months, based on his month-end position. In other words, we will look at the month-end notional value of a person's outstanding OTC derivatives positions in a particular product class for the preceding six months, and calculate the average. When this average exceeds the specified reporting threshold for that product class, the person will need to report reportable transactions falling within that product class.
93. We propose to refer to the notional value rather than the market value of positions held simply to facilitate calculation. If the market value were to be used instead, the value of the positions held would fluctuate more frequently, making calculation difficult.
94. By looking at positions held over the preceding six months, we aim to eliminate any temporary fluctuation in positions.
95. To reduce the compliance burden and avoid the effect of temporary fluctuations, we also propose to provide for an exit threshold, which will be set at a lower level than the specified reporting threshold. Essentially therefore, a person will cease to be subject to the reporting obligation if his average month-end notional positions for the preceding six months falls below a specified exit threshold. However, he will need to notify the HKMA-TR that he has fallen below the exit threshold and is thus no longer subject to the reporting obligation.

Will non-reportable transactions and exempt transactions be included when determining if the specified reporting threshold has been exceeded?

96. As discussed above, not all OTC derivatives transactions are proposed to be subject to the reporting obligation. Rather, our current thinking is that only reportable transactions will be subject to reporting, and in the case of Hong Kong persons an exemption will apply if an AI or LC is involved in the transaction.
97. That notwithstanding, given that thresholds will be set on a per product class basis, we propose that all transactions falling within the same product class should be taken into account for the purposes of determining if the specified reporting threshold has been exceeded, i.e. irrespective of whether or not they are reportable transactions and whether or not an exemption applies. Hence, for example –
- (1) If an aggregate threshold of HK\$X is set in respect of all IRS, and only those categories of IRS listed under paragraph 59 above are reportable transactions, then a person who holds positions in overnight index swaps, single currency basis swaps and amortising swaps will need to take into account his positions in all of these transactions (i.e. including the amortising swaps even though they are not reportable transactions) when determining if he has exceeded the specified reporting threshold.
 - (2) Similarly, taking the same example as above, positions in all three types of IRS will still be taken into account when determining if the threshold has been exceeded even if the positions in the three IRS belong to a Hong Kong person, and in the

case of the overnight index swaps, the person is exempt from the reporting obligation because an AI or LC is involved.²⁰

98. We believe transactions belonging to the same product class should be included when calculating if the threshold has been exceeded because they can affect the magnitude of a person's total exposure, and level of market activity, in that product class.

Will transactions pre-dating the coming into operation of any mandatory reporting obligation be included when determining if the specified reporting threshold has been exceeded?

99. Our current thinking is that all outstanding positions in the same product class should be taken into account when determining if the specified reporting threshold has been exceeded. Hence OTC derivatives transactions entered into prior to any mandatory reporting obligation coming into effect will also need to be taken into account if such positions are still outstanding at that time and fall within the same product class.

Will there be backloading?

100. In order to have a complete picture of a person's exposure, we see merit in requiring backloading, i.e. in requiring that transactions entered into prior to a certain date, but still outstanding at such time, be reported to the HKMA-TR if they are reportable transactions and the relevant criteria for triggering the mandatory reporting obligation (including the threshold criteria, where applicable) otherwise apply. This is in line with the trend internationally.

Will there be a grace period for reporting?

101. We believe a grace period for reporting should be allowed so that persons who are not already subject to the reporting obligation have enough time to –
- (1) set up their reporting channel to the HKMA-TR – for which we propose they should have up to three months, and
 - (2) complete any backloading – for which we propose they should have a longer period of up to six months (inclusive of the 3-month grace period referred to in sub-paragraph (1) above) so as to ease the pressure on the HKMA-TR when the whole market may be seeking to backload at the same time.
102. This means a person subject to the mandatory reporting obligation should start reporting according to the usual T+1 timeframe no later than 3 months after the reporting obligation takes effect. For transactions entered into before the reporting obligation takes effect, and transactions entered into before the person starts reporting on a T+1 basis, these should be backloaded within the remaining part of the 6-month grace period. Hence, for example, if the reporting obligation takes effect on 1 January 2013, the reporting channel must be set up by 31 March 2013, and any backloading must be completed by 30 June 2013.
103. We propose that the grace periods should apply when the mandatory reporting obligation comes into effect.

²⁰ Paragraph 61(3) as well as paragraphs 80 to 82 above discuss when and why such exemptions are granted.

104. However, for persons who are not subject to the mandatory reporting obligation when it first becomes effective, the grace periods should apply when they subsequently become subject to the obligation. Hence, for example –
- (1) In the case of an AI or LC, the grace periods should apply only when the AI or LC first enters into, originates or executes a reportable transaction.
 - (2) In the case of a Hong Kong person, the grace periods should apply only when the person has exceeded the specified reporting threshold. Moreover, if he subsequently falls below the exit threshold and then exceeds the specified reporting threshold again, the grace periods should apply anew when he exceeds the specified threshold again.
105. Additionally, we propose that the grace periods should apply again when the range of reportable transactions is extended to cover a new product type. Hence, for example –
- (1) In the case of an AI or LC that is already subject to the reporting obligation in respect of IRS and NDF, if the list of reportable transactions is extended to cover certain equity derivatives, then the grace periods should apply again – albeit only in respect of transactions in equity derivatives.
 - (2) Similarly, in the case of a Hong Kong person who is already subject to the reporting obligation in respect of IRS and NDF, the grace periods should apply again when he first exceeds the specified reporting threshold for equity derivatives – albeit, only in respect of transactions in equity derivatives. Additionally, if he subsequently falls below the exit threshold for equity derivatives and then exceeds the specified reporting threshold for equity derivatives again, the grace periods should apply anew when he exceeds the specified threshold again.
106. A point to clarify here is that the grace periods would not defer the date on which the mandatory reporting obligation takes effect. Rather, they would extend (for a limited period) the time within which the reporting obligation must be fulfilled.

Overall effect of the proposed mandatory reporting obligation

107. The overall effect of the proposed mandatory reporting obligation is as follows –
- (1) LCs and locally-incorporated AIs will have to report all of their reportable transactions, and irrespective of whether they are a counterparty to the transaction or have only originated or executed the transaction. No reporting threshold will apply.
 - (2) Overseas-incorporated AIs will have to report their reportable transactions if their involvement in such transactions has been through their Hong Kong branch, or if they are a counterparty to the transaction and the transaction has a Hong Kong nexus. Again, no reporting threshold will apply.
 - (3) However, an AI or LC that has originated or executed a reportable transaction, shall be taken to have discharged its reporting obligation if it has received confirmation from the counterparty concerned (i.e. from the counterparty on whose behalf the AI or LC originated or executed the transaction) that the trade has been reported to the HKMA-TR.

- (4) For other players –
 - (a) if they are Hong Kong persons, they will have to report a reportable transaction only if –
 - (i) they are a counterparty to the transaction,
 - (ii) they have exceeded the specified reporting threshold for the product class to which the transaction belongs, and
 - (iii) no AI or LC is subject to a reporting obligation in respect of the transaction, and
 - (b) if they are not Hong Kong persons, then they will not be subject to any mandatory reporting obligation under Hong Kong law.
- (5) Intermediaries in the OTC derivatives market who are required to be licensed for a new Type 11 regulated activity (as discussed under Section III.I below) will become LCs, and therefore be subject to the mandatory reporting obligation.
- (6) Reporting to HKMA-TR can be carried out directly or through an agent.

108. **Appendix C** shows a flow chart that summarises when the mandatory reporting obligation will be triggered.

- Q5. Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?**
- Q6. Do you have any comments on the proposal to adopt a specified reporting threshold for persons other than AIs and LCs, and how the threshold will apply?**
- Q7. Do you have any comments on the proposed grace periods and how they will apply?**

D. Proposed mandatory clearing obligation

Proposal for Hong Kong

- 109. As discussed earlier,²¹ we propose to introduce a mandatory clearing obligation in Hong Kong whereby certain specified OTC derivatives transactions (i.e. clearing eligible transactions) must be cleared through a designated CCP.
- 110. Our current thoughts on how to cast any mandatory clearing obligation are different from our proposals for mandatory reporting. Specifically –
 - (1) We propose that the mandatory clearing obligation should apply to all clearing eligible transactions whenever –

²¹ See discussion under section III.B above.

- (a) an AI, LC or Hong Kong person is a counterparty to the transaction, or an AI or LC has originated or executed the transaction (and in the case of an overseas-incorporated AI, its involvement as a counterparty or person originating or executing the transaction must be through its Hong Kong branch), and
 - (b) both counterparties to the transaction (irrespective of whether or not they themselves are AIs, LCs or Hong Kong persons) have exceeded the specified clearing threshold.
- (2) However, an exemption should be given where –
- (a) both counterparties to the transaction are overseas persons (e.g. when an AI / LC originates a clearing eligible transaction between two overseas persons), and
 - (b) the transaction is either –
 - (i) subject to mandatory clearing under the laws of an acceptable overseas jurisdiction, and has been centrally cleared in accordance with those laws, or
 - (ii) exempted from mandatory clearing under those laws.

Terminology

111. The terms “originated or executed”, “Hong Kong person” and “overseas person” are intended to take on the same meaning for the purposes of the mandatory clearing obligation as they do for the mandatory reporting obligation. Reference is therefore made to paragraphs 64 and 77 to 79 above.

Application to AIs and LCs

Why capture transactions originated or executed by AIs or LCs?

112. For the same reasons discussed in paragraphs 65 and 66 above, we believe any mandatory clearing obligation should not be limited to transactions to which AIs and LCs are counterparties, but should also apply to transactions that have been originated or executed by them.

Will the clearing obligation apply similarly to locally-incorporated and overseas-incorporated AIs?

113. As with mandatory reporting,²² the mandatory clearing obligation will apply differently to locally-incorporated AIs and overseas-incorporated AIs –

- (1) In the case of overseas-incorporated AIs, the mandatory clearing obligation will only apply in respect of activities in clearing eligible transactions conducted through the Hong Kong branch. In other words, it will only apply if the AI has become a counterparty to or has originated or executed the transactions through the Hong Kong branch.

²² See paragraphs 69 and 70 above.

- (2) In the case of locally-incorporated AIs however, the mandatory clearing obligation will apply in respect of all its activities in clearing eligible transactions irrespective of whether such activities are conducted through their Hong Kong office or through any overseas branch. Additionally, to facilitate the HKMA's consolidated supervision of locally-incorporated AIs, the HKMA may require a locally-incorporated AI to comply with the mandatory clearing obligation on an entity level or on a consolidated group basis. In other words, the HKMA may require a locally-incorporated AI to: (i) take into account positions held by one or more of its subsidiaries when determining if the AI has exceeded the specified clearing threshold, and (ii) procure that clearing eligible transactions entered into by the AI's subsidiaries are centrally cleared through a designated CCP. Again, for this purpose, the HKMA will specify which subsidiaries' positions should be taken into account and centrally cleared.

Exemption where both counterparties are overseas persons

What is the rationale for the proposed exemption?

114. Our current thinking is to provide a limited exemption from the mandatory clearing obligation where the transaction is between two overseas persons and is already subject to, or exempt from, mandatory clearing under the laws of an acceptable overseas jurisdiction. The objective here is to avoid overregulation and alleviate to some extent concerns about market players being potentially subject to conflicting regulatory obligations, with the result that they either risk breaching the laws of one jurisdiction or have to forgo the trade.
115. The requirement that the transaction either be centrally cleared in accordance with the laws of an acceptable overseas jurisdiction, or exempt from such laws, is essentially to ensure that even if the transaction is not cleared in accordance with Hong Kong law, it is cleared in accordance with the laws of an acceptable overseas jurisdiction. Alternatively, if the transaction is exempt from mandatory clearing under those laws, then that right to exemption should not be denied by Hong Kong law.

What is an acceptable overseas jurisdiction?

116. The HKMA and SFC have yet to identify which jurisdictions will qualify as acceptable overseas jurisdictions. Essentially, the intention is to cover jurisdictions whose laws on mandatory reporting, clearing and trading of OTC derivatives transactions are on a par with international standards and practices.

Specified clearing threshold

Why apply a specified clearing threshold in all cases?

117. Unlike mandatory reporting, where we propose to apply a threshold only in respect of persons other than AIs and LCs, for mandatory clearing, we propose to apply a threshold in respect of all persons.
118. We believe a more pragmatic approach for clearing is justified because ultimately clearing entails significantly higher costs and is therefore a much more onerous obligation for market participants. Moreover, because we are in any case thinking to impose the mandatory reporting obligation in respect of all transactions involving AIs and LCs, it follows that even if a trade is not centrally cleared (e.g. because the clearing threshold has

not been exceeded), regulators will likely be aware of it as it will have been reported to the HKMA-TR.

119. In any event, because of the nature of clearing, if a clearing obligation is imposed, it will affect both counterparties. The mandatory reporting obligation can be imposed on counterparties independently, i.e. it is possible to impose the obligation on one counterparty and not the other. However, clearing requires participation by both counterparties and hence any mandatory clearing obligation, if imposed, will affect both counterparties. Given this, and given that a threshold would in any event be needed for market participants other than AIs and LCs, there seems no reason to hold back on adopting a similar threshold for AIs and LCs.

What is the specified clearing threshold and how will it be fixed?

120. As with the reporting threshold, the current thinking is to set the clearing threshold in absolute dollar terms and by reference to the notional value. We also propose to set the threshold on a per product class basis, i.e. the threshold will apply separately and independently in respect of different product classes and may also be different for different product classes. Moreover, each product class may include one or more product types. The discussion and example in paragraphs 88 and 89 above therefore apply equally here.
121. We are also currently minded to set the clearing threshold at a suitable level so as to minimise the impact on the market as far as possible without compromising the objectives of the obligation. As with the reporting threshold, the ambit and specific clearing threshold for each product class have yet to be determined. The HKMA and SFC are currently in the process of collecting data on activities in Hong Kong's OTC derivatives market. This data will be used to determine appropriate threshold levels. The specified clearing thresholds will be reviewed every three years and amended as appropriate to ensure it is in step with market development and changes.

How would a person determine if he has exceeded the specified clearing threshold?

122. Again, as with the reporting threshold, our current thinking is to refer to the average notional value of a person's month-end positions for the preceding six months when assessing if the specified clearing threshold has been exceeded. The discussion under paragraphs 92 to 94 above therefore apply equally here.
123. Additionally, for the purposes of consolidated supervision, the HKMA may require a locally-incorporated AI to aggregate both: (i) its own outstanding OTC derivatives positions, and (ii) the outstanding positions of those of its subsidiaries that the HKMA may specify, when determining if it has exceeded the clearing threshold on a group basis. Where the group is determined to be subject to the clearing obligation, the AI will be required to ensure that each of the subsidiaries concerned fulfils the clearing obligation.

Will non-clearing eligible transactions and exempt transactions be included when determining if the specified clearing threshold has been exceeded?

124. As with the reporting threshold, given that the clearing threshold will be set on a per product class basis, we propose that all transactions falling within the same product class should be taken into account for the purposes of determining if the specified clearing threshold has been exceeded, i.e. the calculation should not be limited to only clearing eligible transactions. Hence, if a single threshold is set in respect of all IRS, then in determining if a person's positions in IRS exceed the specified clearing threshold for IRS,

reference should be made to his positions in all IRS, i.e. in both clearing eligible IRS as well as non-clearing eligible IRS.

125. Likewise, positions in clearing eligible transactions that are exempted (e.g. because both counterparties are overseas persons and the transaction is centrally cleared in accordance with the laws of an acceptable jurisdiction) should also be taken into account when determining if the clearing threshold for a particular product class has been exceeded.

Will transactions pre-dating the coming into operation of any mandatory clearing obligation be included when determining if the specified clearing threshold has been exceeded?

126. Here again our current thinking is that all outstanding positions in the same product class should be taken into account when determining if the clearing threshold has been exceeded. Hence OTC derivatives transactions entered into prior to any mandatory clearing obligation coming into effect will also need to be taken into account if such positions are then still outstanding and fall within the same product class.

Will such pre-dating transactions be subject to mandatory clearing?

127. For transactions that: (i) pre-date the coming into effect of any mandatory clearing obligation, or (ii) pre-date the time the specified clearing threshold is exceeded, we do not propose that these should be subject to mandatory clearing even if they are clearing eligible transactions. However, we expect that market participants may nevertheless voluntarily opt to submit these pre-dating transactions to central clearing as they may partially offset new transactions, thereby resulting in netting benefits such as potentially lower margin requirements.

Will there be a grace period for clearing?

128. We propose to allow a 3-month grace period when a person first exceeds the specified clearing threshold, and to provide that such grace period will not in any event expire within the first six months from implementation of the mandatory clearing obligation. Hence, if a person exceeds the specified clearing threshold within the first three months from implementation, a slightly longer grace period will apply. (To illustrate: if implementation is on 1 January 2013, the earliest that the grace period will expire is 30 June 2013. Hence if a person exceeds the specified clearing threshold at any time between 1 January 2013 and 31 March 2013, his grace period will still end on 30 June 2013.) We believe this is appropriate as market players may need time to set up a clearing relationship with a designated CCP (or with clearing agents), as well as the necessary systems infrastructure to support central clearing. The longer 6-month grace period on implementation is proposed because more time may be needed at the outset given that many market players may be seeking connections with the same designated CCP or clearing agents at the same time.
129. The same 3-month and 6-month grace periods will be available when the range of clearing eligible transactions is extended to cover a new product type. Again, the grace periods would not defer the date on which the mandatory clearing obligation takes effect. Rather, they would extend (for a limited period) the time within which the clearing obligation must be fulfilled.
130. As with the mandatory reporting obligation, we propose to include an exit threshold for the mandatory clearing obligation, and to set this at a lower level than the specified clearing

threshold. This is to help reduce the compliance burden in respect of new trades entered into after a person's positions have fallen below the exit threshold. However, trades that have been registered with the CCP for central clearing should remain there until maturity. In any event, we expect most market participants may continue to use central clearing for their new trades so as to benefit from the advantages that this may bring, including reduced counterparty risk, netting advantages, and possible lower capital charges and a more efficient use of capital.

Responsibility for ensuring compliance with the mandatory clearing obligation

131. Unlike the mandatory reporting obligation, which can apply separately and independently to different persons depending on whether they meet the relevant criteria discussed above, the clearing obligation requires participation by parties on both sides of the transaction otherwise it cannot be discharged. Additionally, it is ultimately the counterparties (rather than the persons originating or executing the transaction) that have actual control over whether the transaction is submitted for central clearing or not. However to the extent that AIs or LCs may be involved in the transaction, they can as regulated entities, assist in ensuring that a clearing eligible transaction is cleared through a designated CCP unless exempted.
132. In view of the above, our current thinking is as follows –
- (1) to impose the mandatory clearing obligation on the counterparties²³ to the transaction where they are an AI, LC or Hong Kong person, and
 - (2) if an AI or LC has originated or executed the transaction on behalf of one or both counterparties, then they will be responsible for ensuring compliance with the mandatory clearing requirement – although they may discharge such responsibility by obtaining confirmation from the counterparty that the trade has been cleared through a designated CCP.

(In both cases, where the AI is an overseas-incorporated AI, its involvement as a counterparty or the person originating or executing the transaction, must be through its Hong Kong branch.)

Overall effect of the proposed mandatory clearing obligation

133. The overall effect of the proposed mandatory clearing obligation is as follows –
- (1) LCs, locally-incorporated AIs and Hong Kong persons that are counterparties to a clearing eligible transaction will need to clear the transaction through a designated CCP if both counterparties hold OTC derivatives positions in the same product class beyond the specified clearing threshold.
 - (2) Overseas-incorporated AIs will need to clear a clearing eligible transaction through a designated CCP if –
 - (a) they are counterparties to the transaction, and have become so through their Hong Kong branch, and

²³ We note here also that counterparties may discharge this obligation directly (i.e. by becoming a member of a designated CCP) or indirectly (by clearing through such a member) – see paragraph 153 below.

- (b) both counterparties hold OTC derivatives positions in the same product class beyond the specified clearing threshold.
- (3) AIs²⁴ and LCs that have originated or executed a clearing eligible transaction will need to ensure that the transaction is cleared through a designated CCP unless –
 - (a) one or both counterparties hold OTC derivatives positions in the same product class below the clearing threshold, or
 - (b) both counterparties are overseas persons and the transaction is either centrally cleared in accordance with the laws of an acceptable overseas jurisdiction, or exempted from such laws.
- (4) Overseas persons will not have to clear their clearing eligible transactions through a designated CCP if –
 - (a) none of the counterparties is a Hong Kong person, and none of the counterparties or persons originating or executing the transaction is an LC, a locally-incorporated AI, or an overseas-incorporated AI operating through its Hong Kong branch, or
 - (b) one or both counterparties hold OTC derivatives positions in the same product class below the clearing threshold, or
 - (c) both counterparties to the transaction are overseas persons and the transaction is either centrally cleared in accordance with the laws of an acceptable overseas jurisdiction, or exempt from such laws.
- (5) Intermediaries in the OTC derivatives market who are required to be licensed for a new Type 11 regulated activity (as discussed under Section III.I below) will become LCs, and therefore be subject to the mandatory clearing obligation.

134. **Appendix D** shows a flow chart that summarises when the mandatory clearing obligation will be triggered.

- Q8. Do you have any comments on the proposed mandatory clearing obligation, and how it will apply to different persons?**
- Q9. Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?**
- Q10. Do you have any comments on the proposed grace periods and how they will apply?**

²⁴ The reference to “AIs” here is to: (i) locally-incorporated AIs, and (ii) overseas-incorporated AIs operating through their Hong Kong branch.

E. Mandatory trading obligation

135. Our current thinking is to introduce only a mandatory reporting and a mandatory clearing obligation at the outset, and to advise later on how best to implement a mandatory trading obligation pending further study of local market conditions.

136. As noted in FSB's October 2010 report *Implementing OTC Derivatives Market Reform*:

Although organised platforms are likely to improve transparency, they affect market liquidity and prices in ways that are beneficial for some participants while potentially not beneficial for others. ... Pre- and post-trade transparency can affect the liquidity of markets in ways that may be beneficial to some market participants by improving the quality of prices. ... At the same time, post-trade transparency may reduce the liquidity that would be provided for large trades. ... The transparency arrangements that would result from organised platform trading and their consequences for liquidity need to be considered when determining whether mandatory organised platform trading ... is appropriate. ... Relevant considerations may include whether the market is large enough to support multiple types of platforms to accommodate the goals of different types of traders, or so small that only a single platform is feasible. Additionally, the determination of when organised platform trading is appropriate may depend on the incremental benefits that organised platforms can provide relative to increased standardisation and central clearing and reporting to TRs.

137. In view of the above, we need to look further into the liquidity level and number of trading venues in our market before we can assess how best to implement a mandatory trading obligation. The information obtained as a result of the proposed mandatory reporting obligation will facilitate our assessment of this issue.

<p>Q11. Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?</p>

F. Penalties for breaching mandatory reporting and clearing obligations

138. To ensure that Hong Kong's regime is on a par with international standards and practices, we believe it will be necessary to impose penalties for breach of the mandatory obligations, and to ensure that such penalties are comparable to those imposed in major jurisdictions elsewhere.

139. Although major jurisdictions have yet to announce the detailed penalty provisions that they intend to pursue, we understand that, by and large, the trend internationally is towards imposing civil or administrative fines. Our current thinking therefore is to adopt a similar approach for Hong Kong, i.e. to introduce a regime that provides for the imposition of civil or administrative fines, and for the fines to be set at a level that is commensurate with levels adopted in major jurisdictions elsewhere.

140. Needless to say, any penalty regime introduced will not detract from any existing disciplinary regimes that may apply to AIs and LCs, and legislative amendments will be introduced as necessary to ensure a level playing field among AIs and LCs in this regard.

G. Designation and regulation of CCPs

141. As discussed under Section III.D above, we propose to mandate that clearing eligible transactions must be cleared through a designated CCP. This Section discusses how we propose to designate a CCP and how it will be regulated.

Requirement to be an RCH or authorized ATS provider

142. Our current thinking is that only an RCH or an ATS provider authorized under Part III of the SFO should be permitted to be designated as a CCP for the purposes of the mandatory clearing obligation. We see a number of benefits to adopting such an approach.
143. First, by requiring the CCP to be an RCH or authorized ATS provider, we would be able to leverage on the existing provisions and frameworks that govern the regulation of CCPs. Some amendment will still be needed. In particular, the scope of the existing provisions (which is currently limited to only securities and futures) will need to be extended to cover OTC derivatives transactions.
144. Secondly, the existing regime for RCH and authorized ATS providers is cast in broad terms. This allows the SFC to require that international standards for regulation of OTC derivatives clearing houses must be met before an entity is recognized as an RCH or authorized as an ATS provider for OTC derivatives transactions, including therefore standards relating to governance structures and arrangements, financial resources, membership criteria, risk management policies and procedures, margining requirements, default proceedings and procedures, etc.
145. Thirdly, the ATS regime will be particularly suited to overseas CCPs who wish to provide services to the Hong Kong market. The ATS regime is more flexible and can be calibrated to apply, as appropriate, to overseas CCPs since they will remain primarily regulated in their home jurisdiction.

Location requirement

146. An important issue that arises is whether only domestic CCPs should be designated for the purposes of any mandatory clearing obligation under Hong Kong law.
147. Our initial thinking was that such a restriction may not be necessary. There may also be cost implications for market participants as they would then need to become members of multiple CCPs with the result that they may not be able to enjoy the full extent of any netting benefits that they might otherwise enjoy.
148. However, more recently, concerns have been raised about permitting overseas CCPs to clear transactions in domestic products that are of systemic importance. For example, in their June 2011 discussion paper entitled *Central Clearing of OTC Derivatives in Australia*, the Australian Council of Financial Regulators²⁵ note their reservations about a mandatory clearing requirement that results in a systemically important domestic market – such as the market for Australian dollar-denominated interest rate derivatives (e.g. overnight indexed swaps, forward rate agreements and interest rate swaps) being cleared through

²⁵ The Council comprises the Australian Prudential Regulation Authority, the Australian Securities and Investments Commission, the Reserve Bank of Australia, and the Department of Treasury.

offshore CCPs. Similarly, Japan requires that credit derivatives with Japanese referenced assets which are conducted by domestic participants must be cleared domestically.

149. We see merit in the concerns raised, but appreciate also that the proliferation of CCPs can lead to fragmentation and reduce liquidity. We therefore welcome input on this issue from interested parties.

Acceptability of overseas clearing members

150. In the context of local CCPs, the question of the acceptability of overseas clearing members is important. Local CCPs seeking designation for the purposes of the mandatory clearing obligation may wish to accept overseas clearing members. Likewise, overseas persons that are affected by the mandatory clearing obligation may wish to clear directly (i.e. as a member of a designated CCP) rather than indirectly (i.e. through another member). In either case, a limitation on the acceptability of overseas members would pose difficulty. If we were to mandate the use of local CCPs in certain cases (as discussed in paragraphs 146 to 149 above), then the question of whether we should allow local CCPs to accept overseas clearing members becomes even more important.
151. Our current thinking is that such overseas membership should be allowed so that an overseas person who is a counterparty to a clearing eligible transaction that has to be cleared through a designated CCP can clear the transaction directly (i.e. as a member of a designated CCP) or indirectly (i.e. through another member).
152. However, we expect that different market players may have different views on this issue and that there may be strong views both for and against overseas membership. We therefore welcome input on this issue from interested parties.

Indirect clearing

153. To facilitate market players' compliance with any mandatory clearing obligation, and acknowledging that not all market players may qualify to become members of a CCP, we believe it will be necessary to facilitate client clearing. To that end, we propose that market players should be allowed to perform any mandatory clearing obligation either –
- (1) directly, i.e. as a member of a designated CCP, or
 - (2) indirectly, i.e. through a third party that is a member of a designated CCP, and which is either –
 - (a) an LC licensed to carry on the new Type 11 regulated activity (discussed under Section III.I below),
 - (b) an AI, or
 - (c) an overseas intermediary that is regulated in a recognized overseas jurisdiction with comparable regulatory requirements on OTC derivatives and legislation that supports segregation and portability of client assets.
154. A key aspect of indirect clearing (or client clearing) is to ensure portability and segregation of client positions and collateral. CPSS-IOSCO's March 2011 consultative report entitled *Principles for Financial Market Infrastructures* seeks comments on a single, comprehensive set of 24 principles designed to apply to various financial market

infrastructures including CCPs. In particular Principle 14 recommends that CCPs should have segregation and portability arrangements that are supported by law and that protect positions and collateral belonging to customers of a participant, particularly in the case of insolvency of a participant. Specifically, the report states (at paragraph 3.14.4):

In order to fully achieve the benefits of segregation and portability, the legal framework applicable to the CCP should support its arrangements to protect the positions and collateral of a participant's customers.... a CCP should structure its segregation and portability arrangements in a manner that protects the interest of a participant's customers and achieves a high degree of legal certainty under applicable law.

155. In view of the foregoing, we are reviewing whether and to what extent the insolvency override provisions and other protections under Part III of the SFO need further amendment to support client clearing, and any segregation and portability arrangements put in place by designated CCPs.

Q12. Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?

H. Capital charges and margin requirements

156. In line with the G20 commitment, we are thinking to impose higher capital requirements for OTC derivatives transactions that are not cleared through a CCP. We are also considering whether such transactions should be subject to margin requirements. In this regard, reference will be made to any international standards, including those under Basel III (which the HKMA intends to implement in relation to AIs) and recommendations that may emerge from further work by standard setters on margining requirements for non-centrally cleared OTC derivatives transactions as has been encouraged by FSB in July.

I. Regulation of OTC derivatives market players (other than AIs)

157. A key issue we are currently studying is whether and to what extent players in the OTC derivatives market should be regulated.
158. For Hong Kong, our current thinking is as follows –
- (1) At present, OTC derivatives activities already form a core and integral part of AIs' banking business and are already regulated by the HKMA in respect of capital, liquidity and other relevant requirements as part of its oversight of AIs. In order to bridge the regulatory gap that will otherwise exist, there is a need to require non-AI entities that engage in the OTC derivatives activities (but otherwise than as end users) to be regulated. To that end, we propose to introduce a new Type 11 regulated activity under Schedule 5 of the SFO which would capture the OTC derivatives activities of intermediaries (other than AIs) and bring them under the SFC's licensing regime. The new regulated activity should be cast in such a way as to take into account the unique characteristics of the OTC derivatives market, including in particular that transactions are typically conducted on a principal-to-principal basis.

- (2) We also propose to have a degree of regulatory oversight of large players whose activities may have the potential to raise concerns of systemic risk. This would include commercial entities and financial institutions who do not act as intermediaries but who are essentially price-takers or end users.

Regulation of intermediaries

Which type of activities are we considering to regulate?

159. As explained above, our main focus is on persons, other than AIs, who essentially carry on business as dealers, advisers or clearing agents in the OTC derivatives market.
160. By dealers and advisers, we essentially mean persons who make markets (e.g. by providing two-way quotes, or responding to requests for price quotes) and those who arrange an OTC derivatives transaction or otherwise help in creating the transaction or bringing together the counterparties to it in the ordinary course of their business. We understand that advisory services are typically provided as part of the dealing services, rather than as a discrete service, and that they are likely to relate to specific transactions given the bespoke nature of many OTC derivatives transactions.
161. Clearing agents are proposed to be included because back-to-back transactions are usually entered into with the client and the CCP under certain client clearing models. This is in some way similar to a dealer who makes or offers to make an agreement with another person in relation to OTC derivatives. As we propose to allow the mandatory clearing obligation to be discharged by indirect clearing through a clearing agent, it is important to ensure that clearing agents operating in Hong Kong are adequately supervised in order to protect the interest of their clients. Moreover, the robustness of the CCP will be critical to the effectiveness of the OTC derivatives regime, and hence it is important to ensure that participants of a designated CCP are also subject to adequate regulation and supervision.
162. Our current thinking is to cast the definition along the lines of the existing dealing and advising definitions under the SFO, i.e. the definitions for Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities) and Type 5 (advising on futures contracts) regulated activities, albeit with suitable amendments to take into account the particular characteristics of the OTC derivatives market, including that transactions in this market are typically conducted on a principal-to-principal basis.
163. We do not however intend to regulate financial institutions, commercial entities and others that are essentially price-takers or end users, although if their activities are significant enough, they may qualify as large players and come under our regulatory oversight as discussed below.²⁶

Will the new Type 11 regulated activity only apply to OTC derivatives transactions that are subject to any of the mandatory obligations?

164. We are still considering this issue. Our inclination at this stage is not to limit the scope of the new Type 11 regulated activity so that it only covers those asset classes to which any reportable transactions or clearing eligible transactions belong. In other words, our current inclination is to extend the licensing requirement so that it covers activities in all

²⁶ See paragraphs 169 to 172 above.

OTC derivatives transactions. This would be in line with international standards, as well as with the HKMA's existing supervisory treatment of AIs, whereby activities in all OTC derivatives transactions (and not only those that are reportable or clearing eligible) are subject to prudential regulation by the HKMA.

How will we deal with any overlaps between the new regulated activity and existing regulated activities?

165. The scope of the new regulated activity may overlap with that of some of the existing regulated activities. In particular, with respect to equity derivatives (as and when included), there may be some overlap with Type 1 (dealing in securities) and Type 4 (advising on securities). Similarly, with respect to foreign exchange derivatives, there may be some overlap with Type 3 (leveraged foreign exchange trading).
166. We are still considering how best to deal with such overlaps. In particular –
- (1) One obvious option would be to incorporate appropriate carve outs so that if a person's OTC derivatives activities are limited to activities that fall within the scope of an existing regulated activity, then he should be able to continue on the basis of his existing licence and not need to seek a licence for the proposed new Type 11 regulated activity.
 - (2) An alternative would be to do the opposite. In other words, to amend the scope of the existing regulated activities so as to exclude any activities falling within the scope of the new Type 11 regulated activity.
167. The above options each have their pros and cons. A main attraction of option (1) above is that it would leave the existing regime intact. On the other hand, option (2) has the advantage of being tidier. In terms of impact on market players –
- (1) To the extent that their OTC derivatives activities cover only equity derivatives and they are already licensed for Type 1 regulated activity, option (1) may be preferable as it would allow such players to be able to continue with their business without having to be licensed for the new Type 11 regulated activity.
 - (2) However, to the extent that their OTC derivatives activities cover the full range of asset classes, or asset classes that do not fall within the scope of the existing regulated activities (e.g. interest rate derivatives), there may be little difference between the two options because such players would in any event need to be licensed for the new Type 11 regulated activity.
 - (3) As far as AIs are concerned, since they will not need to be licensed for the new Type 11 regulated activity, option (1) may be better as it leaves AIs' existing regulated activities unaffected.
168. Additionally, any laws, rules and codes applicable to OTC derivatives will need to be reviewed to ensure that they apply to intermediaries equally and as appropriate.

Regulatory oversight of large players

169. We are still considering to what extent large players should be regulated under our regime. This includes financial institutions, commercial entities and others that are essentially price-takers or end users in the OTC derivatives market.

170. We agree that there is a strong argument for having regulatory oversight of large players, by which we mean players who hold positions for their own account only but whose positions raise concerns of potential systemic risk.

171. However, we are not convinced that such players should be regulated as licensed persons since they are not carrying on any intermediary function. In the context of large players however, the regulatory concerns are very different. The focus here would essentially be to better understand the player's activities and motives, and to be able to take action to reduce any build-up or retention of positions that may pose systemic concerns.

172. In view of the above, our current thinking is as follows –

- (1) We propose to set out certain quantitative and/or qualitative criteria for defining large players who operate in Hong Kong. To the extent that these include thresholds, these would in any event be significantly higher than any reporting threshold specified for the purposes of the mandatory reporting obligation. We would add here that we expect only a very limited number of players to fall within the definition of large players. We will also fine tune any thresholds included in the definition when more information is available from the HKMA-TR.
- (2) Persons who meet these criteria will not need to be licensed by, or registered with, the SFC in any way. However, they will become subject to certain obligations and requirements which will also be set out in legislation.
- (3) As to what these specific obligations and requirements should be, our current thoughts are that they should include at least an obligation to –
 - (a) produce such information regarding their OTC derivatives transactions and activities as the SFC may reasonably require, and
 - (b) take steps to reduce their positions in such transactions if so requested by the SFC in certain specified circumstances.

For completeness, we note here that the HKMA and SFC already have powers under existing legislation that would allow them to take similar action against AIs and LCs, i.e. to require AIs and LCs to produce information regarding their OTC derivatives transactions, and take steps to reduce excessive positions. Specifically, under Part X of the SFO, the SFC can require LCs to take certain action in relation to their business, or in relation to certain property or transactions as specified. Additionally, the Securities and Futures (Financial Resources) Rules set out financial resources requirements that LCs must comply with. These may operate to limit the extent of their activities. Similarly in the case of AIs, the HKMA can, under the Banking Ordinance, require AIs to submit information (section 63), take certain action in relation to AIs' business or property under certain circumstances (section 52), and increase the capital adequacy ratio of locally-incorporated AIs (section 101) if they have taken on excessive risks.

- (4) Additionally, because the criteria for large players will be much higher than any specified reporting threshold, they will in any event be subject to the mandatory

reporting obligation discussed earlier.²⁷ However, they may not necessarily be subject to the mandatory clearing obligation discussed earlier – e.g. if their counterparty has not exceeded the specified clearing threshold.

Q13. Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?

Q14. Do you have any comments on the proposed regulatory oversight of large players?

IV. Way forward

173. In terms of timing, the HKMA and SFC are currently working with the Government on the legislative amendments necessary for implementing a regulatory regime for the OTC derivatives market in Hong Kong. Market comments in response to this consultation will be critical to finalising some of the key aspects of the regime and the legislative amendments.
174. Additionally, as mentioned earlier, the detailed requirements of the new OTC derivatives regime will be set out in subsidiary legislation. In accordance with section 398 of the SFO, we aim to issue a consultation paper on the proposed subsidiary legislation by Q1 next year.
175. The timeline for implementing any new OTC derivatives regime is however ultimately subject to a number of external factors, including in particular –
- (1) the due completion of the legislative process,
 - (2) the progress of discussions in the global arena on some of the key aspects of the reform on which consensus has yet to be reached, and
 - (3) any delays in the timetable for implementation in other major jurisdictions, most notably the US and EU.
176. The HKMA and SFC will therefore continue to monitor global discussions and developments closely.

²⁷ See Section III.C above.

Status of implementation efforts in major jurisdictions

A number of jurisdictions have initiated proposals to implement the G20 commitments. Below is a summary of the latest status of their implementation efforts.

United States

1. In July 2010 the US congress passed the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Among other things, the Act creates a new framework for the regulation of OTC derivatives activities. In particular –
 - (1) It provides that the Commodities Futures Trading Commission (**CFTC**) and the Securities and Exchange Commission (**SEC**) will share primary regulatory responsibility for oversight of the OTC derivatives market.
 - (2) It requires central clearing for certain swaps, but provides an exemption for non-financial entities hedging commercial risks. It also requires mandatory trade reporting for centrally cleared and non-centrally cleared swaps to a registered TR. Counterparties must also execute transactions in certain swaps on a board of trade designated as a contract market, an exchange or a Swap Execution Facility.
 - (3) Additionally, swap dealers and major swap participants will have to be registered and be subject to prudential and conduct requirements.
 - (4) All swaps subject to the mandatory clearing requirement will have to be cleared through a regulated CCP.
2. The CFTC and SEC have proposed detailed rules to implement the Dodd-Frank Act in relation to the regulation of the OTC derivatives market. These rules are being finalised by the two regulators and it is expected that they will come into effect by early 2012.

European Union

3. In September 2010, the European Commission published a proposal for regulation of OTC derivative transactions, CCPs and TRs. The proposal –
 - (1) seeks to increase transparency by requiring EU financial and non-financial firms to report information on OTC derivatives transactions to TRs, and
 - (2) aims to reduce counterparty credit risk by mandating central clearing for eligible transactions and risk management techniques for derivatives that are not centrally cleared.
4. More specifically, based on the latest proposals –
 - (1) eligible OTC derivatives transactions will be subject to mandatory central clearing but non-financial counterparties that do not exceed a clearing threshold (yet to be determined) will be exempted,

- (2) in assessing if a non-financial counterparty has exceeded the clearing threshold, transactions that are objectively measurable as reducing risks directly related to that counterparty's commercial activities will be excluded,
 - (3) transactions that are subject to mandatory central clearing must be cleared through a CCP that is authorised and supervised by the relevant competent authority, and
 - (4) centrally cleared and non-centrally cleared OTC derivatives transactions must be reported to a TR registered or recognised by the European Securities and Markets Authority (**ESMA**).
5. As for trading, the European Commission is in the pre-proposal consultation stage and expects a legislative proposal later this year. The current thinking is to mandate trading on organised platforms for certain clearing-eligible derivatives that are sufficiently liquid.
6. The EU proposal is currently going through the legislative process and is expected to be adopted by end-2011. Thereafter, ESMA will make rules to implement the proposal, and it is expected that the EU's regulatory regime will become effective by the end of 2012.

Japan

7. Japan passed an amended law in May 2010 that will be implemented by November 2012.
- (1) The new law requires central clearing for OTC derivatives transactions where the reduction of settlement risk through central clearing would be deemed necessary for the stability of the Japanese market. The Cabinet Office Ordinances will specify the exact products that are to be subject to mandatory clearing.
 - (2) Credit derivatives with Japanese reference assets conducted by Japanese participants must be cleared domestically.
 - (3) Additionally, where a trade is subject to mandatory clearing, the CCP must store the trade information and report it to the regulator. Financial institutions will be subject to a mandatory reporting requirement, but will be able to report to a TR (foreign or domestic) or to the regulator directly.

Australia

8. In June 2011 the Australian Council of Financial Regulators issued a discussion paper on *Central Clearing of OTC Derivatives in Australia*.
9. One of the key issues highlighted in the discussion paper is whether there is a case for requiring activities in Australian dollar-denominated interest rate derivatives to be centrally cleared, and whether this should take place in Australia.
10. The Council agencies are separately considering the other issues addressed by the G20 commitments, and will advise the Australian government in due course.

Singapore

11. The Monetary Authority of Singapore (**MAS**) indicated in July 2011 that it was reviewing its detailed policies and will conduct a consultation by the end of this year on all aspects of

FSB's recommendations. MAS also indicated that it aims to meet the target timeline of implementation by end 2012.

12. In November 2010, the Singapore Exchange (**SGX**) launched its new clearing services for OTC traded financial derivatives, on top of the central clearing services for OTC commodity derivatives that it already offers. The new clearing services currently cover interest rate swaps, and SGX has announced that the services will be expanded to include certain non-deliverable foreign exchange forward contracts.

Initiatives of international standard setting bodies

Financial Stability Board

1. In April 2010 the FSB formed a working group – the FSB OTC Derivatives Working Group – led by representatives from CPSS, IOSCO and the European Commission to identify factors that make derivatives clearable and set out policy options to support the consistency of implementation of clearing and exchange or electronic trading requirements across jurisdictions. Essentially, the objective of the working group was to develop recommendations on the implementation process as a follow-up of the policy objectives of the G20 Leaders' commitment concerning standardisation, central clearing, exchange or electronic trading and trade reporting of OTC derivatives.
2. The working group issued a report in October 2010 entitled *Implementing OTC Derivatives Market Reforms*. The report sets out 21 recommendations for implementing the G20 objectives, and specifies the bodies that will be responsible for taking the recommendations forward. The recommendations put forward cover many of the issues that authorities may encounter concerning standardisation, central clearing, electronic trading and reporting of OTC transactions to TRs.
3. Since then, the working group has been monitoring members' progress in implementing the recommendations. It delivered an initial progress report in April 2011 and a second progress report in October 2011. Both reports have been published by the FSB.
4. The FSB has also encouraged further work by standard setters on margining requirements for non-centrally cleared OTC transactions, and on data reporting requirements for trade repositories.

CPSS-IOSCO initiatives

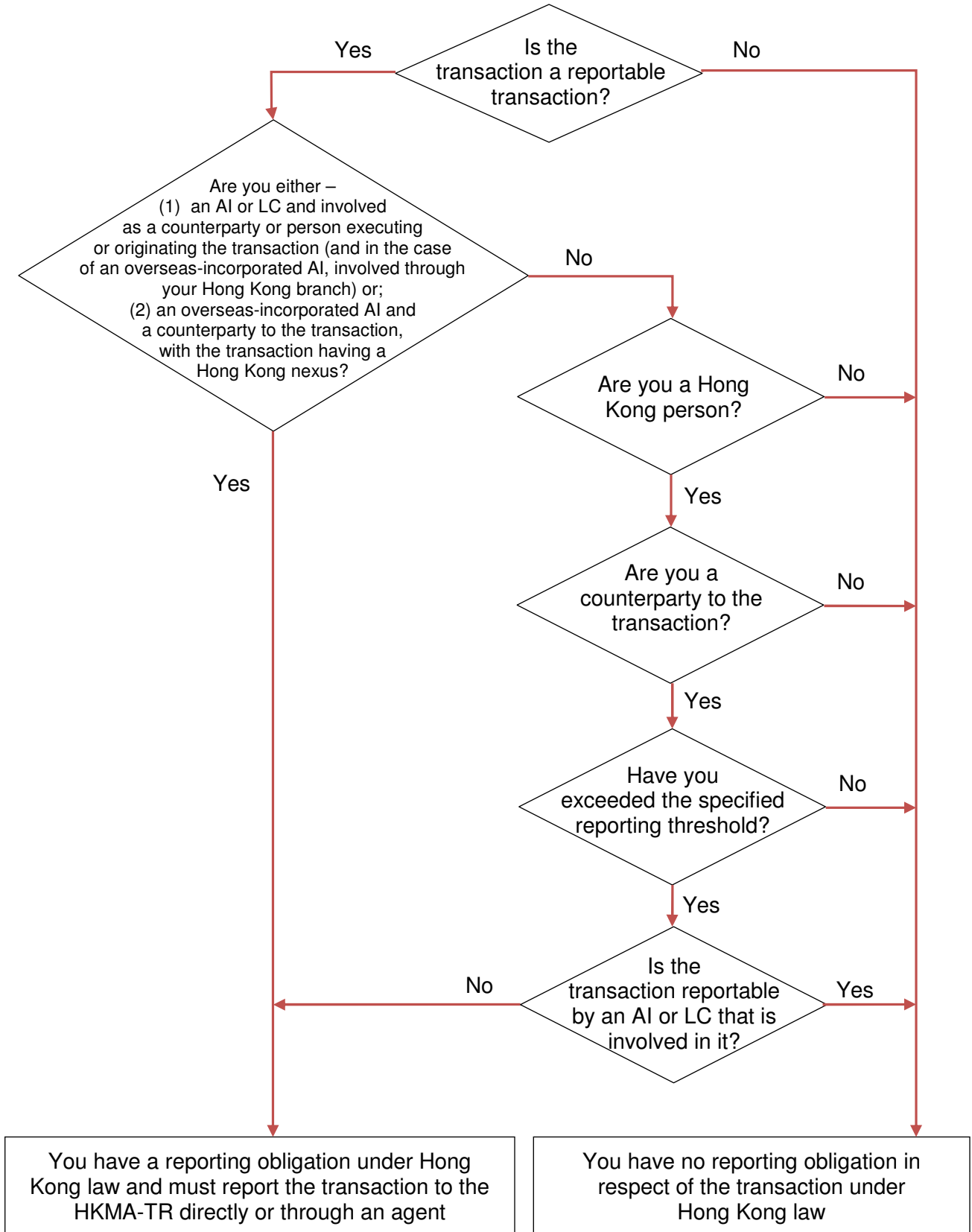
5. Under the G20 commitments, CCPs will play a critical role. Ensuring strong standards and oversight of CCPs will therefore be crucial to reducing systemic risk. Accordingly, in May 2010, CPSS and IOSCO published a consultative report entitled *Guidance on the Application of the 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC Derivatives CCPs*. This report aims to promote consistent application and interpretation of the existing standards for CCPs in order to better address risks associated with clearing OTC derivatives.
6. In parallel, and in light of the growing importance of TRs, CPSS and IOSCO published a second consultative report entitled *Considerations for Trade Repositories in OTC Derivatives Markets*. This report discusses the various factors that should be considered by TRs when designing and operating their services, and by relevant authorities when regulating and overseeing TRs.

7. Both consultative reports will be incorporated into CPSS-IOSCO's comprehensive review of their standards for all financial market infrastructures (**FMI**). CPSS-IOSCO issued a public consultation on the standards for FMIs in March 2011 and expects to issue a final report in early 2012.

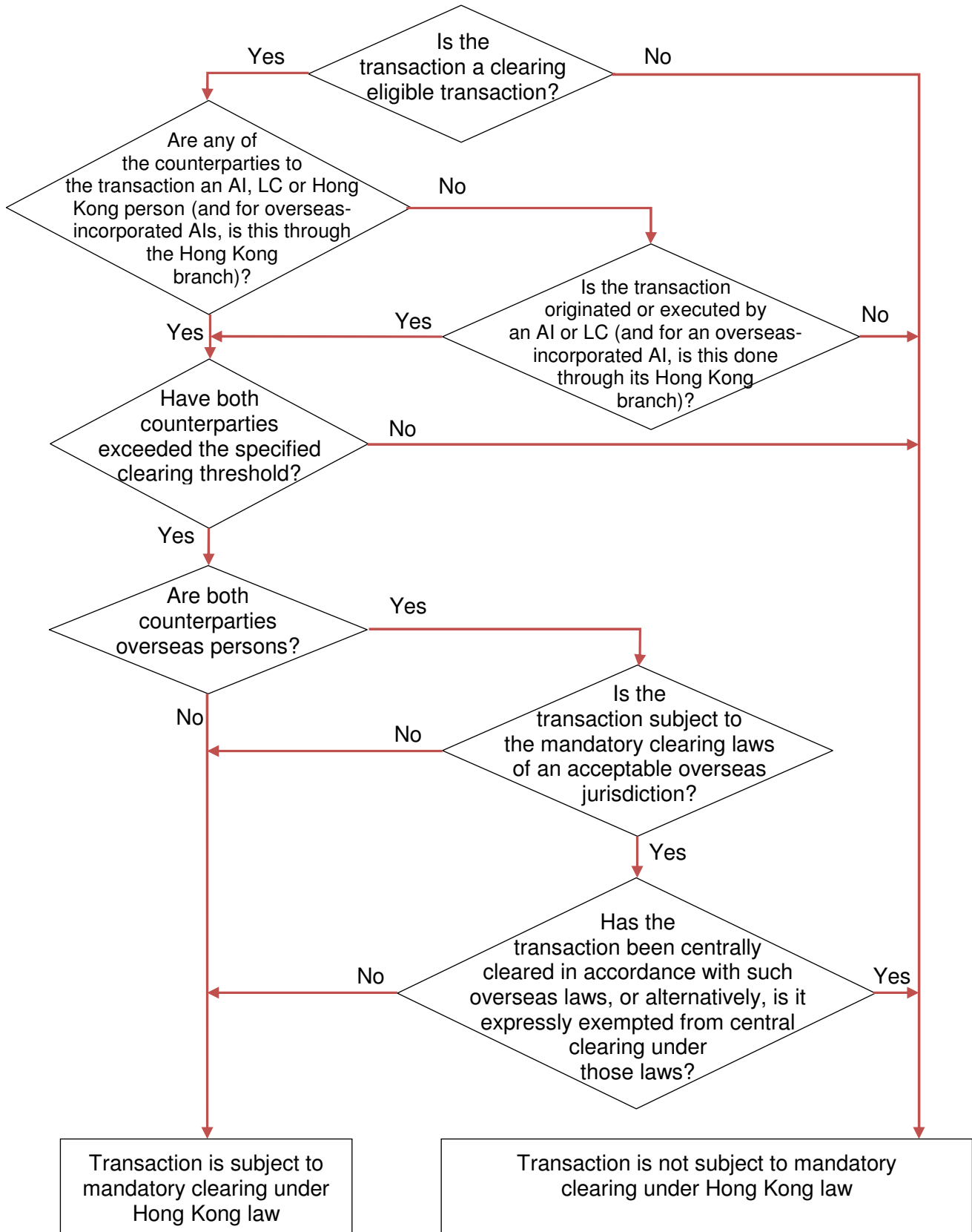
IOSCO initiatives

8. In October 2010, IOSCO established a Task Force on OTC Derivatives Regulation (**Task Force**) to coordinate securities and futures regulators' efforts on developing supervisory and oversight structures relating to OTC derivatives markets. One of the key objectives of the Task Force is to endeavour to develop consistent international standards regarding OTC derivatives regulation in the areas of clearing, trading, trade data collection and reporting, and the oversight of certain market participants.
9. In February 2011, the Task Force completed a report entitled *Report on Trading of OTC Derivatives*. The report analyses the benefits, costs, and challenges associated with increasing exchange and electronic trading of OTC derivative transactions and makes recommendations to assist the transition of trading in standardised derivatives products from OTC venues onto exchanges and electronic trading platforms.
10. The Task Force, working jointly with CPSS, also produced another report entitled *Report on OTC derivatives data reporting and aggregation requirements*, which was released for comments in August 2011. The report specifies minimum requirements for reporting data to a TR and for reporting by a TR to regulators. It also discusses issues relating to authorities' and reporting entities' access to data, and addresses data aggregation mechanisms and tools needed to enable authorities to aggregate data in a manner that fulfils their regulatory mandates. The period for submitting comments on the report ended in late September 2011. It is expected that the final report will be published by the end of 2011.
11. The Task Force is currently working on its third report on international standards. The report aims to set out consistent international standards for derivatives regulation, including in the area of mandatory clearing requirements and the oversight of swap dealers and other market participants. It is expected to be published in January 2012.

Flow chart for the proposed mandatory reporting obligation



Flow chart for the proposed mandatory clearing obligation



Glossary

AI	authorized institution, as defined under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong)
ATS	automated trading services, as defined under the SFO
CCP	central counterparty, i.e. an institution that is interposed between two trading parties, becoming the buyer to every seller and the seller to every buyer
clearing eligible transactions	the specific types of OTC derivatives transactions determined by the HKMA and SFC as being subject to mandatory clearing (as discussed in paragraphs 56 to 58 above)
CLS system	the Continuous Linked Settlement system, which is a global settlement system for cross-border foreign exchange transactions
CPSS	the Committee on Payment and Settlement Systems, a standard setting body for payment and securities settlement systems that also serves as a forum for central banks to monitor and analyse developments in domestic payment, clearing and settlement systems as well as in cross-border and multicurrency settlement schemes
EU	the European Union
FSB	the Financial Stability Board, an international body that monitors and makes recommendations about the global financial system, and which was established in 2009 as a successor to the Financial Stability Forum (a group of finance ministries, central bankers and international financial bodies which was founded in 1999 to promote international financial stability)
G20 Leaders	the group of finance ministers and central bank governors from 20 major economies
HKMA	the Hong Kong Monetary Authority
HKMA-TR	the TR to be established and operated by the HKMA for the collection of data relating to OTC derivatives transactions
Hong Kong nexus	a transaction has a Hong Kong nexus if its underlying asset, currency or rate is (or includes one that is) denominated in Hong Kong dollars, or in the case of credit or equity derivatives (if and when included), the underlying reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law – see paragraph 71 above
Hong Kong person	a person, other than an AI or LC, who is based in Hong Kong as explained in paragraphs 77 to 78 above
IOSCO	the International Organization of Securities Commissions, an association of organisations that regulate the world's securities and futures markets
IRS	interest rate swaps, i.e. a derivatives transaction under which one counterparty exchanges a stream of interest payments for another

	counterparty's cash flow
LC	licensed corporation, as defined under the SFO
NDF	non-deliverable forwards, i.e. a derivatives transaction under which the profit or loss at the time of settlement is calculated by reference to changes in the exchange rate between two currencies (i.e. changes between an agreed rate and the prevailing market rate at the time of settlement), and settled on a net basis in one currency
originated or executed	a transaction is "originated or executed" by a person if he has negotiated, arranged, confirmed or committed to the transaction on behalf of himself or any of the counterparties – see paragraph 64 above
OTC derivatives transactions	bilateral transactions where payment obligations are determined by reference to changes in the value or level of some underlying asset, rate, index, property, futures contract or by reference to the occurrence or non-occurrence of one or more events
overseas person	a person other than an AI, LC or Hong Kong person
RCH	recognized clearing house, as defined under the SFO
REC	recognized exchange company, as defined under the SFO
reportable transactions	the specific types of OTC derivatives transactions determined by the HKMA and SFC as being subject to mandatory reporting (as discussed in paragraphs 56 to 58 above)
SFC	the Securities and Futures Commission
SFO	the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong)
TR	trade repository, i.e. entities that collect and maintain data relating to OTC derivatives transactions
