LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)
Securities and Futures (Futures Contracts) Notice 2012

INTRODUCTION

The Financial Secretary made the Securities and Futures (Futures Contracts) Notice 2012 ("the Notice) at **Annex** on 26 April 2012, in accordance with section 392 of the Securities and Futures Ordinance (Cap. 571) ("SFO"). The purpose of the Notice is to prescribe that any structured product set out in the Schedule to the Notice is to be regarded as a futures contract for the purposes of certain provisions of the SFO, so that if such a structured product is cleared and novated through a recognized clearing house, it may constitute a market contract, and thereby enjoy the insolvency override protection conferred under Division 3 of Part III of the SFO.

BACKGROUND AND JUSTIFICATIONS

2. In line with the G20 Leaders' commitment[1], the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") have been developing a regulatory regime for the over-the-counter ("OTC") derivatives market in Hong Kong. Our plan is to introduce the relevant Bill into the Legislative Council in 2012/13 to provide for the regulatory framework for the OTC derivatives market in Hong Kong. Among other things, the new regime will introduce a mandatory clearing obligation whereby market participants will be

[1] In September 2009, in the wake of the crisis, the G20 Leaders committed to reforms that would require (a) the mandatory reporting of OTC derivatives transactions to trade repositories; (b) the mandatory clearing of certain OTC derivatives transactions through central counterparties; (c) the mandatory trading of certain OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate; and (d) the imposition of higher capital requirements in respect of OTC derivatives transactions not centrally cleared.

obligated to centrally clear certain OTC derivatives through a designated central counterparty ("CCP").

3. The Hong Kong Exchanges and Clearing Limited ("HKEx") is establishing a local CCP to provide central clearing services for specified OTC derivatives products. It aims to commence operation of the local CCP by end 2012. The HKEx has pledged to implement robust and prudent risk management measures for its CCP to minimise the default risk of clearing members. For example, under HKEx's proposals, the HKEx CCP will have power to require a clearing member to reduce its position if the situation warrants, e.g. when the clearing member has accumulated a very large position that may create excessive risk to the market. In addition to margin requirements, the CCP will set up a guarantee fund to provide additional financial resources to cushion any loss that may arise in the event of a default by clearing members. The guarantee fund will consist of contributions from all clearing members and the CCP's capital.

4. The HKEx CCP will need to be approved by the SFC as an recognized clearing house ("RCH") before it can commence operation. Its risk management measures will also be reviewed by the SFC to ensure that the risks it bears are managed prudently. In assessing the HKEx CCP, the SFC will draw reference to the new global standards for Financial Market Intermediaries which were jointly published on 16 April 2012 by the Committee on Payment and Settlement System[2] and International Organisation of Securities Commissions.

5. Notwithstanding that mandatory clearing has yet to be implemented, market participants are already moving towards voluntary clearing (i.e. clearing their OTC derivatives transactions through a regulated CCP on a voluntary basis). Market participants recognize that the earlier they start voluntarily clearing through a CCP, the better prepared they will be when the mandatory clearing obligation is implemented. They also recognize that clearing their OTC derivatives transactions through a CCP brings benefits and protection for both themselves and the market as a whole.

---

[2] Committee on Payment and Settlement System is a committee set up by Bank for International Settlements.

6. A key consideration for market participants when deciding which CCP to use for voluntary clearing is whether the transactions cleared through that CCP enjoy insolvency override protection.[3] If they do not, this will raise concerns about the CCP's default management capability, and consequently defeat the objective of voluntary clearing (which is to better manage counterparty credit risk in the event of a default). Market participants will therefore not opt to voluntarily clear through such CCPs.

7. The insolvency override protection must be conferred by law. The laws of many major markets already confer such protection in respect of transactions cleared through CCPs in their jurisdictions. In the case of Hong Kong however, such protection is only conferred in respect of securities and futures contracts but not in respect of OTC derivatives transactions. This is because the existing insolvency override protection under the SFO only applies to "market contract", which, as defined in Schedule 1 of the SFO, only covers transactions in securities or futures contracts, and only if –

(a) the transactions are subject to the rules of a RCH and entered into by the RCH with a clearing participant pursuant to a novation, and

(b) the novation is for the purposes of clearing and settling transactions –

    (i) effected on a stock or futures market operated by a recognized exchange company ("REC"), or

    (ii) subject to the rules of an REC.

8. If the law remains unchanged, market participants in Hong Kong who wish to opt for voluntary clearing of OTC derivatives transactions will have no option but to clear through an overseas CCP, i.e. they will not have the option to clear through a local CCP regulated by

[3] Transactions that enjoy insolvency override protection are not susceptible to being undone pursuant to general insolvency law. Such protections have to be conferred by statute, and are typically conferred on transactions cleared through a regulated CCP. The objective of such protection is to provide legal certainty of settlement finality for transactions cleared through the CCP.

the SFC and enjoy the advantages of doing so. For example, clearing through a local CCP could facilitate communication since the CCP operates in the same time zone, and enable collateral to be held locally and thus be more readily accessible. In the event of default by a clearing member, the local regulator could more effectively assist local participants and monitor any potential systemic implications for the local market.

9. To support voluntary clearing of OTC derivatives transactions through a local CCP, and pending the introduction of a full-fledged regulatory regime for the OTC derivatives market in Hong Kong, the Financial Secretary has made the Notice under section 392 of the SFO to prescribe that any structured product set out in the Schedule to the Notice is to be regarded as a futures contract for the purposes of certain provisions of the SFO. The overall effect is to –

(a) enable such a structured product to become a "market contract" if it is –

   (i) cleared and novated through an RCH, and

   (ii) either effected on, or subject to the rules of, an REC, and thereby

(b) enjoy the insolvency override protection conferred under Division 3 of Part III of the SFO.

10. It is important to note that the Notice –

(a) will not affect the current licensing regime (i.e. there will be no licensing implications for market participants who deal in or advise on OTC derivatives),

(b) will not mandate central clearing of OTC derivatives, and

(c) will not provide insolvency override protection to all local CCPs that clear OTC derivatives, but only those that are RCHs.

Moreover, the Notice will be repealed upon implementation of the full-fledged regulatory regime for the OTC derivatives market referred to in paragraph 2 above.

11. The Notice will facilitate the implementation of a full-fledged regime for the OTC derivatives market in Hong Kong. Early recognition of a Hong Kong CCP will also give it the opportunity to build up experience and a track record before the implementation of mandatory clearing obligation. This will provide added comfort to market participants who will then be obligated to clear through a designated CCP and would prefer to do so through a CCP in Hong Kong. An existing track record will also facilitate the recognition of the Hong Kong CCP by overseas jurisdictions, thus providing greater choice to market participants who may be subject to mandatory clearing obligations under both Hong Kong law and the laws of their home jurisdiction.

THE NOTICE

12. The Notice is attached at **Annex**. Section 2 of the Notice prescribes that the following structured product set out in the Schedule to the Notice is to be regarded as a futures contract –

- Any structured product that (a) does not fall within the definition of ***"securities"*** in section 1 of Part 1 of Schedule 1 to the SFO; and (b) is not a contract or an option on a contract made under the rules or conventions of a futures market.

13. The prescription essentially excludes (under paragraph (a) transactions that already constitute "securities" and (under paragraph (b) transactions that already constitute "futures contracts". This is because such transactions already enjoy the insolvency override protection.

14. Section 2 of the Notice also sets out the specific provisions of the SFO to which the above prescription applies. The overall effect is to extend the insolvency override protection conferred under Division 3 of Part III of the SFO so that they also cover OTC derivatives transactions

that are cleared and novated through an RCH and subject to the rules of an REC.

PUBLIC CONSULTATION

15. The HKMA and SFC have been engaging market participants in developing a full-fledged regulatory regime for the OTC derivatives market. They have also consulted market participants, through the Treasury Markets Association, on the proposed interim measure. Market participants have not raised any objections or concerns on the proposal.

16. We updated the Legislative Council Panel on Financial Affairs at its meeting on 2 April 2012 on the progress in developing a full-fledged regulatory regime for the OTC derivatives market and the proposed interim measure to facilitate voluntary clearing of OTC derivatives transactions to enhance our market competitiveness. Members were generally supportive of the proposed regulatory regime for the OTC derivatives market and the proposed interim measure.

FINANCIAL AND STAFFING IMPLICATIONS

17. The Notice has no financial or staffing implications for the Administration or the SFC. As mentioned above, the proposed interim measure to support voluntary clearing will facilitate implementation of the full-fledged regime for the OTC derivatives market in Hong Kong. As some CCPs in other jurisdictions are already providing central clearing for HKD and RMB OTC derivatives products, the proposed measure will enable Hong Kong to compete with overseas markets and strengthen Hong Kong's position as an offshore RMB centre.

LEGISLATIVE TIMETABLE

18. The Notice will be published in the Gazette on 4 May 2012 and tabled in the Legislative Council on 9 May 2012.

COMMENCEMENT

19. The Notice will come into operation on 27 June 2012.

PUBLICITY

20. The HKMA and SFC will inform market participants of the publication of the Notice in the Gazette and its intended commencement date. However, the publication of the Notice marks only the first step towards implementation of the voluntary clearing initiative. The implementation of the voluntary clearing initiative will also depend on the successful establishment of the local CCP in Hong Kong. Meantime, HKEx has been discussing with market participants to better understand their needs and expectations of a local CCP for OTC derivatives.

ENQUIRIES

21. For any enquiries relating to the brief, please contact Anthony Li, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) of the Financial Services and the Treasury Bureau at 2810 2056; or Rico Leung, Senior Director, Supervision of Markets Division of the SFC at 2840 9357; or Mr Daryl Ho, Head of Market Development Division of the HKMA at 2878 8265.

Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
2 May 2012

Securities and Futures (Futures Contracts) Notice 2012

(Made by the Financial Secretary under section 392 of the Securities and Futures Ordinance (Cap. 571))

1. Commencement

This Notice comes into operation on 27 June 2012.

2. Structured product to be regarded as futures contract

The structured product set out in the Schedule is to be regarded as a futures contract for the purposes of the following provisions of the Ordinance—

(a) Division 3 of Part III;

(b) section 63(1)(b);

(c) section 71(1)(a)(iii);

(d) the definition of ***clearing house*** in section 1 of Part 1 of Schedule 1 in so far as the definition applies to the following provisions of the Ordinance—

(i) section 37;

(ii) section 43; and

(iii) the definition of ***clearing participant*** in section 1 of Part 1 of Schedule 1; and

(e) the definition of ***market contract*** in section 1 of Part 1 of Schedule 1 in so far as the definition applies to the following provisions of the Ordinance—

(i) section 18;

(ii) Division 3 of Part III;

(iii) section 271(9);

(iv) section 292(9); and

(v) Part 5 of Schedule 3.

Schedule

[s. 2]

Structured Product to be Regarded as Futures Contract

Item	Description of structured product
1.	Any structured product that— (a) does not fall within the definition of ***securities*** in section 1 of Part 1 of Schedule 1 to the Ordinance; and (b) is not a contract or an option on a contract made under the rules or conventions of a futures market.

Financial Secretary

2012

Explanatory Note

This Notice prescribes that, for the purposes of certain provisions of the Securities and Futures Ordinance (Cap. 571), any structured product set out in the Schedule to the Notice is to be regarded as a futures contract so that the structured product, when cleared and novated through a recognized clearing house, may constitute a market contract and accordingly enjoy the insolvency override protection conferred under Division 3 of Part III of that Ordinance.