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# Bill To Regulate The Hong Kong OTC Derivative Market To Be Introduced In The Second Quarter 2013

## Background

The Financial Services and the Treasury Bureau (the **Bureau**), Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC**) jointly submitted a policy brief (the **Brief**) to the Legislative Council (**Legco**) in February 2013 to update Legco on the progress in developing a full-fledged regulatory regime for over-the-counter (**OTC**) derivatives transactions. The Brief indicates that the government proposes to introduce the bill to Legco in the second quarter of 2013.

Two joint consultations (the **Consultations**) were conducted in October 2011 and July 2012 respectively by the HKMA and SFC to receive public views on the regulatory proposals for the OTC derivative market. Consolidating the feedback received from the two consultations, the government is finalising the legislative amendments to be introduced to Legco. Charltons published [a newsletter](/newsletters/hklaw/en/2012/162/nl-hklaw-20120824-162.html) in relation to the Consultations and its conclusions in August 2012.

This newsletter aims to review the key elements of the regulatory regime for the OTC derivative market proposed by the government.

## Interim measures

As the proposed regulatory regime has yet to be legislated, the government encouraged market participants to clear OTC derivatives transactions through a regulated central counterparty (**CCP**) on a voluntary basis in order to better prepare the market for implementation of the mandatory obligation. The Hong Kong Exchange (**HKEx**) has established a local CCP to provide central clearing services for specified OTC derivative products which will commence operation in April 2013.

A trade repository (**TR**)[[1]](#footnote-26) is being set up by the HKMA within its existing Central Moneymarkets Unit (**CMU**) infrastructure to handle OTC transaction reports from authorised institutions (**AIs**), approved money brokers (**AMBs**), licensed corporations (**LCs**) and other prescribed Hong Kong persons. To support voluntary clearing at the CCP of HKEx, the matching and confirmation functions of the TR were launched in December 2012, while the reporting function of the TR is targeted to be launched by mid-2013.

The key element of the laws governing the clearing of OTC derivatives transactions is the insolvency override protection[[2]](#footnote-27) provided to transactions cleared through a regulated CCP. Currently, insolvency override protection is conferred by the Securities and Futures Ordinance (**SFO**) and only applies to “market contracts” as defined under the SFO, which in effect exclude OTC derivatives transactions. Without insolvency override protection, market participants in Hong Kong would have no option but to clear through an overseas CCP instead of a local CCP established by the HKEx.

As a result, in May 2012, the Financial Secretary issued a [Notice](http://www.legco.gov.hk/yr11-12/english/subleg/brief/81_brf.pdf) ([see archive](81_brf.pdf)) under section 392 of the SFO to prescribe certain OTC derivatives transactions to be “futures contracts” for the purposes of certain provisions of the SFO, and hence enjoy the insolvency override protection.

The Notice came into operation on 27 June 2012 and will be repealed upon implementation of the regulatory regime for the OTC derivative market.

## Legislative and regulatory framework

The broad framework of the proposed regulatory regime will be set out in the SFO, while details for implementation will be set out in subsidiary legislation. The proposed regime will be jointly overseen and regulated by the HKMA and SFC, with the HKMA overseeing and regulating the OTC derivative activities of AIs and AMBs, and the SFC overseeing and regulating the activities of LCs. The HKMA will be granted the relevant investigation and disciplinary powers under the SFO to ensure that it is able to take action in respect of any breach of the proposed regulatory regime by AIs and AMBs.

## OTC products coverage and mandatory obligations

Initially, mandatory reporting and clearing requirements will be applied to interest rate swaps and non-deliverable forwards, as the government noted that these are the major types of OTC derivatives transactions in Hong Kong after foreign exchange derivatives with respect to which there is no consensus among major jurisdictions towards stringent regulation.

As regards mandatory trading, the government will conduct further studies to assess how best to implement the requirement in Hong Kong, having regard to the liquidity level and number of trading venues in the Hong Kong market.

## Mandatory reporting

Irrespective of whether they are centrally cleared or not, locally incorporated AIs, AMBs and LCs will have to report all reportable transactions that:

* They are counterparty to; OR
* They have executed or originated; AND
* The transaction has a Hong Kong nexus.

Overseas incorporated AIs will have to report all reportable transactions that:

* They are counterparty to, acting through their Hong Kong branch; OR
* They have executed or originated, acting through their Hong Kong branch; AND
* Have a Hong Kong nexus.

A reportable transaction has a Hong Kong nexus if:

* For equity derivatives and credit derivatives: (i) the underlying entity or the reference entity is listed in Hong Kong (and where there is more than one underlying or reference entity, a specified percentage of the entities are listed in Hong Kong); (ii) the reference entity is wholly owned by the government of Hong Kong; or (iii) the underlying is an index and a specified percentage of the underlying companies are listed in Hong Kong.
* For other derivatives, the underlying asset, currency or rate is denominated in or related to Hong Kong dollars or Renminbi.

Other Hong Kong persons[[3]](#footnote-33) will have mandatory reporting obligations only if the transactions exceed a specified reporting threshold to be determined later. They will however be exempted from the reporting obligations if an AI, AMB or LC is also subject to a reporting obligation in relation to the same transaction.

Overseas persons[[4]](#footnote-34) will not be subject to any mandatory reporting obligation under Hong Kong law.

## Mandatory clearing

AIs, AMBs, LCs and other prescribed persons will have to clear eligible transactions through the designated CCP if the transactions to which they are counterparty exceed a specified clearing threshold to be determined later.

Overseas incorporated AIs will have to clear eligible transactions only if the transaction is booked in their Hong Kong branch.

## Penalty against breaches of mandatory obligations

It is proposed that the Court of First Instance will be empowered to impose civil fines of up to HK$5 million on any person who breaches mandatory obligations and requirements. In respect of breaches by AIs, AMBs or LCs, the HKMA and SFC will be empowered to take disciplinary actions, including imposing disciplinary fines of up to HK$10 million and reprimand.

## Regulation of intermediaries

Some existing regulated activities (**RAs**) will be expanded and two new RAs will be introduced under Schedule 5 to the SFO in relation to OTC derivatives:

* A new Type 11 RA to cover the activities of dealers and advisers;
* A new Type 12 RA to cover the activities of clearing agents;
* Existing Type 9 RA (asset management) will be expanded to cover OTC derivative portfolios; and
* Existing Type 7 RA (provision of automated trading services) will be expanded to cover OTC transactions

AIs and AMBs will continue to be overseen and regulated by the HKMA and will not need to be licensed for the new Type 11 or Type 12 RAs. However, if their OTC derivative activities also constitute the carrying on of an existing RA (including the expanded Type 9 RA) they will have to be licensed or registered as they are today. Other entities that engage in dealing in, advising on or providing clearing agency services in OTC derivatives as a business (other than as end users) will need to be licensed by the SFC for new regulated activities 11 and 12, respectively.

## Systematically important participants (**SIPs**)

To avoid a regulatory gap, the proposed regime will provide for the regulatory oversight of persons who are not licensed or registered with either the HKMA or SFC, but whose positions and activities in the OTC derivative market may raise concerns of potential systemic risks.

Any person whose OTC derivatives positions exceed a certain specified threshold will have to notify the SFC and their names and information will then be entered in a register of SIPs which will be open for public inspection.

Failure to give such notification within a specified period, without a reasonable cause, will constitute a criminal offence liable to the penalty of a fine up to HK$5 million and 7 years imprisonment.

The government expects that it is unlikely that there will be SIPs at the initial stage of the proposed regulatory regime and that AIs, LCs or international investment houses will be the major players.

The HKMA and SFC will be empowered to require SIPs to provide information and take action in respect of their OTC derivatives positions and transactions. Persons who fail to comply with the requirements will be subject to disciplinary action by SFC, including reprimand and fines of up to HK$10 million.

## Regulation of market infrastructure

The proposed regulatory regime will provide for the regulation of the market infrastructure through which any mandatory obligations must be fulfilled, including the TR, CCPs and trading platforms.

The TR being set up by the HKMA will have the capability to pass eligible derivatives transactions to the designated local CCP being developed by HKEx for central clearing. It is proposed that only the TR developed by the HKMA will be recognised for the purpose of the mandatory reporting obligation. In other words, reporting to global TRs will not be sufficient to satisfy the mandatory reporting obligation under Hong Kong law.

Regarding the CCP, it is proposed that only clearing houses recognised under the SFO, and providers of automated trading services authorised under Part III of the SFO, will be eligible for designation as a CCP under the regulatory regime. The SFC will be empowered to designate CCPs and trading platforms for the purpose of the mandatory clearing and trading obligations and to make rules to specify the requirements and procedures for such designation, with the consent of the HKMA and after consultation with the Financial Secretary. Both local and overseas CCPs may be designated.

## Common appeal channels

It is proposed that relevant regulatory decisions made by the HKMA and SFC under the proposed regulatory regime will be made appealable to the Securities and Futures Appeals Tribunal to ensure consistency in regulation and fair hearing.

## Other amendments

The SFO will be amended to require notifications and reports under Part XV “Disclosure of Interests” of the SFO to be filed electronically with a view to improving the timeliness of publication of potentially market sensitive Disclosure of Interests notices.

The SFO and the Organised and Serious Crimes Ordinance will also be amended to enhance SFC’s enforcement regime regarding market misconduct offences under the SFO so that illegal gains from committing an offence can be recouped. Criminal courts will be enabled to make disgorgement orders similar to the Market Misconduct Tribunal for the purpose of recouping illegal gains from an offence.

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1. A trade repository is an entity that centrally collects and maintains the records of OTC derivatives. Acting as authoritative registries of key information regarding open OTC derivatives trades, TR provides an effective tool for mitigating the inherent opacity of OTC derivatives markets. [↑](#footnote-ref-26)
2. If transactions cleared through a CCP do not enjoy insolvency override protection, it will raise concerns about the CCP’s default management capability, and defeat the objective of clearing which is to better manage counterparty credit risk in the event of a default. [↑](#footnote-ref-27)
3. These are other persons who are essentially based in, or operate from, Hong Kong including: (a) Hong Kong residents; (b) the owners of any sole proprietorship or partnership in Hong Kong; (c) companies incorporated or registered in Hong Kong; (d) funds domiciled in Hong Kong; and (e) any other entity established or registered under Hong Kong law. [↑](#footnote-ref-33)
4. Persons other than AIs, AMBs, LCs and Hong Kong persons. [↑](#footnote-ref-34)