



Hong Kong Law

August 2014

HKMA-SFC CONSULT ON RULES IMPOSING MANDATORY REPORTING OBLIGATIONS FOR OTC DERIVATIVE TRANSACTIONS

Introduction

The Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC**) have published a consultation paper on the proposed mandatory reporting and record keeping obligations being introduced under the new regulatory regime for over-the-counter (**OTC**) derivatives. While the framework for the new regime is contained in the Securities and Futures (Amendment) Ordinance 2014 (**Amendment Ordinance**) which was passed in March 2014 (but has not yet come into effect), the precise scope and details of the mandatory reporting, clearing, trading and record keeping requirements it introduces in respect of OTC derivative transactions are to be set out in rules made by the SFC and approved by the HKMA.

The consultation paper focuses on the proposals for the upcoming introduction of mandatory reporting and the related record keeping obligations which will be the first of the mandatory obligations to be implemented. Further consultations will be held in respect of the other obligations. A draft of the proposed Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping) Rules (**Draft Rules**) are set out in Appendix A to the consultation paper.

Stakeholders are invited to respond to the consultation paper on or before **18 August 2014**. The regulators aim to finalise the Draft Rules, publish a consultation conclusions paper and introduce the final rules to the Legislative Council for negative vetting in Q4 2014.

The following provides a summary of the consultation paper's key proposals which cover seven main areas:

- the types of transactions which must be reported;
- the persons subject to the reporting obligation;
- when the reporting obligation arises;
- applicable exemptions and reliefs;
- reporting timeframes and applicable grace periods;
- the form, manner and contents of reports; and
- related record keeping obligations.

Recent Reform – Amendment Ordinance 2014

Prompted by the 2008 global financial crisis, market regulators around the world have engaged in reform of OTC derivatives markets to increase transparency and reduce systemic risk. The G20 leaders have committed to a number of reforms related to OTC markets. The HKMA and SFC have worked together with the Hong Kong Government to implement the G20 commitments and issued consultation papers setting out proposals for Hong Kong's OTC derivatives market in 2011 and 2012. The Amendment Ordinance is Hong Kong's attempt to implement the G20 commitments. Key features of the new regulatory regime to be implemented under the Amendment Ordinance are that:

- The HKMA and SFC will jointly oversee and regulate Hong Kong's OTC derivatives market;

- Certain OTC derivative transactions will be subject to mandatory reporting, clearing and trading;
- These obligations will be supplemented by record keeping requirements;
- These obligations will apply to four groups:
 - Authorised institutions (**AIs**);
 - Approved money brokers (**AMBs**);
 - Licenced corporations (**LCs**); and
 - Other persons as may be prescribed by subsidiary legislation;
- The scope and details of the obligations will be set out in the rules to be made under the Securities and Futures Ordinance (**SFO**) by the SFC with the consent of the HKMA and after consultation with the Financial Secretary;
- To strengthen the regulation of intermediaries in the OTC derivatives market, the licensing regime under the SFO is extended to:
 - i) introduce two new regulated activities (**RAs**): Type 11 RA (dealing in OTC derivative products or advising on OTC derivative products) and Type 12 (providing client clearing services for OTC derivative transactions); and
 - ii) widen the scope of two existing RAs: Type 9 (asset management) and Type 7 (provision of automated trading services); and
- The SFC is able to make subsidiary legislation in relation to systemically important participants (**SIPs**); people who are not regulated but whose positions or activities in the OTC derivatives market may raise concerns of potential systemic risk.

Prior to the Amendment Ordinance coming into effect, the HKMA introduced interim reporting requirements in June 2013 under the Banking Ordinance (Cap. 155) which require licensed banks to report certain OTC derivative transactions (i.e. interest rate swaps (**IRS**) and non-deliverable forward contracts (**NDFs**) entered into between licensed banks. The

interim requirements came into effect in August 2013 and have been in full force since 4 February 2014 following the expiry of the transitional arrangements.

Key Proposals for the New Regime

The regime will be implemented in phases: starting with mandatory reporting, followed by mandatory clearing and finally mandatory trading. Record keeping obligations will be implemented in phases at the time the relevant mandatory obligation takes effect (i.e. the record keeping obligation with respect to mandatory reporting will be introduced in the first phase with mandatory reporting).

Implementation of the new and expanded RAs will be deferred until the necessary amendments to the SFC's various rules, codes and guidelines have been finalised.

1. *Persons other than AIs/AMBs/LCs that will be subject to Mandatory Reporting*

The new reporting obligation will apply to AIs, AMBs and LCs. It will additionally apply to the following persons as provided for in Rule 5 of the Draft Rules:

- a) Central counterparties (**CCPs**) that provide clearing services to persons in Hong Kong; and
- b) Other persons who are based in, or operate from, Hong Kong (**Hong Kong persons**).

The obligation will apply only to CCPs that are recognised clearing houses, or are authorised under section 95(2) of the SFO to provide automated trading services. Accordingly, they will only need to report transactions that they have entered into as part of the clearing process.

The Consultation Paper proposes that the term "Hong Kong person" should cover:

- All Hong Kong residents and all entities established under Hong Kong law (including partnerships, trusts, companies and other entities established under Hong Kong law); and
- All overseas companies registered, or required to be registered, under Part 16 of the Companies Ordinance (Cap. 622) (**non-Hong Kong companies**), in respect of transactions entered into in Hong Kong.

As non-corporate entities established overseas (e.g. overseas partnerships, trusts, etc.) are not expected to be active in the Hong Kong OTC derivatives market, it is proposed that they are not subject to mandatory reporting, even if they are registered or have a presence in Hong Kong, at least in the initial phase. The reporting requirement will only apply to the entity when acting in its capacity as a CCP. The exception is overseas hedge funds, which are dealt with separately.

2. Transactions that will be subject to Mandatory Reporting

The paper proposes that limited types of interest rate swaps (**IRS**) and non-deliverable forward contracts (**NDF**) are initially subject to reporting. These include:

- IRS: Plain vanilla IRS (floating vs fixed) and plain vanilla basis swaps (floating vs floating), in currencies and floating rate indices to be specified by the HKMA. These will be the currencies and floating rate indices that are on the International Organisation for Standardisation (**ISO**) 4217 currency list and FpML Coding Schemes - 5.76 Floating Rate Index Scheme, respectively which are supported by the HKTR (the electronic reporting system developed by the HKMA); and
- NDF: NDF transactions in currencies and precious metals to be specified by the HKMA. These will be those on the ISO 4217 currency list which are supported by HKTR.

3. Reporting Obligations of AIs, AMBs and LCs

AIs, AMBs and LCs will be required to report transactions:

- a) to which they are a counterparty. In the case of an overseas AI, this means that the transaction must be booked with its Hong Kong branch);
- b) that they have conducted in Hong Kong on behalf of an affiliate. The requirement is different for overseas AIs in that they only will be required to report transactions conducted by their Hong Kong branch on behalf of an affiliate, their head office or other non-Hong Kong branches; or
- c) that they have entered into on behalf of a counterparty in their capacity as a person licensed or registered to carry on Type 9 RA (asset management) for that counterparty.

The proposals in paragraphs (b) and (c) above have been amended from the proposals put forward in the previous consultations. It was originally proposed that these entities

should report a reportable transaction: (i) to which they are a counterparty, or (ii) which they *have originated or executed*. Following discussions with the industry, it is now proposed that the second limb should only catch transactions that the AI, AMB or LC has conducted in Hong Kong on behalf of an affiliate with the involvement of a trader based in Hong Kong.

As the 'originated or executed' limb was intended to capture transactions entered into by fund managers who negotiate on behalf of funds, paragraph (c) is now proposed to be added to ensure that the reporting obligation applies:

- to AIs or LCs that (i) are registered or licenced to carry on Type 9 RA; and (ii) manage assets for one or more persons; and
- in respect of transactions that they have entered into on behalf of such other persons.

Thus while an offshore fund might not itself be subject to the mandatory reporting requirement, its positions will nevertheless be reportable if it is managed by a Type 9-licensed LC or a Type 9-registered AI or AMB.

4. Reporting Obligations of CCPs

In order to conform with other major markets, it is now proposed to require CCPs to report transactions to the HKMA. The obligation will apply only to CCPs that are: (i) recognised clearing houses (**RCHs**) under section 37 of the SFO; or (ii) authorised to provide automated trading services under section 95 of the SFO (**ATS-CCP**).

5. Reporting Obligations of Hong Kong Persons

The Consultation Paper notes that Hong Kong persons may hold positions in more than one capacity. For example, a partner of a partnership may hold positions in his capacity both as an individual and as a partner and an individual or corporation could hold positions in the capacity of trustee and in their own capacity. The Rules clarify that the positions are to be viewed separately in respect of each capacity.

It is also proposed that, in relation to a Hong Kong person that is a non-Hong Kong company, only those transactions entered into by it in Hong Kong should be taken into account. This is to prevent onerous reporting obligations being imposed on multinational corporations that have a presence in Hong Kong but are active in other markets.

6. Reporting Obligations of Funds

Onshore funds

Funds domiciled in Hong Kong, whether structured as partnerships, companies, trusts or other vehicles, will come under the definition of Hong Kong persons and be subject to the mandatory reporting obligations. In the case of funds structured as trusts or partnerships, the reporting obligation would fall on the trustee or partners as the legal owner of the funds.

Offshore funds

Funds that are domiciled overseas will only be subject to the reporting requirement if they are structured in the form of a company **and** are registered, or required to be registered, under the Companies Ordinance (Cap. 622). Offshore funds which do not carry on business in Hong Kong (and are thus not required to be registered here) will not be subject to mandatory reporting, although their positions may be reportable to the HKMA by an AI or LC which manages the fund and is registered or licensed for Type 9 RA.

Where a transaction is reportable by both a fund and its fund manager/sub-manager – i.e. where the fund is a Hong Kong person and is managed by an AI or LC, the fund will be exempted from reporting under Rule 20 of the Rules. The exemption does not however apply to a fund which is a Hong Kong person which is not managed by an AI or LC.

7. Reporting Threshold and Exit Threshold

The proposed Draft Rules now contain:

- a reporting threshold which determines when a Hong Kong person becomes subject to a reporting obligation; and
- an exit threshold, which determines when a Hong Kong person ceases to be subject to that obligation.

These thresholds are intended to lessen the compliance burden of Hong Kong persons and ensure that only the more significant market participants are subject to the obligations. The thresholds will apply on a product class basis: thus a Hong Kong person may have reached the reporting threshold for IRS but not NDF, in which case he would only have to report his IRS transactions.

The proposed thresholds are:

	Reporting threshold (USD million)	Exit threshold (USD million)
IRS	3,000	2,100
NDF	1,000	700

Based on client profile information provided by banks in response to earlier surveys, it is estimated that over 95% of Hong Kong persons engaging in IRS and NDF will be exempt from the reporting obligation.

It is expected that the reporting thresholds will be lowered to align with the clearing thresholds when they are introduced, which is expected to occur no earlier than 2017. These lower thresholds are predicted to be:

	Reporting threshold (USD million)	Exit threshold (USD million)
IRS	1,000	700
NDF	500	350

Threshold calculation

Both thresholds will be calculated by reference to the average gross notional value of a person's outstanding positions for the previous six months based on their month-end position. "Month-end position" means the notional principal value of the person's gross positions in the relevant product class as at the last day of the calendar month. Because only the month-end position is looked at, changes to a person's positions, however substantial, will not immediately affect a person's reporting obligation. At the end of the month, the person will need to determine whether the reporting threshold has been crossed and the reporting obligation triggered.

In calculating the reporting threshold, all transactions falling within a particular product class (whether or not of a product type that is reportable (i.e. whether or not all matching the descriptions in the third column of Part 3 of Schedule 1 to the Rules) must be included. In other words, although only reportable transactions will have to be reported, non-reportable transactions that fall within the same product class must also be taken into account when determining if the reporting threshold has been reached. For example, if a person enters into a plain vanilla IRS (floating vs fixed), a plain vanilla basis swap

(floating vs floating), and an amortising IRS, all three, including the amortising IRS even though it is not reportable in the initial phase, will have to be taken into account when determining whether the reporting threshold has been reached.

Threshold calculation for non-Hong Kong companies

Non-Hong Kong companies will only be required to include transactions that they have entered into in Hong Kong when calculating the thresholds. Non-Hong Kong companies will also only be required to count transactions entered into after the product class to which they belong has been included in Part 2 of Schedule 1 to the Rules. This acknowledges that a non-Hong Kong company may have difficulty in retrospectively identifying which of its past transactions were entered into in Hong Kong.

8. Cross Border Transactions

The Draft Rules make clear that a reporting entity must report a reportable transaction regardless of whether one or more counterparties to the transaction is a person outside Hong Kong or the transaction was entered into wholly or partially outside Hong Kong. This will however be subject to the following qualifications:

- a) overseas incorporated AIs will only be required to report transactions if either the Hong Kong branch of the AI is involved either as the booking centre or as the party conducting the transaction in Hong Kong or managing the assets of another person;
- b) in the case of transactions reportable by an ATS-CCP, the counterparty must be a Hong Kong incorporated company;
- c) in the case of a Hong Kong person which is a non-Hong Kong company, the transactions must be entered into by the Hong Kong person in Hong Kong.

9. Exemptions and Relief from Reporting Obligation

Exemption for less active AIs, AMBs and LCs (exempt persons)

It is recognised that AIs, AMBs and LCs that are not active market participants or only enter into transactions intermittently or for hedging purposes, may be discouraged from entering into transactions because of the reporting obligations. The Consultation Paper therefore proposes relief from the reporting

obligation under the counterparty limb (i.e. under Rules 9(1)(a), 10(1)(a), 11(1)(a) or 12(1)(a)) for AIs, AMBs, and LCs that meet the following criteria:

a) *No involvement in 'conducting' or 'fund management'*

The AI, LC or AMB must not have conducted OTC derivative transactions in Hong Kong on behalf of an affiliate, nor have entered into transactions on behalf of another person whose assets it manages, at any time on or after the date on which the relevant product class is included in Part 2 of Schedule 1 to the Rules (the **product class specification day**).

b) *Maximum of 5 transactions outstanding*

The AI, AMB or LC must not at any time on or after the relevant product class specification day have had more than 5 OTC derivative transactions of the same product class outstanding.

c) *Aggregate gross notional value of not more than US\$30 million*

The aggregate gross notional value of AI, AMB or LC's outstanding OTC derivative transactions of the same product class must not exceed US\$30 million at any time (i.e. on or after the product specification day).

d) *Counterparty is not a Hong Kong person*

The counterparty to each such OTC derivative transaction that is outstanding on or after the product specification day must not be a Hong Kong person.

In the case of an overseas incorporated AI, the above criteria will apply only to the Hong Kong branch. It should also be noted that once the relief is lost, it cannot be revived. Hence, once the AI, AMB or LC fails to meet any of the criteria under paragraphs (a) to (d) above, it will permanently cease to be entitled to this relief in respect of that product class. For example if an AI, AMB or LC at any time has six or more IRS outstanding – even if this is only for a very short period – it will no longer be entitled to this relief in respect of its IRS. Those entities which intend to rely on this exemption must therefore monitor their positions closely, particularly if they are already close to the limits of one or more of the criteria.

Licensed banks which have already reported to the HKMA under the interim reporting requirement, and have outstanding reportable transactions in the product classes of IRS or NDF

on the commencement of the Rules, will not be eligible for the exempt person relief for that product class. They will however be entitled to the exempt person relief for any new product class specified in the future if they meet the necessary criteria for that product class.

Exemption for Hong Kong persons where transaction is reportable by an AI, AMB or LC

The reporting obligation of Hong Kong persons is already subject to a reporting threshold. Hong Kong persons who are subject to mandatory reporting may still be exempt from reporting where the transaction is also subject to reporting by an AI, AMB or LC. Thus a Hong Kong person will not be required to report a transaction if:

- a) the other counterparty to the transaction is an AI, AMB or LC;
- b) the other counterparty to the transaction is an affiliate of an AI, AMB or LC and the AI, AMB or LC has conducted the transaction in Hong Kong on behalf of that affiliate; or
- c) the other counterparty to the transaction is a person whose assets are managed by an AI or LC registered or licensed for Type 9 RA, and that AI or LC has entered into the transaction of behalf of such person.

The Consultation Paper acknowledges that Hong Kong persons seeking to rely on the exemption may need to make enquiries, particularly where the situation falls within paragraph (b) or (c) above. The Rules do not specify the enquiries that should be made, although the Consultation Paper notes that persons are expected to act reasonably and pragmatically if they wish to rely on the exemption. This approach is thought to be in keeping with the approach under the Amendment Ordinance, which empowers the Court to impose a financial penalty for breach of the reporting obligation only if it is satisfied that there is "no reasonable excuse" for the breach (new sections 101F and 101G SFO).

Circumstances in which the relief is not available

The exemption is not available:

- a) where a Hong Kong person also clears the reportable transaction, but does so using client clearing services provided by a person other than an AI (in the case of an overseas incorporated AI, not through its Hong Kong branch), AMB or LC. In such cases, even though:

- i) the Hong Kong person might be exempt from reporting the original transaction (e.g. because its counterparty is an AI, AMB or LC); and
- ii) the subsequent transaction entered into as part of the clearing process is reportable by the CCP (e.g. because it is an authorised ATS provider),

any back-to-back transaction between the Hong Kong person and its clearing services provider (i.e. the CCP member) as part of the clearing process will still have to be reported by the Hong Kong person.

- b) To a Hong Kong person merely because the transaction has been cleared through a CCP that is an RCH or ATS-CCP and is thus reportable by such CCP. This is because the exemption is limited to transactions involving an AI, AMB or LC and does not extend to transactions involving only an RCH or ATS-CCP.

The above exemption also applies where a Hong Kong person is the legal owner of a fund or managed account so that where a transaction is reportable both by a fund manager and the legal owner of the assets under management, the latter will be exempt from reporting that transaction.

Relief for AI, AMB or LC where affiliate has reported

When an AI, AMB or LC has conducted a transaction in Hong Kong, they will be taken to have complied with the reporting requirement if its affiliate has confirmed in good faith, that the affiliate has reported the transaction.

Relief for Partners

Where one partner, or another person authorised by all of the partners, has reported to the HKMA a transaction entered into on behalf of a partnership, all partners will be taken to have complied with the reporting requirement (proposed Rule 22).

10. Backloading Requirement for Outstanding Transactions

Backloading requires that a person reports transactions entered into previously and still outstanding when the reporting obligation takes effect. It is proposed to generally apply to all AIs, AMBs, LCs, RCHs, ATS-CCPs and Hong Kong persons.

'Starting day'

The term 'starting day' is used to refer to the day when the reporting obligation in respect of a particular product type take effect, as well as the day that determines which historical transactions need to be back loaded. As the reporting obligation will be introduced in phases for different product types (starting with certain types of IRS and NDF), the starting day will differ for different product types. These will be set out in Part 3 of Schedule 1 to the Rules (i.e. as the **product type specification day**).

Due to the reporting thresholds, the starting day for Hong Kong persons will differ depending on when they reach the threshold. In contrast, AIs, AMBs and LCs will have a single starting day for a particular product type, unless they have qualified for an exemption. For AIs, AMBs and LCs that are able to benefit from the exempt person relief, their starting day will be when they cease to meet the requirements for that exemption. If an entity becomes an AI, AMB, LC, RCH or ATS-CCP after the reporting obligation takes effect, its starting day will be the day it becomes such an entity.

Exemptions and limitations to backloading

a) *Transactions of Hong Kong persons that are non-Hong Kong companies*

An exemption is proposed for transactions of Hong Kong persons who are non-Hong Kong companies if they were entered into before the product class specification day. It is also proposed that backloading should only apply to these persons in respect of transactions entered into in Hong Kong on or after the product class specification day but before the threshold has been reached.

b) *Transactions that an AI, AMB or LC has "conducted in Hong Kong" or entered into on behalf of a person whose assets it manages*

In the case of an AI, AMB or LC, the backloading requirement applies only to transactions to which the entity is a counterparty (and for an overseas incorporated AI, only if the transactions are also recorded in the form of an entry in the books of the AI's Hong Kong branch). Thus, transactions that are 'conducted in Hong Kong' and transactions entered into by an AI or LC licensed for Type 9 RA on behalf of another whose assets it manages, will not

be subject to backloading. Furthermore, the requirement will not apply in respect of transactions 'conducted in Hong Kong' prior to the starting day.

c) *Transactions that mature or are terminated within the relevant grace period*

It is proposed that the backloading requirement will be subject to a grace period. Where a transaction expires or is terminated before the end of this period, the entity will not be subject to the requirement.

11. Time for Reporting: Grace and Concession Periods

It is proposed that the reporting obligation must be fulfilled within 2 business days. However, each time a particular product type first becomes reportable, additional time will be allowed as follows:

- A **concession period** of up to 3 months will be given to reporting entities to enable them to set up their reporting channel to the HKTR; and
- A **grace period** of up to 6 months (including the 3 months concession period) is proposed to be given to reporting entities to complete any backloading.

Both periods begin on the reporting entity's starting day. For Hong Kong persons, the concession and grace periods will always be 3 months and 6 months, respectively. However, the length of these periods may differ for AI, AMB, LC, RCH or ATS-CCP: the concession period may range from 0 days to three months, while the grace period may range from three to six months, depending on a number of factors.

Other points to note are that:

a) *Transactions that were reported under the interim reporting arrangement (i.e. before the relevant starting day)*

Licensed banks that reported their interbank transactions under the interim reporting requirement issued by the HKMA in June 2013, will be deemed to have reported those transactions that are still outstanding on the starting day of the mandatory reporting obligation under the new regime. Any subsequent events in respect of these transactions are reportable within two business days after the event.

b) *Backloading transactions outstanding on the relevant starting day*

Backloading is required to be completed by the last day of the grace period. In addition:

- i) Where the transaction information is reported **within** the concession period, the information reported should reflect the net effect of all subsequent events which have occurred since the transaction was entered into and up to a time no earlier than **two business days** before the date of reporting;

- ii) Where the transaction information is reported **after** the concession period, the information reported should include:

- Transaction information as at the end of the concession period reflecting the net effect of all subsequent events which have occurred since the transaction was entered into; and
- Transaction information (in chronological order) in respect of each subsequent event which has occurred since the end of the concession period and up to a time no earlier than **two business days** before the date of reporting;

- iii) There will be no backloading requirement for a transaction that has reached its maturity date or been terminated before the end of the grace period.

c) *Transactions entered into during concession period*

These transactions must be reported no later than the last day of the grace period and:

- i) If the transaction information is reported **within** the concession period, the information reported should reflect the net effect of all subsequent events which have occurred since the transaction was entered into and up to a time no earlier than **two business days** before the date of reporting;
- ii) If the transaction information is reported **after** the concession period, the information reported should include:

- Transaction information as at the end of the concession period reflecting the net effect of all subsequent events which have occurred since the transaction was entered into; and

- Transaction information (in chronological order) in respect of each subsequent event which has occurred since the end of the concession period and up to a time no earlier than **two business days** before the date of reporting;

- iii) There will be no reporting obligation for a transaction that has reached its maturity date or been terminated before the end of the grace period.

d) *Transactions entered into after concession period*

These transactions must be reported within **two business days** after the transaction is entered into, and any subsequent event must be reported within **two business days** after the event.

12. Adjustments to Reporting Timeframes in Specific Circumstances

The starting day of Hong Kong persons marks the beginning of their concession and grace periods. For reporting entities that are not Hong Kong persons, their starting day is determined by reference to the following:

- a) the relevant product type specification day;
- b) when it attained that regulated status; and
- c) whether, in the case of an AI, AMB or LC, the person qualified for the exempt person relief on the relevant product type specification day, and if so, when it ceased to so qualify.

Accordingly, the duration of the concession and grace periods will be adjusted as follows:

a) *Entity attains regulated status during concession period*

A shorter concession period will apply for an entity that becomes an AI, AMB, LC RCH or ATS-CCP within **three** months after the product type specification day. Their concession period will start on the day they become such a regulated entity, but still end three months after the product type specification day.

b) *Entity ceases to be exempt person during concession period*

The same applies to an AI, AMB, LC RCH or ATS-CCP that ceases to be an exempt person within three months after the product type specification day. Their concession period will start on the day they cease to be an exempt person and end three months after the product type specification day.

c) *Entity attains regulated status after concession period*

An entity that becomes an AI, AMB, LC RCH or ATS-CCP more than three months after the product type specification day will not benefit from a three month period for setting up its reporting channel to HKTR. However, it will have a period of three months, from when it becomes such a regulated entity) to backload previous transactions.

d) *Entity ceases to be exempt person during concession period*

The same applies to a person that was previously an exempt person but ceased to be so more than three months after the product type specification day.

13. Transition from Interim Reporting Arrangement

The HKMA is to issue guidance to extend the interim reporting requirement so that it continues to apply in respect of the IRS and NDF currently reportable under the interim reporting requirements, and continues until the end of the grace period for those product types under the Draft Rules. This means that licensed banks must continue to report new interbank transactions and subsequent events falling under the interim reporting requirement to the HKMA on a T+2 basis without regard to the concession and grace periods provided for in the Draft Rules. Licensed banks will however still be entitled to the concession and grace periods for transactions not covered by the interim reporting requirement (such as transactions that were “conducted in Hong Kong”, or transactions with Hong Kong persons).

14. Form and Manner of Reporting

a) *Information to be reported*

Schedule 2 to the Draft Rules sets out the information relating to the transaction (**transaction information**) which is required to be reported. This includes information relating to:

- Product class and type;

- Dates the transaction was entered into, becomes effective and matures;
- Particulars of counterparties;
- Confirmation, clearing and valuation of the transaction;
- Subsequent events (to be reported to the HKMA within 2 business days of the event); and
- Particular information if the transaction is an interest rate swap or non-deliverable forward contract.

b) *Reporting of “valuation transaction information”*

Initial reporting will require reporting of the notional principal amount of the transaction. To align with requirements in other jurisdictions, it is now proposed that AIs, AMBs, LCs, RCHs and ATS-CCPs will additionally be required to provide, on a daily basis, a mark-to-market valuation of all reported and outstanding transactions. This additional requirement will not apply to non-regulated entities, but may be extended to them in the future if this is considered warranted by market developments, subject to prior consultation.

The HKMA is currently upgrading its reporting system (i.e. HKTR) to include fields supporting the daily reporting of information relating to transaction valuations. It is currently proposed that the daily reporting requirement in respect of valuation information will not be introduced in the initial stage of the regime implementation, and will instead be introduced in a later phase, possibly in or after late 2015.

The types of valuation transaction information that will have to be reported are set out at item 6 of Schedule 2 to the Draft Rules and include the valuation type (i.e. whether it is mark-to-market or mark-to-model based), the valuation date, the valuation of the transaction and the currency of valuation.

15. Method of Reporting

Reportable transactions must be reported to the HKMA via the HKTR. Market participants can appoint a third party (including a global trade repository) as their agent for the purpose of reporting to the HKMA via the HKTR.

16. Reporting of Subsequent Events

Where a person is required to report a subsequent event and more than one such event occurs on the same day, the person is only required to submit transaction information once in respect of that day and should ensure that the information submitted incorporates all of the subsequent events that occurred on that day. The consultation paper also proposes some exceptions to the requirement to report subsequent events including where:

- a) the entity has ceased to be an AI, AMB, LC, RCH, ATS-CCP or Hong Kong person;
- b) the entity is an authorised institution or licensed corporation registered or licensed for Type 9 RA, but has ceased to manage the assets on whose behalf the transaction was entered into; or
- c) the entity is a Hong Kong person and Rule 15 has ceased to apply to that person in respect of a particular product class, because its positions in that product class have fallen below the exit threshold and he thus no longer has a reporting obligation.

The reporting obligation will only cease to apply if the reporting entity has notified the HKMA that it is no longer subject to reporting.

17. Conflicting Confidentiality Obligation

As a temporary measure pending international consensus, it is proposed that an entity may mask certain counterparty identifying information when reporting to the HKMA if:

- a) the laws of another jurisdiction (as designated by the SFC with the HKMA's consent), or an authority or regulatory organisation in that jurisdiction prohibit the disclosure of such information; or
- b) in the case of historical transactions only (i.e. transactions entered into before the Draft Rules first take effect), the person cannot disclose the confidential information without the consent of the counterparty, and despite reasonable effort, such consent cannot be obtained.

The SFC will designate jurisdictions only if it is satisfied that the reporting of counterparty identifying information is prohibited in that jurisdiction.

18. Specified Subsidiaries of Hong Kong Authorised Institutions

An AI incorporated in Hong Kong will have to ensure that any of its subsidiaries that are specified by the HKMA report OTC derivative transactions to which it is a counterparty. This seeks to prevent Hong Kong incorporated AIs from circumventing the reporting obligations by entering into OTC derivative transactions through subsidiaries. Section 101B of the SFO (as amended by the Amendment Ordinance) will impose on the Hong Kong-incorporated AI, the obligation to report transactions entered into by a specified subsidiary – unless the subsidiary is itself subject to the reporting obligation, e.g. because it is an LC, or because it is within the definition of Hong Kong person and has reached the relevant reporting threshold.

It is proposed that the details relating to reporting a specified subsidiary's transactions (e.g. the types of transactions to be reported, the method and timing of reporting, available exemptions and reliefs etc.) will be essentially the same as for transactions to which the AI itself is a counterparty. Where the same transaction is reportable both: (i) as a transaction to which a specified subsidiary of a locally-incorporated AI is a counterparty; and (ii) as a transaction that the AI has "conducted in Hong Kong", the AI will be released from its reporting obligation.

19. Use and Public Disclosure of Data to be collected by HKMA via HKTR

The HKTR intends to share the data it collects with relevant authorities and overseas trade repositories, in conformity with international standards. Any data collected is to be used solely for regulatory and market surveillance purposes and any public disclosure will initially be on an aggregate basis only. The authorities are considering the possibility of public disclosure of the trade repository data and will monitor international standards in the area.

20. Record Keeping Obligation

Record keeping obligations apply to the same persons and transactions as those that are subject to the reporting obligations. Records to be kept include:

For a Hong Kong Person:

- Sufficient records to demonstrate compliance with reporting obligations;

- Where relying on not having reached the reporting threshold (or having reached the exit threshold), sufficient records to demonstrate they have not (or have) met the threshold, and records evidencing the transaction and its main economic terms; and
- When relying on an exemption as a Hong Kong person or relief related to transactions that have matured or been terminated during the grace period, records evidencing the transaction and its main economic terms.

For other reporting entities:

- Sufficient records to demonstrate compliance with reporting obligations;
- Where relying on the exempt person relief, records sufficient to demonstrate that they were entitled to such exemption;
- Where relying on the relief in respect of transactions reported by an affiliate, the confirmation received from the affiliate;
- Records as specified when relying on exemptions or relief related to transactions that have matured or been terminated during the grace period; and
- Where the reporting was done through an agent, records relating to the agent's appointment and to demonstrate monitoring of the agent's compliance.

21. Duration and Manner of Record Keeping

The Draft Rules require reporting entities (other than Hong Kong persons) to keep records in accordance with the following:

- for the first nine months following the product class specification day, the records may be kept in any form or manner as long as they are readily searchable and identifiable by reference to the transaction and counterparty;
- after the first nine months, records should be kept in electronic form and stored in a computer or other electronic system save that: (i) records created and maintained in paper form may be kept in paper form; and (ii) audio recordings may be stored in a sound recording media; and
- Records must be maintained for at least seven years after the maturity or termination of the OTC derivative transaction.

The record keeping obligations of Hong Kong persons are more relaxed and require Hong Kong persons to maintain their records in a legible and retrievable form for at least seven years after the maturity or termination of the OTC derivative transaction.

22. Responses to Consultation

Interested parties are invited submit written comments by any of following methods by 18 August 2014:

Online:	http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/
Email:	fss@hkma.gov.hk or otconsult@sfc.hk
Fax:	(852) 2878 7297 or (852) 2521 7917
Post:	Financial Stability Surveillance Division Hong Kong Monetary Authority 55/F Two International Finance Centre 8 Finance Street, Central Hong Kong Supervision of Markets Division The Securities and Futures Commission 35/F Cheung Kong Center 2 Queen's Road Central Hong Kong

23. Consultation Questions

The questions raised for consultation are as set out below.

Question 1	Do you have any comments or concerns about the proposed definition of “Hong Kong person”, “RCH” and “ATS-CCP”?
Question 2	Do you have any comments or concerns about the proposed types of IRS and NDF that will be subject to the mandatory reporting obligation in the initial phase of implementation?
Question 3	Do you have any comments or concerns as to how IRS and NDF are proposed to be defined in Part 1 of Schedule 1 to the Draft Rules, or how the reportable transactions, or the class to which they belong, have been described in Part 3 of Schedule 1?
Question 4	Do you have any comments or concerns about how the terms “conducted in Hong Kong” and “affiliate” are proposed to be construed, or how this limb of the reporting obligation is cast? In particular, do you have concerns as to how this proposal might impact entities that keep a global book?
Question 5	Do you have any comments or concerns about how we have cast the proposal that AIs and LCs that are registered/licensed for Type 9 RA must report transactions that they have entered into in their capacity as fund managers?
Question 6	Do you envisage any specific difficulties if this proposal were to be extended to also require an AI or LC that is registered/licensed for Type 9 RA to report transactions that it has advised a counterparty on, i.e. even though it has not entered into the transaction on behalf of that counterparty? If so, please provide details of the specific difficulties envisaged.
Question 7	Do you have any comments or concerns about how the reporting obligation in respect of CCPs has been cast?
Question 8	Do you have any comments or concerns about the proposed approach to be taken in respect of the different types of Hong Kong persons?
Question 9	Do you have any comments or concerns about how the reporting obligation will apply to funds? Do you envisage that funds may face practical difficulties in complying with this obligation? If so, please provide details of the specific difficulties envisaged.
Question 10	Do you have any comments or concerns about the proposed methodology for calculating if the reporting threshold or exit threshold has been reached?
Question 11	Do you have any comments or concerns about the proposed levels of the reporting threshold and exit threshold?
Question 12	Do you have any comments or concerns about the proposed reductions to the reporting threshold and exit threshold at a later stage?
Question 13	Do you have any comments or concerns about the proposed application of the mandatory reporting obligation to cross-border transactions? If so, please provide specific details.
Question 14	Do you have any comments or concerns about the proposed exemptions and reliefs, and the criteria for triggering them?
Question 15	Do you have any comments or concerns about the proposal to exclude from the exempt person relief for IRS and NDF those licensed banks which have already reported to the HKMA via the HKTR under the interim reporting requirement and have outstanding reportable transactions on the commencement of the Draft Rules?

Question 16	With respect to the relief for AIs, AMBs and LCs that are less active in the OTC derivatives market, do you consider the proposed criteria of 5 transactions per product class, and aggregate gross notional value of US\$30 million to be appropriate? If not, please provide specific details of why they may be inappropriate and what alternative criteria should be adopted.
Question 17	Do you have any comments or concerns about how the proposed backloading requirement will apply to transactions outstanding on the starting day? If so, please provide specific details.
Question 18	Do you have any comments or concerns about the proposal to have different starting days in respect of different types of reportable transactions? If so, please provide specific details.
Question 19	Do you have any comments or concerns about how the starting day might impact AIs, AMBs and LCs that previously qualified for the exempt person relief? If so, please provide specific details.
Question 20	Do you have any comments or concerns about how the concession period and grace period are proposed to operate?
Question 21	Do you have any comments or concerns about how the grace periods will vary in respect of entities that become an AI, AMB or LC at a later date, or that cease to be an exempt person at a later date?
Question 22	Do you have any comments or concerns about the proposed types of transaction information required to be reported for the purposes of the reporting obligation, or as to how these have been expressed in Schedule 2?
Question 23	Do you have any comments or concerns about the proposal to require the reporting of valuation transaction information in the future?
Question 24	Do you have any comments or concerns about our proposals on how subsequent events are to be reported, and when they will cease to be reportable?
Question 25	Do you have any comments or concerns about the proposals on masking counterparty information under certain circumstances as a temporary measure?
Question 26	Do you have any comments or concerns about the proposals for subsequently reporting information when the pre-requisites for masking cease to exist?
Question 27	Do you have any comments or concerns about the proposal that an AI's reporting obligations in respect of transactions entered into by its specified subsidiaries should be the same as its reporting obligations in respect of transactions to which it is a counterparty itself?
Question 28	Do you have any comments or concerns about the proposed record keeping requirements in relation to mandatory reporting?
Question 29	Do you have any comments or concerns about the types of records proposed to be kept, and the manner in which they are to be kept?
Question 30	Do you have any comments or concerns about the duration for which the records are proposed to be kept?

CHARLTONS

Best Boutique Firm 2013

Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com