



Hong Kong Law

December 2014

## REPORTING AND RECORD-KEEPING OBLIGATIONS RE. OTC DERIVATIVE TRANSACTIONS

In July 2014, the Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC**) published a consultation paper setting out the detailed proposals for the mandatory reporting and record keeping obligations for over-the-counter (**OTC**) derivatives introduced under the Securities and Futures (Amendment) Ordinance 2014 (the **SFAO**) passed in March 2014. (Please see Charltons Newsletter Issue 254 of August 2014 for a summary of the proposals <http://www.charltonslaw.com/newsletters/hong-kong-law/en/2014/254/HKMA-SFC-Consult-on-Rules-Imposing-Mandatory-Reporting-Obligations-for-OTC-Derivative-Transactions.html>). 23 responses to the July consultation paper were submitted. The SFC and HKMA have now published their Consultation Conclusions and Further Consultation on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (**Consultation Conclusions**) which set out the revised draft Rules at Appendix C. It is expected that the revised Rules will be submitted to Legco for negative vetting in the first quarter of 2015, and that, subject to the legislative process, the first phase of the mandatory reporting obligations (and related record keeping obligations) will be implemented in the same quarter.

The key issues raised in the Consultation Conclusions are as follows:

- the new obligations will be introduced in phases by type of reporting entity, with the first stage including the bigger market players, namely approved money brokers, authorised institutions, central counterparties and licensed corporations;

- the commencement of Type 9 licensees' obligation to report OTC derivative transactions they have entered as fund managers will be deferred to allow time to address reporting difficulties raised in relation to funds; and
- expanding the available exemptions and concessions.

The SFC and HKMA's further consultation focusses on the following three issues:

- the detailed requirements for reporting valuation transaction information including the proposed reporting timeframe and implementation timetable;
- the proposed list of jurisdictions to be designated for the purpose of masking relief; and
- the proposed list of markets and clearing houses to be prescribed for the purpose of the definition of "OTC derivative product".

Responses to the further consultation are requested by 23rd December 2014.

### Background to the Consultation

In 2011 and 2012, the HKMA and SFC published consultation papers setting out proposals for the reform of Hong Kong's OTC derivatives market to implement its G20 commitment to increase transparency and reduce systemic risk. The SFAO passed in March is Hong Kong's attempt to implement its G20

commitments. Under the new regime, certain OTC transactions will be subject to mandatory reporting, clearing, trading and record-keeping obligations. Key features of the new regulatory regime under the SFAO are that:

- The obligations will apply to four main groups:
  - Authorised institutions (**AIs**);
  - Approved money brokers (**AMBs**);
  - Licenced corporations (**LCs**); and
  - other persons as may be prescribed by subsidiary legislation;
- The mandatory reporting obligation will additionally apply to:
  - central counterparties (**CCPs**) that provide clearing services to persons in Hong Kong; and
  - other persons who are based in, or operate from, Hong Kong (**Hong Kong persons**);
- The transactions initially subject to mandatory reporting are interest rate swaps (**IRS**) and non-deliverable forward contracts (**NDF**) including:
  - 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.

- The SFC's licensing regime under the SFO is extended to:

- introduce two new regulated activities (**RAs**): **Type 11** (dealing in OTC derivative products or advising on OTC derivative products) and **Type 12** (providing client clearing services for OTC derivative transactions); and

- widen the scope of two existing RAs: Type 9 (asset management) and Type 7 (provision of automated trading services);

- The new regime will be implemented in phases; starting with mandatory reporting, followed by mandatory clearing and finally mandatory trading. The record keeping obligation 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).

However, the SFAO only outlines a framework of reporting and record keeping obligations for OTC derivative transactions. The scope and details of such rules will be set by the SFC and the HKMA after consultation with the Financial Secretary. The July 2014 consultation paper sought public views on the new rules to implement the reporting and record keeping obligations – The Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules.

## Key Revisions in the Consultation Conclusions

The SFC and HKMA received comments under 13 heads which are summarised below together with the regulators' responses.

### 1) Mandatory Reporting Obligations of AIs, AMBs and LCs

Respondents generally supported mandatory obligations being introduced in phases by product type, with the initial phase covering certain types of interest rate swaps (**IRS**) and non-deliverable forwards (**NDF**). Definitions and concepts of these product types are further discussed in Part 1 Schedule 1 of the draft Rules. With respect to the product types which will be subject to the first phase of mandatory reporting, the Consultation Conclusions confirm that:

- the definition of "OTC derivative product" excludes spot contracts;

- overnight index swaps (**OIS**) are within the definition of IRS and will be reportable under the first phase of mandatory reporting if they are within the two types of transaction covered in that phase (e.g. single currency OIS);
  - the mandatory reporting obligation will not cover structured products containing embedded NDF components since subsection 2(f) of the definition of “OTC derivative product” (in section 1B of Part 1 of Schedule 1 to the SFO) excludes embedded derivatives;
  - forward rate agreements (**FRA**) are not IRS and will not therefore be covered in the first phase of mandatory reporting, but will be covered by a subsequent phase;
  - likewise foreign exchange (**FX**) derivatives (other than NDF) will be covered in a future mandatory reporting phase;
  - the definition of NDF has been revised to:
    - i) refer to transactions with only one value or settlement date to ensure that it does not unintentionally catch non-deliverable swaps; and
    - ii) specify the reference currency amount in the settlement currency;
  - precious metals are excluded from the definition of “special currency” (which is used to define NDF) to ensure that commodity-related transactions are not subject to the initial reporting phase;
  - the regulators currently intend to cover other interest rate and FX derivatives, and certain equity derivatives in the next phase of mandatory reporting. Other equity derivatives, together with credit and commodity derivatives will be covered in future phases.
- Product scope will not be expanded without first conducting a public consultation.

## 2) Reporting Obligations of AIs, AMBs and LCs

The consultation paper proposed requiring AIs, AMBs and LCs to report on 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 will only 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.

### **Meaning of “in Hong Kong”**

Respondents generally expressed support for the requirement that relevant parties report transactions that they have conducted in Hong Kong on behalf of an affiliate. However, some respondents asked for greater clarity in defining “conducted in Hong Kong”. The Consultation Conclusions note that:

- the intention is to capture transactions where the intention to enter into them is made by a Hong Kong trader who is employed or engaged by the reporting entity. Hong Kong traders include both junior and senior traders; and
- it is not intended that the activities of a salesman who negotiates between a client and a trader should be covered. Further, a salesman will not be considered to have taken on the role of a trader merely because he can adjust the pricing to achieve a desired sales credit.

### **Meaning of “in Hong Kong”: Transactions Booked in a Global Book**

Concerns were also raised as to how the “conducted in Hong Kong” reporting requirement would apply where a global book is used. The Consultation Conclusions note that:

- transactions booked in a global book are reportable to the HKMA if the trader who decides to enter into the transaction is a Hong Kong trader;
- once a transaction is reported to the HKMA, any subsequent events related to the transaction must also be reported, even if the subsequent events are handled by traders outside Hong Kong. Transactions executed on an electronic trading platform are reportable if a Hong Kong trader sets or last modifies the parameters of the key economic terms;

- if the decision to enter a transaction is not made by a Hong Kong trader, the transaction and any subsequent events relating to it will not be reportable in Hong Kong, even if a Hong Kong trader is involved in a subsequent event relating to the transaction; and
- reporting entities are responsible for determining whether transactions booked in a global book need to be reported to HKMA. If the entity is unable to identify which transactions in a global book were decided on by a Hong Kong trader, the reporting entity should report, at a minimum, all transactions entered into during the period when the global book was managed by a Hong Kong trader. All subsequent events relating to such transactions would also have to be reported to HKMA.

### ***Meaning of “in Hong Kong”: Transactions Executed on an Electronic Trading Platform***

Transactions entered into on an electronic trading platform will be reportable if the trader who sets the parameters of the key economic terms (in particular, pricing) of such transactions, is a Hong Kong trader. In this case, the Hong Kong trader will be regarded as responsible for the decision to enter into the transaction and the transaction will be reportable to the HKMA. Where the parameters of the transaction’s key economic terms are set by a trader outside Hong Kong, but are modified by a Hong Kong trader before the transaction is executed, the Hong Kong trader will be regarded as responsible for the decision to enter the transaction and the transaction will be reportable in Hong Kong. The regulators have revised the definition of “Hong Kong trader” to describe him as someone who is “predominantly based in Hong Kong”.

### ***Meaning of “in Hong Kong”: Transactions subject to an Order Routing Arrangement***

Transactions subject to an order routing arrangement are reportable only if “conducted in Hong Kong” on behalf of an affiliate, or if the dealer is a counterparty to it. However, if the transaction is conducted on behalf of a counterparty that is not an affiliate, e.g. a client, the transaction will not be reportable by the dealer.

HKMA and SFC propose publishing FAQs to provide guidance on the mandatory reporting requirements as it applies to transactions “conducted in Hong Kong”.

### ***Expanded Circumstances in which AIs and LCs are Required to Report***

Type 9 registered/licensed AIs and LCs will be required to report transactions that they enter into in their capacity as fund managers. Many of the issues raised by respondents related to fund managers and the funds they manage. The Consultation Conclusions note that funds tend to rely on their counterparties (who are usually dealers) to report trades to a trade repository. Funds and their managers are thus generally not used to reporting transactions themselves and do not have the necessary reporting systems in place.

The proposals allow for reporting through agents and would thus allow for reporting through dealer-counterparties. However, funds commonly transact with overseas dealers who again would not have the system set-up to report the transactions to the HKMA. Further, as fund managers are not counterparties to the transaction, their information may not be included in the information reported by the dealer-counterparty. The dealer-counterparty would therefore need to make certain technical adjustments before the transaction can be reported on behalf of the fund manager.

The Consultation Conclusions note the issues raised, but more time is needed to address them. The Regulators have therefore decided to implement the mandatory reporting obligation for the main players in the market in the first phase, but have decided to delay the implementation of the Type 9 licensees’ obligation to mandatorily report transactions they have entered into on behalf of clients in their capacity as fund managers.

### ***Other Related Issues***

#### Entities that have been Reporting under the HKMA Interim Reporting Requirements

Entities that have been reporting transactions to the HKMA under the interim reporting requirements will be regarded as having complied with the backloading obligation to the extent that they have reported the relevant information before the Rules commence.

#### Prime Brokerage Arrangements

Where in the context of prime brokerage arrangements, an entity enters into an NDF transaction with its prime broker, and the prime broker enters into a back-to-back trade with an executing broker, both the prime and executing broker will

have a reporting obligation. However, the entity (assuming it is a Hong Kong person) would not be subject to reporting in the first phase since Hong Kong persons will not be subject to the reporting obligation in the first phase.

### 3) Reporting Obligation of CCPs

In order to conform with other major markets, the consultation paper 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**).

Respondents to the consultation paper were generally supportive of the proposals, although there were a number of requests for clarification of certain aspects of the proposals, to which the Consultation Conclusions responded as follows:

- AIs, AMVs, LCs and Hong Kong persons are under no obligation to ensure a CCP's compliance with its reporting obligations;
- the definition of "recognised clearing houses" has been expanded under the SFAO to include those that clear OTC derivatives. This expanded definition is expected to take effect as part of the first phase of implementation;
- it is expected that overseas CCPs intending to provide clearing services to market participants in Hong Kong will apply to be authorised as automated trading services (**ATS**) providers, rather than seek to become RCHs. The definition of ATS has been extended by the SAO to include services for clearing OTC derivatives. That amendment will however only be implemented when mandatory clearing is introduced at a later stage. An ATS provider that clears OTC derivative transactions will only be required to report transactions with counterparties that are Hong Kong incorporated companies;
- CCPs (whether an RCH or an authorised ATS) will need to report transactions they enter into as part of their default management procedures;
- CCPs will only need to report transactions to which they are a counterparty when operating a principal clearing model; and

- There will be no restriction on clearing with overseas CCPs pending their authorisation as an ATS provider, provided the services they provide do not fall within the existing definition of ATS.

### 4) Reporting Obligation of Hong Kong Persons

The Consultation Paper proposed 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 was 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.

The definition of "Hong Kong persons" and the reporting and exit thresholds set for ITS and NDF received general support. However, it was decided to adjust the timeframe for implementation of the relevant obligations. Accordingly, the more significant players in Hong Kong's OTC derivatives market will be subject to reporting obligations in the first phase of implementation. Hong Kong persons, who are less active in the market, will be the last group to be made subject to reporting.

As a result, all references to the reporting obligations and exemptions, as applicable to Hong Kong persons, have been removed from the Rules. The market will be consulted later when the regulators propose to introduce mandatory reporting for Hong Kong persons.

### 5) Application to Cross Border Transactions

The consultation paper proposed that a reporting entity would be required to report a reportable transaction regardless of whether one or more counterparties to the transaction is a

person outside Hong Kong or the transaction is entered into wholly or partially outside Hong Kong. This would however be subject to the following qualifications:

- a) overseas incorporated AIs would 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.

Many responses pointed out the difficulty of reporting to the HKMA through the Hong Kong Trade Repository and suggested adopting a form of “substituted compliance” which would allow reporting to an acceptable overseas trade repository (TR), which would then transmit the data to the HKMA and SFC. The regulators however insisted on reporting being made through HKTR to fulfil the obligation of reporting in Hong Kong and ensure that the regulators have easy access to the TR data. However, recognising the difficulties that reporting entities will face, some flexibility has been built into the regime so that reporting entities will be able to report transactions through an agent, which could be an overseas TR.

#### **6) Exemptions and other Relief from the Reporting Obligation**

##### ***Exemption for Less Active AIs, AMBs or LCs (exempt persons)***

The consultation paper 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 proposed 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.

##### Revisions made in the Consultation Conclusions

The Draft Rule carved out an exemption from the reporting requirement for transactions entered into by AIs, AMBs and LCs that are small and not active in the Hong Kong OTC derivatives market. The exemption will apply on a product class basis.

The regulators agreed to remove the limit on the number of transactions (i.e. a maximum of five transactions outstanding per product class) for the exemption to apply. The revised Rules however retain the US\$30 million limit on the gross notional value of outstanding transactions.

The Consultation Conclusions also confirm that a licensed bank will not be qualified for the exempt person relief in respect of a particular product class if it has already reported a transaction in the same product class to the HKMA through the HKTR, and that transaction is still outstanding when the Rules commence. AIs, AMBs and LCs which have set up a system linkage with HKTR, but have not yet reported to the HKMA, can still enjoy the exemption.

Once the conditions for the exemptions cease to apply, the exemption is lost and cannot be revived, even if the conditions are subsequently satisfied again. Some requested that the

exemption should be revived with the regulator's consent if the relevant criteria are met again. The proposal was however rejected on the basis that the exemption is designed to avoid imposing the costs of setting up a reporting system for OTC derivatives on entities which only occasionally enter into OTC derivative transactions or whose OTC derivative transactions are relatively insignificant. Once the exemption is lost, the entity will need to establish a reporting system and will not be faced with this dilemma if it subsequently requalifies for the exemption.

The condition for the exemption that the reporting entity must not have any derivatives outstanding to which a Hong Kong person is a counterparty will be removed at the initial stage, since Hong Kong persons will not have any reporting obligations under the initial phase of the regime's introduction. The condition's suitability will be reconsidered later when Hong Kong persons' reporting requirements are introduced.

### ***Reports Made by Affiliate***

AIs, AMBs or LCs will be taken to have complied with the reporting requirement for transactions that they have "conducted in Hong Kong", if they have been informed by the affiliate on whose behalf they conducted the transaction, that the affiliate has reported the transaction. Respondents in the banking industry questioned whether an agency agreement confirming that the affiliates would report to HKMA would constitute outsourcing. The Consultation Conclusions note that if an AI chooses to enter into an agency agreement with its affiliate (although this is not a requirement), the HKMA considers that this will constitute "outsourcing" and the AI should follow the guidance published by the HKMA in December 2013. This requires that an AI should issue a notification letter to the HKMA three months before the outsourcing implementation date.

It should be noted though that the reporting obligation still resides with the AI, AMB or LC despite an agency arrangement and the entity should make sure that it has arrangements to ensure it receives relevant confirmations from its affiliates.

The HKMA will provide further guidance on reporting by affiliates and agents in the technical specification or FAQs.

### ***Central Banks, Governments, etc.***

The Consultation Conclusions confirm that overseas central banks and governments will not be caught as reporting entities under the reporting regime. Entities that are counterparties to

central banks and governments will however be subject to the reporting requirements. The Conclusions however stress that data collected will be confidential and public disclosure of data held in the HKTR will initially be on an aggregate basis only.

### **7) Backloading Requirement for Outstanding Transactions**

The Conclusions confirm that the backloading obligation will only apply to transactions to which reporting entities are a counterparty: it will not apply to transactions which they have conducted in Hong Kong on behalf of their affiliates. Accordingly, Rules 9(2), 10(2), 12(2), 13(2) and 14(2) all note that the retrospective effect of the reporting obligation (i.e. the backloading obligation) applies only to counterparty transactions. Overseas AIs are thus only required to backload transactions to which they are a party which are booked into their Hong Kong branch.

### **8) Time for Reporting and Grace Periods**

The concession period for reporting entities to set up their reporting channels to the HKTR has been extended to six months (from three). Similarly, the grace period for reporting entities to complete any backloading has been extended to nine months (from six) but includes the six month concession period. The Consultation Conclusions refused to grant a further concession to entities planning to become AIs, AMBs or LCs after the concession period.

### ***Reporting Timeframes***

The "T" date for a trade that will be cleared is the date on which the trade is accepted by a CCP for clearing.

### **9) Form and Manner of Reporting Obligation**

#### ***How to Report***

Rule 20(2) requires reporting entities to report transactions in accordance with the directions and instructions published by the HKMA in order to comply with the mandatory reporting obligation. The HKMA has already published technical specifications, the Administration and Interface Development Guide on its webpage at <https://hktr.hkma.gov.hk>. These are currently being used for the interim reporting requirement and the HKMA may publish revised specifications in relation to the mandatory reporting obligations.

## **What to Report**

Schedule 2 to the Rules sets out the types of reportable transaction information. The Consultation Conclusions confirm that:

- “confirmation of a transaction” refers to all kinds of confirmation agreed with the counterparty for execution of a trade; and
- the “subsequent events” that are required to be reported are basically all events that will affect the economic terms and conditions of the transactions (e.g. any change in the notional amount, rate, counterparty, etc.). Item 7 of Schedule 2 to the Rules has been revised to specify that the types of subsequent events to be reported will be those that can be accepted for reporting via the HKTR published by the HKMA. Events due to the passage of time (i.e. intrinsic events, such as a trade reaching maturity, fixings, etc.) are not required to be reported.
- The Consultation Conclusions pointed out that two equal and opposite transactions that may have the effect of cancelling each other out are also reportable and that the reporting obligation of an AI, AMB, LC, RCH or ATS-CCP ceases only after an entity has notified the HKMA that it is no longer subject to the reporting obligations.

## **Reporting Valuation Transaction Information**

The types of valuation transaction information that are required to be reported are set out at Item 6 of Schedule 2 to the Rules. The requirement will apply only to regulated entities (i.e. AIs, AMBs, LCs, RCHs and ATS-CCPs) and not to Hong Kong persons. Valuations are expected to be based on the current market price (i.e. marked-to-market), if such information is available. If not, transaction values may be derived from financial models (marked-to-model).

## **Barriers to Reporting Counterparty Identifying Information: Masking Relief**

As a temporary measure pending international consensus, the consultation paper 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. The relief would apply in respect of both new and historical transactions; or
- b) in the case of historical transactions only (i.e. transactions entered into before the 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 Consultation Conclusions revised the above proposals so that where reporting requires client consent, the masking relief will additionally apply to new transactions entered into within the first six months after the Rules are first implemented. The Consultation Conclusions note however that after six months from the implementation of the Rules, the Regulators expect market participants to only enter into transactions with counterparties who are willing to consent to the inclusion of their particulars for the purposes of the mandatory reporting obligation. Market participants are encouraged to obtain necessary consents as soon as practicable and to ensure that they keep records to show that reasonable efforts were made to obtain relevant consents in cases where such consents cannot be obtained.

## **Specified Subsidiaries of Locally-Incorporated AIs**

The consultation paper proposed that an AI incorporated in Hong Kong would 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 SFAO) 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

The Consultation Conclusions note that the OTC derivatives activities of AIs’ subsidiaries are not generally significant and it is not therefore proposed that any subsidiaries of AIs will be specified for the purposes of the reporting obligation at this stage. The situation will however be monitored and reviewed and if it is necessary to implement the requirement in the future, the industry will be consulted on the criteria for specification of subsidiaries.

#### 10) Use and Public Disclosure of Data Collected by the HKMA

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 consultation paper mentioned that authorities are considering the possibility of public disclosure of trade repository data and will monitor international standards in the area.

Respondents to the consultation paper stressed the importance of ensuring the confidentiality of data stored in the HKTR. The Consultation Conclusions noted in response that the secrecy and disclosure provisions under the SFO have been extended to cover data received under the mandatory reporting obligation and that the HKTR will have the necessary procedures and mechanisms in place to safeguard the confidentiality of data reported.

#### 11) Other Matters Related to Reporting

The Consultation Conclusions contain the following illustrations of how the reporting requirements will work in certain scenarios:

- Inter-branch transactions (between branches of the same entity) are generally not reportable, but inter-affiliate transactions (between group entities) will be subject to the reporting obligation if other relevant criteria are met.
- Intra-branch trades (between desks in the same branch) are internal transactions and do not need to be reported.
- Whether the counterparty has a reporting obligation has no effect on the reporting obligation of an AI, AMB or LC.

Other points raised in the Consultation Conclusions were:

- Both counterparties are required to report OTC derivative transactions;
- Over-reporting is allowed so that an AI could backload all outstanding trades even if they are due to mature before the expiry of the grace period. However, once a transaction is reported, all subsequent events relating to that transaction must also be reported;
- Reporting entities need to apply for HKTR membership and set up an account. Entities can then either report themselves or appoint an agent to do so on their behalf;
- Where a reporting entity appoints an agent to report transactions on its behalf, an agent nomination form signed by both parties must be submitted to the HKMA. The agent will also need to perform testing and technical setup for trade report submission via the HKTR.
- Agents need to specify on whose behalf they report via the HKTR. An agent can also delegate the submission function to a sub-agent (the **submission agent**) who must be acknowledged and nominated by the reporting entity on the agent nomination form. The HKTR does not need to know the identity of any “middle agent” and the latter need not sign any documentation. Only the reporting entity and the submission agent will have access to the information submitted. It should be noted that engagement of an agent does not release a reporting entity from its reporting obligation and it must have contingency procedures in place for the reporting of transactions if the agent fails to report.

#### 12) Proposed Mandatory Record Keeping Obligation

Since the mandatory reporting obligation for Hong Kong persons will not be implemented in the first phase of the reporting regime, the mandatory record keeping obligation for Hong Kong persons has been removed from the Rules for the time being.

##### Required Records

The types of records required to be kept are set out in Schedule 3 to the Rules.

## Duration

The minimum record retention period has been reduced to 5 years (from 7 years) after the maturity or termination of the transaction.

### 13) Fees for Reporting to the HKMA via the HKTR

The current fee plan consists of a monthly fee of HK\$4.5 per transaction reported to the HKMA that is outstanding on the last business day of the month, with an annual cap of HK\$1.5 million per reporting entity. The subsidiary legislation containing the fee schedule will be made by the Chief Executive in Council and subject to negative vetting by the Legislative Council.

## Further Consultation

The further consultation seeks views on three issues and requests that any responses should be submitted by 23 December 2014.

### 14) Reporting of Valuation Transaction Information

The further consultation seeks comments on the following proposals in relation to the reporting of valuation information.

Reporting entities will be required to report the following daily valuation transaction information:

- the valuation type and/or source of the valuation (e.g. whether the transaction is valued on a marked-to-market or marked-to-model basis, whether the valuation is sourced from a CCP or agreed between the counterparties, etc. (as set out in item 6 of Schedule 2 to the Rules);
- when the transaction was last valued;
- the transaction value; and
- the currency in which the value is denominated.

The daily reporting of valuation information will only be required of regulated reporting entities (i.e. AIs, AMBs, LCs and CCPs) and information must be reported on a no later than T+2 basis. Where both parties are regulated reporting entities, valuation information must be reported by both.

As to valuation:

- for transactions cleared through a CCP, the CCP should determine the valuation;
- for non-centrally cleared transactions where the counterparties have agreed to exchange margin, the valuation should be one mutually agreed between the counterparties for the purposes of exchanging margin; and
- for other non-centrally cleared transactions, the valuation should be based on the methodology mutually agreed between the counterparties.

It is proposed that the requirement to report valuation transaction information will not be implemented at the initial stage of the reporting regime, but at some point in the future. The regulators are currently considering implementing this requirement in the first quarter of 2016 and to phase the requirement in by types of market participants.

### 15) Prescription of Jurisdictions for Masking Relief

The SFC will designate (with the HKMA's consent) overseas jurisdictions for masking relief where it is satisfied that it is likely that the laws or authorities in the relevant jurisdiction prohibit the reporting of a counterparty's identifying information. The list of designated jurisdictions on which further views are sought is as follows:

Algeria	Israel
Argentina	Luxembourg
Austria	Pakistan
Bahrain	People's Republic of China
Belgium	Samoa
France	Singapore
Hungary	South Korea
India	Switzerland
Indonesia	Taiwan

## 16) Prescription of Markets and Clearing Houses

The term “OTC derivative product”, and thus the SFO’s OTC derivatives regime, aims to cover only products that are typically negotiated bilaterally between counterparties directly. Products traded on a stock or futures market are intended to be excluded as they are already regulated under existing laws.

The definition of “OTC derivative product” in section 1B of Part 1 of Schedule 1 to the SFO already excludes products that are traded on a recognised stock market or recognised futures market (i.e. a market based in Hong Kong, operated by a recognised exchange company, and regulated under the SFO).

For products traded on a market based outside Hong Kong, these are also excluded from the definition of “OTC derivative product” if the relevant market is a stock or futures market prescribed under s329A of the SFO, and the product is cleared through a clearing house also prescribed under that section.

Appendix B to the Consultation Conclusions sets out proposed lists of 79 prescribed stock and futures markets and 55 prescribed clearing houses. Inclusion in the lists means that products traded on prescribed markets and cleared through prescribed clearing houses will not be “OTC derivative products” and thus will not be subject to Hong Kong’s mandatory reporting regime.

## 17) Next Steps

It is intended that the revised Rules will be introduced to Legco for negative vetting in the first quarter of 2015 and that subject to the legislative process, the mandatory reporting and record keeping obligations for AIs, AMBs, LCs and RCHs will be implemented in the same quarter.

ATS-CCP’s mandatory reporting obligation will only come into effect when mandatory clearing is implemented in the future.

A further consultation will be conducted with respect to the mandatory reporting and record keeping obligations of Hong Kong persons in the second quarter of 2015, at the same time as a further consultation is conducted on the detailed rules and regulation of SIPs. These requirements are not expected to commence before the last quarter of 2015.

In the meantime, the Regulators will proceed with the phased-introduction of mandatory clearing and trading and related record-keeping obligations. A further consultation on the

detailed proposals is currently expected to be conducted in the first quarter of 2015. The initial focus will be on dealer-to-dealer trades.

Views on the matters raised in the further consultation should be submitted by 23<sup>rd</sup> December 2014 by:

i) online submission at:

<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/>

ii) email to:

[fss@hkma.gov.hk](mailto:fss@hkma.gov.hk) or [otcconsult@sfc.hk](mailto:otcconsult@sfc.hk)

iii) fax to:

(852) 2878 7297 or (852) 2521 7917

iv) post to either of the following:

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

# CHARLTONS

**Best Boutique Firm 2014**

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](mailto: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](http://www.charltonslaw.com)