

OTC Derivatives: Proposed Hong Kong Reporting & Record Keeping Requirements

Amendments in 2014 to the Securities and Futures Ordinance introduced a new statutory regime for OTC derivative transactions. The regime establishes a framework for mandatory trading, clearing and reporting obligations, leaving it to the SFC and the HKMA to establish rules to define the scope of these obligations. The SFC and the HKMA have now proposed rules which, in broad terms and subject to prescribed exemptions, require regulated clearing houses and financial intermediaries, including firms licensed or registered with the SFC or authorized or approved by the HKMA, to report certain IRS and NDF trades conducted by them (or their affiliates) as counterparties. In this article, we outline the position under the proposed rules.

Enacted in April, 2014 the Securities and Futures (Amendment) Ordinance 2014 (“**Amendment Ordinance**”) amends the Securities and Futures Ordinance (“**SFO**”) to establish a statutory framework for the regulation of the over-the-counter (“**OTC**”) derivatives market in Hong Kong. Under this new framework, prescribed persons, including authorized institutions (“**AIs**”), licensed corporations (“**LCs**”), and approved money brokers (“**AMBs**”), must report certain OTC derivative transactions to the Hong Kong Monetary Authority (“**HKMA**”) and keep records of certain OTC derivative transactions. The new framework empowers the Securities and Futures Commission (“**SFC**”), with the consent of the Hong Kong Monetary Authority (“**HKMA**”) and in consultation with the Financial Secretary of Hong Kong, to make rules to define the scope of these obligations.

In furtherance of this, on July 18, 2014, the HKMA and the SFC issued a joint consultation paper regarding the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping) Rules

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The Consultation Conclusions confirm that the mandatory reporting obligation under the new regulatory framework for OTC derivatives in Hong Kong will be implemented in phases and will initially cover only certain specified types of interest rate swaps and non-deliverable forwards.

(“**Rules**”). Following a public consultation on the Rules, on November 28, 2014, the SFC and the HKMA jointly published the consultation conclusions (“**Consultation Conclusions**”) on the Rules setting out a revised draft of the Rules.

Product Coverage

The Consultation Conclusions confirm that the mandatory reporting obligation under the new regulatory framework for OTC derivatives in Hong Kong will be implemented in phases and will initially cover only certain specified types of interest rate swaps (“**IRS**”) and non-deliverable forwards (“**NDF**”). In this regard, the definitions of IRS and NDF have both been amended to reflect ISDA concepts.

Interest Rate Swaps

Under the Rules an IRS is now defined as:

“an OTC derivative transaction under the terms or conditions of which (a) the 2 counterparties to the transaction agree to exchange interest rate cash flows (payments) at specified intervals while the transaction is still outstanding; and (b) the payments are to be calculated by reference to (i) a notional amount that is denominated in a single currency; and (ii) agreed interest rates or interest rate indexes”

However, at the outset, only a subset of IRS will be covered by the reporting requirements, namely IRS where the

“payments are calculated by reference to (a) a fixed interest rate applied to a notional amount that is denominated in a specified currency; and (b) a specified

floating rate index applied to the same notional amount”,

or the:

“payments are calculated by reference to (a) a specified floating interest rate index applied to a notional amount that is denominated in a specified currency; and (b) another specified floating interest rate index applied to the same notional amount”.

Non-Deliverable Forwards

An NDF is now defined as:

“an OTC derivative transaction under the terms or conditions of which the 2 counterparties to the transaction agree that (a) 1 counterparty is to purchase from the other counterparty a notional amount of a currency (the reference currency) for settlement on a single date in the future (the value date); (b) on settlement of the transaction, the purchase is to be settled (i) on a net cash payment basis (without physical delivery reference currency); and (ii) in an agreed currency (the settlement currency) that is not the same currency as the reference currency; and (c) the amount to be paid by 1 counterparty to the other counterparty is the difference between the values of the notional amount of the reference currency, denominated in the settlement currency, calculated using (i) an agreed currency exchange rate whether express or implied; and (ii) a market currency exchange rate (as determined in accordance with the terms or conditions of the transaction) that is prevailing on an agreed future date (the fixing date)”

As with IRS, only a subset of NDF will be initially covered by the reporting requirements, namely NDF where the

AIs, LCs and AMBs must report transactions by an affiliate where (i) the affiliate is a counterparty... (ii) one of the individuals who made the decision for the affiliate... acted in their capacity as a trader and was employed... to perform their duties predominantly in Hong Kong, and (iii) the transaction is conducted in Hong Kong...

“reference currency is a specified currency and the settlement currency is a specified currency.”

The definition of NDF has now been amended to (i) make it clear that settlement must take place on a future date to ensure that only forwards are captured, notwithstanding that the definition of “OTC derivative product” under the SFO already excludes spot contracts, (ii) make it clear that only transactions with only one value or settlement date are included, so as to ensure that the definition does not unintentionally capture non-deliverable swaps, and (iii) specify the reference currency amount in the settlement currency. The definition of “specified currency” which is used to define NDF has itself been amended to remove the reference to precious metals to avoid bringing transactions relating to commodities into the initial phase of mandatory reporting.

OTC derivative products which may be known in the market as IRS or NDF but which do not fall within the types specified will not be subject to the mandatory reporting requirement in the initial phase. Overnight index swaps (“**OIS**”) will be covered in the first phase of mandatory reporting if they fall within one of the two types of IRS specified (*e.g.* a single currency OIS would be caught) but the definition of IRS does not encompass forward rate agreements (“**FRA**”), as the intention is to cover FRA and other commonly traded interest rate products such as cross currency swaps and options at a later time. Structured products containing embedded NDF components are not caught because embedded derivatives are specifically excluded from the definition of “OTC derivative product” under the SFO. Foreign exchange derivatives (other than NDF) will be covered at a later time.

Regulated Financial Intermediaries

Counterparty and Affiliate Transactions

Under the Rules, AIs, LCs and AMBs (together “**regulated financial intermediaries**”) must report OTC derivative transactions to which they are a counterparty. In addition regulated financial intermediaries must report transactions by an affiliate where:

- the affiliate is a counterparty to a transaction,
- one of the individuals who made the decision for the affiliate to enter into the transaction (i) acted in their capacity as a trader, and (ii) was employed or engaged by the regulated financial intermediary to perform their duties predominantly in Hong Kong, and
- the transaction is conducted in Hong Kong on behalf of the affiliate,

unless the affiliate has confirmed to the regulated financial intermediary in good faith that the affiliate has reported the transaction, directly or indirectly, to the HKMA.

The SFC have stated that the concept of a transaction “conducted in Hong Kong” is intended to capture transactions where the decision to enter into the transaction is made by a Hong Kong trader and is not intended to catch pure sales activities. Thus, for example, it appears that if a sales person at a Hong Kong broker intermediates a deal between a Singapore client and a London broker, the Hong Kong broker will not have to report the transaction.

The SFC have provided guidance on its interpretation of the “conducted in Hong Kong” concept in the following specific circumstances:

AIs and LCs licensed or registered to carry on Type 9 (asset management) regulated activity which enter into OTC derivative transactions in their capacity as fund managers on behalf of a counterparty (i.e. as agent for the counterparty) will be exempt from reporting such transactions pending further consultation.

- where a global book is used, the transaction will be reportable if it is entered by a Hong Kong trader,
- where transactions are executed on electronic trading platforms, the transaction will be reportable if the parameters of the key economic terms of the transaction are set by a Hong Kong trader, and
- where an order routing arrangement is in place, the transaction will only be reportable if it is conducted in Hong Kong on behalf of an affiliate or if the dealer is a counterparty to it.

In all of these circumstances the guiding principle is that the transaction must be “conducted in Hong Kong”, meaning that it is entered into by a trader that is “predominantly based” in Hong Kong, irrespective of the actual location of the trader at the time the transaction was entered into.

The HKMA and the SFC have stated that they will issue FAQs to provide further guidance on the mandatory reporting requirement as it applies to transactions “conducted in Hong Kong”.

In the context of prime broker arrangements, where an entity enters into a transaction with their prime broker who then enters into a back-to-back trade with the executing broker, if the entity, the prime broker and the executing broker are all separate legal entities and each of them fall under the Hong Kong reporting regime, each of them will have a reporting obligation in respect of the transaction.

Fund Managers

LCs and AIs licensed or registered to carry on Type 9 (asset management) regulated activity which enter into

OTC derivative transactions in their capacity as fund managers on behalf of a counterparty (i.e. as agent for the counterparty) will be exempt from reporting such transactions pending further consultation. Most funds rely heavily on their counterparties (who are usually dealers) to report their trades to a trade repository (“TR”) as funds and fund managers are not accustomed to, and do not have the necessary system set-up for, reporting transactions themselves. However, at the same time, when funds transact with dealers that are overseas entities, such dealer counterparties may not have the necessary systems in place to report to the HKTR. In addition, as fund managers are not counterparties to the transaction, their information may not be included in the information reported by the dealer counterparty.

A separate proposal, whereby AIs and LCs registered or licensed for Type 9 regulated activity would have been required to report transactions upon which they have advised a counterparty on, even though such transaction was not entered into by it on behalf of the counterparty, has been completely dropped.

Reporting Obligations of Central Counterparties

Central counterparties (“CCPs”) will only be required to report transactions in their capacity as a CCP (i.e. only transactions entered into as part of the clearing process). In this regard, transactions entered into by a CCP as part of its default management procedures are still transactions entered into in its capacity as a CCP and will therefore be reportable under the Hong Kong reporting regime. However, this is currently not expected to result in any public disclosure of details of the action taken by a CCP in such circumstances, as data collected by the HKMA via the HKTR will be used for regulatory

[The]concession period to enable the set up of connections to the HKTR has been extended to 6 months. As a result, the grace period of up to 6 months (including the 3 month concession period or any remaining part of it) has now been extended to a maximum of 9 months (including the 6 month concession period or any remaining part of it).

market surveillance purposes and the SFC and the HKMA have indicated that at this time, there are no plans for any public disclosure of data otherwise than on an aggregate basis.

For this purpose, CCPs will include both recognized clearing houses (“RCH”) and ATS providers (“ATS CCPs”) authorized to provide clearing services. However, whilst the Amendment Ordinance expanded the definitions of an RCH and an ATS to include clearing houses and ATS that clear OTC derivatives, it is expected that the expanded definition of RCH will apply at the outset but that the expanded definition of ATS will not take effect until mandatory clearing is introduced and, even then, will only apply to require reporting of OTC derivative transactions with counterparties that are Hong Kong incorporated companies.

CCPs that operate a principal clearing model will only be required to report transactions to which they are a counterparty. There is no obligation on a CCP to report transactions between its members and their clearing clients and there is no obligation on regulated financial intermediaries or Hong Kong persons to ensure that a CCP complies with its reporting obligations.

The SFC have confirmed that there will not be any restriction on clearing with overseas CCPs pending their authorization as an ATS provider, so long as the services offered by the CCP do not fall within the current definition of ATS. The SFC has also acknowledged the importance of giving CCPs sufficient time to be authorized to clear OTC derivatives (and designated for the purposes of mandatory clearing where appropriate) before the expanded definition of ATS and mandatory clearing requirements are implemented and it is hoped appropriate transition measures will be implemented.

De Minimis Exemption

A regulated financial intermediary is exempt from reporting transactions to which it is counterparty if, amongst other requirements, the notional amounts of all outstanding OTC derivative transactions within the product class (whether or not the transactions are specified OTC derivative transactions) to which it is a counterparty do not exceed US\$30 million before the relevant product class specification day. A regulated financial intermediary may be eligible for exemption in one product class (e.g. IRS) even if it is not eligible for exemption in a different product class (e.g. NDF).

Timing

Following requests from the industry, the 3 month concession period to enable the set up of connections to the HKTR has been extended to 6 months. As a result, the grace period of up to 6 months (including the 3 month concession period or any remaining part of it) has now been extended to a maximum of 9 months (including the 6 month concession period or any remaining part of it).

Other Hong Kong Persons

In the initial phase of implementation, the mandatory reporting and related record keeping requirements will apply only to regulated financial intermediaries and RCHs. Thereafter, as noted above, these requirements will also apply to ATS CCPs.

The SFC and HKMA have taken the decision to delay applying the mandatory reporting requirements to “Hong Kong persons” other than regulated financial intermediaries as well as RCHs and ATS CCPs until a subsequent phase of implementation. In this regard,

The mandatory reporting obligation under the Rules requires reporting entities to report their reportable transactions to the HKMA via the electronic reporting system (“HKTR”) developed and operated by or on behalf of the HKMA. There will be no option for “substituted compliance”.

the definition of “Hong Kong persons” will include (i) individuals resident in Hong Kong, (ii) partners of partnerships established under Hong Kong law, (iii) trustees of trusts established under Hong Kong law, (iv) Hong Kong incorporated companies, (v) non-Hong Kong companies that have established and continue to have a place of business in Hong Kong, and (vi) any other entity which is established under Hong Kong law but will exclude regulated financial intermediaries and RCHs, and ATS CCPs. The delay in implementation for Hong Kong persons will give the SFC and the HKMA time to align the reporting requirements of Hong Kong persons with the regime for regulating systemically important participants (“SIPs”), as the definition of SIP also expressly excludes regulated financial intermediaries, RCHs, and ATS CCPs (and in addition excludes recognized exchange companies).

Sovereign Bodies and Central Banks

It has also been clarified that there will be no specific exemptive relief for governments and central banks from the reporting requirements on the basis that those entities will not be caught by the Hong Kong reporting regime and the counterparties to such entities will not be exempted.

Form of Reporting

The mandatory reporting obligation under the Rules requires reporting entities to report their reportable transactions to the HKMA via the electronic reporting system (“HKTR”) developed and operated by or on behalf of the HKMA. There will be no option for “substituted compliance”. Thus, notwithstanding that

a transaction may have already been reported to an overseas TR this will not be regarded as fulfilling the reporting obligation in Hong Kong. This is because the SFC and HKMA feel that they need unfettered access to OTC derivatives data held in a TR for various regulatory purposes, including market surveillance and risk monitoring purposes. However, the use of reporting agents will be allowed and as a result, where a transaction has already been reported to an overseas TR, the entity to whom the Hong Kong reporting requirement applies could request the overseas TR to report the transaction to the HKTR. To facilitate reporting, the HKMA will endeavour to ensure that the reporting standards and specifications adopted by the HKTR are in line with international and industry standards.

Cross Border Transactions

Whilst a reporting entity must report a reportable transaction, even if one or more counterparties to the transaction is a person outside Hong Kong or the transaction was entered into wholly or partially outside of Hong Kong, this is subject to a number of qualifications. In particular, in the case of transactions reportable by an overseas incorporated AI, the Hong Kong branch of the AI must be involved either as the booking centre or as the party conducting the transaction in Hong Kong and in the case of transactions reportable by an ATS CCP, the counterparty must be a Hong Kong incorporated company. Whilst the SFC received comments that the circumstances prescribed might be easily circumvented with the result that not all transactions intended to be reportable will be captured, the SFC does not agree with that view. The SFC accepts

Masking relief will allow reporting entities to mask certain counterparty information where there is a statutory barrier which prohibits the reporting of such information to the HKMA via the HKTR or where counterparty consent is required for such disclosure.

that whilst it is important for it to obtain information about OTC derivative transactions that are relevant to the local market, it also understands that it is important to avoid an unnecessarily wide extra-territorial reach when regulating the OTC derivatives market and the proposed approach strikes a balance between these two aims.

Masking Relief

Masking relief will allow reporting entities to mask certain counterparty information where there is a statutory barrier which prohibits the reporting of such information to the HKMA via the HKTR or where counterparty consent is required for such disclosure. In respect of the latter, masking relief has been extended to cover both historical transactions (*i.e.* transactions entered into before the Rules come into effect) and new transactions, each in cases where counterparty consent is required. However, in respect of new transactions, the masking relief is limited to transactions entered into within the first six months following the introduction of the Rules and only where the reporting entity is unable

to obtain counterparty consent despite reasonable efforts to do so.

The Rules clarify that masking relief will continue to apply in a situation where the barrier to TR reporting is removed in another jurisdiction, but the removal in the other jurisdiction does not have retrospective effect.

Record Keeping Requirements

The record retention period has been decreased from 7 years to 5 years after the reportable transaction to which the record relates has matured or been terminated.

Fees

The fees for reporting to the HKMA via the HKTR have been increased in order to support the new requirements to report the valuation of transactions. The monthly fee per transaction reported to the HKMA that is still outstanding on the last business day of the month will now be HK\$4.5 instead of HK\$3, subject to an annual cap of HK\$1.5 million.

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