

TOPIC 7 - OVERVIEW

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1. REPORTING AND RECORD KEEPING OBLIGATIONS FOR OVER-THE-COUNTER (OTC) DERIVATIVE TRANSACTIONS

1.1 Introduction

- There has been an international effort to reduce systemic risks in the **OTC derivatives market** as a result of the global financial crisis of 2008
- There are now requirements for OTC derivative transactions to be **reported to trade repositories** and cleared through a central counterparty (CCP)
- Since 10 July 2015, there has been a Hong Kong requirement for mandatory reporting and record keeping prescribed by the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (“OTCD Reporting Rules”)
- This topic considers the requirements for **Licensed Corporations**

1.2 Scope of Application

- An OTC derivative transaction means a transaction in an OTC derivative product, which is broadly defined in the SFO
- At present, there are five specified product classes:
 - **Interest rate swaps (IRS)**
 - **Foreign currency derivatives**
 - **Equity derivatives**
 - **Credit derivatives**
 - **Commodity derivatives**

1.3 Reporting Obligations

- Unless exempted, all licensed corporations are subject to OTCD Reporting Rules. **The obligations arise when:**
 - A new OTC product becomes a specified product type and the licensed corporation is a counterparty
 - On or after a product becomes a specified product type and the licensed corporation:
 - enters into a transaction in a specified product type as counterparty
 - has conducted a transaction in a specified product type “in Hong Kong” on behalf of a Group company
 - loses its exempt status
 - On or after a product becomes a specified product type, the corporation holding the position becomes a licensed corporation
- After a reporting obligation arises, **open and subsequent** positions must be reported

1.4 Means and Timing of Reporting

- All transaction information must be reported to the HKMA via the **Hong Kong Trade Repository (HKTR)** electronic reporting system operated by the HKMA
- HKTR membership is required to make a report
- Reports must be made **within two business days** of a transaction (T+2)
- A licensed corporation that **ceases to be exempt** will have a **grace period** of three months from the date it ceased to be exempt, to submit the information

1.5 Information to Report

- Information to be reported includes:
 - Product class and type
 - Dates: transaction; effective and maturity
 - Particulars of counterparties
 - Clearing information
 - References assigned to the transaction
 - Transaction particulars (notional amount, currency rate, interest rate etc)
 - Subsequent events
- The primary reporting obligations rests with the licensed corporation, however if the transaction is conducted on behalf of a Group company, the Group company may make the report. In such a case, the licensed corporation needs written confirmation from the Group company to demonstrate compliance with the reporting requirement

1.6 Exemptions

- A licensed corporation is exempt from the reporting requirement if the **notional amount of all outstanding OTC Derivative transactions does not exceed US\$30 million** in aggregate over all product classes collectively
- The **exemption is lost permanently** once the notional value exceeds US\$30 million

1.7 Record Keeping Obligations

- Transaction records must be kept for at least **five years** after the maturity date
- Records must be sufficient to demonstrate compliance with reporting requirements
- Where a licensed corporation is exempt from reporting, records should still be kept to justify the exemption

1.8 Legal Entity Identifiers and Unique Transaction Identifiers

- **Entities subject to the reporting obligation** are required to use their Legal Entity Identifiers (LEI) in transaction reports submitted to the HKTR (see above)
- An LEI is an identifier issued under the Global LEI System enabling the **clear and unique identification of legal entities** participating in financial transactions
- The SFC and HKMA have issued a consultation paper proposing the use of **Unique Transaction Identifiers (UTIs)** – the aim is to improve the transparency of OTC derivative markets by assigning a UTI to each individual transaction

1.9 Consequence of Breaches

- A breach of the Rules can lead to prosecution in the Court of First Instance, with a maximum penalty of HK\$5 million

2. CLEARING AND RECORD KEEPING OBLIGATIONS FOR OTC DERIVATIVE TRANSACTIONS

2.1 Background

- Following on from the Rules introduced in Section 1 above, the SFC introduced mandatory clearing through subsidiary legislation – Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules
- Mandatory clearing of OTC derivative products is being introduced in phases – the first phase was introduced on 1 September 2016

2.2 The Clearing Obligation and Designated CCP

- Where an OTC derivative clearing obligation exists, the transaction must be cleared through a designated central counterparty (CCP) within one business day of the transaction
- Eligible CCPs are:
 - Recognised clearing houses under the SFO
 - Persons authorized by the SFC to provide automated trading services
- Transactions that cannot be cleared in time will be terminated
- As at 1 September 2016, there were four designated CCPs:
 - Chicago Mercantile Exchange
 - Japan Securities Clearing Corporation
 - LCH.Clearnet Limited
 - OTC Clearing Hong Kong Limited

2.3 Product Subject to the Clearing Obligation

- In the first phase, the only class of product subject to mandatory clearing is Interest Rate Swaps (IRS), including:
 - Fixed to floating (28 days to 10 years)
 - Floating vs. floating (28 days to 10 years)
 - Overnight index swaps (7 days to 2 years)
- As the regulatory objective is to catch systemic risks posed by larger and more significant participants in the OTC derivatives market, the OTCD Clearing Rules only apply to positions of US\$20 billion or more (the clearing threshold)
- Transactions below the clearing threshold are not subject to the clearing obligation

2.4 Nature of Persons Who Are Counterparties

- For a transaction to be subject to the clearing obligation, either:
 - Both counterparties to the transaction must be **prescribed persons**; or
 - One counterparty is a **prescribed person** and the other is a **financial services provider**
- If one of the counterparties is a designated **financial services provider**, the clearing obligation falls on the **prescribed person**
- **Prescribed persons** include authorized financial institutions, licensed corporations and others who are listed in the OTCD Clearing Rules as being subject to the clearing obligation
- A **financial services provider** is a person actively engaged in OTC derivative transactions or OTC derivative products outside Hong Kong

2.5 When Clearing Obligation will not Apply

- When a transaction has been cleared under the laws of a designated jurisdiction, through a designated CCP, clearing the transaction in Hong Kong is not required
- There are three further situations where the clearing obligation does not apply:
 - Transaction with a group company member that is an exempt affiliate
 - Transaction is recorded in another jurisdiction that is an exempt jurisdiction
 - Transaction is entered into on a multilateral basis to reduce operational or counterparty credit risk

2.6 Record Keeping Obligations

- Records sufficient to demonstrate compliance with the clearing obligations should be kept for at least **5 years** from the termination/maturity of the transaction

2.7 Consequence of Breaches

- SFC can bring licensed corporations that breach the OTCD Clearing Rules before the Court of First Instance
- Maximum penalty is HK\$5 million and possible disciplinary sanctions

3. CONDUCT REQUIREMENTS IN RELATION TO OTC DERIVATIVE TRANSACTIONS

3.1 Introduction

- Two new regulated activities have been introduced in the Securities and Futures Ordinance:
 - **Type 11** – Dealing in OTC derivative products or advising on OTC derivative products
 - **Type 12** – Providing client clearing services for OTC derivative transactions
- The Code of Conduct addresses conduct requirements intended to mitigate risk where the business of a licensed corporation, or various persons connected to it, involves **OTCD transactions**. The requirements fall into two main parts that deal with:
 - **mitigating risk** in OTCD transactions that are not centrally cleared (NCC); and
 - **managing risk** in relation to group affiliates and other connected persons

3.2 Mitigating Risk in OTCD Transactions that are not Centrally Cleared

- Licensed corporations subject to risk mitigation requirements will be:
 - a contracting counterparty to a NCC OTCD transaction; and
 - licensed for Type 9 regulated activity (asset management), managing a portfolio of non-centrally cleared OTCDs (“NCC OTCDs”)
- Risk mitigation requirements do not apply to registered institutions
- The specific requirements revolve around four key areas: documentation, valuation, portfolio matters and handling of disputes

3.3 Group Affiliates and Other Connected Persons

Risk management

- Licensed corporations should apply the same risk management standards to all such parties, subject to any legal or regulatory requirement or exemption that might be applicable

Dealings

- Licensed persons that solicit, recommend, or arrange for OTCD transactions between a group affiliate and a client (other than a client that is a group affiliate) should always act in the best interests of the client

Disclosures when dealing with unlicensed persons

- Although a group affiliate may frequently be subject to regulatory oversight in Hong Kong or another jurisdiction, this is not always be the case
- In some cases, a licensed corporation may solicit, recommend or arrange for a client (other than a client that is a group affiliate) to enter into an OTCD transaction with a group affiliate that is not a person licensed by the SFC
- In such cases, additional risk disclosures should be included in the written client agreement that bring to the attention of the client that the group affiliate is not licensed by the SFC, and that the regulatory oversight protection afforded to the client might not the same as if the group affiliate were licensed and regulated by the SFC

4. MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED OTC DERIVATIVE TRANSACTIONS

4.1 Introduction

- As part of the post-2008 financial crisis reforms to the OTC derivative market, **minimum standards for margin requirements** for NCC OTCDs have been established jointly by the Bank of International Settlements and IOSCO
- Objectives of the requirements are to **reduce systemic risk** and promote central clearing
- The Code of Conduct provides for the collection of **initial margin (IM)** and **variation margin (VM)**
- IM and VM refer to collateral that has to be posted by one party to the other to protect the receiving party from the giving party defaulting
- IM reflects the **potential future exposure at the time of entering into the OTCD** transaction, whereas VM reflects the **current exposure incurred as the mark-to-market value changes** over time
- IM and VM are normally posted and collected by both parties, protecting each party from the possibility of default

4.2 Scope of Application

Persons subject to the requirements

- The requirements apply to any licensed person who is a contracting party to an NCC OTCD transaction with a “covered entity”. They **do NOT apply to registered institutions**
- “Covered entity” refers to entities that, during the 12-month period from 1 September to 31 August the following year, is either:
 - A financial counterparty (itself or with its group companies) with an average aggregate notional amount of NCC OTCD exceeding HK\$15 billion; or
 - A significant non-financial counterparty (itself or with its group companies) with an average aggregate notional amount of NCC OTCD exceeding HK\$60 billion
- The following are specifically excluded from the definition of covered entity:
 - Governments
 - Central banks
 - Non-commercial government agencies
 - Multilateral development banks specified by the HKMA
 - Bank of International Settlements

Instruments subject to the requirements

- IM/VM requirements apply to all NCC OTCD transactions, however they do not apply for certain physically settled FX transactions, certain commodity forward transactions and certain currency contracts

Exceptions to the margin requirements

- The margin requirements may not apply in three circumstances:
 1. Where there is reasonable doubt about the enforceability of a netting agreement in respect of IM or VM or collateral protection arrangements
 2. Intragroup transactions where risk is managed on a consolidated basis
 3. The licensed person has notified the SFC that it will perform **substituted compliance** – licensed person will adhere to margin requirements of another jurisdiction

4.3 Initial Margin Requirements

- IM must be exchanged where both the licensed person and the counterparty have an average aggregate notional amount of NCC OTCs in excess of HK\$375 billion (this will go down to HK\$60 billion from 1 September 2022)
- IM does not need to be exchanged where the licensed person has no counterparty risk or where the counterparty is a significant non-financial counterparty using NCC OTCs for hedging purposes
- IM does not need to be collected where the amount due is HK\$375 million or less
- IM received by a licensed person should be protected by using a third-party custodian and should be **treated as client assets**
- **IM requirements** will start from **1 September 2021**; **VM requirements** took effect from **1 September 2020**

4.4 Variation Margin Requirements

- Where the licensed person has an average aggregate notional amount of NCC OTCs in excess of HK\$15 billion, VM must be exchanged for a 12-month period commencing 1 September
- For certain FX contracts, the threshold is HK\$60 billion
- The calculation of VM should be subject to a single, legally enforceable netting arrangement
- The licensed person may elect not to exchange VM with a significant non-financial counterparty using NCC OTCs for hedging purposes
- VM does not need to be collected where the amount due since the last exchange is equal to or less than HK\$3.75m. Where the amount is more than HK\$3.75m, the full amount needs to be exchanged VM should be calculated at least on a daily basis

4.5 Assets Eligible as IM and VM

- **Assets accepted as collateral:** cash, marketable debt securities, gold and listed share
- **Assets not acceptable as collateral:**
 - Securities issued by a company in the same consolidated group as the licensed person
 - Securities significantly correlated with the counterparty's creditworthiness or the OTCD's value
 - Securities that are not of investment grade