Baker McKenzie.

Financial Services
Hong Kong

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For further information, please contact:

Karen Man
+852 2846 1004
karen.man@bakermckenzie.com

Samantha Lai
+852 2846 2412
samantha.lai@bakermckenzie.com

OTC Derivative Regulatory Regime in Hong Kong – What's Next?

1. Introduction

The OTC derivative regulatory regime in Hong Kong is being implemented in phases. This briefing is designed to update market participants on the aspects of the regime which have been implemented, those that will be implemented on **1 July 2017** and those that have been announced and are waiting implementation.

This briefing is intended to serve as a high level overview of the key aspects of the OTC derivative regulatory regime in Hong Kong and is not an exhaustive list of all the obligations and requirements which may be applicable to your organisation.

2. What has been implemented?

Mandatory reporting (first phase)

The first phase of mandatory reporting came into effect on 10 July 2015. The key aspects of the first phase of mandatory reporting are as follows:

- OTC derivative products subject to the mandatory reporting obligation comprise certain interest rate swaps ("**IRS**") and non-deliverable forwards.
- The mandatory reporting obligation generally applies to authorized institutions, approved money brokers, licensed corporations and recognised clearing houses.
- The reporting obligation generally applies in respect of transactions: (i) to which the authorized institutions, approved money brokers, licensed corporations and recognised clearing houses are counterparties, or (ii) that authorized institutions, approved money brokers and licensed corporations have conducted in Hong Kong on behalf of an "affiliate"[1] and subject to fulfilling other requirements.
- Reportable transactions are required to be reported to the Hong Kong Monetary Authority's ("**HKMA**") trade repository within two business days after a transaction is entered into.
- Transaction information required to be reported (for example, life-cycle events) is specified in subsidiary legislation.
- There is currently an "exempt person" relief. This exempts small or inactive participants from the mandatory reporting obligation. One criterion for this relief is that the person's outstanding OTC derivative positions must, in aggregate, not exceed US$30 million. This limit is set on a per product class basis, i.e. a person's position in *each* product class must not exceed US$30 million for this exemption to apply.

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1 "Affiliate", in relation to a prescribed person that is a licensed corporation, an authorized financial institution or an approved money broker, means a corporation that is in the same group of companies as the person, except a corporation that is a collective investment scheme.

Margin requirements and risk mitigation standards for uncleared OTC derivatives

These requirements apply to all authorized institutions. The requirements are set out in the HKMA's Supervisory Policy Manual on *"Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards"* (**"HKMA's SPM"**). Broadly, all non-centrally cleared OTC derivatives transactions (with some exceptions, for example, repurchase agreements, securities lending transactions etc) entered into between an authorized institution and a "covered entity" (i.e. a "financial counterparty"[2], a "significant non-financial counterparty"[3] or another entity designated by the HKMA, but excludes certain entities such as central banks etc.) may become subject to margin requirements and certain risk mitigation standards with effect from 1 March 2017 (subject to an initial 6-month transitional period). Broadly, the requirements under the HKMA's SPM are as follows:

- **Margin requirements**: An authorized institution is required to exchange variation margin and initial margin for all relevant non-centrally cleared OTC derivatives transactions entered into with a covered entity.
  - *Variation margin*: The commencement date for the exchange of variation margin was 1 March 2017.
  - *Initial margin:* There is a phase-in approach in respect of the exchange of initial margin. The exchange of initial margin applies in a one-year period (from 1 September of each year to 31 August of the following year) where both the authorized institution and the covered entity have an "average aggregate notional amount"[4] of non-centrally cleared derivatives which exceeds a certain threshold. The first "average aggregate notional amount" calculation period is 1 March 2017 to 31 August 2017 and the threshold for this period is HK$24 trillion.

  The methodologies for calculating margin, timing for exchange of margin, eligible assets for margin etc are set out in the HKMA's SPM.
- **Risk mitigation standards**: These refer to certain risk mitigation techniques to promote legal certainty over the terms of non-centrally cleared OTC derivatives transactions, to foster effective management of counterparty credit risk and to facilitate timely resolution of disputes. Similarly, the adoption of the risk mitigation standards in respect of non-centrally cleared OTC derivatives transactions entered into with a covered entity will be phased in. The risk mitigation standards apply in a one-year period (from 1 September of each year to 31 August of the following year) where both the authorized institution and the covered entity have an "average aggregate notional amount" of non-centrally cleared derivatives which exceeds a certain threshold. The first "average

2 A "financial counterparty" includes an authorized institution, licensed corporation, an insurer authorized by the Insurance Authority, a money service operator licensed by the Commissioner of Customs & Excise etc.

3 A "significant non-financial counterparty" refers to any entity other than a "financial counterparty" for a one–year period from 1 September each year to 31 August of the following year, if the entity itself or the group to which it belongs has an "average aggregate notional amount" of non-centrally cleared derivatives exceeding HK$ 60 billion.

4 "Average aggregate notional amount" is defined in paragraph 2.4.9 of the HKMA's SPM.

aggregate notional amount" calculation period for risk mitigation standards purpose is also 1 March 2017 to 31 August 2017 and the threshold for this period is also HK$24 trillion.

It is indicated in the HKMA's SPM that an authorized institution is expected to start exchanging margin and applying the risk mitigation standards as soon as possible after the commencement date and to make reasonable and continuous progress during the transitional period in order to achieve full compliance by the end of the period.

3. What's coming into effect on 1 July 2017?

Mandatory reporting (second phase)

The second phase of mandatory reporting will come into effect on 1 July 2017 and essentially expands the first phase of mandatory reporting. The key aspects of the second phase of mandatory reporting are as follows:

- IRS and non-deliverable forwards not covered in the first phase of mandatory reporting, and other OTC derivative products such as interest rate derivatives, equity derivatives, credit derivatives, commodity derivatives etc, will be reportable. "Excluded currency contracts"[5] will not be subject to mandatory reporting.
- The scope of persons subject to the mandatory reporting obligation will be expanded to include central counterparties that are authorized to provide automated trading services for clearing OTC derivative products.
- The scope of transaction information required to be reported will be expanded.
- The "exempt person" relief will continue to apply. However, "product class" and "product type" classifications are to be removed, meaning the US$30 million limit will apply across *all* product classes collectively, i.e. a person's positions in *all* product classes *collectively* must not exceed US$30 million for the exemption to apply.

There will be no change to the timing of reporting. The reporting shall continue to be made to the HKMA's trade repository.

Mandatory clearing (first phase)

The key aspects of the first phase of mandatory clearing are as follows:

- The mandatory clearing obligation applies to certain IRS.
- Generally speaking, the mandatory clearing obligation will be triggered where:
  - one counterparty is an authorized institution, authorized money broker, licensed corporation <u>and</u> the other counterparty is an authorized institution, authorized money broker, licensed

5 "Excluded currency contract" means an OTC derivative product that is a forward contract for the sale or purchase of a currency which: (a) is entered into for the purpose of settling a sale or purchase of securities denominated in that currency; and (b) is intended to be settled by the actual delivery of that currency, by the earlier of the following days: (i) the last day of the customary settlement period for the securities referred to in paragraph (a); (ii) the seventh business day after the day on which the forward contract is executed.

corporation or a “financial services provider” (a list of “financial services providers” is published in the gazette); and

- both parties’ outstanding OTC derivative positions[6] must have exceeded the “clearing threshold” of US$20 billion (this is the “clearing threshold” at least for the next two years).

- Transactions subject to mandatory clearing must be cleared within one business day after the transaction is entered into.
- Transactions subject to mandatory clearing must be cleared through a “designated central counterparty”. A list of “designated central counterparties” is available on the SFC’s website. The list currently comprises: Chicago Mercantile Exchange Inc., Japan Securities Clearing Corporation, LCH Limited and OTC Clearing Hong Kong Limited.
- There are certain exemptions available for complying with the mandatory clearing obligation, for example, a transaction entered into between an authorized institution, authorized money broker or licensed corporation, and its affiliate, subject to fulfilling certain requirements.

4. What is yet to be implemented?

Exclusions from the definition of "OTC derivative product"

The HKMA and Securities and Futures Commission (“**SFC**”) issued a joint consultation in April 2017 to address two matters raised by market participants in the context of the second phase of mandatory reporting, both of which relate to adjusting the scope of the term “OTC derivative product”. In their conclusions, which were released on 27 June 2017, the regulators confirmed they will proceed with the proposals.

The first of these involves expanding the list of markets and clearing houses prescribed under section 392A of the Securities and Futures Ordinance (“**SFO**”) in response to concerns that the existing lists are not adequate to carve out all exchange-traded products potentially caught under the second phase of mandatory reporting. As the regime is not intended to cover products that are traded on an exchange and cleared through a clearing house, these are excluded from the definition of “OTC derivative products” and therefore not subject to mandatory reporting. The regulators proposed including seven additional exchange operators and markets and a further five clearing houses to the list, all of which will be reflected in the legislation in due course.

The Consultation also proposed excluding 'Delta One Warrants' from the definition of “OTC derivative product” on the basis that they do not pose the same level of risk, and are generally not regarded by the industry as constituting an OTC derivative product. A number of comments were received on the precise definition and features of Delta One Warrants, which the regulators have acknowledged and will take into account during the drafting process.

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6 Broadly, positions in deliverable FX forwards and deliverable FX swaps are not included in a person’s outstanding OTC derivative position for purpose of determining if the person’s outstanding position has exceeded the “clearing threshold”.

Given the 1 July 2017 start date for the second phase of mandatory reporting, the HKMA and SFC recognize that the legislative amendments to reflect these changes will not take effect before this time. They have indicated however that they will adopt a pragmatic approach in dealing with non-reporting of these products in the interim.

New Licensing Regime

The SFC will also be implementing a new licensing regime which will involve:

- introducing two new regulated activities: 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
- expanding the scope of two existing regulated activities: Type 7 (providing automated trading services) and Type 9 (asset management).

The relevant legislative amendments have already been made in respect of the above. The SFC has indicated that the changes will become effective after all the corresponding amendments to various related rules, codes and guidelines have been finalized.

www.bakermckenzie.com

Beijing
Suite 3401, China World Office 2
China World Trade Centre
1 Jianguomenwai Dajie
Beijing 100004, PRC
Tel: +86 10 6535 3800
Fax: +86 10 6505 2309

Hong Kong
14th Floor, Hutchison House
10 Harcourt Road
Central, Hong Kong
Tel: +852 2846 1888
Fax: +852 2845 0476

Shanghai
Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, PRC
Tel: +86 21 6105 8558
Fax: +86 21 5047 0020

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