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Consultation on proposed regulatory regime for OTC derivatives market.

On 17 October 2011, the Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**") jointly published the *Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong* (the "**Consultation Paper**") to consult the public on a proposed new regime for OTC derivatives transactions in Hong Kong.

The proposed regime is a response to the G20 leaders' regulatory reform commitments following the global financial crisis in 2008, which require the implementation of the following mandatory obligations:

- the mandatory reporting of OTC derivatives transactions to trade repositories ("**TRs**");
- the mandatory clearing of standardized OTC derivatives transactions to central counterparties ("**CCPs**") by the end of 2012;
- the mandatory trading of standardized OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate; and
- the imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

In addition to the imposition of the mandatory obligations in line with G20 commitments, the proposed new OTC derivatives regulatory regime also addresses, firstly, the regulation of market infrastructure (i.e. the TRs, CCPs and trading platforms) required to support the new mandatory clearing, reporting and trading obligations and secondly, the regulation of financial intermediaries that play a key role in the OTC derivatives market. The second aspect in particular presents some interesting questions as to how the proposed new regulated activity in respect of OTC derivatives transactions would interact with existing regulatory requirements under the Securities and Futures Ordinance ("**SFO**").

In Asia Pacific, Hong Kong is one of the first jurisdictions to address these issues in a public consultation and this is to be welcomed. Comment is invited on the proposals contained in the paper during a consultation period which runs until 30 November 2011. This is the first of two consultations and the proposals at this stage relate to the framework of the new OTC derivatives regime. Detailed changes to regulations to implement the regime are expected to be the subject of a second consultation, which is targeted to take place in Q1 2012.

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Framework

Legislative Framework

The legislative framework of the new regime is proposed to be set out in the SFO, which will be amended to cover OTC derivatives transactions in addition to securities and futures. Hong Kong currently does not have a single unified and cohesive legal regime for parties seeking to carry out derivatives business. The advantage of leveraging off the existing SFO legislative framework, rather than creating a new piece of legislation specifically to regulate OTC derivatives, is that legislative changes are minimized. This would facilitate meeting the G20 commitment timeline. However, some of the suggested changes could lead to inconsistencies, as will be explored below.

The Consultation Paper proposes giving wide powers to the SFC and HKMA to develop the new regime through subsidiary legislation. This is proposed to be implemented by setting out the framework of the regime (such as the key terms of the mandatory reporting, clearing and trading obligations, the penalties for breach of such obligations, and the framework for designation of CCPs and trading platforms) in the primary legislation, leaving details of the regime (such as the types of products covered by the mandatory obligations and the conditions of CCP designation) to be set out in subsidiary legislation. This approach has the advantage of providing flexibility for future market changes, and takes into account the still-evolving international regulatory landscape.

However, this approach also means that many key details that are important to understanding the scope and implications of the proposed regime is likely to remain unclear until the second phase consultation on the subsidiary legislation targeted in Q1 2012.

Scope of the new regime

The scope of the SFO is proposed to be expanded via the new concept of ‘OTC derivatives transactions’. This definition is significant because it will delineate the widest possible scope of the mandatory obligations and it may be applied to determine who needs to be licensed with the SFC for the purpose of the proposed new Type 11 regulated activity in respect of OTC derivatives.

The Consultation Paper’s proposed approach is to adopt a very wide definition of ‘OTC derivatives transactions’ in the primary legislation, but at the same time provide that the mandatory obligations would only apply to those OTC derivatives transactions that are specified in subsidiary legislation, thus limiting the types of products that would actually be subject to such obligations. The HKMA and the SFC’s current inclination however is not to limit the definition for the purpose of the licensing of financial intermediaries, which will be discussed further below.

The Consultation Paper proposes to define OTC derivatives transactions using the existing broad, all-encompassing ‘structured products’ definition in the SFO, but with carve outs for:

(1) transactions in securities and futures contracts that are traded on a market operated by a recognized exchange company (i.e. Hong Kong Exchanges and Clearing Limited);
(2) transactions in structured products that are offered to the public and the documentation for which is authorized under s.105 SFO (i.e. ‘retail structured products’); and
(3) transactions in currency-linked, interest rate-linked and currency and interest rate-linked instruments offered by authorized institutions to the public and the documentation for which is exempted from the prohibition under s.103 SFO by virtue of s.103(3)(ea) SFO.

The Consultation Paper proposes further flexibility to the ambit of OTC derivatives transactions by including the power to include or exclude transactions from that definition in the subsidiary legislation.

The proposed definition raises some questions which may need to be clarified. First, the term ‘OTC derivatives’ is commonly understood to mean bilaterally privately negotiated derivatives (in direct contrast to embedded derivatives or exchange traded derivatives). The ‘structured products’ definition upon which the ‘OTC derivatives transactions’ definition is based is wider, and includes a whole range of embedded derivatives (e.g. derivatives embedded in securities) as well as bilaterally negotiated contracts. It would appear that the intention is to take the ‘structured products’ definition, strip out embedded derivatives and exchange traded derivatives using carve-out (1), and thus to limit ‘OTC derivatives transactions’ to what remains. This does not appear to be an elegant approach to drafting and makes the definition difficult to understand. It is also not entirely clear from the Consultation Paper that carve-out (1) is intended to cover securities (both exchange-traded and otherwise) and futures contracts traded on exchange, or if it is meant to be securities and futures, each traded on exchange. This is an ambiguity which we hope will be clarified.

In addition, carve-outs (2) and (3) relate to the marketing of derivatives, i.e. how derivatives and their documentation are authorized when offered for sale to the public, which is distinct from the licensing of intermediaries carrying on the business of dealing in OTC derivatives transactions. Since the ‘OTC derivatives transactions’ definition is used to determine who needs to be licensed for the proposed Type 11 regulated activity, the definition as proposed would mean that a dealer engaging in private placements of derivatives would require to be licensed for a new Type 11 regulated activity, but a dealer engaging in the public offer of derivatives does not need to because it falls within carve-out (2). By contrast, this is certainly not how the securities business is currently regulated - the licensing of securities business does not depend on whether the securities are offered on the basis of private placement or public offer (as distinct from the marketing of securities).

Given the central role played by the term ‘OTC derivatives transactions’, it is critical that the term is defined as clearly as possible and any confusion should be avoided.

Regulation of OTC derivatives market participants

Regulation of financial intermediaries

The Consultation Paper proposes adding a new "Type 11" regulated activity to the SFO, which would impose a licensing requirement on any person, other than an authorized institution, who carries on a business of dealing in or advising on OTC derivatives transactions. The scope of Type 11 is likely to be similar to the existing dealing/advising regulated activities; that is, it would reach persons who induce, advise on, intermediate, arrange or otherwise facilitate transactions, but would be likely to exclude persons who are trading on a purely principal basis (although such persons may be subject to regulation as "large players" as discussed below). Presumably, the new Type 11 would be subject to the same territorial restrictions as current regulated activities, with the licensing obligation falling on a person who carries on a business in Hong Kong or who actively markets the service to the Hong Kong public on a cross border basis (so in that sense would not be extra-territorial as is widely criticised to be the case for the Dodd Frank legislation in the U.S.). Notwithstanding this, given the broad reach of 'OTC derivatives transactions' in the Consultation Paper, the new Type 11 definition could impose a licensing requirement on a significant number of firms in Hong Kong, including firms that are currently arranging OTC derivatives transactions on an unlicensed basis.

It would appear that there will be significant overlap between the new Type 11 regulated activity and existing regulated activities, such as dealing in securities (Type 1) or leveraged foreign exchange trading (Type 3). For example, a firm that is trading in equity option and swap transactions would potentially require licensing for Type 1 as well as the new Type 11 regulated activity. The Consultation Paper invites feedback on how such overlap should be reconciled. The Consultation Paper mentioned two possible approaches. One possibility is that the Type 11 requirement would apply only to activities not caught by the existing regulated activities, the scope of which would remain unchanged. For example, a firm arranging interest rate swaps is not currently required to hold a Type 1 license (as the swaps would not be regarded as "securities") but, under this approach, would be required to obtain a Type 11 license. The second approach is to amend the scope of the existing regulated activities so as to exclude activities falling within the scope of the new Type 11 regulated activity. Whichever approach is taken, it is important that the categories of regulated activity should be well thought through as this will have an impact not only on what exceptions apply but who the applicable regulator is (see box). It is also currently unclear what exceptions, if any, will apply to the new Type 11 regulated activity.

Oversight of intermediaries

The proposed regime creates some complexity in the oversight regime for OTC derivatives transactions. The HKMA and the SFC will have joint oversight of the new OTC derivatives regulatory regime, with authorized institutions' OTC derivatives activity being regulated by the HKMA and the OTC derivatives activities of non-authorized institutions being regulated by the SFC. This is the existing framework for leveraged foreign exchange trading regulated activity but represents an expansion of the oversight of the HKMA into OTC derivatives transactions including those that are not currency-linked or interest rate-linked.

An authorized institution that is dealing equity option and swap transactions will require a Type 1 licence for dealing in securities (and may require a Type 4 licence for any advising activity). Equity option and swap transactions will also be an OTC derivatives transaction. Under the existing regime, authorized institutions will be subject to SFC regulation for the Type 1 regulated activity (but the HKMA acts as the frontline regulator). If the second approach proposed by the SFC and HKMA is adopted, authorized institutions will be exempt from licensing in respect of all OTC derivatives (including equity derivatives). Such activities will be regulated wholly by the HKMA which would represent a narrowing of the SFC's oversight over authorised institutions as compared to the position currently. However, if the approach eventually adopted is that the Type 11 requirement would apply only to activities not caught by the existing regulated activities such as Type 1 and Type 3, the regulation of OTC derivatives transactions would be split between Type 1 (where authorized institutions are subject to the licensing of SFC) and Type 11 (as well as Type 3) (where authorized institutions are exempt from the licensing of SFC). The rationale for such division between Type 1 and Type 11 does not seem immediately obvious.

An alternative approach would be to use the reforms as an opportunity for eliminating (rather than extending) the differential treatment between the regulation of licensed corporations and authorised institutions in the conduct of OTC derivatives. This would ensure that conduct of business requirements are applied evenly across the industry and avoid the current (somewhat unsatisfactory) position where the HKMA expects authorised institutions to observe standards equivalent to (and in some areas higher) than those set by the SFC, although they are not technically bound by them. Prudential supervision would of course remain split between the HKMA and the SFC, as it is currently.

Oversight of "Large Players"

Separately from the Type 11 licensing requirement, the regulators are considering whether to impose a limited degree of regulatory oversight over "large players" in the OTC market. Although the Consultation Paper does not provide any specifics as to what entities will be affected by this, the focus is on persons holding principal positions of such scale as to raise concerns of systemic risk. These entities will not be subject to a licensing requirement but may be required to report their positions above a certain threshold (said to be much higher than the mandatory reporting threshold discussed below) and may be directed by the SFC to reduce their position. The Consultation Paper notes that the regulators expects that "only a very limited number of players" will be subject to this requirement but does not provide an indication of what the threshold will be. Further information is also necessary to identify the circumstances under which the SFC would seek to require large players to reduce their positions in OTC derivatives.

The proposed mandatory obligations

The Consultation Paper proposes the introduction of a mandatory reporting and mandatory clearing requirement for certain types of OTC derivatives transactions. Mandatory trading is not proposed to be imposed at the outset, but the SFO will be amended to allow for such an obligation to be introduced in the future.

Mandatory reporting

Mandatory reporting of OTC derivatives transactions to a TR is key to ensuring that the OTC derivatives market is sufficiently transparent and that concentrations of risk can be monitored by regulators. As anticipated, the Consultation Paper proposes introducing a mandatory reporting obligation in relation to specified OTC derivatives transactions over a certain threshold. At the same time, on the bricks-and-mortar level, the HKMA is in the process of setting up a national TR to enable the SFC and HKMA to assess, mitigate and manage any systemic risk created by OTC derivatives transactions. The current thinking is that this will be the only TR to be recognized under the proposed Hong Kong regime, so as to better enable Hong Kong regulators to monitor OTC derivatives transactions.

What transactions are reportable

The Consultation Paper contemplates a phased approach to reporting, with only certain classes of OTC derivatives transactions to be reportable initially. As anticipated, these will be Non-Deliverable Forwards (NDFs) and Interest Rate Swaps (IRS), and within those classes, only the following types of products will be reportable transactions at the outset: single currency IRS, overnight index swaps, single currency basis swaps and non-deliverable forwards.

Who needs to report

The mandatory reporting obligation will apply in different ways to the following entities:

- Licensed corporations ("**LCs**");
- Authorized institutions ("**AIs**"), both overseas incorporated and locally incorporated; and
- Hong Kong persons, being individuals who are Hong Kong residents, the owners of sole proprietorships or partnerships based in, operated from or registered in Hong Kong, companies that are incorporated or registered in Hong Kong, funds that are managed in or from Hong Kong or any other entity established or registered under Hong Kong law.

LCs and locally incorporated AIs are to be required to report all reportable transactions either to which they are a counterparty or which they have originated and executed. This obligation applies irrespective of whether the AI has conducted its activities through the Hong Kong branch or an overseas branch. To facilitate HKMA's supervision, for locally incorporated AIs, reporting may be required both on an entity level and on a group basis.

The reporting obligation applies slightly differently to *overseas-incorporated AIs*, which are to be required to report both (i) reportable transactions that they are counterparty to, or have originated or executed, in either case through their Hong Kong branch and (ii) reportable transactions that they are a counterparty to and which has a 'Hong Kong nexus'.

Trades will have a 'Hong Kong nexus' if, in the case of equity derivatives and credit derivatives, the underlying entity is the reference entity is established, incorporated or listed in Hong Kong or under Hong Kong law and, in the case of other derivatives, the underlying asset, currency or rate is denominated in (or includes one that is denominated in) Hong Kong dollars. It will be interesting to see what other trades could potentially have a Hong Kong nexus, for example, trades denominated in offshore RMB (CNH)?

'Originated and executed'

'Originated and executed' is a term that extends the scope of mandatory reporting. The effect of this is that an LC or AI (or the Hong Kong branch of an overseas-incorporated AI) that has negotiated, arranged, confirmed or committed to a transaction on its own behalf or on behalf of any counterparty to the transaction is subject to the mandatory reporting obligation even though such LC or AI (or the Hong Kong branch of an overseas-incorporated AI) may not itself be a counterparty to the transaction.

In practice, it should be noted that a number of LCs and AIs (or the Hong Kong branch of an overseas-incorporated AI) rarely book OTC derivatives transactions into Hong Kong. The 'originated and executed' extension would mean that even if such transactions were booked to overseas branches or overseas entities, as long as the LC or AI (or the Hong Kong branch of an overseas-incorporated AI) had negotiated, arranged, confirmed or committed to the transaction on its own behalf or on behalf of any counterparty, the LC or AI (or the Hong Kong branch of an overseas-incorporated AI) would be subject to the mandatory reporting obligation.

Hong Kong persons are to be required to report reportable transactions to which they are a counterparty if the specified reporting threshold has been exceeded. It is worth noting that the reporting threshold only applies to Hong Kong persons and not LCs or AIs.

It is currently not proposed to subject *overseas persons* (i.e. persons that are not an AI, LC or Hong Kong person) to mandatory reporting.

Reporting threshold

The reporting threshold will be set separately for each product class and is proposed to be in absolute dollar terms by reference to the notional value (as opposed to market value) of the relevant transactions. To avoid any temporary fluctuations in positions, this will be assessed by referring to the average notional value of the relevant person's outstanding positions for the previous six months, based on month-end position.

In determining whether the reporting threshold has been exceeded, all transactions for that product class will be taken into account, even if this includes transactions that are not themselves reportable transactions and irrespective of whether an exemption applies. This will also include transactions that have been entered into prior to any mandatory reporting requirement comes into effect as long as they are still outstanding at the relevant time.

It is proposed that a person will cease to be subject to the reporting threshold if the average notional value of outstanding transactions over the six month period falls below a specified exit threshold.

Exemptions or qualifications to the reporting obligation

To reduce the reporting burden on Hong Kong persons, it is proposed to exempt Hong Kong persons from mandatory reporting if an AI or LC is also subject to a reporting obligation in respect of such transaction. It may be thought that the same reasoning would apply for transactions not involving Hong Kong persons, i.e. only party needs to be required to report the transaction. However, the Consultation Paper proposes that no exemption be available in the situation where more than one AI or LC is involved in the reportable transaction. In such case, *all* AIs or LCs involved will have to report such transaction as it is suggested that reporting by both sides would provide a useful check and balance.

It is also proposed that an AI or LC will have discharged its reporting obligation in respect of a reportable transaction if it has originated or executed the transaction on behalf of one of the counterparties and such counterparty has confirmed to the AI or LC that the transaction has been reported to the HKMA TR. However, it is not clear how such a provision would help an AI or LC since, if the counterparty is a Hong Kong person, such person would be exempt from reporting since the AI or LC would have to report; if the counterparty is an overseas person it would not be subject to mandatory reporting in the first place; and if the counterparty is an AI or LC then it seems that all AIs and LCs involved would need to report.

When should the reporting be made

Reporting obligations should be complied with by the end of the business day immediately following the trading day.

Grace period following effective date of reporting obligation

The consultation paper proposes a grace period when the reporting obligation comes into effect. This is proposed to be three months for setting up a reporting channel to HKMA TR and six months for completing any backloading (i.e. reporting transactions already entered into but still outstanding).

Mandatory clearing

The clearing of OTC derivatives transactions through a CCP is an important way to minimize systemic risk as it interposes the CCP as counterparty to each trade. The Consultation Paper also proposes to introduce a mandatory clearing obligation whereby clearing eligible transactions must be cleared through a designated CCP. Mindful of the costs involved in mandatory clearing, the Consultation Paper frames the mandatory clearing obligation more narrowly than the mandatory reporting obligation.

What transactions need to be cleared

The mandatory clearing obligation is proposed to apply to all transactions referred to in the Consultation Paper as clearing eligible transactions. A top-down and bottom-up approach is proposed, which will take into consideration what regulators consider as products suitable for clearing as well as what the designated CCPs are able to clear. At the outset, clearing eligible transactions are proposed to cover the same classes of transactions as reportable transactions (i.e. NDFs and IRSs), although what types of transactions within those two classes should be cleared remain to be determined, and would depend on what transactions the designated CCPs can clear.

Who needs to clear

As a general statement, if an AI, LC or Hong Kong person is either counterparty to a clearing eligible transaction or has originated or executed such a transaction, and if both counterparties have exceeded the specified clearing threshold, then such transaction would need to be cleared.

More specifically, as for mandatory reporting, the mandatory clearing obligation applies slightly differently to locally-incorporated AIs and overseas-incorporated AIs. In respect of locally-incorporated AIs, mandatory clearing will apply in respect of all activities in clearing eligible transactions, irrespective of whether such transactions are carried out through the Hong Kong branch or from an overseas branch. The HKMA may also require a locally-incorporated AI to comply with the mandatory clearing obligation on a group basis. In the case of an overseas-incorporated AI, its involvement in the relevant transaction must be through its Hong Kong branch. Unlike mandatory reporting, there is no alternative route for the mandatory clearing obligation to apply to overseas AIs entering into transactions originated or executed by a non-Hong Kong branch where the transaction has a Hong Kong nexus. Also unlike mandatory reporting, the specified clearing threshold applies to all types of counterparties, not just Hong Kong persons, and needs to be satisfied by both counterparties (see below).

Clearing threshold

As for the mandatory reporting obligation, this threshold is proposed to be determined on a per product class basis, in absolute dollar terms and by reference to the notional value. Again, this is proposed to be assessed by reference to the average notional value of a person's month-end positions for the preceding six months. As for mandatory reporting, in assessing whether the relevant threshold has been reached, all transactions in that product class will be taken into account, including non-clearing eligible transactions and transactions where there is an applicable exemption.

Exemptions to the clearing obligation

Significantly, to mitigate the burden of having to clear an OTC derivatives transaction through multiple CCPs, an exemption is proposed where both counterparties are overseas persons and where the transaction is either subject to or exempt from mandatory clearing under the laws of an acceptable overseas jurisdiction. The SFC and HKMA have yet to identify which are acceptable overseas jurisdictions, but these are anticipated to be where the reporting, clearing and trading of OTC derivatives are on a par with international standards and practices. This exemption will be important in the situation where an AI or LC originates a clearing eligible transaction between two entities that are not an AI, LC or Hong Kong person.

The challenge of conflicting obligations

An important challenge with mandatory clearing is the possibility of conflicting clearing obligations. This may occur where OTC derivative transactions are entered into on a cross-border basis. For instance, if a Hong Kong counterparty transacts with a UK counterparty, both may be subject to mandatory clearing obligations in their respective jurisdictions. As the transaction can only be cleared through one CCP, there must be a mechanism for resolving this conflict. The issue may also arise as a result if laws have extra-territorial impact, for instance, if a mandatory clearing obligation were to catch transactions engaged in by an overseas branch of an entity, and that branch was also subject to a similar obligation under the law of the jurisdiction in which it is established.

Although the proposed Hong Kong mandatory clearing obligation contains some limits to its territorial scope, such as the exemption described above for transactions between two overseas persons, and provides that the clearing obligation applies only to transactions originated or executed by the Hong Kong branch of overseas AIs, there still remains scope for potential conflict with clearing obligations in other jurisdictions. A possible solution to this is for regulatory frameworks to allow for clearing on overseas platforms subject to certain conditions. The proposals in the Consultation Paper, which recognize this issue, contemplate recognition of overseas platforms (see '*Designation and regulation of CCPs*' below).

It is not however clear to what extent regulators internationally are co-operating to devise practical solutions to these issues. The risk, especially given the tight timing for the reforms, is that regulators will press ahead with their own reform agendas without the appropriate solutions having been thought through and reflected in the relevant laws and regulations. This could create significant difficulties and challenges for market participants and for regulators further down the line.

Grace period following effective date of clearing obligation

As for the reporting obligation, a grace period is proposed for clearing.

Mandatory trading

Mandatory trading involves requiring OTC derivatives transactions to be concluded on exchanges or electronic trading platforms. The Consultation Paper considers requiring mandatory trading and proposes that this will only be introduced at a later stage.

Penalties for breach of mandatory clearing or reporting obligations

Detailed penalty provisions have yet to be proposed, but it is anticipated that these will be civil or administrative fines, in line with the trend in international regulatory reform.

Designation and regulation of CCPs

It is proposed that clearing eligible transactions must be cleared through a designated CCP. Designated CCPs are anticipated to be recognized clearing house ("**RCHs**") or an automated trading services ("**ATS**") provider authorized under Part III of SFO (subject to expansion of the relevant definitions to cover OTC derivatives transactions). This opens up the possibility of overseas CCPs obtaining authorization as an ATS provider and providing clearing services in Hong Kong. As indicated above, mutual recognition of CCPs between different jurisdictions is likely to be important to resolve conflicts in mandatory clearing obligations. However, the Consultation Paper also raises concerns about permitting certain systemically important trades to be cleared through overseas CCPs and invites feedback on whether transactions of this nature may only be permitted to be cleared through the domestic CCP.

The RCH and ATS regimes give the SFC broad powers to determine what standards should be applied for the approval of an RCH or ATS, and the Consultation Paper alludes to the fact that this will enable the SFC to apply international standards in determining whether or not to approve a CCP. The SFC is likely to be guided in particular by the standards proposed by the International Organization of Securities Commissions which has (through its Committee on Payment and Settlement Systems) issued guidance on the regulation of CCPs covering areas such as governance structures, financial resources, membership criteria, margin requirements and default management procedures. However, details of the CCP approval requirements are not yet proposed. Persons interested in applying for approval as a CCP in Hong Kong as well as overseas would want to ensure that such approval requirements are not in conflict with international and other overseas CCP requirements.

Client clearing

It is encouraging to note that the Consultation Paper contemplates client clearing. Client clearing is important because the mandatory clearing obligation may potentially catch market participants that do not fulfill the membership criteria set by a CCP and will thus have to clear as 'clients' of members of the CCP. Current Hong Kong insolvency protections in the SFO will protect only dealings between the CCP and its members and not those dealings between the members and its end clients. The Consultation Paper asks for the market's response as to whether it is thought necessary to extend the insolvency protections in the SFO to client contracts. It is important to note that, to give insolvency protection to client clearing, would be on par with equivalent protections accorded to client contracts in the U.S., for example.

Capital charges and margin requirements

Notwithstanding the shift to central clearing, there is general recognition by regulators that there will still be a significant volume of non-cleared trades, partly because some classes of derivative will not be suitable for clearing, but also because parties may in some instances want to enter into a bespoke transaction which is not in standardized form. International standard setters (including the Basel Committee) are therefore considering requirements for mitigating the risks involved in non-cleared trades. These could for instance include requirements in respect of valuation, margin and regulatory capital.

The Consultation Paper indicates that the Hong Kong regulators are considering these issues and that they will have regard to the proposals by the international standard setters in determining what is appropriate.

Conclusion

The proposals in the Consultation Paper are clearly a step in the right direction for the OTC derivatives industry in Hong Kong in line with global efforts. Market participants will be reassured to see that the HKMA and SFC have taken into account international developments and are mindful of developing the Hong Kong OTC derivatives market in line with international standards. However, certain areas remain to be clarified, which hopefully will be addressed as part of the consultation process.

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