Clearing the way: Hong Kong gears up for mandatory clearing and expanded mandatory reporting of OTC derivatives

Clearing and reporting: next stage of consultation

You may remember that, in September last year, the HKMA and SFC published a consultation paper on their proposed next steps on the regulation of OTC derivative transactions. That paper focused on clearing and reporting, with draft rules for both, and we summarised its contents for you at the time.

In that paper, the regulators promised to consider comments from the public on the rules, and to release a further consultation paper containing proposed final versions of the rules early this year.

In February, the regulators published that further paper, being the Consultation conclusions and further consultation on introducing mandatory clearing and expanding mandatory reporting.

The proposed final clearing rules and reporting rules remain largely the same as initially drafted. That being said, the revised rules have implemented some of the comments received, and the regulators responded to some of the comments that were not implemented.

1. Changes to the rules

Significant changes to the draft rules include:

A. Clearing Rules

> **Commencement date postponed**: the commencement date is now 1 September 2016 (not mid-2016), subject to completion of the legislative process. This postponement reflects market concern that the initial, shorter timeframe might limit the number of central counterparties that could apply for designation, and be designated, before the clearing obligation came into force;

> **Revising the definition of and removing the clearing threshold applicable to “financial services providers”**: “financial services providers” are now defined to be the entities included on a gazetted list, rather than entities meeting certain criteria, and are no longer subject to any clearing threshold.

Clearing the way: Hong Kong gears up for mandatory clearing and expanded mandatory reporting of OTC derivatives
For background, the September paper had proposed that “financial services providers” would be “any overseas entity similar to prescribed persons that would have been required to be licensed in Hong Kong if it carried on the relevant business in Hong Kong” and would be subject to a US$1 trillion clearing threshold in respect of their global average positions. However, the market commented on the difficulty involved in applying this definition and the clearing threshold; to do so properly prescribed persons would have had to seek written confirmations from all of their counterparties of their regulatory status and average position, even though phase 1 clearing is intended to focus only on major dealers. This would have been challenging operationally, and the revised approach removes this challenge.

The proposed list of financial service providers is attached to the February paper as an appendix. The regulators noted that they would only designate entities as financial service providers if they, or members of their group, were on either or both of:

- the list of global systemically important banks published by the Financial Stability Board in November 2015, or
- the list of dealer groups which undertook to the OTC Derivatives Supervisors Group to work collaboratively to make structural improvements to the global OTC derivatives markets;

> **Hong Kong nexus for overseas prescribed persons**: the initial draft clearing rules provided that an overseas prescribed persons (that is, overseas authorised financial institutions or approved money brokers) only needs to clear a trade if it is recorded in the Hong Kong books of that person. However, in the case of a trade between two overseas prescribed persons, there was some uncertainty about whether the Hong Kong booking requirement applied to only one or both overseas prescribed persons, The revised draft clearing rules make it clear that the Hong Kong booking requirement only applied to one of the overseas prescribed persons, and the trade would be clearable if one party to the trade is either an overseas prescribed person booked through its Hong Kong branch or a local prescribed person who exceeds the applicable clearing threshold, even if the other counterparty to the trade is an overseas prescribed person booking through a branch outside Hong Kong;

> **Clearing thresholds:**

- **Transactions considered**: the derivative transactions to be included in threshold calculations now exclude deliverable FX swaps (as well as deliverable FX forwards), as the regulators are of the opinion that the two products are similar in nature;
- **Global threshold for overseas prescribed persons removed**: the market had expressed concern that the proposed dual threshold
(US$1 trillion in global positions or US$20bn in local positions) applicable to overseas prescribed persons would cause large overseas prescribed persons with limited Hong Kong trading activity to be caught, which would cause undue operational burden and potentially drive large trading entities away from trading in Hong Kong.

The revised rules state that overseas prescribed persons will only be subject to the US$20bn local threshold (not both their Hong Kong and global positions). However, it’s worth noting that if such an entity is also a financial services provider, and faces another prescribed person who exceeds the clearing threshold, then the zero threshold applicable to financial services providers will apply, and the relevant trade will still be subject to clearing.

> **Introduction of exit threshold:** the rules now include an exit mechanism. This applies where a prescribed person’s relevant outstanding positions are below 70% of the clearing threshold (which is US$14bn) for 12 consecutive months.

To exit, the prescribed person must meet the following requirements:

- its relevant outstanding positions must be below US$14bn as at the last day of each month within the 12-month period;
- it must file an exit notice with the relevant regulator (either the HKMA or the SFC) confirming the above, specifying the 12-month period and its relevant positions on the last day of each month during that period; and
- its relevant positions must be below US$14bn when it files that notice.

If the prescribed person reaches the clearing threshold again, then the clearing obligation will apply once more, though the regulators have stated that they intend the mechanism to be used only by persons who have permanently changed their business model or trading profile; and

> **New clearing exemption for trade compression:** transactions that are created or amended as a result of a trade compression cycle will be exempted, provided that:

- the original transactions were not themselves subject to the clearing requirements;
- the compression cycle is between more than two participants (i.e. multilateral rather than bilateral); and
- the compression cycle is carried out by a third party rather than by the participating counterparties themselves;
B. Expanded Reporting Rules

> **Postponement of commencement date:** to allow market
participants more time to set up and test necessary systems, the
commencement of the expanded reporting regime has been deferred
to 1 July 2017;

> **Further detail on reportable information relating to transactions:**
in terms of:

  - **information to be reported:** the requirement to report
information relating to master agreements and to
supplementary material has been removed,
  - **data fields:** there will be a separate consultation on how
structured transactions should be reported, given that there is
no common method or convention to do so; and
  - **valuation information:** the circumstances where the previous
day’s valuations can be submitted now includes:
    - when there are difficulties in obtaining valuation because
      the counterparty fails to provide daily valuations to the
      reporting entity (for instance, if the relevant transaction is
      packaged, bespoke or exotic); and
    - if latest valuation figures are simply not available; and

> **Further detail on backloading:** the market had expressed concerns
about the difficulties of backloading the expanded information scope
set out in the September paper within the three month grace period,
particularly with respect to transactions “conducted in Hong Kong”. To
this end, the regulators have proposed the concession that in respect
of transactions:

  - reported under phase 1, if those transactions are due to
expire (with respect to the implementation of phase 2
reporting) within:
    - **one year**, reporting entities won’t have to
      backload the expanded information scope. However, they will still need to continue to report
      lifecycle events (within the narrower information
      scope) on a T+2 basis, or
    - **more than one year**, reporting entities will have
      to backload the expanded information scope
      before the end of the applicable grace period.

In both cases, entities will need to report daily valuation
information within two business days once phase 2
reporting comes into effect; or
Clearing the way: Hong Kong gears up for mandatory clearing and expanded mandatory reporting of OTC derivatives

2. Clarifications

There are few other substantive changes to the proposed clearing and reporting rules, although the regulators did take the chance to address some of the market’s concerns around the September paper:

A. Clearing Rules

**Transactions to be cleared:** The transactions subject to phase 1 clearing remain as originally proposed (being several types of vanilla interest rate swaps).

However, the regulators clarified that certain specific types of trade would be subject to clearing:

- novated transactions;
- amended transactions, where the terms and conditions of the transaction are substantially changed, and
- an interest rate swap forming part of a set of related transactions,

while interest rate swaps forming part of a structured transaction, or in the form of an embedded derivative within a note, would not be subject to clearing.

As a result, an interest rate swap forming part of a repackaging transaction could be subject to mandatory clearing, while an embedded interest rate swap within a structured note would not be clearable.

B. Expanded Reporting Rules

**Masking:** The regulators clarified when entities can mask information that would identify their counterparty. Masking relief will only apply where both:

- the submission of such information is prohibited under the laws or regulations of an overseas jurisdiction which is on the list published by the SFC, and
- the entity has carried out reasonable due diligence to ensure that barriers to disclosure still exist in such jurisdiction.

While this relief may apply in a range of situations – for instance:

- transacting with a counterparty located in a masking jurisdiction;
Clearing the way: Hong Kong gears up for mandatory clearing and expanded mandatory reporting of OTC derivatives

3. Conclusion

Thankfully, the revised rules offer few surprises, and the few significant changes provide welcome certainty and flexibility. As the rules start to reach their final form, and the implementation dates draw nearer, it would behove market participants (if they have not done so already) to evaluate their likely obligations under the clearing regime and expanded reporting regime, and to develop processes for ensuring compliance once the regimes take effect.
Clearing the way: Hong Kong gears up for mandatory clearing and expanded mandatory reporting of OTC derivatives

Authors: Chin Chong Liew, Karen Lam, I-Ping Soong and Joseph Cayzer

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters. All Rights reserved 2016

Contacts

For further information please contact:

Chin Chong Liew
Partner
+852 2842 4857
chin-chong.liew@linklaters.com

Victor Wan
Partner
+852 2842 4871
victor.wan@linklaters.com

Karen Lam
Counsel
+852 2842 4871
karen.lam@linklaters.com

I-Ping Soong
Counsel
+852 2901 5181
i-ping.soong@linklaters.com

Derek Chua
Managing Associate
+852 2842 4805
derek.chua@linklaters.com

Stephen Song
Managing Associate
+852 2901 5440
stephen.song@linklaters.com

Joseph Cayzer
Associate
+852 2901 5441
joseph.cayzer@linklaters.com

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at marketing.database@linklaters.com.