



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Development of the regulatory framework for OTC derivatives market in Hong Kong

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Agenda

- **Background**
- **Hong Kong's efforts**
- **International development**

Background – G20 Commitments on OTC Derivatives Market Reform

- **September 2009 G20 Pittsburgh Summit Declaration**

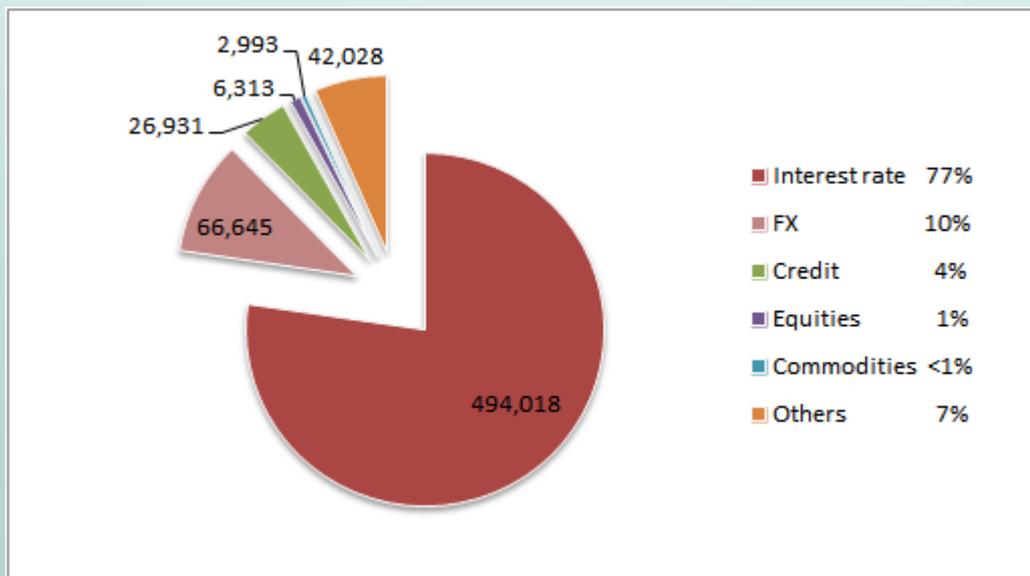
All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.

Background – Objectives and Key Elements

- **Three Key objectives of the reform to promote financial stability**
 - Improve transparency
 - Mitigate systemic risk
 - Protect against market abuse
- **Four key elements**
 - Mandatory clearing obligation
 - Mandatory reporting obligation
 - Mandatory trading obligation (where appropriate)
 - Additional measures on non-centrally cleared trades

Background – Statistics of Global OTC Derivatives Market

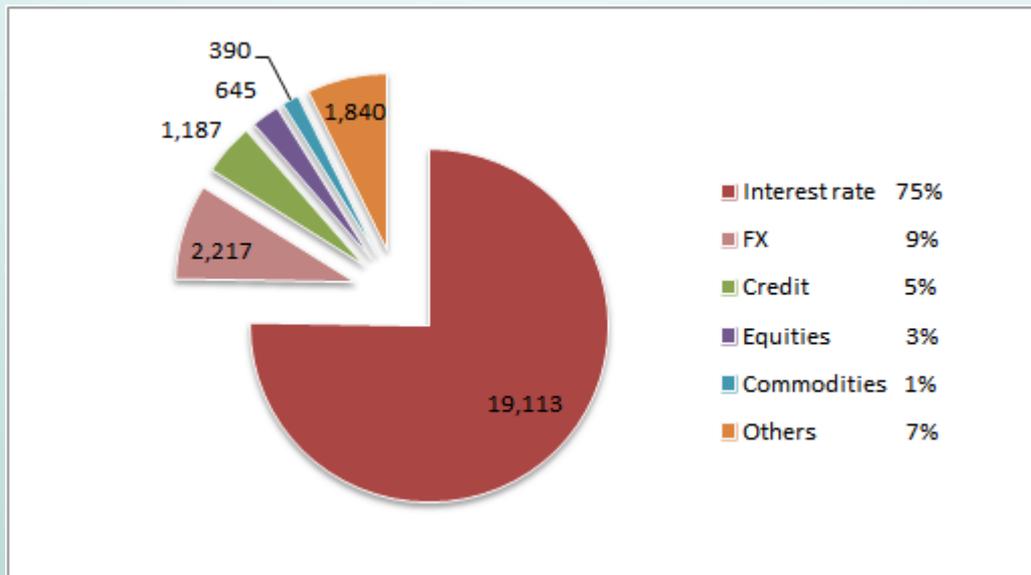
- **Five major asset classes - interest rate, FX, equities, credit and commodities**
- **Products vary from plain vanilla to highly complex and bespoke**
e.g.: standardised fixed vs floating interest rate swaps
interest rate swaps with amortising principals
- **Global notional amount outstanding was about US\$639 trillion (H1 2012)**



Estimated by the Bank for International Settlements (US\$ billion)

Background – Statistics of Global OTC Derivatives Market (cont'd)

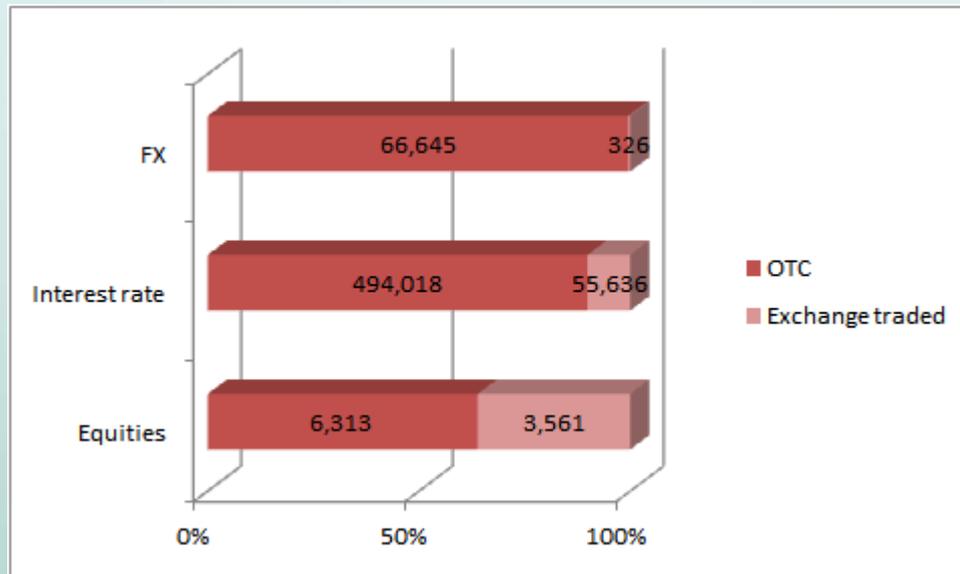
- Global gross market value of outstanding contracts was about US\$25 trillion (H1 2012)



Estimated by the Bank for International Settlements (US\$ billion)

Background - OTC Derivatives vs. Exchange-traded Derivatives

- The OTC derivatives market is generally much larger than the exchange-traded derivatives market in terms of notional amounts outstanding



Notional amounts
outstanding in H1 2012

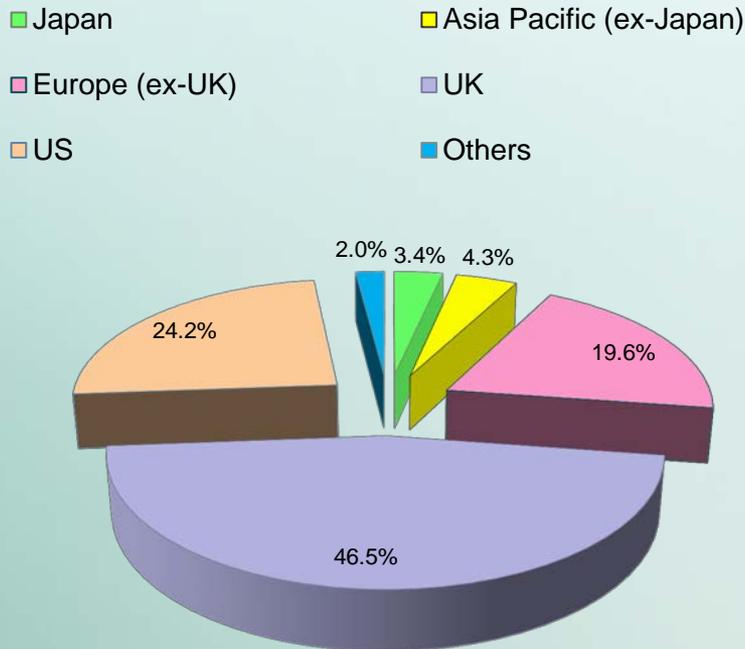
Estimated by the Bank for
International Settlements
(US\$ billion)

Background – Hong Kong Market

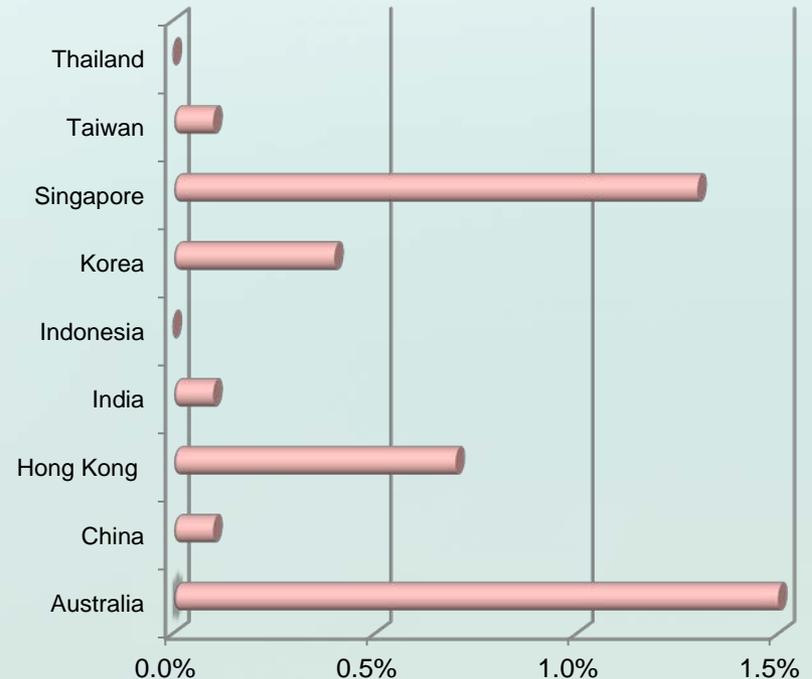
- The Hong Kong OTC derivatives market is relatively small

Geographical Distribution of Global Interest Rate Derivatives Turnover

Global Market Share



Asia Ex-Japan Market Share



Source: [BIS Triennial Central Bank Survey 2010](#)



Hong Kong's Efforts

- **The HKMA and SFC have set up a working group to develop the proposed regime for Hong Kong**
- **Given the relatively small size of Hong Kong's OTC derivatives market, it is not for Hong Kong to drive the reform initiatives**
- **However, due to the global nature of this market, Hong Kong has to closely track the international developments and comply with the international standards in this respect**
- **Our focus therefore is to develop a regime which is on a par with international standards but takes into account local market conditions and characteristics**

Hong Kong's Efforts – Proposed Regime

■ Two key aspects –

- (1) Introduction of mandatory reporting, clearing and (where appropriate) trading obligations, and establishment and regulation of necessary infrastructure through which mandatory obligations must be fulfilled (i.e. trade repositories (**TRs**), central counterparties (**CCPs**) and trading platforms)
- (2) Regulation of key players in the OTC derivatives market –
 - Authorized institutions (**Als**)
 - Licensed corporations (**LCs**)
 - Others who are large players and whose positions may pose systemic risk

■ Joint oversight by the HKMA and SFC

- HKMA : continue to oversee and regulate the OTC derivatives activities of Als
- SFC : oversee and regulate the OTC derivatives activities of non-Als

Hong Kong's Efforts - Legislative Development

- **Amend the Securities and Futures Ordinance (SFO)**
 - Introduce new rule making powers to provide for detailed regulation of the OTC derivatives markets
 - Rule making powers to impose mandatory clearing, reporting and platform trading requirements as appropriate
 - Detailed regulation to be set out in new subsidiary legislation
 - Introduce new regulated activities (**RAs**) to cover OTC derivatives transactions. Als will be carved out from the proposed new RAs.
 - Enable SFC to have certain intervention power on major OTC derivatives market participants not regulated by SFC/HKMA who have accumulated significant positions and become systemically important
- **High level legal framework set out in the primary legislation and detailed rules set out in subsidiary legislation**



Hong Kong's Efforts - Infrastructure Development

- **HKEx is setting up a new CCP in Hong Kong to clear OTC derivatives transactions**
- **Overseas CCPs will also be allowed to clear OTC derivatives transactions through our automated trading services (ATS) regime**
- **HKMA is building a TR under its existing Central Moneymarkets Unit**
- **Both the HKEx CCP and HKMA TR will take a phased development approach. Initial roll out will cover only major OTC derivatives products traded in Hong Kong (i.e. interest rate swaps (IRS) and non-deliverable forwards (NDF))**

Hong Kong's Efforts - Oversight of OTC Derivatives Market Participants

- **New regulated activities**

- Cover dealing, advising and clearing agency services
- New or additional prudential and conduct requirements will be introduced

- **Systemically important players**

- Hong Kong persons that are not regulated by SFC/HKMA
- Have accumulated significant positions that cause systemic concerns
- No intention to regulate them as a licensed corporation under the new regime and thus no prudential or conduct requirement is proposed
- We propose to have intervention powers such as seeking information and, under exceptional circumstances, requesting a reduction of positions

Hong Kong's Efforts – Mandatory Obligations

- **Impose mandatory clearing and reporting obligations on AIs and LCs as well as certain market participants**
- **Types of OTC derivatives products covered**
 - Initially IRS and NDF, two major instruments traded in Hong Kong
 - Will extend to other OTC derivatives asset classes in subsequent phases, including equity derivatives
- **Threshold for triggering the clearing and reporting obligations**
 - Would serve to exempt smaller players and thus avoid over-regulating
- **Who should be allowed to serve as the CCP**
 - Must be a recognized clearing house (RCH) or ATS that meets the designation requirements
- **Who should be allowed to serve as the TR**
 - The HKMA TR will be the only designated TR in Hong Kong
- **We do not intend to implement the mandatory trading obligation in the outset pending further studies on how best to implement this obligation**

Hong Kong's Efforts - Latest Status

- **SFC/HKMA joint public consultation on the general framework of the proposed OTC regulatory regime completed in July 2012**
- **Joint supplemental consultation on the proposed scope of new / expanded regulated activities and regulatory oversight of systemically important players conducted between July and August 2012 and we are finalising the conclusions paper**
- **Next step is to introduce the relevant Bill with the required primary legislative amendments into the Legislative Council**
- **Will also consult on the detailed subsidiary legislation**

Hong Kong's Effort - Voluntary Clearing of OTC Derivatives Transaction

- **An interim measure to support voluntary clearing of OTC derivatives transactions through a local CCP before the OTC derivatives regime is implemented**
- **In May 2012, the Securities and Futures (Futures Contracts) Notice 2012 was made pursuant to the SFO**
 - enables the SFC to regulate a local CCP offering OTC derivatives clearing under the SFO
 - extends the insolvency override provisions under the SFO to also cover OTC derivatives transactions that are cleared and novated through a recognised local CCP
- **The Notice became effective in June 2012**



International Development - US

- **Dodd-Frank Act was signed into law on 21 July 2010**
- **Since then, CFTC has finalised various rules to give effect to the key provisions of the Act**
- **Swap dealers commenced mandatory reporting for interest rate swap and credit index swap transactions on 31 December 2012. Additional reporting of other swap transactions will be phased in over the next few months**
- **Clearing requirement will commence, also in phases starting March 2013**
- **On mandatory trading, rules on swap execution facilities were proposed in 2011 and are still being finalised**

International Development - EU

- **European Market Infrastructure Regulation (EMIR) was passed by the European Parliament and Council on 4 July 2012**
- **European Securities and Markets Authority's (ESMA) proposed technical standards to implement the EMIR provisions were submitted to the European Commission (EC) on 27 September 2012 for consideration**
- **Almost all the standards were adopted by the EC without substantial changes on 19 December 2012**
- **The next step is for these standards to go through the negative vetting by the European Parliament and the Council.**
- **Subject to no unexpected delay in the legislative process, mandatory reporting is expected to begin in July 2013 for interest rate derivatives and credit derivatives, and in January 2014 for other asset classes**
- **Implementation of mandatory clearing requirement will depend on the clearing obligation determination and it is expected that this obligation will not commence earlier than September 2013**
- **On mandatory trading, amendments to Markets in Financial Instruments Directive (MiFID II) were proposed by the EC on 20 October 2011 and are still being finalised**