

**Hong Kong Final Regulation Comes into Force**  
**OTC Derivative Transaction Reporting and Record Keeping**

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**Summary**

Hong Kong are following the same path as other major economies in strengthening the regulation of OTC derivatives. In May 2015 they finalised and published the detailed regulation which extends the requirement to report certain OTC derivative transactions to the HKTR which is a division of the HKMA. The regulations expand the range of market participants and include trades dealt by Hong Kong entities and also trades arranged by Hong Kong entities trading staff for non Hong Kong affiliates. This change will increase both the number of firms required to report and also the transactions which they need to report. The regulation comes into effect on 10 July 2015 and firms affected will need to have their BAU operating process for T+2 reporting live by 10 January 2016.

HKMA and the SFC have had several rounds of consultations with the industry and the final rules do not apply to buy side participants and they have also relaxed some of the record keeping details which the industry had claimed were tougher than other jurisdictions and also technically very difficult to achieve.

The regulation covers vanilla interest rate swaps and non-deliverable forwards but the structure of the rule facilitates updates extending this regime to other products in the future.

**Who Has to Report?**

Reports are required by "prescribed persons" within Hong Kong for trades that they negotiate as principal but also trades where the Hong Kong firm's trader negotiates them on behalf of an affiliate who is outside Hong Kong. Prescribed Persons are;

- 1 A Licensed Corporation (typically broker dealers)
- 2 An Authorised Financial Institution (typically banks)
- 3 An Approved Money Broker (typically the internationally active IDBs)
- 4 A Recognised Clearing House (OTC CCPs)

The trader is the individual who made the decision to enter into the transaction and is employed or engaged to perform their duties predominantly in Hong Kong. The employment status is key. Even if the trader is physically outside Hong Kong at the time of execution the trade must be reported.

IDBs today typically act as intermediaries bringing together two participants who make the decision to trade. In this capacity the IDB's activity will not require it to report although it's very possible that the participants may themselves be required to

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report. Effectively trades may be dual or single reported depending on the status of the two parties. The HKTR has participant logic that seeks to monitor this and also requires firms to "link" trades where both parties have reported.

The Hong Kong entity will have been deemed to have complied with the regulations if the non-Hong Kong affiliate reports the transaction on its behalf.

Minor traders of OTC derivatives may be exempt if their total notional of outstanding OTC derivatives in a product class (which includes products not currently subject to reporting) does not exceed US \$30 million. This exemption is not applicable where;

- 1 The firm arranges OTCs for affiliates outside Hong Kong or
- 2 The firm is a Hong Kong authorised bank.

There is no exemption from reporting simply because the trade has also been reported to the trade repository of another regulatory regime.

### **Which products have to be reported?**

- 1 Fixed versus floating single currency interest rate swap
- 2 Floating versus floating single currency interest rate swap
- 3 Non deliverable forwards on FX contracts.

### **What are the key dates?**

The regulation will be effective from 10 July 2015 for affected persons and transactions. The regulation allows the regulators to also set a date for reporting for those persons providing automated trading services. Record keeping must start from this date but the regulations provide for a "Concession Period" of six months from the start date for firms to establish daily reporting capabilities. There is also a "Grace Period" of nine months from the start date for firms to complete all the back reporting of trades. Where a firm becomes a prescribed person during these periods there is no extension to the end of the concession period or grace period except that if a firm becomes a prescribed person after the end of the concession period then they have a grace period of three months. Also their start date is the date on which they become a prescribed person.

The back-reporting requirement applies to trades dealt after the start date or trades which are still live (i.e. not expired or terminated) at the end of the concession period. however, trades which are not live at the end of the grace period do not need to be back-reporting. The back-reporting of un-matured trades dealt prior to the start date only applies to trades dealt as principal by Hong Kong entities and trades whose records are kept by the Hong Kong branches of non-Hong Kong banks.

Ordinary reporting must be completed within two business days of the execution date of the trade. This becomes effective at the end of the concession period.

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To summarise;

Start of regulation	10 July 2015
Start of mandatory 2 business day reporting	10 January 2016
End of back reporting period	10 April 2016

### Transaction report particulars

The transaction report must include;

- Product class and product type
- Trade date, start date, maturity date
- Counterparty details
- Confirmation details
- Clearing details
- Any subsequent event which does not represent mandatory execution of the original terms such as a restructuring or partial or full unwind must also be reported.
- For interest rate swaps the following further data must be reported; notional, currency, settlement currency, index or interest rate, interest rate tenor, schedule and spread.
- For non deliverable forwards the following data must also be reported; reference currency, settlement currency, notional in the reference currency, notional in the settlement currency, the counterparty who is purchasing the reference currency, the counterparty who is selling the reference currency, the exchange rate, the fixing date, the settlement date.

In practice as reports are made to the Hong Kong Trade Repository reporting parties need to meet its data reporting procedures, validation and data standards which are more detailed and technical. It is possible to report into DTCC and then DTCC feeds the information to the HKTR. At this time most participants have elected for the simpler route of a direct interface to the HKTR.

Where national privacy laws prohibit the disclosure of counterparty identities the regulation includes a concession to mask the identity for those trades dealt before the end of the concession period. The Hong Kong regulators have designated the countries whose privacy laws require this. When they remove a country from their list firms will have three months to supply the counterparty identities. Where the prohibition ends due to counterparty consent firms will have one month to provide the identities.

The regulations also empower the regulators to impose technical standards on trade identifiers. Their aim here is to force the adoption of the universal trade identifiers used by regimes in other regions.

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### **Record Keeping Period**

The records which are required to be kept must be kept until five years after the maturity or termination of the transaction. Record may be kept outside Hong Kong, and the requirement still applies regardless of the location of the counterparty. Records must be easily accessible.

### **Records to be kept;**

- 1 Proof that reporting has occurred.
- 2 Records of the existence and purpose of the transaction and all agreements relating to the transaction.
- 3 Execution details such as orders, confirmations, ledger entries.
- 4 Details of the terms and conditions of the transaction and all payments for margin or settlement.
- 5 Where a firm relies on an agent to perform any of the reporting functions it needs to keep records of the agreement and also records to demonstrate that it has monitored the performance of the agent.
- 6 Where a firm is relying on a de minimis exemption from reporting it needs to keep records to demonstrate that it is below the reporting threshold.

### **What has changed since the last consultation?**

The SFC and HKMA issued their final consultation in November 2014 and included a draft of the regulatory text. The final Gazette version differs with a few minor language changes. The most notable changes are;

- 1 All the text requiring the reporting of daily valuation information has been removed.
- 2 They have made it even clearer that if the Hong Kong employed trader is outside Hong Kong the trade must be reported.
- 3 Affiliates can report subsequent events as well as the initial trade.
- 4 When a person ceases to be a prescribed person the withdrawal process is slightly simpler.
- 5 The records kept no longer have to be specifically searchable by transaction ID or counterparty.
- 6 Some product term definitions have been added.
- 7 Whilst all agreements details, orders and execution details still have to be kept other pre-trade communications and instructions do not.
- 8 The end of the regulation now has an explanatory note on the purpose of the sections.

### **What is the main impact?**

Banks authorised in Hong Kong have been required to report these OTC derivatives for well over a year now when they traded with another Hong Kong authorised bank. The big changes will be the requirement to keep records and the extension of the

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regulatory requirement to; broker dealers, money brokers and clearing houses. For the banks that are currently reporting they will now need to report all their trades. The regulation also empowers the regulators to require the operators of automated trading services to report from a date they may specify in the future.

### What happens next?

In previous consultations the SFC and HKMA have indicated that they wanted to do the following;

- Include major buy side derivative participants in the reporting and record keeping regime.
- Extend the regime to other asset classes of derivatives.
- Extend the regime to include the reporting of valuations.
- Start a consultation process leading to a requirement for mandatory clearing of certain OTC derivatives.

In respect of other parts of the G20 derivative reforms the HKMA and SFC have been fairly quiet. They have indicated that they prefer to review the outcome of the imposition mandatory trading on exchanges of liquid derivatives before making any rules of their own with respect to this. Whilst they have been also quiet about the imposition of initial and variation margin on uncleared OTC derivatives I think it highly likely that they will follow the US, EU and Japan in implementing the BIS/Iosco recommendations with the new deferred implementation timetable.

I also think it very possible that the other post trade risk-mitigation processes such as confirmation and portfolio compression and dispute resolution agreements find their way over time into the Code of Conduct which whilst only official guidance in practice operates as law in the territory.