

Date : 30 August 2013

Mr Howard Lee
Executive Director, Monetary Management Department
Hong Kong Monetary Authority
55th Floor, Two International Financial Centre
8 Finance Street, Central
Hong Kong

Mr Rico Leung
Senior Director, Supervision of Markets
Securities and Futures Commission
35/F, Cheung Kong Center
2 Queen's Road Central
Hong Kong

By email and post

Dear Howard and Rico,

The "originated or executed"¹ definition in the consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

Introduction

1. Thank you for having taken the time to meet with representatives of International Swaps and Derivatives Association (ISDA)² and the industry on 13 August 2013 (the "**August Meeting**"). We are very appreciative for this continuous dialogue between us in relation to the introduction of mandatory reporting requirements for OTC derivatives in Hong Kong.

¹ "originated or executed" – first raised in the consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong released jointly by Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) in Oct 2011 (the "**Consultation Paper**") and revised in the joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong released in July 2012 (the "**Consultation Conclusions Paper**").

² Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA®

2. Following the August Meeting, the industry are also very grateful for the invitation from the HKMA and SFC to submit a definition for "originated or executed". Accordingly, this letter sets out:
 - (a) the industry's revised definition for "originate or execute";
 - (b) the industry's rationale for proposing such revised definition; and
 - (c) examples of activities which are not captured by the revised definition and may need to be further discussed between us.
3. The industry understands the timing pressure in relation to developing the concept of "originate or execute" given the target of publishing in October 2013 the public consultation on subsidiary legislation, and stresses that the revised definition proposed in this letter represents a "building block" for mandatory reporting which can be developed and expanded over time.
4. We reiterate our commitment to assist the regulators across Asia Pacific in achieving their objective of implementing the G20 commitments for reform of the OTC derivatives market in a timely, effective and achievable manner. The industry will explore the application of this revised definition to Singapore and Australia (with appropriate adaptations to the definition to fit the legal framework for the relevant jurisdiction) through the industry's representatives in Singapore and Australia.

Revised definition for "originated or executed"

5. We set out in the annex to this letter a diagrammatic summary of our understanding of the proposed mandatory reporting requirement in Hong Kong. As this letter focuses on the definition of "originated or executed", we have assumed for the purposes of this letter that the transactions described herein are transactions that:
 - (a) involves a prescribed person (a "**Reporting Institution**") as defined under section 101A of the Securities and Futures Ordinance (Cap. 571) (as amended by the Securities and Futures (Amendment) Bill 2013) ("**SFO**");
 - (b) are specified as a class or description of OTC derivative transactions that are subject to the reporting obligation under section 101K(3) SFO (a "**Reportable Transaction**");
 - (c) are booked outside of Hong Kong; and
 - (d) have a Hong Kong nexus.
6. Following our August Meeting, we understand that the revised definition for "originate or execute" should satisfy the following criteria:

International Swaps and Derivatives Association, Inc.
Suite 1502 Wheelock House
20 Pedder Street, Central
Hong Kong
P 852 2200 5900
www.isda.org

NEW YORK	WASHINGTON
LONDON	BRUSSELS
HONG KONG	SINGAPORE
TOKYO	

ISDA

- (a) *Meets policy objectives*: the definition fulfils the HKMA and SFC's policy objectives for mandatory reporting, which includes monitoring activity in the OTC derivatives market and prevention of market misconduct;
- (b) *Legal certainty and operational practicality*: the definition needs to be capable of implementation by those institutions subject to the mandatory reporting obligation both from a legal as well as an operational perspective; and
- (c) *Internationally aligned*: the definition should be aligned, to the largest extent possible, with the equivalent concepts in Singapore³ and Australia⁴. As all three jurisdictions share similar policy objectives, an aligned definition will allow the industry to implement the operational system required in the shortest amount of time across all three jurisdictions and ensure that the information reported to all regulators will be clear and consistent.

7. After careful consideration and deliberation by ISDA and the industry group, we propose that a Reportable Transaction entered into by a Reporting Institution which is booked outside of Hong Kong should be considered to have been "originated or executed" in Hong Kong (and therefore reportable by the Reporting Institution) if:

"the person who carried out the "Execution Function" with respect to such Reportable Transaction is "Mandated" by the Reporting Institution and is "Licensed" in Hong Kong."

8. For the purposes of the defined terms used in paragraph 7 above, we propose that:

- (a) **"Execution Function"** means, in relation to a person and an executed transaction, such person was responsible for the entry into, and booking of, such transaction⁵;
- (b) **"Mandated"** means, in relation to a person, such person has been granted a trading mandate⁶ in Hong Kong by the Reporting Institution; and
- (c) **"Licensed"** means, in relation to a person, such person is or should be provisioned with a Hong Kong license to deal in OTC derivative products under the proposed

³ Singapore currently uses the concept of "traded in Singapore"

⁴ Australia currently uses the concept of "entered into in Australia"

⁵ The industry has provided for a general definition which may capture a range of activities carried out by various persons in a Reporting Institution. As a result, we have suggested the introduction of "Mandated" to identify the activity which is caught within the scope of the reporting obligation.

⁶ A trading mandate refers to internal authorisation granted by the Reporting Institution to such person to enter into transactions on behalf of the Reporting Institution, and which imposes limits or parameters around what type and/or quantity of transactions the relevant person is authorised to enter into.

ISDA

new Type 11 Regulated Activity (or who should be without regard to any applicable exemptions provided under the SFO that may apply to them⁷).

9. ISDA and the industry submit that the above proposed definition for "originated or executed" represents an appropriate balance between legal certainty (enabling the industry to identify the transactions which are reportable), operational practicality (enabling the industry to implement system changes necessary to comply with the reporting requirement) and transparency (enabling the HKMA and SFC to have access to information for the purposes of effective market surveillance).

10. We would like to highlight several aspects of the revised definition:

(a) *Reference to licensing regime:* We note that reservations were expressed during the August Meeting in relation to using the concept of licensed individuals in defining "originate or execute" on the basis that, under the previously proposed definition, the reporting obligation seems to be linked to the person rather than to the Reporting Institution. The industry would like to clarify that the revised definition refers to the licensing regime only for the purposes of identifying the scope of "originate or execute" (i.e. the reporting obligation remains with the Reporting Institution, not the individual), and that a licensed individual will always be accredited to a Reporting Institution.

We strongly prefer using the licensing regime to define the scope of "originate or execute" as it (i) provides the legal certainty required for Reporting Institutions to properly assess the transactions which are within the scope of the mandatory reporting regime, (ii) is a familiar concept to both Reporting Institutions and regulators and (iii) will minimize the operational burden on Reporting Institutions in implementing mandatory reporting; and

(b) *Focus on trading mandate:* The industry believes that, for the purposes of monitoring activity in the OTC derivatives market and market misconduct, the focus of mandatory reporting should be on the activity of the trader, rather than any other function in relation to such transaction (such as sales, structuring or marketing), which is already regulated through the Hong Kong licensing regime. The industry considers that such other functions are not related to the "execution" of the transaction by the Reporting Institution.

Issues and scenarios to be considered in relation to proposed definition

11. As stated above, while ISDA and the industry consider that the revised definition for "originated or executed" represents the optimum starting point, we recognise that certain

⁷ Applicable exemptions include, for example, Authorised Institutions or Licensed Corporations who are exempt from applying for a Type 11 Regulated Activity license as a result of possessing another Regulated Activity license.

ISDA

issues (which are set out below) require further consideration. We would be very happy to meet with the HKMA and SFC in order to discuss these in further detail.

12. **Automated trading:** Under the proposed definition for "originated or executed", automated trading conducted on an electronic trading platform maintained by an overseas affiliate of a Hong Kong Authorized Institution or Licensed Corporation will not be captured by the mandatory reporting requirement⁸. In the industry's opinion, this is the correct treatment for automated trading as:
 - (a) customers will execute trades directly on the automated trading platform without involvement of any trader⁹ (i.e. no person based in Hong Kong will be involved in the execution process); and
 - (b) once executed, the transaction is automatically booked in the overseas affiliate of the Hong Kong Authorized Institution or Licensed Corporation.
13. Based on the above, it is submitted that automated trading conducted on an electronic platform should not be subject to the mandatory reporting requirement as the transactions are not "executed" in Hong Kong (since trading is conducted automatically).
14. **Execution by multiple traders:** Under the scenario where a single client order (transaction) is "executed" by multiple traders, one of whom is Licensed in Hong Kong. For example, an equity derivative transaction referencing a basket of underlying shares which are listed on different stock exchanges (including the Hong Kong Stock Exchange) may be partly "executed" by a person Licensed in Hong Kong. The industry seeks the view of the HKMA and SFC as to whether or not:
 - (a) the entire transaction is reportable on the basis that part of such order is "executed" in Hong Kong;
 - (b) only the part of the transaction "executed" in Hong Kong is reportable; or
 - (c) the transaction is not reportable as it is not completely "executed" in Hong Kong.
15. From the industry's perspective, paragraph (a) above is undesirable as a large portion of the transaction may be entirely unrelated to Hong Kong. Paragraph (b) can result in a misleading report, since the data submitted to the HKTR will not reflect the true size and/or nature of the transaction. Therefore, the industry considers paragraph (c) to be the preferred approach for such transactions.

⁸ For the avoidance of doubt, the industry understands that any electronic trading platform where the transactions are booked into Hong Kong will be subject to mandatory reporting.

⁹ Although a trader's name may be tagged to a transaction conducted on an electronic trading platform, this is purely for client relationship management purposes and such trader will not have had any involvement in the execution of the transaction.

ISDA

16. **Sales Activity:** Certain industry members may have arrangements where the marketing and sales activity is undertaken in one jurisdiction but the transaction is executed in a different jurisdiction.
- (a) The first example is where the sales activity takes place in Hong Kong but the transaction is "executed" by a London trader. The industry submits that, at this stage, it will be very difficult to implement a workable system required to isolate and report such transactions as sales activity is generally not recorded (or even where recorded, not in a consistent manner across different industry members) and therefore requires further consideration between us.
- (b) The second example is the reverse scenario to the first example i.e. where sales activity takes place in London but the transaction is "executed" by a Hong Kong trader. This will be in scope under the revised definition.
17. **Global "portfolios":** As discussed at the August Meeting, there are certain industry members that attribute transactions to a "global portfolio" rather than to individual traders. Such industry members will endeavour to isolate trades attributable to individuals who are Licensed in Hong Kong from the "global portfolio" for the purposes of mandatory reporting.

In the event that such isolation is not possible, the industry would like to discuss the treatment of such "global portfolios" with the HKMA and SFC¹⁰.

18. **Backloading:** As discussed at the August Meeting, the industry would be grateful if the HKMA and SFC could re-confirm that industry members will not be required to conduct backloading for transactions "originated or executed" in Hong Kong as it is very unlikely that the Reporting Institutions will have the data required to isolate such transactions.

Conclusion

19. The industry is highly appreciative of the HKMA and SFC's efforts in engaging the industry on the introduction of a mandatory reporting requirement in Hong Kong for OTC derivatives. In this letter, ISDA and the industry have set out their thoughts on the definition of "originated or executed", which we hope you will find useful.
20. We appreciate that finding a solution which balances the information desired by the regulators and the level of detail firms can provide is a significant challenge. The industry would value the opportunity to meet with the HKMA and SFC in relation to the definition of "originated or executed" if you consider that such a meeting would be

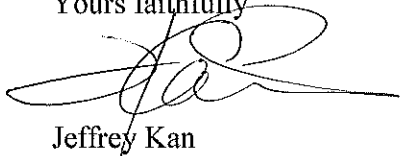
¹⁰ Some industry members have indicated that they can report all transactions attributed to such "global portfolio" to the HKTR (i.e. over-report) (but subject to the ability to mask data in relation to certain jurisdictions where there are concerns in relation to confidentiality laws (in similar fashion to the United States)). However, certain industry members have expressed difficulties with such an approach.

ISDA®

constructive and helpful. ISDA and its members look forward to further the dialogue with HKMA and SFC on this subject matter.

21. If you have any questions on this letter, please do not hesitate to contact Jeffrey Kan (jkan@isda.org).

Yours faithfully



Jeffrey Kan

Director of Infrastructure Management, Asia Pacific

ISDA

International Swaps and Derivatives Association, Inc.
Suite 1502 Wheelock House
20 Pedder Street, Central
Hong Kong
P 852 2200 5900
www.isda.org

NEW YORK	WASHINGTON
LONDON	BRUSSELS
HONG KONG	SINGAPORE
TOKYO	

ANNEX

Diagrammatic summary of proposed mandatory reporting requirement in Hong Kong

