

Hong Kong Regulators Consult on Enhancements to OTC Derivatives Regime

The HKMA and SFC are jointly consulting on further enhancements to OTC derivatives reporting and clearing obligations.

Key Points:

- The HKMA and the SFC have proposed mandating the use of UTIs for the reporting obligation, revising the list of jurisdictions designated by the SFC for masking relief in respect of the reporting obligation, and updating the FSP list in respect of the clearing obligation.
- The enhancements to the reporting obligation align with recent international developments in the OTC derivatives space.

Overview

Hong Kong's over-the-counter (OTC) derivatives regulatory reform is continuing to take shape amid recent international developments. On 26 April 2019, the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) issued a [consultation paper](#) (Consultation) to solicit feedback on their latest proposals to:

1. Mandate the use of Unique Transaction Identifiers (UTIs) — which are essentially unique codes that identify a transaction — for reporting purposes
2. Revise the list of jurisdictions designated by the SFC for masking relief (Designated List) in respect of the reporting obligation
3. Update the list of Financial Service Providers (FSPs) in respect of the clearing obligation

This *Client Alert* sets out the key takeaways in respect of each proposal.

Proposal 1: Mandatory Use of UTIs for Reporting

In September 2014, the Financial Stability Board (FSB) published a [feasibility study](#) on the different approaches to produce and share aggregated data in respect of OTC derivative transactions. One suggested approach was to develop uniform global identifiers, including UTIs. In February 2017, the Committee on Payments and Market Infrastructures and the International Organization of Securities

Commissions issued [technical guidance](#) on the use of UTIs (Technical Guidance). The FSB subsequently issued a [recommendation](#) in December 2017 that UTIs and the Technical Guidance should be implemented by regulatory authorities no later than the end of 2020. Following these international developments, the HKMA and the SFC are now proposing to mandate the use of UTIs for reporting purposes.

Notably, the HKMA and the SFC have proposed:

1. **Requiring both counterparties to share responsibility for generating UTIs:** The HKMA and the SFC have proposed that counterparties should bilaterally agree on who generates the UTI for their transactions. If bilateral agreement cannot be reached, counterparties should take into account the list of factors set out in the Technical Guidance in determining who should generate the UTI.¹
2. **Limiting UTI submissions to new transactions:** If the proposal passes in its current form, parties would only need to submit UTIs when reporting new transactions (including their life cycle events) on or after the implementation date of UTIs. In other words, UTIs would not be required for existing transactions that have been reported to the Hong Kong Trade Repository, or for life-cycle events of an existing transaction, save for certain limited circumstances.
3. **Setting a target implementation date of April 2020, and a grace period for US and EU identifiers:** The HKMA and the SFC have proposed to mandate the use of UTIs in April 2020. However, they have recommended implementing a grace period for the continued use of US and EU identifiers after the implementation of UTIs. Currently, if the Unique Swap Identifier (USI) reportable under the US mandatory reporting requirements and/or the Unique Trade ID (TID) reportable under the EU mandatory reporting requirements are available in respect of a transaction, the USI and/or TID must be reported as identifying references for such transaction. USIs and TIDs may continue to be used in place of UTIs until six months after both the US and the EU have adopted the international standard on UTIs.

Proposal 2: Revisions to the Designated List

Masking relief allows reporting entities to mask certain counterparty information if such information cannot be reported because of restrictions under the laws or regulations of an SFC-designated jurisdiction. Such relief came into effect in 2015 with the implementation of the reporting obligation, pursuant to the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (Reporting Rules). In November 2018, the FSB issued the [Follow-Up Report on Trade Reporting Legal Barriers \(2018 FSB Report\)](#), which re-categorizes a number of jurisdictions as having no reporting barriers or having reporting barriers that can be cured by counterparty consent. The HKMA and the SFC have since revisited the Designated List and are now proposing to remove certain jurisdictions from the Designated List.

Notably, the HKMA and the SFC have proposed:

1. **Removing all jurisdictions from the revised Designated List, except for the People's Republic of China (PRC):** Eighteen jurisdictions are currently on the [Designated List](#).² The HKMA and the SFC are proposing to remove all of them, except for the PRC.
2. **Requiring reporting entities to unmask transactions:** The removal of jurisdictions from the Designated List would have implications for market participants. In light of Rule 26(2) of the Reporting Rules, the HKMA and the SFC have proposed requiring reporting entities to unmask transactions

within three months of the SFC revoking the designation of the relevant jurisdictions by gazetting a revised Designated List. However, the regulators have proposed that transactions would not have to be unmasked if they have matured, expired, or been terminated before the unmasking period becomes effective.

3. **Using a snapshot approach to unmask transactions:** The HKMA and the SFC have proposed that reporting entities should only be required to submit unmasked counterparty information for the latest position (*i.e.*, reporting entities do not have to go back and submit unmasked counterparty information for all past life-cycle events).
4. **Requiring reporting entities to use “reasonable efforts” to obtain counterparty consent:** As a practical matter, the HKMA and the SFC have acknowledged that counterparty consent may still be required in a jurisdiction that has been removed from the Designated List. In certain circumstances, the reporting entity may be unable to obtain consent from the counterparty to submit the counterparty’s information for an existing transaction, despite reasonable efforts to obtain such consent. In such cases, the HKMA and the SFC have indicated that the reporting entity should continue to use reasonable efforts to obtain counterparty consent and unmask the relevant transaction within one month of obtaining such consent. However, what amounts to “reasonable efforts” remains unclear and, in practice, we expect that reporting entities will need to consider what steps they consider to be “reasonable” and develop an internal compliance procedure to address this requirement.
5. **Setting a target implementation period of the fourth quarter of 2019:** The HKMA and the SFC appreciate that market participants will need sufficient lead time to prepare for the unmasking of transactions when the applicable jurisdictions are removed from the Designated List. The regulators aim to publish the revised Designated List for reporting in the Gazette in the fourth quarter of 2019, but in any event no earlier than 1 October 2019.

If the above proposals come into effect, market participants will among other actions need to:

1. Identify existing transactions that will need to be unmasked following the revision of the Designated List
2. Establish procedures to obtain counterparty consent in respect of such transactions, where necessary
3. Unmask the relevant transactions
4. Establish procedures to obtain a standing consent for future transactions, where necessary

Proposal 3: Updates to the List of Financial Service Providers

Under the Securities and Futures (OTC Derivatives Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules, a transaction between an HKMA-authorized institution or an SFC-licensed corporation and an FSP may be subject to the clearing obligation if certain conditions are met. The HKMA and the SFC have a policy of updating the FSP List on an annual basis to maintain its relevance and appropriateness. The HKMA and the SFC have therefore proposed certain updates to the FSP List (as set out in Annex 2 of the Consultation). They aim to publish the updated FSP list for reporting in the Gazette in the fourth quarter of 2019.

Consultation Feedback

Comments must be received no later than 25 May 2019 in respect of the proposed update to the FSP list; and no later than 25 June 2019 in respect of the proposed mandatory use of UTIs and the revisions to the Designated List.

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Endnotes

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- ¹ Counterparties may also bilaterally agree to adopt the list of factors in the Technical Guidance in advance.
 - ² The 18 jurisdictions being: Algeria, Argentina, Austria, Bahrain, Belgium, France, Hungary, India, Indonesia, Israel, Luxembourg, Pakistan, People's Republic of China, Samoa, Singapore, South Korea, Switzerland, and Taiwan.