

Date: 5 April 2013

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Mr Rico Leung  
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By email and mail

Dear Edmond and Rico,

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

Introduction

Thank you for having taken the time to meet with representatives of International Swaps and Derivatives Association (ISDA)<sup>2</sup> and the industry on 4 February. We appreciate greatly the helpful discussions which have taken place between us as well as your explanations of the approach taken to the introduction of the proposed mandatory trade reporting regime in Hong Kong. ISDA and the industry support the G20 commitments including the need for regulators to

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<sup>1</sup> "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").

<sup>2</sup> 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](http://www.isda.org).

have increased transparency regarding the international OTC derivatives markets and we are committed to providing regulators with the information required to meet such G20 commitments.

The cross-border nature of the OTC derivatives markets often presents unique challenges to regulators worldwide in forming effective regulation while preserving the principle of international comity. We value the leadership role Hong Kong is seeking to play in relation to international cooperation among regulators on the issue of mandatory reporting.

## **Phased Approach**

### **Phase 1**

On the basis of the presentation to the Treasury Markets Association on 1 March 2013 (the "**TMA Meeting**"), the industry broadly welcomes the HKMA's proposal on interim trade data reporting requirements ("**Phase 1**"). Further to the TMA meeting, we have also received a copy of the HKMA consultation paper<sup>3</sup> with respect to Phase 1. We believe further clarity is necessary with respect to the detailed proposals under Phase 1 and we shall make a separate submission on these issues shortly.

Therefore, the focus of this letter will be only on our views to the *scope* of mandatory trade reporting under 'Phase 2'.

### **Phase 2**

We understand the transitional arrangements under Phase 1 are to last until the OTC derivatives subsidiary legislation comes into force. We would also like to take this opportunity to set out our views and concerns with respect to the scope of mandatory trade reporting under 'Phase 2' which are proposed for 2014.

### **"Originated or Executed"**

As the HKMA and SFC will be aware, regulators for the two largest derivatives markets (the US and EU) are introducing a mandatory reporting regime which requires a report to be made by broadly defined entities where they are a counterparty to a reportable transaction, providing regulators with transaction transparency as well as information on exposures, market developments and counterparty interconnectedness.

Given the "unique feature"<sup>4</sup> of Hong Kong's market, we understand that Hong Kong prefers a different approach when setting the scope of the mandatory reporting requirement. In addition to trades that are booked into Hong Kong, the Consultation Conclusions Paper contains proposals

<sup>3</sup> Consultation on reporting requirements for OTC derivative transactions dated 14 March 2013

<sup>4</sup> As expressed under *para 66* of the Consultation Paper

for trades with a Hong Kong nexus<sup>5</sup> to also be reported by the Hong Kong regulated entities (even if they are not a counterparty to the transaction) as a result of the policy of requiring OTC derivatives "originated or executed in Hong Kong" to be reported to the trade repository established and operated by the HKMA for the purposes of collection of data relating to OTC derivatives transactions ("**HKMA-TR**"). We appreciate that the proposals under the Consultation Conclusions Paper are a modification based on industry feedback to the original proposal. Furthermore, we understand the rationale for this requirement is two-fold: (i) a desire to improve transparency<sup>6</sup> and (ii) the belief that transactions "originated or executed" in Hong Kong may have implications for the monetary and financial stability of Hong Kong<sup>7</sup>.

While ISDA is very supportive of the HKMA and SFC's efforts and intention to introduce a mandatory reporting regime in Hong Kong which strengthens financial stability and transparency, the industry remains concerned that the "originated or executed" concept, which may form part of Phase 2, is challenging to reconcile with international commitments to reduce duplication and extra-territoriality conflicts. In addition, following lengthy discussions among industry participants on the approach to defining "originated or executed", it became clear that this concept would be very difficult to capture in a manner which was both clearly understandable from a legal perspective as well as being capable of implementation from an operational perspective<sup>8</sup>. This could potentially result in inadvertent non-compliance by Hong Kong regulated entities.

The industry has spent considerable time exploring alternative approaches for reporting OTC derivatives transactions that are booked overseas and provide further details of what has been considered below, along with suggested wording in the annexes.

"Hong Kong nexus approach"

The first suggested approach is for Hong Kong regulated entities to report all OTC derivatives transactions with a "Hong Kong nexus" that are booked onto the balance sheet of an overseas branch of such Hong Kong regulated entity (the "**Hong Kong nexus approach**" and the detailed wording is set out in Part 1 of Annex A). The advantage of this approach is that it would be relatively uncomplicated to implement from an operations perspective. The industry has identified certain challenges with this approach which we believe could be resolved through further dialogue between the industry, the HKMA and the SFC. Examples of the challenges include:

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<sup>5</sup> "Hong Kong nexus" – defined in the Consultation Conclusion Paper, *paras 105-112*.

<sup>6</sup> "...We will retain the "originated or executed" concept in relation to the mandatory reporting obligation to reflect the need to improve transparency ...". The Consultation Conclusion Paper, *para 21*.

<sup>7</sup> The Consultation Conclusion Paper, *para 114*.

<sup>8</sup> We set out further below the difficulties we identified during these industry discussions. Please refer to Annex B.

- (a) its extra-territorial impact, including confidentiality and privacy;
- (b) the broad scope of this approach may well require reporting of trades that have a "Hong Kong nexus" (such as CNY NDFs that are traded and settled outside of Hong Kong) but which have little to no direct impact on the financial stability of Hong Kong; and
- (c) where other regulators adopt an equivalent approach – the industry will be impacted by a proliferation of cross-border trade reporting rules resulting in a trade having to be reported multiple times.

## "Executed approach"

Having discussed with you the difficulties with the definition of "originated or executed" during our meeting in February (which followed up on our earlier letter of 29 January 2013 highlighting various scenarios (as attached to this letter as Annex B)), the industry considers that the optimum balance between (i) legal certainty of the scope of the mandatory reporting requirement and (ii) capturing the trade information required by the HKMA and SFC would be struck by narrowing the concept of "originated or executed" to "executed". This option (the "**executed approach**") is to cover OTC derivative transactions that have a "Hong Kong nexus" and are "executed" in Hong Kong (the detailed proposed wording is set out in Part 2 of Annex A). We understand from the meeting in February that one method of defining the "executed" approach is by reference to the employment status of the relevant employee who 'executed' the reportable transaction. The advantage of this approach is that it is aligned to the regulatory objective of capturing trades that have an impact on the monetary and structural financial stability of Hong Kong. The industry considers that the "executed approach" may raise certain implementation challenges, which again we believe should be resolved through further dialogue with the HKMA/SFC. Examples include:

- (a) operational / system enhancement requirements; and
- (b) the difficulty of identifying the employment status of a person. For example, an individual trader may be employed by one entity within the group and seconded to Hong Kong.

## Conclusion

We have highlighted a number of concerns with the "originated and executed" concept and should be grateful if the HKMA and SFC would consider the alternative proposals ("Hong Kong nexus approach" and "executed approach") set out in this letter.

Furthermore, we would suggest any reporting requirements beyond the scope of Phase 1 be extended only after further international discussions amongst regulators to resolve extra-

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territorial conflicts as well as additional market consultation on how and when to expand the reporting obligations.

Please note that these alternatives are not an endorsement by ISDA or the industry of the appropriateness of cross-border requirements in their current form under the Consultation Conclusions. As reiterated above, we believe that any reporting of cross border transactions should be implemented after further dialogue with other regulators in order to resolve extra-territorial requirements.

We appreciate that finding a solution which balances the information desired by the regulators and what firms can provide in the short-to-medium term is a significant challenge. Whilst we appreciate that the immediate priority is on discussions regarding the reporting requirements under Phase 1, we believe the requirements for Phase 2 are still important and the industry would value the opportunity to meet with the HKMA and SFC at the appropriate time to discuss Phase 2 in further detail, including without limitation such as expectations for the HKMA-TR to carry out trade matching. ISDA and its members look forward to further the dialogue with HKMA and SFC on this subject matter.

If you have any questions on this letter, please do not hesitate to contact Jeffrey Kan ([jkan@isda.org](mailto:jkan@isda.org)) at +852 2200 5907.

Yours faithfully,



Jeffrey Kan

Director of Infrastructure Management, Asia Pacific

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## Annex A

## Part 1

1.1 An Authorized Institution, Licensed Corporation or Approved Money Broker and the counterparty shall each ensure that the details of a reportable transaction with a Hong Kong nexus [through which any branch of such Authorized Institution, Licensed Corporation or Approved Money Broker will perform its obligations]<sup>9</sup> under the reportable transaction be reported to the HK-TR, by no later than the second business day following the date on which the parties entered into the contract.

1.1.1 A "**reportable transaction**" means for the purposes of the foregoing: a transaction falling within a specific type of OTC derivatives transaction published by the Hong Kong Monetary Authority and Commission under [*insert name of subsidiary legislation / notice*] as being subject to mandatory reporting.

1.1.2 A reportable transaction has a "**Hong Kong nexus**" if:

- (a) [in respect of any equity or credit OTC derivatives transaction,
  - (i) securities of an underlying entity or reference entity that are listed on a recognized stock market, and where there is more than one underlying entity or reference entity, a specified percentage of the securities to the underlying entities (by value) are listed on the recognized stock market; or
  - (ii) the underlying is an index, a specified percentage (by value) of the securities to the underlying companies are listed on a recognized stock market; or
  - (iii) the reference entity is, or is wholly owned by, the Government of the Hong Kong Special Administrative Region; and
- (b) in respect of any other OTC derivatives transaction, the underlying asset, currency or rate is or denominated in or related to (or includes an asset, currency or rate that is or denominated in or related to) Hong Kong dollars or Renminbi.]<sup>10</sup>

<sup>9</sup> This language is to contemplate "booking concept".

<sup>10</sup> This is from paragraph 109 of the SFC/HKMA Consultation Conclusions dated July 2012. We note some firms would like to exclude RMB/CNY from the definition.

["**HK-TR**" means a trade repository established and operated by the HKMA for the purposes of collection of data relating to OTC derivatives transactions]<sup>11</sup>.

**Part 2**

1.1.1 An Authorized Institution, Licensed Corporation or Approved Money Broker and the counterparty shall each ensure that the details to a reportable transaction with a Hong Kong nexus [*executed*] by an Authorized Institution, Licensed Corporation or Approved Money Broker be reported to the HK-TR, by no later than the second business day following the date on which the parties entered into the contract.

(a) An Authorized Institution, Licensed Corporation or Approved Money Broker will be regarded as having [*executed*] a reportable transaction with a counterparty for the purposes of the foregoing, if:

(i) [a "related party", rather than the Authorized Institution, Licensed Corporation or Approved Money Broker itself, has been designated to be the contracting party to the reportable transaction]<sup>12</sup>; and

(ii) a Hong Kong employee of the Authorized Institution, Licensed Corporation or Approved Money Broker has, for and on behalf of the related party, taken the final action or step which directly results in the formation or conclusion of a binding contract between the related party and the counterparty on the terms of the reportable transaction.]

(b) A Hong Kong employee of an Authorized Institution, Licensed Corporation or Approved Money Broker includes any individual [to whom the Employment Ordinance applies] / [who is engaged under a contract of employment with the Authorized Institution, Licensed Corporation or Approved Money Broker].<sup>13</sup>

(c) A "**related party**" means for the purposes of the foregoing, any company or branch within the same group as the Authorized Institution or Licensed Corporation or Approved Money Broker.

<sup>11</sup> This is the definition used in the SFC/HKMA Consultation Conclusions dated July 2012.

<sup>12</sup> This is from paragraph 115 of the SFC/HKMA Consultation Conclusions dated July 2012.

- (d) A "**reportable transaction**" means for the purposes of the foregoing: a transaction falling within a specific type of OTC derivatives transaction published by the Hong Kong Monetary Authority and Commission under [*insert name of subsidiary legislation / notice*] as being subject to mandatory reporting.
- (e) A reportable transaction has a "**Hong Kong nexus**" if:
  - (i) [in respect of any equity or credit OTC derivatives transaction,
    - (A) securities of an underlying entity or reference entity that are listed on a recognized stock market, and where there is more than one underlying entity or reference entity, a specified percentage of the securities to the underlying entities (by value) are listed on the recognized stock market; or
    - (B) the underlying is an index, a specified percentage (by value) of the securities to the underlying companies are listed on a recognized stock market; or
    - (C) the reference entity is, or is wholly owned by, the Government of the Hong Kong Special Administrative Region; and
  - (ii) in respect of any other OTC derivatives transaction, the underlying asset, currency or rate is or denominated in or related to (or includes an asset, currency or rate that is or denominated in or related to) Hong Kong dollars or Renminbi.]<sup>14</sup>

["**HK-TR**" means a trade repository established and operated by the HKMA for the purposes of collection of data relating to OTC derivatives transactions]<sup>15</sup>.

<sup>14</sup> This is from paragraph 109 of the SFC/HKMA Consultation Conclusions dated July 2012. Note some firms would like to exclude RMB from definition.

<sup>15</sup> This is the definition used in the SFC/HKMA Consultation Conclusions dated July 2012.



Annex B



Date: 29 January 2013

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 Senior Director, Supervision of Markets  
 Securities and Futures Commission  
 8th Floor, Chater House  
 8 Connaught Road Central  
 Hong Kong

By email and mail

Dear Edmond / Rico,

**The “originated or executed”<sup>1</sup> definition in the consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong**

The International Swaps and Derivatives Association (ISDA)<sup>2</sup> is writing to express our concern with the impact of the existing “originated or executed” definition embedded in the proposed HK trade reporting regime.

Consistent with our mission, we support the G20 commitments to provide regulators with transparency regarding OTC derivatives markets. To achieve this, it is of utmost importance that there is certainty, clarity and transparency in relation to the reporting requirements, followed by a

<sup>1</sup> “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”).

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practical implementation schedule in order that the industry can deliver in an effective and efficient manner.

To achieve the transparency objective, the requirements in the largest derivatives markets, the US and Europe, will require regulated entities to report a trade to which they were a counterparty, thus providing regulators with information to monitor exposures, market developments and interconnectedness.

HK has taken a different approach which in addition requires that trades with a Hong Kong nexus<sup>3</sup> be reported by the HK regulated entities (even if they are not a counterparty to the transaction) as a result of the embedded “originated or executed” definition. We appreciate that Hong Kong regulators: (i) want to improve transparency<sup>4</sup> and (ii) believe transactions “originated or executed” in Hong Kong have implications for the monetary and financial stability of Hong Kong<sup>5</sup>. However, we are concerned that the result of the current proposals will be both inadvertent non-compliance by HK regulated entities and undue reliance being placed by regulators on the data submitted.

Hong Kong regulators have recognised the compliance difficulty<sup>6</sup> faced by the industry by narrowing the reporting obligation of overseas-incorporated AIs<sup>7</sup>. Nonetheless, the “originated or executed” definition in the Consultation Conclusions Paper<sup>8</sup> remains problematic. We have two main concerns:

- The definition is not explicit enough for a firm to comply with beyond doubt. To illustrate this, the industry has identified some examples where the treatment is unclear (please refer to Appendix A); and
- Even where theoretically there will be a clear reporting obligation on the HK entity, the practical reality is that identifying these trades is extremely difficult within existing

<sup>3</sup> “Hong Kong nexus” – defined in the Consultation Conclusion Paper, *para 105-112*.

<sup>4</sup> “...We will retain the “originated or executed” concept in relation to the mandatory reporting obligation to reflect the need to improve transparency ...”. The Consultation Conclusion Paper, *para 21*.

<sup>5</sup> The Consultation Conclusion Paper, *para 114*.

<sup>6</sup> “...there was concern that the [Hong Kong nexus] concept could create compliance problems as the Hong Kong branch of an overseas-incorporated AI may not be able to ensure that all transactions that have a Hong Kong nexus and that are handled by either its head office or other overseas branches are reported to the HKMA-TR – particularly if the Hong Kong branch is not involved at all...” The Consultation Conclusion Paper, *para 107*.

<sup>7</sup> As defined in the Consultation Paper.

<sup>8</sup> Defined as “an AI, LC or AMB will only be regarded as having “originated or executed” an OTC derivatives transaction if –

(a) it has agreed with the counterparty the normal economic terms of the transaction, either directly or through an intermediary, and

(b) a “related party”, rather than the AI or LC itself, has been designated to be the final contracting party to the transaction.

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systems and firms will have to build manual processes. These will be costly and cannot eliminate the possibility of erroneous under-reporting. To automate the process will involve changing the existing architecture of their systems. This will be difficult as the definition is subjective and the costs will be significant. An illustration is provided in Appendix B.

We appreciate that finding solution which balances the information desired by the regulators and what firms can provide in the short-to-medium term is a significant challenge. ISDA and its members look forward to continued dialogue with HKMA and SFC on this subject matter. We would be grateful if a meeting could be arranged between Hong Kong regulators and industry participants before the Chinese New Year to discuss this in details. If you have any questions on this letter, please do not hesitate to contact Jeffrey Kan ([jkan@isda.org](mailto:jkan@isda.org)) at +852 2200 5907.

Yours faithfully



Jeffrey Kan

Director of Infrastructure Management, Asia Pacific

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## Appendix A

### Fact pattern scenarios requiring clarification:

#### 1. Structurer role

##### Background:

In the trade execution flow, a structurer is sometimes involved in the function of calibrating whether a financial product meets customer's needs. The structurer interacts with sales / marketers (who obtain customer's financial objectives and discuss the price of the trade with the customer) and position traders (who manage the risk of the financial instruments of the deal). The structurer will then construct a deal with the applicable financial instruments and advise the product structure to the sales / marketers.

The structurer is located in the Front Office area but has no interaction with customers or any responsibility in managing the risk of the transaction.

The situation could be further illustrated in the example below:

A sales person identifies a hedging need for his customer on his fixed rate callable loan (the loan is callable when the floating rate of any quarterly payment exceeds X%). The customer would like to enter into an interest rate swap to swap his fixed rate obligation with a floating rate obligation together with a callable feature. The structurer would construct a callable interest rate swap by combining swaps and swaptions offered by position traders. Once the deal is executed by the sales, the position traders will then manage the swap and swaption risk.

Issue: There are occasions where the structurer of a deal is located in HK but the sales / marketers and position traders are located outside HK. It is unclear whether the involvement of a HK structurer would lead the deal be categorized as "originated or executed" in HK.

Frequency of occurrence: Daily

#### 2. A HK "sales" involved in deals concluded via an FX electronic trading platform

##### Background:

FXNDF is traded on an FX electronic trading platform maintained by an overseas affiliate of a HK LC. The price of an FX NDF trade is quoted and uploaded to the e-trading platform automatically (even in the absence of any customer order), based on pricing models developed by quantitative research analysts based outside of HK. Clients can place the order directly (i.e. without involving a sales) by accepting the prices offered on the e-trading platform. Once accepted by the client, the order will be executed automatically and booked (i.e. between the client and the overseas affiliate of the HK LC).

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Clients who have any questions over functions of the e-platform could call their sales representatives, some of whom are located in HK. Though such sales representatives are performing a sales function (marketing a product / price negotiation) in “other” transactions, they have no right to accept a client order on such e-trading platforms. The sales representative may or may not receive sales commission for these e-trades depending on the commission structure setup.

Issue: Given the limited involvement the HK sales representative has in the trades conducted through the e-platform, it is unclear whether those deals should be categorized as “originated or executed” in HK.

Frequency of occurrence: Daily

### 3. HK based quantitative research analysts

Background:

As in the case of “A HK “sales” involved in deals concluded via a FX electronic trading platform” above, the only difference is that the quantitative research analysts are based in HK.

The quantitative research analysts are only responsible for developing pricing model but are not accountable for risk management or marketing the deal to the customer.

Issue: With the involvement of a HK quantitative research analyst, it is unclear whether such deals should be categorized as “originated or executed” in HK.

Frequency of occurrence: Daily

### 4. Market maker role

Background: In flow trade execution, a trade could be executed by a “market maker”, who offers a price on a trade. The role of market maker is different from sales (marketing the product) and trader (managing the risk position). It is not known whether the trade will go through a HK market maker even if the sales and trader are outside of HK. Market maker information is currently not kept in the trading system (while the position trader for the trade is tagged). Such trades are placed in a portfolio with other trades that are not “originated or executed” in HK (not utilizing any HK-market maker and no HK based sales / traders were involved).

Issue: If trades conducted via a HK market maker are categorized as “originated or executed” in HK, it would be difficult for firms to identify those transactions amongst the general population of trades.

Frequency of occurrence: Daily

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### Appendix B

#### Known reportable scenario example:

A HK sales person of a regulated entity executes a deal with a customer, and this is booked in an overseas group entity's balance sheet. The identification of such trade from the trade population could not simply be achieved by tracking the parameters in any derivatives confirmation documentation (sales person is not a required data input), not to mention in any electronic confirmation matching platform. Firms would have to identify such information from other internal systems or even by changing the existing architecture of their systems to incorporate the sales person's details. This is a manually intensive process and the timely delivery of an automated solution could hardly be guaranteed amidst competition from other prioritized IT deliverables. The effectiveness and efficiency of trade reporting can best be maintained if the reporting requirements relate to captureable data in existing confirmation documentation.

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