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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

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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).

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.

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) at +852 2200 5907.

Yours faithfully



Jeffrey Kan

Director of Infrastructure Management, Asia Pacific

ISDA

## 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).

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 thru 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

## 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.