

**Frequently Asked Questions on the Implementation and Operation of the  
Mandatory Clearing Regime**

**(14 December 2018)**

*These FAQs elaborate on how the mandatory clearing regime under the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (Clearing Rules) will operate and are intended to help market participants better understand their obligations and responsibilities under the Clearing Rules so that they are better able to prepare for implementation of the new regime and ensure compliance going forward.*

## **Table of**

### **Definitions and interpretation**

*Unless the context otherwise requires, terms defined in Schedule 1 to the SFO or in the Clearing Rules bear the same meaning when used in the questions and answers below, and the following terms bear the following meanings:*

- “HKMA” refers to the Hong Kong Monetary Authority;
- “Clearing Rules” means the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules;
- “SFC” refers to the Securities and Futures Commission;
- “SFO” refers to the Securities and Futures Ordinance (Chapter 571, Laws of Hong Kong);
- “specified OTC derivative transaction” means an OTC derivative transaction that is specified in section 2 of Schedule 1 to the Clearing Rules, which will be subject to mandatory clearing if certain criteria are satisfied.

### **Legislation and technical guidance**

#### **Q1. Where are the clearing and record keeping requirements set out?**

The broad framework for clearing and record keeping obligations is contained in Part IIIA of the SFO, and the detailed requirements are set out in the Clearing Rules.

These documents are accessible at the Department of Justice’s website: [www.legislation.gov.hk](http://www.legislation.gov.hk).

### **Commencement date**

No, there is no provision for transitional arrangement under the Clearing Rules. That said, the first date a person may be required to clear a specified OTC derivative transaction is 1 July 2017, i.e. there is a gap of 10 months from the date the Clearing Rules come into operation on 1 September 2016. This is explained in Q6 below.

**Persons subject to clearing and record keeping obligations**

**Q4. Who would be subject to the mandatory clearing and related record keeping requirements?**

The Clearing Rules at present are intended to cover specified OTC derivative transactions entered into between major dealers (**phase 1 clearing**). The clearing and record-keeping obligations apply to the following persons:

- (a) an authorized institution (**AI**);
- (b) an approved money broker (**AMB**); or
- (c) a licensed corporation (**LC**).

In respect of an AI and AMB that is incorporated overseas, the obligations apply only to the transactions that are recorded in the Hong Kong books of that AI and AMB, and transactions that are not recorded in the Hong Kong books are not subject to the obligations.

AIs, AMBs and LCs will need to ensure that their spe turiJ -0 turiJ -0 trere w25 >>BDC

- (b) The transaction is entered into on or after the prescribed day for the calculation period in respect of which the AI, AMB or LC reached the clearing threshold for the first time (or for the first time again after giving an exit notice). (Please see Q6 on calculation period and prescribed day and Q35 and Q36 on exit notice.)
- (c) The counterparty is an AI/AMB/LC and is also required to clear the transaction concerned (i.e. circumstances (a) and (b) above are applicable to that counterparty), or the counterparty is a financial services provider. (Please see **Error! Reference source not found.** below for the definition of a financial services provider.).

### **Calculation period, prescribed day and clearing threshold**

#### **Q6. What is a calculation period and what is a prescribed day in relation to a calculation period?**

A calculation period is the period in which a person's applicable position in OTC derivatives is calculated to determine whether it has reached the clearing threshold. Please see Q8 to Q10 for further information. There are multiple calculation periods. Each calculation period is three months in duration and there is a six-month interval between the start of one calculation period and the

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|    | Calculation period                   | Prescribed day |
|----|--------------------------------------|----------------|
| 1. | 1 September 2016 to 30 November 2016 | 1 July 2017    |
| 2. | 1 March 2017 to 31 May 2017          | 1 January 2018 |
| 3. | 1 September 2017 to 30 November 2017 | 1 July 2018    |
| 4. | 1 March 2018 to 31 May 2018          | 1 January 2019 |

**Q7. What is the clearing threshold for an AI/AMB/LC?**

The clearing threshold for phase 1 clearing is set out in Schedule 2 to the Clearing Rules. It is currently set at US\$ 20 billion for all four calculation periods specified in the rules. We may lower the threshold in future as appropriate.

**Q8. When is a person regarded as having reached the clearing threshold?**

A person has reached the clearing threshold if its applicable position for a calculation period equals or exceeds the clearing threshold for that calculation period. (Please see Q9

Total position

As we intend to cover only dealer-to-dealer transactions for now, only persons that meet the following criteria are included in the current gazette list of financial services providers –

- (a) persons that are clearing members of the largest IRS central counterparties (CCPs) in the US, Europe, Japan and Hong Kong as at 28 February 2018; and
- (b) persons that belong to a group of companies appearing on the list of global systemically important banks published by the Financial Stability Board in November 2017, and/or on the list of dealer groups which undertook to the OTC Derivatives Supervisors Group to work collaboratively with CCPs, infrastructure providers and global supervisors to continue to make structural improvement to the global OTC derivatives markets.

The factors that are relevant to determining the list of financial services providers may also change when we expand our clearing obligation in the future to cover a wider range of entities. We will review the list of financial services providers from this perspective.

In respect of the list of financial services providers going forward, we will have an annual update based on a snapshot of the entities that would fall within the criteria at the end of each calendar year, and consult the market within Q1 of the following year. The effective date for the revised list of financial services providers will be the Prescribed Day that corresponds to the Calculation Period that is nearest to when the consultation conclusion is published.

Point to note:

If the clearing obligation is applicable to a transaction between an AI/AMB/LC and a financial services provider, the responsibility for ensuring compliance with clearing obligation rests with the AI/AMB/LC and not with the financial services provider.

### **Transactions subject to mandatory clearing**

#### **Q12. What OTC derivative transactions are subject to the clearing obligation?**

Only specified OTC derivative transactions which are set out in Schedule 1 to the Clearing Rules are subject to clearing obligation under the Clearing Rules (reproduced below for ease of reference) –

- (a) a basis swap that has all of the features specified for an item in a row of the table below –

| Item | Currency | Floating rate<br>index | Tenor | OptionalitDC | .9 (p)-7 (tio)-7 | Q q | 225.84 674 |
|------|----------|------------------------|-------|--------------|------------------|-----|------------|
|------|----------|------------------------|-------|--------------|------------------|-----|------------|

**Q13. Are historical transactions subject to clearing obligation?**

No, historical transactions are not subject to clearing obligation under the Clearing Rules. Only specified OTC derivative transactions which the person entered into on or after the prescribed day that corresponds to the calculation period with respect to which the person reached the clearing threshold for the first time (or for the first time again after giving an exit notice) will be subject to the clearing obligation when other criteria are satisfied (see Q5 above). Please see Q6 above for the different calculation periods and their corresponding prescribed days.

**Q14. Is a swaption subject to clearing obligation?**

A swaption is an option to enter into a swap transaction, and is not itself a swap transaction. As it does not fall within the definition of IRS in the Clearing Rules, it is not subject to phase 1 clearing.

**Q15. Is an IRS entered into pursuant to the physical exercise of a swaption subject to clearing obligation?**

An IRS entered into on or after the relevant prescribed day pursuant to the physical exercise of a swaption may be subject to phase 1 clearing if:

- (a) it falls within the definition of IRS under the Clearing Rules and its features meet the specified criteria set out in Schedule 1 to the Clearing Rules,

and (b) it is entered into on or after the relevant prescribed day pursuant to the physical exercise of a swaption.

the terms and conditions of the transaction would result in a new transaction and hence may be subject to clearing obligation.

A pragmatic approach should be adopted when assessing if an amendment results in a new transaction that is subject to clearing obligation.

**Q17. Is an IRS that forms part of a larger, complex or packaged structure subject to clearing obligation?**

When an IRS that falls within Schedule 1 to the Clearing Rules is a transaction on its own and is combined with other separate transactions to make up a larger, complex or packaged structure, that particular IRS transaction will be caught by our clearing requirements.

However, if the larger, complex or packaged structure is a single transaction with different components and one of the components is similar to an IRS, we do not intend to require the single transaction to be broken down into its individual components and subject the component which is similar to an IRS to clearing obligation.

Also, if the larger, complex or packaged structure is in fact an embedded derivative, i.e. a simple instrument (e.g. shares, bonds, notes) with the IRS being merely an embedded feature that makes the structure a “structured product” (as defined in the SFO), the structure itself falls outside the scope of “OTC derivative product” (as defined in the SFO). The IRS, being only an embedded feature of the structure, will not be subject to mandatory clearing.

**Q18. Is an IRS created as a result of novation subject to clearing obligation?**

An IRS transaction that results from a novation will be subject to clearing if its features meet the specified criteria set out in Schedule 1 to the Clearing Rules. As these features are likely to be the same for both the original transaction and the new transaction resulting from the novation, it follows that if the original transaction was subject to clearing, the new transaction will be subject to clearing also.

Additionally, the new IRS transaction may be subject to clearing even if the old transaction was not. This can happen when the old transaction is a historical transaction executed prior to the prescribed day for a calculation period and the novation may happen after the relevant prescribed day.

**Q19. Is a zero coupon swap subject to mandatory clearing?**

A zero coupon swap is an exchange of income streams in which the stream of floating rate interest payments is made periodically, but the stream of fixed rate payments is made as one lump-sum payment at maturity instead of periodically



Point to note:

An affiliate of a person is a corporation that is in the same group of companies as the person, except a corporation that is a collective investment scheme.

**Q25. What should a person do if it becomes aware that an affiliate will no longer meet the requirements set out in Rule 8(2) of the Clearing Rules after an exemption notice has been sent in respect of that affiliate to the HKMA or the SFC?**

When a person becomes aware that an affiliate will no longer meet the requirements, it should give a cessation notice to the HKMA or the SFC. A cessation notice must specify the following –

- (a) the identity of the affiliate(s) that will no longer be regarded as an exempt affiliate; and
- (b) the date from which the affiliate is no longer an exempt affiliate and the date must not be backdated, i.e. it must not be earlier than the day the notice is received by the HKMA or the SFC.

It is the responsibility of the person (that otherwise has the clearing obligation) to ensure that it is entitled to benefit from the exemption. As and when an exempt affiliate ceases to meet the requirements under Rule 8(2) of the Clearing Rules, even if a cessation notice has not been sent to the relevant regulator, any new transaction between the person and that affiliate cannot benefit from the exempt affiliate exemption.

Point to note:

Only transactions after the affiliate stops meeting the requirements under Rules 8(2) of the Clearing Rules are not exempted from clearing. Historical transactions prior to that date are not affected.

**Exempt jurisdiction exemption**

**Q26. How does an exempt jurisdiction exemption under Rule 9 operate, and what are the procedures to follow if a person wishes to benefit from the exemption?**

An exempt jurisdiction exemption is available to an LC or a local AI/AMB. This exemption applies to the transactions of such an institution that are booked

in its branch in certain overseas jurisdictions provided that the conditions in Rule 9(2) are met. (Please see Q28 below.)

To benefit from the exemption, a person must send an exemption notice to the relevant regulator (if it is an LC, to the SFC, and if it is a locally incorporated AI or AMB, to the HKMA). The exemption notice should

If the total position of the person for any one exempt jurisdiction on the list specified in the exemption notice exceeds the 5% threshold, then the requirement under Rule 9(2)(a) is not met, and consequently, the exemption for not only that exempt jurisdiction but also all other exempt jurisdictions on the list will cease. Therefore, a person should remove any exempt jurisdiction that will not be able to comply with the 5% threshold in advance, so that the exemption in respect of the other exempt jurisdictions on the list will not be affected.

Similarly, if any increase of the total position of one exempt jurisdiction on the list is going to bring the total position of all exempt jurisdictions above the 10% threshold, the person should take action (e.g. remove that particular exempt jurisdiction) in advance to bring the total position down, so that the person can continue to utilise the exemption.

It is therefore critical that the list of exempt jurisdictions is kept up-to-date at all times and the person that is relying on the exemption closely monitors the level of activity in each exempt jurisdiction.

**Q29. How can a person remove an exempt jurisdiction from the list?**

When a person becomes aware that total position of an exempt jurisdiction will not be able to meet the requirements in the near future, it should give a cessation notice in respect of that jurisdiction as soon as possible to the HKMA or the SFC, as applicable. The cessation notice must specify the following –

- (a) the jurisdiction(s) that will no longer be regarded as exempt jurisdiction(s); and
- (b) the date from which the jurisdiction is no longer regarded as an exempt jurisdiction and the date must not be backdated, i.e. it must not be earlier than the day the notice is received by the HKMA or the SFC, as applicable.

It is the responsibility of the person (that otherwise has the clearing obligation) to ensure that it is entitled to benefit from the exemption. As and when the total position of an exempt jurisdiction or the total position of all exempt jurisdictions (as the case may be) ceases to meet the requirements under Rule 9(2) of the Clearing Rules, even if a cessation notice has not been sent to the relevant regulator, any new transaction in respect of all exempt jurisdictions on the list cannot benefit from the exempt jurisdiction exemption.

Point to note:

Only new



the list as the global regulatory reform in respect of OTC derivative markets makes further progress. We will continue to monitor international developments in this area and consider whether new jurisdictions should be added to the list. The market will be consulted before the list is expanded.

### **Exit from clearing obligation**

#### **Q35. What is an exit threshold and how does it work?**

An exit threshold serves to determine how a person can exit from its clearing obligation when, for instance, there is a permanent change in the person's

calculation only counts the position that is booked at the person's Hong Kong branch.

Calculation of the applicable position is on a "gross" notional basis, without any netting.

**Q36. What happens when the person subsequent reaches the clearing threshold again, after it has given an exit notice to the relevant regulator?**

If the person subsequently reaches the clearing threshold after giving an exit notice, it will become subject to clearing obligation again. The calculation methodology for determining whether a person has reached the clearing threshold again will be the same as that for determining whether a person has reached the

Point to note:

### **Consequences of breaches**

#### **Q43. What are the consequences of breaching the clearing or record keeping obligation?**

Compliance with the clearing and record keeping obligations is a legal requirement. In the event of a breach, the HKMA (in the case of a breach by an AI or AMB) or the SFC (in the case of a breach by any other person) may apply to the Court of First Instance, which may then inquire into the case. If satisfied that there is no reasonable excuse for the breach, the Court may impose a financial penalty of up to HKD 5 million. Additionally, the HKMA (in the case of a breach by an AI or AMB) and the SFC (in the case of a breach by an LC) may take disciplinary action against the person in respect of the breach.

#### **Q44. What is the consequence when a person has obtained confirmation from a counterparty that it has not reached the clearing threshold, and subsequently it comes to light that the counterparty has in fact reached the clearing threshold at the relevant time?**

Where the person has received the confirmation in good faith, the confirmation should provide a reasonable excuse (in the case of any action under section 101F or 101G of the SFO) and a mitigating factor (in any disciplinary proceedings against the person) for not having centrally cleared the transaction in question.

Hong Kong Monetary Authority  
Securities and Futures Commission



31. HSBC Bank USA, N.A.
32. HSBC France
33. HSBC Securities (USA) Inc.
34. ING Bank N.V.
35. ING Bank Śląski S.A.
36. ING-DiBa AG
37. JPMorgan Chase Bank, N.A.
38. JPMorgan Securities Japan Co., Ltd.
39. J.P. Morgan Securities LLC
40. J.P. Morgan Securities plc
41. Merrill Lynch Capital Services Inc.
42. Merrill Lynch International
43. Merrill Lynch Japan Securities Co., Ltd.
44. Merrill Lynch, Pierce, Fenner & Smith Incorporated
45. Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.
46. Mizuho Bank, Ltd.
47. Mizuho Capital Markets LLC (formerly known as Mizuho Capital Markets Corporation)
48. Mizuho International plc
49. Morgan Stanley & Co. International plc
50. Morgan Stanley & Co. LLC
51. Morgan Stanley Capital Services LLC
52. Morgan Stanley MUFG Securities Co., Ltd.
53. MUFG Bank, Ltd. (formerly known as The Bank of Tokyo-Mitsubishi UFJ, Ltd.)
54. MUFG Securities EMEA plc (formerly stated as MUFG Securities EMEA PLC)
55. NATIXIS
56. NatWest Markets plc (formerly known as The Royal Bank of Scotland plc)
57. Nomura Financial Products & Services, Inc.
58. Nomura Global Financial Products, Inc.
59. Nomura International plc
60. Nomura Securities Co., Ltd.
61. Nomura Securities International, Inc.
62. Nordea Bank Abp (formerly known as Nordea Bank AB)

- 63. RBC Capital Markets, LLC
- 64. RBC Europe Limited
- 65.



### **Annex 3**

#### List of designated CCPs

1. Chicago Mercantile Exchange Inc
2. Japan Securities Clearing Corporation
3. LCH.Clearnet Limited
4. OTC Clearing Hong Kong Limited