

The Delta Report

Derivatives Newsletter

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In this issue of The Delta Report, we bring you further updates on developments in the global derivatives space. In Europe, the focus is on Brexit and the newly-released EU final regulatory standards on the valuation of derivatives for the purpose of bail-in. We also highlight recent rulings of the US Bankruptcy Court and German Federal Court which impact CDO transactions and netting clauses under German law respectively. Across the globe, we continue to provide insight to the latest regulatory developments.

Developments in Asia

OTC Derivatives Reporting and Clearing in Hong Kong – A Snapshot

Background

The first phase of the OTC derivatives regulatory regime in Hong Kong commenced in April 2014 with the enactment of the *Securities and Futures (Amendment) Ordinance 2014* (the “**Amendment Ordinance**”).¹¹⁴ The Amendment Ordinance serves as a broad framework which allows for the implementation of mandatory reporting, clearing, trading and record keeping obligations in respect of OTC derivative transactions. On 10 July 2015, the *Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules* (the “**Reporting Rules**”) came into effect. The Reporting Rules set out the detailed reporting and related record keeping requirements. The Amendment Ordinance and the Reporting Rules together introduced mandatory reporting in Hong Kong in respect of certain interest rate swaps and non-deliverable forwards (“**Phase 1 Reporting**”).

On 30 September 2015, the Hong Kong Monetary Authority (the “**HKMA**”) and the Securities and Futures Commission (the “**SFC**”) issued a joint consultation paper (the “**Consultation Paper**”) to propose the next steps to the OTC derivatives regulatory regime:

- (a) mandatory clearing of certain derivative trades (“**Phase 1 Clearing**”); and
- (b) expansion of the mandatory reporting requirements (“**Phase 2 Reporting**”).

The conclusions of the Consultation Paper (the “**Conclusions Paper**”) were published on 6 February 2016 which included a draft of the *Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules* (“**Clearing Rules**”).

This article provides a snapshot of the current mandatory reporting and clearing requirements and outlines the key proposals under Phase 2 Reporting and Phase 1 Clearing.

Mandatory Reporting

Requirements for consideration	Phase 1 Reporting	Phase 2 Reporting
When do reporting and record keeping requirements commence?	10 July 2015	Expanded reporting regime under Phase 2 Reporting to commence on 1 July 2017. ¹¹⁵
Who needs to report and comply with the record keeping obligations?	Each of the following “Prescribed Persons” is subject to the initial reporting requirements: ¹¹⁶ <ul style="list-style-type: none"> (1) an authorised institution (“AI”)¹¹⁷ (2) an approved money broker (“AMB”)¹¹⁸ (3) a licensed corporation (“LC”)¹¹⁹ 	Central counterparties authorised to provide automated trading services (“ ATS-CCP ”) will be subject to mandatory reporting in its current form (i.e. Phase 1 Reporting) from 1 September 2016. “Product class” and “product type” classifications are to be removed.

¹¹⁴ The Amendment Ordinance amended the Securities and Futures Ordinance.

¹¹⁵ The original commencement date for Phase 2 Reporting was intended to be 1 January 2017.

¹¹⁶ Note: Fund managers and Hong Kong persons (i.e. persons (other than AIs, AMBs, LCs and central counterparties) that are based in or operating from Hong Kong) are excluded at this stage and are likely to be subject to the Reporting Rules in the future (HKMA and SFC, *Consultation Conclusions and Further Consultation on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules*, November 2014, paragraphs 17, 21 and Section III(D)).

¹¹⁷ An authorised institution includes authorised financial institutions incorporated in Hong Kong as well as those incorporated outside Hong Kong (*Reporting Rules*, Rules 11 and 12).

¹¹⁸ *Reporting Rules*, Rules 9 and 13.

¹¹⁹ *Reporting Rules*, Rules 9 and 10.

Requirements for consideration	Phase 1 Reporting	Phase 2 Reporting
	<p>(4) a recognised clearing house acting as a central counterparty (“RCH”)¹²⁰</p> <p>provided that, the Prescribed Person:</p> <p>(1) is a counterparty to the relevant transaction; or</p> <p>(2) in the case of AI, AMB and LC, the relevant transaction was “conducted in Hong Kong”¹²¹ by the Prescribed Person on behalf of its affiliate.</p> <p>and the Prescribed Person is not an “exempt person”.¹²²</p>	<p>Accordingly the US\$30 million limit for “exempt person” relief will be calculated from the whole spectrum of OTC derivative products and not just on a product class basis.</p>
Which products are required to be reported?	<p>(1) Interest rate swaps (“IRS”):¹²³</p> <p>(a) single-currency IRS (floating v fixed); and</p> <p>(b) single-currency basis swaps (floating v floating),</p> <p>each in currencies and floating rate indices specified by HKMA by notice in the Gazette;¹²⁴ and</p> <p>(2) Non-deliverable forwards (“NDF”)¹²⁵ where both the reference currency and the settlement currency are specified currencies specified by HKMA by notice published in the Gazette.¹²⁶</p>	<p>In addition to the products captured under Phase 1 Reporting, all OTC derivative transactions within the 5 key asset classes – interest rate derivatives, FX derivatives, equity derivatives, credit derivatives and commodity derivatives, except that FX forwards entered into for the purposes of buying or selling securities in a foreign currency and which are settled within the settlement cycle¹²⁷ for the securities are excluded.</p>
What information needs to be reported?	<p>(1) Retrospective reporting (i.e. backloading)</p> <p>Applies in respect of transactions to which</p>	<p>Backloading will not apply if the transaction is due to mature within one year of the implementation of</p>

¹²⁰ Reporting Rules, Rules 9 and 14.

¹²¹ For an AI, AMB and LC, it is required to report a transaction that it has “conducted in Hong Kong” (a) on behalf of an affiliate (in the case of any AI, AMB or LC) or (b) on behalf of its head office or its branch/office outside Hong Kong (in the case of an overseas incorporated AI with a Hong Kong branch). A transaction is regarded as “conducted in Hong Kong” if one of the individuals who made the decision to enter into the transaction was a trader employed or engaged by the reporting entity (irrespective of his/her location at the time of entering into the transaction) and the transaction was entered into on behalf of the relevant Prescribed Person’s affiliate (and booked in that affiliate) or the transaction was entered into by the Hong Kong branch of an overseas incorporated AI on behalf of its head office or overseas branch (and booked in such head office or overseas branch) (Reporting Rules, Rule 4. See also SFC, *Frequently Asked Questions on the Reporting Rules*, 10 July 2015, p 11).

¹²² A Prescribed Person is exempted from the reporting obligation if: (i) the sum of the notional amounts of all of its outstanding OTC derivative transactions within the relevant product class does not exceed US\$30 million, (ii) the relevant transaction(s) are not “conducted in Hong Kong” on behalf of the Prescribed Person’s affiliate and (iii) in the case of an AI incorporated outside Hong Kong, it is not a counterparty to the relevant transaction and the transaction is not recorded in its principal place of business (outside Hong Kong) or a branch (other than a local branch) of the Prescribed Person.

¹²³ Includes single currency overnight index swaps (“OIS”) but not forward rate agreements.

¹²⁴ See Gazette dated 10 July 2015.

¹²⁵ Excludes FX spot and NDF swap transactions.

¹²⁶ See Gazette dated 10 July 2015.

¹²⁷ The settlement period is subject to a T+7 cap (Conclusions Paper, paragraph 135).

Requirements for consideration	Phase 1 Reporting	Phase 2 Reporting
	<p>reporting entities are counterparty and not in respect of transactions that they have “conducted in Hong Kong”.¹²⁸</p> <p>(2) Transaction information as set out in Schedule 2 of the Reporting Rules (includes valuation transaction information).</p>	<p>Phase 2 Reporting.</p> <p>Approach to identifying information to be reported changed – data fields for reporting purposes will now be specified by notice in the Gazette.</p> <p>In terms of valuation transaction information, HKMA has clarified that third party valuations are acceptable provided that they are agreed to by both counterparties and calculated on a mark-to-market or mark-to-model basis. Internal valuations are permitted in very limited and exceptional circumstances.</p>
How to report?	Via the electronic reporting system (“HKTR”) to HKMA.	No change.
Timeline for complying with reporting and record keeping obligations	T+2, subject to any transitional arrangements.	No change.

Mandatory Clearing

Requirements for consideration	Phase 1 Clearing
When do the Clearing Rules commence?	Aimed for implementation on 1 September 2016 (subject to completion of legislative process).
Who is subject to the clearing obligation?	<p>Where at least one of the counterparties to the relevant transaction is a Prescribed Person and the other must either be a Prescribed Person or a financial services provider¹²⁹ AND both counterparties (who are Prescribed Persons) have crossed the relevant threshold.¹³⁰</p> <p>Note a proposed exit mechanism from being subject to clearing is contemplated. However it will only be permitted in limited circumstances e.g. if there is a permanent change in the Prescribed Person’s business model or trading profile and its positions do not pose a systemic risk concern.¹³¹</p>
Which transactions are subject to mandatory clearing?	<p>Certain standardised vanilla IRS¹³² entered into between major dealers that exceed the threshold specified for that period:</p> <p>(1) fixed-to-floating swaps (with a minimum tenor of 28 days and a maximum tenor of 10 years) – denominated in HKD, USD, EUR, GBP or JPY with floating rate index being HIBOR, LIBOR, EURIBOR, GBP LIBOR and JPY</p>

¹²⁸ *Reporting Rules*, Rules 9(2), 10(2), 11(2), 12(2), 13(2) and 14(2).

¹²⁹ “Financial Services Provider” refers only to entities on a list prescribed by the SFC with the HKMA’s consent and published in the Gazette (Conclusions Paper, paragraph 76).

¹³⁰ No clearing threshold will apply in respect of financial service providers (Conclusions Paper, paragraph 76).

¹³¹ Conclusions Paper, paragraphs 95-99.

¹³² IRS entered into pursuant to the exercise of a swaption or created as a result of novation due to restructuring of a corporate group could be subject to clearing but IRS that is/are part of a packaged structure or is/are an embedded feature will not be subject to clearing.

Requirements for consideration	Phase 1 Clearing
	<p>LIBOR respectively;</p> <p>(2) basis swaps (with a minimum tenor of 28 days and a maximum tenor of 10 years) – denominated in HKD, USD, EUR, GBP or JPY with floating rate index being HIBOR, LIBOR, EURIBOR, GBP LIBOR and JPY LIBOR respectively; and</p> <p>(3) OIS (with a minimum tenor of 7 days and a maximum tenor of 2 years) – denominated in USD, EUR or GBP with floating rate index being Fed Funds, EONIA and SONIA respectively.</p>
<p>What is the threshold that applies?</p>	<p>In determining whether the threshold has been crossed, the entire portfolio of OTC derivative transactions (minus deliverable FX forwards and FX swaps) will be taken into account. The calculations will be based on gross notional amounts without netting.¹³³</p> <p>The proposed clearing threshold is set at US\$20 billion (at least for the next two years) and which will be measured against:</p> <p>(1) in the case of a locally incorporated Prescribed Person, all of its outstanding positions; and</p> <p>(2) in the case of an overseas incorporated Prescribed Person, only those of its outstanding positions booked in the books of its Hong Kong branch.</p>
<p>Timeline for complying with clearing obligation</p>	<p>T+1</p>
<p>Are there any exemptions or reliefs that apply?</p>	<p><u>Intra-group transactions</u>¹³⁴</p> <p>Intra-group transactions are exempted from the clearing obligation if:</p> <p>(1) the transaction is between a Prescribed Person and its affiliate;</p> <p>(2) the accounts of the Prescribed Person and the affiliate are consolidated in full by the holding company and prepared in compliance with the relevant accounting standards applicable to the holding company;</p> <p>(3) both counterparties are subject to centralised risk evaluation, measurement and control procedures; and</p> <p>(4) the affiliate is an “exempt affiliate” i.e. the Prescribed Person has notified either the HKMA or the SFC that the affiliate is to be regarded as an exempt affiliate and such notice remains in force.</p> <p><u>Jurisdiction-based exemption</u>¹³⁵</p> <p>Transactions booked in one or more pre-identified overseas jurisdictions may be exempted from mandatory clearing if:</p> <p>(1) the relevant transaction is entered into by a Prescribed Person that is not an overseas-incorporated AI or an overseas-incorporated AMB;</p> <p>(2) the relevant jurisdiction is an “exempt jurisdiction” i.e. the Prescribed Person has notified either the HKMA (in the case of an AI or AMB) or the SFC (in the case of an LC) that the jurisdiction in question is to be regarded as an exempt jurisdiction and such notice is still in force; and</p> <p>(3) the aggregate notional amount of relevant OTC derivative transactions</p>

¹³³ Consultation Paper, paragraph 86.

¹³⁴ Consultation Paper, paragraph 125; Conclusions Paper, paragraphs 108-110.

¹³⁵ Consultation Paper, paragraphs 130 and 132; Conclusions Paper, paragraphs 111-112.

Requirements for consideration	Phase 1 Clearing
	<p>booked by the Prescribed Person in an exempt jurisdiction does not exceed:</p> <ul style="list-style-type: none"> (a) in the case of each exempt jurisdiction, 5% of the aggregate notional amount of all relevant OTC derivative transactions entered into by the Prescribed Person (wherever booked), and (b) in the case of all exempt jurisdictions together, 10% of the aggregate notional amount of all relevant OTC derivative transactions entered into by the Prescribed Person (wherever booked).
<p>Is substituted compliance permitted?</p>	<p>Yes, in respect of cross-border transactions that meet the following criteria:</p> <ul style="list-style-type: none"> (1) the transaction is one that is required to be centrally cleared under the clearing requirements of a comparable jurisdiction,¹³⁶ and (2) the transaction must have been cleared through one of the designated central counterparties (“CCPs”)¹³⁷ and in accordance with the laws of that comparable jurisdiction.

¹³⁶ The initial list of “comparable jurisdictions” are members of the OTC Derivatives Regulators Group which are Australia, Brazil, Canada, Member states of the European Union, Japan, Singapore, Switzerland and the United States (Consultation Paper, paragraph 155).

¹³⁷ It is anticipated that both local and overseas CCPs may become designated CCPs for the purposes of the clearing obligation. The relevant CCP must also be a RCH or an ATS under the regime.

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