

COMMISSION IMPLEMENTING DECISION (EU) 2021/1107**of 5 July 2021****on the recognition of the legal, supervisory and enforcement arrangements of Hong Kong for derivatives transactions supervised by the Hong Kong Monetary Authority as equivalent to certain requirements of Article 11 of Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories****(Text with EEA relevance)**

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ⁽¹⁾, and in particular Article 13(2) thereof,

Whereas:

- (1) Article 13 of Regulation (EU) No 648/2012 provides for a mechanism under which the Commission is empowered to adopt equivalence decisions whereby the legal, supervisory and enforcement arrangements of a third country are declared equivalent to the requirements laid down in Articles 4, 9, 10 and 11 of Regulation (EU) No 648/2012 so that counterparties which enter into a transaction within the scope of that Regulation, where at least one of the counterparties is established in that third country, are deemed to have fulfilled those requirements by complying with the requirements set out in that third country's legal regime. The declaration of equivalence contributes to the achievement of the overarching aim of Regulation (EU) No 648/2012 namely to reduce systemic risk and increase the transparency of derivatives markets by ensuring an internationally consistent application of the principles agreed with third countries and laid down in that Regulation.
- (2) Article 11(1), (2) and (3) of Regulation (EU) No 648/2012 which is supplemented by Commission Delegated Regulation (EU) No 149/2013 ⁽²⁾ and Commission Delegated Regulation (EU) 2016/2251 ⁽³⁾, establish the Union's legal requirements concerning the timely confirmation of the terms of an OTC derivative contract, the conduct of a portfolio compression exercise and the arrangements under which portfolios are reconciled in relation to OTC derivative contracts not cleared by a central counterparty ('CCP'). In addition, those provisions lay down the valuation and dispute resolution obligations applicable to those contracts ('operational risk mitigation techniques') as well as the obligations on the exchange of collateral ('margins') between counterparties.
- (3) In order for a third country's legal, supervisory and enforcement regime to be considered equivalent to the regime of the Union in respect of operational risk mitigation techniques and margins requirements, the substantive outcome of the applicable legal, supervisory and enforcement arrangements is to be equivalent to Union requirements set out in Article 11 of Regulation (EU) No 648/2012, ensure protection of professional secrecy that is equivalent to the protection provided for in Article 83 of that Regulation. Furthermore, equivalent legal, supervisory and enforcement arrangements must to be effectively applied in an equitable and non-distortive manner in that third country. The assessment of equivalence therefore encompasses a verification whether the legal, supervisory and enforcement arrangements of a third country ensures that OTC derivative contracts not cleared by a CCP and entered into by at least one counterparty established in that third country do not expose financial markets in the Union to a higher level of risk and consequently do not pose unacceptable levels of systemic risk in the Union.

⁽¹⁾ OJ L 201, 27.7.2012, p. 1.

⁽²⁾ Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to regulatory technical standards on indirect clearing arrangements, the clearing obligation, the public register, access to a trading venue, non-financial counterparties, and risk mitigation techniques for OTC derivatives contracts not cleared by a CCP (OJ L 52, 23.2.2013, p. 11).

⁽³⁾ Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty (OJ L 340, 15.12.2016, p. 9).

- (4) On 1 October 2013, the Commission received the technical advice of the European Securities and Markets Authority ('ESMA') on the legal, supervisory and enforcement arrangements in Hong Kong ⁽⁴⁾, including on the operational risk mitigation techniques applicable to OTC derivative contracts not cleared by a CCP. In its technical advice, ESMA concluded that, given that Hong Kong was still in the process of finalising its regulatory regime for the clearing obligation, non-financial counterparties and risk mitigation techniques for uncleared contracts, it was not in a position to perform a conclusive and complete analysis and deliver a technical advice on those matters.
- (5) The Commission has taken into account the regulatory developments that have occurred in Hong Kong since 2013 and made a comparative analysis of the legal, supervisory and enforcement requirements applicable in Hong Kong. It also assessed that the outcome of those requirements and their adequacy to mitigate the risks arising from OTC derivative contracts not cleared by a CCP could be considered equivalent to the outcome of the relevant requirements laid down in Regulation (EU) No 648/2012.
- (6) The legal, supervisory and enforcement arrangements applicable to 'authorised institutions' ('AIs') (as defined in section 2(1) of the Banking Ordinance ('BO'), consisting of licensed banks, restricted licence banks and deposit-taking companies) in Hong Kong for transactions on non-centrally cleared derivative contracts are set out in Supervisory Policy Manual module CR-G-14 entitled 'Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards' ('the Policy Manual') of the Hong Kong Monetary Authority ('HKMA'), a statutory guideline issued under section 7(3) of the BO. Under the BO, the principal function of the HKMA is to promote the general stability and effective working of the banking system through the regulation of banking business and the business of taking deposits, and the supervision of AIs and their business activities. The purpose of the Policy Manual is to set out minimum standards that the HKMA expects AIs to adopt in relation to margin and other risk mitigation techniques for non-centrally cleared OTC derivatives transactions. The Policy Manual was first published on 27 January 2017 and then updated on 11 September 2020. Some of its requirements are subject to a phase-in in accordance with the international framework and aligned with the existing phase-in in Delegated Regulation (EU) 2016/2251. Non-compliance with the statutory guideline may trigger the review of the authorisation criteria set out in the Seventh Schedule of the BO and as such with regard to its outcome, the statutory guideline may be considered equivalent to a legal requirement in the context of this decision.
- (7) The Policy Manual applies to non-centrally cleared derivatives, with the exception of physically settled foreign exchange ('FX') forwards and swaps, FX transactions embedded in cross-currency swaps associated with the exchange of principal, physically settled commodity forwards and, until further notice, non-centrally cleared single-stock options, equity basket options and equity index options. For the purposes of the Policy Manual, 'non-centrally cleared derivative' refers to an OTC derivative product (as defined in section 1B, Part 1 of Schedule 1 of the Securities and Futures Ordinance ('SFO')) that is not cleared through a central counterparty (as defined in section 2(1) of the Banking (Capital) Rules). That definition of 'non-centrally cleared derivative' should be considered equivalent to that of OTC derivatives in Regulation (EU) No 648/2012. This decision should therefore be taken with respect to arrangements applying to OTC derivatives that are subject to margins under the Policy Manual.
- (8) The Policy Manual generally applies to transactions in non-centrally cleared derivatives conducted between AIs and 'covered entities'. For the purposes of the Policy Manual, 'covered entities' mean financial counterparties, significant non-financial counterparties, or other entities designated by the HKMA, but exclude sovereigns, central banks, public sector entities, multilateral development banks, and the Bank for International Settlements. Under the Policy Manual, 'financial counterparty' refers to any entity for a one-year period from 1 September each year to 31 August of the following year, if the entity itself or the group to which it belongs has an average aggregate notional amount of non-centrally cleared derivatives exceeding HKD 15 billion, and that is predominantly engaged in any of the following activities: banking, securities business, management of retirement fund schemes, insurance business, operation of a remittance or money changing service, lending, securitisation (except where and to the extent that the related special purpose entity enters into non-centrally cleared derivatives transactions for the sole purpose of hedging), portfolio management (including asset management and funds management) and activities that are ancillary to the conduct of those activities. Under the Policy Manual, 'significant non-financial counterparty' refers to any entity other than a financial counterparty for a one-year period from 1 September each year to 31 August of the following

⁽⁴⁾ ESMA/2013/1369, Technical advice on third country regulatory equivalence under EMIR – Hong Kong, Final report, European Securities and Markets Authority, 1 October 2013.

year, that has itself, or the group to which it belongs, an average aggregate notional amount of non-centrally cleared derivatives exceeding HKD 60 billion. The definition of 'covered entities' therefore broadly corresponds to the definition of 'financial counterparty' in Article 2(8) of Regulation (EU) No 648/2012, while excluding in a similar manner special purpose vehicles where the transaction is conducted for the sole purpose of hedging.

- (9) The Policy Manual contains similar obligations to those provided for in Article 11(1) and (2) of Regulation (EU) No 648/2012 and in Delegated Regulation (EU) No 149/2013. In particular, Chapter 4 of the Policy Manual ('Risk mitigation standards') contains specific requirements regarding timely confirmation, portfolio compression, portfolio reconciliation, transaction valuation and dispute resolution applicable to OTC derivative contracts not cleared by a CCP, which could be considered equivalent to those set out in Union law.
- (10) In relation to non-centrally cleared derivatives covered by the Policy Manual, the legal, supervisory and enforcement arrangements applicable should therefore be considered equivalent to the requirements set out in Article 11(1) and (2) of Regulation (EU) No 648/2012 in respect of timely confirmation, portfolio compression and reconciliation, valuation and dispute resolution applicable to OTC derivative contracts not cleared by a CCP.
- (11) Pursuant to the Policy Manual, variation margin must be exchanged and initial margin must be posted and collected for all new non-centrally cleared derivative transactions, with the exception of physically settled FX forwards and swaps, FX transactions embedded in cross-currency swaps associated with the exchange of principal, physically settled commodity forwards, and until further notice, non-centrally cleared single-stock options, equity basket options and equity index options, between an AI and a covered entity according to the internationally agreed phase-in which thresholds expressed in HKD should be considered equivalent to the thresholds used in Delegated Regulation (EU) 2016/2251. Similar exemptions for physically settled FX forwards and swaps and for single-stock equity options or index options are provided for in Articles 37 and 38 of Delegated Regulation (EU) 2016/2251. This Decision should therefore only apply to OTC derivatives contracts that are subject to margin requirements under Regulation (EU) No 648/2012 and the Policy Manual.
- (12) In accordance with the Policy Manual, variation margin is to be called no later than at the end of the following business day and be collected no later than two business days after it has been called. Footnote 64 to the Policy Manual states that if variation margin is exchanged at less than a daily frequency, the number of days in between the collection of variation margin should be added to the 10-day horizon used for the calculation of initial margin under the internal model approach. In case variation margin is exchanged at a varying frequency between the calculations of initial margin amounts, the number of days to be added to the 10-day horizon should be the maximum number of days in between variation margin collections within this period.
- (13) The Policy Manual provides for a combined minimum transfer amount of initial and variation margin of HKD 3,75 million, whereas Article 25 of Delegated Regulation (EU) 2016/2251 provides for an amount of EUR 500 000. Taking into account the marginal difference in the value of those amounts and the common objective of the Policy Manual and Delegated Regulation (EU) 2016/2251, those amounts should be considered equivalent.
- (14) The requirements in the Policy Manual for the calculation of initial margin should be considered equivalent to the requirements set out in Delegated Regulation (EU) 2016/2251. In a manner similar to the standardised method for the calculation of the initial margin set out in Annex IV to Delegated Regulation (EU) 2016/2251, the Policy Manual allows for the use of a standardised approach equivalent to the one laid down in that Annex IV. Alternatively, internal or third party models can be used under the Policy Manual to calculate the initial margin where those models contain certain specific parameters equivalent to those set out in Delegated Regulation (EU) 2016/2251, including minimum confidence intervals and margin periods of risk and certain historical data, including stressed periods. AIs must seek formal approval from the HKMA before using an internal or third-party model (except for an industry-wide standard initial margin model which AIs may use after notifying the HKMA of the intent of doing so and the HKMA would conduct post-implementation review of).

- (15) The requirements in the Policy Manual on eligible collateral and on how that collateral is held and segregated should be considered equivalent to those set out in Article 4 of Delegated Regulation (EU) 2016/2251. The Policy Manual contains an equivalent list of eligible collateral, and AIs are to have appropriate controls in place to ensure that the collateral collected does not exhibit significant wrong-way risk or significant concentration risk. Concentration should be assessed in terms of an individual issuer, issuer type and asset type. Margin rules for OTC derivative contracts not cleared by a CCP contained in the Policy Manual should therefore be considered equivalent to those provided for under Article 11(3) of Regulation (EU) No 648/2012.
- (16) With regard to the level of protection of official secrecy, the Chief Executive of the HKMA and the employees of the HKMA must abide by section 120(1) of the BO to preserve, and aid in preserving, secrecy with regard to all matters relating to the affairs of any person that may come to their knowledge in the exercise of any function under the BO. Subject to permitted exceptions, they must not communicate any such matter to another person (other than the person to whom such matter relates) and must not suffer or permit another person to have access to any records in their possession, custody or control. A person who contravenes any of those requirements is liable to a fine and imprisonment. Section 120(1) of the BO thus provides for official secrecy, including the protection of confidential information shared by the HKMA (under applicable legal disclosure gateways) with third parties, that should be considered equivalent to those set out in Title VIII of Regulation (EU) No 648/2012.
- (17) With regard to the effective supervision and enforcement of the legal arrangements for transactions on non-centrally cleared derivative contracts in Hong Kong, the HKMA has primary responsibility for the monitoring and enforcement of compliance with the Policy Manual through its ongoing risk-based supervisory approach for AIs. The supervisory measures that the HKMA may take include requiring the AI concerned to submit a report under section 59(2) of the BO to identify the root causes of any deficiency in margining or risk mitigation practices for future rectification, and issuing directions under section 52 of the BO to an AI requiring it to strengthen its internal control systems. Moreover, adherence to the Policy Manual will be reflected in an AI's CAMEL rating and/or supervisory review process assessment. Significant non-compliance with the Policy Manual may cause the HKMA to undertake a review of whether the AI remains in compliance with the authorisation criteria in the Seventh Schedule to the BO and whether its management remains fit and proper for its role. Further, though not commonly exercised, the HKMA has the power to revoke or suspend the authorisation of an AI. Those powers are provided for in sections 22(1), 24(1) and 25(1) of the BO. Those provisions should be considered to provide for the effective application of the relevant legal, regulatory and enforcement arrangements under the Policy Manual in an equitable and non-distortive manner and to ensure effective supervision and enforcement equivalent to the supervisory and enforcement arrangements available under the Union legal framework..
- (18) This Decision recognises equivalence of the regulatory requirements set out in the Policy Manual applicable to OTC derivative contracts at the time of adoption of this Decision. The Commission, in cooperation with ESMA, will monitor on a regular basis the evolution of the legal, supervisory and enforcement arrangements for these OTC derivative contracts and their consistent and effective implementation, regarding the timely confirmation, portfolio compression and reconciliation, valuation, dispute resolution and margin requirements applicable to OTC derivative contracts, not cleared by a CCP with respect to which this Decision has been taken. As part of its monitoring efforts the Commission may request the HKMA to provide information on regulatory and supervisory developments. The Commission may undertake a specific review at any time, where relevant developments make it necessary for the Commission to re-assess the declaration of equivalence granted by this Decision. Such re-assessment may lead to the repeal of this Decision, which would as a consequence make counterparties automatically subject again to all requirements laid down in Regulation (EU) No 648/2012.
- (19) The measures provided for in this Decision are in accordance with the opinion of the European Securities Committee,

HAS ADOPTED THIS DECISION:

Article 1

For the purposes of Article 13(3) of Regulation (EU) No 648/2012, the legal, supervisory and enforcement arrangements of Hong Kong for timely confirmation, portfolio compression and reconciliation, valuation and dispute resolution that are applicable to non-centrally cleared derivative transactions regulated by the Hong Kong Monetary Authority ('HKMA') shall be considered equivalent to the requirements set out in paragraphs 1 and 2 of Article 11 of that Regulation where at least one of the counterparties to such a transaction is an authorised institution as defined in section 2(1) of the Banking Ordinance and subject to the risk mitigation requirements set out in the HKMA's Supervisory Policy Manual module CR-G-14 entitled 'Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards'.

Article 2

For the purposes of Article 13(3) of Regulation (EU) No 648/2012, the legal, supervisory and enforcement arrangements of Hong Kong for the exchange of collateral that are applicable to non-centrally cleared derivative transactions regulated by the HKMA shall be considered equivalent to the requirements set out in Article 11(3) of that Regulation.

Article 3

This Decision shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Done at Brussels, 5 July 2021.

For the Commission
The President
Ursula VON DER LEYEN
