

MAS Consultation on OTC Derivatives Reform

MAS issues two consultation papers in respect of regulation of the over-the-counter derivatives market and regulatory oversight of OTC commodity derivatives in Singapore

The Monetary Authority of Singapore (MAS) has on 13 February 2012 issued two consultation papers in respect of the over-the-counter (OTC) derivatives market in Singapore:

- a consultation paper on the proposed regulation of OTC derivatives including, amongst other things, the introduction of mandatory clearing and reporting of OTC derivatives trades and the implementation of a regulatory regime for market operators, clearing facilities, trade repositories (TRs) and market intermediaries for OTC derivatives trades (referred to in this client briefing as the MAS Consultation Paper); and
- a consultation paper on the proposed transfer of regulatory oversight of commodities derivatives from International Enterprise Singapore Board (IE) to MAS (referred to in this client briefing as the MAS/IE Consultation Paper).

The former also outlines MAS's current thinking in respect of regulating the OTC derivatives market through amendments to the Securities and Futures Act (SFA).

Consultation process

The deadline by which comments should reach MAS is **26 March 2012**. Clifford Chance has formed a team of lawyers, highly experienced in the sectors affected by these proposals (as detailed below), to respond to the consultation papers. We would be pleased to guide you through the response process and assist you with any questions you may have.

Initiatives contained in the MAS Consultation Paper

This consultation has long been anticipated as part of global market reforms for strengthening financial stability coming out of the commitments made by the G-20 in Pittsburgh in September 2009. Following this, in October 2010, a report from the Financial Stability Board (FSB) to G-20 Finance Ministers and Central Bank Governors made 21 recommendations addressing practical issues that authorities may encounter in implementing the proposed market reforms.

These recommendations included the following relating to OTC derivatives:

- increased standardisation of OTC products' contractual terms and operational processes;
- a requirement that all standardised derivatives contracts be centrally cleared through central counterparties (CCPs);
- a requirement that all standardised derivatives contracts be traded on exchanges or electronic trading platforms;
- a requirement that all OTC derivatives contracts (regardless of whether they are eventually centrally cleared) be reported to trade repositories (TRs); and

- increased capital and/or margin requirements in respect of derivatives contracts that are not centrally cleared.

Although Singapore is not a member of the G-20, it is a member of the FSB and accordingly is committed to changing the Singapore legislative and regulatory framework to achieve the G-20 commitments in respect of OTC derivatives reform. In line with this, MAS announced in July 2011 that it will meet the objectives set by the G-20 as well as recommendations by the FSB on the implementation of these objectives. The MAS Consultation Paper follows such announcement and sets out the current thinking of MAS on some of the key aspects of a new regulatory regime for the OTC derivatives market in Singapore.

The key proposals considered in the MAS Consultation Paper are as follows:

- i. the expansion of the scope of the SFA to regulate OTC derivatives activities;
- ii. the introduction of mandatory central clearing of derivative contracts (clearing mandate);
- iii. the introduction of mandatory reporting of derivative contracts (reporting mandate);
- iv. the introduction of mandatory trading of derivative contracts on exchanges or electronic trading platforms (trading mandate);
- v. the enhancement of the current regulatory framework for market operators, clearing facilities, TRs and capital markets intermediaries in respect of OTC derivatives.

Regulatory proposals in connection with capital requirements in respect of non-centrally cleared derivatives are being considered as part of the consultation on proposed amendments to introduce Basel III capital standards, while those in connection with margin requirements will be consulted on by MAS at a later stage.

A brief summary of some of the more important proposals set out in the MAS Consultation Paper is set out below.

Expansion of the scope of the SFA

It is proposed that the scope of the SFA be expanded to regulate OTC derivatives activities. This will be achieved by the introduction of a new class of instruments called "derivative contracts" in the SFA. The proposed new class will encompass the five major underlying asset classes where derivatives are currently traded over-the-counter: commodities, credit, equities, foreign exchange and interest rates.

To align the treatment for securities and futures contracts (which are currently covered by the SFA) and OTC derivatives contracts, MAS will consider amendments to the SFA at a later stage.

Clearing mandate

The approach taken by MAS is that only derivatives contracts falling within identified products types and booked in a specified manner by relevant entities are subject to mandatory clearing.

Types of products

Not all products will be subject to mandatory clearing. To determine products that will be subject to mandatory clearing, MAS proposes to adopt the following approaches:

- a bottom-up approach where an eligible CCP submits to MAS a written application requesting MAS to consider a product or a set of products to be subject to mandatory clearing; and
- a top-down approach where MAS initiates a review to determine such products.

The proposed criteria for determining whether a product should be subject to mandatory clearing include the following:

- level of systemic risk posed by the product;
- product characteristics and level of standardisation of contractual terms and operational processes;
- depth and liquidity of the market for the product;
- availability of fair, reliable and generally accepted pricing sources;
- robustness of the relevant CCP's risk management systems; and
- international regulatory approach towards the product and anti-competitive considerations.

MAS is proposing to initially mandate clearing for SGD interest rate swaps (IRS), USD IRS and non-deliverable forwards (NDFs) denominated in selected Asian currencies, while exempting foreign exchange forwards and swaps.

Types of contracts

In respect of a product subject to mandatory clearing, MAS is proposing to require mandatory clearing for all such derivatives contracts where at least one leg of the contract is booked in Singapore and either:

- a) both parties to the contract are resident or have presence in Singapore and are subject to the clearing mandate (see below for further elaboration); or
- b) one party to the contract is resident or has presence in Singapore and is subject to the clearing mandate, and the other party would have been subject to the clearing mandate if it had been resident or had presence in Singapore.

The scope of the clearing obligation is not intended to include any derivatives contract between two entities who are neither resident nor having a presence in Singapore unless such an obligation is "necessary or appropriate to prevent the evasion of Singapore's derivatives regulations".

MAS is proposing the backloading of outstanding derivatives contracts (that are subject to mandatory clearing) with remaining maturity of more than one year.

Types of entities

Only certain entities are "subject to the clearing mandate". It is proposed that only financial entities (being financial institutions regulated by MAS) and non-financial entities with derivatives exposure above a certain threshold (clearing threshold) be subject to the clearing mandate.

Financial entities with minimal exposure to derivative contracts may, however, be excluded.

With respect to non-financial entities, it is proposed that hedging transactions by such entities be excluded when determining whether their derivatives exposure exceeds the clearing threshold.

Exemptions

It is proposed that central banks, central governments and supra-national organisations will be exempt from the clearing obligation.

MAS is considering exempting intra-group transactions from mandatory clearing, but subjecting such trades to collateralisation requirements.

Location of CCPs

MAS does not propose to mandate clearing at a domestic CCP. Instead it will allow clearing at foreign CCPs which satisfy requirements under a proposed new recognition framework (see below for further elaboration).

Reporting mandate

The approach taken by MAS is that derivatives contracts (phased in according to identified product types) booked or traded in a specified manner by relevant entities are subject to mandatory reporting.

Types of products

Derivative contracts across all five asset classes are proposed to be subject to mandatory reporting. However, a phased implementation is suggested and the initial products earmarked for mandatory reporting are interest rate derivatives, foreign exchange derivatives and oil derivatives.

Types of contracts

It is proposed that only derivative contracts (of the relevant product type) that are booked or traded in Singapore be reported to an eligible TR.

MAS proposes the backloading of pre-existing contracts with a remaining maturity of greater than one year.

Types of entities

MAS proposes to require all financial entities and non-financial entities with derivatives exposure above a certain threshold (reporting threshold) to be subject to mandatory reporting. It would appear that the reporting threshold may not be the same as the clearing threshold. It is notable that, unlike in respect of the clearing threshold, there is no mention of excluding hedging transactions when determining whether a non-financial entity's derivatives exposure exceeds the reporting threshold.

Manner and timing of reporting

MAS is open to single-sided reporting (i.e. where there is reporting by one party only) as well as the use of a third party (such as a CCP or electronic trading platform) to report on parties' behalf. MAS nevertheless expects all the parties to the derivative contract to retain responsibility for the timeliness and accuracy of the information provided.

It is proposed that the reporting of contracts (and any updates) be done within one business day of the transaction.

Location of TR

As with mandatory clearing, MAS does not propose to mandate reporting at a domestic TR. Instead it will allow reporting to foreign TRs which satisfy requirements under a proposed new recognition framework (see below for further elaboration).

Trading mandate

There is no proposal to introduce mandatory trading of OTC derivatives on exchanges or electronic platforms at this stage. That said, MAS proposes to work with the industry to study further whether (taking into consideration the characteristics of the OTC derivative market in Singapore) such a trading mandate would be practicable and provide benefits over and above those from standardisation, central clearing and reporting of derivative contracts to TRs. MAS also proposes to continue to engage the industry on suitable initiatives to encourage trading on organised platforms. As such, a consultation on whether to introduce a trading mandate may occur at a later date.

Enhancement of the current regulatory framework for market participants

Market operators

In line with the IOSCO recommendation in respect of regulation of centralised trading platforms, MAS proposes to regulate trading platforms for derivative contracts that satisfy certain criteria.

It is proposed that the current two-tier regulatory regime that is applicable to approved exchanges (AEs) and recognised market operators (RMOs) be extended to entities that establish or operate derivatives markets. Corporations operating derivatives markets that are systemically-important will be regulated by MAS as AEs.

For overseas RMOs, recognising that there are limits to which MAS can assume direct oversight, MAS proposes to place reliance on the home regulatory regimes of such overseas RMOs and coordination between MAS and the home regulators to supervise such overseas RMOs. Requirements imposed on an overseas RMO will be deemed to be met if it is subject to comparable requirements in its home jurisdiction, its home regulator has signed a memorandum of understanding with MAS and it submits a self-assessment report on a regular basis. However if MAS imposes a higher standard than the home jurisdiction, the higher standard will have to be complied with.

Clearing facilities

Facilities for the clearing or settlement of derivative contracts are proposed to be added to the existing definition of "clearing facilities" in the SFA. At the same time, it is proposed that the current designation approach for regulating clearing facilities be changed to an authorisation framework with a two-tier regime applicable to approved clearing houses (ACHs) and recognised clearing houses (RCHs). All clearing facilities performing the role of CCPs will generally be considered to be systemically-important clearing facilities and regulated as ACHs.

Overseas RCHs will be regulated in a similar manner as overseas RMOs as stated above. In addition, for an overseas RCH that performs the role of a central counterparty, a comparable regime is one that subjects the RCH to standards on par with that of an ACH under the SFA.

TRs

Only TRs that collect and disseminate data on derivatives contracts subject to the reporting mandate will be subject to regulation. There will be two categories of TRs: locally-incorporated TRs will be regulated as approved TRs (ATRs) while foreign-incorporated TRs will be regulated as recognised overseas trade repositories (ROTRs).

ROTRs will be regulated in a similar manner to overseas RMOs as stated above.

Moving away from the US approach which requires foreign regulators requesting data from a TR licensed in the US to indemnify the TR and the regulator for any expenses arising from litigation related to data provided by the TR, MAS has stated that it is not inclined to require foreign regulators to provide indemnification to an ATR or ROTR and to MAS prior to obtaining data from the ATR or ROTR.

Capital markets intermediaries

Recognising that the two main groups of capital markets intermediaries operating in the OTC derivatives market are banks licensed under the Banking Act and non-bank intermediaries and the current gap that the latter (other than where conducting existing regulated activity) are not regulated by MAS, MAS proposes to regulate such non-bank intermediaries. As such, non-bank intermediaries which deal in derivative contracts where the underlying asset class is equity, interest rate, foreign exchange, credit or commodity will require a Capital Markets Services licence under the SFA to conduct dealing in derivatives contracts.

A new regulated activity of "dealing in derivatives contracts" will be included in the SFA.

Potential exemptions from such regulation include ones that apply to certain derivatives brokers and end-users. End-users may however be subject to the clearing and reporting mandates mentioned above.

Initiatives contained in the MAS/IE Consultation Paper

Transfer of regulatory oversight

As a consequence of the proposed expansion of the scope of the SFA to include derivative contracts on the major asset classes (which include commodities), commodity derivative contracts will come under the ambit of the SFA. To avoid overlap of regulation of commodity derivatives which currently falls under the Commodity Trading Act (CTA) regulated by the IE, this consultation paper proposes for MAS to take over regulatory oversight of commodity derivatives under the SFA.

Scope of SFA regulation

Pursuant to the proposals under the MAS Consultation Paper, regulation of OTC commodity derivatives markets, clearing facilities and market intermediaries will be included under the SFA.

While assuming regulatory oversight of OTC commodity derivatives, MAS proposes to preserve the status quo in connection with the scope of commodity types being regulated. As such, only derivatives contracts in respect of tangible commodities will continue to be regulated. However, there will remain the power to include intangible commodity derivatives contracts by way of prescription in the future where necessary.

It is proposed that physically-settled commodity forward contracts be excluded from regulation under the SFA.

CTA regulation

The revised CTA will only regulate spot commodity trading.

Timetable

Significant legislative and regulatory amendments will be required to ensure compliance. No timetable is set out in the MAS Consultation Paper, although the MAS/IE Consultation Paper states that the proposed transfer of regulatory oversight of commodity derivatives from IE under the CTA to MAS under the SFA is targeted for Q4 of 2012.

Significant impact on business

The proposed new regulatory regime on which views are now being sought will have a significant impact on the way in which market players conduct their business in the OTC derivatives market in Singapore.

It is important to remember that this is only part of a much larger global review of financial markets generally which will have far-reaching consequences on the conduct of cross-border business (see *CC briefing papers "OTC derivatives reforms – Impact on cross-border business – July 2011"* and *"HKMA and SFC begin joint consultation process relating to the reporting, clearing and trading of OTC derivatives in Hong Kong – October 2011"*).

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