

MAS REVIEWS REGULATION OF DERIVATIVES MARKET IN SINGAPORE

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On 13 February 2012, the Monetary Authority of Singapore ("**MAS**") issued a consultation paper on its proposals to expand the scope of the Securities and Futures Act ("**SFA**") to regulate over the counter ("**OTC**") derivatives. This move is pursuant to MAS' July 2011 announcement that it would meet the objectives set by the G20 committee and recommendations made by the Financial Stability Board ("**FSB**"), following the global financial crisis, to improve the regulation and supervision of OTC derivatives and strengthen the international financial regulatory system.

After the Lehman crisis of September 2008, the G20 summit was held in 2009 where the finance ministers from the G20 group proposed a central clearing system to minimize the counterparty risks in the OTC derivatives market. A central counterparty ("**CCP**") is a clearing facility that provides a service by which a party to a transaction substitutes, through novation or otherwise, the credit of a clearing facility for the credit of its counterparty to the transaction. CCPs allow for multilateral netting of transactions and thus are argued to reduce counterparty credit risk. Singapore is one of the major derivatives markets in Asia attracting trade of about US\$9.8 trillion a year, mainly relating to interest rates, foreign exchange and oil. Currently, the Singapore Exchange ("**SGX**") is the only clearinghouse in Singapore for OTC derivatives and some banks have their own in-house e-trading platform for OTC products. The proposals have generally been welcomed by institutions who dominate trading of OTC derivatives and will likely have a significant impact on the OTC derivatives market when passed as legislation.

The proposals in the consultation paper ("**CP**") are summarised below.

Expanding the scope of SFA to regulate OTC derivatives

MAS proposes to introduce a new class of instruments to the SFA - "derivative contracts" - which will encompass commodities, credit, equities, foreign exchange and interest rate derivatives, thereby bringing the major asset classes of the derivatives market within the SFA's ambit.

Clearing mandate: MAS proposes mandatory clearing of derivatives contracts.

Scope of the clearing mandate

1. **Products:** As not all products may be suitable for mandatory clearing MAS proposes to adopt either a "bottom-up" or "top-down" approach to determine products for mandatory clearing. Foreign exchange forwards and swaps will be exempted from this clearing obligation as the main systemic risk arising from these products are settlement risks which are already mitigated by an international settlement process.

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2. **Contracts:** Central clearing will be required for all derivative contracts where at least one leg of the contract is booked in Singapore and either both contracting parties are resident or have presence in Singapore, or one party is resident/has a presence in Singapore and the other party would have been subject to the clearing mandate if it had been resident/had a presence in Singapore. Where neither party is resident/has a presence in Singapore this clearing obligation will not apply unless it is necessary or appropriate to prevent the evasion of Singapore's derivatives regulations.
3. **Entities:** All financial entities (i.e. financial institutions regulated by MAS) and non-financial entities above relevant thresholds will be subject to mandatory clearing of derivatives contracts. In calculating the threshold for non-financial entities, MAS proposes to take into account that entity's assets and derivatives exposure. However, hedging transactions by such entities will not be considered when calculating derivatives exposure.

The following entities will be exempt from the clearing obligations:

- Entities with minimal exposure to derivative contracts
- Public bodies: central banks, central governments and supra-national organisations.
- Intra-group trades. These entities will, however, be subject to bi-lateral collateralisation.
- Pension schemes.

Risk mitigation measures for derivative contracts

Financial entities entering into derivative contracts not cleared by a CCP should ensure appropriate measures are in place to mitigate risks arising from such transactions.

Reporting mandate: MAS proposes mandatory reporting of clearing mandates to a trade repository ("TR") to enhance the regulator's ability to assess systemic risk. Potentially, data collected from reporting could also be used for market surveillance and enforcement, and supervision of market participants.

Scope of reporting mandate:

1. **Products:** MAS proposes that derivative contracts across all asset classes be reported to TRs. However, this requirement will be implemented in phases, focusing on mandatory requirement for products and assets which form a significant part of Singapore's OTC derivatives market. Thus mandatory reporting will apply initially to (a) interest rate derivatives (b) foreign exchange derivatives (c) oil derivatives.
2. **Contracts:** All contracts subject to the reporting mandate which are booked or traded in Singapore will need to be reported to an eligible TR. An eligible TR is one that is either recognised or approved

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by MAS to provide trade reporting services to entities subject to reporting obligations in respect of relevant derivative contracts in Singapore. Where there are no eligible TRs the entity will report directly to MAS.

3. **Entities:** All financial entities and non-financial entities above a certain threshold, based on asset size, will be required to report their derivative contracts to TRs. Singapore-incorporated banks will be subject to a group-wide reporting obligation so that supervision will be effectively consolidated. TRs may also allow single-side reporting or the use of third-party service providers by entities to fulfil this requirement.
4. **Public bodies:** All public bodies listed above will be exempt.

Information to be reported

MAS will adopt international data reporting and aggregation standards recommended by CPSS-IOSCO. Such data will include transaction economics, counterparty information, information on the underlying entity, operational data and event data. MAS will also encourage parties to adopt a legal entity identifier and product classification system as forms of unique identifiers to facilitate data aggregation.

Trading mandate: While the G20 leaders agreed that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, MAS will not be introducing a trading mandate.

In the IOSCO Report on Trading of OTC Derivatives, the benefits of trading on organised platforms was counterbalanced by costs such as restriction of trading venue choice, limitations on platforms and costs of change and uncertainty. No other jurisdictions have proposed requirements concerning the mandatory trading of OTC derivatives on exchanges or electronic platforms, except for the US and Europe. In the US, the Commodity Futures Trading Commission and SEC specified that an OTC derivative contract subject to mandatory central clearing must also be traded on a Swap Execution Facility or a Designated Market Contract. In Europe, the revised Markets in Financial Instruments Directive proposes to require sufficiently liquid OTC derivatives to be traded on exchanges or Organised Trading Facilities.

MAS will be working with the industry to better understand the costs and benefits of a trading mandate.

The regulatory framework for market operators: MAS proposes to enhance the current regulatory regime and extend it to operators of derivative contract markets ("**DMO**").

Definition of derivative markets

MAS will regulate trading platforms for derivative contracts which exhibit certain key attributes, for example, systematic and recurring transactions are made on the trading platform, and buyers and sellers have reasonable expectations of transacting based on the information on the trading platform.

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The regulatory regime for derivative market operators

DMOs will need to be authorised by MAS and be subject to certain ongoing obligations. The current regulatory regime will be extended to DMOs so that a corporation operating a systemically important market will be regulated as an approved exchange ("**AE**") and a corporation operating another market will be regulated as a recognised market operator ("**RMO**").

The refinement to the current regime for RMOs

MAS intends to differentiate how locally incorporated RMOs and overseas RMOs are regulated by imposing additional criteria on both types of RMOs affecting their business rule. In addition to the current admission criteria, RMOs will be expected to have a minimum base capital, maintain financial resources and its key officers should have sufficient work experience with at least 5 years experience relevant to the operation of a market.

The regulatory framework for clearing facilities: Clearing facilities perform the role of CCPs or of facilitating securities settlement and are presumed to be systemically important. MAS proposes to recalibrate the current approach to regulating clearing facilities and to bring persons operating clearing facilities for market operators under the purview of the SFA.

Definition of derivatives clearing facilities

The current definition of "clearing facilities" in the SFA will be extended to the clearing or settlement of derivatives contracts.

New authorisation framework for clearing facilities

MAS will move to an authorisation framework for all clearinghouses. A two-tier approach is proposed where systemically important clearing facilities will be regulated as an approved clearinghouse and all other clearing facilities will be recognised clearinghouses. As with RMOs, clearing facilities will be subject to admission criteria pertaining to their fitness and propriety.

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Insolvency protection

The insolvency provisions of Division 4 of Part III of the SFA will be extended to all approved and recognised clearinghouses.

The regulatory framework for trade repositories ("TR"): TRs collect and disseminate information about trades transacted by market participants. MAS proposes to regulate TRs since they perform a crucial role in the aggregation of data regarding trades transacted by market participants, provide transparency on trading activities and facilitate risk reduction and operational efficiency.

Scope of Regulation

MAS will not be regulating all entities which collect/disseminate data since data may be collected for private use, research or other purposes not necessitating regulation. Thus TRs which will be subject to regulation under the SFA will be defined as "a facility for the collection and dissemination of data on derivative contracts that are subject to a reporting mandate".

Authorisation framework for TRs

TRs which have to be authorised by MAS will be subject to a single-tier regulatory regime. The two categories of TRs which will be regulated are: (i) Approved trade repository, which is locally incorporated TRs and (ii) Recognised overseas trade repository, for foreign incorporated TRs.

Both categories will be subject to the same standards on risk management and requirements in relation to the collection, maintenance and dissemination of data. However, the requirements on the overseas TR will be deemed to be met if it is subject to comparable obligations in its home jurisdiction. These standards will be adapted from international standards, which have yet to be finalised.

The regulatory framework for capital market intermediaries: MAS proposes to require non-bank intermediaries which deal in derivative contracts where the underlying is equity, interest rate, foreign exchange, credit or commodity to hold a Capital Markets Services licence to conduct the regulated activity of dealing in derivative contracts. However, brokers will be exempt from this requirement if they do not take any principal position, hold customers' positions and deal only with institutional investors.

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