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Contributing Editor:
Jonathan Gilmour
Travers Smith LLP

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Expert Analysis Chapter

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Jonathan Gilmour & Tom Purkiss, Travers Smith LLP

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1 Documentation and Formalities

1.1 Please provide an overview of the documentation (or framework of documentation) on which derivatives transactions are typically entered into in your jurisdiction. Please note whether there are variances in the documentation for certain types of derivatives transactions or counterparties; for example, differences between over-the-counter ("OTC") and exchange-traded derivatives ("ETD") or for particular asset classes.

In Hong Kong, derivatives transactions are typically documented using the framework of documentation published by the International Swaps and Derivatives Association ("**ISDA**").

OTC derivatives are customised contracts entered directly between two counterparties, and their documentation would typically include ISDA Master Agreements (1992 or 2002 versions), Credit Support Annex or Credit Support Deed where credit support is involved, and Confirmations that outline the commercial and other specific terms of the transactions. On the other hand, ETDs are standardised contracts traded on an exchange, and their documentation is usually based on the standard forms and following the rules and regulations of the appropriate exchanges, which ensures a more uniform approach to these ETD transactions.

Additionally, there may be variations in the documentation for particular asset classes, such as interest rate derivatives, credit derivatives, or equity derivatives. These variations would be reflected in the product-specific definitions and Confirmations that supplement the ISDA Master Agreements to cater to the unique features of each asset class.

ISDA's published definitions for the key asset classes (namely interest rates, foreign exchange ("**FX**"), equities, credit and commodities) include the: 2021 ISDA Interest Rate Derivatives Definitions, refining the previous 2006 ISDA Definitions; ISDA FX and Currency Option Definitions, applicable to FX and currency option transactions; 2002 ISDA Equity Derivatives Definitions for equity derivatives transactions, such as equity swaps, options, and forwards; 2014 ISDA Credit Derivatives Definitions for credit derivatives transactions, such as credit default swaps and credit-linked notes; and ISDA Commodity Definitions, covering commodity derivatives transactions, such as commodity swaps, options, forwards, and futures.

Furthermore, on 28 February 2022, ISDA published the 2022 ISDA Securities Financing Transactions ("**SFT**") Definitions and the SFT Schedule Provisions, allowing derivatives and SFT transactions that include derivatives, repos and stock loans to be documented under a single ISDA Master Agreement and enabling such derivatives, repos and stock loans to be governed by a single close-out netting arrangement under the ISDA Master Agreement.

This chapter focuses on OTC derivatives unless otherwise expressly stated.

1.2 Are there any particular documentary or execution requirements in your jurisdiction? For example, requirements as to notaries, number of signatories, or corporate authorisations.

In Hong Kong, there are no derivative-specific documentary or execution requirements under the law, as long as they comply with the company's constitutional documents and are executed within its corporate powers. Corporate authorisation documents, including board resolutions and, where applicable, shareholder resolutions and directors' certificates, are typically required. However, certain transactions may require additional terms depending on market practices. For instance, banks often apply their own standard terms to FX and equity derivatives transactions, which may dictate particular documentary or execution requirements.

1.3 Which governing law is most often specified in ISDA documentation in your jurisdiction? Will the courts in your jurisdiction give effect to any choice of foreign law in the parties' derivatives documentation? If the parties do not specify a choice of law in their derivatives contracts, what are the main principles in your jurisdiction that will determine the governing law of the contract?

In Hong Kong, English law is most often specified in ISDA documentation as the governing law of derivatives transactions. New York State law is also sometimes used. It is also not uncommon to see Hong Kong law-governed derivatives transactions with local banks and corporates, especially for derivatives products in the private banking sector and in retail structured products. The choice of a foreign law in derivatives documentation will be valid and given effect by Hong Kong courts, provided that such choice of law has been made in good faith, does not contravene Hong Kong public policy and is not intended to evade the provisions of another legal system with which the parties have a closer connection. Parties to a transaction often require legal opinions that the overall agreement will be enforceable under the proposed foreign law and the proposed foreign governing law would be given effect by Hong Kong courts.

If the parties do not specify a choice of law in their derivatives contracts, under Hong Kong conflicts of law rules, the governing law would be the law that has the "most real and substantial connection" with the transaction. However, in a

cross-border trade, this determination may be difficult and could be a matter of debate between the parties, and a Hong Kong court would likely consider various factors. It is, however, very rare to find a properly documented derivatives contract where a choice of law is not specified.

2 Credit Support

2.1 What forms of credit support are typically provided for derivatives transactions in your jurisdiction? How is this typically documented? For example, under an ISDA Credit Support Annex or Credit Support Deed.

There are two main ways in which collateral is taken in Hong Kong: "security interest"; and "title transfer". The types of credit support provided in each transaction can vary, but may include cash, debt or equity securities, or guarantees or letters of credit from third-party financial institutions. Hong Kong parties to derivatives transactions often document credit support using either an ISDA Credit Support Annex or Credit Support Deed. For example, in the case of title transfer, the 1995 ISDA Credit Support Annex (Transfer – English law) or the 2016 ISDA Credit Support Annex for Variation Margin (VM) (Transfer – English law) is used, or where a security interest arrangement is contemplated, the ISDA 2018 Credit Support Deed for Initial Margin (IM) (Security Interest – English law) can be used. Other bespoke documentation can also be used.

2.2 Where transactions are collateralised, would this typically be by way of title transfer, by way of security, or a mixture of both methods?

Collateral in derivatives transactions can be taken in various ways depending on the nature of the transactions. For example, hedges for secured debt transactions are usually collateralised through security documents that secure the principal debt transaction, rather than through a separate Credit Support Annex or Deed. More information on this topic can be found in question 2.1.

2.3 What types of assets are acceptable in your jurisdiction as credit support for obligations under derivatives documentation?

There are two principal classes of collateral assets that are generally acceptable in Hong Kong as credit support for obligations under derivatives documentation: (i) cash and liquid equity; and (ii) fixed-income securities such as listed shares, US treasuries, corporate bonds and other readily marketable debt securities. Marketable debt securities are often issued or fully guaranteed by a sovereign, a relevant international organisation, a multilateral development bank or a public sector entity. The specific types of acceptable assets may depend on the nature of the transaction and the creditworthiness of the parties involved. In Hong Kong, where the counterparty borrower is a sizable PRC corporation and when it enters into hedges in connection with its underlying loan obligations, it is also common to see the use of standby letters of credit issued by a third-party bank as credit support.

2.4 Are there specific margining requirements in your jurisdiction to collateralise all or certain classes of derivatives transactions? For example, are there requirements as to the posting of initial margin or variation margin between counterparties?

Yes. In Hong Kong, the Hong Kong Monetary Authority ("**HKMA**") expects authorised institutions ("**AIs**") to adopt margins and other risk mitigation standards for non-centrally cleared OTC derivatives transactions. The collateral requirements for non-cleared OTC derivatives are outlined in Module CR-G-14 of the HKMA's Supervisory Policy Manual ("**SPM**"), titled "Non-Centrally Cleared OTC Derivative Transactions – Margin and other Risk Mitigation Standards" ("**Margin Rules**"). The Margin Rules include the requirements of posting initial margin ("**IM**") and variation margin ("**VM**") between counterparties in order to mitigate potential losses in events of default. Starting from 1 September 2022, Hong Kong has implemented the final phase of the IM requirements.

Covered products

The Margin Rules apply when AIs such as banks and approved money brokers, whether or not incorporated in Hong Kong, have entered into derivatives instruments on "covered products" with a "covered entity" (but if the AI is not locally incorporated, only in respect of non-cleared derivatives booked in its Hong Kong branch).

"Covered products" under the Margin Rules include: (i) all non-centrally cleared derivatives transactions, with the exception of repurchase agreements and securities lending transactions, which are not themselves derivatives but share some attributes with derivatives; (ii) indirectly cleared derivatives; (iii) physically settled FX forwards and FX swaps; (iv) the "FX transactions" embedded in cross-currency swaps associated with the exchange of principal; (v) physically settled commodity forwards; and (vi) non-centrally cleared single-stock options, equity basket options and equity index options (note: in light of the different approaches currently adopted by other jurisdictions on these non-centrally cleared equity options, the HKMA has extended the exemptions on these products until further notice).

There are also exemptions covering intragroup transactions between entities that are subject to consolidated supervision and meet certain requirements, and for transactions entered into by a securitisation special purpose vehicle ("**SPV**") for the sole purpose of hedging.

Covered entities

A "covered entity" is either a "financial counterparty" or a "significant non-financial counterparty".

A "financial counterparty" includes: (i) an AI, a corporation licensed by the Securities and Futures Commission ("**SFC**"), a Mandatory Provident Fund scheme, an authorised insurer, a licensed money lender, a collective investment scheme ("**CIS**"), a private equity fund, and an SPV or special purpose entity (but excludes an SPV that enters into uncleared derivatives transactions for the sole purpose of hedging); and (ii) a financial entity that belongs to a consolidated group for which the average aggregate notional amount ("**AANA**") of derivatives transactions exceeds HKD 15 billion.

A "significant non-financial counterparty" is any entity that: (i) is not a financial counterparty; and (ii) belongs to a consolidated group for which the AANA of derivatives transactions exceeds HKD 60 billion.

AANA threshold

AIs must exchange VM for all relevant non-centrally cleared derivatives entered into with a "covered entity" from 1 March 2017 to fully collateralise the current exposures of the derivatives transactions. Furthermore, as of 1 September 2022, AIs must exchange IM in respect of all relevant non-centrally cleared derivatives entered into with a "covered entity", where both the AI and "covered entity" have an AANA of these derivatives transactions exceeding HKD 60 billion in any one-year period (the "**AANA threshold**") (calculated from 1 September to 31 August).

IM threshold
Despite the AANA threshold, an AI may agree with a "covered entity" not to exchange IM if the amount due is equal to or lower than HKD 375 million (the "**IM threshold**"). The threshold is applied and shared at the level of the respective consolidated groups to which the AI or the covered entity belongs, and is based on all outstanding non-centrally cleared derivatives transactions between the two consolidated groups.

An investment fund managed by an investment advisor will be considered a separate entity for the purpose of applying the IM threshold as long as the fund is a distinct segregated pool of assets (from the assets of its investment advisor) and would be treated as such in insolvency or bankruptcy scenarios of either the fund or the investment advisor, and the fund is not collateralised, guaranteed or otherwise supported by the investment advisor or any other investment fund managed by the investment advisor.

There are also various requirements for safeguarding the IM collected. For example, it is preferable to hold the IM collected under custodian arrangements, ideally managed by third-party custodians; alternatively, sufficient asset segregation measures should be implemented, accompanied by legally valid documentation. Additionally, except limited exceptions, the re-hypothecation, re-pledging, or any form of reuse of the IM collected is prohibited under the terms of the relevant contracts, such as custodian agreements.

SFC regime
In parallel, the SFC had also proposed and consulted upon similar risk mitigation and margining requirements applicable to licensed corporations ("**LCs**") and their counterparties in non-centrally cleared derivatives transactions. The SFC issued the "Consultation Conclusions on the OTC derivatives regime for Hong Kong – Proposed margin requirements for non-centrally cleared OTC derivative transactions" in December 2019, setting out similar margin requirements, which are applicable to LCs with appropriate modifications and clarifications.

Starting from September 2020, a licensed person who enters into a non-centrally cleared OTC derivatives transaction should implement the risk mitigation and margin requirements set out in Parts I and III of Schedule 10 to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("**Code of Conduct**").

On 15 January 2024, the SFC announced its decision[1] to defer the effective date of its margin requirements for non-centrally cleared OTC single-stock options, equity basket options, and equity index options until 4 January 2026 (extended by two years from the original effective date of 4 January 2024).

The SFC's decision aligns the effective date of its margin requirements with the UK and EU timelines. The SFC explained that this is to prevent regulatory arbitrage, considering that licensed corporations' exposures to these non-centrally cleared equity options are currently insignificant (note: the SFC also indicated that Paragraph 7(e) of Part III of Schedule 10 to its Code of Conduct will be amended accordingly and gazetted in due course).

As regulatory requirements may be subject to change from time to time, it is recommended to refer to the latest information on the HKMA and SFC's websites.

2.5 Does your jurisdiction recognise the role of an agent or trustee to enter into relevant agreements or appropriate collateral/enforce security (as applicable)? Does your jurisdiction recognise trusts?

Yes. In Hong Kong, the role of an agent or trustee to enter into relevant agreements, or appropriate collateral, or to enforce security is recognised. Trusts are also recognised in Hong Kong. It is recommended that a trustee should only enter into agreements or take appropriate collateral/enforcement actions on behalf of a trust if they are duly authorised under a relevant trust deed. A trust deed may be governed by Hong Kong law, English law, New York law or other laws, and would typically follow the governing law of the relevant security documents.

2.6 What are the required formalities to create and/or perfect a valid security over an asset? Are there any regulatory or similar consents required with respect to the enforcement of security?

There are four main types of security interests in Hong Kong: charges; mortgages; pledges; and liens. If the security provider is a Hong Kong incorporated company or a registered non-Hong Kong company under Part 16 of the Companies Ordinance of Hong Kong (Cap. 622 of the Laws of Hong Kong), and the asset falls into a registrable category (covering any floating charge and fixed security over most, but not all, asset types), the security interest must be registered within one month of the relevant security document's creation against the security provider at the Companies Registry of Hong Kong.

Aside from the above, no other regulatory consents are required for security enforcement in Hong Kong, provided that the collateral provider is not in insolvency proceedings. For example, a secured party can enforce an enforceable and properly perfected, first-ranking, Hong Kong law-governed, fixed security interest over shares located in Hong Kong through its out-of-court power of sale.

On the other hand, enforcing security after the collateral provider's insolvency may be subject to Hong Kong law restrictions. There are so-called "clawback periods" before a Hong Kong company's liquidation commencement date, during which transfers or dispositions may be clawed back or set aside upon challenges by a liquidator or other insolvency officials, on grounds such as unfair preference, undervalue transactions, and voidable floating charge.

In August 2021, Hong Kong implemented a statutory automatic stay regime, potentially imposing further restrictions on security enforcement during insolvency situations involving a Hong Kong AI as a counterparty in a derivatives contract. It is crucial to consider the implications of these automatic stay rules when handling security enforcement, particularly when affected entities involve Hong Kong AIs, their holding companies, and their other group companies that are not classified as Hong Kong AIs. For a more detailed discussion on this topic, please refer to question 4.2 below.

3 Regulatory Issues

3.1 Please provide an overview of the key derivatives regulation(s) applicable in your jurisdiction and the regulatory authorities with principal oversight.

Overview
The Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong) ("**SFO**") is the primary legislation, which sets out, among other things:

(i) the licensing requirements for dealers in Hong Kong and the framework for mandatory clearing, reporting, recordkeeping and trading requirements in Hong Kong;
(ii) the authorisation requirements for advertisement, invitation, disclosure or offering documents in respect of the offering of structured products or derivatives products to the general public in Hong Kong; and

(iii) civil and criminal liabilities in respect of market misconducts, including but not limited to insider dealing, false trading, price rigging, stock market manipulation, and disclosure of false and misleading information-inducing transactions.

Derivatives transactions that reference shares of a Hong Kong Stock Exchange listed company or other listed securities are also subject to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.

Key derivatives regulations

The regulatory framework in Hong Kong consists of the SFO and its relevant pieces of subsidiary legislation, as well as the guidelines and circulars issued by the SFC and HKMA for the implementation and operation of these rules. The purpose of these derivatives regulations is to increase transparency, reduce systemic risk, and ensure a fair and orderly OTC derivatives market in Hong Kong.

Key derivatives regulations in Hong Kong include:

- The Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules 2016 (Cap. 571AL of the Laws of Hong Kong), setting out a mandatory reporting and record-keeping regime for certain prescribed persons engaging in non-cleared OTC derivatives activities.
- The Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (Cap. 571AN of the Laws of Hong Kong), outlining a mandatory clearing regime, with effect from 1 July 2017, for example, to specify the applicable clearing threshold for an AI, approved money broker, or LC to follow, and what OTC derivatives transactions are subject to the clearing obligation, with any applicable exemptions.
- On 3 March 2023, the SFC and HKMA jointly published detailed FAQs on the Implementation and Operation of the Mandatory Clearing Regime for in-scope OTC derivatives. These FAQs are intended to help market participants better understand their obligations and responsibilities under the OTC derivatives regime.
- Additionally, certain classes of non-cleared derivatives are subject to mandatory margining requirements. These requirements apply to AIs that are either locally incorporated or have non-cleared derivatives booked in its Hong Kong branch. The specific margining requirements depend on the notional amount of the derivatives transaction. For further information in this respect, please refer to question 2.4 above.
- For the implementation of the Basel III final reform package, the Banking (Capital) Rules (Cap. 155L of the Laws of Hong Kong) (the "**Rules**") and related amendments form the key pieces of legislation. Specifically, by the operation of the Banking (Capital) (Amendment) Rules 2023, the revised market risk and credit valuation adjustment ("**CVA**") risk capital frameworks will be set out in Parts 8 and 8A of the Rules, respectively. They will come into effect on a day to be appointed by the HKMA (intended to be 1 January 2025).[2]
- In relation to the Rules, on 15 March 2024, the HKMA issued new SPM modules – MR-1: Market Risk Capital Charge and MR-2: CVA Risk Capital Charge – as statutory guidance. Both new SPM modules are designed to provide additional technical details (in addition to the Rules) and to cover all the related requirements. They set out the minimum standards that all locally incorporated AIs are expected to adopt for the calculation of their market risk and CVA risk capital charges.

The regulatory framework governing Hong Kong's OTC derivatives market has undergone multiple amendments since its inception in 2016. These amendments reflect the regulators' ongoing efforts to modernise the regulatory regime to align it with international standards. It is anticipated that further revisions will be made in the future to ensure that the regulatory framework remains up to date and aligned with international financial regulations.

Regulatory authorities

The SFC and HKMA are the two primary financial services regulators and jointly oversee the OTC derivatives regime in Hong Kong.

The SFC administers and supervises securities and futures markets in Hong Kong, including OTC derivatives and SFC-licensed or registered persons. The SFC is responsible for the public consultation, formulation and enforcement of derivatives regulations, and issues and updates guidelines and codes of conduct for licensed or registered persons.

The HKMA supervises AIs such as banks and approved money brokers in relation to their OTC derivatives activities, and issues relevant rules through supervisory manuals and circulars. These include Module CR-G-14 as mentioned in question 2.4 in relation to margining requirements, the new SPM modules on Market Risk/CVA Risk Capital Charges as mentioned in question 3.1, a circular on phase 2 reporting requirements for OTC derivatives, and guidelines on exercising disciplinary power to order a pecuniary penalty under the SFO in respect of OTC derivatives.

3.2 Are there any regulatory changes anticipated, or incoming, in your jurisdiction that are likely to have an impact on entry into derivatives transactions and/or counterparties to derivatives transactions? If so, what are these key changes and their timeline for implementation?

As mentioned in question 2.4, Module CR-G-14 was updated on 11 September 2020. It is yet to be seen whether further amendments will be made in respect of margin requirements. On 28 January 2022, the HKMA and SFC jointly issued circulars to banks and SFC-licensed intermediaries with new guidelines targeting Virtual Asset-related ("**VA**") products including VA-related derivatives products, and there may be further updates to these guidelines as the VA market continues to develop in Hong Kong. For the latest updates on the final phase of LIBOR transition for OTC derivatives transactions, please refer to question 8.2 below.

On 20 March 2023, the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) (Amendment) Rules 2023 (L.N. 61 of 2023) were gazetted, providing for certain amendments to the Securities and Futures (OTC Derivative Transactions Reporting and Record Keeping Obligations) Rules. These amendments provide for an exemption from the OTC derivatives reporting rules under Chapter 571AL for a new Type 13 intermediary (see further details in question 3.3) that is a counterparty to specified OTC derivatives transactions in its capacity as a trustee of a relevant CIS. The amendments also provide for records that are required to be kept by such persons by virtue of it being a counterparty to a specified OTC derivatives transaction in its capacity as a trustee of a relevant CIS. These amendments will become effective on 2 October 2024.

Implementation timeline for the Basel III final reform package

On 10 November 2023, the HKMA issued a letter to the Hong Kong Association of Banks (the "**Letter**"),[3] updating the

timetable for the implementation of the Basel III final reform package after further consultation on the draft rules.

In accordance with the Letter:

- all standards in the package (on credit risk, operational risk, market risk, CVA risk and the output floor) will take effect on 1 January 2025; and
- the reporting-only requirement for the new standards on market risk and CVA risk will commence on 1 July 2024, as planned.

The HKMA will consider whether further refinements are necessary before finalising them for submission to the Legislative Council for negative vetting. During the reporting-only period, local AIs would still calculate their regulatory market and CVA risk capital charges based on the existing Rules.

Hong Kong's reporting-only timeline is slightly ahead of the UK and EU, while the full implementation of the new standards is aligned with the new timeline in the UK and EU, which is expected to be 1 January 2025, and closer to the revised implementation date consulted in the US, which is 1 July 2025.

3.3 Are there any further practical or regulatory requirements for counterparties wishing to enter into derivatives transactions in your jurisdiction? For example, obtaining and/or maintaining certain licences, consents or authorisations (governmental, regulatory, shareholder or otherwise) or the delegating of certain regulatory responsibilities to an entity with broader regulatory permissions.

The SFO prohibits a person from carrying out a regulated activity unless the person is an LC or an AI that is duly authorised and registered under the SFC regime. Dealing in and/or advising on derivatives may constitute regulated activities of "dealing in securities" (Type 1), "dealing in futures contracts" (Type 2), "advising on securities" (Type 4), "advising on futures contracts" (Type 5), and/or "securities margin financing" (Type 8) as stipulated in the SFO, unless an exemption or exception can be relied upon. An example of a commonly used exemption is where an investment manager who has a Type 9 (asset management) licence advises on a futures contract covered under Type 5, in which case the manager will not be required to apply for a Type 5 licence as long as it is proved to be wholly incidental to the manager's asset management business.

In June 2020, the SFC submitted proposed amendments to the OTC derivatives licensing regime as part of the Securities and Futures and Companies Legislation (Amendment) Bill 2021 to the Legislative Council, introducing the SFC-regulated activities of "dealing in OTC derivative products or advising on OTC derivative products" (RA 11) and "providing client clearing services for OTC derivative transactions" (RA 12). The date on which the amended regime will come into effect has not yet been fixed. For ETDs, the rules and procedures of the Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, the SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited impose various requirements and obligations on their respective participants.

Additionally, in 2019, the SFC proposed a new regulatory framework on Type 13 regulated activity (RA 13), to supervise trustees and custodians of funds in Hong Kong. The regulatory regime focuses on how trustees and custodians safeguard scheme assets and oversee scheme operations. In 2022, after consultation, the SFC refined the definition of RA 13 to "providing depositary services for a relevant CIS (i.e., collective investment scheme)". The regulatory framework focuses on two core functions of a depositary: custody and safekeeping of scheme property; and oversight of the operation of the relevant CIS to ensure compliance with its constitutive documents. The implementation date for the new regime is also yet to be fixed.

3.4 Does your jurisdiction provide any exemptions from regulatory requirements and/or for special treatment for certain types of counterparties (such as pension funds or public bodies)?

Pension funds in Hong Kong are schemes that are registered under either the Mandatory Provident Fund Schemes Ordinance (Cap. 485 of the Laws of Hong Kong) or the Occupational Retirement Schemes Ordinance (Cap. 426 of the Laws of Hong Kong). There are certain requirements to be met by such schemes before they can enter into derivatives transactions.

According to the Code on Unit Trusts and Mutual Funds issued by the SFC, retail unit trust funds may only use derivatives for the purposes of and to such extent prescribed in its investment objectives, policies and restrictions. Generally speaking, derivatives that are used for hedging purposes are subject to less restrictions than those for speculative purposes. For example, a securitisation SPV that entered into uncleared OTC derivatives transactions with a financial institution is exempt from the margining requirements as discussed in question 2.4, if and to the extent that the SPV entered into such OTC derivatives transactions for the sole purpose of hedging.

4 Insolvency / Bankruptcy

4.1 In what circumstances of distress would a default and/or termination right (each as applicable) arise in your jurisdiction?

In Hong Kong, a "bankruptcy" event of default as referred to in the ISDA Master Agreement would give rise to a default and/or termination right. The grounds on which a company may be wound up are contained in section 177 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the Laws of Hong Kong) ("**CWUMPO**"). One of the grounds is that the company is "unable to pay its debts".

A company is unable to pay its debts if:

(a) a creditor who is owed HKD 10,000 or more (then due) has served a statutory demand on the company at its registered office and the company neglects to pay the sum due or to secure or compound for it to the satisfaction of the creditor within three weeks of service;

(b) execution or other process issued on a judgment or court order in favour of the creditor is returned unsatisfied; or

(c) after considering the contingent and prospective liabilities of the company, it is proved to the court that the company cannot pay its debts. The usual test relied upon is the cash flow test, but the balance sheet test is also applicable.

Other events of default and termination events (for example, failure to pay, misrepresentation and cross-default) may also be triggered if a party to a derivatives transaction is in a distressed scenario.

While certain of ISDA's standard termination provisions might arguably be activated (in part or indirectly) by sanctions, these provisions were not designed to deal with the potential consequences to derivatives counterparties and transactions or the mechanics for termination and determination of the close-out amount in a sanctions scenario. ISDA has published a guidance note on sanctions and derivatives that addresses this problem by proposing an additional termination event specifically tailored to such a scenario. Despite this, it is still unclear whether parties would accept to have these sanctions-related terms incorporated into their agreements, due to the difficulties of agreeing on such terms.

4.2 Are there any automatic stay of creditor action or regulatory intervention regimes in your jurisdiction that may protect the insolvent/bankrupt counterparty or impact the recovery of the close-out amount from an insolvent/bankrupt counterparty? If so, what is the length of such stay of action?

Under section 186 of the CWUMPO, when a winding-up order has been made, or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company except by leave of the court, and subject to such terms as the court may impose. However, this generally will not prevent a termination right against the counterparty being exercised, or an out-of-court enforcement of security over the counterparty's assets by a receiver.

If the counterparty is a "within scope financial institution" for the purpose of the Financial Institutions (Resolution) Ordinance (Cap. 628 of the Laws of Hong Kong), certain obligations of the counterparty may be temporarily stayed, but set-off, netting, title transfer and security arrangements are generally protected in relation to partial property transfers and bail-in.

4.3 In what circumstances (if any) could an insolvency/bankruptcy official render derivatives transactions void or voidable in your jurisdiction?

Derivatives transactions may be rendered void or voidable in the circumstances as set out in question 4.4 below.

4.4 Are there clawback provisions specified in the legislation of your jurisdiction that could apply to derivatives transactions? If so, in what circumstances could such clawback provisions apply?

Yes. The insolvency clawback provisions in Hong Kong include:

- Transactions at undervalue – the company enters into a transaction at undervalue with a person if the company receives no consideration, or consideration that is significantly less than the consideration provided by the company. The transaction has been entered into in the five-year period before the company's winding up is commenced at a time when the company was unable to pay its debts, or the company became unable to pay its debts as a result of entering into the transaction. However, the transaction will not be set aside if the court is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and there were reasonable grounds for believing that the transaction would benefit the company. Therefore, this would not apply to derivatives transactions entered into on arm's length terms.
- Unfair preferences – an unfair preference is an action taken by the company, influenced by a desire to prefer, that puts one creditor in a better position in the event of insolvency than it would otherwise have been. The transactions caught are those that take place during the six-month period before the company winding up is commenced, but this can be extended to a two-year period if the recipient is a person connected with the company. Transactions involving persons connected with the company are presumed to be an unfair preference unless proven otherwise.
- Extortionate extensions of credit to the company – an extension of credit to the company within the three-year period before the commencement of the winding up may be set aside upon the application of a liquidator if, having regard to the risk accepted by the person providing the credit, the terms of it are such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of credit, or if it otherwise grossly contravenes ordinary principles of fair dealing. Provided that the derivatives transaction documentations and transactions thereunder are *bona fide*, these provisions are unlikely to apply.
- Floating charges – if it is created by the company within the two-year period before the company's winding up commenced (if granted in favour of a connected person), or 12 months before the company's winding up commenced (if granted in favour of a non-connected person), and the company was unable to pay its debts at the time it was granted or became unable to pay its debts as a result, save to the extent of any new money provided to the company in return for the charge.
- Transactions made with the intention to defraud creditors or for a fraudulent purpose – a transaction can be set aside if it took place with the aim of placing assets beyond the reach of creditors. However, if the property disposed of is held by a *bona fide* third-party purchaser for value and without notice of the fraud, then the transaction will not be set aside.
- With the approval of the court and within the 12-month period of the commencement of the liquidation, the liquidator can also disclaim onerous property of the company, including unprofitable contracts. However, the single agreement and flawed asset provisions in an ISDA Master Agreement could defeat the liquidator's right to cherry-pick individual transactions because all transactions form part of a single agreement and the obligations of the non-defaulting party cease to be due post-insolvency.

4.5 In your jurisdiction, could an insolvency/bankruptcy-related close-out of derivatives transactions be deemed to take effect prior to an insolvency/bankruptcy taking effect?

Unless Automatic Early Termination ("**AET**") is elected under an ISDA Master Agreement and specified to apply, insolvency/bankruptcy close-out will not be deemed to take effect prior to any insolvency/bankruptcy taking effect. If parties elect AET, insolvency/bankruptcy close-out would be deemed to take effect immediately preceding any insolvency/bankruptcy event, without requiring the further step of serving a termination notice. It is not essential to make such election for close-out netting to be valid under Hong Kong law. In fact, it is not common for parties in Hong Kong to elect for AET to apply as far as Hong Kong insolvency law is concerned.

4.6 Would a court in your jurisdiction give effect to contractual provisions in a contract (even if such contract is governed by the laws of another country) that have the effect of distributing payments to parties in the order specified in the contract?

As long as the contract demonstrates a clear intention of the parties, Hong Kong courts would generally give effect to the contractual provisions in the contract (even if such contract is governed by the laws of another country (see question 1.3 above)) that have the effect of distributing payments to parties in the order specified in the contract.

5 Close-out Netting

5.1 Has an industry-standard legal opinion been produced in your jurisdiction in respect of the enforceability of close-out netting and/or set-off provisions in derivatives documentation? What are the key legal considerations for parties wishing to net their exposures when closing out derivatives transactions in your jurisdiction?

For derivatives transactions documented using an ISDA Master Agreement, ISDA has commissioned Hong Kong legal opinions in respect of the enforceability of close-out netting and/or set-off provisions in derivatives documentation.

Generally speaking, the contractual netting and set-off provisions in the ISDA Master Agreement are enforceable in Hong Kong where the parties are solvent. There are several forms of set-off in Hong Kong, and contractual set-off pursuant to an agreement is generally enforceable.

If a counterparty is insolvent, then statutory/insolvency set-off would apply to mutual credits, mutual debts and other liabilities arising out of mutual dealings between the counterparties. The application of statutory/insolvency set-off is mandatory and cannot be contracted out of by the counterparties. Netting and set-off provisions under an ISDA Master Agreement are likely to comply with statutory/insolvency set-off requirements.

5.2 Are there any restrictions in your jurisdiction on close-out netting in respect of all derivatives transactions under a single master agreement, including in the event of an early termination of transactions?

Close-out netting is generally effective in Hong Kong, as Hong Kong contract law typically respects parties' freedom of contract. It is expected that close-out netting in respect of all derivatives transactions under a single master agreement would be enforceable in Hong Kong. Where the parties have elected "Multiple Transaction Payment Netting" under the ISDA Master Agreement, it is expected that such arrangement would also be enforceable.

5.3 Is Automatic Early Termination ("AET") typically applied/disapplied in your jurisdiction and/or in respect of entities established in your jurisdiction?

AET is usually disapplied in Hong Kong and/or in respect of entities established in Hong Kong. See question 4.5 above for further details.

5.4 Is it possible for the termination currency to be denominated in a currency other than your domestic currency? Can judgment debts be applied in a currency other than your domestic currency?

Yes. It is possible for the termination currency to be denominated in a currency other than Hong Kong dollars, and judgment debts can be applied in a currency other than Hong Kong dollars. However, in the event of an insolvency of a counterparty, for procedural reasons, the amount must be converted into Hong Kong dollars if the insolvent judgment debtor refuses to make payment voluntarily, and execution must be levied to obtain the funds.

6 Taxation

6.1 Are derivatives transactions taxed as income or capital in your jurisdiction? Does your answer depend on the asset class?

Hong Kong does not have a capital gains tax regime. Treatment for gains derived from derivatives transactions will follow tax treatment for accounting purposes and could be subject to profits tax in Hong Kong. The Inland Revenue Department ("**IRD**") of Hong Kong issued a revised departmental interpretation and practice note (DIPN No. 42) in June 2020 providing guidance on the tax treatment of financial instruments, including derivatives. The tax treatment may vary based on factors such as the classification of the instrument (whether the instrument is a capital or revenue asset), and whether it is held for trading, investment, or solely for hedging purposes. On the other hand, posting or exchange of margins/collaterals between derivatives counterparties are not generally subject to stamp duty but, if such transaction constitutes a transfer of "Hong Kong stocks" within the meaning of the Stamp Duty Ordinance (Cap. 117 of the Laws of Hong Kong), stamp duty may be applicable for such transfer or exchange. Tax advice in Hong Kong is typically provided by professional accountants. Transaction parties would normally seek tax advice when structuring their transactions.

6.2 Would part of any payment in respect of derivatives transactions be subject to withholding taxes in your jurisdiction? Does your answer depend on the asset class? If so, what are the typical methods for reducing or limiting exposure to withholding taxes?

Hong Kong does not have a withholding tax regime. Therefore, in cross-border transactions where there is a counterparty in a jurisdiction with a withholding tax regime, parties to the derivatives documentation would typically build in appropriate tax gross-up provisions based on the relevant tax laws and regulations, to offset or minimise the effect of any withholding tax in the relevant jurisdiction.

6.3 Are there any relevant taxation exclusions or exceptions for certain classes of derivatives?

As discussed in question 6.1, gains from derivatives could be subject to profits tax depending on various factors. However, where applicable, hedge accounting treatment would apply in determining profits tax involved in hedging contracts.

7 Bespoke Jurisdictional Matters

7.1 Are there any material considerations that should be considered by market participants wishing to enter into derivatives transactions in your jurisdiction? Please include any cross-border issues that apply when posting or receiving collateral with foreign counterparties (e.g. restrictions on foreign currencies) or restrictions on transferability (e.g. assignment and novation, including notice mechanics, timings, etc.).

There are generally no cross-border restrictions in Hong Kong when posting or receiving collateral with foreign counterparties, except that participants should consider any applicable licensing, disclosure and margining requirements, and the implications of

other relevant regulations such as anti-money laundering and international sanctions regulations before entering into a transaction. There is also no currency or FX control regime in Hong Kong.

However, it should be noted that the PRC has a currency control regime with respect to the PRC onshore RMB, and the pledging of certain types of RMB denominated assets may be subject to regulatory restrictions. The PRC also imposes FX controls that may restrict the transfer of funds and foreign currency between a PRC counterparty and an offshore counterparty, in terms of both timing and amount, and such PRC restrictions may affect the transfer of collaterals between a PRC counterparty and an offshore counterparty. Therefore, transaction parties should be aware of the implications of any applicable PRC legal requirements when posting or receiving collateral with PRC counterparties.

Additionally, parties entering into derivatives trades with a PRC counterparty should be aware that the new Futures and Derivatives Law (中华人民共和国期货和衍生品法) ("**FDL**") in the PRC came into effect on 1 August 2022. The new law introduces a framework for regulating OTC derivatives transactions in the PRC; therefore, parties trading derivatives with PRC counterparties should be aware of any new requirements under the new FDL, which may include, for example, registration, filing, reporting, disclosure and/or margining requirements.

Similarly, the place where a foreign counterparty resides or is incorporated, as applicable, may impose restrictions on the pledging and transfer of collateral. Parties should therefore consider all relevant legal implications.

8 Market Trends

8.1 What has been the most significant change(s), if any, to the way in which derivatives are transacted and/or documented in recent years?

Regulatory reforms

As a response to the 2007 global financial crisis, comprehensive regulatory reforms were enacted to mitigate systemic risks in financial markets, including derivatives regulations. These reforms cover various aspects such as IM and VM requirements, derivatives clearing, reporting, and record-keeping standards.

In May 2015, the SFC implemented reporting and record-keeping protocols for OTC derivatives transactions and established a trade repository in Hong Kong to enhance transparency and risk monitoring for OTC derivatives.[4]

Additionally, since March 2017, the HKMA has implemented margin requirements and risk mitigation standards for non-centrally cleared OTC derivatives transactions, aligning with the global standards set by entities like the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

In recent years, the HKMA has actively implemented the phase-in of the Basel framework, aligning with the evolving international standards on regulatory capital treatment for cleared derivatives.

Under the Basel framework, cleared derivatives trades, which potentially help eliminate or minimise systemic risks, would receive preferential capital relief treatment compared to uncleared trades.

Bespoke ISDA amendments

Over the years, ISDA has issued various bespoke ISDA amendments, protocols or modules specifically for Hong Kong counterparties to incorporate into their ISDA agreements.

Most notably, in all new ISDA agreements entered with a local bank, it has become common practice for local banks to require counterparties to agree to incorporate the following:

- the ISDA Amendment Agreement Relating to the HKMA Risk Mitigation Standards, which allows parties to amend the terms of their covered master agreements to reflect certain portfolio reconciliation, dispute resolution, and other risk mitigation requirements imposed by the HKMA for non-centrally cleared OTC derivatives; and
- the ISDA Hong Kong Jurisdictional Module, which allows market participants to comply with the Financial Institutions (Resolution) Ordinance (Cap. 628 of the Laws of Hong Kong) and other relevant regulations in Hong Kong.

8.2 What, if any, ongoing or upcoming legal, commercial or technological developments do you see as having the greatest impact on the market for derivatives transactions in your jurisdiction? For example, developments that might have an impact on commercial terms, the volume of trades and/or the main types of products traded, smart contracts or other technological solutions.

LIBOR transitions

LIBOR transition will continue to have an impact on both new and legacy derivatives transactions in Hong Kong and will remain closely watched in light of the global LIBOR transition efforts in other major jurisdictions.

The HKMA has developed three transition milestones for the banking sector. From 31 December 2021, all AIs should have ceased to issue new LIBOR-linked products. The HKMA has indicated that AIs should include adequate fallback provisions in all newly issued LIBOR instruments that will mature after 2021. From 1 January 2022 onwards, all sterling, euro, Swiss franc and Japanese yen settings, and the one-week and two-month US dollar settings, should have either ceased to be provided by any administrator or no longer be representative. From 1 July 2023 onwards, the remaining US dollar settings (i.e. the one-, three-, six- and 12-month settings) will either cease to be provided by any administrator or no longer be representative. Although these milestones are not targeted specifically at derivatives, they will nevertheless apply to derivatives instruments.

The HKMA has encouraged parties to adhere to the ISDA IBOR Fallbacks Protocol for smooth transition from LIBOR to risk-free rates. The ISDA IBOR Fallbacks Protocol (which includes the ISDA IBOR Fallbacks Supplement) provides robust contractual fallbacks for market participants transitioning to alternative benchmarks such as SOFR or SONIA.

Bilateral agreements for incorporating contractual fallbacks to legacy non-cleared derivatives contracts are an alternative to the Protocol. While the HKMA has not announced a specific replacement for HKD LIBOR, participants are advised to review contracts and ensure that appropriate fallback provisions are in place.

Crypto-derivatives

Derivatives referencing digital assets, like cryptocurrencies, are poised to play a significant role in the global digital asset market. Nevertheless, the SFC, Hong Kong's primary financial regulator, has expressed reluctance to license individuals or entities aiming to conduct business in crypto-derivatives due to their complexity and associated risks. As such, offerings or marketing of crypto-derivatives are likely limited to professional investors ("**PIs**"), not retail ones.

In their recent Joint Circular to intermediaries[5] on 20 October 2023 (which was further updated and superseded by a Joint Circular issued on 22 December 2023) (the "**Joint Circular**"), the SFC and HKMA set out their updated policy and approach on regulating virtual asset-related activities and virtual asset-related products in Hong Kong. In particular, the Joint Circular made it clear that certain virtual asset-related products are considered complex products and should only be offered to PIs.

The PI restriction does not apply to a limited suite of virtual-asset related derivatives products that are traded on regulated exchanges specified by the SFC,[6] nor to exchange-traded virtual asset derivatives funds authorised or approved for offering to retail investors by respective regulators in designated jurisdictions.[7] Nonetheless, as these products are complex exchange-traded derivatives, they may still be caught by the SFC's complex product regime; in connection with this, the SFC has issued a non-exhaustive list of examples of non-complex and complex products to help the public decide whether a product in question is a complex or a non-complex product. If it is a complex product, intermediaries are subject to the relevant requirements under the complex product regime, including various selling restrictions and the application of suitability requirements when clients purchase complex products on an unsolicited basis.

Swap Connect

Lastly, following a recent joint announcement by the People's Bank of China ("**PBOC**"), the SFC, and the HKMA, the Swap Connect scheme commenced operation on 15 May 2023. Initially, it will provide a Northbound trading channel, offering Hong Kong and global institutional investors an entry point into China's interbank financial derivatives market.

The Swap Connect scheme will be facilitated through a connection between the financial infrastructure institutions of both Hong Kong and Mainland China, involving the collaboration between OTC Clear (the clearing subsidiary of the Hong Kong Exchanges and Clearing Limited ("**HKEX**")), the China Foreign Exchange Trade System ("**CFETS**"), and the Shanghai Clearing House ("**SHCH**"), which will work together to launch and manage the scheme.

In its initial stages, Swap Connect will allow CFETS and overseas electronic trading platforms approved by the PBOC to offer trading services to Hong Kong and international investors. Initially, it will provide access to interest rate swaps, which will be priced, settled, and cleared in RMB.

According to the HKEX, OTC Clear and SHCH will collaborate to provide clearing and settlement services through a central counterparties link. OTC Clear, an SFC-recognised clearing house and an internationally recognised qualifying central counterparty, will offer central clearing services for Hong Kong and international investors. In contrast, SHCH will cater to investors in Mainland China with similar services. OTC Clear's role includes the provision of clearing and settlement services for OTC derivatives transactions.

In future, the Swap Connect programme could pave way to the addition of other RMB OTC derivatives, such as forwards and credit default swaps, depending on market demands and conditions. This expansion of tradable products could further diversify and open up the derivatives market in both Hong Kong and China, enhancing its appeal to global investors.

Endnotes

1. Source: https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=24EC3
2. Source: New SPM modules on market and CVA risk: MR-1 and MR-2 (https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2024/20240315e1.pdf).
3. Source: https://www.hkma.gov.hk/media/eng/regulatory-resources/consultations/Letter_to_HKAB_B3_20231110.pdf
4. Source: Update on reporting and record keeping rules for OTC derivatives | Securities & Futures Commission of Hong Kong (https://apps.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR49).
5. "Intermediary" refers to a licensed corporation or registered institution as defined in Schedule 1 to the SFO.
6. See the list of specified exchanges set out in Schedule 3 to the Securities and Futures (Financial Resources) Rules (Cap. 571N).
7. The designated jurisdictions are Australia, France, Germany, Ireland, Luxembourg, Malaysia, the Netherlands, Switzerland, Taiwan, Thailand, UK and USA.

Vincent Sum is a partner of Mayer Brown. He focuses on complex capital markets matters, including structured products, securitisations, derivatives (including equity derivatives, credit derivatives, corporate derivatives, fund derivatives and commodity derivatives), retail and non-retail funds (including SFC-approved funds, UCITS and ETFs), secured lending and financing and debt capital markets matters. He advises underwriters, arrangers, portfolio managers, issuers, trustees and institutional investors, and is qualified to practise in Hong Kong, New York, and England and Wales. Vincent has practised in New York for almost 10 years and also practised in Tokyo and London prior to relocating to Hong Kong.

Vincent has been ranked as a leading individual in Capital Markets: Derivatives & Structured Products and Securitisation in *Chambers Greater China Region* (2022–2024), *Chambers Asia-Pacific* (2013–2021) and *Chambers Global* (2013–2024). He was accredited as a recommended lawyer in Structured Finance and Securitisation (Hong Kong) in *The Legal 500 Asia Pacific* (2013–2024) and a highly regarded/leading lawyer in both Capital Markets: Derivatives and Capital Markets: Structured Finance and Securitisation (Hong Kong) in *IFLR1000* (2013–2023). Clients told *IFLR1000* (2021) that "Vincent Sum provides practical advice which really adds value to the organisation" and "Vincent was very strong at providing practical cost effective legal solutions".

Vincent also completed a US Court Internship as a law intern for the late Honourable Leonard Sand, a Senior United States Federal Court Judge of the United States District Court, Southern District of New York.

Mayer Brown
16th–19th Floors, Prince's Building
10 Chater Road, Central
Hong Kong

Tel: +852 2843 2272
Email: vincent.sum@mayerbrown.com
LinkedIn: www.linkedin.com/in/vincent-sum

Sylvia Leung is an associate in the Banking and Finance practice in Mayer Brown's Hong Kong office. Sylvia focuses on derivatives (equity derivatives, credit derivatives and corporate derivatives), structured finance, securitisations, and international debt capital markets (high-yield/investment-grade/convertible bonds and medium-term notes). She also regularly advises on funds, asset management, secured lending, cross-border financing and a variety of banking and financial regulatory matters, and has represented portfolio managers, institutional investors, trustees, banks, securities firms, corporate borrowers, high-net-worth individuals and government authorities. Prior to joining Mayer Brown, Sylvia practised in an international law firm focusing on a board range of banking and finance transactions.

Mayer Brown
16th–19th Floors, Prince's Building
10 Chater Road, Central
Hong Kong

Tel: +852 2843 2470
Email: sylvia.leung@mayerbrown.com
LinkedIn: www.linkedin.com/in/sylvia-ky-leung

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