

22 October 2015

### **Circular to intermediaries and other persons engaging in activities concerning over-the-counter (OTC) derivative products or transactions**

This circular is issued to update the market on the implementation of the OTC derivatives regulatory regime, and to highlight the transitional arrangements for market participants who intend to continue with their existing OTC derivatives activities in Hong Kong.

#### **OTC derivatives regulatory regime**

The Securities and Futures (Amendment) Ordinance 2014 (**Amendment Ordinance**)<sup>1</sup> was passed by the Legislative Council in March 2014. Among other things, it introduces a regulatory regime for OTC derivatives in Hong Kong. The new regime provides –

- a) a framework for introducing reporting, clearing and trading requirements through subsidiary legislation (that will require specified OTC derivative transactions to be reported to the Hong Kong Monetary Authority (**HKMA**), centrally cleared through a designated central counterparty, and executed on a designated trading platform);
- b) that certain activities relating to OTC derivatives shall be regulated activities (**RAs**) and thus persons carrying on a business in those activities shall be subject to licensing or registration under the Securities and Futures Ordinance (**SFO**); and
- c) a framework for regulating systemically important participants (**SIP**), i.e. persons who are not regulated by either the Securities and Futures Commission (**SFC**) or the HKMA, but whose activities or transactions in OTC derivatives may raise concerns of potential systemic risk.

#### *Aspects implemented since July 2015*

The OTC derivatives regulatory regime is to be implemented in phases. The first phase came into effect on 10 July 2015.<sup>2</sup> It introduced mandatory reporting in respect of certain interest rate swaps and non-deliverable forwards, and applies to certain regulated entities including licensed corporations (**LCs**).<sup>3</sup> The reporting obligation applies in respect of both new transactions (i.e. those entered into after 10 July 2015) and old ones that are still outstanding. A concession period of six months from implementation is provided for

<sup>1</sup> The Amendment Ordinance was gazetted in April 2014 (<http://www.gld.gov.hk/egazette/pdf/20141814/es1201418146.pdf>).

<sup>2</sup> The Securities and Futures (Amendment) Ordinance 2014 (Commencement) Notice 2015 was gazetted in May 2015 (<http://www.gld.gov.hk/egazette/pdf/20151920/es22015192095.pdf>).

<sup>3</sup> The regulated entities that are subject to mandatory reporting in the first phase include authorized institutions, approved money brokers and licensed corporations. The reporting obligation applies in respect of transactions to which the reporting entities are counterparties, or which the reporting entities have conducted in Hong Kong on behalf of an affiliate.



reporting entities to set up the necessary system connection for reporting. After that, new transactions have to be reported on a T+2 basis. Provision is also made to allow for more time to report old transactions and those entered within the concession period – basically, market participants have until 9 April 2016 to report transactions entered into on or before 9 January 2016. Details of the mandatory reporting regime for the first phase are set out in the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules. The SFC and the HKMA have also issued FAQs on how the Rules will operate and be implemented.<sup>4</sup>

### Aspects proposed to be implemented next

The next phase will focus on: (i) mandating the central clearing of certain standardized interest rate swaps entered into between major dealers; and (ii) expanding the mandatory reporting regime so that it applies in respect of all OTC derivative transactions, and widens the scope of information to be reported, including the reporting of daily valuations.

The SFC and the HKMA have issued a joint consultation paper on the detailed proposals for this next phase (**Consultation Paper**), which is accessible on both the [SFC's](#) and the [HKMA's](#) website. The proposals will affect LCs and registered institutions (**RI**s) that engage in OTC derivative transactions, including firms that are not currently subject to the mandatory reporting regime.

In particular, under the currently proposed expanded reporting regime –

- a) All OTC derivative transactions will be reportable, i.e. including transactions in standardized and non-standardized rate and FX derivatives, equity derivatives, credit derivatives and commodity derivatives. The specific data fields to be completed when reporting are set out in [Appendix D to the Consultation Paper](#).
- b) It will be necessary to report the details of new transactions, certain historical transactions, subsequent events<sup>5</sup> relating to the transactions, as well as daily valuations in respect of the transactions. Additionally, the scope of information to be reported under the proposed expanded regime will be wider than the scope under the existing regime.
- c) LCs or RIs who are not active in the OTC derivatives market may be exempted from the reporting obligation if they qualify under the proposed criteria for “exempt person” relief. The criteria include that their outstanding positions in OTC derivative transactions must, in aggregate, not exceed US\$30 million.

In addition, as part of the proposed mandatory clearing regime, it is proposed to implement the expanded definition of “automated trading services” under the SFO in so far as it relates to the provision of services or facilities for the clearing of OTC derivative transactions. This means that market participants who currently provide such OTC derivative services will need to be authorized by the SFC under the proposed regime.

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<sup>4</sup> The Rules were gazetted in May 2015 (<http://www.gld.gov.hk/egazette/pdf/20151920/es22015192096.pdf>). The FAQs are published on the SFC's website at <http://www.sfc.hk/web/EN/faqs/otc-derivatives/>.

<sup>5</sup> The term “subsequent events” means the changes to the terms and conditions of, or the persons involved in, the transaction after the transaction was entered into.



LCs and RIs who engage in OTC derivative transactions are urged to review the Consultation Paper for the next phase of implementation. Interested parties are requested to submit their comments, in writing, to the SFC or the HKMA by 31 October 2015, except that comments on the specific data fields to be reported (i.e. those set out in Appendix D to the Consultation Paper) may be submitted by 30 November 2015.

The SFC and the HKMA aim to conclude the consultation by end 2015 or early 2016 and to introduce the relevant subsidiary legislation into the Legislative Council for negative vetting in the first quarter of 2016.

### Aspects to be implemented in future phases

Other aspects of the OTC derivatives regulatory regime, including:

- further expansion of mandatory reporting and clearing;
- implementation of platform trading requirements;
- implementation of the new SIP regime; and
- implementation of the licensing regime for new and expanded RAs

will be implemented in phases in the future.

The new licensing regime will become effective after all the corresponding amendments to various related rules, codes and guidelines have been finalized. In relation to capital and other prudential requirements to be imposed on LCs engaging in OTC derivatives activity, the SFC released a consultation paper in July 2015 on proposed changes to the Securities and Futures (Financial Resources) Rules. Other related amendments are in progress and will be publicly consulted as soon as practicable. We do not expect the OTC derivatives licensing regime to be implemented before mid-2016.

### **New licensing regime**

Under the Amendment Ordinance, two new RAs will be introduced:

- Type 11 RA (dealing in OTC derivative products or advising on OTC derivative products); and
- Type 12 RA (providing client clearing services for OTC derivative transactions).

The Amendment Ordinance will also expand the scope of two existing RAs:

- Type 7 RA (providing automated trading services); and
- Type 9 RA (asset management),

to cover OTC derivative transactions or products.



When the OTC derivatives licensing regime commences, corporations intending to engage in a business in Hong Kong in dealing in or advising on OTC derivative products, providing client clearing services for OTC derivative transactions, managing portfolios of OTC derivative products, and/or providing automated trading services (**ATS**) for OTC derivative transactions, will need to be licensed or registered for the new and/or expanded RA(s) unless exempted.<sup>6</sup> Authorized institutions (**AIs**) and approved money brokers<sup>7</sup> will be exempted under certain circumstances, and their OTC derivatives activities will be overseen and regulated by the HKMA.

Corporations and individuals that are already licensed or registered for Type 9 RA will be deemed to be subject to a condition imposed on their licences or registrations restricting them from managing portfolios of OTC derivative products, unless they can satisfy the specified criteria under a notification mechanism (see below).

Existing Type 7 licensees that intend to provide ATS for the trading of OTC derivative products will need to satisfy the specified criteria for Type 11 RA under a deeming mechanism (see below) and notify the SFC of the changes in the scope and operation of their ATS for the trading of OTC derivative products. The requirement for the OTC derivatives related activities under the expanded Type 7 RA coupling with Type 11 RA is consistent with the current requirement for the securities or futures activities under Type 7 RA coupling with Type 1 RA (dealing in securities) or Type 2 RA (dealing in futures contracts).

### **Transitional arrangements**

Market participants whose existing OTC derivatives activities will trigger the licensing requirements for the new or expanded RA(s), and who intend to pursue these activities, should now prepare for the transition. The Amendment Ordinance includes the following transitional arrangements:<sup>8</sup>

#### **1. Transitional period**

There will be a six-month grace period (**Transitional Period**) starting from the commencement date of the OTC derivatives licensing regime. During this period, market participants may continue their activities that fall within the definition of the new or expanded RAs, without the relevant licences or registrations.

Upon the expiry of the Transitional Period, no entity can engage in a new or expanded RA unless and until it is appropriately licensed or registered or deemed licensed or registered under the transitional arrangements.

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<sup>6</sup> Please refer to sections 52 and 53 of the Amendment Ordinance for the respective scope of the expanded and new RAs.

<sup>7</sup> Both terms are defined under the Banking Ordinance.

<sup>8</sup> Please refer to section 55 of the Amendment Ordinance.



## 2. Deeming mechanism

The deeming mechanism applies to market participants that meet specified criteria and apply under Part V of the SFO for a licence or registration for the new or expanded RA during the first three months of the Transitional Period (**Application Period**). After an initial screening by the SFC or the HKMA, eligible corporate and individual applicants will be deemed to be licensed or registered for the new or expanded RA immediately after the end of the Transitional Period, while the SFC or the HKMA will continue to process their applications. Their deemed licences or registrations will continue to have effect until their applications have been approved, refused or withdrawn. In the case of an individual applicant, he will also cease to be deemed licensed if he ceases to be accredited to a principal that is licensed or deemed licensed for the relevant new or expanded RA.

If an applicant applies during the Application Period but does not meet the specified criteria, the SFC or the HKMA will issue a “no-deeming notice” to notify the applicant that they are ineligible to be deemed licensed or registered. Ineligible corporate applicants and the individual applicants who carry on the new or expanded RA for them will have a grace period of three months, starting from the date the no-deeming notice is issued, to wind down their existing OTC derivatives business, close out existing positions, and/or transfer their business to another corporation that is entitled to carry on the relevant activities.

The specified criteria include:

- *Experience requirements* – Corporate applicants and their proposed responsible officers (**ROs**)<sup>9</sup> should have been carrying on a business in an activity that would have constituted the new or expanded RA in Hong Kong<sup>10</sup> for at least two years immediately before the commencement date of the OTC derivatives licensing regime.
- *Existing licensing and regulatory requirements* – As the OTC derivatives licensing regime is an extension of the existing regulatory framework under the SFO, all the existing licensing and regulatory requirements will also be generally applicable to corporate applicants and their proposed ROs (e.g. at least two ROs for each new or expanded RA concerned with at least one being an executive director as defined under section 113 of the SFO).<sup>11</sup>
- *Application documents* – Together with their application documents for a licence or registration under Part V of the SFO, a corporate applicant must submit a prescribed form confirming, inter alia, its:
  - satisfaction of the related experience requirement;

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<sup>9</sup> Or proposed executive officers of RIs or AIs, in relation to expanded Type 9 RA.

<sup>10</sup> For Type 12 RA, RO applicants' overseas experience will be recognized, whilst corporate applicants' overseas experience, affiliates' experience, or experience of clearing proprietary trades will also be recognized. Please refer to section 55 of the Amendment Ordinance for further details.

<sup>11</sup> Further details of the general licensing and regulatory requirements are published on the SFC's website at <http://www.sfc.hk/web/EN/regulatory-functions/intermediaries/licensing/>.



- having at least two individuals who have applied to be its ROs<sup>12</sup> or executive officers (**EOs**) (as the case may be) for each new or expanded RA concerned and who satisfy the specified criteria as RO or EO; and
- compliance with existing or new requirements under the SFO or the Banking Ordinance (**BO**) (as the case may be), and related codes and guidelines that are or will be applicable to its OTC derivatives activities.<sup>13</sup>

The specified criteria for proposed RO and EOs include, inter alia, their submission of relevant licence applications under the SFO or applications for consent under the BO, and a confirmation that they have satisfied the related experience requirements. Proposed licensed representatives (**LRs**) are not required to submit any confirmation.

Table: Summary of specified criteria

	Applicant	Experience requirement	Licence Application	Confirmation
New or expanded RA	LC	✓	✓	✓
	RO	✓	✓	✓
	LR	N/A <sup>14</sup>	✓	N/A
Expanded Type 9 RA	RI	✓	✓	✓
	EO	✓	✓	✓

### 3. Notification mechanism

For an existing Type 9 LC or RI to continue its activities that amount to the new component of the expanded Type 9 RA (i.e. management of a portfolio of OTC derivative products) (**New Type 9 activities**), it will have to file a prescribed notification form within the Application Period, covering:

- a statement of its intention to continue with such activities;
- a detailed business plan of its New Type 9 activities, internal controls and operational procedures pertaining to such business (including human and technical resources), organizational structure, contingency plans and related matters; and

<sup>12</sup> With at least one of the ROs being an executive director of the corporate applicant for each of the new or expanded RA and each of such executive director having applied to be an RO.

<sup>13</sup> For example, for an LC, its compliance with the requirements for office premises and the new financial resources requirements; for an RI, its compliance with the requirements in paragraph 6 of the Seventh Schedule to the BO, as well as the requirements imposed under Part XVIA of the BO if it is a locally incorporated AI.

<sup>14</sup> In order to be deemed licensed, an LR applicant is required to be carrying on the relevant new or expanded RA for or on behalf of the principal at the time the application is made.



- a confirmation that the LC or RI has at least one Type 9 RO or EO (as the case may be) in Hong Kong who has two years of Hong Kong or overseas experience in New Type 9 activities within the six years immediately before the commencement date of the OTC derivatives licensing regime, and that the LC or RI complies, or has arrangements in place to ensure compliance, with the new requirements under the SFO, related codes and guidelines that are or will be applicable to the related OTC derivatives activities.

The Type 9 RO or EO will also have to file a prescribed notification form within the Application Period confirming that he has satisfied the relevant experience requirement.

Existing Type 9 LCs, RIs, ROs or EOs that do not file a prescribed notification form within the Application Period, or that do not fulfil the notification criteria will be deemed to be subject to a condition imposed on their licences or registrations restricting them from managing portfolios of OTC derivative products upon the expiry of the Transitional Period.

#### 4. New market participants

Any person can apply for a licence or registration for the new or expanded RAs any time after the OTC derivatives licensing regime commences. These applications will be processed in the usual manner and the transitional arrangements will not apply.

#### **Next steps**

The SFC and the HKMA will further consult the public on various aspects of the OTC derivatives regulatory regime in coming months and will publish updates about the implementation of the new regime when appropriate.

**Licensing Department  
Intermediaries Division  
Securities and Futures Commission**

**Supervision of Markets Division  
Securities and Futures Commission**

Ends