



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions on (1) the OTC derivatives regime for Hong Kong – Proposed requirements in relation to OTC derivative risk mitigation and client clearing; and (2) Proposed conduct requirements to address risks posed by group affiliates

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Abbreviations and acronyms

CCP	Central clearing counterparty
CFA	Client facing affiliate
CIS	Collective investment scheme
Code of Conduct	Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
EU	European Union
FMCC	Fund Manager Code of Conduct
FRR	Securities and Futures (Financial Resources) Rules
G20	Group of Twenty
HKMA	Hong Kong Monetary Authority
Internal Control Guidelines	Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission
ISDA	International Swaps and Derivatives Association
NAV	Net asset value
OTC	Over-the-counter
RA	Regulated activities
RBA	Risk booking affiliate
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance
UK	United Kingdom
US	United States
WGMR	Working Group on Margin Requirements

Executive summary

1. On 20 December 2017, the Securities and Futures Commission (**SFC**) issued a Consultation Paper on (1) the over-the-counter (**OTC**) derivatives regime for Hong Kong – Proposed refinements to the scope of regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters; and (2) Proposed conduct requirements to address risks posed by group affiliates (**Consultation Paper**), and invited public comments on:
 - (a) refinements to the scope of the new Type 11¹ and Type 12² regulated activities (**RA**);
 - (b) proposed requirements in relation to OTC derivatives in the areas of risk mitigation, client clearing, client money, client securities and record keeping;
 - (c) proposed conduct requirements to address risks posed by group affiliates and other connected persons; and
 - (d) proposed licensing fees, insurance, competence and continuous professional training requirements under the new OTC derivatives licensing regime.
2. This consultation conclusions paper will only cover the proposed requirements under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) (collectively, the **Proposals**), namely:
 - (a) Part I – proposed risk mitigation requirements in relation to OTC derivatives (ie, Part III of the Consultation Paper);
 - (b) Part II – proposed requirements in relation to OTC derivatives on client clearing (ie, Part IV A of the Consultation Paper);
 - (c) Part III - proposed conduct requirements to address risks posed by group affiliates and other connected persons (ie, Part VI of the Consultation Paper); and
 - (d) Part IV – a proposed consequential amendment on client agreement requirements (ie, Part VIII A of the Consultation Paper).
3. The consultation conclusions on other requirements proposed in the Consultation Paper which relate to amendments to the Securities and Futures Ordinance (**SFO**) and subsidiary legislation with respect to the new Type 11 RA and Type 12 RA will be published separately in due course.
4. The consultation ended on 20 February 2018. The SFC received 16 written submissions on the Proposals, including from various industry associations, asset management firms, market participants, professional services firms and other stakeholders. Four respondents requested that both their names and submissions or just their names be withheld from publication. One respondent requested that its submission be withheld from publication. A list of the respondents (other than those who requested anonymity) is set out in Appendix E.

¹ Type 11 RA of dealing in OTC derivative products or advising on OTC derivative products.

² Type 12 RA of providing client clearing services for OTC derivative transactions.

Key comments on proposed requirements in relation to OTC derivative risk mitigation

5. Respondents generally agreed with the proposed requirements. A few respondents suggested that substituted compliance be made available. However, respondents did not identify any specific conflicts between our proposed requirements and those in overseas regimes resulting from a lack of substituted compliance.
6. The SFC does not consider that the absence of substituted compliance will impose an undue burden on licensed corporations, given that (a) the proposed high-level, principles-based risk mitigation requirements are compatible with the requirements implemented in major overseas jurisdictions and are less prescriptive; and (b) some of the existing regulatory requirements applicable to licensed corporations also require control measures which are essentially the same as those under the risk mitigation requirements. Accordingly, substituted compliance will not be available.
7. Several respondents also suggested that the SFC phase-in the risk mitigation requirements by adopting a phase-in schedule similar to the one applicable to HKMA's risk mitigation standards³.
8. The SFC's risk mitigation requirements are in some respects less detailed and less prescriptive than HKMA's standards, to cater for the fact that licensed corporations' OTC derivatives activities differ in scale. The risk mitigation requirements also reinforce key information management and risk management requirements in the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Internal Control Guidelines**). As such, it is expected that licensed corporations would already have a number of the relevant controls in place and the risk mitigation requirements would not put a major additional burden on licensed corporations.
9. Accordingly, the SFC does not consider it necessary to adopt the phase-in under HKMA's regime, but the SFC will provide a longer transition period. The risk mitigation requirements will become effective on 1 September 2019 to allow the industry more time to prepare.
10. For the reasons set out below, and having regard to the majority support for the Proposals, the SFC has adopted the Proposals, with certain clarifications of the regulatory intent as set out in this paper.
11. The major comments received and our responses are detailed in Part I of this paper.

Key comments on proposed conduct requirements to address risks posed by group affiliates and other connected persons

12. Respondents generally supported the proposals. Some commented on the necessity of the proposal that client facing affiliates (**CFAs**) introduced by licensed corporations to enter into OTC derivative transactions with clients must be regulated by the SFC or HKMA or similarly regulated in a comparable overseas jurisdiction as OTC derivative dealers or banks (hereinafter referred to as the *Regulated CFA Requirement*). Some expressed concerns over the difficulty in licensing CFAs before Type 11 RA comes into operation.

³ Supervisory Policy Manual CR-G-14, Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards issued in January 2017.

13. We maintain our view that client interests would be better protected with the Regulated CFA Requirement in place. In view of the concern over the difficulty in licensing CFAs under the current licensing regime, we propose a transitional period for compliance in respect of existing CFAs which fall outside the range of regulated persons set out in the requirement. During the transitional period, licensed corporations may continue to introduce clients to such CFAs but should implement reasonable measures to protect clients from the conduct and prudential risks of such CFAs. The transitional period for Regulated CFA Requirement will end with the expiry of the transitional period for Type 11 RA.
14. Some respondents requested that the SFC publish the list of comparable overseas jurisdictions (renamed as comparable OTCD jurisdictions) as soon as possible and issue a list of deemed comparable OTCD jurisdictions in the interim. To help market participants prepare for compliance with the proposed conduct requirements, we have provided a list of deemed comparable OTCD jurisdictions in Part III.B of this paper.
15. Details of the major comments received and our responses are set out in Part III of this paper.

Implementation

16. The final texts of the Code of Conduct requirements (with amendments made subsequent to the Consultation Paper marked-up) are set out in Appendices A to D.
17. To allow the industry reasonable time to implement the necessary operational and system changes to comply with the requirements, the risk mitigation requirements as set out in Appendix A of this consultation conclusions paper will become effective on 1 September 2019.
18. The requirements for client clearing and a consequential amendment set out in Appendices B and D of this consultation conclusion will become effective when the new OTC derivatives licensing regime commences.
19. The proposed conduct requirements to address risks posed by group affiliates and other connected persons, including the transitional period for compliance with the Regulated CFA Requirement in respect of existing CFAs which fall outside the range of regulated persons stipulated in the Regulated CFA Requirement, will become effective six months after the gazettal of the Code of Conduct amendments set out in Appendix C.
20. We would like to thank all respondents for their time and effort in reviewing the Proposals and for their detailed and thoughtful comments.
21. The Consultation Paper, the responses (other than those from respondents who requested they be withheld from publication) and this paper are available on the SFC website at www.sfc.hk.

Part I. Proposed risk mitigation requirements

A. Overview

Question raised in the Consultation Paper

Q7. Do you have any comments or concerns about the high-level, principles-based approach we propose to take in respect of applying the risk mitigation requirements, including the scope of application of our proposed requirements and the entities to whom our proposals apply? Are there specific challenges with respect to cross-border issues which may need to be taken into account under our proposed approach?

(i) Substituted compliance

Public comments

22. A majority of the respondents agreed with the high-level, principles-based approach we proposed to take in respect of applying the risk mitigation requirements.
23. Several respondents requested that substituted compliance be made available. They suggested that the SFC should specify a list of deemed comparable foreign jurisdictions or deem the risk mitigation requirements of the Working Group on Margin Requirements (**WGMR**) member jurisdictions⁴ as comparable until a comparability assessment is completed. One respondent made a general remark that, without substituted compliance, differences in requirements across jurisdictions could potentially result in regulatory conflicts and increase market participants' operational and compliance burdens.
24. Another respondent stated that the counterparty of a licensed corporation could in principle be out of scope of the SFC's risk mitigation requirements or subject to the risk mitigation requirements of its home jurisdiction. Without substituted compliance, the licensed corporation will need to perform a gap analysis, imposing an unnecessary compliance burden on both the licensed corporation and its counterparty.

The SFC's responses

25. The respondents did not identify any specific conflicts between our requirements and other regimes resulting from a lack of substituted compliance. The SFC's high-level, principles-based risk mitigation requirements are largely in line with the requirements implemented in other major jurisdictions and are less prescriptive. This enables market participants to implement our requirements in a manner commensurate with their level of non-centrally cleared OTC derivatives activity.
26. Irrespective of whether a licensed corporation's counterparty is outside of the scope of the SFC's risk mitigation requirements or not, some existing regulatory requirements applicable to the licensed corporation require essentially the same controls as those under the risk mitigation requirements. For example:

⁴ The WGMR member jurisdictions are Australia, Canada, the EU, Hong Kong, India, Japan, the Republic of Korea, Mexico, Russia, Singapore, Switzerland and the US.

- (a) A licensed corporation which is a contracting party to OTC derivative transactions is required under the Securities and Futures (Keeping of Records) Rules to keep accounting, trading and other records sufficient to enable it to readily establish whether it has complied with the Securities and Futures (Financial Resources) Rules (**FRR**); and
- (b) Under the Internal Control Guidelines, licensed corporations are currently required to have effective procedures to ensure the:
 - (i) integrity, reliability and thoroughness of all information, including the documentation and electronically stored data, relevant to the licensed corporation's business operations, and to perform regular reconciliation of its records; and
 - (ii) proper management of financial and other risks to which the firm and its clients are exposed. These would include the legal, operational and counterparty risks which the proposed risk mitigation requirements seek to address.

A licensed corporation which does not have proper trading relationship documentation, trade confirmation or portfolio reconciliation should critically review whether it is in full compliance with our existing requirements.

27. Accordingly, the SFC does not consider that the absence of substituted compliance will impose an undue burden on licensed corporations. Consequently, substituted compliance will not be available.

(ii) Scope of risk mitigation requirements

Hedging and small notional amount

Public comments

28. One respondent recommended that, to strike the right balance between preventing the buildup of systemic risk and avoiding an excessive regulatory burden on licensed corporations, the SFC should consider a pragmatic and less stringent approach to applying the risk mitigation requirements: (a) for non-centrally cleared OTC derivatives which are executed for hedging purposes or (b) if the aggregate notional amount of non-centrally cleared OTC derivatives executed for trading purposes is below a certain quantitative threshold.

The SFC's responses

29. Respondents did not identify any specific issues or difficulties for a licensed corporation which uses non-centrally cleared OTC derivatives for hedging or has a small aggregate notional amount of non-centrally cleared OTC derivatives to comply with the risk mitigation requirements.
30. The risk mitigation requirements are applicable to any licensed corporation which is a contracting party to a non-centrally cleared OTC derivative transaction, irrespective of the licensed corporation's outstanding notional amount of non-centrally cleared OTC derivatives or whether or not the transaction is executed for hedging purposes. This is because the risk mitigation requirements address legal, operational and counterparty

credit risks which exist regardless of the size of the non-centrally cleared OTC derivatives exposure or the intent behind the transaction. Accordingly, we consider the implementation of the risk mitigation requirements by licensed corporations contracting in non-centrally cleared OTC derivatives transactions to be a prudent measure as well as a sound business risk management practice.

31. Additionally, the existing Internal Control Guidelines contain requirements which are similar to some of the risk mitigation requirements. As such, it is expected that licensed corporations should already have the corresponding controls in place and the risk mitigation requirements would not put a major additional burden on licensed corporations.

Hong Kong branch of overseas-incorporated licensed corporations

Public comments

32. Another respondent suggested that the risk mitigation requirements should only apply to non-centrally cleared OTC derivative transactions booked in the Hong Kong branch of a licensed corporation incorporated outside of Hong Kong, similar to the approach adopted by the HKMA.

The SFC's responses

33. The SFC does not consider the respondent's suggestion appropriate. Even if a licensed corporation is incorporated overseas, some of the SFC's regulations, including the fitness and properness criteria and the capital requirements under the FRR, generally apply at the legal entity level. If a licensed corporation lacked proper trading relationship documentation or did not perform trade confirmation or portfolio reconciliation, this would call into question the completeness of its record of transactions and its ability to correctly identify its obligations under the transactions. This legal risk equally impacts the branch operation in Hong Kong, and has corresponding implications for the robustness of the licensed corporation's FRR computation and the adequacy of the licensed corporation's financial resources. The SFC will take a principles-based approach to assessing a licensed corporation's compliance where it is incorporated outside Hong Kong.

Executed by the licensed corporation on behalf of a CIS

Public comments

34. One respondent sought clarification of what activity "executed by the licensed corporation on behalf of a collective investment scheme (CIS)" would capture. The respondent asked whether a licensed corporation is subject to the risk mitigation requirements if (a) it is named as the investment manager in the trade documentation but the non-centrally cleared OTC derivative trade is executed outside of Hong Kong by its affiliate or (b) it executes a non-centrally cleared OTC derivative trade in Hong Kong for a contracting party to the transaction which is an overseas affiliate.

The SFC's responses

35. Our intention has always been to capture an asset manager licensed for Type 9 RA (Asset Manager) who (a) manages a portfolio which consists of non-centrally cleared OTC derivatives and (b) executes the non-centrally cleared OTC derivative trade for the

CIS it manages. If the Asset Manager's dealing desk executing the trade is outside Hong Kong or if the Asset Manager's Hong Kong dealing desk is executing the trade for its overseas affiliates, then the risk mitigation requirements do not apply directly. However, as mentioned in paragraph 53 of the Consultation Paper, under the first scenario above where an Asset Manager manages a CIS but the trades are executed by a group company's dealing desk on behalf of the CIS, the Asset Manager is expected to review whether appropriate procedures are in place to achieve a similar risk mitigation outcome in relation to the portfolio under its management.

Direct interface

Public comments

36. One respondent asked for clarification of the meaning of "direct interface" in the example set out in the Consultation Paper, where an Asset Manager is not responsible for complying with the proposed requirements if the trustee, custodian or other operator of the CIS directly interfaces with trade counterparties and handles the trading relationship documentation and all post-trade processes directly with trade counterparties. Another respondent commented that even though a trustee may sign the trading relationship documentation on behalf of a CIS structured as a unit trust, it is not involved in, for example, investment decision-making or the execution of trades in the market. Hence, the mere signing of trading relationship documentation should not render a trustee responsible for complying with the risk mitigation requirements.

The SFC's responses

37. The risk mitigation requirements are applicable to licensed persons which enter into non-centrally cleared OTC derivative transactions. If an Asset Manager provides a service of managing a portfolio of OTC derivative products for a CIS managed by it, and the Asset Manager executes non-centrally cleared OTC derivative transactions on behalf of that CIS, the Asset Manager is responsible for complying with all the risk mitigation requirements, except for any requirement which is handled by the governing body of the CIS or its delegate.

Discretionary accounts

Public comments

38. One respondent argued that given that it may be difficult to know what transactions are executed by other asset managers or the client itself for a discretionary account, it may be appropriate to narrow the scope of the risk mitigation requirements applicable to discretionary accounts. The respondent also queried whether: (a) there are any requirements for the form or content of the arrangements between the licensed corporation and discretionary account client regarding the application of the risk mitigation requirements; (b) the requirements are applicable to clients not regulated by the SFC or domiciled outside of Hong Kong; and (c) only the trading relationship documentation and trade confirmation requirements are applicable to discretionary accounts that trade foreign exchange (FX) security conversion transactions.

The SFC's responses

39. The SFC recognises the bespoke nature of discretionary accounts and the variations in the set-up and operation of discretionary accounts managed by licensed corporations.

Where a licensed corporation manages a discretionary account, we leave it to the licensed corporation and its client to agree between themselves whether and how to apply the risk mitigation requirements, including when the discretionary account is used to trade FX security conversion transactions. Whilst the risk mitigation requirements are not formally applicable to discretionary accounts managed by licensed corporations, we encourage market participants to adopt them for discretionary accounts to the extent practicable as a matter of sound risk management, and to document the agreed arrangements.

B. Risk mitigation requirements

Questions raised in the Consultation Paper

Q8. Do you have any comments on the proposed risk mitigation requirements, including trading relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression or dispute resolution?

Q9. Are any of the risk mitigation requirements inappropriate for a corporation licensed for Type 9 RA which carries out OTC derivative products management, in respect of non-centrally cleared OTC derivative transactions executed by the licensed corporation on behalf of any CIS managed by it? If so, how should the corresponding risk be mitigated?

Q10. Will any established industry practice be adversely affected in a material respect by the proposed risk mitigation requirements?

Q11. Is it appropriate to subject FX security conversion transactions only to the proposed risk mitigation requirements for trading relationship documentation and trade confirmation? If not, what are the reasons for exempting such transactions from these proposed requirements? How should the legal and operational risks of such transactions be mitigated?

(i) Trading relationship documentation

Use of ISDA documents

Public comments

40. One respondent sought guidance from the SFC on the meaning of the term “legal certainty” and the scope of “material rights and obligations” as stated in paragraphs 60(a) and 60(b) respectively of the Consultation Paper. The respondent also sought confirmation from the SFC that the industry-wide ISDA templates or agreements commonly used by industry for documenting OTC derivative transactions are sufficient to fulfil the requirements to provide “legal certainty” and include “all the material rights and obligations” of transaction counterparties.
41. Several respondents also sought confirmation from the SFC that the valuation and dispute resolution processes contained within the ISDA documents are sufficient to fulfil the valuation and dispute resolution requirements under the risk mitigation requirements.

The SFC's responses

42. As mentioned in paragraph 58 of the Consultation Paper, we take notice of dealers' practice of using industry standard legal documentation such as master agreements to document derivative transactions. We support industry efforts to develop standard documentation terms such as the ISDA templates and agreed operational practices to promote standardisation and enhance efficiency. We do not prescribe any specific form of documents or processes to be used.
43. With regard to questions on the adequacy of ISDA documentation, to our knowledge, contracting parties may choose to supplement or modify the ISDA standard terms or definitions to clarify the parties' respective rights and obligations in view of the specific characteristics of the market, asset class, hedging strategy, or the legal, tax or regulatory environment applicable to their trades. Bespoke arrangements may also be used for structured transactions or less commonly traded asset classes. Accordingly, the contracting parties are best placed to assess whether the ISDA standard terms are appropriate for their specific circumstances.
44. Additionally, the assessment of legal certainty should not be a one-off action. New market events, as well as developments in the applicable laws and practices, may point to new legal risks and merit a review of legal certainty. Accordingly, a licensed corporation should assess whether the trading relationship documentation with each counterparty contains sufficient terms and conditions governing the rights and obligations of the licensed corporation and its counterparty.
45. With regard to the requirement to agree on the valuation process, contracting parties are free to agree on a valuation process which uses the valuation of a designated party (which may be one of the contracting parties or a third party), or use a joint valuation or other mechanisms, so long as the agreed process enables the value of a non-centrally cleared OTC derivative transaction to be determined in a timely manner and minimises disputes.
46. With regard to the requirement to agree on the dispute resolution process, again contracting parties are free to agree to a dispute resolution process or mechanism which determines when discrepancies in trade populations, material terms, valuations and margins should be considered as disputes, as well as how such disputes should be resolved, so long as the agreed process or mechanism enables the contracting parties to effectively and efficiently manage, resolve and minimise disputes.

One-off transactions

Public comments

47. Another respondent sought guidance on the meaning of "one-off transactions" and how the trading relationship documentation requirement operates if a licensed corporation enters into two transactions with similar economic terms one year apart.

The SFC's responses

48. A "one-off transaction" refers to a transaction where the licensed corporation does not expect to enter into another transaction with the same counterparty in the foreseeable future. Given that our requirements are principles-based, the need to have trading

relationship documentation applies regardless of whether or not the transaction is one-off.

49. Where a licensed corporation expects to have a series of transactions with a counterparty on an ongoing basis, a master agreement signed at the inception of the trading relationship can streamline the documentation for subsequent trades. On the other hand, if it is not clear whether there will be a series of subsequent trades with a given counterparty, a licensed corporation may elect to have the trading relationship documentation take the form of a trade confirmation which includes all the material rights and obligations of the counterparties to the non-centrally cleared OTC derivative transaction. Licensed corporations should also note that master agreements may be useful for effecting bilateral close-out netting, through documenting all transactions between contracting parties under enforceable master netting agreements. Close-out netting is an important measure for managing counterparty risk.

(ii) Trade confirmation

Public comments

50. One respondent suggested that two-way confirmation was a more prudent way to minimise the risk of disputes between counterparties about contractual terms, as one-way confirmation may have a higher risk of human error. The respondent also suggested that the segregation of duties should be maintained by requiring the person performing trade confirmation within the licensed corporation to be different from the one who executes or records the non-centrally cleared OTC derivative transaction.
51. Another respondent commented that licensed corporations may find it impractical to follow the suggested format of the trade confirmation as set out in Appendix 2 of the Consultation Paper.

The SFC's responses

52. The SFC notes that the use of two-way confirmation can reinforce legal certainty, but only if the confirmation is executed by both parties in a timely manner. The SFC allows the use of one-way confirmation to reduce possible operational burden on a licensed corporation's counterparty, which may not be a regulated entity and may not have the operational infrastructure to execute confirmations promptly. Additionally, the use of one-way confirmation is not mandatory and is subject to prior agreement by both parties to the trade. This flexibility enables each licensed corporation to adopt the most suitable approach to trade confirmation with its counterparties. Hence, the SFC will not change the proposed requirement and will allow the use of one-way confirmation.
53. As to the comment on the need to segregate duties, there are already requirements on the segregation of key duties and functions in the Internal Control Guidelines.
54. Regarding the comment on the format of trade confirmations, Appendix 2 of the Consultation Paper merely sets out a list of possible material terms that can be included in a trade confirmation. It does not prescribe the format of trade confirmations, which we leave to market participants to agree upon.

(iii) Valuation

Agreeing on the valuation process

Public comments

55. One respondent commented that practically, it is difficult for a licensed corporation and its counterparty to agree on the valuation process, as some counterparties may: (a) see valuation models as proprietary information which would not be shared, and (b) have different systems and valuation models using different inputs, data sources and data vendors. Given the challenges of agreeing on a standard at the outset, the respondent asked for greater flexibility.

The SFC's responses

56. The proposed requirement is for a licensed corporation to agree with its counterparty on the valuation *process*, and does not require the licensed corporation to agree on the actual valuation model with its counterparty. Market participants are free to choose their own valuation models as they consider appropriate.
57. On the other hand, as explained in paragraph 71 of the Consultation Paper, even when both counterparties use the same valuation model, valuation breaks may still legitimately exist due to differences in data, the way the data is applied or the way the valuation model is set up or calibrated. Accordingly, the SFC's requirement is for a licensed corporation to agree with its counterparties on the process by which the value of a non-centrally cleared OTC derivative will be determined throughout the lifecycle of the transaction, from the time it is executed until its termination, maturity or expiration.

Valuation model requirements

Public comments

58. One respondent noted that the valuation of some non-centrally cleared OTC derivatives may be relatively straightforward and only involve the use of a simple mathematical formula. The respondent used an example of interpolating spot rates to value an FX forward. The respondent argued that valuations based on a simple formula should not be regarded as using a proprietary valuation model.
59. A few respondents commented that a licensed corporation may not be able to perform due diligence on a third-party valuation model as: (a) the methodologies used by the third party may not be transparent or available to the licensed corporation; and (b) the third party may view its model as proprietary information and so would not share it.
60. The respondents queried whether the requirement to exercise due skill, care and diligence to confirm that a third-party valuation model satisfies the valuation model requirements for third-party models could be satisfied by a representation from the third party.
61. Respondents asked for clarification of whether valuation model requirements would apply when a licensed corporation imports an external valuation into its internal system. Respondents cited the example of using Bloomberg for the valuation of FX instruments such as spot FX transactions, FX forwards and non-deliverable forwards.

62. One respondent queried whether broker quotes are considered to be third-party valuation models.

The SFC's responses

63. With regard to the comment on the use of simple valuation formulae, licensed corporations should note that the SFC's requirements are principles-based. Even if a simple formula is used to perform a valuation, there is a risk that: (a) the formula is inappropriate, or (b) the formula is appropriate but is implemented or applied incorrectly. Accordingly, a licensed corporation using formulae to value a non-centrally cleared OTC derivative transaction should ensure that the formulae: (a) are in line with a valuation methodology with an accepted economic or sound theoretical basis which incorporates all factors which counterparties would reasonably consider in valuing the non-centrally cleared OTC derivative transaction; and (b) are subject to independent review, validation and approval by another person who is independent of the person who implemented the valuation formulae. These requirements should be applied in a risk-based manner commensurate with, for example, the complexity of the formulae and their materiality in terms of the number or notional amount of non-centrally cleared OTC derivatives valued using such formulae.
64. As to the comments on third-party valuation models, whilst the SFC recognises that a third-party vendor may not share detailed information on its proprietary valuation model with a licensed corporation, we would like to point out that a licensed corporation should not use a third-party valuation model if it is not aware of its valuation methodology. Knowledge of the methodology of the third-party valuation model is fundamental for the licensed corporation to make an informed decision about whether it is appropriate to use it to value a particular non-centrally cleared OTC derivative.
65. The SFC considers that relying solely on a vendor's representation that its model satisfies the third-party valuation model requirements is not sufficient. The licensed corporation is expected to discuss with the vendor to understand:
- (a) what valuation methodology and risk factors are used to assess whether the model is appropriate for valuing a particular non-centrally cleared OTC derivative;
 - (b) how the model is calibrated and tested to assess whether the data used and tests performed are appropriate; and
 - (c) what model risk governance process the third-party vendor has in place to manage model risk, such as whether and how the model is subject to review, validation and approval, to satisfy itself that the model is subject to an adequate model risk management framework.
- The extent of due diligence should be commensurate with the complexity of the model and the materiality of the model valuation relative to the aggregate value of the total portfolio.
66. Licensed corporations should also conduct regular independent reviews and verification of third-party model outputs. A licensed corporation may verify these outputs by using alternative methods or simplified formulae to arrive at an approximate valuation to

check the reasonableness of the model outputs⁵. All these requirements are designed to allow licensed corporations to satisfy themselves that the third-party models used to value non-centrally cleared OTC derivative are well specified⁶, appropriate, implemented sensibly and subject to robust model development and validation controls.

67. Whether the valuation model requirements would apply to a licensed corporation “importing an external valuation into its internal system” depends on the circumstances of each case. For example, if the licensed corporation is importing Bloomberg data as an input into its own internal valuation model, the proprietary valuation model requirements would apply. If the licensed corporation is using Bloomberg as an external valuation system and using Bloomberg’s valuation result for a non-centrally cleared OTC derivative, then the third-party valuation model requirements would apply. However, if the licensed corporation is using broker quotes from Bloomberg to value a non-centrally cleared OTC derivative, then the valuation model requirements would not be applicable.
68. Whilst the SFC does not consider broker quotes to constitute a third-party valuation model, a licensed corporation is nevertheless expected to exercise due skill, care and diligence in sourcing and applying broker quotes for valuation purposes.

Application of valuation model requirements for Asset Managers

Public comments

69. One respondent noted that an asset manager is not usually the valuation agent – typically, the responsibility for producing the official net asset value (**NAV**) valuation is taken up by another party such as a trustee or custodian. The respondent therefore proposed that the valuation model requirements should only be applicable to an Asset Manager which has only been delegated the valuation responsibility and should not extend to an Asset Manager which is responsible for the overall operation of the CIS.
70. Another respondent noted that the official NAV calculation is typically performed by a third party such as a fund administrator and that if an Asset Manager is required to comply with the valuation requirements and determine the official NAV, then established industry practice may be adversely affected in a material respect.
71. Some respondents commented that an Asset Manager may send reports containing valuation information on non-centrally cleared OTC derivatives to external parties, such as the CIS custodian or fund administrator, for their information. The respondents stated that such information does not constitute an official NAV valuation; rather, the valuation information is sent for the external party’s reference as part of a portfolio holding report. The respondents asked whether such reports are subject to the valuation model requirements.

⁵ An Asset Manager may satisfy the verification requirement for third-party model outputs by using the same means or by comparing the model outputs with the valuation of the non-centrally cleared OTC derivative transaction from the transaction counterparty.

⁶ For example, licensed corporations can assess whether a third-party valuation model is well specified by reviewing the model’s methodology or specification document.

The SFC's responses

72. An Asset Manager who is responsible for the overall operation of the CIS or has been delegated valuation responsibility will have responsibility under paragraph 5.3.1 of the revised Fund Manager Code of Conduct (**FMCC**) (which has become effective on 17 November 2018) to ensure that appropriate policies and procedures are established so that a proper valuation of the fund assets can be performed.
73. Where such an Asset Manager arranges the appointment of a third party to perform the valuation services, the Asset Manager is required to exercise due skill, care and diligence in the selection of the third party and remains responsible for the valuation of the fund assets, notwithstanding the appointment of a third party to perform valuation services, pursuant to paragraph 5.3.4 of the revised FMCC.
74. Accordingly, the Asset Manager should ascertain the valuation process and methodology utilised by the third-party valuation provider. Where the third-party valuation provider uses a proprietary valuation model to value non-centrally cleared OTC derivatives, the Asset Manager should check that the third-party valuation provider has a process to ensure the valuation model satisfies paragraphs 5(a) to (d) of Part I of Schedule 10 to the Code of Conduct (ie, the risk mitigation requirements). Alternatively, if the Asset Manager itself uses a proprietary valuation model to cross check the valuation output of the third-party valuation provider, the Asset Manager may elect to comply with paragraphs 5(a) to (d) of the risk mitigation requirements by demonstrating that its own valuation model complies with those requirements.
75. The valuation model requirements apply to an Asset Manager which executes non-centrally cleared OTC derivative transactions on behalf of a CIS managed by it, where: (a) it is responsible for the overall operation of the CIS or has been delegated valuation responsibility for the CIS; and (b) the Asset Manager elects to use a proprietary or third-party valuation model to value such non-centrally cleared OTC derivatives as part of the official portfolio valuation (ie, to calculate the fund NAV). An Asset Manager which does not have valuation responsibility but which uses valuation models for internal purposes (such as for calculating a shadow NAV or for internal risk management purposes) would not be subject to the valuation model requirements. Accordingly, the sending of portfolio holding reports containing valuation information to third parties for their reference would not fall within the scope of the valuation model requirements.

(iv) Portfolio reconciliation

Public comments

76. One respondent suggested that the SFC establish a minimum requirement for licensed corporations to perform portfolio reconciliation at least once a year.

The SFC's responses

77. The SFC has adopted a high-level, principles-based approach to the risk mitigation requirements, taking into account the different sizes and scales of market participants' OTC derivatives operations. Accordingly, the SFC does not prescribe a minimum frequency for portfolio reconciliation. Licensed corporations should use a risk-based approach to decide their portfolio reconciliation frequency for themselves, taking into account the size and volatility of their non-centrally cleared OTC derivative portfolios

with counterparties. We would expect portfolio reconciliation to be more frequent than once a year.

(v) Portfolio compression

Public comments

78. Several respondents sought guidance from the SFC on how regularly a licensed corporation should assess the need for portfolio compression as well as how such portfolio compression should be performed, including whether compression need not be considered unless the outstanding portfolio size with a given counterparty exceeds a certain number of trades.

The SFC's responses

79. The SFC takes a principles-based approach. Accordingly, we neither prescribe the frequency for assessing whether portfolio compression should be performed, nor do we prescribe how such portfolio compression should be performed. Licensed corporations should assess the use of portfolio compression in a risk-based manner, taking into account the level of non-centrally cleared OTC derivative exposure or activity, the availability and efficiency of portfolio compression tools and services, as well as industry best practice. The number of outstanding trades is a relevant factor but is not necessarily the only factor to be considered.

C. Implementation timetable for risk mitigation requirements

Public comments

80. Several respondents suggested that the SFC phase-in the risk mitigation requirements and adopt a phase-in schedule similar to that in the HKMA's regime so that: (a) the industry has sufficient time to prepare; and (b) market participants with a lower average aggregate notional amount of non-centrally cleared OTC derivatives may be captured at a later stage.

The SFC's responses

81. The SFC's risk mitigation requirements are set at a high level, and in some respects are less detailed than the HKMA's standards, to cater for licensed corporations with different scales of OTC derivatives activities. In general, the volume of licensed corporations' non-centrally cleared OTC derivatives activities is lower than that of banks, and licensed corporations will likely need to coordinate with fewer counterparties in implementing the risk mitigation requirements.
82. In any case, the SFC's risk mitigation requirements reinforce key information management and risk management requirements in the Internal Control Guidelines. As such, it is expected that licensed corporations would already have a number of the relevant controls in place and therefore the risk mitigation requirements would not put a major additional burden on licensed corporations.
83. Taking into account the industry's concerns about the implementation timetable, the SFC will provide a longer transition period. The risk mitigation requirements as set out in Appendix A of this consultation conclusions paper will become effective on 1 September 2019.

Part II. Proposed requirements for client clearing

A. Segregation and portability, indirect clearing

Questions raised in the Consultation Paper

Q12. Do you agree with our proposed segregation and portability requirements? Where both individual client segregation and omnibus client segregation are offered by a central clearing counterparty (**CCP**), should a licensed corporation which is a clearing member of the CCP be required to offer its clients both account structures? As part of the proposed disclosure requirements in relation to the risks of different account structures, should licensed corporations also be required to explicitly flag to clearing clients the risk that the clients themselves may be exposed to losses as part of the CCP recovery and resolution, eg, via variation margin gains haircutting?

Q13. Is it appropriate to prohibit the use of client assets for the benefit of the licensed corporation's affiliates? If so, is it appropriate to identify affiliates of a licensed corporation by reference to the concept of controlling-entity relationship as defined under the SFO?

Q14. Do you agree with our proposed notification and information disclosure requirements in relation to indirect clearing?

Public comments

84. In general, respondents supported the proposed requirements. One respondent suggested that, given the global nature of OTC derivative transactions and market participants, the segregation and portability requirements should be in line with those of other jurisdictions.
85. Two respondents offered opposing views on whether a licensed corporation which is a clearing member of a CCP offering both individual client segregation and omnibus client segregation account structures should be required to offer both account structures to its clients.

The SFC's responses

86. The client clearing segregation requirement is set at a high level to accommodate different legal forms of account and collateral arrangements in various jurisdictions. In order to cater for the different segregation models which may be offered by a CCP and to provide flexibility for licensed corporations, we do not prescribe which segregation model a licensed corporation must adopt, as long as the licensed corporation segregates assets held for clients in separate accounts at the CCP which can be distinguished from its own assets. Accordingly, licensed corporations are free to choose whether they offer both individual and omnibus client segregation accounts when available at CCPs.

B. Clearing confirmation to clients

Question raised in the Consultation Paper

Q15. Do you agree with our proposed clearing confirmation requirements?

Public comments

87. In general, respondents supported the proposed requirements. One respondent suggested licensed corporations should notify clients as soon as technologically practicable that a transaction has been successfully cleared and that the SFC should impose straight-through-processing (**STP**) requirements similar to those in the US and EU to reduce market, credit and operational risks as well as to promote global consistency in OTC derivatives clearing frameworks.

The SFC's response

88. The SFC encourages licensed corporations to adopt STP for OTC derivatives transactions where practicable. Full STP implementation will involve corresponding infrastructure support from the licensed corporation's clients. As the proposed requirement applies to all licensed corporations providing OTC derivatives client clearing services regardless of the size and scale of their activities, we will provide flexibility and leave it to licensed corporations to assess for themselves the costs and benefits of implementing STP. We will adhere to our original proposal, namely that a licensed corporation which provides client clearing services should provide a clearing confirmation to its clients no later than the end of the following business day after the client's OTC derivative transaction is accepted for clearing by the CCP.

C. Implementation timetable for requirements on client clearing

89. In line with the proposal in the Consultation Paper, the requirements for client clearing set out in Appendix B of this consultation conclusions paper will become effective when the new OTC derivatives licensing regime commences.

Part III. Proposed conduct requirements to address risks posed by group affiliates and other connected persons

A. Proposed conduct requirement for the management of financial exposures to group affiliates and other connected persons

90. It was proposed in the Consultation Paper to require licensed corporations to properly manage financial exposures to group affiliates and other connected persons, namely their shareholders, directors and employees, according to the same risk management standards they would deploy in respect of financial exposures to independent third parties undertaken by them on an arm's length basis to minimise interconnectedness risk. In order to avoid a scenario where the proposed requirement inadvertently hinders the application of other regulations which permit or require different treatments to be applied to financial exposures to group affiliates or other connected persons, we also suggested that the proposed requirement will cease to apply if its application to a financial exposure will have the effect of overriding an applicable requirement⁷ or exemption⁸ under any law, rule or regulation administered or issued by the SFC or the regulators (if any) of the group affiliate or other connected person in respect of the exposure or transaction giving rise to the exposure.

Question raised in the Consultation Paper

Q18. Do you agree with our proposal to require licensed corporations to properly manage financial exposures to group affiliates and other connected persons according to the same risk management standards they would apply in respect of exposures to independent third parties undertaken by the licensed corporations on an arm's length basis in order to minimise interconnectedness risk? If not, what other conduct requirements should be introduced in order to minimise the impact of interconnectedness risk?

Scope of application

Public comments

91. Respondents generally supported the proposal. Some respondents sought clarification of the scope of the application of the proposal and their comments are summarised as follows:
- (a) whether the proposed requirement applies to all licensed corporations or only licensed corporations engaging in OTC derivative activities and the rationale for applying it to all licensed corporations or only licensed corporations engaging in OTC derivative activities;
 - (b) whether the proposed requirement applies to registered institutions or inter-branch transactions; and

⁷ For example, a requirement to manage the exposure in a specified way.

⁸ For example, an exemption from a mandatory margining requirement specifically provided for the transaction.

- (c) what kinds of exposures and which types of affiliates are covered by the proposed requirement.

The SFC's responses

92. Our responses to the above comments are as follows:

- (a) the proposal applies to all licensed corporations with financial exposures to group affiliates and other connected persons. We consider that limiting its application to licensed corporations engaging in OTC derivative activities will undermine the objective of the proposal, as interconnectedness risks will also arise from activities other than OTC derivative activities. Moreover, we issued a circular in December 2017 to remind licensed corporations, among others, to establish, maintain and adhere to prudential risk management practices to safeguard client money, and in particular to set and enforce concentration limits for affiliated financial institutions⁹;
- (b) the proposal will not be applicable to registered institutions or inter-branch transactions; and
- (c) all types of financial exposures including on-balance sheet and off-balance sheet exposures as well as exposures arising from OTC derivative activities will be governed by the proposed requirement. Group affiliate refers to any company which is within the same group of companies (as defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance) as the licensed corporation.

Scope of intra-group "financial exposures"

Public comments

93. A respondent suggested to exclude the following intra-group financial exposures from the proposed requirement:

- (a) uncollateralised amounts receivable from affiliated banks or brokers which are authorized institutions or licensed corporations, as the probability of default of such affiliates is remote;
- (b) amounts receivable from affiliates arising from securities dealing which are settled on a delivery-versus-payment basis and which are not yet due for settlement, as the licensed corporation can liquidate the underlying securities to recover the amounts should the affiliates default;
- (c) client margin and client money held with affiliated banks or brokers for which the licensed corporation is not liable to compensate the clients for losses suffered as a result of default of the affiliated banks or brokers; and
- (d) other amounts receivable from affiliates which are not included in the licensed corporation's liquid assets, as there will be minimal impact on the licensed corporation's liquid capital when the affiliates default.

⁹ See "Circular to licensed corporations on liquidity risk management" issued by the SFC on 18 December 2017.

The SFC's responses

94. While risks may vary depending on the nature of an exposure, licensed corporations should manage all exposures prudently with regard to their underlying risks. There is no conflict between this risk management principle and the proposed requirement. Secondly, the proposed requirement aims to enhance licensed corporations' risk management of exposures to group affiliates and other connected persons. Irrespective of the capital treatments of their financial exposures in the capital rules, licensed corporations have the responsibility to practise prudent risk management.

Other comments

Public comments

95. A respondent considered that it would not be practicable to monitor financial exposures to each group affiliate if there were a large number of group affiliates.
96. Another respondent opined that risk management at the entity level is not necessary as managing risks at the group level would be sufficient to control the risk of spill-over of the unlicensed affiliates' financial risks to the licensed corporation. The respondent suggested allowing the industry to develop, and continue using, their own risk management program instead of prescribing a single risk management model which might not work or might not be necessary for every institution. The respondent also suggested making the proposal a fallback for licensed corporations which have no proper risk management policies in place.

The SFC's responses

97. We do not consider that the number of group affiliates is a valid reason for not monitoring the financial exposures to them. Licensed corporations are expected to design and implement control and risk management programmes which are commensurate with the scale and complexity of their operations. We also disagree that managing risks at the group level can address the interconnectedness risks arising from exposures to group affiliates, as such risks exist only at the entity level.

Public comments

98. A respondent requested that licensed corporations be exempted from the proposed requirement if they have access to information about their affiliates' liquidity and capital positions or other "insider information".

The SFC's responses

99. As mentioned in the Consultation Paper, licensed corporations must take into account all the information they have about their group affiliates or other connected persons in their risk management of exposures to these parties according to the same standards they would apply for exposures to an independent third party about whom they have similar knowledge. Having knowledge about a group affiliate's financial positions may enable the licensed corporation to make better-informed decisions, but it does not guarantee that the exposures to the affiliate would become risk-free and need not be managed.

100. In view of the general support from respondents and the importance of controlling interconnectedness risks between licensed corporations and their group affiliates and other connected persons, we will proceed to implement the proposal.

B. Proposed conduct requirements relating to the introduction of clients to enter into OTC derivative transactions with a CFA

101. We proposed in the Consultation Paper that a licensed person, when soliciting or recommending clients who are not group affiliates to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and its clients who are not group affiliates, should:
- (a) act in the best interests of the clients (*Best Interest Requirement*);
 - (b) make such a solicitation, recommendation or arrangement (Note) only if the group affiliate is a licensed corporation, an authorized financial institution or a corporation similarly regulated as an OTC derivative dealer or bank in a comparable overseas jurisdiction (*Regulated CFA Requirement*); and
 - (c) if the group affiliate is not a licensed corporation, provide an appropriate risk disclosure statement to clients in the client agreements which should, at a minimum, contain the risk disclosure statement in respect of the risk of entering into OTC derivative transactions with an unlicensed person (*Risk Disclosure Requirement*).

Note: A licensed person is exempt from the Regulated CFA Requirement if the client is a licensed corporation, an authorized financial institution or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction.

Questions raised in the Consultation Paper

Q19. Do you agree that licensed corporations should be allowed to: i) solicit or recommend clients to enter into OTC derivative transactions with a group affiliate; or ii) arrange for OTC derivative transactions to be entered into between their clients and a group affiliate only if the group affiliate is a licensed corporation, an authorized financial institution or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction subject to the exemption set out in paragraphs 136 and 139?

Q20. Do you agree with the proposed risk disclosure requirement for licensed corporations using unlicensed CFAs?

Best Interest Requirement

Public comments

102. Respondents generally agreed with the proposed Best Interest Requirement. Two respondents asked for guidance on how licensed corporations could meet the requirement. One respondent opined that the interests of clients would be adequately protected by the existing conduct requirements (eg, suitability checks and disclosure

requirements in the Code of Conduct) and the proposed Regulated CFA Requirement and Risk Disclosure Requirement.

The SFC's responses

103. We consider it necessary to maintain the principles-based nature of the proposed requirement as acting in the client's best interest is a key conduct standard for the financial services industry. The question of compliance will depend on the circumstances of each individual case. We also emphasise that the proposed Best Interest Requirement is independent of all other requirements in the Code of Conduct.

Regulated CFA Requirement

Public comments

104. Some respondents supported the proposed Regulated CFA Requirement and one considered that it would close the loophole of using an unlicensed CFA to avoid the SFC's regulation at the expense of clients' interests. Some respondents were concerned about the necessity for and impact of the requirement and their comments are summarised below:
- (a) intra-group or inter-affiliate trades play an important role in effective risk management;
 - (b) CFA arrangements have generally not presented additional client protection issues;
 - (c) there are sufficient requirements in the current Code of Conduct, such as product assessment and suitability requirements, to protect clients trading with CFAs. The SFC may instead provide more detailed guidance if it considers that industry participants are falling short of those requirements;
 - (d) the proposed Risk Disclosure Requirement is sufficient to protect clients from the additional risks arising from CFA arrangements;
 - (e) other major jurisdictions do not have a similar requirement;
 - (f) the SFC should instead issue a product specification guideline or adopt a "funds passporting" regime;
 - (g) currently, OTC derivative product issuers are not required to be licensed as the Types 11 and 12 RAs have not yet taken effect. As such, from the perspective of an OTC derivative product issuer, its counterparty is not its "client" in the context of the Code of Conduct. Moreover, it is doubtful whether an OTC derivative product issuer would be able to be licensed under the current licensing regime (ie, under Types 1 to 10 RAs) given the carve-outs provided in the definitions of the various types of RAs¹⁰. Furthermore, since the existing FRR are not suitable for OTC derivative activities, there will be a large number of applications for the modification of FRR requirements if the OTC derivative business is to be carried out by and booked in licensed corporations;

¹⁰ For instance, an OTC derivative product issuer may be entitled to claim the "principal-to-principal exemption" under paragraph (v) of the definition of "dealing in securities" in Part 2 of Schedule 5 to the SFO.

- (h) the proposal would lead to regulatory arbitrage across different types of entities, as authorized financial institutions will not be subject to the same proposed requirement;
- (i) the proposal is inconsistent with or otherwise limits the “dealing through” exemption in the definition of Type 11 RA and would result in an unlevel playing field between financial groups and non-financial groups;
- (j) the interests of clients or licensed corporations would be prejudiced due to:
 - (i) limited product choice for clients as the proposal precludes clients from entering into OTC derivative transactions with unregulated CFAs;
 - (ii) as the issuance of OTC derivative products is not an RA before the Types 11 and 12 RAs take effect, licensed corporations might be encouraged to sell OTC derivative products issued by unregulated third parties, and financial groups might be incentivised to cross-sell each other’s structured products and transfer the risks back to their respective licensed corporations through back-to-back transactions. It would also send the investing public a misleading message that OTC derivative products issued by third parties are safer and licensed corporations know third-party products better than those issued by their affiliates; and
 - (iii) the proposal creates regulatory arbitrage across products, as some products do not fall within the definition of “OTC derivative products” and hence would not be covered by the proposal;
- (k) Mainland-based securities firms would not be able to conduct OTC derivative activities across the boundary if the Mainland is not included in the list of comparable OTCD jurisdictions;
- (l) the exemption given to overseas-regulated CFAs would give foreign entities an unfair advantage; and
- (m) the proposal would raise the cost of doing OTC derivative business in Hong Kong and drive the business to other regional financial centres.

The SFC’s responses

105. Our responses to the above comments are as follows:

- (a) the proposed requirement would not have any impact on intra-group transactions as it specifically exempts transactions with clients which are group affiliates;
- (b) the proposed requirement is necessary to protect clients from the conduct and prudential risks of unregulated or under-regulated CFAs;
- (c) compliance with the suitability requirements in paragraph 5.2 of the Code of Conduct would not provide the same protection against conduct and prudential risks of the CFA as direct supervision of the CFA by a competent regulator. Clients would receive better protection if the CFA is adequately regulated;

- (d) similarly, risk disclosure cannot provide the kind of regulatory protection discussed in the preceding paragraph;
- (e) the proposed requirement aims to address the concerns arising from the CFA models used in Hong Kong and has been tailor-made to cater for the unique characteristics of the local market and strike a balance between business development and investor protection;
- (f) the client protection and regulatory arbitrage concerns arising from the CFA models cannot be addressed by issuing product specification guidelines. Given the bespoke and bilateral nature of most OTC derivative contracts, it is impracticable to introduce a passporting regime similar to those for investment funds;
- (g) from the perspective of the licensed corporation which introduces a person to enter into OTC derivative transactions with a CFA, to the extent that the introduction falls within a type of RA currently in force, the person being introduced would be its client for the purposes of the SFO and Code of Conduct, and as such all the proposed requirements in paragraph 101 would be applicable to it. On the other hand, the CFA's act of entering into OTC derivative transactions with the licensed corporation's clients may fall outside the definition of RA due to the carve-outs contained in the definition of the types of RA that may otherwise apply. As a result, the CFA may not be eligible to apply for a licence even if it wants to. If the licensed corporation is not allowed to introduce clients to the CFA under the proposed requirement, they may have to suspend their OTC derivative business until the CFA is granted a licence for Type 11 RA. Although it can be argued that, in the interim, the licensed corporation may enter into OTC derivative transactions directly with clients instead of introducing the clients to the CFA, to adopt such an approach would be a major change in the business models of the licensed corporation and the CFA, which would involve substantial revisions of their business plans, contractual relationships with clients, capital requirements as well as accounting and other systems. The process will be long and complex. In view of the above concerns, we will allow licensed corporations a transitional period to comply with the proposed requirement in respect of *existing CFAs* which fall outside the range of regulated persons set out in the proposed requirement. Details of the arrangements for the transitional period and the definition of "existing CFA" are discussed in paragraphs 131 to 134 below;
- (h) the proposed requirement would not lead to regulatory arbitrage because OTC derivative dealing by authorized financial institutions is already carved out from Type 11 RA and is regulated by the HKMA;
- (i) the proposed requirement would not affect the application of the exemption provisions in the definitions of various types of RAs to CFAs;
- (j) (i) we are not convinced that product choices for investors would be unduly limited by the proposal, as under the proposed requirement, licensed corporations may introduce clients to CFAs which are licensed corporations, authorized financial institutions or OTC derivative dealers or banks similarly regulated in a comparable OTCD jurisdiction;
 - (ii) it is unlikely that the proposed requirement would incentivise licensed corporations to market third-party products, instead of their groups' products, to

clients or enter into complex back-to-back arrangements with third parties to avoid the requirement, as doing so may incur additional costs and risks (eg, reputational, legal and counterparty credit risks); and

(iii) the proposed requirement aims to enhance protection for clients trading OTC derivative products with CFAs; other investment products are regulated by their respective regulatory regimes which ensure proper investor protection;

- (k) the SFC will determine the list of comparable OTCD jurisdictions after considering whether other jurisdictions' regulatory frameworks for OTC derivative dealing activities are comparable to Hong Kong's;
- (l) the proposed requirement would indeed provide a level playing field for all licensed corporations, irrespective of their country of origin, by applying a set of common standards to regulate the use of CFAs;
- (m) the proposals have struck the right balance between compliance cost and investors protection. In particular, licensed corporation may continue to use CFAs which are subject to comparable regulation, whereas clients would be protected from being introduced to CFAs not subject to comparable regulation.

Regulated client exemption

Public comments

106. Two respondents suggested expanding the scope of the regulated client exemption set out in the note to the proposed Regulated CFA Requirement to include clients who are experienced individual professional investors, institutional professional investors and corporate professional investors whom the licensed corporation is exempt from the requirements to enter into written client agreements with and provide risk disclosure statements to under paragraph 15 of the Code of Conduct.

The SFC's responses

107. As discussed in the Consultation Paper, one of the reasons for exempting regulated clients from the application of the proposed Regulated CFA Requirement is that the OTC derivative transactions entered into by a regulated client will likely be subject to regulations similar to those applicable to transactions entered into by a regulated CFA. The regulations which apply to transactions entered into by regulated persons, however, may not necessarily apply to transactions between professional investors and unregulated CFAs. Therefore, we maintain our view that the regulated client exemption will not be expanded to include the suggested types of clients.

List of comparable OTCD jurisdictions (formerly known as comparable overseas jurisdictions in the Consultation Paper)

Public comments

108. Respondents had the following comments in relation to the list of comparable OTCD jurisdictions:
- (a) a few respondents sought clarification of the criteria for determining the list and requested that the SFC publish the list as soon as possible;

- (b) two respondents suggested that the list should not be determined only with reference to the status of implementation of the Group of Twenty (**G20**) Reforms and that the SFC should take into consideration the broader regulatory environment in which the affiliate operates;
- (c) one respondent suggested the SFC include in the list: (i) member jurisdictions of WGMR¹¹; (ii) the UK, separate from the EU; and (iii) the names of the regulators in each jurisdiction. The respondent further suggested that the SFC take an outcome-based approach rather than a granular approach to determining the list;
- (d) two respondents suggested some countries for inclusion in the list¹²; and
- (e) two respondents suggested issuing a list of deemed comparable OTCD jurisdictions as an interim measure before the final list is determined.

The SFC's responses

109. A comparable OTCD jurisdiction is a jurisdiction which has implemented a regulatory framework on OTC derivative dealing activities comparable to Hong Kong's. In conducting the comparability review, we noted that the status of the implementation of the OTC derivative market reforms by G20 members varies. For this reason, and in order to facilitate licensed corporations' preparation for compliance with the proposed requirements, we agree that it is desirable to issue a list of deemed comparable OTCD jurisdictions in the interim. If a deemed comparable OTCD jurisdiction is excluded from the final list, sufficient time will be allowed for the affected licensed corporations to make the necessary arrangements to comply with the related requirements.
110. The list of comparable OTCD jurisdiction will be determined with reference to the jurisdictions' implementation of prudential and conduct requirements for supervising intermediaries conducting OTC derivative dealing. References will also be made to public reports on the jurisdiction's regulatory framework issued by international organisations¹³. For the purposes of the deemed list, these jurisdictions' commitment to reform will also be taken into account.
111. Based on our preliminary assessment, the list of deemed comparable OTCD jurisdictions will include the securities, futures and banking regulators in the following countries (in alphabetical order) - Australia, Canada, the Mainland, France, Germany, Italy, Japan, Netherlands, the Republic of Korea, Singapore, Spain, South Africa, Switzerland, the UK and the US.
112. We will keep in view the need to update the list and the comparability assessments to finalise the list of comparable OTCD jurisdictions. The public is welcome to contact the SFC with any comment on the list of deemed comparable OTCD jurisdictions.

¹¹ Including Australia, Canada, the EU, Hong Kong, India, Japan, the Republic of Korea, Mexico, Russia, Singapore, Switzerland and the US.

¹² Namely Australia, China, the EU, Japan, Singapore, Republic of Korea, the UK and the US.

¹³ Such as the Financial Stability Board and the International Organization of Securities Commissions.

Scope of application

Public comments

113. One respondent sought clarification of whether the proposed requirement would apply to a licensed corporation which recommends that a client sign an investment management agreement (or similar arrangements) with a group affiliate for the management of a portfolio which includes OTC derivatives where the group affiliate is not the contracting party of the OTC derivative transactions.

The SFC's responses

114. We clarify that the proposed requirement would not apply to the referral of asset management services of group affiliates to clients. Such referrals continue to be subject to the regulation of paragraph 3.10 of the Code of Conduct.

Risk Disclosure Requirement

Public comments

115. We received strong support for the proposed requirement. A few respondents sought clarification of whether the risk disclosure could be made on a one-off basis in the client agreement instead of on a trade-by-trade basis. Another respondent sought clarification of whether the proposed requirement would apply if a licensed corporation enters into a client agreement with a client notwithstanding that the exemption relating to the client agreement and risk disclosure requirements in the Code of Conduct applies.

The SFC's responses

116. We clarify that the proposed risk disclosure is to be made in respect of each CFA in the client agreement on a one-off basis. If a licensed corporation is exempt from the client agreement and risk disclosure requirements in respect of a client pursuant to paragraph 15.4 of the Code of Conduct, it is not required to comply with the proposed requirement.

Public comments

117. Respondents also suggested exempting licensed corporations from the proposed requirement if: (i) the CFA is regulated; or (ii) the client is regulated, a professional investor or a special purpose vehicle.

The SFC's responses

118. We do not consider it appropriate to exempt licensed corporations from the proposed requirement in respect of CFAs which are regulated other than by the SFC. The proposed risk disclosure aims to remind clients about the possibility of differences between the SFC's regulation and the regulation of other jurisdictions in order to prevent them from mistaking unlicensed CFAs introduced by licensed corporations as also subject to the SFC's regulation.
119. Regarding the suggestion to exempt licensed corporations from the proposed requirement in the case of regulated or professional clients, we have already proposed in the Consultation Paper to expand the scope of the exemption in paragraph 15.4 of

the Code of Conduct relating to risk disclosure to clients to include the proposed requirement.

C. Proposed conduct requirements for licensed corporations booking OTC derivative transactions in risk booking affiliates (RBAs)

120. It was proposed in the Consultation Paper to require a licensed corporation which arranges OTC derivative transactions which are entered into with the licensed corporation's clients, or on a back-to-back basis against a client transaction, for group affiliates which are not licensed corporations, authorized financial institutions or corporations similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD jurisdiction to,
- (a) in a case where the licensed corporation has responsibility for or oversight of the management of the risks undertaken by a group affiliate in the OTC derivative transactions so arranged, ensure that such risks are properly managed; or
 - (b) in any other case, take reasonable steps to ensure that the risks undertaken by each group affiliate in the OTC derivative transactions so arranged are covered by a risk management programme whose standards are not less stringent than the risk management standards set by the SFC for licensed corporations, by the HKMA for authorized financial institutions, or by a securities, futures or banking regulator in a comparable OTCD jurisdiction for OTC derivative dealers or banks entering into similar transactions.

Question raised in the Consultation Paper

Q21. Do you agree with the proposed risk management requirements for licensed corporations arranging for OTC derivative transactions to be booked in RBAs?

Public comments

121. Respondents generally supported the proposals. Some respondents sought guidance on the steps licensed corporations should take to ensure that the risks undertaken by each group affiliate are covered by a risk management programme and on the elements or contents to be included in the risk management programme. A respondent requested the SFC to provide the industry with the flexibility to develop their risk management programmes or continue to use the existing risk management programme.

The SFC's responses

122. We believe that it would be appropriate to maintain the principles-based nature of the requirement to allow the industry the flexibility to tailor-make for themselves suitable compliance procedures and risk management programmes. In this regard, licensed corporations should take into account guidance on risk management provided from time to time by the SFC or the regulators (if any) of their RBAs or groups in designing their programmes.

Public comments

123. One respondent requested clarification of the following areas in relation to the proposed requirement:
- (a) where a licensed corporation has more than one affiliate along a risk booking chain, whether all affiliates in the chain or only the ultimate risk booking entity at the end of the chain would be regarded as an RBA;
 - (b) whether compliance with the proposed risk mitigation requirements would be sufficient for the purpose of complying with the proposed requirement relating to RBAs; and
 - (c) whether RBAs are subject to any capital requirements, and if yes, what are the requirements.

The SFC's responses

124. Our responses are as follows:
- (a) the proposed requirement applies to group affiliates for whom OTC derivative transactions are arranged by the licensed corporation which have a direct or indirect relationship with client transactions as described in the proposal;
 - (b) the proposed risk mitigation standards are part of the risk management requirements which apply to licensed corporations. Licensed corporations should take into account other risk management requirements and related guidance issued by the SFC or other regulators (where applicable); and
 - (c) the proposed requirement does not require RBAs to be subject to capital requirements.

Public comments

125. One respondent asked why a licensed corporation would be subject to the proposed requirement when it arranges for a regulated CFA to enter into an OTC derivative transaction with an affiliate while it would not be subject to the proposed requirement when the same transaction is entered into with a third party.

The SFC's responses

126. The proposed requirement aims to address the concern that risks undertaken by a group may be kept in or transferred to an unregulated RBA without adequate oversight of its risk management, which may eventually affect the interests of the CFA, the licensed corporation or the licensed corporation's clients through contagion within the group. While the proposed requirement does not apply to licensed corporations arranging OTC derivative transactions for the CFA with third parties, licensed corporations should exercise due care and diligence in conducting business activities under the General Principles of the Code of Conduct.

Public comments

127. One respondent commented that the proposed requirement would not provide additional protection to clients as the clients who contract with the CFA would have direct recourse only to the CFA when the CFA defaults, even if the default is driven by the default of the RBA. The respondent further submitted that licensed corporations should be exempt from complying with the proposed requirement if the CFA is regulated.

The SFC's responses

128. The proposal aims to minimise the default risk of RBAs, which may spill over to the clients of the licensed corporation through the licensed corporation or CFA contracting with the clients. It is considered inappropriate to provide an exemption in respect of regulated CFAs as such a contagion risk may not necessarily be prevented by the regulation to which the CFA is subject.

D. Implementation timetable for conduct requirements to address risks posed by group affiliates and other connected persons

Public comments

129. Two respondents commented that it would take time for the industry to amend the existing client agreements in order to comply with the proposed Risk Disclosure Requirement and requested a six-month grace period.
130. A respondent suggested that the implementation of the entire regulatory regime proposed in the Consultation Paper should not be earlier than September 2020, with a suitable phase-in period to align with the timeline of the broader OTC derivative market reform in Hong Kong.

The SFC's responses

131. We proposed in the Consultation Paper that all the requirements proposed in Part VI of the Consultation Paper will take effect six months after the gazettal of the related Code of Conduct amendments. Given that those requirements generally do not require substantial infrastructure changes, we maintain that the proposed implementation timetable is suitable, except that a transitional period for the application of the Regulated CFA Requirement for dealings with *existing CFAs* which fall outside the range of regulated persons set out in the requirement will be provided for the reasons discussed in paragraph 105(g) (Note).

Note: An *existing CFA* is defined as a CFA which has an ongoing introduction agreement with a licensed corporation within the same group which was established and in effect before the date of the release of this paper, ie, 12 December 2018, whereby the licensed corporation agrees to introduce clients to enter into OTC derivative transactions with the CFA.

132. During the transitional period, the Regulated CFA Requirement will not apply to solicitations, recommendations and arrangements relating to existing CFAs which fall outside the range of regulated persons set out in the requirement. Licensed corporations should implement reasonable measures to protect clients from the conduct and prudential risks of such existing CFAs.

133. No transitional period will be provided for the Best Interest Requirement and Risk Disclosure Requirement. In other words, licensed corporations are required to comply with the Best Interest Requirement and Risk Disclosure Requirement in respect of solicitations, recommendations and arrangements relating to all existing and new CFAs. Licensed corporations must ensure that their clients are fully informed about the regulated or unregulated status (as the case may be) of their CFAs in the risk disclosures. The proposed wording of the specified risk disclosure statement has been amended to cater for a situation where an unregulated CFA may be used during the transitional period.
134. The transitional period for the Regulated CFA Requirement will end with the transitional period for Type 11 RA.

Public comments

135. One respondent commented that the new FRR will be the most critical part of the OTC derivative regime and suggested that: (i) sufficient time should be given to the industry for implementing the new FRR; and (ii) the OTC derivative regulations should only be implemented after the new FRR comes into effect. Another respondent commented that the new FRR should be implemented simultaneously with Type 11 RA and Type 12 RA.

The SFC's responses

136. We noted the comments and clarify that the proposed FRR transitional arrangements have been discussed in the FRR consultation conclusions and further consultation paper published last year¹⁴.

¹⁴ See Section H of Part II of Consultation Conclusions and Further Consultation on Proposed Changes to the Securities and Futures (Financial Resources) Rules issued by the SFC on 24 July 2017.

Part IV. Consequential amendment

137. With the introduction of Type 11 RA and Type 12 RA, we have proposed to make a consequential amendment to the note to paragraph 6.2(i) of the Code of Conduct such that the current client agreement requirement also covers solicitations or recommendations of OTC derivative products under the new RAs. The respondents have no comments on this consequential amendment. This amendment, as set out in Appendix D, will become effective at the time the two new RAs come into effect.

Appendix A Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – new paragraph 4.3A and new Schedule 10 Part I

Insert new paragraph 4.3A

“4.3A Risk mitigation requirements and margin requirements in relation to non-centrally cleared OTC derivative transactions;

Requirements for persons licensed for providing client clearing services for OTC derivative transactions

A licensed person which enters into non-centrally cleared OTC derivative transactions should implement the risk mitigation and margin requirements set out in Part I and Part II of Schedule 10 respectively. A licensed person which provides client clearing services for OTC derivative transactions should implement the requirements set out in Part III of Schedule 10.”

Insert new Schedule 10 Part I

“Schedule 10 Risk mitigation and margin requirements in relation to non-centrally cleared OTC derivative transactions; Requirements for persons licensed for providing client clearing services for OTC derivative transactions

Part I Risk mitigation requirements in relation to non-centrally cleared OTC derivative transactions

The risk mitigation requirements set out in this Part of this Schedule apply to:

- (a) a licensed corporation (regardless of the regulated activity for which it is licensed) which is a contracting party to OTC derivative transactions that are not centrally cleared¹⁵; and
- (b) a corporation licensed for Type 9 regulated activity which provides a service of managing a portfolio of OTC derivative products for a collective investment scheme managed by it, in respect of non-centrally cleared OTC derivative transactions executed by it on behalf of the collective investment scheme managed by it, except to the extent that the risk mitigation requirements are handled by the governing body of the collective investment scheme or its delegate.

The risk mitigation requirements do not apply to registered persons.

Trading relationship documentation

1. A licensed corporation should execute written trading relationship documentation with its counterparties prior to, or contemporaneously with, executing a non-centrally cleared

¹⁵ An excluded currency contract as defined under Rule 2 of Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules is only subject to the requirements on Trading Relationship Documentation and Trade Confirmation.

OTC derivative transaction. Such documentation should contain all material terms governing the trading relationship between the counterparties, including credit support arrangements where applicable.

Trade confirmation

2. A licensed corporation should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared OTC derivative transactions are confirmed in writing as soon as practicable after the execution of a transaction. Material terms confirmed should include the terms necessary to promote legal certainty for a transaction.
3. A licensed corporation may use one-way confirmation instead of two-way confirmation insofar as both parties have agreed in advance to confirm trades using this process, so that the outcome is legally binding on both parties.

Valuation

4. A licensed corporation should agree with its counterparty in writing the process for determining the value of non-centrally cleared OTC derivatives in a predictable and objective manner at any time from the execution of the transaction to the termination, maturity, or expiration thereof. The valuation determinations should be based on economically similar transactions or other objective criteria. All agreements on the valuation process should be documented in the trading relationship documentation or trade confirmation.
5. If a licensed corporation values a non-centrally cleared OTC derivative transaction using a proprietary valuation model, the licensed corporation should ensure that the model:
 - (a) employs a valuation methodology with an accepted economic or sound theoretical basis which incorporates all factors that counterparties would reasonably consider in valuing the non-centrally cleared OTC derivative transaction;
 - (b) is appropriately calibrated and tested for validity;
 - (c) is subjected to independent model review, validation and approval periodically and when material changes to the methodology or the model are made; and
 - (d) outputs are subjected to regular independent review and verification.

The results of model calibration, testing, review and validation should be documented.

If a licensed corporation values a non-centrally cleared OTC derivative transaction using a third party valuation model, the licensed corporation should exercise due skill, care and diligence to confirm that the model satisfies paragraphs (a) to (c) above, and the licensed corporation should conduct regular independent reviews and verification of the model outputs.

6. A licensed corporation with material exposures to non-centrally cleared OTC derivative transactions should perform periodic reviews of the agreed-upon valuation process to take into account any changes in market conditions.

Note: In respect of an asset manager licensed for Type 9 regulated activities, paragraphs 4 to 6 (inclusive) of the risk mitigation requirements are only applicable to an asset manager that is responsible for the overall operation of a fund or has been delegated responsibility for fund valuation.

Portfolio reconciliation

7. A licensed corporation should establish and implement policies and procedures to ensure that the material terms are exchanged and valuations (including variation margin) are reconciled with counterparties, at regular intervals.
8. The frequency of portfolio reconciliation with each counterparty should be commensurate with the risk exposure profile of the counterparty, taking into account the size and volatility of the non-centrally cleared OTC derivative portfolio of the licensed corporation with a particular counterparty.

Portfolio compression

9. A licensed corporation should, in respect of non-centrally cleared OTC derivative portfolios, establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression, proportionate to the level of exposure or activity of the licensed corporation.

Dispute resolution

10. A licensed corporation should agree in writing with its counterparties, other than counterparties who are individuals, the mechanism or process for determining when discrepancies in trade populations, material terms, valuations and margins should be considered disputes, as well as how such disputes should be resolved as soon as practicable. Where the counterparty is not a financial counterparty, the licensed corporation may meet this requirement by establishing and implementing effective policies and procedures regarding the type of counterparties with whom such dispute resolution mechanism or process should be agreed, proportionate to the level of exposure to the counterparty.

For the purposes of the risk mitigation requirements in relation to non-centrally cleared OTC derivative transactions:

- (1) “financial counterparty” means:
 - (a) an authorized institution (AI) as defined in section 2(1) of the Banking Ordinance (Cap 155);
 - (b) a licensed corporation;
 - (c) a mandatory provident fund scheme registered under the Mandatory Provident Fund Schemes Ordinance (Cap 485), or its constituent fund as defined in section 2 of the Mandatory Provident Fund Schemes (General) Regulation (Cap 485 sub. leg. A);
 - (d) an occupational retirement scheme registered under the Occupational Retirement Schemes Ordinance (Cap 426), or any scheme which is an offshore scheme as defined in the section 2(1) of the Occupational Retirement Schemes Ordinance (Cap 426);

- (e) a company authorised by the Insurance Authority to carry on any class of insurance business under the Insurance Companies Ordinance (Cap 41);
- (f) a money service operator (ie, remittance agents and money changers) licensed by the Commissioner of Customs & Excise under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap 615);
- (g) a money lender licensed under the Money Lenders Ordinance (Cap 163);
- (h) a special purpose vehicle or a securitisation vehicle, except where and to the extent that the special purpose vehicle enters into non-centrally cleared OTC derivative transactions for the sole purpose of hedging;
- (i) a collective investment scheme as defined in section 1, Part 1 of Schedule 1 of the SFO, or any scheme which is similarly constituted under the law of any place outside Hong Kong;
- (j) an entity that carries on a business outside Hong Kong and is engaged predominantly in any one or more of the following activities¹⁶:
 - Banking;
 - Securities or derivatives business;
 - Asset management;
 - Insurance business;
 - Operation of a remittance or money changing service;
 - Lending;
 - Activities that are ancillary to the conduct of these activities.”

¹⁶ For the avoidance of doubt, this would include (but is not limited to) hedge funds, pension funds and asset managers.

Appendix B Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – new Schedule 10 Part II

Amend paragraph 4.3A

“4.3A Risk mitigation requirements in relation to non-centrally cleared OTC derivative transactions; Requirements for persons licensed for providing client clearing services for OTC derivative transactions”

A licensed person which enters into non-centrally cleared OTC derivative transactions should implement the risk mitigation requirements set out in Part I of Schedule 10. A licensed person which provides client clearing services for OTC derivative transactions should implement the requirements set out in Part II of Schedule 10.”

Amend Schedule 10 heading

“Schedule 10 Risk mitigation ~~and margin~~ requirements in relation to non-centrally cleared OTC derivative transactions; Requirements for persons licensed for providing client clearing services for OTC derivative transactions”

Insert new Schedule 10 Part II

“Part III Requirements for persons licensed for providing client clearing services for OTC derivative transactions

The requirements set out in this Part of this Schedule apply to persons licensed for providing client clearing services for OTC derivative transactions in respect of their carrying on of that regulated activity. They do not apply to registered institutions.

Segregation and portability

1. If a licensed person offers to its client different methods of client asset segregation provided by a particular central counterparty, the licensed person should fully inform each client about the different methods. In respect of each method, the licensed person should explain the costs, risks and portability arrangements, including the legal implications and risk of loss mutualisation to which the client may be subject.
2. For cleared OTC derivative transactions, a licensed corporation should segregate collateral belonging to clients from the licensed corporation's proprietary assets. No licensed person should apply any monies, securities or any other form of collateral that is standing to the credit of any client's ledger account for the benefit of its own position accounts, accounts of its directors or employees or accounts of any corporations with which the licensed person is in a controlling entity relationship.
3. The client clearing agreement entered into between the licensed person and its client should provide for the transfer of the client's positions and collateral of the client's cleared transactions both in the normal course of business and (where the licensed person is also a clearing member of a central counterparty) following the licensed

person's default, where permissible under the applicable legal framework and subject to any requirements of the relevant central counterparty.

Indirect clearing

4. If a licensed person provides client clearing services to its clients by submitting the client's OTC derivative transactions for clearing through one or more clearing intermediaries, the licensed person should notify each client of the names of each clearing intermediary (including the clearing member) and the central counterparty. The licensed person should also explain to each client the asset segregation arrangement between the licensed person and the clearing intermediaries in respect of the client's transactions, and the corresponding legal implications.

Clearing confirmation to clients

5. A licensed person should provide a clearing confirmation to its client no later than the end of the following business day after the client's OTC derivative transaction is accepted for clearing by the central counterparty."

Appendix C Amendments to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission – new paragraphs 20.1 to 20.5 and amendments to paragraph 15.4(b)(i) and Schedule 1

Insert new paragraphs 20.1 to 20.5:

“Dealing with group affiliates and other connected persons

Financial exposures to group affiliates and other connected persons

20.1 A licensed corporation should manage financial exposures to group affiliates and other connected persons, namely its shareholders, directors and employees, according to the same risk management standards it would apply in respect of financial exposures to independent third parties undertaken by it on an arm’s length basis, except where doing so would have the effect of overriding an applicable requirement or exemption under any law, rule or regulation administered or issued by the Commission or the regulators (if any) of the group affiliates or other connected persons in respect of the exposure or transaction giving rise to the exposure.

Soliciting or recommending clients to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and clients

20.2 A licensed person, when soliciting or recommending its clients ~~which~~ who are not group affiliates to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and its clients ~~which~~ who are not group affiliates, should:

- (a) act in the best interests of the clients;
- (b) make such solicitation, recommendation or arrangement ~~(Note)~~ only if the group affiliate is a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD overseas jurisdiction (Notes 1 and 2); and
- (c) if the group affiliate is not a licensed corporation, provide to the clients an appropriate risk disclosure statement in the client agreements which should, at a minimum, contain the risk disclosure ~~statement~~ in respect of the risk of entering into OTC derivative transactions with an unlicensed person as specified in Schedule 1 to the Code.

Note 1: A licensed person is exempt from the provision set out in paragraph 20.2(b) if the client is a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD overseas jurisdiction.

Note 2: Transitional period in respect of existing client facing affiliates which fall outside the range of regulated persons set out in paragraph 20.2(b) (“Transitional Period”): The provision set out in paragraph 20.2(b) does not apply to solicitation, recommendation or arrangement related to an existing client facing affiliate which falls outside the range of regulated persons set out in that paragraph until the

date immediately after the end of the transitional period for Type 11 regulated activity (as defined in section 1 of Part 1 of Schedule 11 to the Securities and Futures Ordinance as amended by section 55 of the Securities and Futures (Amendment) Ordinance 2014). An *existing client facing affiliate* means a group affiliate which has an ongoing introduction agreement with a licensed corporation within the same group that was established and in effect before 12 December 2018 whereby the licensed corporation agrees to introduce clients to enter into OTC derivative transactions with it. During the Transitional Period, licensed corporations should implement reasonable measures to protect clients from conduct and prudential risks of existing client facing affiliates which fall outside the range of regulated persons set out in paragraph 20.2(b).

Booking OTC derivative transactions in group affiliates

- 20.3 A licensed corporation should comply with paragraph 20.4 if it arranges a group affiliate ~~that which~~ is not a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD overseas jurisdiction, to:
- (a) enter into OTC derivative transactions with its clients;
 - (b) enter into OTC derivative transactions with it on a back-to-back basis against OTC derivative transactions entered into by it with clients; or
 - (c) enter into OTC derivative transactions with another group affiliate on a back-to-back basis against OTC derivative transactions entered into by that other group affiliate with its clients under its solicitation, recommendation or arrangement introduction.
- 20.4 The licensed corporation referred to in paragraph 20.3 should, in respect of the risks undertaken by the first-mentioned group affiliate in the OTC derivative transactions arranged by it for that group affiliate ~~:-~~:
- (a) ~~ensure the risks are properly managed~~ in the case where the licensed corporation has responsibility for or oversight of the management of such risks, ensure the risks are properly managed; or
 - (b) in any other case, take reasonable steps to ensure that the risks are covered by a risk management programme whose standards are not less stringent than the risk management standards set by the Commission for licensed corporations, by the Hong Kong Monetary Authority for authorized financial institutions, or by a securities, futures, or banking regulator in a comparable OTCD overseas jurisdiction for OTC derivative dealers or banks entering into similar transactions.
- 20.5 The comparable OTCD overseas jurisdictions referred in paragraphs 20.2 to 20.4 ~~20.2(b) and 20.4(b) are jurisdictions that have implemented a regulatory framework on OTC derivative dealing activities that is comparable to that of Hong Kong as set out in the list of comparable OTCD overseas jurisdictions published on the Commission's website for the purposes of those paragraphs.~~

Consequential amendment

In paragraph 15.4(b)(i), insert “paragraph 20.2(c),” after “paragraph 6.1.”

“15.4 (b) Client agreement

- (i) the need to enter into a written agreement and the provision of relevant risk disclosure statements (paragraph 6.1, paragraph 20.2(c), paragraph 2 of Schedule 3, paragraph 2 of Schedule 4 and paragraph 1 of Schedule 6 to the Code);”.

In Schedule 1 (Risk disclosure statements), insert the following after the risk disclosure statement for Risk of trading Nasdaq-Amex securities at The Stock Exchange of Hong Kong Limited:

“The following risk disclosure should be given to clients where a licensed person (i) ~~a licensed person~~ solicits or recommends its clients ~~which who~~ are not group affiliates to enter into OTC derivative transactions with a group affiliate which is not a licensed person; or (ii) ~~a licensed person~~ arranges for OTC derivative transactions to be entered into between a group affiliate which is not a licensed person and its clients ~~which who~~ are not group affiliates.

Risk of entering into over-the-counter derivative transactions with an unlicensed person

~~If you enter into over-the-counter derivative transactions with [name of the group affiliate] (“The Unlicensed Affiliate Counterparty”) which is an affiliate of [name of the licensed corporation] (“Licensed Dealer”) and [state clearly the regulated status of the group affiliate and the name and country of its regulator], it is important for you to note that unlike the Licensed Dealer, the Unlicensed Affiliate Counterparty is not licensed by the Securities and Futures Commission (“SFC”) and as such, it is not subject to the regulation (including the financial and conduct requirements) of the SFC. Although the Unlicensed Affiliate Counterparty is regulated by another regulatory body, the regulation of such regulatory body may be different from the regulation of the SFC. It is possible that the protection that you may receive under the regulation of that regulatory body is not the same as the protection that you would receive if the Unlicensed Affiliate Counterparty were licensed by the SFC. You should cautiously consider whether it would be in your best interest to enter into over-the-counter derivative transactions with the Unlicensed Affiliate Counterparty instead of the Licensed Dealer and consult independent professional advice when in doubt.~~

If you enter into over-the-counter derivative transactions with [name of the group affiliate] (Your Counterparty), it is important for you to note that Your Counterparty is not licensed by the Securities and Futures Commission (SFC) and hence is not subject to the conduct and prudential supervision by the SFC.

[Notes for licensed persons: Where the group affiliate is regulated by a financial regulator, describe the regulated status of the group affiliate, state the name of the regulator and the jurisdiction where the regulator is located, and include also the following risk disclosure statement:

“Although Your Counterparty is regulated by another regulatory body, the regulation of such regulatory body may be different from the regulation of the SFC, and the protection that you may receive under the regulation of that regulatory body might not be the same as the protection that you would receive if Your Counterparty were licensed by the SFC.”

Notes for licensed persons: Where the group affiliate is also not regulated by any other financial regulator, include also the following risk disclosure statement:

“You should also note that Your Counterparty is not regulated by any other financial regulator and as such, you may not receive any regulatory protection at all.”

You should cautiously consider whether it would be in your best interest to enter into over-the-counter derivative transactions with Your Counterparty instead of a licensed corporation and seek independent professional advice when in doubt.”

Appendix D Amendment to the note to paragraph 6.2(i) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

Amend note to paragraph 6.2(i) as follows:

~~“Note: “Financial product” means any securities, futures contracts or leveraged foreign exchange contracts as defined has the meaning assigned to it under the SFO. For the avoidance of doubt, this requirement only applies to financial products in the context of regulated activities carried on by licensed or registered persons. Regarding “leveraged foreign exchange contracts”, it is only applicable to those traded by persons licensed for Type 3 regulated activity.”~~

Appendix E List of respondents

(in alphabetical order)

1. Asia Securities Industry & Financial Markets Association
2. Citadel
3. CLP Holdings Limited
4. CompliancePlus Consulting
5. Hong Kong Investment Funds Association
6. HSBC Institutional Trust Services (Asia) Limited
7. International Swaps and Derivatives Association, Inc
8. Linklaters
9. NEX Optimisation
10. SSW & Associates
11. The Hong Kong Association of Banks
12. The Law Society of Hong Kong