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

Consultation conclusions on the OTC derivatives regime for Hong Kong – Proposed refinements to the scope of regulated activities and competence requirements under the OTC derivatives licensing regime

June 2020

Table of Contents

Introduction

1. On 20 December 2017, the Securities and Futures Commission (SFC) issued a consultation paper on the over-the-counter (OTC) derivatives regime for Hong Kong which proposed refinements to the scope of regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters and proposed conduct requirements to address risks posed by group affiliates (Consultation Paper), and invited public comments.

2. A consultation conclusions paper on the proposed requirements under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission was issued in December 2018. It covered requirements in relation to risk mitigation and client clearing, conduct requirements to address risks posed by group affiliates and other connected persons, as well as a consequential amendment to the client agreement requirements.

3. This consultation conclusions paper covers the proposed refinements to the scope of the regulated activities (RAs) under the OTC derivatives licensing regime (please refer to Part II of the Consultation Paper), as well as the proposed competence and continuous professional training (CPT) requirements under the OTC derivatives licensing regime (please refer to Part VII C of the Consultation Paper).

4. The consultation ended on 20 February 2018. The SFC received 14 written submissions on the proposed refinements to the scope of the RAs and the proposed competence and CPT requirements, including from industry associations, market participants (including non-financial companies), professional services firms and other stakeholders. Two respondents requested that their names be withheld from publication and one respondent requested that its submission be withheld from publication. Two respondents requested that both their names and submissions be withheld from publication. A list of the respondents (other than those who requested anonymity) is set out in the Appendix.

5. A consultation conclusions paper on the other proposals in the Consultation Paper will be published separately in due course.

Executive summary

6. The legislation encompassing the OTC derivatives regulatory framework was enacted in 2014 and has been implemented in phases. We have engaged with market participants throughout the implementation and identified a number of issues relating to the scope of RAs under the OTC derivatives licensing regime, which has not yet taken effect.

7. In response to market comments, we issued the Consultation Paper seeking views on some proposed refinements to the scope of RAs. In addition, we proposed competence and CPT requirements for the new and expanded RAs to complement the OTC derivatives licensing regime. Our proposals, market responses and our conclusions are set out below.

Refinements to the scope of regulated activities under the OTC derivatives licensing regime

Corporate treasury activities

8. We proposed to narrow the scope of the expanded Type 9 RA and the new Type 11 RA so that they do not capture corporate treasury activities of non-financial groups.

9. Respondents generally supported our proposal. While some respondents suggested extending the proposed carve-out to financial groups, we decided not to expand this carve-out after further consideration. This is explained in paragraphs 27 to 29 below. We will therefore proceed with our proposal as mentioned in the Consultation Paper. We intend to clarify the proposed definitions of "financial group" and "financial services" and are working with the Department of Justice (DoJ) on the drafting.

10. We have also revisited the scope of the carve-out for corporate treasury activities in light of market developments. Taking into account the increasing popularity of central clearing for OTC derivative transactions, we consider it appropriate to expand the carve-out for corporate treasury activities of non-financial groups to cover Type 12 RA.

Activities of providers of post-trade multilateral portfolio compression services

11. We proposed to narrow the scope of Type 11 RA so that it does not capture the provision of post-trade multilateral portfolio compression services. We received broad support for this proposal. One respondent opposed the proposed carve-out for the provision of multilateral portfolio compression services from the advising limb of Type 11 RA (ie, for "advising on OTC derivative products"). We disagree with the suggestion for the reasons set out in paragraphs 40 and 41 below.

12. One respondent requested that the carve-out be expanded to cover market neutral bilateral compression activities and other post-trade risk reduction services which are designed to reduce secondary risks from existing derivative transactions. We do not believe it is appropriate to provide a blanket exemption since services which may involve more specific or tailor-made advice ought to be regulated.

13. One respondent proposed that multilateral portfolio compression services should be carved out from the definition of Automated Trading Services (ATS), while another respondent held the opposite view. We do not believe amending the definition of ATS is

necessary for providers of multilateral portfolio compression services which do not provide a trading platform. Those who do should be regulated as ATS providers.

14. We also received a number of drafting suggestions in relation to the definition of "multilateral portfolio compression services". We have taken them into account and, subject to DoJ's comments, will fine-tune the definition. Please refer to paragraph 46 below for details.

Provision of compression services by CCPs and providers of client clearing services

15. We proposed to narrow the scope of Type 11 RA so that it does not capture portfolio compression services (whether bilateral or multilateral) provided by a central counterparty (CCP) or a provider of client clearing services. We received overwhelming support for this proposal and will therefore proceed to revise the scope of Type 11 RA on this basis.

Activities of overseas clearing members and their agents

16. We proposed to expand the carve-out from Type 12 RA so that, subject to certain prerequisites such as being regulated in a comparable jurisdiction for providing client clearing services and marketing their services through an authorized institution or a licensed corporation, Type 12 RA does not capture overseas clearing members of overseas CCPs. We also proposed to narrow the scope of Type 11 RA to carve out these clearing members' dealing and advising activities which are incidental to client clearing services. We received general support for these proposals and will proceed with the expansion of the carve-out.

17. One respondent sought clarification of the scope of the carve-out for agents and proposed extending it to cover "introducing brokers". In view of the proposed refinement to the definition of "providing client clearing services for OTC derivative transactions" to specify the capacity of the service provider, market participants would now have more certainty and therefore an expansion of the carve-out is no longer necessary.

Changes to the scope of Type 12 RA to exclude certain ancillary and fund manager services

18. We proposed to refine the scope of Type 12 RA so that it does not capture activities which are only ancillary to the clearing and settlement process. For future flexibility, we also proposed to enable the SFC to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of Type 12 RA. We received general support for these proposals.

19. We will proceed with our proposal to provide clarity for the definition of Type 12 RA. Please refer to paragraph 67 below for the revised definition. Subject to the DoJ's comments, we will make further drafting changes to clarify some additional concepts, such as elaborating on the description of the concept of "indirect client". Please refer to paragraphs 56 to 66 below for details.

Request to expand carve-outs for fund managers

20. We proposed to expand the current carve-outs, that is, (a) under Type 9 RA, managing an OTC derivatives portfolio for wholly-owned group companies and by professionals where the services are wholly incidental to discharging their professional roles to cover all OTC derivative products; and (b) under Type 3 RA, to cover fund managers who

deal in foreign exchange derivatives solely for the purpose of managing assets. For future flexibility, we also proposed enabling the SFC to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of Type 9 RA.

21. Respondents generally welcome our proposals and we will proceed with the amendments mentioned in the Consultation Paper. Some respondents suggested other amendments or sought clarifications, and our responses can be found in paragraphs 72 to 75 below.

Competence and CPT requirements under the OTC derivatives licensing regime

22. We proposed that the existing requirements under the *Guidelines on Competence* should also apply to Types 11 and 12 RAs. New examination papers would be developed and existing examination papers would be modified to cover the industry and regulatory knowledge individual licensees are expected to have in relation to the new and expanded RAs. We also proposed that the existing CPT requirements would cover the new and expanded RAs.

23. We received broad support for the above proposals and will proceed as proposed. A few market participants sought clarification of the proposals and our responses are detailed in paragraphs 80 to 87 below.

Comments and conclusions on the refinements to the scope of regulated activities

24. The Securities and Futures (Amendment) Ordinance 2014 (SFAO 2014) was enacted to introduce an OTC derivatives regulatory framework in Hong Kong. Among other things, it creates an OTC derivatives licensing regime, which has not yet taken effect, by introducing two new RAs – Type 11 RA (dealing in OTC derivative products or advising on OTC derivative products) and Type 12 RA (providing client clearing services for OTC derivative transactions) – and expanding the scope of some of the existing regulated activities. Through active dialogue with market participants, we identified a number of issues with the scope of the regulated activities. Therefore, changes have been proposed in the Consultation Paper in the following areas.

Corporate treasury activities

25. We proposed in the Consultation Paper to narrow the scope of the expanded Type 9 RA and the new Type 11 RA so that they do not capture corporate treasury activities of non-financial groups.

26. Respondents generally supported our proposal to carve out corporate treasury activities conducted by non-financial groups from the scope of regulated activities.

Corporate treasury activities of non-financial groups

27. Some respondents suggested extending this carve-out to financial groups, or to financial groups if their intra-group transactions are conducted for hedging purposes, or when their aggregate notional amount is below a certain quantitative threshold. One respondent also proposed another carve-out for an entity which deals with a firm licensed for Type 11 RA, on either an intra-group or external counterparty basis.

28. After carefully considering these suggestions, we decided not to expand this carve-out. First, further expanding the carve-out may weaken the overall effectiveness of the regime which aims to ensure that the activities of derivatives market intermediaries are properly regulated, including through risk monitoring and supervision of their intra-group transactions. In addition, introducing the “hedging” criteria would potentially create licensing uncertainty. Due to the size of financial conglomerates and the complexity of the interconnections among their group affiliates, there may be practical difficulties for firms to identify the transactions which meet the “hedging” criteria. This is especially the case when some transactions may be across affiliates, borders or asset classes.

29. The suggestion to introduce a de minimis threshold is not consistent with the existing licensing regime as there are no de minimis thresholds for other RAs. The need to monitor whether OTC derivative transactions remain below the relevant threshold may also create licensing uncertainty or a compliance burden.

30. As to the comment to carve out from the licensing requirements under Type 11 RA an entity which deals with a Type 11 RA licensed firm, it should be noted that the existing “dealing through” carve-out under the dealing limb of Type 11 RA includes a similar concept. The entity concerned should assess whether this carve-out may apply to its circumstances.

Definitions of “financial group” and “financial services”

31. One respondent sought clarification of the proposed definition of “financial group” in the Consultation Paper. Another respondent suggested providing more flexibility in the proposed definition of “financial services” given that financial markets evolve rapidly and the scope of financial services may expand or change over time.

32. As explained in the Consultation Paper, the proposed definition of “financial group” is a two-tiered concept which covers a group of companies primarily engaging in (a) a business in Hong Kong that constitutes one or more of the proposed types of “financial services”; or (b) a business that, if carried on in Hong Kong, would constitute one or more of the proposed types of “financial services”.

33. We consider that the proposed definition of “financial services” should adequately cover all the common types of financial services including businesses in regulated activities, banking and insurance. In light of the fast-changing market environment, we will monitor market developments and consult the market again when there is a need to revise the definition.

34. To clarify the meaning of “financial group” and “financial services”, we intend to refine the proposed definition of “financial group” as follows, subject to the drafting of the DoJ:

financial group means a group of companies that is primarily engaged in carrying on business (whether in Hong Kong or elsewhere) that, if carried on in Hong Kong, would constitute, one or more of the following –

(a) a regulated activity;

(b) banking business as defined by section 2(1) of the Banking Ordinance (Cap. 155);

(c) any business that is required to be carried on under –

(i) an authorization within the meaning of section 2(1) of the Insurance Ordinance (Cap. 41); or

(ii) a licence within the meaning of section 64F of that Ordinance.

Expansion of the carve-out to Type 12 RA

35. One respondent agreed that there is no need to expressly carve out corporate treasury activities from Type 12 RA, and suggested including a confirmatory provision in the definitions to avoid any doubt.

36. When considering this suggestion, we revisited the scope of the carve-out for corporate treasury activities in light of market developments. Taking into account the increasing popularity of central clearing for OTC derivative transactions, we now consider it appropriate to expand the carve-out for corporate treasury activities to cover Type 12 RA as well. We understand that for administrative and operational reasons group companies may have only one entity which is a client of a clearing service provider. We propose that so long as the clearing and settlement services are provided by the corporate treasury desk of a non-financial group to its affiliates only, these activities will be carved out from the scope of Type 12 RA. This non-financial group qualification can provide us with the necessary regulatory handle on the traditional providers of client

clearing services because they usually belong to financial groups. This proposal is also in line with our policy intent, which is to exclude the corporate treasury activities of non-financial groups from the regulatory net. In effect, the corporate treasury activities of non-financial groups will be carved out entirely from the OTC derivatives licensing regime so long as they satisfy the criteria.

Activities of providers of post-trade multilateral portfolio compression services

37. We proposed in the Consultation Paper to narrow the scope of Type 11 RA so that it does not capture the provision of post-trade multilateral portfolio compression services.

38. The respondents who commented on this proposal broadly supported it. One respondent supported the proposed carve-out of the provision of post-trade multilateral portfolio compression services from the definition of "dealing in OTC derivative products", but opposed the proposed carve-out from the definition of "advising on OTC derivative products" under Type 11 RA.

39. The respondent argued that providing multilateral portfolio compression proposals is similar in nature to the provision of advice on the terms or conditions on which the OTC derivative products should be acquired or disposed of. The respondent also stated that a large volume of OTC derivative transactions concentrated among large market participants introduces significant systemic risk, creating demand for better mitigation of risk exposures and suitable portfolio compression proposals. The respondent suggested that therefore, regulation of the provision of multilateral portfolio compression services is needed.

40. Although we appreciate the comments about concentration risk and the importance of post-trade risk mitigation, we disagree with the suggestion that licensing regulation or other requirements be imposed on the provision of multilateral portfolio compression services. This is because multilateral portfolio compression services are different from the activities provided by traditional financial advisors. Providers of multilateral portfolio compression services do not provide advice on trading OTC derivative transactions. Instead, they calculate which transactions can be terminated, modified or replaced using the compression algorithms under certain criteria and set forth the calculation results for participants of the compression cycle to consider. Users of their services are large market participants with sizeable OTC derivative portfolios who will benefit from compression services. These participants have the expertise and internal risk management capabilities to evaluate the results calculated by the service providers and detect any errors.

41. Multilateral portfolio compression is a valuable risk mitigation measure which ought to be encouraged. Imposing unnecessary regulatory requirements on service providers will increase their operational and compliance burden, which may in turn discourage the development of these services in Hong Kong. On the balance of the costs and the benefits, we believe the respondent's suggestion is not appropriate and may be counter to our regulatory objective of reducing risks in the market by encouraging multilateral portfolio compression.

42. One respondent requested to expand the carve-out to cover market neutral bilateral compression activities and other post-trade risk reduction services designed to reduce secondary risks from existing derivative transactions, such as counterparty credit, operational and basis risks. As explained in the Consultation Paper, we understand that the provision of bilateral portfolio compression services (except those provided in the

context of the CCP clearing process, as discussed in paragraph 49 below) is less common and may involve providing more specific or tailor-made advice. Therefore, we believe that we should not provide a blanket exemption to the providers of such services. The carve-out for bilateral compression activities from Type 11 RA only applies in the context of the CCP clearing process, as discussed in paragraph 49 below, because CCPs and providers of client clearing services are or will be subject to appropriate regulation. This is not the case for other providers of bilateral portfolio compression services which are not in the context of the CCP clearing process.

43. Some of the post-trade risk reduction services suggested by the respondent may fall within the proposed definition of multilateral portfolio compression services and will therefore be carved out from Type 11 RA. For other, new services which may involve the provision of more specific or tailor-made advice, or which may result in a change of the market risk profile of participants, we do not feel comfortable exempting them at this time.

44. One respondent proposed that multilateral portfolio compression services should be carved out from the definition of ATS, while another respondent held the opposite view. As explained in the Consultation Paper, we understand that providers of multilateral portfolio compression services essentially provide a service for calculating how the exposure of participants can be reduced. If they do not provide a trading system or a platform for the termination or modification of existing transactions, or for entering into replacement OTC derivative transactions, they will not be caught by the definition of ATS. However, if they also provide ATS for the termination or modification of existing transactions, or for entering into replacement OTC derivative transactions, they should rightfully be regulated as ATS providers. Hence, we do not believe amending the definition of ATS is necessary.

45. We received a suggestion that a market neutral element should be introduced in the definition of "multilateral portfolio compression services". We also received a comment indicating that the proposed definition appears appropriate, but the meaning of "risk tolerance level" is not clear and will need to be carefully defined and clarified. We agree with these drafting comments and are working with the DoJ to fine-tune the definition to address these concerns.

46. Subject to the drafting of the DoJ and in light of these comments, we intend to further fine-tune the wording of the definition of "providing multilateral portfolio compression services" as follows:

providing multilateral portfolio compression services means providing services that fall within the following description –

(a) services that are provided –

(i) by a person (*service provider*) for analyzing the portfolios of OTC derivative transactions of more than 2 other persons (*participants*);

(ii) in accordance with –

(A) the operating rules set by the service provider for participation in the compression cycle; and

(B) the parameters agreed between the service provider and each of the participants;

(iii) without changing the market risk of the portfolio of OTC derivative transactions of each of the participants beyond any market risk tolerance level set by the participant concerned; and

(iv) for the purpose of reducing counterparty credit risk or operational risk for the participants; and

(b) services in which proposals having the effect of reducing exposures between or among the participants are put forward by the service provider as to how any or all of the OTC derivative transactions –

(i) may be modified;

(ii) may be terminated; or

(iii) may be terminated and replaced with one or more new OTC derivative transactions.

47. It is noted that the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules (Clearing Rules) also contain a carve-out from the clearing obligation for transactions resulting from multilateral portfolio compression exercises. We will align the definition of "multilateral portfolio compression cycle" in the Clearing Rules as a consequential amendment to the current proposed changes. We will not separately consult the market on the changes to the Clearing Rules since the changes do not involve any policy changes.

48. Separately, we received a request to add a requirement to the definition of "multilateral portfolio compression services" so that the services are cycle-based, where the post-trade risk reduction proposal must be accepted in full by all participants, or its component transactions will not be executed at all. While we understand that these are the usual features of multilateral compression services, we do not see the benefit of restricting the definition of "multilateral portfolio compression services" to any particular cycle or allowing any subsequent bilaterally-agreed actions among the participants of a compression cycle to affect the exemption status of the previous multilateral portfolio compression service provided for that cycle. We take the view that it is not desirable to adopt the suggestion.

Provision of compression services by CCPs and providers of client clearing services

49. We proposed in the Consultation Paper to narrow the scope of Type 11 RA so that it does not capture portfolio compression services (whether bilateral or multilateral) provided by a CCP or a provider of client clearing services. As mentioned in paragraph 42 above, CCPs and providers of client clearing services are or will be subject to appropriate regulation. We do not see the need to impose additional requirements on compression services in relation to transactions that are being cleared through the CCPs or the client clearing service providers. We received overwhelming support for this proposal and will therefore proceed to revise the scope of Type 11 RA on this basis.

Activities of overseas clearing members and their agents

50. We proposed in the Consultation Paper to expand the exemption of Type 12 RA so that, subject to certain prerequisites such as being regulated in a comparable jurisdiction for providing client clearing services and marketing their services through an authorized institution or a licensed corporation, it does not capture overseas clearing members of overseas CCPs. We also proposed in the Consultation Paper to narrow the scope of Type 11 RA so that dealing and advising activities incidental to client clearing services are carved out. We received general support for these proposals.

51. One respondent supported our proposal to carve out the activities carried out by acceptable participants but did not agree with the current definition of "acceptable participant", which includes persons who have applied to become CCP members but have not yet become official members. The respondent took the view that it is prudent to conduct marketing activities only after the CCP membership is granted, in order to protect client interests. While we appreciate the respondent's prudent view, we also have to balance the risk of pre-approval marketing activities against the practical need for communication with potential clients, especially with respect to educating clients about central clearing. Before the CCP membership is granted, the applicant is only able to carry out marketing activities through regulated entities, but not actual client clearing services. There should be no client assets or money at risk. In addition, as stated in the Consultation Paper, we proposed to amend the definition of "acceptable participant" to make it clear that acceptable participants may include persons who have applied to become CCP members but only so long as their application has not been rejected or withdrawn. We believe this measure should ensure that the flexibility provided is not abused.

52. We received another comment urging us to take a principles-based approach in determining which jurisdiction is a "comparable overseas jurisdiction". We acknowledge the respondent's comments and wish to make it clear that we do take a principles-based approach in determining whether a jurisdiction is a "comparable overseas jurisdiction".

53. Another respondent proposed extending the carve-out to cover "introducing brokers". It sought clarification of the scope of the carve-out for agents, and in particular, whether the carve-out captures a situation where the agent or "introducing broker" (eg, on an outsourced basis) may have a very limited role in handling or routing client money or assets, but the contractual party is the overseas person.

54. In view of the proposed refinement to the definition of "providing client clearing services for OTC derivative transaction" (as discussed in paragraphs 55 to 67 below) by specifying the capacity of the service provider, we wish to clarify that the carve-out for agents of acceptable participants under Type 12 RA (ie, section 4(d) of Part 2A of Schedule 5 to the Securities and Futures Ordinance), which concerned the respondent, is no longer necessary and will be repealed. Market participants may refer to the refined definition of Type 12 RA as discussed in paragraph 67 below to determine whether the agent or "introducing broker" falls within the scope. Entities which are not acting in any of the stated capacities will not be captured under Type 12 RA.

Changes to the scope of Type 12 RA to exclude certain fund manager services and ancillary services

55. We proposed in the Consultation Paper to refine the scope of Type 12 RA so that it does not capture certain fund managers or other activities which are only ancillary to the clearing and settlement process, rather than central to that process. For future flexibility, we also proposed to enable the SFC to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of Type 12 RA. We received general support for this proposal.

56. Some respondents sought clarification of the proposed carve-out. Two respondents asked whether the definition of "funds" in paragraphs 32 and 33 of the Consultation Paper includes only authorized funds, or whether it also includes unauthorized funds or discretionary accounts of licensed or registered fund managers.

57. Another respondent sought clarification on the meaning of:

(a) "ancillary", and specifically, whether mere passing or routing of orders to (or selection of) clearing houses or providers of client clearing services is "ancillary";

(b) "in the capacity of either a CCP member" or "in the capacity of a direct or indirect client of a CCP member"; and

(c) "indirect client", and in particular, where a fund manager engages a broker for funds managed by its affiliates (and the broker is a direct or indirect client of a CCP member).

58. The respondent also invited the SFC to:

(a) clarify whether "agents" of providers of client clearing services include "introducing brokers", and suggested that the SFC include "introducing brokers" in the carve-out, regardless of whether they fall under the concept or description of "agency"; and

(b) clarify whether Type 11 RA licensees which as part of their dealing or advising business pass clearing instructions to clearing houses would require to be licensed for Type 12 RA, and suggested that the SFC include in the carve-out the mere passing or routing of orders to (or selection of) clearing houses or providers of client clearing services, given the importance of this to the industry.

59. As set out in paragraph 34(a) of the Consultation Paper, we proposed to carve out the provision of client clearing services by fund managers for assets they manage. The proposed carve-out will be cast in similar terms as the carve-out for fund managers from "dealing in OTC derivative products" and "advising on OTC derivative products". Therefore, the proposed carve-out is intended to cover client clearing services by a person licensed for Type 9 RA who carries out client clearing services solely for the purpose of providing a service of OTC derivative products management permitted under that licence. In other words, the carve-out covers the provision of client clearing services by licensed asset managers for the asset management activities they are licensed for and solely for the purpose of such asset management, regardless of whether the asset manager is managing authorized or unauthorized funds, or managed or discretionary accounts.

60. As far as the meaning of “ancillary” is concerned, the proposed refinement of the scope of Type 12 RA as set out in paragraph 34(b) of the Consultation Paper clarifies that only those clearing and settlement services provided in the capacity of either a CCP member or in the capacity of a direct or indirect client of a CCP member will be captured. Agents or “introducing brokers” not acting in any of these capacities will not be considered as providing these clearing and settlement services and therefore will not be captured under the proposed refined scope of Type 12 RA, even though they pass or route the orders to clearing houses or providers of client clearing services.

61. Providing clearing and settlement services in the capacity of a CCP member means being a CCP member and utilising the CCP membership to allow others to clear their transactions through it.

62. To avoid ambiguity in the term “a direct or indirect client of a CCP member”, we propose to make it clear that Type 12 RA will capture service providers in the capacity of a CCP member or a clearing client, regardless of how many layers of entities and client relationships are involved. As set out in paragraph 67 below, a client of a CCP member (direct client), a client of a direct client (first indirect client), a client of a first indirect client (second indirect client), a client of a second indirect client or a client, whether direct or indirect, of any of those persons, will be captured. This will achieve our regulatory intent to capture all the layers of clearing clients involved in the client clearing arrangement, as well as provide more clarity to the market.

63. As such, for the situation in paragraph 57(c) above, if a fund manager engages a broker to provide client clearing services to funds managed by its affiliates, and the fund manager is not itself acting in the capacity of a clearing client (ie, not a client of the broker either directly or via multiple layers of client relationships with the broker), the fund manager will not be viewed as providing client clearing services to the funds managed by its affiliates simply because it coordinates with the broker on behalf of the funds. As a result, the fund manager will not be required to be licensed for Type 12 RA.

64. Further, even in the situation where an entity is itself a client of a CCP member for clearing its own proprietary transactions, its provision of ancillary clearing and settlement services to an affiliate (that is, another clearing client of a CCP member) by merely passing clearing and settlement instructions on the affiliate’s behalf to the CCP member, will not be regarded as providing client clearing services to the affiliate. This is because for Type 12 RA to apply to an entity, the entity must provide the services to another person in the capacity of a CCP member or of a clearing client. An entity which merely passes clearing and settlement instructions, but does not utilise its capacity as a CCP member or a clearing client, is not providing a service to another person in that capacity. Consequently, Type 12 RA is not relevant in connection with those transactions. However, if the entity uses its status as a clearing client to provide clearing and settlement services to its affiliate in connection with the affiliate’s transactions (ie, when the affiliate is not a clearing client), those services are likely to be within the scope of Type 12 RA.

65. In addition, we wish to highlight that the four situations in paragraphs 32(a)-(d) of the Consultation Paper are only examples raised by the industry. We reiterate that we have no intention to capture these activities under the scope of Type 12 RA when the entities concerned are not acting in the capacity of a CCP member or a clearing client. As explained in the Consultation Paper, these activities are considered to be ancillary to the clearing and settlement process.

66. However, it is undesirable to set out these examples as carve-outs in law drafting as suggested by the respondent because doing so may unintentionally restrict the scope of the carve-out to particular examples or situations. We believe that by fine-tuning the definition of "providing client clearing services for OTC derivative transactions" as proposed in paragraph 34 of the Consultation Paper, the scope of Type 12 RA will be more clearly defined so as not to capture any activities which are ancillary to the clearing and settlement process.

67. Subject to the drafting of the DoJ and in light of the above concerns, we intend to further refine the definition of Type 12 RA as follows, and also proceed with including a general power to carve out further activities from the scope of Type 12 RA as proposed:

providing client clearing services for OTC derivative transactions, in relation to a person and subject to Part 2A, means providing services to another person for the clearing and settlement of OTC derivative transactions through a central counterparty (whether located in Hong Kong or elsewhere) –

(a) as a member of the central counterparty; or

(b) as a client of a member of the central counterparty (*direct client*), a client of a direct client (*first indirect client*), a client of a first indirect client (*second indirect client*), a client of a second indirect client or a client, whether direct or indirect, of any of those persons.

68. Separately, one respondent suggested carving out from the scope of Type 12 RA the provision of client clearing services by a local entity, which is a clearing member of a particular CCP, to its affiliates, because often only one entity in a group of companies is a clearing member of a particular CCP, and it would clear the transactions on behalf of all of its affiliates through the CCP for administrative and operational reasons.

69. We do not think it is appropriate to provide such a general carve-out for the clearing of all intra-group transactions because carving out these activities would be inconsistent with our original regulatory intent to ensure appropriate supervision of the activities of derivatives market intermediaries. First, the OTC derivative transactions cleared through the CCP by the local clearing member on behalf of its affiliates may include clients' transactions, the clearing of which may constitute Type 12 RA. Second, carving out the clearing of all intra-group transactions from Type 12 RA not only renders our risk monitoring and supervision of the transactions of the derivatives market intermediaries inadequate, but also deviates from our regulatory approach to the dealing activities of OTC derivative products, securities and futures contracts, which do not have such a carve-out.

Request to expand carve-outs for fund managers

70. We proposed in the Consultation Paper to (a) extend the existing carve-outs under Type 9 RA for managing an OTC derivatives portfolio for wholly-owned group companies and by professionals where the services are wholly incidental to discharging their professional roles (ie, solicitors, counsels, certified public accountants and trust companies registered under Part 8 of the Trustee Ordinance) to cover all OTC derivative products; and (b) incorporate a carve-out under Type 3 RA to cover fund managers who deal in foreign exchange derivatives solely for the purpose of managing assets. For future flexibility, we also proposed including a provision to enable the SFC

to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of Type 9 RA.

71. Respondents generally welcome our proposals to expand the carve-outs available to fund managers.

72. One respondent suggested simplifying the criteria for the Type 3 RA carve-out as mentioned in paragraph 41 of the Consultation Paper. The respondent was of the view that sub-paragraph 41(b) has been effectively covered in sub-paragraphs 41(a) and 41(c); and further suggested replacing sub-paragraph 41(d) by the criteria that dealing in foreign exchange derivatives is solely for the purpose of managing funds.

73. In our view, it is necessary to keep sub-paragraph 41(b) because this criteria is not entirely covered by sub-paragraphs 41(a) and 41(c). Expanded Type 9 RA will have three limbs when the OTC derivatives licensing regime comes into operation, namely (i) real estate investment scheme management, (ii) securities or futures contracts management, and (iii) OTC derivative products management. In practice, we would impose licensing conditions to reflect which limb of expanded Type 9 RA the intermediary is permitted to engage in. In order to qualify for the carve-out relating to OTC derivative products management, the intermediary shall have a licence or registration which allows it to manage a portfolio of OTC derivative products. We also believe it is not necessary to replace sub-paragraph 41(d). We consider that the "sole-purpose" element has already been incorporated in sub-paragraph 41(c). The suggestion to confine the purpose only to managing funds would preclude intermediaries which manage discretionary accounts involving OTC derivative products from relying on this carve-out.

74. Another respondent sought clarifications of the following –

(a) Whether a fund manager will be required to be licensed for both Types 3 and 11 RAs if for funds managed by its affiliates it deals in a product which constitutes both "leveraged foreign exchange contract" and "OTC derivative contract"; and

(b) Whether a fund manager will be required to be licensed for Type 3 RA merely due to the foreign exchange element of an OTC derivative transaction it deals with for funds managed by its affiliates.

75. In respect of these two queries, we would like to clarify that since the dealing activities set out in paragraph 74 above relate to the funds managed by the affiliates of the fund manager rather than by the fund manager itself (ie, the fund manager does not perform a management role in relation to the affiliates' funds), the fund manager will need a dealing licence for those dealing activities. If the fund manager is already licensed for either Type 3 or 11 RA and the product in question falls within the definitions of both "leveraged foreign exchange contract" and "OTC derivative product", the fund manager does not need to be licensed for both Types 3 and 11 RAs given the overlapping carve-out available for these two RAs. However, if the product falls within the definition of one but not the other, the fund manager will need to be licensed for the RA relevant to the product.

Other comments

76. We received requests that the OTC derivatives licensing regime not be implemented earlier than the related revamp of the Securities and Futures (Financial Resources)

Rules (FRR) to avoid the over-estimation of capital requirements. We appreciate these concerns and confirm that the OTC derivatives licensing regime will not be implemented until the amendments to other relevant subsidiary legislation, including the FRR, are completed.

Comments and conclusions on competence and CPT requirements

77. We proposed that the existing requirements under the *Guidelines on Competence* should also apply to Types 11 and 12 RAs. We also proposed to develop new examination papers and modify existing examination papers to cover the industry and regulatory knowledge in relation to the new and expanded RAs. We proposed that the existing CPT requirements will cover the new RAs and we also reiterated that it remains our intention to grandfather market participants who qualify for a deemed status under the transitional arrangements as set out in section 55 of the SFAO 2014.

78. Respondents generally supported our proposals. Three sought clarification of the grandfathering arrangements and competence requirements. These are discussed below.

79. We take note of feedback that the new *Licensing Handbook* should reflect the new guidelines. We will update the *Licensing Handbook* accordingly when the OTC derivatives licensing regime is launched.

Grandfathering arrangements

80. One respondent sought clarification of the grandfather arrangements, specifically:–

(a) Whether licensed corporations are required to file attendance records for the refresher course;

(b) Whether licensed corporations are required to monitor the completion status of the refresher course or notify the SFC of the attendance status;

(c) Whether licensed corporations are required to notify the SFC if a licensed person has not completed the refresher course within the required period, and whether the SFC would revoke the person's licence or impose licensing conditions to restrict them from conducting certain regulated activities;

(d) Whether the refresher course is a one-off requirement;

(e) Whether the content of the refresher course is the same for a responsible officer (RO) and a licensed representative (LR); and

(f) For a licensed individual who has undertaken to complete additional CPT hours in the regulatory knowledge of a relevant RA within 12 months from obtaining a licence so that he is exempted from taking the relevant local regulatory framework paper (LRP), whether the refresher course would count as additional CPT hours.

81. As mentioned in paragraph 162 of the Consultation Paper, details of the grandfathering arrangements will be announced at a later stage. The proposed refresher course arrangement is a one-off requirement in addition to the normal CPT requirements. Similar to the existing requirements under the *Guidelines on Continuous Professional Training*, we expect both licensed corporations and licensed individuals to keep CPT

records, including for the refresher course, be able to provide relevant attendance records as evidence to the SFC upon request and inform the SFC of any non-compliance. Failure to complete the refresher course within the required period will adversely affect the fitness and properness of licensed persons, and depending on the circumstances, may lead to disciplinary action.

Relevant industry experience

82. One respondent sought clarification of what experience would be assessed after the transition period as relevant for Types 11 and 12 RAs and expanded Type 9 RA under Option 2 or Option 3 of the Test of Competence for Representative in Appendix B to the *Guidelines on Competence*, especially if an individual has no direct prior involvement in these RAs.

83. We will adopt the same approach as other RAs to assess the "relevance" element of an individual's experience for Types 11 and 12 RAs and expanded Type 9 RA. As mentioned in footnote 5 of Appendix B to the *Guidelines on Competence*, we will consider the role and functions to be undertaken by the applicant and whether the applicant possesses the recognised industry qualifications; and we will also recognise experience gained in Hong Kong or elsewhere which is closely related to the functions to be performed. If the individual has no direct prior involvement in such RAs, he or she may consider obtaining the stated academic qualifications or recognised industry qualifications so that he or she may be considered under other options under the *Guidelines on Competence*.

84. One respondent sought clarification of whether an individual applying to be an RO or an LR for expanded Type 7 RA has to demonstrate competence in academic qualification, industry qualification or regulatory knowledge.

85. As already mentioned in the Consultation Paper, as with the existing Type 7 RA, no specific competence requirement will be imposed in respect of the expanded Type 7 RA. For an individual applying to be an RO or an LR for the expanded Type 7 RA, depending on whether such individual will be providing the ATS in respect of securities, futures contracts, leveraged foreign exchange contracts or OTC derivative products, he or she will also require to be additionally licensed for the appropriate RA for the dealing activities, that is, one or more of Types 1, 2, 3 and 11 RAs. The individual will therefore be required to demonstrate his or her competence in academic qualification, industry qualification or regulatory knowledge with respect to either of these dealing RAs in accordance with the requirements in the *Guidelines on Competence*.

LRP requirement

86. One respondent asked that paragraphs (3) and (4) of Appendix E to the *Guidelines on Competence* be amended such that applicants applying for a temporary licence for Type 11 RA are fully exempted from the LRP requirements. We agree to this suggestion and will include this in our coming revamp of the competency framework exercise as mentioned in paragraph 88 below.

87. One respondent enquired whether the conditional exemptions to LRP requirements in Appendix E to the *Guidelines on Competence* apply to Type 12 RA. As stated in the Consultation Paper, it is our intention that the existing competence requirements under the *Guidelines on Competence*, including the conditional exemptions, will also apply to Types 11 and 12 RAs.

Revamp of competency framework

88. The SFC is reviewing the existing competency framework covering both the competence requirements and the CPT requirements. The proposed competence and CPT requirements for Types 11 and 12 RAs as well as expanded Types 7 and 9 RAs under the Consultation Paper and these conclusions will be subject to review. We will consider consulting on our proposals for revamping the competency framework later this year.

Concluding remarks and next steps

89. We take this opportunity to thank everyone who took the time and effort to comment and assist us in finalising the above proposals.

90. The proposals to refine the scope of regulated activities will require amendments to the SFAO 2014, the Securities and Futures Ordinance and the Clearing Rules. The SFC is working with the DoJ on the drafting of the relevant amendments. We note that some respondents have provided drafting suggestions on the scope of the RAs. As discussed above, we will take these into account when we work with the DoJ. Since we have already consulted on the proposed drafting changes, we do not plan to expose the final draft of the amendments for further public consultation and it will be published in the Government Gazette before the legislative changes are introduced into the Legislative Council.

91. As mentioned, the OTC derivatives licensing regime will not be implemented until the amendments to other relevant subsidiary legislation, including the FRR, are completed. In the meantime, we will continue to maintain close dialogue with the industry on issues relating to the OTC derivatives licensing regime.

Appendix – List of respondents

(in alphabetical order)

1. Asia Securities Industry & Financial Markets Association
2. CLP Holdings Limited
3. CompliancePlus Consulting Limited
4. E Fund Management (HK) Co., Ltd.
5. HSBC Institutional Trust Services (Asia) Limited
6. Linklaters on behalf of its clients
7. NEX Optimisation (respondent requested that its submission be withheld from publication)
8. The Hong Kong Association of Banks
9. The International Swaps and Derivatives Association, Inc.
10. The Law Society of Hong Kong
11. Respondent 1 (respondent requested that its name be withheld from publication)
12. Respondent 2 (respondent requested that its name be withheld from publication)
13. Respondent 3 (respondent requested that both its name and submission be withheld from publication)
14. Respondent 4 (respondent requested that both its name and submission be withheld from publication)