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

SFC
證監會

Consultation Paper on (1) the 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

December 2017

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Foreword

The Securities and Futures Commission (**SFC**) invites market participants and interested parties to submit written comments on the proposals discussed in this consultation paper or to comment on related matters that might have a significant impact upon the proposals by no later than 20 February 2018. Any person wishing to comment on the proposals on behalf of any organisation should provide details of the organisation whose views they represent.

Please note that the names of the commentators and the contents of their submissions may be published on the SFC's website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.

Written comments may be sent as follows:

By mail to:	Securities and Futures Commission 35/F Cheung Kong Center 2 Queen's Road Central Hong Kong Re: Consultation Paper on (1) the 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
By fax to:	(852) 2523 4598
By online submission:	http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/
By e-mail to:	otcandconduct_consultation@sfc.hk

All submissions received before expiry of the consultation period will be taken into account before the proposals are finalised and a consultation conclusions paper will be published in due course.

Securities and Futures Commission
Hong Kong

20 December 2017

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5. Personal data provided to the SFC in response to this consultation paper will be retained for such period as may be necessary for the proper discharge of the SFC's functions.

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Enquiries

6. Any enquiries regarding the personal data provided in your submission on this consultation paper, requests for access to personal data or correction of personal data should be addressed in writing to:

   The Data Privacy Officer
   The Securities and Futures
   Commission
   35/F Cheung Kong Center
   2 Queen's Road Central
   Hong Kong

7. A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

Part I. Background

1. In September 2013, the SFC released consultation conclusions on the primary legislation for the regulation of OTC derivatives ("primary legislation consultation")[3]. The Securities and Futures (Amendment) Ordinance 2014 (**SFAO**) was enacted in 2014 and is commencing in phases.[4] References in this consultation paper to "OTC derivative" are to be interpreted as having the meanings given to the terms "OTC derivative product" and "OTC derivative transaction" in Schedule 1 to the Securities and Futures Ordinance (**SFO**).

2. As mentioned in the consultation conclusions and the SFAO, two new regulated activities (**RA**) have been introduced under Schedule 5 to the SFO, namely:

   (a) a Type 11 RA of dealing in OTC derivative products or advising on OTC derivative products; and

   (b) a Type 12 RA of providing client clearing services for OTC derivative transactions.

3. Additionally, the existing Type 9 RA (asset management) will be expanded to cover the management of portfolios of OTC derivative transactions. The definition of Automated Trading Services (**ATS**) under the existing Type 7 RA (providing ATS) will also be expanded to cover OTC derivative transactions.

4. The purpose of this consultation paper is to seek views on:

   (a) Part II – refinements to the scope of RAs in response to market comments;

   (b) Parts III to V - proposed requirements in relation to OTC derivatives in the areas of risk mitigation, client clearing, client money, client securities and record keeping;

   (c) Part VI – proposed conduct requirements to address risks posed by group affiliates and other connected persons; and

   (d) Part VII - proposed licensing fees, insurance, competence and continuous professional training (**CPT**) requirements under the new OTC derivatives licensing regime.

5. The proposed risk mitigation requirements referred to in Part III of this paper will apply to any licensed corporation which is a contracting party to **non-centrally cleared OTC derivative transactions only**. In addition, these proposals will also apply to 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 collective investment scheme (**CIS**) managed by it, except to the extent that the measures required are handled by the governing body of the CIS or its delegate. The risk mitigation requirements will not apply to OTC derivative transactions which are centrally cleared, directly or indirectly. Indirect clearing refers to an arrangement whereby a licensed corporation provides client clearing

[3] Joint Supplemental Consultation Conclusions on the OTC Derivatives Regime in Hong Kong – Proposed Scope of New/ Expanded Regulated Activities and Regulatory Oversight of Systemically Important Participants (September 2013).

[4] http://www.gld.gov.hk/egazette/pdf/20141814/es1201418146.pdf

services by submitting the client's OTC derivative transactions for clearing through another clearing intermediary.

6. The proposed requirements on client clearing referred to in Part IV of this paper will apply to any licensed corporation which provides client clearing services for OTC derivative transactions.

7. The proposed record keeping requirements referred to in Part V of this paper will apply to (a) any licensed corporation which is a contracting party to OTC derivative transactions, (b) a corporation licensed to carry out OTC derivative products management in respect of OTC derivative transactions executed by the licensed corporation on behalf of any CIS managed by it except to the extent that the measures required are handled by the governing body of the CIS or its delegate, as well as (c) any licensed corporation which provides client clearing services for OTC derivative transactions.

8. The proposed conduct requirements to address risks posed by group affiliates and other connected persons referred to in Part VI of this paper will apply to any licensed corporation which has dealing with group affiliates and other connected persons.

9. These proposals would not apply to systemically important participants[5].

[5] Systemically important participant has the meaning assigned to it by section 101A of the SFO.

Part II. Proposed refinements to the scope of regulated activities in response to market comments on the OTC derivatives licensing regime

10. Since the enactment of the SFAO in April 2014, we have been implementing the OTC derivatives regulatory regime in phases. The SFC has engaged with market participants throughout this process. The discussions have been constructive and helped identify a number of issues relating to the scope of the RAs under the OTC derivatives regulatory regime. To address these issues, we propose a number of further amendments to Schedule 5 to the SFO, namely:

    (a) to narrow the scope of expanded Type 9 RA and Type 11 RA so that they do not capture corporate treasury activities of non-financial groups;

    (b) to narrow the scope of Type 11 RA so that it does not capture the provision of post-trade multilateral portfolio compression services;

    (c) 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 clearing counterparty (**CCP**) or a provider of client clearing services;

    (d) to narrow the scope of Type 12 RA so that, subject to certain prerequisites, it does not capture overseas clearing members of overseas CCPs;

    (e) to refine the scope of Type 12 RA so that it does not catch certain asset managers or other activities which are only ancillary to the clearing and settlement process rather than central to that process;

    (f) for future flexibility, to build in a general power to carve out further activities from the scope of Types 9 and 12 RA;

    (g) to narrow the scope of expanded Type 9 RA so that it does not capture OTC derivative products management activities carried out for wholly owned group companies in respect of all OTC derivative products;

    (h) to narrow the scope of expanded Type 9 RA so that it does not capture incidental portfolio management activities carried out by professionals in respect of all OTC derivative products; and

    (i) to narrow the scope of Type 3 RA so that licensed Type 9 RA intermediaries dealing in OTC derivative products which also constitute “leveraged foreign exchange contracts” are not captured.

11. We discuss each of these in turn below. A point to highlight is that the precise language of the amendments discussed below will be subject to the drafting practice and approach adopted by the Department of Justice.

A. Corporate treasury activities

12. In previous consultations[6], we noted that our policy intention was to exclude price takers from the scope of "dealing in OTC derivative products". We view price takers as end-users of OTC derivative transactions whose transactions are not intended to affect or move the market price. Their activities are therefore different from those of derivatives market intermediaries who make markets in or offer price quotes for OTC derivative transactions as a business in order to profit from price differentials between transactions or from hedges which they enter into. The "price taker carve-out" in section 2(g) of Part 2A of Schedule 5 to the SFO was included for this reason.

13. Consistent with the above, it has never been our intention to regulate corporate treasury activities of non-financial groups as OTC derivative intermediaries so long as their activities remain akin to those of a price taker or end user. However, subsequent to the enactment of the SFAO, some corporate treasury personnel of non-financial groups raised concerns that their activities may nevertheless be caught by the current scope of expanded Type 9 RA (OTC derivative products management) and Type 11 RA (dealing in or advising on OTC derivative products). The concerns are summarised below.

    (a) ***Dealing:*** Corporate treasury desks in Hong Kong may conduct OTC derivative transactions to manage risk exposures arising from their group's commercial activities. It is common for such transactions to be entered into between affiliates so that risks can be pooled together in a single entity (ie, the treasury affiliate) for more effective risk management. It is unclear however whether *both* sides to an intra-group OTC derivative transaction can claim to be acting as price takers and thus benefit from the "price taker carve-out".

    (b) ***Advising and arranging:*** Some corporate treasury desks may choose not to centralise risks. Instead, they may manage risks on an individual entity basis within the affiliates where such risks arise. Consequently, they may merely advise or arrange for affiliates to enter into specific OTC derivative transactions directly with external counterparties to hedge their exposures. However, the provision of such advice or arrangement may be captured by the current scope of Type 11 RA. This is because while there is a carve-out in respect of advice given to affiliates (under section 1(g) of Part 2A of Schedule 5 to the SFO), it only applies if the affiliate is a wholly-owned subsidiary of the corporate treasury desk or vice versa, or if both are wholly owned by the same holding company. We understand however that affiliates in some jurisdictions may not be wholly-owned subsidiaries due to foreign ownership restrictions. Hence, the section 1(g) carve-out may not suffice. In any case, the act of arranging for an affiliate to enter into specific OTC derivative transactions may still be caught (since such acts may constitute "inducing or attempting to induce" the affiliate to enter into an OTC derivative transaction and thus come within the scope of "dealing in OTC derivative products").

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[6] See the following papers jointly issued by the HKMA and SFC: (i) Supplemental Consultation on the OTC Derivatives Regime for Hong Kong – Proposed Scope of New/ Expanded Regulated Activities and Regulatory Oversight of Systemically Important Players (July 2012); and (ii) Joint Supplemental Consultation Conclusions on the OTC Derivatives Regime in Hong Kong – Proposed Scope of New/Expanded Regulated Activities and Regulatory Oversight of Systemically Important Participants (September 2013).

(c) ***Portfolio managing:*** Additionally, some corporate treasury desks also manage their affiliates' portfolio of OTC derivative transactions. However, current carve-outs from the expanded Type 9 RA do not suffice to carve these out.

14. We appreciate the concerns raised. We confirm that it is not our policy intention to regulate corporate treasury desks of non-financial groups as derivatives market intermediaries so long as they remain genuine price takers, ie, so long as they are not in the business of making markets in or offering price quotes for OTC derivative transactions. To make this clear, we propose the following.

(a) ***Type 11 RA – dealing limb:*** to amend the definition of "dealing in OTC derivative products" to expressly carve out the following:

(i) entering into or offering to enter into an OTC derivative transaction with an affiliate;

(ii) inducing or attempting to induce an affiliate to enter into or offer to enter into an OTC derivative transaction,

by a company within a group of companies which is not a financial group;

(b) ***Type 11 RA – advising limb:*** to amend the definition of "advising on OTC derivative transactions" to expressly carve out advice given to an affiliate but only if the advice is given by a company within a group of companies that is not a financial group;

(c) ***Type 9 RA:*** to amend the definition of "OTC derivative products management" to expressly carve out the management of a portfolio of OTC derivative products for an affiliate by a company within a group of companies which is not a financial group;

(d) ***Others:*** to incorporate definitions along the following lines in Schedule 5 to the SFO:

(i) "affiliate" – any corporation within the same group of companies but excluding CIS[7];

(ii) "financial group" – a group of companies which is primarily engaged in the provision of, or in supporting the provision of, financial services or the conduct of financial activities;

(iii) "financial services" –

- services in an RA (as defined in the SFO);
- services in the banking business (as defined in section 2(1) of the Banking Ordinance (Cap.155)); or
- services in the insurance business as contemplated under the Insurance Companies Ordinance.

While the term "financial services" is to be defined (based on the activities conducted) under the laws of Hong Kong, when considering the primary nature of a group, we intend to cover the activities of any overseas affiliate within the group of companies which if carried out in Hong Kong would constitute "financial services" proposed above.

[7] The proposed definition of "affiliate" is similar to the definition adopted in the Securities and Futures (OTC Derivative Transactions—Reporting and Record Keeping Obligations) Rules.

15. We believe the above amendments will address the concerns raised in respect of non-financial groups. It is also worth noting the following.

(a) The proposed carve-out from dealing will cover cases where both parties to the transaction are companies within a non-financial group, and thus make it unnecessary to rely on the price taker carve-out.

(b) To the extent that a corporate treasury desk within a non-financial group engages in OTC derivative transactions with external counterparties, this new carve-out will not be relevant. However, so long as the corporate treasury desk remains a price taker (ie, it does not make markets in or offer price quotes for OTC derivative transactions as a business), it will still be able to benefit from the price taker carve-out.

(c) To the extent that a corporate treasury desk within a non-financial group engages in OTC derivative transactions for group companies which are funds, the carve-out will not apply given that "affiliate" is proposed to be defined to exclude CIS.

(d) For financial groups, because of the potential build-up of exposures and the financial impact they may pose to the market and wider economy, it is important for regulators to be able to monitor the risks and exposures associated with the financial group's transactions by capturing information on their OTC derivatives activities and monitoring such activities within the groups. As such, we do not consider it appropriate for financial groups to benefit from the corporate treasury carve-out in the way intended for non-financial groups. That said, for financial groups, their corporate treasury personnel may still rely on other existing carve-outs for their corporate treasury activities where appropriate, such as:

(i) the "price taker" carve-out[8];
(ii) the "dealing through" carve-out[9]; and
(iii) the "wholly-owned group companies" carve-out.[10]

(e) Lastly, we have also considered whether the Type 12 RA should be amended to expressly carve out corporate treasury activities. We do not believe this is necessary in light of our proposal to refine the scope of Type 12 RA to exclude certain fund managers and ancillary services (discussed under paragraphs 32 to 34 below).

Q1a. Do you have any comments or concerns about how we propose to carve out corporate treasury activities conducted within non-financial groups from the scope of OTC derivative products management (ie, Type 9 RA)?
Q1b. Do you have any comments or concerns about how we propose to carve out corporate treasury activities conducted within non-financial groups from the scope of "dealing in OTC derivative products" (ie, the dealing limb of Type 11 RA)?
Q1c. Do you have any comments or concerns about how we propose to carve out corporate treasury activities conducted within non-financial groups from the scope of "advising on OTC

[8] This refers to the carve-out from "dealing in OTC derivative products" under section 2(g) of Part 2A of Schedule 5 to the SFO.

[9] This refers to the carve-out from "dealing in OTC derivative products" under section 2(n) of Part 2A of Schedule 5 to the SFO.

[10] This refers to the carve-out under paragraph (c) of the definition of "OTC derivative products management" and also the carve-out from "advising on OTC derivative products" under section 1(g) of Part 2A of Schedule 5 to the SFO.

derivative products" (ie, the advising limb of Type 11 RA)?

Q1d. We do not propose to carve out corporate treasury activities from Type 12 RA because we believe that corporate treasury personnel do not typically provide client clearing services. Do you have any comments or concerns in this regard? Please provide detailed reasons and justification if you believe such a carve-out is necessary or useful.

Q1e. The term "affiliate" is proposed to be defined by reference to the terms "group", and hence "subsidiary", as defined in Schedule 1 to the SFO. Among other things, the latter is defined by reference to: (i) control of the composition of the board of directors; (ii) control of more than 50% of the voting power at general meetings; or (iii) ownership of more than 50% of the issued capital (excluding capital which carries no right to participate beyond a specified amount on a distribution of profits or capital). Do you have any comments or concerns about defining "affiliate" in this way?

Q1f. Do you have any comments or concerns about how we propose to define "financial group" and "financial services"?

B. Activities of providers of post-trade multilateral portfolio compression services

16. Multilateral portfolio compression services are post-trade risk reduction services. They facilitate modification, early termination, or replacement of OTC derivative transactions among multiple participants to a compression cycle so as to reduce the notional amount of their outstanding transactions, the number of transactions among participants or both. In general, providers of multilateral portfolio compression services are not themselves contracting parties to the OTC derivative transactions which are subjected to the compression cycle or that result from the compression process. Also, they do not get involved in the execution or settlement of such transactions. However, given the role they play (in particular, providing compression proposals), their activities may constitute "dealing in OTC derivative products" or "advising on OTC derivative products" under the new Type 11 RA.

17. In view of the above, we have considered whether providers of such services should be subject to the licensing regime or whether their activities should be carved out. For the following reasons, we believe they should be carved out.

(a) One of the objectives of reforming the OTC derivatives market is to mitigate systemic risk. Post-trade risk reduction services, such as multilateral portfolio compression services, can serve to reduce both the counterparty credit risk and operational risk of persons participating in the compression services. This can in turn lessen systemic risk and enhance overall financial market stability.

(b) Portfolio compression is therefore a useful and efficient tool for risk mitigation, and should be encouraged. However, requiring providers of multilateral portfolio compression services to be licensed as intermediaries (and hence subject to the capital and other requirements imposed on intermediaries) may hinder the development of post-trade risk reduction services in Hong Kong.

(c) Existing users of multilateral portfolio compression services are large market participants with sizeable OTC derivatives portfolios. They should have the expertise and internal risk management capabilities to evaluate compression proposals put to them by providers of such services.

(d) We understand that other major jurisdictions do not currently regulate the provision of multilateral compression services.

18. The above said, we will monitor international and market developments in this area, and revisit the issue of whether multilateral portfolio compression service providers should be licensed, as necessary.

19. In the meantime, we propose to carve out the provision of multilateral portfolio compression services from both "dealing in OTC derivative products" and "advising on OTC derivative products". For this purpose, we propose to define multilateral portfolio compression services as services that:

(a) are provided:

(i) by a person (service provider);

(ii) in accordance with the rules of the service provider and within risk tolerance levels set by the persons referred to in (b) below (participants);

(iii) for the purposes of reducing operational risk or counterparty credit risk for the participants; and

(b) whereby the portfolios of OTC derivative transactions of three or more persons (none of which is the service provider) are analysed; and

(c) proposals are put forward as to how some or all of the transactions may be:

(i) modified to reduce their notional value;

(ii) terminated; and/ or

(iii) replaced with one or more new OTC derivative transactions with reduced exposures between or among the participants.

20. For completeness, we have also considered whether multilateral portfolio compression services should be carved out from the scope of ATS as well. We do not believe this is necessary. As we understand it, the providers of multilateral portfolio compression services essentially provide a service for calculating how the exposure of participants can be reduced, rather than a facility for terminating, modifying, or entering into replacement OTC derivative transactions. As such, we do not believe their activities come within the scope of ATS. Conversely, to the extent that providers of multilateral portfolio compression services also facilitate the termination, modification or replacement of OTC derivative transactions, we see no reason why they should be exempted from the scope of ATS. We therefore do not propose any amendment to the definition of ATS.

Q2a. Do you have any comments or concerns about our proposal to carve out multilateral portfolio compression services from both "dealing in OTC derivative products" and "advising on OTC derivative products"?

Q2b. Do you have any comments or concerns about how we propose to define "multilateral portfolio compression services"?

Q2c. We do not propose to amend the definition of "automated trading services". If you disagree, please provide details of the amendment you consider to be necessary, together with supporting reasons and justification.

Q2d. Other than portfolio compression services, are there other post-trade services which should also be carved out? If so, please provide detailed reasons and justifications.

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

21. A similar issue arises in the context of CCPs. We understand that some CCPs have started providing compression services for their clearing members and the latter's clients. Similar to the multilateral portfolio compression services discussed in paragraphs 16 to 20 above, such services allow clearing members and their clients to reduce the notional value of, and/or the number of transactions in, their portfolio, thus enhancing capital and operational efficiency. However, a compression cycle provided by a CCP may be conducted on a solo or bilateral basis (ie, in respect of the portfolios of only one person or of two persons). It follows that the carve-out discussed under paragraphs 16 to 20 above will not suffice (since it only applies to compression cycles involving three or more participants). The question arises as to whether the provision of solo or bilateral portfolio compression services should also be carved out.

22. As we understand it, the provision of solo or bilateral portfolio compression services outside the CCP environment is less common and may involve providing more specific or tailor-made advice. We believe therefore that providers of such services should be regulated. However, in the case of CCPs which offer clearing and settlement services in Hong Kong (either by operating here or marketing their services to persons here), they are already subject to regulation as a CCP, ie, either as a clearing house recognized under section 37(1) of the SFO (**RCH**), or an ATS provider acting in its capacity as a CCP and authorized under section 95(2) of the SFO (**ATS-CCP**). We therefore propose as follows.

    (a) To amend the definition of "advising on OTC derivative products" so as to carve out any advising act carried out by a CCP which is an RCH or an ATS-CCP but only if the act is an advising act that: (i) is carried out by an RCH or an ATS-CCP; and (ii) relates to any transaction to which the RCH or ATS-CCP is a counterparty in its capacity as a CCP.

    (b) As for the definition of "dealing in OTC derivative products", there is already a carve-out in respect of RCHs and authorized ATS providers, ie, section 2(e) of Part 2A of Schedule 5 to the SFO carves out acts carried out by an RCH or authorized ATS provider for the purpose of performing their functions. However, there may be doubt as to whether the provision of portfolio compression services constitutes the performance of functions of an RCH or authorized ATS provider. To avoid such ambiguity, we propose to also carve out any dealing act that: (i) is carried out by an RCH or an ATS-CCP; and (ii) relates to any transaction to which the RCH or ATS-CCP is a counterparty in its capacity as a CCP.

23. Depending on the structure and operation of a CCP, the compression services provided by it may also affect the back-to-back transactions between the CCP's clearing member and the latter's direct and indirect clients, ie, those back-to-back transactions will have to be correspondingly compressed. In view of this, it is necessary to also provide carve-outs for persons licensed for Type 12 RA. To that end, we propose to narrow the scope of "advising on OTC derivative products" by carving out OTC derivative advising acts carried out by persons licensed for Type 12 RA provided the act is wholly incidental to carrying on Type 12 RA. A similar carve-out is not necessary in respect of dealing

because section 2(i) of Part 2A of Schedule 5 to the SFO already carves out all dealing acts carried out by persons licensed for Type 12 RA.

Q3a. Do you have any comments or concerns about how we propose to carve out the provision of compression services by CCPs from the scope of "advising on OTC derivative products"?

Q3b. Do you have any comments or concerns about how we propose to amend the carve-out for CCPs from the scope of "dealing in OTC derivative products"?

Q3c. Do you have any comments or concerns about how we propose to carve out persons licensed for Type 12 RA from the scope of "advising on OTC derivative products"?

D. Activities of overseas clearing members and their agents

24. The current scope of Type 12 RA excludes remote clearing members of a Hong Kong CCP which meet certain pre-requisites[11]. Such members are thus able to actively market their client clearing services for OTC derivative transactions to persons in Hong Kong via an authorized institution (as defined in section 2(1) of the Banking Ordinance) or a licensed corporation (as defined in Schedule 1 to the SFO) without having to be licensed for Type 12 RA.

25. A market participant has asked why this carve-out is not extended to the activities of overseas persons which are clearing members of an *overseas* CCP (instead of a Hong Kong CCP). As noted in an earlier consultation conducted jointly by the Hong Kong Monetary Authority (**HKMA**) and the SFC[12], the intention was for section 115 of the SFO to govern the position of overseas persons who are members of overseas CCPs, ie, they would only require a licence for Type 12 RA if they actively marketed their services to the public in Hong Kong. On reflection, however, we agree that the location of the CCP should not be critical to determining the scope of the carve-out. The more important factor is that the overseas person must be able to meet the pre-requisites. In particular, its provision of client clearing services for OTC derivative transactions must be regulated in a comparable jurisdiction and it must not market its services to persons in Hong Kong other than through an authorized institution or licensed corporation. We also take into account that the clearing obligation (now in force under section 101C of the SFO) mandates the central clearing of certain OTC derivative transactions through designated CCPs, and that three of the four CCPs currently designated are overseas CCPs. Also, central clearing via CCPs (whether local or overseas CCPs) will reduce counterparty risk and interconnectedness among counterparties. This should therefore be encouraged even when there is no clearing obligation for the transaction concerned.

26. In view of the above, we propose to expand the carve-out to cover overseas persons who are clearing members of any CCP. To that end, we propose to:

(a) amend section 4(c) of Part 2A of Schedule 5 to the SFO so as to remove the reference to a CCP "located in Hong Kong"; and

[11] For example, they must not have a place of business in Hong Kong, any marketing of their services to persons in Hong Kong must be through an authorized institution or licensed corporation, and their provision of clearing and settlement services must be regulated in a comparable overseas jurisdiction.

[12] See paragraphs 24 to 29 of the HKMA and SFC's joint supplemental consultation on the OTC derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systematically important players (July 2012).

(b) amend paragraph (b) of the definition of "acceptable participant" under section 5 of Part 2A of Schedule 5 to the SFO so that it refers to overseas persons who are or have applied to become clearing members of any CCP.

27. As a result of the above changes, the existing carve-out for agents under section 4(d) of Part 2A of Schedule 5 to the SFO will be extended accordingly, ie, agents of overseas persons who are members of an overseas CCP (and who meet the relevant criteria of an acceptable participant) will also be able to benefit from the carve-out for agents so long as they do not handle client money or client assets.

28. Consistent with the above, we believe the carve-out from Type 12 RA (including the proposed carve-out discussed under paragraph 23 above) should be extended to "acceptable participants" as well. This is because:

(a) they too are regulated persons (albeit not regulated under Hong Kong law);

(b) their provision of services akin to the client clearing services provided by persons licensed for Type 12 RA may be caught under the definition of dealing in OTC derivative products; and

(c) their back-to-back transactions with clients may also be similarly affected by any portfolio compression services provided by the CCP of which they are a member.

29. We accordingly propose to;

(a) carve out from the scope of "advising on OTC derivative products" any OTC advising act that: (i) is carried out by an acceptable participant; and (ii) is wholly incidental to its provision of services akin to the client clearing services provided by persons licensed for Type 12 RA; and

(b) carve out from the scope of "dealing in OTC derivative products" any OTC derivative dealing act that: (i) is carried out by an acceptable participant; and (ii) wholly incidental to its provision of services akin to the client clearing services provided by persons licensed for Type 12 RA.

30. We also propose to take this opportunity to clarify an anomaly between paragraphs (b) and (d) of the definition of "acceptable participant". The former requires such a person to be a member of the CCP while the latter refers to the person as being a CCP member or a client of a CCP member. The intention is for the carve-out from Type 12 RA to only apply in respect of a person's activities as a CCP member, and not its activities as a client of a CCP member. Accordingly, we propose to amend paragraph (d) to remove the reference to indirect client clearing. Similar changes are proposed to paragraph (a) of the definition of "comparable overseas jurisdiction" (which also refers to indirect clearing).

31. Separately, we wish to clarify that paragraph (b) of the definition of "acceptable participant" will continue to refer to both persons who are, and persons who *have applied to become*, CCP members. The intention here is to allow a person who has applied to become a CCP member to conduct marketing activities even before its CCP membership application is granted. However, we do not intend that a person whose membership application is rejected should continue to be able to market its services. In practice, we do not expect it would do so. However, to avoid any doubt or confusion, we will amend paragraph (b) to make 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.

Q4a. Do you have any comments or concerns about how we propose to narrow the scope of Type 12 RA so as to align the position of overseas persons providing client clearing services irrespective of whether they do so as members of a local CCP or an overseas CCP? Q4b. Do you have any comments or concerns about our proposal to narrow the scope of Type 11 RA (both dealing and advising) so that activities carried out by acceptable participants which are not licensed for Type 12 RA are carved out?

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

32. Type 12 RA is intended to capture clearing and settlement services provided to another person through a CCP, whether directly (ie, in the capacity of a clearing member) or indirectly (ie, via another person which is a clearing member). Concerns have been raised by some market participants that, because the current definition of Type 12 RA is cast so widely, it is unclear whether activities which are essentially *ancillary to* the clearing and settlement process are also caught. In particular, we have been asked by market participants and industry associations to clarify whether the following activities would fall within the scope of Type 12 RA:

    (a) custodians and settlement banks releasing or receiving assets to or from a provider of client clearing services or a CCP for the purposes of settling an OTC derivative transaction for their clients;

    (b) authorized or licensed ATS providers, with direct connectivity to one or more clearing houses or client clearing services providers, providing straight-through-processing for participants by submitting executed orders to the relevant clearing houses or providers of client clearing services for clearing and settlement;

    (c) agents of providers of client clearing services marketing the latter's client clearing services;

    (d) licensed or registered fund managers selecting, or passing clearing instructions to, providers of client clearing services and CCPs for funds.

33. We wish to clarify that there is no policy intention to capture any of the above activities under the Type 12 RA. There is also no intention to capture fund managers to the extent that they provide client clearing services to funds which they themselves manage. We regard such services as being provided solely for the purpose of providing fund management services to their own funds.

34. To make the above clear, we propose to amend the definition of "providing client clearing services for OTC derivative transactions" as follows:

    (a) we will expressly carve out the provision of client clearing services by fund managers to funds they manage. We propose to cast this in similar terms as the carve-outs for fund managers from "dealing in OTC derivative products" and "advising on OTC derivative products", ie, it will only apply to fund managers licensed for the expanded

Type 9 RA, and only in so far as the client clearing services are provided to funds that they manage.[13] It follows that fund managers who provide client clearing services to other funds, including funds managed by their affiliates, will still need to be licensed for Type 12 RA. As fund managers are not responsible for funds managed by their affiliates, we do not believe it is appropriate for them to benefit from the carve-out.

(b) we will also refine the scope of Type 12 RA so that it only refers to services for the clearing and settlement of OTC derivative transactions which are provided:

(i) to another person through a CCP (whether in Hong Kong or elsewhere); and

(ii) in the capacity of either:

a. a CCP member; or

b. a direct or indirect client of a CCP member.

We believe this refinement (specifying the capacity in which the services must be provided) should suffice to clarify that ancillary activities of the kind discussed in paragraph 32 are not captured under Type 12 RA as those services are not provided in the capacity of a CCP member or a direct or an indirect client of a CCP member.

(c) additionally, and for future flexibility, we also propose including a provision which enables the SFC to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of Type 12 RA. This would be similar to the power conferred under section 2(k) of Part 2A of Schedule 5 to the SFO in respect of Type 11 RA.

35. It is worth highlighting what the above changes will mean for fund managers who provide clearing and settlement related services to funds managed by other persons, including funds managed by their affiliates. In such cases, so long as the services provided are ancillary, the fund manager will not need to be licensed for Type 12 RA. However, if the services are not ancillary (eg, if the fund manager is a clearing member or a client of a clearing member, and providing services in that capacity), it will need to be licensed for Type 12 RA.

Q5a. Do you have any comments or concerns about how we propose to carve out clearing and settlement services provided by fund managers from the scope of Type 12 RA?

Q5b. Do you have any comments or concerns about how we propose to refine the definition of Type 12 RA to exclude services that are essentially ancillary to the clearing and settlement process?

F. Requests for expanding carve-outs for fund managers

36. Currently, a corporation does not need to be licensed for Type 9 RA if it only provides portfolio management services (in respect of securities or futures contracts) for its wholly-owned group companies. This carve-out is not reflected in the expanded Type 9 RA (in respect of OTC derivatives), except to the extent that the OTC derivative products in the portfolio also constitute "securities" or "futures contracts". This was to ensure that the existing carve-out in respect of securities and futures is preserved.

[13] These carve-outs are set out in sections 1(e) and 2(h) of Part 2A of Schedule 5 to the SFO.

37. We have received a request from a solicitors' firm to align the expanded Type 9 RA with the existing Type 9 RA in this regards, ie, to expand the carve-out so that it applies in respect of all OTC derivative products managed for wholly-owned group companies, and not only in respect of OTC derivative products which also constitute "securities" or "futures contracts.

38. The requested expansion would bring the OTC derivatives licensing regime in alignment with the current practices for securities and futures contracts. We believe that it will be helpful to market participants while not compromising regulatory standards. Accordingly, we propose to extend the existing carve-out for managing an OTC derivatives portfolio for wholly-owned group companies to cover all OTC derivative products.

39. We note that a similar issue arises in the context of professionals (ie, solicitors, counsel, certified public accountants and trust companies registered under Part 8 of the Trustee Ordinance) who provide portfolio management in respect of OTC derivative products. In their case, the carve-out from having to be licensed for Type 9 RA only applies to the extent that the OTC derivative products in their portfolio also constitute "securities" or "futures contracts". However, given that the carve-out is in light of their professional role, and only applies if their provision of portfolio management services is incidental to discharging that professional role, we consider that the carve-out can be further relaxed to cover all OTC derivative products. We therefore propose to amend the definition of "OTC derivative products management" accordingly.

40. Another concern raised by the solicitors' firm is that it is uncertain whether licensed[14] fund managers who wish to trade in foreign exchange derivatives as part of their asset management strategy are also required to be licensed for Type 3 RA (leveraged foreign exchange trading). We have no regulatory intention to require licensed fund managers to be licensed for Type 3 RA if they deal in foreign exchange derivatives solely for the purpose of managing funds. We agree that an exemption under Type 3 RA for licensed fund managers is necessary to help to clarify this.

41. We therefore propose to carve out from Type 3 RA any act which meets all of the following criteria:

    (a) it is performed by a person who is licensed for Type 9 RA;

    (b) the person provides a service of managing a portfolio of OTC derivative products for another person which the person is permitted to provide under that licence;

    (c) it is performed solely for the purposes of carrying on OTC derivative products management; and

    (d) it also constitutes an OTC derivative dealing act.

42. Paragraph 41(d) above is intended to ensure that only products which constitute both "leveraged foreign exchange contracts" and "OTC derivative products" may benefit from the carve-out. The incidental dealing activities of licensed fund managers are already carved out from Type 11 RA. For consistency, they should also be carved out from Type 3 RA.

[14] This concern only applies in respect of licensed fund managers but not registered fund managers. Authorized financial institutions' activities are already carved out under paragraph (xii) of the definition of "leveraged foreign exchange trading".

43. Since the expanded Type 9 RA is a new regime, for future flexibility and similar to what we propose for Type 12 RA above, we propose including a provision which enables the SFC to prescribe (by subsidiary legislation) further classes of persons whose activities may be carved out from the scope of the expanded Type 9 RA. This would be similar to the power conferred under section 2(k) of Part 2A of Schedule 5 to the SFO in respect of Type 11 RA.

Q6a. Do you have any comments or concerns about our proposal to expand the carve-out for professionals so that it covers all OTC derivative products?

Q6b. Do you have any comments or concerns about how we propose to carve out licensed fund managers' from Type 3 RA?

G. Other issues relating to fund managers' activities

44. A further issue raised by fund managers is whether their activities can be further carved out from the current scope of dealing and advising. Under the current regime, so long as fund managers are licensed for securities or futures contracts management, and their dealing and advising activities relate to such management activities (ie, the dealing and advising is only in respect of funds under their management), they do not need to be additionally licensed for such related dealing or advising. Carve-outs have been built into the dealing and advising RAs[15] to reflect this.

45. We have received a request to extend these carve-outs so that, in respect of OTC derivatives as well as securities and futures contracts, fund managers licensed for fund management may also provide dealing and advising services to funds managed by their affiliates. In this regard, we understand that some fund managers may centralise their group's dealing and advising activities into a single entity for operational reasons.

46. We do not consider that this would be appropriate. The existing incidental exemption under Type 9 RA is to carve out the dealing or advising activities which are integral to the fund management function of the fund managers. If fund managers are only providing dealing or advising services in relation to the funds managed by their affiliates without any fund management role, their dealing or advising role will be not much different from that of a dealer or an advisor. So we do not see any reason why they should not be regulated as such.

[15] The dealing and advising RAs referred to here are Type 1 and Type 4 RAs (in the case of securities), Type 2 and Type 5 RAs (in the case of futures contracts), and Type 11 RA (in the case of OTC derivative products).

Part III. Proposed risk mitigation requirements

A. Overview

47. Given the global nature of OTC derivative transactions and market participants, a number of working groups and task forces have been set up under the auspices of various international standard setting bodies to provide guidance to regulatory and supervisory authorities on some of the key aspects of OTC derivatives regulation and to promote a coordinated and generally consistent approach globally.

48. In June 2012, the International Organization of Securities Commissions (**IOSCO**) published a report, entitled International Standards for Derivatives Market Intermediary Regulation[16] (**IOSCO DMI report**), which contains recommendations to provide high-level international standards for the regulation of derivatives market intermediaries, including record-keeping standards. In January 2015, IOSCO published another report, entitled Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives (**IOSCO RMS**)[17], which presents IOSCO's standards for risk mitigation techniques for non-centrally cleared OTC derivatives. We have taken into account the standards in these IOSCO reports in developing the proposals in this paper.

49. The IOSCO RMS presents standards for risk mitigation techniques for non-centrally cleared OTC derivatives. These techniques can:

    (a) promote legal certainty and facilitate timely dispute resolution;

    (b) facilitate the management of counterparty credit risk and operational risk; and

    (c) increase financial stability.

50. In general, we have taken a high-level approach to the proposed risk mitigation standards, rather than a prescriptive one, taking into account the different size and scale of market participants' OTC derivatives operations. In addition, our regulatory approach intends to provide sufficient flexibility to cater for cross-border impact. This is in recognition of the global nature of OTC derivative transactions, where the counterparties transacting with SFC-licensed corporations may be in various overseas jurisdictions and subject to their own domestic or home country requirements, especially at the transaction level. In light of this, we have taken the view that a high-level, principles-based approach would be appropriate to ensure compatibility with different cross-border requirements and firm-specific characteristics.

51. As the proposed risk mitigation standards are set at a high level, we propose that the requirements apply to all licensed corporations in respect of non-centrally cleared OTC derivative transactions to which the licensed corporation is a contracting party, instead of confining the application of the requirements to corporations licensed for Type 11 RA. Since OTC derivatives dealing is regulated in most major financial markets, when a licensed corporation enters into a non-centrally cleared OTC derivative transaction with an OTC derivatives market maker, the licensed corporation's counterparty may itself be subject to similar risk mitigation standards required by the counterparty's regulator.

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[16] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD381.pdf

[17] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf

Those standards may be more prescriptive and detailed than the requirements proposed in this consultation. Accordingly, it would appear that applying our proposed regime to licensed corporations which are not OTC derivatives market makers would not impose a disproportionate burden on them.

52. In addition, we propose that the requirements apply to 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 such licensed corporation on behalf of CIS managed by it. However, if the proposed requirements are handled by the governing body of the CIS or its delegate, then the proposed requirements will not be applicable to the licensed corporation managing such CIS. For example, if the trustee, custodian or other operator of the CIS has the direct interface with trade counterparties and handles the trading relationship documentation and all post-trade processes directly with trade counterparties, then the licensed corporation is not responsible for complying with the proposed requirements. Where a licensed corporation manages a discretionary account instead of a CIS, we will leave it to the licensed corporation and its client to make the necessary arrangements between themselves.

53. Where a licensed corporation manages a CIS but transactions are executed by a group company's dealing desk on behalf of the CIS, the proposed requirements do not apply directly, but the licensed corporation is expected to review whether appropriate procedures are in place to achieve a similar risk mitigation outcome in relation to the portfolio under management by the licensed corporation.

54. We have considered whether the proposed risk mitigation requirements should apply to a licensed corporation with smaller non-centrally cleared OTC derivative exposure, for example, if such exposure does not exceed a quantitative threshold. We believe all licensed corporations, regardless of their level of exposure to non-centrally cleared OTC derivatives, should be subject to the proposed risk mitigation requirements because our proposals pertain to sound risk management techniques which are in line with current industry practice. The proposed requirements seek to address certain legal and counterparty risks which a licensed corporation may incur if the proposed measures are not put in place. As discussed below, we have adopted a high-level, principles-based approach which is proportionate to the level of exposure or activity of the licensed corporation to cater for differences in the size and scale of the non-centrally cleared OTC derivative activities of different licensed corporations.

55. The requirements proposed in Parts III to V of this paper would not apply to registered institutions, which would continue to be overseen and regulated by the HKMA. Registered institutions are generally required to comply with the risk mitigation standards set out in section 4 of the Supervisory Policy Manual CR-G-14, Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards, issued by the HKMA on 27 January 2017. Accordingly, we propose that an institution registered to carry on Type 9 RA (asset management) should comply with the HKMA's risk mitigation standards in respect of non-centrally cleared OTC derivative transactions executed by the registered institution on behalf of any CIS managed by it[18].

56. We plan to set out the risk mitigation requirements in a new Schedule 10 to the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures

[18] Registered Institutions will continue to be subject to the SFC's jurisdiction in respect of the Registered Institution's compliance with HKMA's risk mitigation standards set out in section 4 of the Supervisory Policy Manual CR-G-14.

Commission (**Code of Conduct**)[19] (Schedule 10). The proposed requirements are included in Appendix 1 of this paper. In addition, it is proposed that margin requirements will apply to certain non-centrally cleared OTC derivative transactions, and these will be subject to a separate consultation in due course. The proposed margin requirements will also be set out in this new Schedule 10.

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?

B. Risk Mitigation Requirements

57. We propose to impose on licensed corporations (as referred to in paragraphs 51 and 52) requirements in relation to OTC derivatives trading relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression and dispute resolution. The proposed risk mitigation requirements apply to non-centrally cleared OTC derivatives, and do not apply to centrally cleared derivatives. In general, the requirements are to be applied in a proportionate manner commensurate with the licensed corporation's OTC derivatives exposure.

Trading relationship documentation

58. The use of trading relationship documentation enables a licensed corporation to establish a framework to govern the trading relationship with its counterparties. Trading relationship documentation sets out key particulars such as payment obligations, defaults or other termination events, calculation and any netting of obligations upon termination, transfer of rights and obligations, governing law, processes for valuation, credit support arrangements and collateral segregation arrangements. In general, global OTC derivatives dealers make use of industry standard legal documentation, such as master agreements to document derivative transactions, which facilitates bilateral cross-asset class netting of transactions between the trading counterparties so that counterparty exposure is reduced. A licensed corporation's exposure to its counterparty may also be reduced by collateral received from its counterparty. Proper documentation of the credit support arrangements is necessary to identify the margining arrangements, the types of eligible collateral, and any agreed asset valuation haircut. Effective reduction of counterparty risk can only be achieved if such netting and collateral arrangements are legally enforceable in the event that outstanding trades have to be terminated or collateral enforced following the counterparty's default.

59. To ensure proper documentation of trades, we propose to require a licensed corporation to execute written trading relationship documentation with each counterparty prior to or

[19] As set out in the Consultation Conclusion on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts issued in November 2017, paragraph 1.4 of the Code of Conduct will be deleted when the revised Code of Conduct comes into effect. Under paragraph 1.4, to the extent that a licensed or registered person acts in the capacity of a management company in relation to the discretionary management of CIS, the Code of the Conduct does not apply to such activity.

contemporaneously with executing a non-centrally cleared OTC derivative transaction.

60. Trading relationship documentation should:

(a) provide legal certainty for non-centrally cleared OTC derivatives;

(b) include all the agreed material rights and obligations of counterparties concerning the non-centrally cleared OTC derivatives trading relationship;

(c) be executed in writing; and

(d) be consistent with any applicable law or regulation.

61. The material rights and obligations may include any payment obligations, events of default or other termination events, calculation and any netting of obligations upon termination, transfer of rights and obligations, governing law, processes for valuation, portfolio reconciliation, dispute resolution, credit support arrangements and collateral segregation arrangements.

62. Rights and obligations of the counterparties may be incorporated by reference to other specified documents, such as master agreements.

63. In the case of one-off transactions, trading relationship documentation may 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.

Trade confirmation

64. To ensure that a licensed corporation maintains an up to date and accurate record of its OTC derivatives trades and monitors the corresponding exposures arising from such transactions, timely trade confirmation is essential.

65. Before the global financial reforms which brought OTC derivatives under regulation, the rapid expansion of OTC derivatives trading created stresses in the operational infrastructure of market participants. Executed transactions failed to be confirmed in a timely manner, and a backlog of outstanding trade confirmations developed over time. Supervisory authorities in major OTC derivatives markets overseas have since sought to enhance the post-trade processing of OTC derivative transactions and to improve the operational efficiency of the OTC derivatives market through engagement with the industry to promote the automation of trade processing and the timely confirmation of trades.

66. Confirmation of non-centrally cleared OTC derivative transactions is an important part of operational risk management. There should be a written record for each transaction evidencing all the material transaction terms to ensure the legal certainty of the agreed terms. Trading relationship documentation or any other document which contains material trade terms may be incorporated by reference. In the absence of clear evidence of such agreed terms, the terms of the trade have to be reconstructed from other evidence, which increases the chance of disputes. Prompt trade confirmation through which the trade counterparties verify the accuracy of the terms of their trade is also an industry best practice. Timely trade confirmation allows discrepancies in the terms of non-centrally cleared OTC derivative transactions to be identified and resolved promptly, and facilitates downstream operational risk management such as accurate valuation,

assessment of risk exposure, calculation of margin requirements, and discharge of settlement obligations.

67. We propose that a licensed corporation should establish and implement policies and procedures to ensure that the material terms of all non-centrally cleared OTC derivative transactions are confirmed as soon as practicable after the execution of the transaction. Licensed corporations are expected to track the status of unconfirmed transactions with a view to obtaining proper confirmation of all transactions in a timely manner.

68. A list of possible material terms is set out in Appendix 2.

69. Trade confirmation should be done in writing by electronic or manual means. These policies and procedures may cover the use of one-way confirmation (sometimes referred to as negative affirmation[20]) of a trade insofar as both parties have agreed in advance to confirm trades using this process, so that the outcome is legally binding on both parties. This takes into account the possible operational burden on a licensed corporation's counterparties which may not be regulated entities and may not have the operational infrastructure to execute confirmations promptly. The use of one-way confirmation or negative affirmation can reduce the legal uncertainty which might otherwise arise if the counterparty fails to execute a trade confirmation. Nevertheless, we encourage the industry to engage with counterparties to increase the use of electronic confirmation across asset classes and markets to facilitate prompt trade confirmation.

70. When a licensed corporation enters into a transaction, including a new transaction resulting from novation, trade confirmation should be done. Trade assignments and amendments should also be documented to ensure a clear and definitive record of the identity of the parties who have legal rights and obligations under the transaction. Licensed corporations should also consider adopting policies and procedures to confirm other changes to the transaction, such as termination prior to the scheduled maturity date, so that each party to a transaction can have an accurate record of the contract terms of the transaction at any given point in time.

Valuation

71. Valuation of non-centrally cleared OTC derivative transactions plays an important role in monitoring market and counterparty credit risk. First, accurate valuation of non-centrally cleared OTC derivative positions enables market participants to determine their risk exposures correctly and to appropriately risk manage their positions, be it in the form of calling variation margin from the transaction counterparty, hedging the position or (partially) unwinding or terminating the transaction. Secondly, market participants need to accurately value their non-centrally cleared OTC derivative positions to correctly assess and determine their minimum liquid capital requirements under the Securities and Futures (Financial Resources) Rules (**FRR**). Valuation of non-centrally cleared OTC derivatives, even simple vanilla products, may not be straightforward as they do not necessarily trade on exchanges or swap execution facilities (**SEF**s), so prices from exchanges or SEFs may not be available. Market participants may rely on broker quotes or on valuations produced by proprietary or third party models, which could be based on

[20] Negative affirmation refers to a process whereby a party sends a unilateral communication to its counterparty setting out the terms of the transaction, a fixed deadline for objecting to any terms of the transaction is agreed and, upon expiry of the deadline, the terms of the transaction sent by one party of the transaction to its counterparty is deemed to be finalised and accepted by both parties.

a variety of different valuation methodologies, each with their own assumptions, inputs and parameters. For non-centrally cleared OTC derivatives which are not widely traded, external price quotations may not be readily or regularly available, and quoted prices may not represent actual transaction prices. Even where market participants agree on a certain valuation methodology and the market inputs required to populate a valuation model are readily available, counterparties may still not agree with the valuation of a non-centrally cleared OTC derivative due to legitimate differences in the way the market inputs are applied or the way the valuation model is set up or calibrated. Valuation difficulties may be further aggravated during a major market stress, when the market inputs required for valuation may not be available for a wider range of instruments.

72. Consequently, to minimise the occurrence of valuation breaks and to enable more effective management of such breaks when they do occur, we propose that a licensed corporation should 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. Where valuation breaks do occur, the portfolio reconciliation and dispute resolution processes proposed below may highlight deficiencies or shortcomings in the valuation processes, methodologies or models of the licensed corporation. In such cases, the licensed corporation should take remedial actions to address the deficiencies or shortcomings identified to improve its valuation processes, methodologies and models to prevent future recurrences. This will reduce disputes between counterparties and result in effective risk mitigation through more accurate margining.

73. Valuations of non-centrally cleared OTC derivatives should be performed on a fair value basis by marking to market where practicable. Where a licensed corporation chooses to value non-centrally cleared OTC derivatives using a proprietary valuation model, the licensed corporation should generally use a model which employs valuation methodologies with mainstream acceptance. Nevertheless, the licensed corporation may also consider new methodologies with a sound theoretical basis if it can demonstrate that the new methodology addresses a known limitation of the existing methodology, leads to an improvement in the reliability or accuracy of the resulting valuation, or can be justified by market developments. Readily observable market inputs should be sourced to populate the valuation model as much as possible. The inputs feeding the valuation model should be appropriately verified and the model itself should be independently[21] reviewed, validated and calibrated prior to use, periodically and when material changes are made to the methodology or the model. Verification of model inputs and calibration of the model are particularly important for valuing non-centrally cleared OTC derivatives which may not have readily observable market inputs as the valuation of such instruments may be dependent on assumptions, estimates and opinions. Licensed corporations should review such valuations by, for example, checking if the model can replicate the market prices of other similar instruments observed in the market. Further comfort with the appropriateness of the model inputs and model calibration can be obtained by using alternative valuation methodologies or models to value the same instrument.

74. Where a licensed corporation chooses to value non-centrally cleared OTC derivatives using a third party valuation model, ie, a vendor model as opposed to an internally developed proprietary model, the licensed corporation may not have as much access to

[21] The independent review can be performed by a function within the licensed corporation which is operationally independent from the developer of the valuation model.

or understanding of the internal workings of the model as the third party vendor who developed it. We propose that a licensed corporation should exercise due skill, care and diligence in confirming that the third party valuation model employs a sensible valuation methodology and has been appropriately calibrated as well as independently reviewed and validated. The licensed corporation should still conduct a regular independent review and verification of the model outputs. This is a critical step which model users should perform to evaluate the appropriateness of valuation models, irrespective of whether the model is developed internally or by a third-party vendor.

75. Accordingly, we propose that where a licensed corporation values a non-centrally cleared OTC derivative by marking to a proprietary valuation model, it should ensure:

(a) that the model employs a valuation methodology with either an accepted economic or sound theoretical basis;

(b) that the analysis and rationale behind the choice of inputs are documented and that the model inputs and calibration are subjected to independent review, challenge and verification;

(c) that the model is subjected to independent review, validation and approval and the results of such reviews are documented; and

(d) that the outputs of the valuation model are subjected to regular independent review and verification.

76. If a licensed corporation values a non-centrally cleared OTC derivative using a third-party valuation model, we propose that the licensed corporation should:

(a) exercise due skill, care and diligence to confirm that the model satisfies the requirements under paragraphs 75(a), 75(b) and 75(c); and

(b) conduct a regular independent review and verification of the model outputs.

77. The proposed valuation model requirements stated above will also apply to a SFC-licensed 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, and (b) the licensed corporation elects to use proprietary or third party valuation models 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 who uses valuation models for internal purposes (such as for calculating a shadow NAV) would not be subject to the proposed valuation model requirements.

Portfolio Reconciliation

78. It is an existing requirement under the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (**Internal Control Guidelines**) that a licensed corporation undertakes regular reconciliation of the firm's records to those issued by third parties, such as its counterparties, to identify and highlight for action any errors or omissions, and such

reconciliation should be reviewed and approved by appropriate senior staff members[22].

79. Portfolio reconciliation is an important post-trade process to ensure effective confirmation of the key contract terms of a non-centrally cleared OTC derivative transaction, to establish the accuracy of a licensed corporation's record of its entire trade population with its counterparties and to identify trade booking errors and resolve discrepancies between the parties on the valuation of the non-centrally cleared OTC derivatives portfolio as early as possible. A material discrepancy between counterparties in the key terms of a non-centrally cleared OTC derivatives transaction may point to a failure in the trade confirmation process or an error in the internal process of a transaction party. Portfolio reconciliation is conducive to reducing valuation and margin call disputes. It can improve the integrity and efficiency of the licensed corporation's internal process, and enhance the proper assessment of the licensed corporation's overall risk exposures arising from the non-centrally cleared OTC derivative transactions.

80. We propose that 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 in respect of all non-centrally cleared OTC derivative portfolios at regular intervals. We propose a risk-based approach such that the frequency of portfolio reconciliation with each counterparty should be commensurate with the risk exposure profile of the counterparty, taking into account, for example, the size and volatility of the licensed corporation's non-centrally cleared OTC derivative portfolio with the counterparty.

81. The reconciliation should aim to ensure that the record of the material terms and valuations of all the non-centrally cleared OTC derivative transactions are accurate, and discrepancies in the material terms and valuations are identified and handled in a timely manner.

82. The proposed portfolio reconciliation requirement does not explicitly prescribe that transactions entered into with individuals be covered. It is expected that the total volume of trades a licensed corporation enters into with individuals will be relatively low, and the corresponding exposure limited. Licensed corporations are encouraged to adopt the same standard in respect of such counterparties to the extent practicable.

Portfolio Compression

83. Portfolio compression allows two or more derivatives market participants with a sizeable portfolio of outstanding non-centrally cleared OTC derivative transactions to terminate wholly or partially those transactions which have substantially similar economic terms and replace them with a smaller number of transactions with a lower aggregate notional value. This exercise seeks to replace economically-equivalent transactions by decreasing the number of transactions or the notional value of a portfolio of non-centrally cleared OTC derivative transactions. Compression may enable derivatives market participants to reduce risks and operational inefficiency in their non-centrally cleared derivatives portfolios.

84. Portfolio compression can reduce the outstanding gross notional value of non-centrally cleared OTC derivative transactions and may therefore increase capital efficiency and liquidity. However, portfolio compression may disadvantage the legal, tax, accounting or

[22] Internal Control Guidelines, part VII Operational Controls, paragraph 10.

operational status of a market participant and therefore may not be appropriate in all circumstances.

85. We propose that a licensed corporation with non-centrally cleared OTC derivative transactions should establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression. Portfolio compression may be performed on a bilateral or multilateral basis. We note that portfolio compression services currently available in the market do not cover all asset classes or all product types within an asset class. We also recognise that a licensed corporation having a directional portfolio with few offsetting non-centrally cleared OTC derivative transactions may enjoy limited benefits from engaging in portfolio compression, as the reduction of notional and counterparty exposure could be minimal. The requirement is to be applied in a proportionate manner depending on the level of exposure or activity undertaken by a licensed corporation.

Dispute Resolution

86. In the event of a dispute between a licensed corporation and its counterparty relating to the material terms, valuation or margining of a non-centrally cleared OTC derivative transaction, it is important that the dispute is resolved as soon as practicable and in a way both parties understand. Licensed corporations should be alert to the risk of disputes arising from changes to the terms of a transaction due to trade lifecycle events (such as transaction novation, assignment, partial unwind or notional increase), corporate actions (such as stock splits, rights issues, spin-offs and mergers and acquisitions activity) as well as inventory breaks. Disputes should be investigated and resolved as a matter of priority because they prevent a licensed corporation from having a true and accurate picture of its non-centrally cleared OTC derivative exposure, which in turn directly affects and impairs the accurate valuation, margining and risk management of such positions. Whilst counterparties may have legitimate reasons to dispute the valuation or margining of a non-centrally cleared OTC derivative, licensed corporations should not use the pretext of a dispute to unduly delay or avoid payment of variation margin which is rightly due. In the event of a dispute, the undisputed amount of margin should be exchanged. We propose that a licensed corporation should agree in writing with its counterparties on the mechanism or process for determining when discrepancies in material terms, valuations or margin calls should be considered disputes, as well as how such disputes should be resolved as soon as practicable. The agreed dispute resolution mechanism can be covered as part of the trading relationship documentation. It is expected that a licensed corporation should have internal procedures in place for the escalation of material disputes to an appropriate level of senior management.

87. Where the counterparty is not a financial counterparty, the licensed corporation is expected to establish and implement effective policies and procedures regarding the type of counterparties with which such dispute resolution mechanisms or processes should be agreed, proportionate to the level of exposure to the counterparty. Licensed corporations are encouraged to adopt the same standard in respect of such counterparties to the extent practicable.

Foreign Exchange Security Conversion Transactions

88. We understand that it is common for market participants to enter into foreign exchange (**FX**) security conversion transactions to facilitate the purchase or sale of foreign securities. FX security conversion transactions involve the purchase or sale of an amount of foreign currency equal to the price of the foreign securities. Both the securities and FX

security conversion transactions are executed contemporaneously to effect delivery of the foreign securities by the customary settlement period of the foreign securities, ie, FX security conversion transactions are intended to be settled by the actual delivery of the foreign currency within the standard settlement cycle of the foreign securities. We note that these transactions serve a very specific purpose and, but for the settlement cycle of the relevant securities transaction, would essentially be FX spot contracts. Such contracts are excluded from mandatory reporting requirements and are defined as "excluded currency contracts" in Rule 2 of the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules. Excluded currency contracts are defined with a T+7 day cap on the settlement period. Taking into consideration the operational burden versus the benefits of subjecting FX security conversion transactions to the full suite of the proposed risk mitigation requirements, we believe that there are certain legal and operational risks associated with such transactions which should be mitigated as a matter of sound business practice and prudent risk management. Given the importance of ensuring the legal certainty of the transactions and contractual terms and to minimise operational risk, we propose that these FX security conversion transactions only be subject to the risk mitigation requirements for trading relationship documentation and trade confirmation as set out above. For FX security conversion transactions, trading relationship documentation can take the form of FX terms of business or client agreements.

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?

Part IV. Proposed requirements on client clearing

A. Proposed amendments to the Code of Conduct

89. We propose that the following additional requirements should apply to a corporation licensed for providing client clearing services for OTC derivative transactions, regardless of whether the licensed corporation itself is a clearing member of a CCP. We plan to set the additional requirements in the new Schedule 10. The proposed requirements are in Appendix 3 of this paper.

Segregation and portability

90. The SFC does not impose a location requirement for clearing under the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations) Rules. Therefore, OTC derivative transactions subject to mandatory clearing under those Rules can be cleared by a CCP outside Hong Kong so long as the CCP is a "designated CCP". Accordingly, we propose to set our segregation requirements at a high level in order to accommodate different legal forms of account and collateral arrangements in various jurisdictions.

91. Under the CPSS-IOSCO Principles for Financial Market Infrastructures (**PFMI**)[23], a CCP should have rules and procedures which enable the segregation and portability of positions of a clearing member's clients and the collateral provided to the CCP with respect to those positions. CCPs employ different models of segregation, including omnibus client segregation and individual client segregation. Our proposed requirements for the licensed corporation pertaining to its client segregation obligations take into account the different segregation models which may be offered by CCPs.

92. Under an omnibus client segregation model, collateral belonging to clients of a particular clearing member is commingled and held in an account segregated from that of the clearing member. Some CCPs offer more than one form of account structure for omnibus client segregation. A clearing client may be subject to loss mutualisation pursuant to the rules and procedures of the CCP at which the client's trades are cleared. For example, assets which are provided to the CCP as margin for an OTC derivative transaction recorded in an omnibus client account at the CCP may be used to cover losses in that account, even if such losses relate to another client of that account. In addition, where non-cash collateral is provided to the CCP as margin for a given omnibus account, the CCP may not record specific assets in an omnibus account as being attributable to a particular client of that account. The CCP may only be able to identify in its records the type of assets provided as margin for the omnibus account as a whole.

93. Under an individual client segregation model, each client's collateral is held in a separate, segregated individual account at the CCP and, depending on the legal framework as well as the clearing rules and procedures applicable to the CCP, a client's collateral may only be used to cover losses associated with the default of that client, ie, client collateral is protected on an individual basis. On the default of a clearing member, porting an individual segregated client account to a replacement clearing member may be easier than porting an omnibus client account.

94. In order to cater for the different segregation models which may be offered by a CCP,

[23] Principles for financial markets infrastructures (April 2012) http://www.bis.org/publ/cpss101a.pdf

and to provide flexibility for licensed corporations, we do not propose to prescribe which segregation model a licensed corporation must adopt, as long as the licensed corporation segregates those assets held for clients in separate accounts at the CCP which can be distinguished from its own assets.

95. While individual client segregation is likely to offer clearing clients better protection with respect to the risk of default of other clients or of the clearing member, we are not prescribing this as a minimum requirement, ie, we are not proposing that a licensed corporation should offer individual client segregation to its clients wherever it is available from a CCP. Major jurisdictions are implementing new regulatory requirements relating to OTC derivatives client clearing using a phased approach. Client account structures available at several major CCPs are not identical, and the level of client asset protection may also vary by reason of the legal framework applicable to the CCP or the clearing member. Some clients may be at an early stage of considering their options for OTC derivatives clearing, and may not have decided on the client account structure to be used. Individual client segregation will entail a higher operational burden on the clearing member, which may have corresponding cost implications. At this stage, there is no indication that the volume of demand for individual client segregation cannot be met by offerings from the major clearing members. We therefore consider it more conducive to the development of OTC derivatives client clearing that a licensed corporation be given flexibility to discuss with its clearing clients the optimal client clearing account structures and client asset segregation models, rather than prescribing that licensed corporations establish infrastructure for individual client segregation which clients may choose not to use.

96. At the same time, where a licensed corporation offers the client a choice of client account structures and client asset segregation models, it is important for clients to understand that there are different costs and risks associated with the different segregation models, and be able to make an informed decision about which model they would prefer. In light of this, we propose that where a licensed corporation clears a client's OTC derivative transactions and different levels of client asset segregation at the CCP are offered to the client, a licensed corporation should inform its client and provide a clear explanation of the costs, risks and portability arrangements of the different levels of segregation provided by the CCP, including the legal implications of the respective levels of segregation offered and the risk of loss mutualisation which the client may be subject to. We have not proposed any specific terms to be included in the licensed corporation's explanation and risk disclosure to clients, having regard to the possible differences in client account structures and segregation models offered by CCPs, as well as differences in the legal framework applicable to the relevant CCP and the clearing member[24]. As most clients using OTC derivatives clearing services are likely to be institutional clients, we expect clearing clients to conduct their own due diligence on the clearing and client asset segregation models selected.

97. To ensure that client assets are adequately safeguarded, a licensed corporation should segregate collateral belonging to clients from the licensed corporation's own proprietary assets. It is also important that client assets should not be used for the benefit of the

[24] The implications of the different segregation models and the risk of loss mutualisation could be a function of the CCP's default management rules as well as the legal and regulatory frameworks applicable to the clearing member. Accordingly, even though a CCP may provide risk disclosures for the different client account structures and client asset segregation models offered by the CCP, it would still be appropriate for the licensed corporation to explain the implications and risks of these client account structures and client asset segregation models to its clearing clients.

house positions of the licensed corporation or any corporations with which the licensed corporation is in a controlling entity relationship. Accordingly, we propose that a licensed corporation should not apply client assets for the benefit of its own position accounts, accounts of its directors or employees or accounts of any corporations with which the licensed corporation is in a controlling-entity relationship. As defined under the SFO, a corporation is in a controlling-entity relationship with a licensed corporation when:

(a) the licensed corporation is the controlling entity of the corporation;

(b) the corporation is a controlling entity of the licensed corporation; or

(c) another person, who is a controlling entity of the corporation, is also a controlling entity of the licensed corporation.

The scope of "controlling entity" under the SFO, in relation to a corporation, means a person who, either alone or with any of his associates, amongst other things, is entitled to exercise or control the exercise of not less than 20% of the voting power at general meetings of the corporation. This definition may cover a wider set of group companies than "affiliates" under the rules of the relevant CCPs by which client trades are cleared.

98. It is conducive to a clearing client's counterparty risk management that the client should be able to transfer positions and collateral relating to its cleared OTC derivatives transactions to another clearing intermediary. This capability is known as portability. Following the default of a clearing member providing clearing services to a client, if portability arrangements are effective, client positions and collateral could be transferred to non-defaulting clearing members without liquidating and re-establishing the positions. This could mitigate the adverse impact on the client by reason of the clearing member's default, and enhance financial stability. Accordingly, we propose that the client clearing agreement entered into by a licensed corporation providing client clearing services should cater for the transfer of client positons and collateral both in the normal course of business[25] and (where the licensed corporation is also the clearing member) following the licensed corporation's default, where permissible under the applicable legal framework and subject to any requirements of the relevant CCP.

99. According to PFMI[26], a CCP should have rules and procedures which enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions. Under the rules of some CCPs, it is possible for a client to transfer its positions and collateral following a clearing member's default without further assistance from the clearing member. On this basis, there does not appear to be a need for us to impose specific additional obligations on a licensed corporation which clears client trades at a CCP to facilitate portability following the licensed corporation's default.

100. However, the ability of a clearing client to transfer positions and collateral upon a clearing member's default may vary among CCPs, and may depend on multiple factors including the client account structure selected by the client, the legal framework applicable to the client account and the clearing member, the porting mechanism at the CCP, and any incremental margin and credit requirements at the CCP applicable to the replacement

[25] Normal course of business refers to the scenario where there is no default of the licensed corporation who provides client clearing services.

[26] Principle 14 http://www.bis.org/cpmi/publ/d101a.pdf

clearing member in relation to the porting. Given this, clearing clients should assess the practicability of transferring their positions and collateral and make such arrangements with their clearing members as the clients consider necessary.

Indirect clearing

101. If a licensed corporation provides client clearing services by submitting the client's OTC derivative transactions for clearing through another clearing intermediary, we propose that the licensed corporation should notify the client of the names of that clearing intermediary (if not the clearing member), the clearing member and the CCP. We also propose that the licensed corporation should explain to its clients the asset segregation arrangements between the licensed corporation and the clearing intermediaries in respect of the client's transactions and collateral, as well as the corresponding legal implications, to enable the clients to understand the costs and risks associated with the segregation arrangements. To our knowledge, indirect clearing in the OTC derivatives market is currently limited and in the development phase. On this basis, we do not propose to impose detailed requirements regarding indirect clearing at this stage. Rather, we will monitor market evolution and global policy developments.

Q12. Do you agree with our proposed segregation and portability requirements? Where both individual client segregation and omnibus client segregation are offered by a 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 clients themselves may be exposed to losses as part of 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?

Clearing confirmation to clients

102. A client's centrally cleared OTC derivative transactions may be subject to lower counterparty risk[27] and different margining requirements compared to non-centrally cleared OTC derivative transactions. To facilitate informed risk management decisions, the client should be notified in a timely manner of whether an OTC derivative transaction has been cleared. We therefore propose 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.

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

[27] The nature and level of the risk to the client for clearing by a given CCP may depend on multiple factors, including the default management mechanism at the CCP, the client account structure selected by the client and the legal framework governing the clearing member or the CCP.

B. Proposed amendments to Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules

103. The Securities and Futures (Client Money) Rules (**CMR**) and Securities and Futures (Client Securities) Rules (**CSR**) require certain client money, client securities and securities collateral to be segregated, and restrict the payment of client money and the transfer of client securities or securities collateral out of segregated accounts maintained by an intermediary.

104. The IOSCO DMI report recommends that for cleared OTC derivative transactions, derivative market intermediaries should segregate collateral belonging to clients from their own proprietary assets, and employ an account structure that enables the identification and segregation of collateral belonging to clients. We therefore propose to extend the segregation requirements under CMR to client money received in respect of providing client clearing services for OTC derivative transactions.[28]

105. We propose to allow a licensed corporation to deposit segregated client money to a CCP, or to a client account maintained by a clearing member of a CCP, to meet settlement or margin requirements arising from the client's OTC derivative transactions. The margining practices at CCPs vary. Some CCPs require initial margin to be posted before accepting a transaction into clearing. Most CCPs have the power to make intraday margin calls, both scheduled and unscheduled. A client may make corresponding arrangements with the licensed corporation through the use of a standing authority under the existing provisions of CMR[29].

106. To faciliate indirect clearing by a licensed corporation, we propose that a licensed corporation providing client clearing services for OTC derivative transctions may deposit client securities or securities collateral with another intermediary licensed for providing client clearing services for OTC derivative transactions[30]. This would allow the licensed corporation to deposit client margin to a clearing member of a CCP for clearing.

107. Proposed amendments to the CMR and the CSR are set out in Appendices 4 and 5 respectively.

Q16. Are the proposed CMR and CSR requirements appropriate in the context of client clearing?

[28] No corresponding revision is required for CSR, since the existing segregation requirements of CSR are able to cover client securities and securities collateral received in providing client clearing services.

[29] Section 4(4)(d) and section 5(1)(c) of CMR

[30] Section 5(1)(a)(i) and section 5(2)(a)(i) of the CSR already permit client securities and securities collateral respectively to be deposited with an authorized financial institution.

Part V. Proposed record keeping requirements

108. Appropriate record keeping by licensed corporations is necessary to ensure that regulators have access to the information they need to properly regulate and supervise licensed corporations. It is also an essential part of running an effective business operation and proper risk management.

109. Licensed corporations are subject to the Securities and Futures (Keeping of Records) Rules (**KRR**) which set out general record-keeping requirements in relation to the businesses which constitute RAs for which they are licensed, and particular record keeping requirements for certain RAs. The general requirements will apply, as appropriate, to corporations licensed for the new and expanded RAs.

110. The information management requirements set out in the Internal Control Guidelines are applicable to all licensed corporations.

111. The Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules contain record-keeping requirements which apply to licensed corporations subject to clearing obligations specified in the rules. The Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules contain record-keeping requirements which apply to licensed corporations which are a counterparty to an OTC derivative transaction or conduct an OTC derivative transaction on behalf of an affiliate (together, the **OTCD Rules**).

112. In considering the record keeping requirements which should apply to OTC derivative market participants, the IOSCO DMI report contains the following principles-based recommendations:

(a) market participants should be required to retain OTC derivative transaction records and be able to provide them in a timely, organised and readable manner.

(b) the record retention period for OTC derivative transactions should apply for a specified period after its termination, maturity, novation or assignment.

113. Taking into account the IOSCO DMI report recommendations and the OTCD Rules, we propose additional record-keeping obligations, to be set out in the KRR. For licensed corporations which are contracting parties to OTC derivative transactions, or corporations licensed to carry out OTC derivative products management which execute OTC derivative transactions on behalf of any CIS managed by it, we propose that the licensed corporation should maintain records to show or evidence the following:

(a) particulars of all orders or instructions concerning OTC derivative transactions it receives or initiates;

(b) all agreements relating to non-centrally cleared OTC derivative transactions entered into with counterparties;

(c) particulars of each executed OTC derivative transaction;

(d) particulars of all post-trade processing and events relating to each OTC derivative transaction, including, as applicable, termination, netting, compression, reconciliation, valuation, margining, collateralisation and central clearing;

(e) particulars of all OTC derivative transactions in respect of which it has facilitated the clearing of the transaction;

(f) particulars of the descriptions and amounts or market values of any collateral held by it and any assets received by it from counterparties to OTC derivative transactions;

(g) rehypothecation of collateral in respect of OTC derivative transactions;

(h) particulars, in respect of its counterparty to OTC derivative transactions, of each description of collateral and margin calls; and

(i) all client clearing agreements and agreements entered into with a CCP relating to each OTC derivative transaction.

114. The proposed amendments to the KRR are set out in Appendix 6.

115. As the proposed requirements will be added to the KRR by way of a new section 3A, we also propose to make consequential amendments to the Securities and Futures (Accounts and Audit) Rules Cap 571P as set out in Appendix 7.

Record retention period

116. Section 10 of the KRR governs the period for which records should be retained, and generally requires intermediaries to keep records for a period of not less than seven years, while records showing particulars of the orders and instructions should be kept for a period of not less than two years.

117. In line with the recommendation in the IOSCO DMI report, we propose to amend Section 10 to require licensed corporations to keep trading relationship documentation, trade confirmations and the valuation processes agreed with counterparties (which are part of the risk mitigation requirements) for a minimum of five years after the termination, maturity, novation or assignment of OTC derivative transactions.

118. It should be noted that under the existing section 10 of the KRR, where the SFO or other subsidiary legislation prescribes record retention periods which differ from the period provided for in the KRR, those more specific retention periods shall override any general period provided for in the KRR.

Q17. Is the requirement to retain trading relationship documentation, trade confirmations and valuation processes agreed with counterparties for a minimum of five years after the termination, maturity, novation or assignment of OTC derivative transactions appropriate? Should this requirement be extended to any other record?

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

A. Background and regulatory concern

119. From time to time, a licensed corporation which belongs to a large financial group may conduct business with group affiliates (eg, placing deposits with affiliated banks) or enter into arrangements with group affiliates (eg, providing guarantees for group affiliate's liabilities) which give rise to financial exposure to the group affiliates. Improper management of such exposure could be disastrous for the licensed corporation if the group affiliates run into financial difficulties, as seen in previous cases such as the collapse of the Lehman Brothers and MF Global groups. Similarly, excessive or preferential lending to other persons connected to the licensed corporation, including shareholders, directors or employees, will pose additional credit risks to the licensed corporation. All these issues raise regulatory concerns about whether licensed corporations should be required to properly monitor and manage exposures to group affiliates and other connected persons.

120. Separately, a number of firms responding to the SFC's Over-the-Counter Derivatives Activities Survey 2016[31] reported that they only act as agency dealer inducing clients to enter into OTC derivative transactions with a group affiliate (referred to as "client facing affiliate" (**CFA**)). The CFA, which is usually not licensed by the SFC, may offload the market risks to another group company (referred to as "risk booking affiliate" (**RBA**)), which may also be unlicensed, by entering into back-to-back OTC derivative transactions with the RBA; or retain the market risks of the OTC derivative transactions entered into with clients and, in the latter scenario, the CFA doubles up as the RBA. While some licensed corporations reported that they enter into OTC derivative transactions with clients, they may offload the market risks of the transactions to RBAs.

121. The use of an unlicensed CFA to enter into OTC derivative transactions with clients or the use of an unlicensed RBA to book proprietary OTC derivative transactions entered into by a licensed corporation gives rise to the following regulatory concerns:

(a) the interests of the clients contracting with the unlicensed CFA may not be adequately protected as the CFA, not being subject to the SFC's regulation, may not be subject to any legal or regulatory obligation to segregate client money, issue contract notes and account statements to the clients, or maintain adequate financial resources, books and records as well as internal control and risk management systems;

(b) the unlicensed RBA may not be subject to adequate risk oversight. The RBA may pose financial and reputational risks to the CFA or licensed corporation it contracts with if the RBA defaults due to its failure to properly manage its risks, including the risks arising from the OTC derivative transactions entered into with the CFA or licensed corporation. The crystallisation of these risks may also affect, directly or indirectly, the interests of the licensed corporation's clients.

122. Given the above concerns, it is proposed to introduce new conduct requirements for

[31] A survey carried out in June 2016 to collect information in relation to activities concerning OTC derivative products or transactions engaged in by intermediaries and their affiliated corporations.

licensed corporations having financial exposures to group affiliates or other connected persons or adopting the CFA/RBA models in order to mitigate the potential risks which such exposures and business models may pose to the licensed corporations and their clients. These requirements are proposed to be included in the Code of Conduct (See Appendix 8 of this paper for the proposed changes), as discussed below.

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

123. We propose to require licensed corporations to properly manage financial exposures to group affiliates and other connected persons, including 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.

124. In proposing this requirement, we have made reference to a requirement imposed by the UK Prudential Regulation Authority (**PRA**) which requires banks to apply the same standards to the management of exposures to group affiliates which are not regulated by the PRA as they would to third parties[32]. Reference has also been made to section 83 of the Banking Ordinance which imposes limitations on the amounts of unsecured lending by an authorized institution incorporated in Hong Kong to certain connected persons including shareholders, directors and employees. The proposed requirement is also similar in nature to the risk management standards imposed by the US Commodity Futures Trading Commission (**CFTC**) on swap dealers and major swap participants whereby swap dealers and major swap participants are required inter alia, to take into account the risks posed by group affiliates in their risk management programs[33].

125. To comply with the proposed requirement, licensed corporations are expected to apply the same robust standards of approval, monitoring and control to financial exposures to group affiliates and other connected persons as they would to independent third parties. Licensed corporations must take into account all the information they have about the group affiliates or other connected persons in their risk management of exposures to these parties and manage the exposures according to the same standards they would apply in respect of exposure to an independent third party about whom they have similar knowledge.

126. The SFC does not expect a licensed corporation to apply exactly the same monitoring and oversight procedures to financial exposures to group affiliates and other connected persons as it would to independent third parties, though if this is the case it is more likely that the proposed requirement will be met.[34]

127. We are cognisant of the possibility that the proposed requirement may conflict with other regulations which specifically require or permit a licensed corporation to apply different treatments to intragroup or connected party exposures and to third-party exposures. One example of different treatments being allowed for intragroup exposures and for third party exposures is margining for non-centrally cleared OTC derivative transactions. Under key

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[32] See Chapter 7 of the Supervisory Statement Ring-fenced bodies (RFBs) – SS8/16 (February 2017) issued by the PRA.

[33] See CFTC Rule: 17 CFR 23.600(c) - Elements of the Risk Management Program.

[34] Reference has been made to paragraphs 7.3 and 7.4 of the Supervisory Statement Ring-fenced bodies (RFBs) – SS8/16 (February 2017) issued by the PRA.

principle 6 of the margin framework for non-centrally cleared derivatives[35] set by IOSCO and the Basel Committee on Banking Supervision (**BCBS**), local supervisors are given the flexibility to decide whether to impose margining requirements on non-centrally cleared intragroup OTC derivative transactions. The HKMA specifically excludes intragroup transactions from the application of its margining requirements on non-centrally cleared OTC derivative transactions for AIs subject to certain conditions[36].

128. 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 suggest that the proposed requirement will cease to apply if its application to a financial exposure will have the effect of overriding an applicable requirement[37] or exemption[38] 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.

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?

C. Proposed conduct requirements relating to the introduction of clients to enter into OTC derivative transactions with CFAs

129. OTC derivative transactions usually have bespoke structures and terms and create an ongoing contractual relationship between the counterparties to the transaction. The interests of the counterparties to an OTC derivative transaction are therefore highly dependent on each other's willingness and ability to carry out the obligations under the contract. In order to protect the interests of clients entering into OTC derivative transactions with licensed corporations, the SFC has proposed a set of conduct and prudential regulations for licensed corporations entering into OTC derivative transactions with clients. However, these regulations would not apply to an unlicensed CFA. If clients are introduced by a licensed corporation to contract with an unlicensed CFA, there is no practical way to ensure the clients will receive exactly the same protection as they would if they were contracting with the licensed corporation instead. The interests of the clients could be prejudiced if the CFA misconducts itself in its dealing with the clients or fails to fulfil its obligations under the contract due to its poor financial condition or failure to properly manage its risks.

130. We are of the view that a licensed corporation, when soliciting or recommending a client

[35] See Margin requirements for non-centrally cleared derivatives issued by the IOSCO and BCBS in March 2015.

[36] Module CR-G-14 Non-centrally Cleared OTC Derivatives Transactions – Margin and Other Risk Mitigation Standards of the Supervisory Policy Manual sets out the minimum standards which the HKMA expects authorized institutions to adopt in relation to margin for non-centrally cleared OTC derivative transactions.

[37] For example, a requirement to manage the exposure in a specified way.

[38] For example, an exemption from mandatory margining requirement specifically provided for the transaction.

to enter into an OTC derivative transaction with a CFA or arranging for an OTC derivative transaction to be entered into between a client and a CFA, owes the client a duty to act in his best interest.

131. This is in line with an existing requirement under paragraph 3.10 of the Code of Conduct whereby a licensed corporation should act in the best interests of its clients in recommending the services of an affiliated person to its clients. This entails the licensed corporation should (i) take reasonable steps to minimise any gap in client protection arising from such a CFA arrangement, and (ii) give the client sufficient warning to enable the client to make an informed decision in choosing whom (the licensed corporation or the unlicensed CFA) to contract with.

132. We are also concerned about the use of unlicensed CFAs for the purpose of avoiding the SFC's regulation. While we are aware of the business needs of using CFAs (such as for centralised client relation management purposes), measures need to be put in place to filter out unlicensed CFAs which do not meet the standard of diligence and care expected in the Code of Conduct.

133. Certain conduct requirements are thus proposed along these lines.

Proposed requirements

134. First, we propose to require a licensed corporation to act in the best interests of its clients when it solicits or recommends clients to enter into OTC derivative transactions with a CFA (whether or not the CFA is licensed by the SFC) or when it arranges for OTC derivative transactions to be entered into between a CFA and clients.

135. Second, we propose that a licensed corporation may 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 a group affiliate and its clients, 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.

136. This restriction may be relaxed if the client concerned (who enters into OTC derivative transactions with a CFA) is a regulated institution, which should be capable of judging whether the counterparty is suitable for it. Moreover, it is likely that the OTC derivative transactions entered into between a regulated client and an unregulated CFA will be subject to regulations (such as risk mitigation and margining requirements) similar to those applicable to transactions between a regulated CFA and an unregulated client. Accordingly, it is proposed to exempt licensed corporations from the requirement proposed in the preceding paragraph 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.

137. A comparable overseas jurisdiction is proposed to be a jurisdiction which has implemented a regulatory framework on OTC derivative dealing activities comparable to that of Hong Kong. We propose to publish on the SFC website a list of comparable overseas jurisdictions for the public's reference. We will monitor international development in this area and update the list as appropriate.

138. Third, in order to draw the attention of clients to the risks of entering into OTC derivative transactions with unlicensed CFAs, we propose to require the introducing licensed

corporations to include a specified risk disclosure statement in client agreements reminding clients of the risks of entering into OTC derivative transactions with an unlicensed person. Please refer to Appendix 8 for the proposed wordings of the specified risk disclosure statement.

139. Furthermore, it is proposed that the above requirements would not apply to clients who are group affiliates of the licensed corporation in order to avoid any inadvertent implication to intra-group transactions. It is also proposed to extend the current exemption in the Code of Conduct relating to risk disclosure to cover the proposed risk disclosure requirement. In other words, licensed corporations would be exempt from the proposed risk disclosure requirement if the client is an institutional professional investor or a corporate professional investor whom the licensed corporation is exempt from the requirement to enter into a written client agreement with and to provide risk disclosure statements to under paragraph 15 of the Code of Conduct.

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 its 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?

D. Proposed conduct requirement for licensed corporations booking OTC derivative transactions in RBAs

140. We noted that RBAs may be used as passive booking vehicles in OTC derivative dealing, ie, their affiliated licensed corporation or other group affiliates arrange for them to enter into proprietary OTC derivative transactions.

141. Such arrangements may give rise to regulatory concerns about the adequacy of the risk management of the OTC derivative transactions booked in licensed corporations' RBAs. This is because the financial risk of an RBA may spill over to the CFA or licensed corporation with which it contracts, and indirectly to the licensed corporation's clients. If the licensed corporation has a loss-sharing agreement with the RBA for the transactions arranged for the RBA, the licensed corporation will also be liable to absorb, in whole or in part, the RBA's losses arising from those transactions. It is therefore imperative to ensure the risks arising from OTC derivative transactions arranged by licensed corporations for RBAs are properly managed.

142. While there may be legitimate reasons to arrange for OTC derivative transactions to be entered into by and booked in RBAs[39], we consider that a licensed corporation should only do so when it can ensure that the risks arising from the OTC derivative transactions will be properly managed, in particular when the RBA is not licensed or not subject to

[39] Such as to book all the market risks undertaken by the group into one single entity for centralised risk management purposes.

comparable regulatory oversight as the licensed corporation.

143. We appreciate that the licensed corporation might have no responsibility for the management of the risks booked in the RBA. For example, if OTC derivative transactions are arranged by a licensed corporation for an RBA which is the risk management hub of the group and is only a fellow subsidiary of the licensed corporation, the licensed corporation might not have any oversight responsibility or authority over the risks undertaken by that the RBA. Nevertheless, we consider that the licensed corporation should ensure that the risks of the transactions it arranged for the RBA are properly managed, whether by the RBA itself, by another group affiliate or by its holding company.

144. In light of the foregoing, it is proposed to require a licensed corporation which arranges OTC derivative transactions 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 overseas jurisdiction, to

(a) ensure the risks undertaken by each group affiliate in the OTC derivative transactions arranged for the group affiliate by the licensed corporation are properly managed in the case where the licensed corporation has responsibility for or oversight of the management of such risks; or

(b) in any other case, take reasonable steps to ensure that the risks undertaken by each group affiliate in the OTC derivative transactions arranged for the group affiliate by the licensed corporation are covered by a risk management program 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/banking regulator in a comparable overseas jurisdiction (Note) for OTC derivative dealers or banks entering into similar transactions.

Note: It is proposed to adopt the same list of comparable overseas jurisdictions as proposed in paragraph 137 above.

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

145. In addition to the above proposed conduct requirements, we consider it important for the SFC to regularly receive information on OTC derivative transactions introduced to or arranged for CFAs or RBAs by licensed corporations, as well as on the related hedging transactions booked in RBAs for which the licensed corporations have risk management or oversight responsibility. Such information may be collected through regular financial returns submitted by licensed corporations under the FRR. This will be folded into a future consultation on the FRR amendments relating to OTC derivative activities.

Part VII. Proposed amendments to Securities and Futures (Fees) Rules (Cap 571AF), Securities and Futures (Insurance) Rules (Cap 571AI), Guidelines on Competence and Guidelines on Continuous Professional Training

146. When the new OTC derivatives licensing regime comes into force, persons (including corporations and individuals) carrying on any of the new RAs will be required to be licensed or approved (as the case may be) under Part V of the SFO unless otherwise exempted[40]. We propose to make certain consequential amendments to the Securities and Futures (Fees) Rules (**Fees Rules**)[41] and the Securities and Futures (Insurance) Rules (**Insurance Rules**) in relation to these new activities.

147. We also propose to amend Appendix C to the Guidelines on Competence and footnote 1 to the Guidelines on Continuous Professional Training (**CPT Guidelines**) to cover the new RAs and the expanded RAs.

A. Licensing fees

148. Currently, certain licensing fees, such as licence application fees and annual fees, are prescribed on a per RA basis under Schedule 3 to the Fees Rules. A standard fee amount is imposed in respect of each RA, with the exception of Type 3 RA (leveraged foreign exchange trading) where a higher fee is charged[42].

149. For consistency, we propose that the same fee structure and fee levels set out in Schedule 3 to the Fees Rules currently charged in respect of all RAs other than Type 3 RA should also apply to the new Type 11 and Type 12 RAs. No amendments will be required to the Fees Rules to effect this proposal. Type 9 RA is already covered within the existing Fees Rules and we do not propose any changes to those fees in respect of the expanded scope of Type 9 RA.

150. Currently, section 11(3) of the Fees Rules prescribes waivers of fees in certain circumstances in respect of Type 7 RA. We propose that an additional waiver be provided for in that section to waive the application fee and annual fee in respect of Type 7 RA where:

(a) a corporation or an individual is, or applies to be, licensed or approved for Type 7 RA in addition to Type 3 or Type 11 RA, and

(b) the carrying on, or proposed carrying on, of Type 7 RA by the corporation or individual, as the case may be, is incidental to its or his carrying on, or proposed carrying on, of Type 3 or Type 11 RA, as the case may be.

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[40] For example, OTC derivatives activities conducted by authorized financial institutions in their ordinary course of business will, generally speaking, be carved out from Type 11 RA, Type 12 RA and the expanded scope of Type 7 RA. Refer to the SFAO for precise details of these and other exemptions in respect of expanded Type 9 RA which are applicable to authorized financial institutions and approved money brokers.

[41] The Fees Rules are made by the Chief Executive in Council. After this consultation, the SFC will make recommendations to the Chief Executive in Council regarding proposals for amendments to the Fees Rules.

[42] For information, the prescribed fee payable on an application for the grant of a Type 3 licence to a licensed corporation is HK$129,730, as opposed to HK$4740 for other RAs.

151. Under the new regime, certain leveraged foreign exchange contracts will constitute OTC derivative products. Also, the expanded definition of ATS will cover OTC derivative products. Therefore, persons licensed for Type 3 RA may also need to be licensed for Type 7 RA if they provide ATS in respect of leveraged foreign exchange contracts which also constitute OTC derivative products. Similarly, persons licensed for Type 11 RA will also need to be licensed for Type 7 RA if they provide ATS in respect of OTC derivative products.

152. The proposed fee waiver in these situations is consistent with the existing waiver of fees for Type 7 RA for persons who are also licensed or registered for Type 1 (dealing in securities) or Type 2 (dealing in futures contracts) RAs.

B. Insurance requirements

153. The Insurance Rules apply to a corporation licensed under section 116(1) of the SFO to carry on any RA, except such a corporation which is:

(a) not an exchange participant of the Stock Exchange Company (ie, The Stock Exchange of Hong Kong Limited (**SEHK**)) or of the Futures Exchange Company (i.e. Hong Kong Futures Exchange Limited (**HKFE**)); and

(b) subject to a licensing condition that it shall not hold client assets.

154. Where the SFC has approved a master policy of insurance under section 5 of the Insurance Rules in respect of a period of insurance for an RA, a specified licensed corporation licensed for that RA shall take out and maintain insurance for that RA in relation to the specified risks[43] for not less than the specified insured amount during that period of insurance. Currently, an insured amount of HK$15,000,000 is specified under Part 2 of Schedule 2 to the Insurance Rules for each of Type 1, Type 2 and Type 8 (securities margin financing) RAs, while an insured amount of "nil" is specified for Types 3, Type 4 (advising on securities), Type 5 (advising on futures contracts), Type 6 (advising on corporate finance), Type 7 and Type 9 RAs.

155. For the year ending 31 March 2018, the SFC has approved only master policies of insurance applicable to SEHK participants licensed for Type 1 RA and HKFE participants licensed for Type 2 RA. Accordingly, licensed corporations not falling into either of these two categories are currently not required to take out insurance under the insurance Rules.

156. We propose to specify an insured amount of "nil" for the new Type 11 and Type 12 RAs because:

(a) the bilateral nature of OTC derivative transactions is similar to that under Type 3 RA, for which the specified insured amount is currently "nil";

(b) it has been proposed that Type 11 and Type 12 licensed corporations will be subject to substantially higher and more risk-based financial resources requirements[44] than

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[43] "Specified risks" are set out in Schedule 1 to the Insurance Rules to cover primarily the risks arising from the loss of client assets due to fraudulent or dishonest conduct by employees, robbery or theft, forgery or fraudulent acts.

[44] Please refer to the Consultation Paper on Proposed Changes to the Securities and Futures (Financial Resources) Rules issued in July 2015 and the Consultation Conclusions and Further Consultation on Proposed Changes to the

Type 3 licensed corporations[45], which are themselves subject to more stringent financial resources requirements than Type 1, Type 2 and Type 8 licensed corporations[46];

(c) the HK$15 million insured amount for Type 1, Type 2 and Type 8 licensed corporations is to protect the licensed corporations against the specified risks, bearing in mind that the minimum paid-up share capital for Type 1 and 2 licensed corporations is only HK$5 million and for licensed corporations providing securities margin financing (whether as Type 1 or 8) is HK$10 million. The much higher proposed capital requirements for Type 11 and Type 12 licensed corporations will serve as a stronger buffer to absorb financial losses caused by the specified risks; and

(d) Type 11 and Type 12 licensed corporations will mainly deal with market players or clients which are institutional or sophisticated investors, whereas many Type 1 and Type 2 licensed corporations (which are currently obliged to maintain insurance) are more likely to deal with retail investors.

157. Despite the expansion of Type 7 and Type 9 RAs to cover OTC derivative products, we have no intention to change the specified insured amount of "nil" for these two RAs because:

(a) for expanded Type 7 RA, it has been proposed that licensed corporations providing ATS for the trading of OTC derivative products will be subject to the same level of proposed capital requirements as Type 11 RA. These substantially higher and more risk-based[47] capital requirements will serve as a stronger buffer to absorb financial losses caused by the specified risks.

(b) for expanded Type 9 RA, the expansion should cause no fundamental change to the specified risks for the licensed corporations conducting this RA.

158. Incidentally, we note that no amendment has been made to the Insurance Rules to cover the Type 10 RA (providing credit rating services) licensing regime implemented in 2011. We want to take this opportunity to propose an additional amendment to the Insurance Rules to specify an insured amount of "nil" for Type 10 RA. That is in line with the specified insured amount of "nil" for Type 4, Type 5 and Type 6 RAs, which are similar in nature to Type 10 RA in that they all relate to advising.

159. The proposed amendments to the Insurance Rules are set out in Appendix 9.

Securities and Futures (Financial Resources) Rules issued in July 2017 for the proposed financial resources requirements for the new RAs.

[45] Corporations licensed for Type 3 RA are subject to a minimum paid-up share capital of HK$30 million and a minimum liquid capital of HK$15 million.

[46] Corporations licensed for Type 1 or Type 2 RA are subject to a minimum paid-up share capital of HK$5 million and minimum liquid capital of HK$3 million. Type 1 licensed corporations which engage in securities margin financing or corporations licensed for Type 8 RA are subject to a minimum paid-up share capital of HK$10 million and a minimum liquid capital of HK$3 million.

[47] Please refer to footnote 44 above for the proposed financial resources requirements for expanded Type 7 RA. Also note that the requirement that the provision of OTC derivatives trading platform related activities under expanded Type 7 RA must be bundled with Type 11 RA is consistent with the current requirement that securities or futures activities under Type 7 RA must be bundled with Type 1 or Type 2 RA.

C. Competence and CPT requirements

160. The Guidelines on Competence are applicable both to corporations and individuals[48] which apply to carry on an RA. We propose that the existing competence requirements under the Guidelines on Competence should also apply to Type 11 and 12 RAs. The competence requirements for corporations are not RA specific and so no change to the body of the Guidelines is considered necessary. For the examination requirements applicable to individuals stipulated in Appendix C to the Guidelines on Competence, we propose that:

(a) the existing local regulatory papers (for responsible officer applicants) and recognized industry qualifications papers for Type 2 and Type 5 RAs be expanded to cover dealing in and advising on OTC derivative products. In other words, Type 2, Type 5 and Type 11 RAs will belong to the same competence group as far as licensing examinations are concerned;

(b) a new local regulatory paper (for responsible officer applicants) and recognized industry qualification paper be developed specifically for Type 12 RA. In other words, Type 12 RA will be a standalone competence group;

(c) the Hong Kong papers for the existing RAs (which will include expanded Type 9 RA), be updated where appropriate to cover OTC derivative activities; and

(d) as with existing Type 7 RA, no specific competence requirements will be imposed in respect of expanded Type 7 RA.

161. The SFC is working with the Hong Kong Securities and Investment Institute on the development of the new examination papers and modifications to the existing examination papers to cover the industry and regulatory knowledge in relation to the new and expanded RAs.

162. It remains our intention to grandfather market participants who qualify for a deemed status under the transitional arrangements[49] and to exempt them from the local regulatory framework paper requirement provided that they complete a post-licensing refresher course within a certain period after being deemed licensed or registered. The refresher course will concern the legal and regulatory framework of the new or expanded RAs and will be additional to the normal CPT requirements. Details of the grandfathering arrangements will be announced at a later stage.

163. The proposed amendments to the Guidelines on Competence are set out in Appendix 10.

164. An individual who is licensed or registered must comply with the ongoing training requirements according to the CPT Guidelines[50]. For the purposes of the CPT

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[48] The Guidelines on Competence are applicable to licensed representatives and responsible officers under the SFO, as well as relevant individuals and executive officers under the Banking Ordinance (Cap 155).

[49] Transitional arrangements are set out in section 55 of the SFAO (http://www.gld.gov.hk/egazette/pdf/20141814/es1201418146.pdf).

[50] CPT Guidelines are applicable to licensed representatives, responsible officers, relevant individuals and executive officers.

requirements, the competence group classifications are similar to those set out in Appendix C to the Guidelines on Competence regarding examination requirements. Therefore, we propose that the existing CPT requirements will cover the new RAs. As mentioned above, Type 2, Type 5 and Type 11 RAs will be under the same competence group while Type 12 RA will be a standalone competence group. The only necessary amendment to the CPT Guidelines is to update the table of competence groups as set out in footnote 1 to paragraph 4.3.3. We also want to take this opportunity to reflect the standalone competence group of Type 10 RA in the CPT Guidelines for completeness.

165. The proposed amendments to the CPT Guidelines are set out in Appendix 11.

Q22. Are the proposed licensing fees in relation to the new RAs appropriate? Do you have any comment on the proposed extension of the fee waiver for Type 7 RA which is conducted incidentally to Type 3 or Type 11 RA?

Q23. Is the proposed insured amount of "nil" for Type 10, Type 11 and Type 12 RAs appropriate? Please explain your views.

Q24. Are the proposed amendments to the competence and CPT requirements appropriate? Please explain your views.

Part VIII. Miscellaneous

A. Consequential amendment

166. With the introduction of the new RAs, the client agreement requirements under the Code of Conduct will also be applicable to licensed or registered persons soliciting the sale of or recommending OTC derivative products to their clients. An amendment will be made to the note to paragraph 6.2(i) of the Code of Conduct with an effect to cover OTC derivative products. The proposed amendment is set out in Appendix 12 of this paper.

B. When will the proposed requirements come into effect?

167. We consider that the Code of Conduct requirements on risk mitigation proposed in Part III as well as the conduct requirements proposed to address risks posed by group affiliates and other connected persons in Part VI should take effect as soon as possible after the related Code of Conduct amendments are made. That said, in order to ensure a smooth transition, we propose that these requirements take effect six months after the gazettal of the Code of Conduct amendments. Moreover, we propose not to apply those conduct requirements which apply to CFA and RBA arrangements retrospectively to existing OTC derivative transactions entered into before the effective date.

168. The requirements proposed in other parts of this consultation paper will become effective when the new OTC derivatives licensing regime commences.

Appendix 1

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

Paragraph 4.3A

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

Requirements for licensed persons 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[51] 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.

Schedule 10 Risk mitigation and margin requirements in relation to non-centrally cleared OTC derivative transactions; Requirements for licensed persons 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 cleared[52]; 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 OTC derivative transaction. Such documentation should contain all material terms

[51] It is proposed that margin requirements will apply to certain non-centrally cleared OTC derivative transactions, and these will be subject to a separate consultation in due course.

[52] 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.

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 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 review and verification of the model outputs.

6. A licensed corporation with material exposures in 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.

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 activities[53]:

- 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.

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

Appendix 2

Possible Material Terms for Trade Confirmation[54]

General Terms

1. Trade date
2. Effective date
3. Underlying instrument
4. Termination date
5. Settlement method (cash or physical)
6. Settlement date (and time zone, if multiple currencies are involved)
7. Business day convention
8. Governing law

Asset Class: Credit/Equity

1. Counterparty purchasing the protection
2. Counterparty selling the protection
3. Information identifying the reference entity
4. Notional amount
5. Currency in which notional amount is expressed
6. Amount of initial payment
7. Currency in which initial payment is expressed (where applicable)
8. Payment frequency
9. Spread (where applicable)

Asset Class: FX

1. Currency 1
2. Currency 2
3. Notional amount 1
4. Notional amount 2
5. Exchange rate
6. Payer of currency 1
7. Payer of currency 2

Asset Class: Interest Rate

1. Notional amount (leg 1)
2. Notional currency (leg 1)
3. Notional amount (leg 2)
4. Notional currency (leg 2)
5. Amount of initial payment
6. Currency in which initial payment is expressed
7. Rate of leg 1
8. Day count of leg 1
9. Rate of leg 2
10. Day count of leg 2
11. Payment frequency of leg 1

[54] These examples do not represent an exhaustive list of confirmation terms

12. Payment frequency of leg 2
13. Reset frequency period of leg 1
14. Reset frequency period of leg 2
15. Spread
16. Payer of leg 1
17. Payer of leg 2

Asset Class: Commodity

1. Quantity unit
2. Quantity frequency
3. Total quantity
4. Price unit
5. Price currency
6. Grade
7. Floating rate payer

Appendix 3

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

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 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 4

Proposed amendments to Securities and Futures (Client Money) Rules Cap 571I

Proposed amendments to sections 4, 5 and 9:

4 **Payment of client money into segregated accounts**

(1) A licensed corporation or an associated entity of a licensed corporation that receives or holds client money of the licensed corporation as referred to in subsection (3) shall establish and maintain in Hong Kong one or more segregated accounts for client money in accordance with subsection (2), each of which shall be designated as a trust account or client account.

(2) A segregated account referred to in subsection (1) shall be established and maintained with—

(a) an authorized financial institution; or

(b) any other person approved by the Commission for the purposes of this section, either generally or in a particular case.

(3) The following amounts of client money of a licensed corporation that are received or held by the licensed corporation or an associated entity of a licensed corporation shall be dealt with in accordance with subsection (4)—

(a) all amounts that are received from or on behalf of a client of the licensed corporation in respect of dealing in securities or future contracts-

(i) less brokerage and other proper charges in connection with such dealing;

(ii) except those amounts that the licensed corporation is required to pay on the day of receipt or within the following 2 business days in order to meet the client's obligations to meet settlement or margin requirements in respect of such dealing; and

(iii) except those amounts that are reimbursements to the licensed corporation of money which the licensed corporation has paid at any time before the day of receipt in order to meet the client's obligations to meet settlement or margin requirements in respect of such dealing;

(b) all amounts that are received from or on behalf of a client of the licensed corporation to whom the licensed corporation provides financial accommodation to facilitate the acquisition and, where applicable, the continued holding of securities, except those amounts that are used to reduce the amount owed by the client to the licensed corporation;

(c) all amounts that are received from or on behalf of a client of the licensed corporation in respect of leveraged foreign exchange trading, less brokerage and other proper charges in connection with such trading;

(ca) all amounts that are received from or on behalf of a client of the licensed corporation in respect of the licensed corporation providing client clearing services for OTC derivative transactions—

(i) less brokerage and other proper charges in connection with providing the services;

(ii) except those amounts that the licensed corporation is required to pay on the day of receipt or within the following 2 business days in order to meet settlement or margin requirements in respect of the client's OTC derivative transactions; and

(iii) except those amounts that are reimbursements to the licensed corporation of money which the licensed corporation has paid at any time before the day of receipt in order to meet settlement or margin requirements in respect of the client's OTC derivative transactions;

(d) all other amounts that are received from or on behalf of a client of the licensed corporation, except—

(i) the amounts referred to in paragraph (a)(i), (ii) and (iii);

(ii) the amounts that are used to reduce the amount of financial accommodation owed by a client of the licensed corporation to the licensed corporation, as referred to in paragraph (b); ~~and~~

(iii) the brokerage and other proper charges referred to in paragraph (c); and

(iv) the amounts referred to in paragraph (ca)(i), (ii) and (iii).

(4) Within one business day after a licensed corporation or an associated entity of a licensed corporation receives any amount of client money of the licensed corporation as referred to in subsection (3), the licensed corporation or associated entity shall pay it—

(a) into a segregated account;

(b) to the client from whom or on whose behalf it has been received;

(c) subject to subsection (6), in accordance with a written direction; or

(d) subject to subsections (5) and (6), in accordance with a standing authority.

(5) A licensed corporation or an associated entity of a licensed corporation shall not pay any amount of client money of the licensed corporation under subsection (4)(d) if—

(a) to do so would be unconscionable; or

(b) the standing authority authorizes payment to an account in Hong Kong of the licensed corporation or associated entity, or an account in Hong Kong of any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation, and that account is not a segregated account.

(6) Neither a licensed corporation nor an associated entity of a licensed corporation may pay, or permit to be paid, any amount of client money of the licensed corporation to—

(a) any of its officers or employees; or

(b) any officer or employee of any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation, unless that officer or employee is the client of the licensed corporation from whom or on whose behalf such client money has been received.

5 Payment of client money out of segregated accounts

(1) A licensed corporation or an associated entity of a licensed corporation that holds any amount of client money of the licensed corporation in a segregated account shall retain it there until it is—

(a) paid to the client of the licensed corporation, being the client on whose behalf it is being held;

(b) subject to subsection (3), paid in accordance with a written direction;

(c) subject to subsections (2) and (3), paid in accordance with a standing authority;

(d) required in order to meet the client's obligations to meet settlement or margin requirements in respect of dealing in securities or futures contracts carried out by the licensed corporation on behalf of the client of the licensed corporation, being the client on whose behalf it is being held;

(da) if the licensed corporation is providing client clearing services for OTC derivative transactions to the client on whose behalf it is being held, required in order to meet settlement or margin requirements in respect of the client's OTC derivative transactions; or

(e) required to pay money that the client of the licensed corporation, being the client on whose behalf it is being held, owes—

(i) to the licensed corporation in respect of the carrying on by the licensed corporation of any regulated activity for which it is licensed; or

(ii) to the associated entity in respect of the receipt or holding of client money for or on behalf of the client by the associated entity.

(2) A licensed corporation or an associated entity of a licensed corporation shall not pay any amount of client money of the licensed corporation under subsection (1)(c) if—

(a) to do so would be unconscionable; or

(b) the standing authority authorizes payment to an account in Hong Kong of—

(i) the licensed corporation or associated entity in circumstances other than those set out in subsection (1)(d), (da) or (e); or

(ii) any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation,

and that account is not a segregated account.

(3) Neither a licensed corporation nor an associated entity of a licensed corporation as referred to in subsection (1) may pay, or permit to be paid, any client money of the licensed corporation to—

(a) any of its officers or employees; or

(b) any officer or employee of any corporation with which the licensed corporation is in a controlling entity relationship or in relation to which the associated entity is a linked corporation,

unless that officer or employee is the client on whose behalf such client money is being held.

9 Receipt of cheques for client money

For the purposes of section 4(3)(a) and (ca) and (4), a licensed corporation or an associated entity of a licensed corporation that receives a cheque for an amount of client money is regarded as having received such amount only upon receipt by it of the proceeds of that cheque.

Appendix 5

Proposed amendments to Securities and Futures (Client Securities) Rules Cap 571H

Proposed amendments to section 5:

5. Requirement for deposit or registration of client securities and securities collateral

(1) Subject to section 6, an intermediary or an associated entity of an intermediary which receives any client securities of the intermediary shall ensure that, as soon as reasonably practicable, the client securities are—

(a) deposited in safe custody in a segregated account which is designated as a trust account or client account and established and maintained in Hong Kong by the intermediary or associated entity for the purpose of holding client securities of the intermediary with—

(i) an authorized financial institution;

(ii) an approved custodian; ~~or~~

(iii) another intermediary licensed for dealing in securities; or

(iv) if the intermediary is a corporation licensed for providing client clearing services for OTC derivative transactions, another corporation licensed for providing client clearing services for OTC derivative transactions; or

(b) registered in the name of—

(i) the client on whose behalf the client securities have been received; or

(ii) the associated entity.

(2) Subject to section 6, an intermediary or an associated entity of an intermediary which receives any securities collateral of the intermediary shall ensure that, as soon as reasonably practicable, the securities collateral is—

(a) deposited in safe custody in a segregated account which is designated as a trust account or client account and established and maintained in Hong Kong by the intermediary or associated entity for the purpose of holding securities collateral of the intermediary with—

(i) an authorized financial institution;

(ii) an approved custodian; ~~or~~

(iii) another intermediary licensed for dealing in securities; or

(iv) if the intermediary is a corporation licensed for providing client clearing services for OTC derivative transactions, another corporation licensed for providing client clearing services for OTC derivative transactions; or

(b) deposited in an account in the name of the intermediary or associated entity (as the case may be) with—

(i) an authorized financial institution;

(ii) an approved custodian; or

(iii) another intermediary licensed for dealing in securities; or

(c) registered in the name of-

(i) the client on whose behalf the securities collateral has been received;

(ii) the intermediary; or

(iii) the associated entity.

Appendix 6

Proposed amendments to Securities and Futures (Keeping of Records) Rules Cap 571O

Proposed addition of section 3A and Schedule 2, amendments to section 10, renumbering of the Schedule and consequential amendment to section 3(2)(a)

3. General record keeping requirements for intermediaries

…

(2) Without limiting the generality of subsection (1)(a), the records referred to in that subsection shall, where applicable, include—

(a) the records specified in ~~the~~ Schedule 1; and

(b) the records specified in section 5, 6, 7(2) or 8.

3A Record keeping requirements for licensed corporations in respect of OTC derivative transactions

(1) This section applies to a licensed corporation in relation to an OTC derivative transaction (***the transaction***) if the licensed corporation—

(a) is a counterparty to the transaction;

(b) is licensed for providing client clearing services for OTC derivative transactions and provides those services in respect of the transaction; or

(c) is licensed for OTC derivative products management and in the course of managing a collective investment scheme, executes the transaction on behalf of the collective investment scheme.

(2) Subject to subsection (3), in relation to OTC derivative transactions, a licensed corporation referred to in subsection (1) must keep, where applicable, the records specified in Schedule 2.

(3) Subsection (2) does not require a licensed corporation referred to in subsection (1)(c) to keep particular records specified in Schedule 2 in relation to OTC derivative transactions to the extent that the governing body of the collective investment scheme (or a delegate of the governing body) carries out the processes or acts from which the particular records would be generated.

(4) In this section—

OTC derivative products management (*場外衍生工具產品管理*) has the meaning given by Part 2 of Schedule 5 to the Ordinance.

10. Record retention period

Except as otherwise provided in the Ordinance (including any subsidiary legislation made under it), an intermediary, or an associated entity of an intermediary, shall retain—

(a) subject to paragraphs (b) and (c), the records that it is required to keep under these Rules, for a period of not less than 7 years; ~~and~~

(b) in the case of records showing particulars of any of the orders and instructions referred to in section 1(d) of ~~the~~Schedule 1 and section 1 of Part 2 of Schedule 2, for a period of not less than 2 years; and

(c) in the case of records referred to in section 2 of Schedule 2 in respect of an OTC derivative transaction, for a period of not less than 5 years after the transaction has matured or been terminated, novated or assigned.

Schedule 1

[ss. 3 & 10]

Records to be Kept by Intermediaries under Section 3(2)(a)

…

Schedule 2

[sections 3A and 10]

Records to be kept by licensed corporations under section 3A(2) in respect of OTC derivative transactions

Part 1

Interpretation

In this Schedule, a reference to ***counterparties*** to OTC derivative transactions includes, for a person referred to in section 3A(1)(c) of these Rules, the counterparties of the collective investment scheme that it manages.

Part 2

Records to be kept

1 Records showing particulars of all orders or instructions concerning OTC derivative transactions that it receives or initiates, including particulars—

(a) of each transaction that is executed to implement any such order or instruction;

(b) identifying with whom or for whose account the transaction is executed; and

(c) that enable the transaction to be traced through its accounting, trading and settlement systems.

2. Records evidencing all agreements relating to OTC derivative transactions that are executed and which are not cleared with a central counterparty, including—

(a) particulars of the material terms governing its trading relationships with counterparties;

(b) where applicable, credit support arrangements;

(c) in relation to each transaction, confirmations, and any other records showing particulars of the terms and conditions of the transaction, including the terms and conditions of novations, assignments or amendments of the transaction; and

(d) particulars of the processes agreed with its counterparties for determining the value of the transactions.

3. Records showing particulars of each executed OTC derivative transaction, including—

(a) the date the transaction was executed;

(b) whether the transaction remains unconfirmed after the date the transaction was executed, including aging reports, where applicable;

(c) if applicable—

(i) the swap execution facilities or other single-dealer or multi-dealer trading platforms on which the transaction was executed; and

(ii) the central counterparty with which the transaction was cleared.

4. Records showing the particulars of all post-trade processing and events relating to each OTC derivative transaction, including, as applicable, termination, netting, compression, reconciliation, valuation, margining, collateralization and central clearing.

5. Records showing the particulars of all OTC derivative transactions in respect of which it has facilitated the clearing of the transaction.

6. Records showing particulars of the descriptions and amounts or market values of—

(a) any collateral held by it in respect of OTC derivative transactions; and

(b) any assets other than collateral received by it from counterparties to OTC derivative transactions.

7. Records evidencing the rehypothecation of collateral in respect of OTC derivative transactions.

8. Records showing the particulars, in respect of each of its counterparties to OTC derivative transactions, of—

(a) the market value, and market value after any haircut prescribed by it, of each description of collateral held by it;

(b) the aggregate of the market values of all descriptions of collateral;

(c) the aggregate of the market values after haircut prescribed by it of all descriptions of collateral; and

(d) margin calls.

9. Records evidencing all client clearing agreements and agreements entered into with central counterparties relating to each OTC derivative transaction.

Appendix 7

Proposed amendments to Securities and Futures (Accounts and Audit) Rules Cap 571P

Proposed amendments to sections 4(1)(f)(i) and 5(a)

4. Auditor's report

(1) For the purposes of section 156(1)(b) or (2)(b) of the Ordinance, an auditor's report required to be submitted by a licensed corporation or an associated entity of an intermediary shall contain a statement by the auditor as to whether, in the auditor's opinion—

(f) in so far as applicable, during the financial year in question, the licensed corporation or the associated entity (as the case may be) has complied with—

(i) sections 3, 3A and 4 of the Securities and Futures (Keeping of Records) Rules (Cap. 571 sub. leg. O);

…

5. Matters reportable by auditors under section 157 of the Ordinance

The following provisions are prescribed requirements for the purposes of the definition of prescribed requirement" in section 157(3) of the Ordinance—

(a) sections 3, 3A and 4 of the Securities and Futures (Keeping of Records) Rules (Cap. 571 sub. leg. O);

Appendix 8

Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("the Code")

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 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 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 overseas jurisdiction; 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: 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 overseas jurisdiction.

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 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 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 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; or

(b) in any other case, take reasonable steps to ensure that the risks are covered by a risk management program 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/banking regulator in a comparable overseas jurisdiction for OTC derivative dealers or banks entering into similar transactions.

20.5 The comparable overseas jurisdictions referred in paragraphs 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 overseas jurisdictions published on the Commission's website.

Schedule 1 Risk disclosure statements

The following risk disclosure should be given where i) a licensed person solicits or recommends clients which 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 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.

Consequential amendment

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);

Appendix 9

Proposed amendments to Securities and Futures (Insurance) Rules Cap 571AI

Add items 10, 11 and 12 to Part 2 of Schedule 2 after item 9 as follows:

PART 2

INSURED AMOUNT

	Regulated activity	Insured amount ($)
10.	Providing credit rating services	Nil
11.	Dealing in OTC derivative products or advising on OTC derivative products	Nil
12.	Providing client clearing services for OTC derivative transactions	Nil

Appendix 10

Proposed amendments to the Guidelines on Competence

Appendix C to the Guidelines on Competence

Draft list of Recognized Industry Qualifications and Local Regulatory Framework Papers for Types 11 and 12 Regulated Activities

Table 1 – Recognized Industry Qualifications and Local Regulatory Framework Papers by Regulated Activities (Responsible Officer)

RA	Country	Recognized Industry Qualifications	Local Regulatory Framework Papers
11	Hong Kong	- HKSI DPE Papers 1+3 - HKSI LE Papers 7+9 - HKSI PDFM Modules 1+2+3+6+7	- HKSI DPE Paper 2 - HKSI LE Papers 1*+3 - HKSI PDFM Modules 4+5
12	Hong Kong	- HKSI LE Paper 7 + new industry paper	- HKSI LE Paper 1* + new regulatory paper

*Note: * Not required for a licensed representative applying to be a responsible officer.*

Table 2 – Recognized Industry Qualifications and Local Regulatory Framework Papers by Regulated Activities (Representative)

RA	Country	Recognized Industry Qualifications	Local Regulatory Framework Papers
11	Hong Kong	- HKSI DPE Papers 1+3 - HKSI LE Papers 7+9 - HKSI PDFM Modules 1+2+3+6+7	- HKSI DPE Paper 2 - HKSI PDFM Modules 4+5 - HKSI LE Paper 1
12	Hong Kong	- HKSI LE Paper 7 + new industry paper	- HKSI LE Paper 1

Note: Qualifications and exams that are shaded are also applicable to a responsible officer.

Appendix 11

Proposed amendments to the Guidelines on Continuous Professional Training

Footnote 1 to paragraph 4.3.3

Groups of regulated activities with same competence requirements:

Type of regulated activities
1 – dealing in securities 4 – advising on securities 8 – securities margin financing
2 – dealing in futures contracts 5 – advising on futures contracts 11 – dealing in OTC derivative products or advising on OTC derivative products
3 – leveraged foreign exchange trading
6 – advising on corporate finance
9 – asset management
10 – providing credit rating services
12 – providing client clearing services for OTC derivative transactions

Appendix 12

Proposed 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

1. All licensed or registered persons are required under paragraph 6.2(i) of the Code of Conduct to incorporate a clause in their client agreement that if they solicit the sale of or recommend any financial product to the client, the financial product must be reasonably suitable for the client having regard to the client's financial situation, investment experience and investment objectives.

2. With the introduction of Type 11 RA and Type 12 RA, the above-mentioned client agreement requirement will also be applicable to solicitations or recommendations of OTC derivative products. Currently, the term "financial product" is defined in the note to paragraph 6.2(i) of the Code of Conduct to mean any securities, futures contracts or leveraged foreign exchange contracts as defined under the SFO. An amendment will be made to the note by referring to the definition of "financial product" under the SFO so as to cover the OTC derivative products and any other financial products in the context of regulated activities carried on by licensed or registered persons. The proposed amendment to the note is set out below:

   "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.~~"

3. The above amendment will become effective at the time Type 11 RA and Type 12 RA come into effect.

Abbreviations and acronyms

ATS	Automated Trading Services
ATS-CCP	ATS provider acting in its capacity as a CCP and authorised under section 95(2) of the SFO
BCBS	Basel Committee on Banking Supervision
CCP	Central clearing counterparty
CFA	Client facing affiliate
CFTC	Commodity Futures Trading Commission
CIS	Collective Investment Scheme
CMR	Securities and Futures (Client Money) Rules
Code of Conduct	Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
CPT	Continuous professional training
CPT Guidelines	Guidelines on Continuous Professional Training
CSR	Securities and Futures (Client Securities) Rules
Fees Rules	Securities and Futures (Fees) Rules
FRR	Securities and Futures (Financial Resources) Rules
FX	Foreign exchange
HKFE	Hong Kong Futures Exchange Limited
HKMA	Hong Kong Monetary Authority
Insurance Rules	Securities and Futures (Insurance) Rules
Internal Control Guidelines	Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission
IOSCO	International Organization of Securities Commissions
IOSCO DMI Report	International Standards for Derivatives Market Intermediary Regulation
IOSCO RMS	Risk Mitigation Standards for Non-centrally Cleared OTC

	Derivatives
KRR	Securities and Futures (Keeping of Records) Rules
OTCD Rules	Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules and Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules
PFMI	Principles for Financial Market Infrastructures
PDPO	Personal Data (Privacy) Ordinance (Cap. 486)
PICS	Personal Information Collection Statement
PRA	Prudential Regulation Authority
RA	Regulated activity
RBA	Risk booking affiliate
RCH	Recognized clearing house
SEFs	Swap execution facilities
SEHK	Stock Exchange of Hong Kong Limited
SFAO	Securities and Futures (Amendment) Ordinance 2014
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)