

Summary – Consultation Conclusions on the OTC Derivatives Regime for Hong Kong – Proposed Refinements to the Scope of Regulated Activities and Competence Requirements under the OTC Derivatives Licensing Regime (Issued on June 10, 2020)

Background

On December 20, 2017, the Securities and Futures Commission (“SFC”) issued a consultation paper on the over-the-counter (“OTC”) derivatives regime for Hong Kong (“Consultation Paper”) which proposed refinements to the scope of regulated activities as well as other requirements. A prior consultation conclusions paper on the proposed requirements under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission was issued in December 2018.

This consultation conclusions paper (“Conclusions”) covers the proposed refinements to the scope of the regulated activities (“RAs”) under the OTC derivatives licensing regime, as well as the proposed competence and continuous professional training (“CPT”) requirements under the OTC derivatives licensing regime.

Refinements to the scope of the RAs

(1) Corporate Treasury Activities

The corporate treasury activities of non-financial groups provided to affiliates will generally be carved out entirely from the OTC derivatives licensing regime (including expanded Type 9 (Asset management), Type 11 (Dealing or advising in OTC derivative products) and Type 12 (Providing clearing agency services for OTC derivatives transactions) RAs), so long as they satisfy the criteria (e.g. services provided to affiliates only), but may still capture corporate treasury activities of financial groups. The definition of “financial group” will include a group of companies primarily engaging in regulated activities, banking business or insurance business in Hong Kong or elsewhere.

(2) Activities of Providers of Post-trade Multilateral Portfolio Compression Services

Multilateral portfolio compression is a risk mitigation measure aims to calculate which transactions can be terminated, modified or replaced using the compression algorithms under certain criteria and set forth the calculation results for participants of the compression cycle to consider. Given that users of such services are large market participants with sizeable OTC derivative portfolios who should have the expertise and internal risk management capabilities to evaluate the results calculated by the service providers and detect any errors, the SFC is of the view that the activities of providers of multilateral portfolio compression services will generally be carved-out from Type 11 RA.

(3) Provision of Compression Services by Central Clearing Counterparties (“CCPs”) and Providers of Client Clearing Services

The scope of Type 11 RA will generally not capture portfolio compression services (whether bilateral or multilateral) provided by a CCP or a provider of client clearing services as they are/will be subject to appropriate regulations elsewhere.

(4) Activities of Overseas Clearing Members and their Agents

Subject to certain prerequisites (e.g. being regulated in a comparable jurisdiction for providing client clearing services and marketing their services through an authorized institution or a licensed corporation), Type 12 RA will generally not capture overseas clearing members of overseas CCPs.

In addition, the current definition of “acceptable participant” (in relation to certain carve-outs for Type 12 RA) includes persons who have applied to become CPP members but have not yet become official members. This definition is proposed to be amended so to make clear that acceptable participants will include (amongst other persons) persons who have applied to become CCP members but only so long as their application has not been rejected or withdrawn.

For clarifications on carve-outs for agents and introducing brokers for Type 12 RA (regardless of whether the contractual party is an overseas person), please see section (5) below.

(5) Changes to the Scope of Type 12 RA to Exclude Certain Ancillary and Fund Manager Services

The SFC clarifies that the provision of client clearing services by licensed asset managers for the asset management activities they are licensed for and solely for the purpose of such asset management, regardless of whether the asset manager is managing authorized or unauthorized funds, or managed or discretionary accounts, will generally not need to be licensed for Type 12 RA.

The refined scope of Type 12 RA now only captures those clearing and settlement services provided in the capacity of either a CCP member or in the capacity of a direct or indirect client of a CCP member. The SFC clarifies that agents or introducing brokers (regardless of whether the contractual party is an overseas person) not acting in any of these capacities will not be considered as providing clearing and settlement services. Therefore, even though they pass or route the orders to clearing houses or providers of client clearing services, they will not be captured under the proposed refined scope of Type 12 RA.

In addition, Type 12 RA will generally capture service providers in the capacity of a CCP member or a clearing client, regardless of how many layers of entities and client relationships are involved. However, an entity which merely passes clearing and settlement instructions, but does not utilise its capacity as a CCP member or a clearing client, is not providing a service to another person in that capacity, and so will not need to be licensed for Type 12 RA.

(6) Request to expand carve-outs for fund managers

In relation to funds managed by a fund manager's affiliates (i.e. the fund manager does not perform a management role in relation to the affiliates' funds), the fund manager will need to be licensed for Type 3 and/or Type 11 RA for dealing activities in the relevant products (i.e. leveraged foreign exchange contracts and/or OTC derivative contracts) for such funds.

Competence and CPT requirements under the OTC derivatives licensing regime

As mentioned in the Consultation Paper, the SFC intends to grandfather market participants who qualify for a deemed status under the transitional arrangements and to exempt them from the local regulatory framework paper (“LRP”) requirement, provided that they complete a post-licensing refresher course within a certain period after being deemed licensed or registered. The refresher course will cover the legal and regulatory framework of the new or expanded RAs. It is a one-off requirement in addition to the normal CPT requirements. Details of the grandfathering arrangements will be announced at a later stage.

In relation to what experience would be assessed after the transition period as relevant for Types 11 and 12 RAs and expanded Type 9 RA under Option 2 or Option 3 of the Test of Competence for Representative in Appendix B to the “Guidelines on Competence”, especially if an individual has no direct prior involvement in these RAs, the SFC will adopt the same approach as other RAs to assess the ‘relevance’ element, including the roles and functions to be undertaken by the applicant and whether the applicant possesses the recognised industry qualifications. The SFC will also recognise experience gained in Hong Kong or elsewhere which is closely related to the functions to be performed.

For applicants applying for a temporary licence for Type 11 RA, they will be fully exempted from the LRP requirements.

Concluding Remarks

The SFC is working with the Department of Justice on the drafting of the relevant amendments to the Securities and Futures (Amendment) Ordinance 2014, and the OTC derivatives licensing regime will not be implemented until the amendments to other relevant subsidiary legislation, including the FRR, are completed.