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January 25, 2019

Hong Kong SFC Adopts New Derivatives Rules

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January 25, 2019 TO: ICI Members

ICI Global Members

Derivatives Markets Advisory Committee

ICI Global Trading & Markets Committee

Securities Operations Advisory Committee SUBJECTS: Derivatives

International/Global RE: Hong Kong SFC Adopts New Derivatives Rules

The Securities and Futures Commission of Hong Kong (SFC) has adopted rules amending Hong Kong's regulations governing over-the-counter (OTC) derivatives. The amended rules apply to entities that engage in regulated activities as defined by the Hong Kong Securities and Futures Ordinance.[\[1\]](#) The SFC adopted the new rules following a consultation period that concluded in February 2018.[\[2\]](#) This memorandum summarizes the new rules, which address risk mitigation techniques for uncleared OTC derivatives, requirements designed to facilitate clearing of OTC derivatives for clients of clearing members (such as regulated funds), and rules to address risks posed by affiliates of licensed corporations.[\[3\]](#)

Risk Mitigation Requirements

The new risk mitigation requirements apply to all licensed corporations—including licensed asset managers—that are counterparties to non-centrally cleared over-the-counter derivatives. The new requirements, which are provided in Appendix A of the Release address trade relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression and dispute resolution.[\[4\]](#) The new requirements will become effective on 1 September 2019.[\[5\]](#)

Trading relationship documentation. The new rules require a licensed corporation to execute written trading relationship documentation with each counterparty prior to or contemporaneously with executing a non-centrally cleared OTC derivatives transaction.

Trade confirmation. The new rules require a licensed corporation to establish and implement policies and procedures to ensure that the material terms of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practicable after execution. The requisite policies and procedures may allow confirmation by negative consent.

Valuation. The new rules require a licensed corporation to agree with its counterparties on the process by which the value of a non-centrally cleared OTC derivative will be determined

throughout the life of the transaction. The Release emphasizes that this new rule does not require a licensed corporation to agree on the actual valuation model with its counterparties. Market participants are free to choose their own valuation models as they deem appropriate.^[6] Valuation determinations should be based on economically similar transactions or other objective criteria. If a licensed corporation uses a proprietary valuation model, the model should employ accepted valuation methodologies. In addition, the new rules provide that a licensed corporation should exercise due skill, care, and diligence to review any third-party valuation model that it uses to value non-centrally cleared OTC derivatives. The Release states that a licensed corporation should not use a third-party valuation model if it is not aware of the valuation methodology. If a licensed corporation uses a vendor's valuation methodology, the licensed corporation should understand (i) what valuation methodology and risk factors are used to assess whether the model is appropriate for valuing a particular OTC derivative, (ii) how the model is calibrated and tested to assess whether the data used and tests performed are appropriate, and (iii) what model risk governance process the vendor has in place.^[7] With respect to asset managers, the new valuation rules apply only to an asset manager that is responsible for the overall operation of a fund or that has been delegated responsibility for fund valuation. An asset manager that does not have valuation responsibility but that uses valuation models for internal purposes (such as for calculating a shadow NAV or for internal risk management purposes) would not be subject to the valuation model requirements.^[8]

Portfolio reconciliation. The new rules require a licensed corporation to establish and implement policies and procedures for portfolio reconciliation—a process that involves exchanging material terms and valuations of uncleared derivatives transactions with counterparties and resolving discrepancies. Licensed corporations must conduct portfolio reconciliation at regular intervals, and the Release states that the SFC expects portfolio reconciliation to be more frequent than once a year.^[9]

Portfolio compression. The new rules require a licensed corporation with non-centrally cleared OTC derivatives transactions to establish and implement policies and procedures to assess their portfolios regularly and, to the extent appropriate, engage in portfolio compression.

Dispute resolution. The new rules require a licensed corporation to 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.

Requirements on Client Clearing

The new rules include requirements for firms that provide clearing services for OTC derivatives. These new requirements, which are provided in Appendix B of the Release, address segregation and portability of customer assets, indirect clearing, and confirmation of clearing. These new requirements will take effect when Hong Kong's new OTC derivatives licensing regime commences.

Segregation and Portability. The new rules provide clearing firms with flexibility to offer clients (such as regulated funds) a variety of segregation options, while at the same time ensuring that clients have adequate information about the protections available under different segregation regimes. To that end, the rules require a clearing firm to inform its client about the levels of asset segregation that CCPs offer to client assets and provide a clear explanation of the costs, risks, and portability arrangements of these different levels. The rules also require a clearing firm to segregate customer collateral from the firm's

proprietary assets. In addition, the new rules require a clearing firm to attempt to accommodate porting if it defaults, if porting is permissible under applicable law.

Indirect Clearing. An indirect clearing arrangement permits a client of a clearing firm to offer clearing services to its own clients through the clearing firm. The new rules require firms providing indirect clearing services to notify their clients of the names of the clearing member and the CCP that will be used to clear the client's transaction. The rules also require firms providing indirect clearing services to explain to their clients the asset segregation arrangements between the indirect clearing firm and any other intermediaries involved in clearing the clients' transactions.

Confirmation of Clearing. The new rules require a clearing firm to provide clearing confirmation to a client by the end of the business day after a client's OTC derivatives transaction is accepted for clearing.

Conduct Requirements to Address Risks Associated with Interaffiliate Transactions

The new rules also seek to mitigate risks that might arise when a licensed corporation conducts business with its affiliates.^[10] Specifically, the new rules require licensed corporations to manage financial exposures to affiliates and other connected persons—such as connected persons, shareholders, directors, and employees—according to the same risk management standards that govern financial exposures to independent third parties. To avoid potential conflicts with the rules of other jurisdictions, these new conduct requirements do not apply if their application would have the effect of overriding other applicable law.

In addition, the rules impose new conduct requirements for licensed firms that introduce clients to a client-facing affiliate (CFA) so that the CFA can enter into an OTC derivatives transaction with the client. The new rules require the licensed firm to act in the client's best interest and permit a licensed corporation to refer clients to a CFA only if the CFA is a licensed corporation, an authorized financial institution or a corporation regulated as an OTC derivatives dealer or a bank in a comparable overseas jurisdiction.^[11] To draw the client's attention to the risks of entering into OTC derivatives transactions with unlicensed CFA's, the rules require the introducing licensed firm to make a specific risk disclosure to the client, if the CFA is not a licensed corporation.

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endnotes

^[1] Securities and Futures Commission, Consultation Conclusions on (1) the OTC derivatives regime for Hong Kong – Proposed requirements in relation to OTC derivative risk mitigation and client clearing; and (2) Proposed conduct requirements to address risks posed by group affiliates, December 2018, *available at* https://www.sfc.hk/web/EN/files/SOM/OTC/Consultation%20Conclusion%20on%20RMS%20and%20conduct%20requirements_Final_EN.pdf (Release).

^[2] See ICI Memorandum No. 31001 (January 3, 2018), *available at* https://www.ici.org/my_ici/memorandum/memo31001.

[3] The SFC's consultation also proposed new recordkeeping requirements for licensed corporations and various refinements to the scope of regulated activities. The Release states that those proposals are still under consideration and "will be published separately in due course." Release at ¶ 3.

[4] An "excluded currency contract" is subject only to the requirements on trading relationship documentation and trade confirmation. Rule 2 of the SFC's OTC Derivatives Transactions—Reporting and Recordkeeping Obligations Rules defines "excluded currency contract" as "an OTC derivative product that is a forward contract for the sale or purchase of a currency which— (a) is entered into for the purpose of settling a sale or purchase of securities denominated in that currency; and (b) is intended to be settled by the actual delivery of that currency, by the earlier of the following days— (i) the last day of the customary settlement period for the securities referred to in paragraph (a); (ii) the seventh business day after the day on which the forward contract is executed."

[5] See Release at ¶ 17.

[6] See *id.* at ¶ 56.

[7] See *id.* at ¶¶ 64-65.

[8] See *id.* at ¶ 75. The Release also states that sending of portfolio holding reports containing valuation information to third parties would not fall within the scope of the valuation model requirements.

[9] See *id.* at ¶ 77.

[10] These rules are in Appendix C of the Release.

[11] Part III.B of the Release includes a list of overseas jurisdictions that are deemed to have comparable OTC derivatives regulation to Hong Kong. These jurisdictions include "the securities, futures, and banking regulators" in: Australia, Canada, mainland China, France, Germany, Italy, Japan, Netherlands, the Republic of Korea, Singapore, Spain, South Africa, Switzerland, the United Kingdom, and the United States. See Release at ¶ 111.