

MEMO# 31001

January 3, 2018

Hong Kong SFC Proposes New Derivatives Rules

[31001]

January 3, 2018 TO: ICI Members

ICI Global Members

Derivatives Markets Advisory Committee

ICI Global Trading & Markets Committee

Securities Operations Advisory Committee SUBJECTS: Derivatives

International/Global

Trading and Markets RE: Hong Kong SFC Proposes New Derivatives Rules

The Securities and Futures Commission of Hong Kong (SFC) recently issued a consultation paper proposing amendments to Hong Kong's regulations governing over-the-counter (OTC) derivatives, which were enacted in 2014. The rules proposed in the Consultation generally would apply to corporations that engage in regulated activities as defined by the Hong Kong Securities and Futures Ordinance. This memorandum summarizes the Consultation, which includes proposals on risk mitigation techniques for uncleared OTC derivatives, recordkeeping requirements for OTC derivatives, requirements designed to facilitate clearing of OTC derivatives for clients of clearing members (such as regulated funds), and proposals to address risks posed by affiliates of licensed corporations.

Comments on the Consultation must be received by 20 February 2018.[\[1\]](#) **Please contact George Gilbert (george.gilbert@ici.org) by 26 January** if you would like to share your views on the Consultation. ICI Global does not expect to comment on the Consultation.

Proposed Risk Mitigation Requirements

The Consultation proposes new risk mitigation requirements that would apply to all licensed corporations—including licensed asset managers—that are counterparties to non-centrally cleared over-the-counter derivatives.[\[2\]](#) The new requirements address trade relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression and dispute resolution.[\[3\]](#) The Consultation notes that these new proposed rules are intended to ensure compatibility with risk mitigation requirements in other jurisdictions.

Trading relationship documentation. The Consultation proposes to 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.[\[4\]](#)

Trade confirmation. The Consultation proposes to 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 permit trade confirmation either through electronic or manual means, and may allow confirmation by negative consent.[\[5\]](#)

Valuation. The Consultation proposes to 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 Consultation notes that valuations should be performed on a fair value basis by marking to market where practicable. If a licensed corporation uses a proprietary valuation model, the model should employ accepted valuation methodologies. The Consultation states 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.[\[6\]](#)

Portfolio reconciliation. The Consultation would 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. The Consultation would require licensed corporations to conduct portfolio reconciliation at regular intervals to enhance accuracy and ensure that discrepancies are identified and resolved in a timely manner.[\[7\]](#)

Portfolio compression. The Consultation would 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.[\[8\]](#) Portfolio compression could be performed on a bilateral or multilateral basis.

Dispute resolution. The Consultation would 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.[\[9\]](#)

Proposed Recordkeeping Requirements

The Consultation notes that licensed corporations presently must comply with general recordkeeping requirements in relation to their business. The Consultation would enhance these requirements by requiring 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 an OTC derivatives transaction. In addition, a licensed firm that is a counterparty to OTC derivatives transactions would be required to maintain records concerning the following:

- Orders or instructions concerning OTC derivatives transactions it receives or initiates;
- All agreements relating to non-centrally cleared OTC derivatives transactions entered into with counterparties;
- Each executed OTC derivatives transaction;
- All post-trade processing and events relating to each OTC derivatives transaction, including, as applicable, termination, netting, compression, reconciliation, valuation, margining, collateralization and central clearing;
- OTC derivatives transactions in respect of which it has facilitated the clearing of the transaction;

- Collateral held by it and any assets received by it from counterparties to OTC derivatives transactions;
- Rehypotheication of collateral in respect of OTC derivatives transactions;
- Collateral and margin calls;
- All client clearing agreements and agreements entered into with a central counterparty relating to each OTC derivatives transaction.[\[10\]](#)

Proposed Requirements on Client Clearing

The Consultation proposes new requirements for firms that provide clearing services for OTC derivatives. The proposed new requirements would address segregation and portability of customer assets, indirect clearing, and confirmation of clearing.

Segregation and Portability. The proposal seeks to provide clearing firms with flexibility to offer clients (such as regulated funds) a variety of segregation options—including individual segregation—while at the same time ensuring that clients have adequate information about the protections available under different segregation regimes. To that end, the Consultation would 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 Consultation also would require a clearing firm to segregate customer collateral from the firm’s proprietary assets. In addition, the Consultation would require a clearing firm to attempt to accommodate porting if it defaults, if porting is permissible under applicable law.[\[11\]](#)

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 Consultation notes that indirect clearing arrangements are limited in Hong Kong, but proposes that firms providing indirect clearing services should notify their clients of the names of the clearing member and the CCP that will be used to clear the client’s transaction. The Consultation also proposes to 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.[\[12\]](#)

Confirmation of Clearing. The Consultation would 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.[\[13\]](#)

Proposed Conduct Requirements to Address Risks Associated with Interaffiliate Transactions

The Consultation recognizes that licensed corporations sometimes conduct business with their affiliates and that these interaffiliate transactions can create unique risks. To mitigate these risks the Consultation proposes to require licensed corporations to manage financial exposures to affiliates and other connected persons—such as 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 margin rules for uncleared derivatives trades in other jurisdictions, the SFC proposes that this new conduct requirement would not apply if its application would have the effect of overriding other applicable law.[\[14\]](#)

In addition, the Consultation proposes 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 Consultation notes that in these circumstances the licensed firm must act in the client’s best interest and proposes to 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.^[15] To draw the client's attention to the risks of entering into OTC derivatives transactions with unlicensed CFA's, the Consultation would require the introducing licensed firm to make a specific risk disclosure to the client, if the CFA is not a licensed corporation.^[16]

Other Aspects of the Consultation

The Consultation proposes several refinements to the scope of regulated activities in response to comments received on Hong Kong's OTC derivatives licensing regime. The proposed amendments would:^[17]

- Narrow the scope of regulated activities covered by license Type 9 (asset management) and Type 11 (dealing in OTC derivatives products or advising on OTC derivatives products) so that they do not capture corporate treasury activities of non-financial groups;
- Narrow the scope of regulated activities covered by license Type 11 so that it does not capture the provision of post-trade multilateral portfolio compression services, including those provided by a central counterparty or a provider of clearing services
- Narrow the scope of regulated activities covered by license Type 12 (providing clearing agency services for OTC derivatives transactions) so that it generally would not capture overseas clearing members of overseas central counterparties
- Refine the scope of regulated activities covered by license Type 12 so that it does not catch certain asset management or other activities which are only ancillary to the clearing and settlement process rather than central to that process;
- Create a mechanism that allows activities to be carved out of license Types 9 and 12;
- Narrow the scope of regulated activities covered by license Type 9 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;
- Narrow the scope of regulated activities covered by license Type 9 so that it does not capture incidental portfolio management activities carried out by professionals in respect of all OTC derivatives products; and
- Narrow the scope of regulated activities covered by license Type 3 (leveraged FX trading) so that licensed Type 9 intermediaries dealing in OTC derivatives products which also constitute "leveraged foreign exchange contracts" are not captured.

George M. Gilbert
Assistant General Counsel

endnotes

^[1] Securities and Futures Commission, 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, 20 December 2017, *available at* <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=17CP9> (Consultation).

[2] See Consultation at ¶¶ 51-54 (describing the application of the proposed risk mitigation requirements to asset managers and advised funds).

[3] One type of OTC derivatives transaction, known as a foreign exchange (FX) security conversion, would be exempted from all the proposed risk mitigation requirements except for the trading relationship documentation and trade confirmation requirements. An FX security conversion involves the purchase or sale of a foreign currency equal to the price of foreign securities. These two transactions are executed contemporaneously to effect delivery of the foreign securities by the customary settlement period of the foreign securities. See id. at ¶ 88.

[4] See id. at ¶¶ 58-63.

[5] See id. at ¶¶ 64-70.

[6] See id. at ¶¶ 71-77.

[7] See id. at ¶¶ 78-82.

[8] See id. at ¶¶ 83-85.

[9] See id. at ¶¶ 86-87.

[10] See id. at ¶¶ 108-118 and Appendix 6.

[11] See id. at ¶¶ 90-100. In addition, the Consultation would extend the segregation requirements under the SFC's client money rules to client money received in respect of providing client clearing services for OTC derivatives.

[12] See id. at ¶ 101.

[13] See id. at ¶ 102.

[14] See id. at ¶¶ 123-128.

[15] A comparable overseas jurisdiction is proposed to be a jurisdiction which has implemented a regulatory framework on OTC derivatives dealing activities comparable to that of Hong Kong. The SFC proposes to publish a list of comparable overseas jurisdictions on its website for the public's reference.

[16] See Consultation at ¶¶ 129-139. These proposed requirements would not apply to clients that are affiliates of the licensed corporation. The Consultation, however, does propose to require a licensed corporation that arranges OTC derivatives transactions for its affiliates to ensure appropriate risk management for such transactions.

[17] See id. at ¶ 10. The Consultation also proposes amendments to certain securities and futures fees, insurance requirements, and professional training requirements. See id. at ¶¶ 146-165.

should not be considered a substitute for, legal advice.