

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

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I. Introduction

1. On 11 July 2012 the Hong Kong Monetary Authority (**HKMA**) and Securities and Futures Commission (**SFC**) issued a Consultation Conclusions Paper on the proposed regulatory regime for the over-the-counter (**OTC**) derivatives market in response to our Consultation Paper published in October 2011.
2. At the same time, the HKMA and SFC also issued a Supplemental Consultation Paper on the proposed scope of the new/expanded regulated activities (**RAs**) to be introduced under the proposed OTC derivatives regime, and the proposed oversight of systemically important players. The term systemically important players was subsequently changed to systemically important participants (**SIPs**).
3. This Supplemental Consultation Conclusions Paper summarises the comments received on the Supplemental Consultation Paper, the HKMA and SFC's responses to these comments and our conclusions and proposals. This paper should be read together with the Consultation Paper (in October 2011), the Consultation Conclusions Paper (in July 2012), the Supplemental Consultation Paper (in July 2012) and the comments received thus far.
4. We received a total of 18 written submissions from a range of respondents including banks, investment houses, service providers, consulting firms, law firms, industry and professional bodies. A list of the respondents (other than those that requested to remain anonymous) is set out in **Appendix 1** and the full text of their comments (unless requested to be withheld from publication) can be viewed on the websites of the HKMA (www.hkma.gov.hk) and the SFC (www.sfc.hk).
5. We take this opportunity to thank everyone who took the time and effort to comment on the proposals in our Supplemental Consultation Paper. Your comments and suggestions have been most useful, and have helped us refine and finalise many key aspects of the new licensing requirements on intermediaries and oversight of SIPs under the OTC derivatives regime.

II. Executive Summary

6. The Consultation Conclusions Paper published in July 2012 set out the framework to provide for the regulation and oversight of key players, i.e. authorized institutions (**AIs**), approved money brokers (**AMBs**), licensed corporations (**LCs**) and other relevant persons in the OTC derivatives market. It confirmed the need to introduce new RAs and expand existing RAs to properly regulate persons who serve as intermediaries in the OTC derivatives market. It also confirmed the need to have a degree of regulatory oversight in respect of SIPs, i.e. players in Hong Kong who are not licensed or registered with either the HKMA or SFC, but whose positions and activities in the OTC derivatives market may raise concerns of potential systemic risk.
7. The Supplemental Consultation Paper set out the detailed scope of the new RAs and expanded RAs as well as the proposed framework for oversight of SIPs.

8. Two new regulated activities, Type 11 RA and Type 12 RA, were proposed to be introduced under Schedule 5 to the Securities and Futures Ordinance (**SFO**). Type 11 RA would cover the activities of dealers and advisers and Type 12 RA would cover the activities of clearing agents. Additionally, the existing Type 7 RA and Type 9 RA were proposed to be expanded to cover OTC derivatives.
9. It was also proposed that market participants in Hong Kong whose OTC derivatives positions exceed prescribed notification level should notify the SFC, and their name and details should then be entered in the SIP register. Additionally, the HKMA and SFC should have power to require registered SIPs to provide information and take certain action in respect of their OTC derivatives positions and transactions as may be required.
10. Most of the feedback focused on matters concerning the new RAs and the expanded RAs, in particular the ambit and application of certain carve-outs and transitional arrangements which were proposed in the Supplemental Consultation Paper. Respondents also provided comments and raised queries on how the requirements and licensing regime would apply to funds and their fund managers. With regard to regulation of SIPs, the feedback centred on the assessment criteria of an SIP.

New Type 11 RA

11. We received strong support for the introduction of the new Type 11 RA. Type 11 RA was proposed to be cast to capture the activities of dealers and advisers in relation to OTC derivatives transactions. In our proposal, we set out specific activities that would be excluded from the scope of the new Type 11 RA. Respondents were generally supportive of this.
12. Having said that, some respondents proposed for additional activities to be excluded from the scope of the new Type 11 RA. We have reviewed and considered their views. In this regard, we have explained below in detail our rationale and policy intention on why we have not taken on board some of their proposals.
13. We also discuss below a carve-out to exclude activities of a price taker from the licensing requirement of Type 11 RA. In our Supplemental Consultation Paper, we said that we were considering how best to cast the definition of a price taker and would welcome any views on this. We received suggested definitions and approaches. In summary, having considered the respondents' views and our policy intention, our current approach is to leave the term price taker to its ordinary meaning, as the term is widely used and understood in its context.

New Type 12 RA

14. We proposed to regulate and supervise the activities of persons who serve as clearing agents in OTC derivatives under the new Type 12 RA. We also proposed carve-outs to exclude AIs, AMBs, the central counterparty (**CCP**) itself, and other persons subject to certain conditions. We received support for these proposals.

15. In view of the fact that clearing agency services for OTC derivatives transactions are a new type of services required as a result of the mandatory clearing obligation, we have made appropriate adjustments to the proposed transitional arrangements for the new Type 12 RA. This would minimise market disruption and facilitate the launch of the mandatory clearing mandate.

Expanded Type 7 RA and Type 9 RA

16. We proposed to expand Type 7 RA and Type 9 RA to cover OTC derivatives. We received, for the expanded Type 9 RA, various concerns relating to the impact on existing investment managers, particularly in relation to transitional arrangements. Respondents also proposed carve-outs for the expanded Type 9 RA. These are dealt with below in the detailed explanation of our responses. We also suggest appropriate adjustments to the proposed transitional arrangements.

Transitional arrangements

17. A longer application period of three months and a longer transitional period of six months are now proposed to facilitate market players to ease into the new licensing regime with minimum disruption on their existing businesses. The transitional period is applicable to both the new Type 11 and 12 RAs as well as the expanded Type 7 and 9 RAs. Relaxation of the experience requirement is available to applicants for Type 12 RA since central clearing of OTC derivatives transactions is a relatively new practice around the world. Existing Type 9 licensees and registrants intending to continue to provide OTC derivatives products management will also enjoy a simplified process of notification instead of application.

Systemically Important Participants

18. We asked for comments on our proposal for how SIPs should be identified and regulated, and we received some comments from respondents. We now propose that the quantitative criteria will be set by reference to a person's positions in a specific class of OTC derivatives products, and it will only affect persons in Hong Kong (please also see paragraph 94). We also clarify below that we will not be requiring information on related persons of SIPs. With respect to penalties, we now propose that penalties for breach of a notification requirement by an SIP should be set at the same level as penalties for unlicensed activities (instead of our previous proposal to set it on a par with penalties for breaches of notification obligations under Part XV of the SFO). We have also set out below the proposal to let SIPs have a right of appeal in respect of our decisions on various matters, including registration and de-registration by the SFC and directions by the SFC or the HKMA for the SIP to take specified action.

III. Comments received and our responses

A. *New Type 11 RA*

19. We proposed in the Supplemental Consultation Paper to cast the initial ambit of the new Type 11 RA, which covers the activities of dealers and advisers of OTC derivatives products, along the lines of the initial ambit of the existing dealing and advising definitions in the SFO. Carve-outs should then be provided to exclude activities undertaken by certain types of persons or in certain types of situations, and to deal with overlaps between the scope of the new Type 11 RA and the scope of existing RAs.
20. We received substantive comments from respondents supporting our proposed new Type 11 RA and the proposed carve-outs. We welcome the strong support and we propose to proceed casting Type 11 RA along the approach detailed in the Supplemental Consultation Paper.
21. We received proposals from some respondents requesting for additional carve-outs to be made available. Some respondents commented or sought clarification on other issues. These proposals and comments are set out below together with our views and responses.

Existing licensed persons

22. Some respondents suggested that existing licensed persons who are not expressly restricted from dealing in or advising on OTC derivatives products should be exempted from the licensing regime of new Type 11 RA. We disagree with this view. Our policy intention is to regulate intermediaries whose OTC derivatives activities are currently not regulated by the HKMA or caught by the licensing regime under the SFO. There are dealing or advising activities in certain OTC derivatives products such as interest rate derivatives which are not covered under existing RAs. Accordingly, the existing licensed persons who are not AIs, AMBs or their employees would need to be additionally licensed under Type 11 RA if they engage in dealing in or advising on such OTC derivatives products.

Acting as a principal

23. We received responses suggesting that the criteria for an entity dealing in OTC equity derivatives to be exempted from Type 11 RA should be whether the entity is already licensed for Type 1 RA. Further, it was suggested that a distinction should not be drawn as to whether the entity under the existing Type 1 RA licence engages as an agent or as a principal. We disagree with this view.
24. As we pointed out in our Supplemental Consultation Paper, we do not agree to preserve a carve-out for persons acting as principals in the new Type 11 RA. This is because transactions in the OTC derivatives market are typically conducted on a principal-to-principal basis. Therefore, exempting persons dealing in OTC derivatives products as a principal from the new Type 11 RA would undermine the efficacy of our proposed licensing regime. Our policy intention is to bring such principal-to-principal

transactions within the scope of the OTC derivatives regime and have such persons licensed under Type 11 RA. Therefore, a Type 1 RA licensee who intends to carry on OTC equity derivatives transactions on a principal-to-principal basis would also need to apply for a Type 11 RA licence. This is because such principal-to-principal transactions are not caught under the existing Type 1 RA, but they will be caught by the new Type 11 RA.

Other carve-outs suggested by respondents

25. We have also received suggestions from market participants requesting for specific carve-outs for the following activities:-
- (a) “agency – non clearance” related activities such as collateral management, paying agency and pricing services;
 - (b) a Type 4 RA licensee communicating offers of contracts or arrangements covered under Type 11 RA (since a similar carve-out for OTC equity derivatives is currently available to Type 4 RA licensees when they comply with section 175 of the SFO); and
 - (c) intra-group dealings as market participants do not perceive any risk in such activities.
26. We do not propose to provide a specific carve-out for the provision of collateral management, paying agency and pricing services (see paragraph 25(a) above). Our view is that so long as the nature of the services provided does not fall within entering into, or facilitation of entering into OTC derivatives transactions or giving advice on these, it does not fall within the scope of Type 11 RA. We do not think that there is a need to provide a specific carve-out. Such services are, by their nature, unlikely to fall within the ambit of Type 11 RA.
27. We do not propose to provide a carve-out for communication of any contracts or arrangements under Type 11 RA (see paragraph 25(b) above). Whilst Type 4 RA (advising on securities) licensees are carved out from Type 1 RA when they communicate offers of securities which are OTC equity derivatives and they are in compliance with section 175 of the SFO, we do not propose extending such carve-out to other types of OTC derivatives products. This is because a Type 4 RA licensee advising on OTC derivatives products which do not also fall under the definition of securities would in any event have to register for a Type 11 RA even if it does not deal in them. Unlike Type 1 RA or Type 4 RA, which capture either dealing or advisory services only, Type 11 RA captures both dealing and advisory services. Hence it would not be appropriate to grant the requested carve-out from Type 11 RA.
28. We do not propose carving out dealing in intra-group transactions from Type 11 RA (see paragraph 25(c) above). We note that there is currently no such carve-out provided under the Type 1 RA. Our policy intention is to ensure that activities of derivatives market intermediaries are properly regulated. If intra-group transactions are not subject to appropriate risk monitoring and control by market participants, concerns may arise about systemic risk. Therefore, there is still a need to have appropriate supervision over activities of market players including their intra-group transactions (see also paragraphs 35 and 36 below).

29. Nevertheless, a person entering into OTC derivatives transactions with its affiliated companies may not be required to obtain Type 11 RA licence provided that its activity falls within the ambit of a price taker which is carved out from Type 11 RA (see paragraphs 37 to 40 below). The relevant criterion in determining whether the transactions carried out by such person come outside the ambit of Type 11 RA is whether the person is a price taker and not whether the transactions are intra-group transactions.

OTC derivatives products with futures contract as underlying

30. One respondent sought clarification in respect of the ambit of Type 2 RA since there is currently an uncertainty in the market regarding whether OTC derivatives products that have a futures contract as an underlying asset would themselves fall within the definition of futures contracts. This is important because this will affect whether persons dealing in such products will need to be licensed under Type 11 RA if they have already been licensed for Type 2 RA.
31. It is difficult to make a general statement on whether OTC derivatives products with a futures contract as the underlying asset fall within the definition of futures contracts or not. Much is dependent on the structure of the particular OTC derivatives product concerned. Our policy intention is that if the particular OTC derivatives product falls within the definition of futures contracts under the SFO and the person is licensed for Type 2 RA, it will not be necessary for the person to apply for Type 11 RA to continue the activities (see paragraph 10 of the Supplemental Consultation Paper where we proposed a carve-out when there is an overlap between a new RA and an existing RA).
32. Where the particular OTC derivatives product does not fall within the definition of a futures contract but the person is required to be licensed for Type 2 RA (because for example, the subsequent delivery of the underlying futures contracts at maturity may be viewed as dealing in futures contracts), it will also be necessary for the person to be licensed for Type 11 RA in order to continue the activity. This is because dealing in that OTC derivatives product does not fall within the definition of dealing in a futures contract and is therefore not covered under his existing Type 2 RA licence.

Impact on investment managers and investment funds because of new Type 11 RA

33. Some respondents wanted to clarify whether we intend to require a person to apply for Type 11 RA when that person has an investment manager who negotiates and enters into the OTC derivatives on its behalf and the investment manager appointed is already licensed under Type 9 RA or regulated under an equivalent overseas regime. A typical example would be when an investment fund enters into an OTC derivatives transaction as a counterparty solely under the investment management direction of an appropriately regulated investment manager.
34. We do not intend to provide a specific carve-out for investment funds from Type 11 RA. Generally, we expect a fund will not need to be licensed for Type 11 RA since its activities should involve taking prices from the market to enter into an OTC derivatives transaction to enhance or hedge its portfolio. Therefore, it should qualify as a price taker (see paragraphs 37 to 40 below). In respect of a fund whose activities may constitute that of an OTC derivatives market intermediary (for example, acting as a

market maker by creating market liquidity through quoting prices in a particular OTC derivatives product) then it would likely need to be licensed as a Type 11 RA. Under the SFO, only a corporation (as defined in the SFO) is permitted to be licensed to carry on business in a RA. Accordingly, an intermediary intending to conduct these types of activities in Hong Kong would have to be a corporation that meets all of the applicable licensing requirements under the SFO and such other rules or guidelines as might be relevant. With regard to an investment manager already licensed under expanded Type 9 RA, it may be exempted from Type 11 RA if the OTC derivatives dealing is solely for the purpose of providing OTC derivatives products management under expanded Type 9 RA.

35. We have also received a suggestion that existing licensed persons who deal in OTC derivatives transactions - including executing OTC derivatives transactions for their affiliates / subsidiaries and portfolios managed by their affiliates or subsidiaries - should be exempted from Type 11 RA licence. It was suggested that this would facilitate international asset management companies to continue to use Hong Kong as their “central dealing hub” in Asia Pacific.
36. We do not believe it is appropriate to exclude OTC derivatives market intermediaries which carry out dealing activities on behalf of their affiliates from our licensing requirement. Requiring them to be licensed under Type 11 RA is also consistent with the current requirement for them to be licensed under Type 1 and Type 2 RAs for acting as the “central dealing desks” for securities and futures contracts.

Carve-out of a price taker from the new Type 11 RA

37. We have received general support to carve out price takers from the scope of the new Type 11 RA. In this regard, we have sought views on the definition of “price taker” and have received several suggestions. The suggestions included catering for the following exemptions -
- (a) persons that have appointed a discretionary investment manager (who holds an expanded Type 9 RA licence or is regulated under an equivalent overseas regime);
 - (b) persons holding a Type 4 RA licence for “advising on securities” - the presumption is that as advisers, they will not make markets or offer price quotes; and
 - (c) persons who use OTC derivatives in their ordinary course of business, without any form of market making.

We have considered the above suggestions and have concluded that the above are too specific and may not properly exclude classes of persons that do not influence the pricing of OTC derivatives transactions.

38. It should be noted that a carve-out has already been proposed to exclude dealing activities performed through an AI or through an LC licensed for Type 11 RA, and dealings for no remuneration. Our policy intention is to exclude price takers who negotiate and enter into OTC derivatives transactions directly (without going through an OTC derivatives market intermediary). The key features of price takers are:-

- (a) they enter into derivatives contracts as principal to acquire directly a position or exposure – whether for hedging or other purposes - (as opposed to market makers or liquidity providers who stand ready to enter into any transaction);
- (b) they bid on the price offered; and
- (c) their transactions are not intended to affect or move the market price.

A market maker, as opposed to a price taker in the context of an OTC derivatives transaction, will enter into the transaction any time as the counterparty to anyone in the market who wants to be the counterparty to the transaction. A market maker therefore either constantly quotes prices for entering into OTC derivatives transactions or responds with a price quote if requested and, typically profit from the price differentials between the transactions and hedges that it enters into.

- 39. Whilst we had noted in the Supplemental Consultation Paper that we were looking at how best to define a price taker, we believe that the term is widely used and understood, and that a definition is not necessary. We will monitor the situation upon the launch of the licensing regime, and revisit the need for further guidance at that stage.
- 40. For the avoidance of doubt, we would like to reiterate that if a person is not considered to be dealing in OTC derivatives products but is providing advisory services for OTC derivatives products, the person would still need to be licensed for Type 11 RA. This is because when a person either deals in or give advice on OTC derivatives products, a licence for Type 11 RA will be required.

B. New Type 12 RA

- 41. In order to manage counterparty risk arising from a bilateral OTC derivatives transaction, market participants have started clearing their OTC derivatives transactions through a CCP. They can do so directly (i.e. by becoming a member of the CCP) or indirectly (i.e. by clearing with a CCP through a third party). Due to the stringent admission criteria of CCPs, not every market participant may become member of a CCP and clear directly. They may instead engage third parties who provide clearing agency services so that they can clear indirectly through a CCP. As we implement mandatory clearing obligations to cover more market participants, the demand for indirect clearing is likely to increase. In this regard, we set out in our Supplemental Consultation Paper our proposed scope for the new Type 12 RA, which is intended to capture activities of those who serve as clearing agents for OTC derivatives.
- 42. We received support for having a separate new Type 12 RA as well as our proposed carve-outs. In particular, respondents noted that our approach to proposed carve-outs for activities by AIs and AMBs is consistent with the proposed division of regulatory responsibilities between the HKMA and SFC.
- 43. Type 12 RA covers a relatively new service, and the OTC derivatives products being cleared are fairly complex. As we are going to impose mandatory clearing obligations on OTC derivatives market participants and allow such obligation to be discharged by indirect clearing through a clearing agent, special attention is warranted for these

clearing agents and accordingly they need to be adequately supervised in order to protect the interests of their clients

44. We would also like to take this opportunity to clarify that the new Type 12 RA covers the provision of clearing and settlement services on behalf of another person in respect of that other person's OTC derivatives transactions (i.e. client clearing services). The new Type 12 RA does not cover clearing and settlement activities in relation to a person's own proprietary positions in OTC derivatives transactions.

C. *Expanded Type 7 RA*

45. We explained in the Supplemental Consultation Paper that the definition of Automated Trading Services (**ATS**) will need to be expanded to include OTC derivatives transactions; the current definition only includes facilities for the trading or clearing of securities or futures contracts. Further, the OTC derivatives transactions activities covered by the licence for the expanded Type 7 RA would be expected to be bundled with the new Type 11 RA (instead of the existing Type 1 or Type 2 RA).
46. We also asked for feedback on our proposals on how the provision of ATS (for OTC derivatives transactions) by AIs and AMBs should be regulated. In this regard, we received support for our proposal that where OTC derivatives dealing activities of AIs and AMBs are overseen and regulated by the HKMA, their incidental provision of ATS should also be overseen and regulated by the HKMA.
47. We also received comments with respect to whether providers of post trade services would be required to be regulated as ATS providers. We would like to emphasize that this is dependent on whether the service being provided falls within the definition of ATS. We are happy to discuss this further with providers of post trade services if necessary.

D. *Expanded Type 9 RA*

48. We received general support for our proposal to expand the licensing regime for Type 9 RA to cover the management of portfolios of OTC derivatives products. In particular we received support for the carve-out applicable for AIs and AMBs where such activities are wholly incidental to their dealing activities. We also received comments and suggestions on transitional arrangements and experience requirements for current Type 9 RA licensees and registrants. These are proposed to be simplified and relaxed and are explained further in paragraphs 80 to 83 below.

Relationship between Investment Manager and Sub-Investment Manager

49. A few market participants expressed concerns about potential duplicative licensing requirements when an investment manager of a fund delegates investment management responsibility to a sub-investment manager and the sub-investment manager uses OTC derivatives transactions in managing the portfolio. They sought clarification on whether both the investment manager and its sub-investment manager would need to comply with the expanded Type 9 RA licensing requirement. They also

suggested that where the sub-investment manager is already appropriately qualified or regulated (in Hong Kong or overseas), the investment manager should be able to rely on the expertise of its delegate to meet the eligibility criteria under expanded Type 9 RA.

50. Our policy intention is to regulate persons who carry out activities in OTC derivatives products management unless they fall within our proposed carve-outs. Whether an investment manager who delegates his investment management responsibility for a portfolio of OTC derivatives products to a sub-manager is required to be licensed for the expanded Type 9 RA depends on whether the investment manager itself has any remaining function to be carried out in Hong Kong which falls under the scope of the expanded Type 9 RA. Further, if an investment manager is required to be licensed under the expanded Type 9 RA, it must be able to meet the eligibility criteria in its own right (and cannot rely on the qualification of its delegate).
51. The same would apply to the sub-manager. If the sub-manager carries out any investment management responsibility for a portfolio of OTC derivatives products in Hong Kong (for example, pursuant to the functions delegated to him by the investment manager), then it will need to be licensed under the expanded Type 9 RA and meet the eligibility criteria in its own right.

Impact on persons marketing asset management services

52. A query was raised as to what would happen to individuals who have been actively marketing asset management services under the existing Type 9 RA when the expanded Type 9 RA is introduced – i.e. whether such individual would need to obtain the expanded Type 9 RA in order to continue with the “active marketing” of the expanded Type 9 RA services. To clarify, under the existing regime, persons holding a Type 9 RA license are only entitled to an incidental exemption from dealing activities (including inducing or attempting to induce another person to deal in securities) where the act is performed solely for the purpose of carrying on Type 9 RA. Hence, under the new regime, individuals are allowed to engage in the expanded Type 9 RA if their principal can do so under its licence.
53. The respondent also mentioned that it might be difficult for such individuals to prove that they have at least two-years of experience in OTC derivatives products management. It was therefore suggested that the HKMA and SFC should remove the two-year experience requirement so that such individuals could continue to carry on their current activities. As mentioned earlier, we propose to simplify the transitional arrangements and relax the experience requirements for current Type 9 RA licensees and registrants. Please see paragraphs 80 to 83 below.

Definition of portfolio of OTC derivatives products

54. A respondent said that a “portfolio” of OTC derivatives products should be more clearly defined and the percentage level of OTC derivatives products within a portfolio should exceed a prescribed level before the expanded Type 9 RA licensing requirement is triggered for the person managing the portfolio. There is no analogous triggering mechanism for any other RAs; we do not therefore propose setting a percentage

threshold for the level of OTC derivatives products within a portfolio being managed before the expanded Type 9 RA is triggered for licensing purposes.

55. Some respondents also wanted to ensure that the drafting of the expanded Type 9 RA should make it clear that a portfolio can include securities, futures and OTC derivatives. In this regard, a person who is licensed to carry on OTC derivatives products management should also be licensed to carry on securities and futures contracts management if his portfolio includes securities and futures contracts as well as OTC derivatives products.

E. Other Issues relating to the new licensing and registration regime

Validity of OTC derivatives transactions if application for new or expanded RA is rejected

56. Some respondents raised a concern on the need for clarity that any OTC derivatives transactions entered into or cleared through an applicant for the new Type 11 or 12 RA prior to the date of an application being rejected should remain valid and legally binding.
57. The OTC derivatives licensing regime is intended to regulate derivatives market intermediaries. It is not intended to invalidate transactions or affect contracting parties' rights or obligations under bilateral trades, solely by reason that the intermediary's application for a licence is subsequently rejected.

Examination requirements

58. Some respondents raised questions about examination requirements for representatives, responsible officers (ROs) of LCs applying for new RAs or expanded Type 9 RA and executive officers (EOs) of AIs applying for expanded Type 9 RA. Some have suggested grandfathering arrangements for employees and officers.
59. We are considering detailed examination requirements, which will be introduced at a later stage. Broadly speaking, we are prepared to grandfather market participants who qualify for deemed status under transitional arrangements, and to exempt them from the local regulatory framework paper requirement of the competence requirements provided that they will, within a certain period after being deemed licensed or registered, complete a post-licensing refresher course concerning the legal and regulatory framework relating to the RA(s) concerned. Such refresher course will be additional to the normal continuous professional training requirements.

F. Transitional arrangements

The broad framework

60. Transitional arrangements for the new RAs and the expanded RAs are intended to facilitate market players who have been engaging in OTC derivatives activities to move into the new licensing regime with minimum impact on their existing businesses, and to

facilitate the launch of the mandatory clearing obligation. In addition to the proposed new Types 11 and 12 RAs and the expanded Type 9 RA, we also consider it beneficial to include the expanded Type 7 RA in the transitional arrangements. After considering responses, we set out in the following paragraphs, the revised criteria and mechanism for market participants to be qualified for deemed licensed status (for an LC / RO / LR) or deemed registered status (for an AI / EO) to continue with their existing activities while their applications for licences, approvals as ROs or registration under Part V of the SFO or for consent to be EO under section 71C(1)(a) of the Banking Ordinance (collectively, **Full Applications**) are being processed by the SFC or HKMA. Market participants should submit the Full Application and the related documents for deemed status (collectively, **Application Documents**) simultaneously.

Application period

61. Respondents were generally supportive of the deeming arrangements proposed in the Supplemental Consultation Paper. There will be an application period in which market participants will be able to make a Full Application, and pending the processing of that application, they will be deemed to be licensed or registered (as the case may be) after the transitional period referred to below until the Full Applications have been dealt with, provided that they have satisfied all requisite criteria. There was a general concern about the time allowed for an applicant to make an application. We have agreed to extend the application period to three months, starting from the commencement date of the OTC derivatives regime.

Transitional period

62. Likewise, in view of the feedback on the need for a grace period for winding down operations (as discussed in paragraphs 70 and 71 below), we now propose a longer transitional period of six months, starting from the commencement date of the OTC derivatives regime, instead of the previously proposed four to six weeks.
63. During the six-month transitional period, the SFC and HKMA will not take action against any person for carrying on the new RAs or the new component of the expanded RAs. In other words, a person will not be regarded as having contravened any prohibition under section 114 of the SFO in respect of the new RAs or the new component of the expanded RAs - even though that person may not have made a Full Application to the SFC/ HKMA to carry on the new RAs or expanded RAs, or, where that person has made such an application, the licence/ registration has not been granted.
64. The rationale for having two distinct periods for application and transitional arrangements is to ensure that market participants who are already engaged in OTC derivatives activities can continue to do so for a limited period of time despite not being licensed for such new or expanded RAs. This allows the SFC and the HKMA to set a time frame for receiving the applications and, thereafter, to process licensing or registration applications for the new RAs and expanded RAs, with minimal disruption to the market. In addition, this should facilitate the winding down process or the transfer process for corporations who may not wish to, or are not able to, apply for the new or expanded RAs.

65. We have proposed in our Supplemental Consultation that transfer of accreditation under section 122 of the SFO should be possible during the transitional period. As there are now two distinct periods, if an individual wishes to be accredited to another corporation, he can do so either by withdrawing his original application and submitting another during the Application Period, or by making an application under section 122 of the SFO after he has been granted a licence under section 120 of the SFO.

Deemed status

66. During the transitional period, the SFC or the HKMA will check the Application Documents received during the application period to see if the relevant deeming criteria have been met. If they have not, the SFC or the HKMA will issue a notice to the applicant noting that the person is not entitled to be deemed to be licensed or registered to carry on the relevant new or expanded RA (or approved as an RO or an EO). For applicants who are not qualified for deemed status, they will have a grace period for winding down the existing business (see paragraphs 70 and 71 below). They can only restart the business after they are licensed or registered. For applicants who qualify for deemed status, they will be deemed to be licensed or registered to carry on the relevant RA(s) (or deemed to be approved as an RO or an EO), after the expiry of the transitional period until there is a final decision on the Full Application or a triggering event which will bring his deemed licensed, registered or approved status to an end. A deemed licence, registration or approval carries the same rights and obligations as a regular licence, registration or approval.

Cessation of deemed status

67. The SFC or the HKMA will assess during the transitional period whether an applicant should be deemed to be licensed or registered for the relevant new RA or expanded RA (or deemed to be approved as an RO or an EO). This will be a screening check only, and will not involve a thorough consideration of the application itself. Therefore, whilst a person may be considered suitable for a deemed licence, registration or approval, it is possible that the SFC or the HKMA may subsequently refuse the Full Application. This will bring the person's deemed licensed or registered or approved status to an end.
68. Under the transitional arrangements, the intention is that deemed status will stay in place until the Full Application has been processed, and until any appeals against a decision to refuse the application have been determined.
69. If an individual ceases to act for or on behalf of his principal, his deemed licensed, registered or approved status will also be brought to an end.

Refusal of application and grace period for winding down business

70. Some respondents expressed concern about the winding down of their existing activities in OTC derivatives products if their applications for new or expanded RAs are eventually refused by the SFC. Respondents suggested that corporate applicants should be entitled a reasonable grace period to wind down their business and where necessary, permitted to enter into new OTC derivatives transactions in order to close

out or hedge existing transactions or transfer the business to an appropriately licensed corporation or registered institution (RI).

71. A grace period of 3 months is now proposed to apply to all corporate applicants which have been issued a notice that they are not eligible to be deemed licensed or registered and all corporate applicants which have been deemed licensed or registered but are unsuccessful in their Full Applications. This period runs from the date when the notice is issued to a corporate applicant or when the decision to refuse to grant the license or registration in relation to a Full Application takes effect.

Failure to submit the Application Documents during the application period

72. Persons who fail to submit the Application Documents for the new RAs or expanded RAs during the application period will not be entitled to conduct the relevant OTC derivatives activities after the expiry of the six-month transitional period until they are licensed or registered pursuant to a subsequent regular application. After the six-month transitional period, the SFC or the HKMA may initiate action against any unlicensed or unregistered RA in respect of the new or expanded RAs (except against those who are entitled to a grace period for winding down).
73. We consider the three-month application period and six-month transitional period to be sufficient for any persons who wish to seek deemed licensed, registered or approved status under the new regime, as well as those who choose to wind down their operations.

G. *Transitional arrangements – deeming criteria*

Experience requirements for Type 11 RA and Type 12 RA

74. As the transitional arrangements are designed for existing market participants but not intended to be a shortcut for “opportunists” without adequate and relevant experience, we proposed in our Supplemental Consultation Paper that certain experience requirements will need to be fulfilled. There were various views from respondents on the level of experience required. We have concluded that LCs and their respective ROs should have two years of experience i.e. the applicant has been carrying on a business in Hong Kong in an activity that would have constituted Type 11 RA/ Type 12 RA, as the case may be, for at least 2 years immediately before the commencement date of the OTC derivatives regime. We propose to relax this requirement for Type 12 RA applicants as explained in paragraphs 76 to 78 below.
75. Individual applicants who wish to be deemed licensed representatives will have been working under the supervision of experienced ROs in an established LC. We therefore propose not to require them to meet any additional experience requirement to take advantage of the transitional arrangements to be deemed licensed representatives.
76. In the case of Type 12 RA (provision of clearing agency services), we received a comment that the experience requirements would severely limit the number of entities being deemed licensed. Submitting OTC derivatives transactions to central clearing is a relatively new practice around the world, and entirely new in Hong Kong, and there

are few established providers of such services. Therefore persons who provide such services are likely to be newcomers.

77. We have therefore extended the two-years experience requirements for Type 12 RA to also recognize overseas experience, experience of an affiliate company in the same group of companies and experience in clearing proprietary trades in OTC derivatives. We believe that these measures are fair to participants in this new market activity and would facilitate market participants to comply with the mandatory clearing obligation when launched.
78. For the avoidance of doubt, although the experience requirement for Type 12 RA transitional arrangements now includes experience in the clearing of proprietary trades, we have no intention to expand the scope of Type 12 RA to regulate clearing of proprietary trades.

General criteria for deeming

79. Apart from experience requirements, applicants also need to comply with other general criteria when they apply for a deemed licence under the transitional arrangements. For example, an LC applicant must have at least two qualified ROs, at least one Executive Director (as defined under the SFO) and premises suitable for keeping records or documents. It must also comply with the financial resources requirements and other applicable requirements under the SFO, Codes and Guidelines, etc. These are normal licensing requirements that we take into account when assessing all licence applications.

Qualification requirements for the expanded Type 9 RA

80. We received comments that the experience requirements for the expanded Type 9 RA are onerous. While we maintain that the experience requirements of new LC, RI and their respective RO and EO applicants (i.e. entities without a Type 9 RA licence/registration immediately before the commencement of the OTC derivatives regime) should be consistent with that of Type 11 RA, we have, however, simplified the transitional arrangements and relaxed the experience requirements for existing Type 9 licensees and registrants.
81. We propose that existing Type 9 LCs, RIs and their respective ROs and EOs who wish to continue to provide a service of managing a portfolio of OTC derivatives products for third parties will not need to make an application. They will instead need to submit a notification of their intention to continue to provide the service within the application period and to confirm, among other things, that they have at least one RO (for LC) or EO (for RI) in Hong Kong who has two years of experience in OTC derivatives products management over the past six years and to provide details of its business plan and related controls and operational procedures. The two-year experience can be gained in Hong Kong or overseas. We believe that taking into account the global nature of the asset management industry, it is appropriate to extend the experience requirement to that gained overseas. In addition, existing Type 9 RA licensees and registrants have already been subject to the SFC or the HKMA requirements and have been running an asset management business involving OTC derivatives products. For

individuals who wish to apply to be deemed licensed representatives, as with Type 11 and 12 RA, we will not require them to meet any experience requirement in OTC derivatives products to take advantage of the transitional arrangements to be deemed licensed representatives. New applicants only need to submit the Application Documents as required provided that they are carrying on OTC derivatives products management at the time the application is made. Existing Type 9 licensed representatives and relevant individuals may continue to provide services for OTC derivatives products management without any application or notification provided the entity they work for (i.e. their principal) does not have a licensing condition restricting them from carrying on such services.

82. It is also important to note that the deemed licensed or registered status for Type 9 RA only covers managing a portfolio of OTC derivatives products. Hence applicants granted a deemed licensed or registered status may be subject to the licensing condition that it cannot carry on securities and futures contracts management if it is not already licensed or registered to do so.
83. If a LC or RI does not submit any notification and confirmation as described above, or submits a notification and confirmation but does not meet the relevant experience requirements, the LC or RI (together with their ROs or EOs) will be deemed to have a condition imposed on its licence or registration to the effect that it cannot manage a portfolio of OTC derivatives products after the expiry of the transitional period.

Experience requirements for the expanded Type 7 RA

84. As licences and registration of existing Type 7 RA have been granted in relation to particular trading systems and by reference to particular products, the expansion of the definition of Type 7 RA to include OTC derivatives products would not enable existing Type 7 licensees and registrants to provide the expanded services. They will therefore need to submit a notification for the expanded business and application for modification of licensing conditions if they wish to continue to provide ATS services for OTC derivatives products. Since there is only a small number of existing Type 7 RA licensees, these will be dealt with on a case by case basis.
85. Transitional arrangements for expanded Type 7 RA are therefore only applicable in respect of persons who do not already hold an existing Type 7 RA. The arrangements and experience requirements will track those for Type 11 RA above. Likewise for Type 9 RA, the deemed licensed status for Type 7 RA covers ATS in relation to OTC derivatives products only.

Summary of the experience requirements for deemed status for different RAs

86.

	New Type 11 RA applicants	New Type 12 RA applicants	New Type 9 RA applicants	Existing Type 9 RA licensees / registrants	New Type 7 RA applicants
LC	2 years of Hong Kong experience	2 years of Hong Kong or overseas experience, affiliates experience recognised, clearing proprietary trades experience recognised	2 years of Hong Kong experience	Carrying on the New Type 9 RA at the time of making notification, with at least 1 RO having 2 years of Hong Kong or overseas experience over the last 6 years	2 years of Hong Kong experience
Representative	Nil	Nil	Nil	Nil	Nil
RO	2 years of Hong Kong experience	2 years of Hong Kong or overseas experience in clearing proprietary trades (including an affiliate's trade) is recognised	2 years of Hong Kong experience	2 years of Hong Kong or overseas experience over the last 6 years	2 years of Hong Kong experience
RI	N/A (regulated by HKMA under the current regime)	N/A (regulated by HKMA under the current regime)	2 years of Hong Kong experience	Carrying on the New Type 9 RA at the time of making notification, with at least 1 EO having 2 years of Hong Kong or overseas experience	N/A (regulated by HKMA under the current regime)

				over the last 6 years	
Relevant Individual	N/A (regulated by HKMA under the current regime)	N/A (regulated by HKMA under the current regime)	Nil	Nil	N/A (regulated by HKMA under the current regime)
EO	N/A (regulated by HKMA under the current regime)	N/A (regulated by HKMA under the current regime)	2 years of Hong Kong experience	2 years of Hong Kong or overseas experience over the last 6 years	N/A (regulated by HKMA under the current regime)

* Unless otherwise stated, two years of experience means two years of qualifying experience in the relevant OTC derivatives activity gained immediately before the commencement date of the OTC derivatives regime.

H. Regulations of SIPs

87. In the Supplemental Consultation Paper, we proposed persons who meet the quantitative criteria of an SIP to notify the SFC. Their names and details of their OTC derivatives positions would then be entered in the SIP register. The respondents were generally supportive of regulatory oversight of SIPs so that we can effectively monitor and track significant positions of SIPs in OTC derivatives products.
88. One respondent pointed out that the IOSCO Report on International Standards for Derivatives Market Intermediary Regulation did not indicate that regulation of SIPs is necessary. We would like to clarify that we do not propose to regulate SIPs in the same way as a derivatives market intermediary. Instead, we propose to have appropriate regulatory oversight so that we can manage the potential systemic risk that positions may bring to Hong Kong market,

Assessment criteria for an SIP

89. In the Supplemental Consultation Paper, we noted that we would only use quantitative criteria to determine whether a person should be regarded as an SIP. In that regard, we were considering setting the notification level by reference to either (i) a person's aggregate position in all OTC derivatives transactions, or (ii) the person's position in a particular product class or transaction type or (iii) a combination of the foregoing.
90. We have considered this further and believe that setting the notification level by reference to the person's position in a specific class of OTC derivatives transactions is a good starting point. In other words, the notification requirement is triggered if a

person's position in a specific class hits a set level. Further, once an SIP has notified its position in a specific class, and is entered into the SIP register, the registered SIP is not required to comply with notification requirement in respect of that specific class. However, the SIP is still subject to notification requirements once it crosses the notification level for other specific classes.

91. We received feedback that we should factor in the way in which a portfolio has been collateralised in calibrating the person's position, as this has a direct impact on the risk profile of the portfolio. We also received a suggestion that hedging activities of a commercial end-user should be excluded from the calculation of that person's position.
92. Our preference is to keep the calculation for the assessment simple and to set the quantitative level at many times higher than the proposed reporting and clearing thresholds for the mandatory clearing and reporting obligations. We therefore feel that notification is warranted when this exceptionally high threshold is reached.

SIP provisions not to extend to overseas person

93. The purpose of oversight over SIPs is to protect the financial stability of Hong Kong. Due to extraterritoriality issues, we do not intend to extend the SIP provisions to persons outside Hong Kong who merely transact or hold positions in OTC derivatives transactions that have a Hong Kong nexus.
94. In this regard, we have in our Consultation Conclusions Paper (issued in July 2012) proposed that the ambit of Hong Kong persons should refer to (i) individuals who are Hong Kong residents, (ii) the owners of any sole proprietorship or partnership that is based in, operated from, or registered in Hong Kong; (iii) companies that are incorporated or registered in Hong Kong; (iv) funds that are domiciled in Hong Kong (i.e. established under Hong Kong law); and (v) any other entity that is established or registered under Hong Kong law.

Notification requirement and penalty for failure to notify

95. A penalty will be imposed where an SIP breaches a notification requirement without reasonable excuse. The Supplemental Consultation Paper mentioned that we were considering the level of penalties, and that one possibility was to set the penalties on a par with those for other notification obligations under Part XV of the SFO.
96. We have reconsidered this and we are of the view that SIP notification failure warrants penalties at a much higher level now than breaches of the notification obligations under Part XV of the SFO.
97. We now believe that it is more appropriate to draw comparison with the penalties imposed under section 114(8) of the SFO which deals with unlicensed activities (i.e. breach of the obligation under the SFO to be licensed before carrying on an RA). In this regard, we now propose that:-
 - (a) notification should be given within the period prescribed by the notification rules when the notification level is reached; and

- (b) failure to notify the SFC would result in penalties which are on a par with those for unlicensed RA – (i) on conviction on indictment, liable to a fine of \$5 million and seven years imprisonment, or (ii) on summary conviction, liable to a fine of \$500,000 and two years imprisonment.

98. The notification process enables the SFC to have a regulatory handle over an SIP by entering the SIP on the SIP register and to have certain powers over it. Although there may be differences between an unlicensed person's activities which may be harmful to the investing public and the activities of an SIP who fails to meet the notification requirement which may result in a systemic risk not being properly managed, both activities should be subject to adequate regulatory oversight in order to ensure that risks they bring to the market are properly monitored. We therefore believe a breach of the obligation to notify the SFC of the notification level being reached is analogous to a breach of the licensing requirement for an RA, both resulting in the SFC not being able to exercise its regulatory oversight on their activities. In both cases, we are addressing the same mischief – i.e. persons carrying on certain activities must make themselves known to the SFC (either by notification for an SIP or by applying for a licence to carry on an RA), and thereby become subject to SFC's regulation.

Public disclosure of registered SIP identity

99. We have considered the merits and demerits of having a public register. One of the key objectives of the global reform of OTC derivatives agreed by the G20 leaders is to improve the transparency of the OTC derivatives market. Therefore it should be beneficial to financial stability if market players could be alerted to the fact that they are dealing with an SIP and hence can take suitable measures to mitigate the risks. This could be particularly important for dealing with SIPs in OTC derivatives transactions which are not subject to central clearing.
100. The proposed disclosure would be limited to (i) the identity of the SIP and (ii) the specific class of OTC derivatives transactions in respect of which the notification level has been reached. As no other information is disclosed (e.g. the position level or other portfolio information), any undesirable impact on SIPs should be limited. This strikes an appropriate balance between improving the transparency of the OTC derivatives market and protecting proprietary information of market players.

Regulatory powers over registered SIP

101. We now propose that either the SFC or the HKMA may by written notice require the SIP to provide information on –
- (a) its activities and transactions in OTC derivatives products;
 - (b) the risk management systems and policies established for such transactions; and
 - (c) other matters (which will be prescribed in the rules) – which may relate to other OTC derivatives transactions, and may not necessarily be in that specific class for which the SIP has crossed the notification threshold.

Further, the HKMA and SFC may also apply to the Court of First Instance for an inquiry into a failure to give the required information.

102. In addition, we propose that the SFC may, with the consent or at the request of the HKMA, require registered SIPs to take certain action in respect of their OTC derivatives positions and transactions under certain circumstances. Such action includes reducing or refraining from increasing position with respect to one or more specific classes, and/or collecting or posting additional collateral. The SFC may also request the registered SIP to restrict the use of collateral or to take any other action as directed. In this regard, we propose to reprimand and impose disciplinary fines up to an amount that is the higher of \$10 million or three times the gain or loss avoided as a result of failing to comply with the SFC's requirements.

Persons related to registered SIP

103. We said in our Supplemental Consultation Paper that we were considering whether the power to require an SIP to provide information should also be extended to cover information about positions and activities of persons related to the SIP. Our current thinking is that we do not intend to have a direct regulatory handle on SIPs' related parties; this would mean that the concept of "related person" would be excluded in our oversight of SIPs. Accordingly, we will not require an SIP to provide information relating to positions and activities of its related persons (including companies within the same group as the SIP). Having said that, we will monitor international developments on this area and will also gather further information to assess whether not including a "related person" for purposes of determining an SIP's threshold would potentially be subject to market abuse. We will further consult the market on the scope of an SIP should there be a need to do so.

Disciplinary powers and right of appeal of an SIP

104. We propose to introduce rights of appeal by SIPs against any decision to (i) enter its name on the register; (ii) refusal to deregister the SIP from the SIP register; or (iii) require the registered SIP to take specified action. We would like to clarify further that the right of appeal is also available in respect of any decision of the SFC to take disciplinary action against a person on the SIP register.
105. Time is of essence in ensuring that any specified action be taken to address systemic risk to the Hong Kong market. Thus, whilst the appeal process is available to the SIP, we propose that the directions issued by the SFC should take effect immediately and will not be delayed until after the appeal. This is to ensure that there is no adverse impact on the financial stability of Hong Kong. This is an appropriate balance between ensuring an SIP has the right to be heard and protecting the financial stability of Hong Kong.

IV. Concluding remarks and next steps

106. We are grateful for the many comments and suggestions submitted in response to our Supplemental Consultation Paper. These have been helpful in finalising the licensing regime for the new and expanded RAs and the oversight of SIPs.
107. We have been working with the Administration on the legislative amendments to implement the new OTC derivatives regime. In this regard, the Securities and Futures (Amendment) Bill 2013 (**the Bill**) was introduced to the Legislative Council in July 2013. Interested parties are also welcome to refer to the Bill which sets out provisions dealing with the matters discussed in the joint supplemental consultation paper, including the scope of new and expanded RAs, transitional arrangements, as well as the regulation of SIPs.
108. We are currently working on the detailed requirements of the new regime which will be set out in subsidiary legislation. We target to conduct a public consultation of these detailed requirements in the fourth quarter of 2013.

Appendix 1

List of Respondents

(in alphabetical order)

1. Alternative Investment Management Association Ltd, The
2. Anonymous – *one respondent requested that its identity not be published*
3. Anonymous – *one respondent requested that its identity and contents of its submission not be published*
4. Anonymous – *one respondent submitted two submissions and requested that one not be published*
5. Clifford Chance
6. Corporate Support (HK) Ltd
7. DBS Bank Ltd, Treasury & Markets, and HK Branch and DBS Bank (HK) Ltd
8. Deacons
9. FIX Protocol Ltd
10. Guardian Regulatory Consulting Ltd
11. Hong Kong Association of Banks, The
12. Hong Kong Investment Funds Association
13. Hong Kong Society of Financial Analysts
14. Hong Kong Trustees' Association Ltd
15. J.P. Morgan
16. Kinetic Partners (Hong Kong) Ltd
17. Linklaters
18. Lydia Tan