



Hong Kong

September 2017

SFC'S CONSULTATION CONCLUSIONS AND FURTHER CONSULTATION ON CHANGES TO FINANCIAL RESOURCES RULES

Introduction

On 24 July 2017, the Securities and Futures Commission (SFC) published consultation conclusions¹ on the proposed regulatory capital regime for licensed corporations (LCs) engaged in over-the-counter derivatives (OTCD) activities and other proposed changes to the Securities and Futures (Financial Resources) Rules (FRR).

New modifications to the proposed regime include reducing the minimum capital requirements for fund managers' central dealing desks meeting certain conditions and extending the transitional period for full compliance with the new FRR requirements from six months to one year. The SFC will also introduce an internal models approach benchmarking to the latest standards set by the Basel Committee on Banking Supervision.

Subject to the results of the further consultation on the proposals set out in the paper, amendment rules for implementing the proposals will be drafted for consultation. The SFC has attached for consultation in Appendix 1 the draft amendment rules on proposals not specific to OTCD activities, incorporating the revised proposed amendments relating to the 2011 consultation, which will be implemented separately once finalized. The draft amendment rules on the OTCD-related proposals will be published for consultation once available.

Capital regime and minimum capital requirements for LCs engaging in OTCD activities

Proposed minimum capital requirements for LCs licensed for Type 11 Regulated Activity (RA11 dealers) and Non-RA11 OTCD dealers²

The SFC proposed to apply the FRR's liquid capital regime to LCs engaging in OTCD activities and supplement the liquid capital requirement with a fixed-dollar baseline capital requirement (either a paid-up share capital or tangible capital requirement, depending on the nature of the OTCD activity conducted by the LC).

Type of OTCD dealers	Minimum paid-up share capital requirement	Minimum tangible capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC

¹ <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=15CP3>

² LC dealing in OTC derivative products exempt from licensing for Type 11 RA because it is already licensed for Type 1, 2 or 3 RA (Non-RA11 OTCD dealers)

<p>LC dealing in OTC derivative products and not approved to use the internal models approach</p> <ul style="list-style-type: none"> • R C C P - cleared OTCD dealers • Where the LC is not an RCCP-cleared OTCD dealer and qualifies for OTCD de minimis reduction • In any other case 	<p>HK\$30 million</p> <p>Not applicable</p> <p>Not applicable</p>	<p>Not applicable</p> <p>HK\$500 million</p> <p>HK\$1 billion</p>	<p>HK\$15 million</p> <p>HK\$78 million</p> <p>HK\$156 million</p>
<p>LC dealings in OTC derivative products and approved to use the internal models approach</p>	<p>Not applicable</p>	<p>HK\$2 billion</p>	<p>HK\$156 million</p>

The SFC proposes lower capital requirements for any OTCD dealer meeting the following conditions (**OTCD central dealing desk dealer**):

- a) In respect of any dealing in OTC derivative products it carries out, other than those carried out incidentally to any Type 9 RA for which it is licensed,
 - i) it only handles orders placed by:
 - an asset management company which is within the same group as it and is licensed for Type 9 RA; or

- an asset management company which is within the same group as it and carries on a business in a specified jurisdiction outside Hong Kong which, if carried on in Hong Kong, would constitute Type 9 RA, under an authorization by an authority or regulatory organization in that jurisdiction
- for client accounts in the course of carrying on the Type 9 RA or that business;
- ii) it does not hold client assets;
 - iii) it is not a contracting party to any OTCD transactions executed in the course of such dealing, whether as principal or agent;
 - iv) it will not incur any liability to the contracting parties to the OTCD transactions executed in the course of such dealing except for its own negligence, willful default or fraud; and
 - v) it does not carry out any market making activity in such dealing itself or on behalf of the asset management company referred to in (i) above or the clients of that asset management company.

The SFC proposes to subject OTCD central dealing desk dealers to a minimum paid-up share capital requirement of HK\$30 million and a floor required liquid capital (**RLC**) of HK\$15 million. It is also proposed to exclude these dealers from the application of Standardized Market Risk Approach (**SMRA**) and Standardized OTCD Counterparty Credit Risk Approach (**SOCCRA**), but to permit them to opt into SMRA and/or SOCCRA using the same mechanism that applies to other LCs.

The SFC also proposes relaxing the floor RLC of OTCD dealers that engage in limited OTCD activities (**OTCD de minimis reduction**) by setting the thresholds at 50% of the transitional, instead of final, US registration thresholds. It is proposed that in relation to the "OTCD" definition, FRR should adopt the Securities and Futures (Amendment) Ordinance 2014 (**SFAO**)'s definition of "Over-the-counter (**OTC**) derivative products". OTCD transactions which are incidental to the carrying on of the Type 9 RA the LC is licensed for should be excluded from the calculation of its OTCD activity level.

OTCD de minimis thresholds will be defined as:

- a) for OTC derivative transactions in credit default swaps, an aggregate gross notional amount of transactions which the LC entered into for its own or its client account or cleared for another person over the preceding 12 months, of HK\$32 billion;
- b) for OTC derivative transactions in security-based products, an aggregate gross notional amount of transactions which the LC entered into for its own or its client account or cleared for another person over the preceding 12 months, of HK\$1.6 billion; or
- c) for OTC derivative transactions other than those referred to in subparagraphs (a) and (b) above, an aggregate gross notional amount of transactions which the LC entered into for its own or its client account or cleared for another person over the preceding 12 months, of HK\$32 billion.

The SFC proposes to allow a three-month grace period for an LC which ceases to qualify for the OTCD de minimis reduction to acquire capital. The SFC also proposes requiring LCs seeking to rely on OTCD de minimis reduction to notify the SFC in writing within one business day of applying the reduced capital requirements confirming that their activity level does not exceed any of the OTCD de minimis thresholds, to carry out a comparison of their OTCD activity level with the OTCD de minimis thresholds on a semi-annual basis, as well as to notify the SFC in writing within one business day of becoming aware that their activity level exceeds any of the OTCD de minimis thresholds, and allowing a three-month grace period for LCs which cease to qualify for OTCD de minimis reduction to acquire capital.

Leveraged foreign exchange (**LFE**) traders whose LFE trading is confined to rolling forex trading purposes will continue to be subject to the existing minimum capital requirements that apply to Type 3 RA. The SFC will proceed to apply the proposed minimum capital requirements for regulated central counterparty (**RCCP**)-cleared RA11 dealers, as well as using a similar concept as qualifying central counterparty (**QCCP**) under the Basel Capital Accord as the benchmark for the definition of Regulated central counterparty (**Regulated CCP**).

Approval of CCPs as Regulated CCPs will be granted based on a set of qualifying criteria, benchmarked to the qualifying criteria for QCCP under the Basel Capital Accord subject to modifications to address the differences between the

FRR's liquid capital regime and the Basel Capital Accord, and include compliance with the Principles for Financial Market Infrastructures (**PFMI**) issued by the Committee on Payment and Market Infrastructures (**CPMI**) and International Organisation of Securities Commissions (**IOSCO**).

Proposed minimum capital requirements for RA11 advisers and non-RA11 OTCD advisers (collectively OTCD advisers)

LC advising on, but not dealing in, OTC derivative products	Minimum paid-up share capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
<ul style="list-style-type: none"> • Subject to the licensing condition of not holding client assets • In any other case 	Not Applicable HK\$5 million	HK\$100,000 HK\$3 million

The SFC will proceed to apply these requirements accordingly.

Proposed minimum capital requirements for Type 12 RA

Type 12 RA	Minimum tangible capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
<ul style="list-style-type: none"> • Where the LC qualifies for OTCD de minimis reduction • In any other case 	HK\$1 billion HK\$2 billion	HK\$195 million HK\$390 million

The OTCD de minimis thresholds that apply to LCs licensed for Type 12 RA will be benchmarked to the transitional US registration thresholds.

Proposed new component of variable RLC with regard to OTCD transactions

OTCD transactions arranged for clearing by an LC (instead of through the LC), which will not be liable to any liability arising from the OTCD transactions when any party involved in the clearing process defaults, shall not be included in the calculation of the LC's variable RLC. The floor initial margin amount calculation should be based on the potential future exposure calculated by the Current Exposure Method (CEM) in the absence of a margin amount independently calculated by a Regulated CCP.

Proposed minimum capital requirements for the new Type 7 activity

The new Type 7 activity	Minimum tangible capital requirement	Minimum liquid capital requirement = The higher of (i) variable RLC; and (ii) the following floor RLC
Provision of ATS for the trading of OTC derivative products	HK\$1 billion	HK\$156 million
Provision of ATS for the novation, clearing, settlement or guarantee of OTC derivative transactions	HK\$2 billion	HK\$390 million

The proposals as above will proceed to be implemented. Type 7 RA not involving the new Type 7 activity will be subject to the existing minimum capital requirements under the FRR.

Proposed minimum capital requirements for the new Type 9 activity

LCs carrying on the new Type 9 activity, OTC derivative products management, will be subject to the same minimum capital requirements for existing Type 9 RA. Asset managers licensed for the new Type 9 activity will be subject to the same

minimum capital requirements as Type 9 RA. If their dealing in OTC derivative products is incidental to the new Type 9 activity, they are exempt from licensing for Type 11 RA.

Impact analysis

The SFC has assessed the impact of the relevant proposed capital requirements on the above responding firms and existing OTCD dealing LCs by comparing their capital with the capital requirements proposed (next page):

Capital treatments for market risks of OTCD and other proprietary trading positions

Proposed SMRA

Capital relief will be provided to arbitrage portfolios referring to specified equity index. The following indices will be defined as the "specified equity index":

- Hang Seng Index;
- Hang Seng China Enterprises Index;
- FTSE 100 Index;
- S&P 500 Index;
- Nikkei Stock Average;
- Euro Stoxx 50 Index; and
- Any other index approved by the SFC as a "specified equity index".

The definition of "equity" will be modified to remove the condition that shares must be held for trading purposes from the definition in order that "equity" can include shares that are held by the LC as collateral or long term investment. "Equity" will therefore include shares issued by a corporation, shares in mutual funds and units in unit trusts. Investments in subsidiaries will be carved out from the standardized equity risk framework. The SFC will also subject non-investment grade and unrated debt securities to a specific risk charge based on the security's initial issuance size, and subject non-investment grade securitization/re-securitization to a 100% specific risk charge.

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Proposed capital requirements	Number (percentage) of relevant covered firms that can fulfill the proposed capital requirement and their aggregate OTCD market share	Number of relevant covered firms that could not fulfill the proposed capital requirement	Range of tangible capital/paid-up share capital shortfall of those firms referred to in column 3 (HK\$)	Range of liquid capital shortfall of those firms referred to in column 3 (HK\$)
OTCD Dealers				
<p>Paid-up share capital of HK\$30 million</p> <p>Floor RLC of HK\$15 million</p> <p>(i.e. proposed capital requirements for RCCP-cleared OTCD dealers not using the internal models approach and OTCD central dealing desk dealers)</p>	93 firms (89%), which in aggregate account for 99.8% of OTCD market share	<ul style="list-style-type: none"> • 6 firms were unable to meet both the paid-up share capital requirement and floor RLC • 2 firms were only unable to meet the paid-up share capital requirement • 3 firms were only unable to meet the floor RLC 	10 million to 25 million	3 million to 11 million
<p>Tangible capital of HK\$500 million</p> <p>Floor RLC of HK\$78 million</p> <p>(i.e. proposed capital requirements for non-RCCP-cleared OTCD dealers which qualify for OTCD de minimis reduction and not using the internal models approach)</p>	63 firms (61%), which in aggregate account for 99% of OTCD market share	<ul style="list-style-type: none"> • 29 firms were unable to meet both the tangible capital requirement and floor RLC • 11 firms were only unable to meet the tangible capital requirement • 1 firm was only unable to meet the floor RLC 	38 million to 495 million	4 million to 74 million
<p>Tangible capital of HK\$1 billion</p> <p>Floor RLC of HK\$156 million</p> <p>(i.e. proposed capital requirements for OTCD dealers not approved to use the internal models approach and not falling within any of the categories mentioned above)</p>	53 firms (51%), which in aggregate account for 96.9% of OTCD market share	<ul style="list-style-type: none"> • 35 firms were unable to meet both the tangible capital requirement and floor RLC • 15 firms were only unable to meet the tangible capital requirement • 1 firm was only unable to meet the floor RLC 	140 million to 995 million	16 million to 152 million

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<p>Tangible capital of HK\$2 billion</p> <p>Floor RLC of HK\$156 million</p> <p>(i.e. proposed capital requirements for OTCD dealers approved to use the internal models approach)</p>	<p>43 firms (41%), which in aggregate account for 90.27% of OTCD market share</p>	<ul style="list-style-type: none"> • 36 firms were unable to meet both the tangible capital requirement and floor RLC • 25 firms were only unable to meet the tangible capital requirement, with 10 of them having a tangible capital of more than HK\$1 billion 	<p>27 million to 1.99 billion</p>	<p>16.3 million to 151.7 million</p>
<p>Type 12 RA</p>				
<p>Tangible capital of HK\$2 billion</p> <p>Floor RLC of HK\$156 million</p> <p>(i.e. proposed capital requirements for OTCD dealers approved to use the internal models approach)</p>	<p>43 firms (41%), which in aggregate account for 90.27% of OTCD market share</p>	<ul style="list-style-type: none"> • None 	<p>Not applicable</p>	<p>Not applicable</p>
<p>Tangible capital of HK\$2 billion</p> <p>Floor RLC of HK\$390 million</p> <p>(i.e. proposed capital requirements for LCs in any other case) All 4 firms (100%)</p>	<p>All 4 firms (100%)</p>	<ul style="list-style-type: none"> • None 	<p>Not applicable</p>	<p>Not applicable</p>

New Type 7 activity				
<p>Tangible capital of HK\$1 billion</p> <p>Floor RLC of HK\$156 million</p> <p>(i.e. proposed capital requirements for LCs whose business involves the provision of ATS for the trading of OTC derivative products)</p>	2 firms (66.7%)	<ul style="list-style-type: none"> 1 firm was unable to meet both the tangible capital requirement and floor RLC 	1.96 billion	376 million
<p>Tangible capital of HK\$2 billion</p> <p>Floor RLC of HK\$390 million</p> <p>(i.e. proposed capital requirements for LCs whose business involves the provision of ATS for the novation, clearing, settlement or guarantee of OTC derivative transactions)</p>	2 firms (66.7%)	<ul style="list-style-type: none"> 1 firm was unable to meet both the tangible capital requirement and floor RLC 	1.96 billion	376 million

The original consultation paper proposed not to adopt the existing Basel treatment for a correlation trading portfolio. On 14 January 2016, the Basel Committee on Banking Supervision (**Basel Committee**) published a revised standardized market risk approach which includes a special treatment for the correlation trading portfolio, and hence the SFC will monitor international developments in this area.

In respect of non-marketable debt securities, a 100% specific risk charge on the higher of the market value of the total long position and total short position on an issue-by-issue basis will be applied. The proposals apply a higher capital charge on non-marketable debt securities. The charge percentage has been benchmarked to the Securities and Exchange Commission's Net Capital Rules. The "marketable debt securities" definition is proposed to be modified to include

The SFC proposes to modify the calculation of general risk charge for interest rate risk exposures in controlled currencies such that separate maturity ladders should be used for the onshore and offshore positions in a controlled currency respectively. The standardized foreign exchange risk charge will remain at 8%. Physical positions in illiquid investments should be assessed based on their liquidity status on the reporting date.

It is proposed to rename "freely convertible currency", which was defined as a currency other than a controlled currency, to which the Basel shorthand method shall be applied to determine the foreign exchange risk charge, to "freely floating foreign currency", and "controlled currency" to "non-freely floating foreign currency".

"Non-freely floating foreign currency" will be defined to mean a foreign currency in respect of which an authority of its jurisdiction specifies:

- a) the rate at which the currency is permitted by the authority to be converted into one or more other currencies; or
- b) a range of rates within which the currency is permitted by the authority to be converted into one or more other currencies.

Onshore and offshore positions in a non-freely floating foreign currency will be deemed as positions in the same currency for foreign exchange risk charge calculation purpose, such that opposite onshore and offshore positions could be offset, subject to a foreign exchange risk charge which equals to 1.5% of one side of the matched positions to cover execution risk and basis risk.

The calculation of net foreign currency position will include net spot positions as well as foreign exchange exposures arising from FX derivatives and non-FX derivatives. Foreign exchange exposures arising from non-FX derivatives do not include any foreign exchange exposures which have already been included in the net foreign currency position calculation in the form of assets or liabilities arising from the non-FX derivatives.

A standardized commodity risk framework will be adopted. Non-continuous options will not be excluded from the application of the standardized option risk framework, and will be subjected to the same capital treatments as proposed for non-standard instruments. The SFC will monitor the adequacy of the capital requirements of those LCs that have material exposures to volatile stocks and short-dated at-the-money options.

Certain prudential and capital requirements, including a Margin-based Charge and a Specified Market Risk Charge, will be adopted. A concentration risk charge will be imposed on concentrated proprietary positions.

The SFC seeks views on whether the offsetting of opposite positions should be disallowed if the proceeds upon realization of one of the opposite positions are subject to remittance control because the proceeds would not be readily available for meeting the LC's liabilities or obligations under the other position. The market risk charge would be calculated on one side of the matched positions under such circumstances.

Proposed Basic Market Risk Approach (BMRA)

The SFC sought views on whether the proposed capital charges for OTCD transactions are sufficient for addressing the market risk of OTCD for LCs which adopt BMRA. A prudent

market risk charge for non-cleared OTCD is necessary. For OTCD that are cleared by a Regulated CCP, the Margin-based OTCD Market Risk Charge will use the initial margin requirements applicable to the product as the objective basis of charge.

The SFC has proposed to adopt the definition of "OTC derivative product" under the SFAO for the FRR. The SFC also proposes to introduce into the BMRA the same concept of non-standard instruments as proposed under SMRA and apply similar capital charges.

The client facing affiliate (**CFA**) may retain the market risks of the OTCD transactions so entered or offload the risk to another group company – a risk booking affiliate (**RBA**) by entering into back-to-back OTCD transactions with the RBA. The OTCD dealer may periodically share all or part of the trading profit or loss caused by price movements on the transactions booked in the CFA/RBA (**trading profit/loss sharing arrangement**). Accordingly, it is imperative to ensure the OTCD dealer maintains sufficient capital to absorb the market risks associated with the transactions booked in the CFA/RBA that are indemnified by it. The SFC proposes to require any LC which has entered into a trading loss sharing arrangement with a group company to provide capital for the market risks of proprietary transactions booked in the group company that are covered by the trading loss sharing arrangement (**within-scope transactions**) in a timely manner. The LC will be required to calculate the proposed market risk capital charges as if the within-scope transactions were booked in the LC adopting the same market risk capital charge calculation approach (i.e. SMRA or BMRA) that applies to it. Where the LC is required to share only a portion of the trading losses of within-scope transactions or the maximum amount of loss shared is capped, it is proposed that the LC may similarly apportion or cap the total amount of market risk capital charges on the within-scope transactions subject to the SFC's approval. It is proposed to permit the LCs to reduce the market risk capital charges on the within-scope transactions up to the amount receivable from the group company concerned which has not been included in the LC's liquid assets. In the case where the LC shares only trading profits of the within-scope transactions but any profits shared may be clawed back by the group company before finalization, the LC may opt for excluding any interim profit shared from its liquid assets in lieu of undertaking the proposed market risk capital charges subject to the SFC's approval.

A separate consultation will be issued on new conduct and control standards for LCs using CFAs and RBAs.

Proposed mechanism for opting out of SMRA

LCs that are required to adopt SMRA and whose OTCD activity level does not exceed the OTCD de minimis thresholds will be permitted to opt out of SMRA and use BMRA to calculate market risk capital requirements.

Proposed mechanism for opting into SMRA

The LCs that do not engage in OTCD dealing/clearing/automated trading services (**ATS**) activities will be permitted to adopt SMRA to calculate market risk capital requirements provided that they can meet the same minimum capital requirements as an RA11 dealer.

Other comments on the proposed market risk frameworks

In view of the issuance of a revised standardized market risk approach by the Basel Committee in January 2016, it is proposed to allow LCs, subject to the SFC's approval, to apply the latest Basel standardized market risk approach that is in force to calculate capital charges for their market risks.

Capital treatments for counterparty credit risk arising from OTCD transactions

Proposed SOCCRA

The SFC will proceed to adopt the modified CEM to calculate counterparty credit risk exposures while monitoring the development of the new standardized approach for counterparty credit risk (**SA-CCR**) introduced by the Basel Committee.

The SFC proposes to allow LCs, subject to the SFC's approval, to apply the latest Basel standardized approach for counterparty credit risk.

For a Capital Market Services Charge calculation, the applicable margin requirement for a transaction which is not cleared through a Regulated CCP equals the highest of the respective margin requirements imposed by the LC, CCP, any clearing intermediary involved in the clearing process, and the potential future exposure (**PFE**) of the transaction calculated by CEM.

For the purposes of calculating CCR Charge under SOCCRA:

- a) in respect of a portfolio of Regulated CCP-cleared OTCD transactions which are subject to net margining by a Regulated CCP, the initial margin requirements imposed by the Regulated CCP should be used as the PFE; and
- b) in respect of a portfolio of OTCD transactions which are not cleared through a Regulated CCP, the higher/highest of the PFE calculated by using the PFE add-on factors and the initial margin requirements imposed by a non-Regulated CCP, the parties to the transactions or clearing intermediary should be used as PFE.

The SFC will proceed to apply the lower risk weights (that apply to a clearing member of a Regulated CCP) to a clearing intermediary which is a client of a clearing member of a Regulated CCP if certain conditions are met.

The proposed conditions for applying a 2% risk weight to exposures to clearing members of Regulated CCP are:

- a) The offsetting transaction between the clearing member and the CCP is identified by the CCP as a client transaction and collateral to support it is held by the CCP and/or the clearing member, as applicable, under arrangements that prevent any losses to the client due to: (i) the default or insolvency of the clearing member; (ii) the default or insolvency of the clearing member's other clients; and (iii) the joint default or insolvency of the clearing member and any of its other clients. The LC must have conducted a sufficient legal review and have a well-founded basis to conclude that, in the event of a legal challenge, the relevant courts and administrative authorities would find that such arrangements mentioned above would be legal, valid, binding and enforceable under the relevant laws of the relevant jurisdiction(s).
- b) The effect of relevant laws, regulations, rules, or contractual or administrative arrangements is that the offsetting transactions with the defaulted or insolvent clearing member are highly likely to continue to be indirectly transacted through the CCP, or by the CCP, if the clearing member defaults or becomes insolvent. In such circumstances, the LC's positions and collateral with the CCP will be transferred at market value unless the LC requests to close out the position at market value.

LCs will be required to calculate and include in their ranking liabilities a credit valuation adjustment (**CVA**) Charge in respect of their credit exposures to counterparties, CCP and clearing intermediaries. The clearing members of Regulated CCP can be exempt from the proposed CVA Charge, provided that those exposures are qualified to enjoy the 2% risk weight in SOCCRA.

A Counterparty Concentration Charge on exposures to individual OTCD counterparties in respect of non-centrally-cleared OTCD transactions has been proposed in the original consultation. The deduction of the amount of CCR Charge in respect of the current exposures of non-centrally-cleared OTCD transactions will be allowed from the corresponding aggregate uncollateralized current exposure in the Counterparty Concentration Charge calculation. The SFC also fine-tuned the proposed three-tier sliding scale for determining the Counterparty Concentration Charge percentage by assigning a 20% charge to counterparties with a risk weight of 50% and a 50% charge for counterparties with a risk weight higher than 50%.

The SFC proposes to allow the deduction of the amount of CCR Charges in respect of the current exposures of non-centrally-cleared OTCD transactions from the corresponding aggregate uncollateralized current exposure in the Liquidity Adjustment calculation.

It is proposed that the LC may include in liquid reserve cash, marketable debt securities with an issue rating which maps to credit quality grade 1, 2 or 3, and other liquid assets approved by the SFC for this purpose, subject to the following:

- a) the asset must be monetizable;
- b) the asset must not be overdue or in default;
- c) the asset must be free from encumbrances and there must be no regulatory, legal, contractual or other restrictions that inhibit the LC from liquidating, selling, transferring or assigning the asset;
- d) the value of the asset must be readily identifiable and measurable;
- e) the asset must be freely transferable and available to the LC and must not be subject to any liquidity transfer restriction;
- f) the asset must not be a subordinated debt security;

g) if the asset is a structured financial instrument, the structure of the instrument must be simple and standardized; and

h) the asset must be denominated in Hong Kong dollars or in a currency freely convertible into Hong Kong dollars.

Liquidity stress test results will have to be submitted to the SFC within three weeks after the calendar month in which the requirement to perform liquidity stress testing was triggered. The stress test will be based on the LC's positions and assets and liabilities as at the accounting cut-off date of the calendar month in which the requirement to perform liquidity stress testing was triggered. A 30-day time horizon should be applied in the stress test.

The SFC proposes to require LCs subject to specified liquidity risk management measures to establish liquid reserve and submit to the SFC their emergency funding plan within one month after the submission of their liquidity stress test results.

LCs will be allowed to cease carrying out the specified liquidity risk management measures if they did not trigger either the Counterparty Concentration Charge or Liquidity Adjustment in the preceding three months, with no expressed consent of the SFC. The LC will however need to file a notification within one business day of cessation of the specified liquidity risk management measures confirming the cessation and that both the Counterparty Concentration Charge and Liquidity Adjustment had not been triggered in the three months preceding the cessation. In all other cases, the specified liquidity risk management measures, once triggered, can only be ceased with the SFC's consent. LCs not applying SOCCRA but identified to be exhibiting high liquidity risk will be required to take out the specified liquidity risk management measures.

Uncollateralized receivables from affiliates in respect of current exposures of non-centrally-cleared OTCD transactions should be treated in the same way as third party exposures in the calculation of Counterparty Concentration Charge and Liquidity Adjustment and in the determination of the triggering event for imposing the specified liquidity risk management measures. Collateral posted for securing non-centrally-cleared OTCD transactions should not be included in the application of Counterparty Concentration Charge, Liquidity Adjustment and specified liquidity risk management measures.

The SFC proposes to allow LCs using SOCCRA to adopt the existing Basel comprehensive approach subject to certain modifications for calculation of the capital requirements for repo-style transactions. LCs adopting the proposed alternative treatment are also required to follow the same minimum standards for legal documentation and eligibility requirements, and haircut percentages for collateral received as for SOCCRA. The haircut percentages under SOCCRA (or the market risk charge percentage under SMRA if the exposure is not qualified as an eligible collateral under SOCCRA) instead of the haircut percentages under the Basel Capital Accord will be applied to the exposures. If LCs choose not to recognize the netting effects in calculating the capital charge, each transaction will be subject to a capital charge as if there was no netting agreement.

Proposed Basic OTCD Counterparty Credit Risk Approach (BOCCRA)

BOCCRA, a simpler approach than SOCCRA, is the default approach for LCs other than RA11 dealers, Non-RA11 OTCD dealers, LCs licensed for the new Type 7 activity and LCs licensed for Type 12 RA to treat counterparty credit risk of OTCD transactions.

The SFC proposes to apply a haircut of 0.16% on exposures to clearing members of Regulated CCP which fulfil the same conditions as those set out in SOCCRA for applying a 2% risk weight to exposures to clearing members of Regulated CCP. Where an LC is not protected from losses in the case where the clearing member and another client of the clearing member jointly default or become jointly insolvent, but all other conditions are met, the LC may apply a 0.32% haircut on the exposures to clearing members of the Regulated CCP concerned.

Proposed mechanism for opting out of SOCCRA

An “opt-out” mechanism will be adopted in the FRR: RA11 dealers, Non-RA11 OTCD dealers and LCs licensed for the new Type 7 activity or Type 12 RA will be permitted to adopt BOCCRA instead of SOCCRA if the level of their OTCD activities does not exceed the OTCD de minimis thresholds. All OTCD transactions entered into for the LC’s own or its client account or cleared for another person must be aggregated and included in the calculation of the LC’s aggregate gross notional amounts of OTCD transactions for the purpose of comparing the LC’s OTCD activities with the OTCD de minimis thresholds.

Proposed mechanism for opting into SOCCRA

An “opt-in” mechanism of SOCCRA for other LCs will be adopted.

Introduction of internal models approach

An internal models approach will be introduced into the FRR. LCs will be required to apply the applicable non-model-based market risk and counterparty credit risk approaches in the FRR before receiving the approval to use the internal models approach. The LC must continue to apply the applicable non-model-based market risk and counterparty credit risk approaches for those areas not covered by the approval. Model approval applicants should further ensure that they have the systems for calculating both model-based capital requirements and non-model-based capital requirements.

To be eligible for application for approval to use the internal models approach, the applicant will have to have a clean record of compliance with the FRR in the previous three years. A pragmatic approach will be adopted in considering the implication of past FRR breaches of the applicant, including but not limited to the nature and materiality of the breaches, the circumstances leading to the non-compliance and the rectification measures taken by the applicant to prevent further breaches.

The SFC will consider the need to impose a leverage ratio requirement on internal model users on a case-by-case basis. It will update the criteria for approval of use of the internal models approach and the related application guidelines to reflect the latest Basel standards for further consultation.

Measures to address operational risks of LCs engaging in certain regulated OTCD activities and LCs opting into the standardized approaches

OTCD dealers, LCs licensed to carry on the new Type 7 activity or Type 12 RA, and LCs opting into SMRA or SOCCRA will be required to annually conduct a self-assessment of their internal controls and risk management and to submit results to the SFC. The Self-Assessment Return will be subject to further changes.

Notification and other requirements

A number of additional notification and reporting requirements for LCs engaging in OTC or other derivative transactions will be added to remove the existing notification requirement under section 55(4) of the FRR.

Miscellaneous technical changes

Revised proposal – replacing the proposed cap on aggregate uncollateralized receivables from affiliated banks and brokers with a proposed control requirement

The SFC proposes a control requirement to address interconnectedness, which will require LCs to properly manage their financial exposures to affiliates in the same manner as exposures to independent third parties undertaken by the LCs on an arm's length basis.

Proposal on reducing reliance on external credit ratings

An assessment criterion will be included in the Self-Assessment Return, requiring an LC to supplement the consideration of external ratings with due diligence or other analysis by the LC in order to encourage it to conduct its own credit risk assessment.

Proposed treatment of currency subject to exchange control or assets the proceeds of which upon realization being subject to remittance control

An LC may disapply section 18(2) of the FRR to an amount of currency that is subject to exchange control and any asset the proceeds of which upon realization are subject to remittance control if such currency/asset can be freely applied to meet an existing liability or obligation of the LC which is settled in the same currency without needing to seek approval from the relevant authority.

Modified proposal on updating the list of specified exchanges

China Financial Futures Exchange will be added to the list of specified exchanges in the FRR. Dalian Commodity Exchange, Shanghai Futures Exchange, Shanghai International Energy Exchange and Zhengzhou Commodity Exchange are proposed to be included into the list of specified exchanges in Schedule 3 to the FRR.

Proposals to update haircut percentages for certain types of securities and commodities

An LC will be allowed to calculate the haircut percentage of the basket or index underlying equity-linked instruments or index funds tracking an equity or debt securities index on a weighted average basis after seeking the SFC's approval.

Structured funds and funds investing in financial derivative instruments will be subject to a 40% haircut. The haircut percentage of an index fund (including exchange traded funds) that tracks a debt securities index is proposed to be equal to the haircut percentage for its underlying debt securities index. A 100% haircut will be specified for illiquid investments and securities not specified in Schedule 2 to the FRR. Investments not specified in Schedule 2 to the FRR (i.e. investments other than specified investments) will also be subject to a 100% haircut.

The following incidental changes to the FRR will be made to clarify the treatment of illiquid investments and miscellaneous investments:

- a) the definitions of "marking to market", "floating losses", "floating profits" and "trade date" in section 2 of the FRR will be expanded to cover illiquid investments and miscellaneous investments;
- b) the definition of "haircut percentage" for listed shares will be amended to cease to apply to shares which are illiquid investments;
- c) securities and investments which are illiquid investments will be excluded from the definitions of "qualifying debt securities", "special debt securities", "specified securities" and "specified investments";
- d) section 8 (Accounting for transactions on trade date basis) of the existing FRR will be expanded to cover transactions in illiquid investments and miscellaneous investments;
- e) section 9 (Valuation of proprietary positions, etc.) of the existing FRR will be expanded to cover open positions in illiquid investments and miscellaneous investments;

- f) the scope of section 43(1) of the existing FRR will be expanded to cover short positions in illiquid investments and miscellaneous investments;
- g) the scope of section 43(2) of the existing FRR will be expanded to cover short positions in illiquid investments and miscellaneous investments; and
- h) section 43(3)(a) and (c) will be repealed following the expansion of the scopes of sections 43(1) and (2).

Modified proposal on treatment of financial instruments with leverage

In calculating the market risk charges and counterparty credit risk charges, the use of the effective notional amount of a product will be required instead of its stated notional amount. The definition of "haircut amount" will be amended to reflect the leverage embedded in a security or investment. A cap for the haircut amount at 100% of the market value is proposed for a security or an investment where the maximum possible loss on the position is capped at the market value.

Proposed treatment of amounts receivable in respect of dealings in securities

The wording relating to amounts receivable in respect of dealings in securities will be revised. In order to facilitate third party clearing by LCs, LCs are proposed to be allowed to include in their liquid assets:

- a) any amount receivable from a general clearing participant (**GCP**) of a recognized clearing house in respect of securities sales cleared by the GCP on a cash-against-delivery basis, which is not yet due for settlement according to the settlement date of the transaction; and
- b) where the LC is a GCP of a recognized clearing house, any amount receivable from a clearing client (including non-clearing participants of the recognized clearing house) on securities purchase cleared for the client on a cash-against-delivery basis, which is not yet due for settlement according to the settlement date of the transaction.

It is intended to allow an LC to set off its amounts receivable from and amounts payable to a GCP of a recognized clearing house under a netting arrangement only in exceptional

situations where the settlement risk is considered to be low after considering the financial status and default risk control of the GCP. Existing modifications in respect of the amended rule may be subject to review.

The SFC proposes to amend the FRR to clarify that in respect of clearing transactions, amounts receivable from and cash deposits with Euroclear, Clearstream and Korea Securities Finance Corporation can be admitted as liquid assets. Similar amendment is proposed for sections 28(3) and 29 of the FRR in respect of transactions cleared through future and option clearing houses and clearing participants and dealers.

New proposal – Treatment of client money received for settlement of client transactions

The SFC proposes to amend the FRR to allow LCs to include in liquid assets the client money held for settling outstanding securities transactions. The corresponding amount payable to the clearing house will continue to be included in the LC's ranking liabilities and variable RLC calculation.

New proposal – Treatment of underwriting fees receivable

The SFC proposes to amend FRR to allow underwriters to include in liquid assets any underwriting fee accrual or receivable not meeting the above conditions up to the amount of the corresponding accrued sub-underwriting fee liabilities or sub-underwriting fee payable by it, the settlement of which is contingent upon collection of the underwriting fee by the LC.

New proposal – Treatment of tenancy agreements for business premises

Due to recent changes in accounting standards, the SFC proposes to amend the FRR to allow an LC to exclude the amount of recognized liabilities arising from a tenancy agreement entered into by it in respect of any premises used in carrying on the regulated activity for which it is licensed from its ranking liabilities up to the amount of recognized assets arising from the tenancy agreement which is not included in its liquid assets. It is also proposed to exclude the amount of recognized liabilities, which has been excluded from ranking liabilities, from the variable RLC calculation.

New proposal – Revision of the scope of qualifying debt securities and special debt securities

The SFC proposes to remove the listing status on a recognized stock market as a qualifying criterion for qualifying debt securities and special debt securities.

The SFC proposes to amend the definition of “special debt securities” to replace the term “indexed bond” by “structured note”. It is proposed that the haircut percentage for structured notes should be the same haircut percentage as that applied to their permitted underlying. Only structured notes with simple structures will be accepted. It is proposed to amend the definition of “qualifying debt securities” to exclude structured products (other than (a) bonds with a coupon rate that has an inverse relationship to a money market or interbank reference interest rate that is widely quoted; or (b) inflation-linked bonds).

The SFC proposes to define in FRR the term “fixed rate coupon” as a coupon for which the interest is payable periodically calculated by reference to a predetermined fixed interest rate, and “floating rate coupon” as a coupon for which the interest is payable periodically calculated by reference to a variable interest rate that is reset periodically to equate to a money market or interbank reference interest rate that is widely quoted plus or minus a specified rate (if any).

The SFC also proposes to categorize in Table 5 (“Haircut percentages for qualifying or special debt securities, by remaining term to maturity”) of Schedule 2 to the FRR those debt securities that would qualify for the haircut percentages specified in Column (I) as “category 1 qualifying or special debt securities”, which will cover qualifying or special debt securities with a fixed rate coupon or a floating rate coupon, except bonds with: (a) no maturity date; or (b) remaining term to maturity over 30 years (collectively referred to as “excluded bonds”). These excluded bonds and any other qualifying or special debt securities will be categorized as “category 2 qualifying or special debt securities” and subject to the haircut percentages specified in Column (II).

Remaining term to maturity	Category 1 qualifying or special debt securities Haircut Percentage %	Category 2 qualifying or special debt securities Haircut Percentage %
(a) Less than 6 months	1	1
(b) 6 months to less than 3 years	3	3
(c) 3 years to less than 5 years	4	5
(d) 5 years to less than 10 years	7	10
(e) 10 years or more, or infinite	10	22

New proposal – Haircut percentage for constituents of Hang Seng Composite LargeCap Index

The SFC has concluded that the Hang Seng Composite LargeCap Index may justify a haircut percentage of 20% and exemption from being classified as illiquid collateral. There will be no lower haircut percentage applied to Hang Seng Composite MidCap Index constituents.

New proposal – Treatment of opposite onshore and offshore positions in non-freely floating foreign currency

It is proposed to apply a new capital charge in the form of ranking liabilities which equals 1.5% of one side of the matched onshore and offshore positions in a non-freely floating foreign currency that has been set off in the net position calculation to cover execution and basis risks.

New proposals – Sundry technical changes

The following technical changes to the FRR which are not specific to OTCD activities are proposed:

- a) the definitions of “gross foreign currency position” and “net position” in a foreign currency in sections 2 and 52(3) of the FRR will clarify that all amounts of the foreign currency in respect of which the LC

- is exposed to the risk of a decline or rise in the value of the foreign currency under outstanding contracts shall be included in the calculation of these positions;
- b) the definition of “in-the-money amount” in section 2(1) of the FRR will be expanded to cover index options;
 - c) the use of fair value determined in accordance with generally accepted accounting principles as the basis for valuation of securities, investments, derivative contracts etc. will be allowed, if no published market price is available, and the valuation basis provided in section 9 of the FRR will be rationalized, including short positions in suspended listed securities and non-marketable debt securities will be valued at the higher of their fair value and last closing price before the suspension of trading/face value;
 - d) in item 1(a) of Table 2 in Schedule 2 to the FRR, the Nikkei 500 Index will be replaced by the Nikkei Stock Average;
 - e) the amount required to be included in ranking liabilities under section 47(1)(a)(i) of the FRR in respect of underwriting transactions will be capped at the amount of net underwriting commitment, which is the maximum possible loss under a securities underwriting transaction;
 - f) the definition of “segregated account” in section 2(1) of the FRR will specify that the segregated account is established and maintained by the LC concerned;
 - g) section 37(a) of the FRR will be expanded to allow an LC to exclude from its ranking liabilities amount payable to any of its clients in respect of client money held by it in a segregated account maintained with a person approved by the SFC for the purposes of section 4(2) of the Securities and Futures (Client Money) Rules;
 - h) the definitions of “qualifying debt securities” and “special debt securities” in section 2(1) of the FRR, section 58(2)(b) and Table 4 of Schedule 2 to the FRR will be amended to recognize credit ratings issued by Fitch Ratings;
 - i) the haircut percentage tables for shares will be combined and streamlined to better reflect the policy of allowing LCs to elect a lower applicable haircut percentage for shares which are listed on more than one exchange; and
 - j) clarification of the applicability of various FRR provisions to listed options (such as listed warrants) and other options will be made.

Transitional arrangements

The transitional period for full compliance with the new FRR requirements by pre-existing Non-RA11 OTCD dealers is proposed to be set to one year (**the FRR transitional period**) using a phase-in approach, as well as for LCs deemed to be licensed for the new Type 7 activity, Type 11 RA or Type 12 RA.

The LCs approved to use the internal models approach will be subject to the applicable minimum capital requirements immediately upon the grant of the approval.

The table below summarizes the revised transitional arrangements for the compliance with the new FRR requirements:

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	FRR requirement	During the first 6 months beginning from the commencement date of the FRR amendments ("Commencement Date")	Between the 7th month and 12th month from the Commencement Date	After the end of the FRR transitional period
A pre-existing Non-RA11 OTCD dealer	<p>Fixed-dollar baseline capital requirement and floor RLC</p> <p>Approaches to calculate capital for market risk and counterparty credit risk</p>	<ul style="list-style-type: none"> Subject to existing paid-up share capital requirement and floor RLC BMRA and BOCCRA Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements as an LC licensed for Type 11 RA to carry on dealing in OTC derivative products 	<ul style="list-style-type: none"> OTCD dealers (other than RCCP-cleared OTCD dealers and OTCD central dealing desk dealers): <ul style="list-style-type: none"> i) if the level of OTCD activities does not exceed OTCD de minimis thresholds: HK\$250 million tangible capital requirement and HK\$39 million floor RLC ii) in any other case: HK\$500 million tangible capital requirement and HK\$78 million floor RLC RCCP-cleared OTCD dealers and OTCD central dealing desk dealers: HK\$30 million paid-up share capital requirement and HK\$15 million floor RLC BMRA and BOCCRA Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements as an LC licensed for Type 11 RA to carry on dealing in OTC derivative products 	<ul style="list-style-type: none"> Subject to all new FRR requirements
	Other FRR requirements	<ul style="list-style-type: none"> Applicable 	<ul style="list-style-type: none"> Applicable 	

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<p>LCs deemed to be licensed for the new Type 7 activity, Type 11 RA (dealing in OTC derivative products) or Type 12 RA</p>	<p>Fixed-dollar baseline capital requirement and floor RLC</p>	<ul style="list-style-type: none"> • Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> • OTCD dealers (other than RCCP-cleared OTCD dealers and OTCD central dealing desk dealers): <ul style="list-style-type: none"> i) if the level of OTCD activities does not exceed OTCD de minimis thresholds: HK\$250 million tangible capital requirement and HK\$39 million floor RLC ii) in any other case: HK\$500 million tangible capital requirement and HK\$78 million floor RLC • RCCP-cleared OTCD dealers and OTCD central dealing desk dealers: HK\$30 million paid-up share capital requirement and HK\$15 million floor RLC • New Type 7 activity (trading): HK\$500 million tangible capital requirement and HK\$78 million floor RLC • New Type 7 activity (novation, clearing, settlement): HK\$1 billion tangible capital requirement and HK\$195 million floor RLC • Type 12 RA: HK\$1 billion tangible capital requirement and HK\$195 million floor RLC • BMRA and BOCCRA • Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements • Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements 	
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	Approaches to calculate capital for market risk and counterparty credit risk	<ul style="list-style-type: none"> Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> BMRA and BOCCRA Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements
	Other FRR requirements	<ul style="list-style-type: none"> Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> Applicable
LCs deemed to be licensed for the new Type 9 activity and Type 11 RA (advising on OTC derivative products)	Fixed-dollar baseline capital requirement and floor RLC	<ul style="list-style-type: none"> Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> Applicable
	Approaches to calculate capital for market risk and counterparty credit risk	<ul style="list-style-type: none"> Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> BMRA and BOCCRA Option to adopt SMRA and SOCCRA if meeting the new minimum capital requirements as an LC licensed for Type 11 RA to carry on dealing in OTC derivative products
	Other FRR requirements	<ul style="list-style-type: none"> Not applicable if not licensed for any other RA (Note 1) 	<ul style="list-style-type: none"> Applicable
All other LCs	<ul style="list-style-type: none"> Subject to all applicable new FRR requirements on the Commencement Date 		

For the avoidance of doubt, firms licensed for one or more than one existing RA shall continue to be subject to the capital requirements, including any new FRR requirements that apply to their existing RAs on the Commencement Date.

The SFC welcomes LCs and firms planning to apply for a licence for carrying out regulated OTCD activities to plan ahead for the implementation of the new FRR requirements and share with the SFC any major implementation issues they envisaged or encountered during their testing.

Comments received in relation to the consultation paper issued in 2011

A consultation was conducted on 4 May 2011 (**2011 consultation**) on a proposal to (i) add four futures exchanges: Hong Kong Mercantile Exchange Limited (**HKMEx**), Taiwan Futures Exchange Corporation, Thailand Futures Exchange Public Company Limited and Tokyo Commodity Exchange, Inc., to the list of specified exchanges in Schedule 3 to the FRR; (ii) to include participants of HKMEx in the definition of “exchange participant” in section 2(1) of the FRR; and (iii) to update the names of certain exchanges specified in the FRR that have changed their names. The consultation conclusion was put on hold following the cessation of business of HKMEx.

The SFC proposes to include a new provision in the FRR to ensure that a reference to an exchange or a clearing house in the FRR will survive any subsequent name change of the exchange/clearing house or any succession of the exchange/clearing house by another exchange/clearing house. Given that HKMEx’s ATS authorization has been withdrawn, HKMEx will not be included in the list of specified exchange as originally proposed.

The SFC updated the related proposed FRR amendments in the 2011 consultation, i.e. the Proposed Securities and Futures (Financial Resources) Amendment (No.2) Rules 2011, to reflect the subsequent changes of the names of some exchanges and market development, and included the updated amendments in Appendix 1 to the Consultation Paper for further consultation.

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