



Hong Kong

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SFC PUBLISHES CONSULTATION CONCLUSIONS ON OTC DERIVATIVES AND CONDUCT RISKS

Introduction

On 12 December 2018, Hong Kong's securities regulator, the Securities and Futures Commission (**SFC**) issued its consultation conclusions¹ on amendments to the Hong Kong code of conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Hong Kong Code of Conduct**) to:

- introduce new requirements on over-the-counter (**OTC**) derivatives in relation to derivative risk mitigation and client clearing;
- impose conduct requirements to address risks posed by group affiliates; and
- make a consequential amendment on client agreement requirements (**Consultation Conclusions**).

The SFC will publish the consultation conclusions on amendments to the Securities and Futures Ordinance (**SFO**) and subsidiary legislation with respect to the new regulated activities types 11 (dealing or advising in OTC derivative products) and 12 (providing clearing agency services for OTC derivatives transactions) separately.

¹ <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR141>

SFC. Consultation Conclusions on (1) the OTC derivatives regime for Hong Kong – Proposed requirements in relation to OTC derivative risk mitigation and client clearing; and (2) Proposed conduct requirements to address risks posed by group affiliates. December 2018. <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP9>

1. New risk mitigation requirements in relation to non-centrally cleared OTC derivatives

New paragraph 4.3A to the Hong Kong code of conduct will require SFC licensed corporations which enter into **non-centrally cleared OTC derivative transactions** to implement specified risk mitigation requirements. The SFC licensed corporations subject to specified risk mitigation requirements are set out in a new Schedule 10 to the Hong Kong code of conduct.

Under Part I of Schedule 10, the specified risk mitigation requirements will apply to:

- i) an SFC licensed corporation (regardless of the regulated activity for which it is licensed) which is a contracting party to OTC derivative transactions that are not centrally cleared, irrespective of the SFC licensed corporation's outstanding notional amount of non-centrally cleared OTC derivatives or whether or not the transaction is executed for hedging purposes; and
- ii) a type 9 licensed corporation (**Asset Manager**) which manages a portfolio of OTC derivatives for a collective investment scheme managed by it, in respect of non-centrally cleared OTC derivative transactions executed by it on behalf of the collective investment scheme managed by it, except to the extent that the risk mitigation requirements are handled by the governing body of the collective investment scheme or its delegate.

Asset Managers should note that the definition of “collective investment scheme” under the SFO is broad. It includes retirement schemes and other arrangements, in addition to investment funds.

OTC derivatives which are centrally cleared, either directly or indirectly, are not subject to the new risk mitigation requirements. Indirect clearing is an arrangement whereby an SFC-licensed corporation provides client clearing services by clearing a client’s OTC derivative transactions through another clearing intermediary. In the Consultation Conclusions, the SFC also clarified that the risk mitigation obligations are not applicable:

- iii) if an Asset Manager executes transactions on the instructions of its overseas affiliates (e.g. it is performing a dealing activity, rather than an asset management activity); and
- iv) to discretionary accounts, although the SFC encourages an Asset Manager to adopt the risk mitigation requirements for discretionary accounts to the extent practicable.

Where an Asset Manager that manages a collective investment scheme enters into a non-centrally cleared OTC derivative transaction and the trade is executed by another group company, the SFC expects that the Asset Manager should review whether appropriate procedures are in place to achieve a similar risk mitigation outcome.

Risk mitigation requirements

The SFC takes a principles-based approach. The following risk mitigation requirements are framed as high level principles in Part I of new Schedule 10 to the Hong Kong code of conduct.

i) Trading relationship documentation

An SFC licensed corporation is required to execute written trading relationship documentation (which should include all material terms governing the trading relationship) with its counterparties prior to, or contemporaneously with, executing a non-centrally cleared OTC derivative transaction.

ii) Trade confirmation

An SFC licensed corporation should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared OTC derivative transactions are confirmed in writing as soon as practicable after execution of a transaction. An SFC licensed corporation may use one-way confirmation instead of two-way confirmation insofar as agreed by both parties in advance.

iii) Valuation

An SFC licensed corporation should agree with its counterparty in writing on the process for determining the value of non-centrally cleared OTC derivatives in a predictable and objective manner at any time from the execution of the transaction to the termination, maturity, or expiration thereof. The valuation determinations should be based on economically similar transactions or other objective criteria.

Where an SFC licensed corporation uses a proprietary valuation model, it must use a model employing valuation methodologies with mainstream acceptance. If new methodologies are used, these should have a sound theoretical basis and the SFC licensed corporation will need to justify their use, e.g. by showing that the new methodology addresses a limitation of an existing methodology or improves the reliability of the valuation.

An SFC licensed corporation with material exposures to non-centrally cleared OTC derivative transactions is required to perform periodic reviews of the agreed-upon valuation process having regard to changes in market conditions.

The valuation requirements only apply to an Asset Manager that is responsible for the overall operation of a fund or has been delegated responsibility for fund valuation.

iv) Portfolio reconciliation

An SFC licensed corporation should establish and implement policies and procedures to ensure that the material terms are exchanged and valuations (including variation margin) are reconciled with counterparties, at regular intervals. The frequency

of portfolio reconciliation with each counterparty should be commensurate with the counterparty's risk exposure profile.

v) Portfolio compression

An SFC licensed corporation is required to establish and implement policies and procedures to regularly assess and engage in portfolio compression as appropriate in respect of non-centrally cleared OTC derivative portfolios. This should be proportionate to the level of exposure or activity of the SFC licensed corporation.

vi) Dispute resolution

An SFC licensed corporation should agree in writing with its counterparties (other than those who are individuals) on the mechanism for determining when discrepancies in trade populations, material terms, valuations and margins should be considered disputes, and the ways to resolve disputes as soon as practicable.

Implementation date

In order to allow the industry time to implement the necessary operational and systemic changes to comply with the new requirements, new paragraph 4.3A and Schedule 10 to the Hong Kong code of conduct will come into effect on **1 September 2019**.

2. New client clearing requirements in relation to OTC derivatives

The new client clearing requirements are set out in Part II of Schedule 10. They apply to licensed persons which provide client clearing services for OTC derivative transactions, irrespective of whether the licensed person itself is a clearing member of a central clearing counterparty. The clearing requirements do not apply to registered institutions. The requirements include:

i) Segregation and portability

Where a licensed person provides its client with different methods of client asset segregation offered by a particular central counterparty, the licensed person must fully inform each client about the different methods.

For cleared OTC derivative transactions, a SFC licensed corporation should segregate collateral belonging to clients from the SFC licensed corporation's proprietary assets. A licensed person should not apply any monies, securities or any other form of collateral that is standing to the credit of any client's ledger account for the benefit of its own position accounts, accounts of its directors or employees or accounts of any corporations with which the licensed person is in a controlling entity relationship.

Where a licensed person enters into a client clearing agreement with its client, it should provide for the transfer of the client's positions and collateral of the client's cleared transactions both in the normal course of business and (where the licensed person is also a clearing member of a central counterparty) following the licensed person's default, subject to the applicable legal framework and requirements of the relevant central counterparty.

ii) Indirect clearing

Where a licensed person provides client clearing services to its clients by submitting the client's OTC derivative transactions for clearing through one or more clearing intermediaries, it should notify each client of the name of each clearing intermediary (including the clearing member) and the central counterparty. The licensed person should also explain to each client the asset segregation arrangement between the licensed person and the clearing intermediaries in relation to the client's transactions, and the corresponding legal implications.

iii) Clearing confirmation to clients

A licensed person should provide a clearing confirmation to its client no later than the end of the following business day after acceptance of the client's OTC derivative transaction for clearing by the central counterparty.

Implementation Date

The new client clearing requirements will come into force when the new types 11 and 12 regulated activities take effect.

3. New conduct requirements to address risks posed by group affiliates and other connected persons

Requirement for SFC licensed corporations to manage financial exposure to group affiliates and other connected persons

New paragraphs 20.1 to 20.5 will be added to the Hong Kong code of conduct. Paragraph 20.1 requires an SFC licensed corporation to manage financial exposures to group affiliates and other connected persons, including its shareholders, directors and employees, according to the same risk management standards it would apply in respect of financial exposures to independent third parties undertaken on an arm's length basis. The requirement does not however apply where the effect of its application would be to override an applicable requirement or exemption under any law, rule or regulation administered or issued by the SFC or the regulators (if any) of the group affiliates or other connected persons in respect of the exposure or transaction giving rise to the exposure.

Requirements when soliciting or recommending clients to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and clients

Where a licensed person solicits or recommends its clients who are not its group affiliates to enter into OTC derivative transactions with a group affiliate, or arranges for OTC derivative transactions to be entered into between a group affiliate and its clients that are not its group affiliates, it should comply with the following requirements:

i) Best interest requirement

A licensed person is required to act in the clients' best interests. The SFC reiterated in the Consultation Conclusions that this requirement applies independently of all other requirements in the Hong Kong code of conduct.

ii) Regulated client facing group affiliates (CFAs) requirement

A licensed person should make such solicitation, recommendation or arrangement only if the group affiliate is an SFC licensed corporation, an authorised financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD overseas jurisdiction.

A licensed person is exempt from this requirement if the client is an SFC licensed corporation, an authorised financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD overseas jurisdiction.

A comparable OTCD jurisdiction means a jurisdiction having implemented a regulatory framework on OTC derivative dealing activities comparable to Hong Kong's. Based on the SFC's preliminary assessment, the list of deemed comparable OTCD jurisdictions will include the securities, futures and banking regulators in Australia, Canada, Mainland China, France, Germany, Italy, Japan, the Netherlands, the Republic of Korea, Singapore, Spain, South Africa, Switzerland, the UK and the US. The SFC will keep in view the need to update the list and the comparability assessments to make a final list of comparable OTCD jurisdictions.

iii) Risk disclosure requirement

Where the group affiliate is not an SFC licensed corporation, a licensed person should provide clients with an appropriate risk disclosure statement in their client agreements. Client agreements must contain, at a minimum, a statement reminding clients of the risks of entering into OTC derivative transactions with an unlicensed person in the form set out in Schedule 1 to the Hong Kong code of conduct.

Requirement for SFC licensed corporations booking OTC derivative transactions in group affiliates

There are new risk management requirements for SFC licensed corporations which arrange for OTC derivatives to be booked in a group affiliate which is not an SFC licensed corporation, authorised financial institution or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD jurisdiction. The risk management requirements apply where an SFC licensed corporation arranges for such a group affiliate to enter into OTC derivative transactions: (i) with the SFC licensed corporation's clients; (ii) on a back-to-back basis against a client transaction; and (iii) with another group affiliate on a back-to-back basis against OTC derivative transactions entered into by that other group affiliate with its clients under

the solicitation, recommendation or arrangement of the SFC licensed corporation. The obligations on the SFC licensed corporation are as follows:

- i) where it is responsible for or oversees risk management, to ensure that risks are properly managed; or
- ii) in any other case, to take reasonable steps to ensure the risks are covered by a risk management programme. The standards of the risk management programme should not be less stringent than those set by the SFC for SFC licensed corporations, by the Hong Kong Monetary Authority for authorised financial institutions, or by a securities, futures, or banking regulator in a comparable OTCD jurisdiction for OTC derivative dealers or banks entering into similar transactions.

Implementation date

All the new conduct requirements to address risks posed by group affiliates and other connected persons will take effect on **14 June 2019**, except that there will be a transitional period in respect of the new requirement of regulated CFAs. A transitional period will be available for compliance by existing CFAs with the requirement that they must be regulated (by the SFC or HKMA or similarly regulated in a comparable overseas jurisdiction as OTC derivative dealers or banks) where they are introduced by SFC licensed corporations to enter into OTC derivative transactions with clients. The SFC has clarified that an existing CFA is a CFA which has an ongoing introduction agreement with an SFC licensed corporation within the same group which was established and in effect before 12 December 2018, whereby the SFC licensed corporation agrees to introduce clients to enter into OTC derivative transactions with the CFA. This transitional period will end with the six-month transitional period for type 11 regulated activity.

During the transitional period, the requirement for regulated CFAs will not apply to recommendations, solicitations and arrangements in relation to existing CFAs. Nevertheless, the SFC expects SFC licensed corporations to implement reasonable measures to safeguard their clients against the conduct and prudential risks of such existing CFAs. The SFC also reminds SFC licensed corporations to fully inform their clients about the regulated or unregulated status (as the case may be) of their CFAs in the risk disclosures.

4. Modified note to paragraph 6.2(i) of the Hong Kong code of conduct

Paragraph 6.1 of the Hong Kong code of conduct requires a licensed or registered person to enter into a written agreement with each client before providing services to the client (**Client Agreement**). Paragraph 6.2(i) stipulates that the following clause must be included in a Client Agreement:

- iii) "If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause."

A consequential amendment to the note to paragraph 6.2(i) will define "financial product" by reference to its meaning under the SFO. As a result, the client agreement requirement under paragraph 6.2(i) will apply to recommendations or solicitations of OTC derivative products under the new types 11 and 12 regulated activities when they take effect.

The SFC notes in the Consultation Conclusions that paragraph 6.2(i) will only apply to financial products in the context of regulated activities carried on by licensed or registered persons.

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