



## II. REPORT

The date of First Reading of the Bill is 10 July 2013. Members may refer to the LegCo Brief (File Ref.: SUB 12/2/7 (2013)) issued by the Financial Services Branch of the Financial Services and the Treasury Bureau on 26 June 2013 for further details.

### Object of the Bill

2. To amend the Securities and Futures Ordinance (Cap. 571) (SFO) to -

- (a) provide for the regulation of activities and other matters connected with over-the-counter (OTC) derivative products;
- (b) amend Part III of SFO in relation to the power of recognized clearing houses to make rules to cater for certain circumstances;
- (c) amend Part XV of SFO in relation to the requirements of certain notifications and reports to be filed electronically; and
- (d) provide for the courts' power to make disgorgement orders in respect of market misconduct offences,

and to amend the Organized and Serious Crimes Ordinance (Cap. 455) (OSCO) concerning orders such as confiscation orders for market misconduct offences under SFO.

### Background

3. According to paragraphs 2 to 4 of the LegCo Brief, the global financial crisis of 2008 revealed structural deficiencies in the OTC derivative market. In September 2009, the Group of Twenty (G20) Leaders committed to certain reforms of OTC derivative transactions. Market players in all major markets are gearing up for the implementation of the new regulatory requirements such as the United States, Europe, Japan and Singapore.

4. According to the Administration, authorized financial institutions<sup>1</sup> (AIs), approved money brokers<sup>2</sup> (AMBs) and licensed corporations<sup>3</sup> (LCs) are

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<sup>1</sup> It has the same definition as "authorized institution" in the Banking Ordinance (Cap. 155) (BO), which means a bank (i.e. a company which holds a valid banking licence), a restricted licence bank (i.e. a company which holds a valid restricted banking licence) and a deposit-taking company (i.e. a company which is currently registered).

<sup>2</sup> It is defined in BO to mean a money broker which holds a valid certificate of approval attached to a notice under section 118C(1)(a) served on a company.

<sup>3</sup> It is defined in SFO to mean a corporation which is granted a licence under section 116 or 117 of SFO.

the main players in the OTC derivative markets. Under the proposed regime, the regulatory authorities are the Securities and Futures Commission (SFC) and the Monetary Authority (MA), with SFC regulating the OTC derivative activities of LCs and other prescribed persons (such persons to be prescribed by subsidiary legislation) and MA regulating such activities of AIs and AMBs.

## **Provisions of the Bill**

### ***Regulation of OTC derivative products and transactions***

5. Clause 52 of the Bill adds, among others, a new section 1B to Part 1 of Schedule 1 of SFO to define the meaning of OTC derivative product as a structured product<sup>4</sup> except certain products specified in the new section 1B(2).

6. Clause 9 adds a new Part IIIA (new sections 101A to W) to SFO relating to obligations and requirements regarding OTC derivative transactions.

### **Mandatory reporting, clearing and trading obligations**

7. Under the proposed new section 101B, AIs, AMBs, LCs and persons to be prescribed by subsidiary legislation (collectively, the "prescribed persons") must report certain OTC derivative transactions to MA unless exempted under the proposed new section 101G. MA may by a written notice specify subsidiaries of AIs incorporated in Hong Kong for the purpose of complying with such reporting obligation, whether such subsidiaries are incorporated in or outside Hong Kong.

8. Under the proposed new section 101C, the prescribed persons must clear certain OTC derivative transactions with a designated CCP<sup>5</sup> unless exempted under the proposed new section 101G. MA may by a written notice specify subsidiaries of AIs incorporated in Hong Kong for the purpose of complying with such clearing obligation, whether such subsidiaries are incorporated in or outside Hong Kong.

9. Under the proposed new section 101D, the prescribed persons must execute certain OTC derivative transactions only on a designated trading platform<sup>6</sup> unless exempted under the proposed new section 101G. MA may by a written notice specify subsidiaries of AIs incorporated in Hong Kong for

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<sup>4</sup> The meaning of "structured product" is provided in section 1A of Part 1 of Schedule 1 of SFO.

<sup>5</sup> Under the proposed new section 101A, a designated CCP refers to a person designated as a central counterparty by SFC (with the consent of MA and after consultation of the Financial Secretary) under the proposed new section 101I.

<sup>6</sup> Under the proposed new section 101A, a designated trading platform refers to a person designated as a trading platform by SFC (with the consent of MA and after consultation of the Financial Secretary) under the proposed new section 101J.

the purpose of complying with such trading obligation, whether such subsidiaries are incorporated in or outside Hong Kong.

10. SFC may, with the consent of MA and after consultation with the Financial Secretary, designate CCPs and trading platforms (the proposed new sections 101I and 101J).

11. Under the proposed new sections 101E and 101F, a maximum fine of \$5,000,000 may be imposed by the Court of First Instance (CFI) on the prescribed person who breaches any of the above 3 mandatory obligations. Application to the Court of First Instance is to be made by MA for breaches by AIs and AMBs; and by SFC for breaches by prescribed persons other than AIs and AMBs.

#### Regulation of "systemically important participants"

12. Under the proposed new sections 101A and 101O(1), systemically important participants (SIPs) are persons who engage in OTC derivative transactions but are not AIs, LCs and AMBs and whose position in respect of a specific class of OTC derivative transactions has reached the prescribed threshold that requires notification to SFC.

13. Failure to give such notification to SFC within a specified period by a SIP, without reasonable excuse, constitutes a criminal offence and punishable with a fine up to \$5,000,000 and up to 7 years' imprisonment.

14. Under the proposed new section 101P, SFC must maintain a register of SIPs. Under the proposed new section 101T(1), SFC has the power to require information from registered SIPs and the proposed new section 101T(2) gives the same power to MA. Under the proposed new section 101U, SFC has the power to require a registered SIP to take certain actions such as to refrain from increasing, or to reduce, the registered SIP's positions in one or more specific classes if SFC has reasonable cause to believe that the registered SIP's activities or transactions in OTC derivative products pose, or may pose, a systemic risk in the securities and futures industry or to the financial stability of Hong Kong. The proposed new section 101V gives the power to SFC and MA to apply to CFI for an inquiry into the failure to comply with a requirement imposed under the proposed new sections 101T or 101U.

#### Two new regulated activities in relation to OTC derivative

15. Clause 53 of the Bill amends Schedule 5 of SFO to add two new regulated activities (RAs) in relation to OTC derivative products, namely (a) a new Type 11 RA to cover the activities of dealers and advisers, and (b) a new Type 12 RA to cover the activities of clearing agents, and to expand the existing

Type 9 RA (asset management) and Type 7 RA (provision of automated trading services) to cover OTC derivative portfolios and transactions respectively. The purpose is for SFC to regulate the provision of services in relation to OTC derivative products and transactions by entities that are not AIs and AMBs.

16. Clause 55 adds a new Schedule 11 to provide transitional arrangements for the new and expanded RAs, so that the relevant persons who are already serving in the OTC derivative market may continue to do so for a limited period of time while their application to be licensed or registered for the new or expanded RAs is being considered.

17. Clause 10 amends section 109 of SFO to extend the offence of issuing advertisements relating to RAs to cover the new Type 11 RA.

#### Investigatory and disciplinary powers of SFC and MA

18. Clauses 15 to 37 amend Part VIII and Part IX of the SFO to extend SFC's existing investigatory and disciplinary powers under SFO and to confer new investigatory and disciplinary powers on MA for the purposes of regulating OTC derivative transactions.

19. Clause 40 adds a new Division 1A to Part XVI of the SFO to impose a confidentiality requirement on MA and other persons involved in carrying out MA's functions under the proposed regime except in specified situations.

#### ***Miscellaneous amendments***

20. Part 3 of the Bill (clauses 56 to 60) amends Part III of SFO to, inter alia, provide for the power of a recognized clearing house to make rules to cater for certain circumstances and to amend Part 5 of Schedule 3 to SFO by specifying the obligation to comply with certain requirements under section 1 in respect of each separate capacity of a clearing participant under which market contracts are recorded.

21. Part 4 of the Bill (clauses 61 to 64) amends SFO in respect of requirements of notifications and reports that are to be made under Part XV (Disclosure of Interests) to be filed electronically.

22. Part 5 of the Bill (clauses 65 to 68) amends SFO to provide for disgorgement orders for market misconduct offences for the purpose of recouping illegal gains from committing a market misconduct offence; and OSCO to include certain market misconduct offences to allow orders such as confiscation orders to be made under OSCO in relation to the proceeds of, or property derived from, those offences.

## **Public Consultation**

23. According to paragraph 22 of the LegCo Brief, MA and SFC conducted a joint consultation on the proposed regulatory regime for the OTC derivative market in October 2011 and a supplemental public consultation on the proposed licensing regime for the new RAs and the oversight on SIPs in July 2012. The respondents generally supported the proposed regulatory regime and the proposed division of regulatory responsibilities between the MA and SFC. There was also general support for not imposing the mandatory trading requirement at the outset but according priority to efforts on the mandatory reporting and clearing obligations at the initial stage.

## **Consultation with LegCo Panel**

24. The Clerk to the Financial Affairs Panel has advised that the Panel on Financial Affairs was consulted on the legislative proposal to develop a regulatory regime for the OTC derivative market at its meetings on 3 January 2011, 2 April 2012 and 4 March 2013. Various concerns were expressed by members, including the establishment and operation of trade repositories and central counterparties, the product coverage of the proposed regulatory regime, thresholds for mandatory reporting and clearing, the definition of "Hong Kong nexus" in relation to mandatory reporting obligation, and investor protection measures.

## **Conclusion**

25. In view of Members' concerns raised at the Panel meetings and the significance of the Bill's impact on the financial market in Hong Kong, Members may wish to consider setting up a Bills Committee to study the Bill in detail.

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