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**Report of the Bills Committee on Securities and Futures
(Amendment) Bill 2013**

Purpose

This paper reports on the deliberations of the Bills Committee on Securities and Futures (Amendment) Bill 2013 ("the Bills Committee").

Background

2. The global financial crisis of late 2008 highlighted the structural deficiencies in the over-the-counter ("OTC") derivative market, and the systemic risk it poses for the wider market and economy. The absence of regulation and the bilateral nature of OTC derivative transactions rendered it difficult for regulators to assess OTC derivative positions held by market players in order to monitor the build-up of exposures that might threaten the market or the wider economy. The global nature of the transactions also contributed to the interconnectedness of market players thereby creating the potential for contagion risk.

3. In the wake of the crisis, the Group of Twenty ("G20") Leaders committed to reforms that would require :

- (a) mandatory reporting of OTC derivative transactions to trade repositories ("TRs");
- (b) mandatory clearing of standardized OTC derivative transactions through central counterparties ("CCPs");
- (c) mandatory trading of standardized OTC derivative transactions on exchanges or electronic trading platforms, where appropriate; and

- (d) imposition of higher capital requirements in respect of OTC derivative transactions that are not centrally cleared¹.

4. In line with the G20 Leaders' commitment and regulatory developments in major international financial centres, the Hong Kong Monetary Authority ("HKMA") and Securities and Futures Commission ("SFC") issued a joint consultation paper on 17 October 2011 to invite public views on the proposed regulatory regime for the OTC derivative market. A joint consultation conclusions paper was issued together with a supplemental public consultation on the proposed licensing regime for the new or expanded regulated activities ("RAs") and the oversight of systematically important participants ("SIPs") in July 2012. The conclusions of the supplemental consultation were issued in September 2013. According to the Administration, respondents were generally supportive of the proposed regulatory regime and recognized the need for Hong Kong to develop and implement measures in line with G20 commitments of reforming the OTC derivative market. They also supported the proposed division of regulatory responsibilities between HKMA and SFC and not imposing the mandatory trading requirement in the initial stage of implementation of the regulatory regime.

The Bill

5. To provide for a regulatory framework for the OTC derivative market in Hong Kong and to incorporate other improvements for the regulation of the financial market, the Administration published the Securities and Futures (Amendment) Bill 2013 ("the Bill") in the Gazette on 28 June 2013 which received its First Reading at the Legislative Council ("LegCo") meeting of 10 July 2013.

6. The main provisions of the Bill are as follows:

Regulatory regime for the OTC derivative market

- (a) Clause 9 adds a new Part IIIA of the Securities and Futures Ordinance (Cap. 571) ("SFO") on OTC derivative transactions to provide for the obligations and requirements relating to them. That Part has five divisions. Division 2 (proposed sections 101B – 101H) adds new provisions to impose the reporting,

¹ For banks, higher capital requirements for OTC derivative transactions that are not cleared through a CCP have been introduced in January 2013 as part of Basel III implementation in Hong Kong. According to the Administration, it is closely monitoring the international development on margining and other risk mitigation requirements for non-centrally cleared OTC derivative transactions, and the Administration will take steps to develop legislation and a regulatory framework to implement the relevant requirements in Hong Kong in line with the recommended timeline.

clearing and trading obligations on prescribed persons. Each obligation applies only to OTC derivative transactions specified by rules made under Division 4 and these may differ in respect of each obligation. Division 3 (proposed sections 101I and 101J) empowers SFC to designate CCPs and trading platforms. Division 4 (proposed sections 101K – 101N) contains the rule-making powers relating to the mandatory obligations and to designations. Division 5 (proposed sections 101O – 101W) has provisions relating to the oversight of SIPs.

- (b) Clauses 15 to 37 amend Part VIII and Part IX of SFO to ensure that both HKMA² and SFC have the necessary investigatory and disciplinary powers to oversee and regulate activities in the OTC derivative market.
- (c) Clause 40 adds a new Division 1A (proposed sections 381A – 381F) to Part XVI of SFO to impose a confidentiality requirement on HKMA and other persons involved in carrying out HKMA's functions under the proposed regime, and to create exceptions to the requirement in specified situations.
- (d) Clause 53 amends Schedule 5 to SFO to include two new RAs and to expand two existing RAs.
- (e) Clause 55 adds a new Schedule 11 to SFO to provide for the transitional arrangements for the new and expanded RAs.

Other improvements for the regulation of the financial market

- (f) Clause 63 amends section 374 of SFO to require notifications and reports under Part XV "Disclosure of Interest" of the Ordinance to be filed electronically.
- (g) Clause 66 amends section 303 of SFO to enable the criminal courts to make disgorgement orders similar to the Market Misconduct Tribunal ("MMT") for market misconduct offences.
- (h) Clause 68 amends Schedule 2 to the Organized and Serious Crimes Ordinance (Cap. 455) ("OSCO") to include certain market misconduct offences to allow orders to be made under OSCO in relation to the proceeds of, or property derived from, such offences.

² The term "Monetary Authority" is used in SFO and the Bill. Under SFO, Monetary Authority means "the Monetary Authority appointed under section 5A of the Exchange Fund Ordinance (Cap. 66)". The Monetary Authority's functions are carried out by HKMA. In this report the term HKMA has the same meaning as Monetary Authority in the Bill.

The Bills Committee

7. At the House Committee meeting on 12 July 2013, members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon CHAN Kam-lam, the Bills Committee has held nine meetings to discuss with the Administration and met with deputations for views on the Bill in one of these meetings. The Bills Committee has also received 12 written submissions from deputations. The list of deputations which have provided views to the Bills Committee is in **Appendix II**.

Deliberations of the Bills Committee

Regulatory regime for the OTC derivative market in Hong Kong (clauses 2 - 60)

8. The Bills Committee supports the legislative proposal to provide for a regulatory regime for the OTC derivative market in Hong Kong which aims at reducing counterparty risk, improving overall transparency, protecting against market abuse, and ultimately enabling regulators to better assess, mitigate and manage systemic risk in the OTC derivative market. The Bills Committee also notes that deputations are supportive of the legislative proposal to regulate the OTC derivative market in light of the lesson drawn from the global financial crisis of 2008. Deputations consider that the reform will strengthen Hong Kong's competitiveness as an international financial centre and enhance the stability and liquidity of the OTC derivative market. They have also made various suggestions to improve the operation of the regulatory framework.

9. In scrutinizing the Bill, the Bills Committee has focused on the operation of the proposed regulatory regime, including the mandatory obligations to be imposed on parties (paragraphs 13 – 34), oversight of SIPs (paragraphs 35 – 38), transitional arrangements for existing market intermediaries in the OTC derivative market (paragraphs 39 – 44), duties and powers of the regulators under the regime (paragraphs 45 – 58), and investor protection issues (paragraphs 59 – 61). The deliberations of the Bills Committee are summarized in the ensuing paragraphs.

Legislative and regulatory framework

10. The Bills Committee notes that the broad regulatory framework for the OTC derivative market is set out in the Bill, with details prescribed in the rules to be made under SFO by SFC with the consent of HKMA and after

consultation with the Financial Secretary ("FS"). Such rules are subsidiary legislation subject to the negative vetting procedure of LegCo. The new regime will be jointly overseen and regulated by HKMA and SFC, with HKMA regulating the OTC derivative activities of authorized institutions ("AIs") and approved money brokers ("AMBs"), and SFC regulating such activities of licensed corporations ("LCs") and other prescribed persons³.

11. Given that the details of the regulatory regime and the requirements will be set out in subsidiary legislation, the Bills Committee shares with the views of deputations on the importance for the Administration to prepare the detailed rules for consultation with the stakeholders as soon as possible. Moreover, members of the Bills Committee consider it necessary for HKMA and SFC to align the requirements of the regulatory regime with international standards to avoid potential conflicts with similar rules in other jurisdictions and adverse impact on the liquidity and efficiency of the OTC derivative market in Hong Kong. This would also minimize the risk of regulatory arbitrage and compliance cost on market participants.

12. HKMA and SFC have stressed that they are mindful of the need to strike a balance between strengthening regulation and reducing compliance burden on the industry, and will strive to facilitate a smooth implementation of the reform, including introducing appropriate transitional arrangements for the new licensing requirements. They will continue to liaise with overseas regulatory bodies and engage the local financial services industry with a view to facilitating a smooth implementation of the new regulatory regime and minimizing conflicting requirements. The Bills Committee notes that HKMA and SFC are preparing the draft rules taking into account the relevant international standards, regulations and rules of other major jurisdictions like the United States ("US") and the European Union ("EU"), and plan to conduct a public consultation on the matter in the first half of 2014.

Mandatory obligations and requirements

13. The Bills Committee notes that the mandatory reporting, clearing and trading obligations and requirements relating to OTC derivative transactions are set out in the new Part IIIA of SFO. They apply to "prescribed persons", i.e. AIs, AMBs, LCs and others prescribed persons⁴. Mandatory trading obligation will not be implemented at the outset pending further study of local market conditions, in particular the liquidity level and the trading venues available in the local market. Clause 52 amends Schedule 1 to SFO to include a board definition of "OTC derivative product" by reference to the term "structured product" which already exists under SFO. The specific types of OTC

³ AIs refer to authorized institutions as defined in the Banking Ordinance (Cap. 155), and LCs refer to corporations licensed by SFC under SFO. AIs, AMBs and LCs are the main players in the OTC derivative markets and so they are referred to expressly in the Bill.

⁴ These matters will be prescribed in subsidiary legislation subject to the negative vetting procedure of LegCo.

derivative transactions to be subject to the mandatory obligations will be specified in the subsidiary legislation⁵. The Bills Committee notes the Administration's intention to apply the mandatory reporting and clearing obligations to certain types of interest rate swaps and non-deliverable forwards as they are of systemic importance to the local market and are capable of standardization. The obligations will be extended in phases to cover other types of transactions and products to be determined by HKMA and SFC after public consultation and consultation with FS. This approach will also enable HKMA and SFC to adjust the regulatory regime to respond to market developments when new types of OTC derivative transactions are introduced or become more popular.

Mandatory reporting obligation

14. In respect of the mandatory reporting obligation, the Bills Committee notes that AIs, AMBs, LCs and other prescribed persons will be required to report certain OTC derivative transactions (as specified in the rules, "reportable transactions") to HKMA. The reporting obligation will apply irrespective of whether the reportable transaction is centrally cleared or not, and may be fulfilled either directly or indirectly, i.e. through an agent⁶. AIs, AMBs and LCs will be subject to more stringent mandatory reporting requirements than other prescribed persons⁷. In particular, the latter will only have to report if their OTC derivative positions reach certain reporting thresholds, but no such thresholds will apply to AIs, AMBs and LCs.

15. The Bills Committee notes that reportable transactions will be required to be reported to the TR developed by HKMA ("HK-TR") for the purpose of the mandatory reporting obligation. HK-TR is an electronic system for keeping information and records of OTC derivative transactions. The reporting standards and specifications adopted by the HK-TR will be in line with those set by international standard-setting bodies and major industry platforms. HK-TR will also share information on OTC derivative transactions with other overseas TRs and regulators. The Bills Committee notes that the reporting function of HK-TR was launched in July 2013 and reporting from licensed banks under HKMA's regulatory requirement has begun since August 2013.

⁵ The new section 1B of Schedule 1 specifies that an OTC derivative product includes a product prescribed by notice under section 392(1)(a)(vii) of SFO (i.e. FS may prescribe a product to be regarded as an OTC derivative product by way of notice which is subsidiary legislation subject to the negative vetting procedure of LegCo).

⁶ The reporting agent may be a trade matching and confirmation platform or an overseas TR.

⁷ Other prescribed persons will essentially cover persons other than AIs, AMBs and LCs that are based in or operate from Hong Kong. Overseas persons with no presence or operation here will not be subject to any mandatory reporting obligation under Hong Kong law.

Concern about multiple reporting

16. The Bills Committee has expressed concern about multiple reporting on OTC derivative transactions to regulators of various jurisdictions which would increase compliance costs on the industry. Members note that deputations have suggested that besides allowing reporting to HK-TR through third parties or agents, such as global TRs, HKMA should explore the feasibility of recognizing global TRs to mitigate the cost burden on the industry.

17. The Administration has responded that it is necessary for HKMA and SFC to have effective and efficient access to OTC derivative transaction information to ensure their effective surveillance and monitoring work. HK-TR will facilitate the management of adequate amount of trade reports, instead of relying primarily on data sharing by overseas TRs or regulators. To address the concerns of reporting entities, there are linkages with major global TRs and regular dialogue with the industry so that they can readily entrust global TRs to file reports to HKMA on their behalf. To enhance efficiency in processing the outsourcing applications in relation to reporting, HKMA has been in close contact with reporting agents that are global TRs advising them the essential information and contributions required from them to support the outsourcing applications.

Exemptions from the reporting obligation

18. As regards some deputations' suggestion to provide exemption from compliance with the reporting obligation in situations where such reporting may be prohibited by conflicting laws, especially in relation to confidentiality, HKMA has stressed that it will take note of the development of relevant industry protocol as well as the development in other major jurisdictions in dealing with trade reporting issues, such as conflicting laws and confidentiality issue, so as to ensure Hong Kong's regulations are in line with international standard and practice.

Rule-making power on fees by HKMA

19. In relation to the use of HK-TR by reporting entities, the Bills Committee notes that, for the purpose of better certainty, the Administration will propose Committee Stage amendments ("CSAs") to add the new section 101KA of SFO to provide for the power of the Chief Executive in Council to make rules, after consultation with HKMA, to prescribe fees to be charged by HKMA in this respect⁸. HKMA will charge the fees on a cost recovery basis. It plans to conduct a public consultation on the proposal in the first half of 2014.

⁸ See footnote 4 above.

Mandatory clearing obligation

20. On the mandatory clearing obligation, the Bills Committee notes that AIs, LCs, AMBs and other prescribed persons will be required to clear certain OTC derivative transactions (as specified in the rules, "clearing eligible transactions") through a designated CCP if both the prescribed person and its counterparty to an OTC derivative transaction have reached the clearing threshold, and they may do this either directly (i.e. as a member of the designated CCP) or indirectly (i.e. through a third party that is a member of the designated CCP, or a client of such member)⁹.

21. Sections 101I and J of the new Part IIIA of SFO empower SFC to designate CCPs and trading platforms. SFC will be empowered to make rules to specify the requirements and procedures in this respect and can exercise the powers to designate and to make rules with the consent of HKMA and after consulting FS¹⁰. Both local and overseas entities may be designated as CCPs and trading platforms. As a pre-requisite to such a designation, a CCP will first need to be either a recognized clearing house ("RCH") or an authorized automated trading services ("ATS") provider under SFO. The operator of the trading platform must be a recognized exchange company or an authorized ATS provider under SFO. The Bills Committee notes that the Hong Kong Exchanges and Clearing Limited ("HKEx") has established a new clearing house in Hong Kong as a CCP for clearing OTC derivative products which commenced operation in late 2013.

Concern about overlapping in the clearing obligation

22. Given that OTC derivative transactions are cross-border by nature, and the two counterparties to the transactions are often from two different jurisdictions where each has its own regulatory framework and rules, the Bills Committee is aware that deputations have expressed concern that some rules may have extraterritorial effect and the counterparties may face two sets of rules which are conflicting or overlapping, especially when a transaction involving two counterparties is required to be cleared at separate CCPs designated by two jurisdictions. As a result, the transaction cannot take place. This may bring about undesirable market fragmentation and liquidity problems. Hence, deputations have suggested that SFC should pursue mutual recognition of CCPs.

⁹ As with the reporting obligation, the clearing obligation will only apply to AIs, AMBs, LCs and other prescribed persons that are based in or operate from Hong Kong, i.e. it will not apply to overseas persons that have no presence or operation in Hong Kong. However, such persons may nevertheless be affected if they have entered into a clearing eligible transaction and their counterparty is an AI, AMB, LC or other prescribed person. This is because the clearing obligation can only be fulfilled if both counterparties clear through a designated CCP.

¹⁰ See footnote 4 above.

23. The Administration has reiterated that Hong Kong's regulatory regime will be aligned with the international standards and those of the major markets while recognizing the local circumstances. There will be room for deeming certain cross-border transactions to be compliant with Hong Kong's requirements, provided that such transactions have already complied with the regulations under recognized regimes. Moreover, there is no location requirement on CCPs. Overseas CCPs can be authorized to provide services to prescribed persons and designated as a CCP for the purpose of meeting the mandatory clearing obligation under Hong Kong's regime. Effectively, the two counterparties to an OTC derivative transaction will have a choice to use a CCP as long as the CCP is authorized and designated by SFC.

Insolvency override protections for indirect clearing

24. Part III of SFO contains insolvency override protections which aim to prevent transactions cleared through a RCH from being unravelled by the application of insolvency law in the event of a default by any of the RCH's members. These protections are crucial because of the potential domino effect that any such unravelling might otherwise have on other members of the RCH. Currently, these protections only apply to arrangements and agreements between the RCH and its members in respect of defaults of a RCH member.

25. The Bills Committee notes that clauses 56 to 60 amend Part III of SFO mainly to extend the coverage of the insolvency override protections so that they also apply (a) in respect of defaults of the RCH itself; and (b) in the context of client clearing¹¹, not only to the agreements and arrangements between the CCP and its members, but also to the related agreements and arrangements between such members and their clients. The amendments also clarify that any collateral, margin, or guarantee fund contributions deposited with a RCH is to be regarded as falling within the scope of "market collateral", and are thus covered by the insolvency override protections.

26. The Bills Committee has examined how the proposed amendments under the new section 40(2A) work in extending the insolvency override protections with reference to a typical client clearing arrangement in relation to an OTC derivative transaction. SFC has explained that under a typical client clearing arrangement in relation to an OTC derivative transaction, if a RCH member who is an OTC client clearing service provider defaults, the clients' positions and collateral will either be ported (i.e. moved) to another RCH member who is also an OTC client clearing service provider and who is willing to take them up, or else liquidated (i.e. the transaction will be terminated) by the RCH and any remaining collateral returned to the client. These arrangements will usually be reflected in the RCH's rules. By bringing such client clearing

¹¹ Client clearing refers to the clearing of OTC derivative transactions via another person that is a member of the CCP, or a client of such member.

arrangements within the definition of "default rules", it will provide legal certainty that the positions and collateral of the client will not be included among the assets of the defaulting OTC client clearing service provider and will not be used to repay creditors of the defaulting OTC client clearing service provider. They can therefore be ported to another OTC client clearing service provider or disposed of and the balance returned to the client, as initially envisaged.

27. SFC advises that while different clearing houses may provide for different client clearing arrangements under their rules, the rules of a clearing house that is a RCH have to be approved by SFC under section 41 of SFO. As a clearing house will want to ensure that their participants' clients (i.e. the OTC client clearing service providers' clients) can benefit from the insolvency override protection in respect of any OTC client clearing arrangements put in place, they will have the incentive to ensure that the provisions are appropriately and adequately drafted. Moreover, international standards jointly set by the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO") require a CCP to ensure that there is a high degree of legal certainty as regards the enforceability of its rules, including in the case of insolvency. Hence, it is believed that a clearing house will obtain a legal opinion on such enforceability.

28. As regards why the proposed amendments also cover defaults of the RCH itself, SFC has pointed out that the CPSS-IOSCO Principles for Financial Market Infrastructure (which apply to all CCPs and not just CCPs for OTC derivatives) advocate the need for legal certainty as regards the enforceability of procedures that facilitate the implementation of a CCP's plans for recovery or orderly wind-down. Extending the insolvency override protections to cover the defaults of a RCH would help provide legal certainty in this regard. The new section 40(2A) is therefore intended to cover all CCPs and not just those clearing OTC derivatives.

29. The Bills Committee notes that the Administration has taken on board HKEx's suggestions on the technical drafting of clauses 57 to 60 to better clarify the extended coverage of the insolvency override protections, including –

- (a) to provide greater specificity in respect of the amendments to section 40 of SFO so that the context and purpose of the amended provisions are clearer, and thus better understood;
- (b) to amend section 45 of SFO to expressly include reference to the provision of market collateral so as to ensure that market collateral provide by way of an outright transfer rather than by way of a charge is also covered by the insolvency override protections;

- (c) to provide greater specificity in respect of the amendments to Schedule 3 to SFO so that the provisions on segregation are clearer in distinguishing between omnibus client accounts and individual client accounts; and
- (d) to make expressly clear in Schedule 3 to SFO that references to "set-off" or "offset" should be construed as including the concept of netting.

30. As such, the Administration will move CSAs to clauses 57 to 60 with a view to adding new provisions to incorporate HKEx's suggestions, clarifying the meaning of certain terms, and improving the drafting of provisions. The Bills Committee supports the Administration's proposed CSAs in this respect.

Mandatory record keeping obligation

31. The Administration has explained that when developing the regulatory regime for the OTC derivative market, the principal focus was on the implementation of the mandatory clearing, reporting and trading obligations. As such there was no specific reference in the Bill to the record keeping requirement. Notwithstanding this, it is naturally expected that adequate records would be kept for audit trail and compliance purposes. However, after observing the approaches taken by other major overseas jurisdictions, such as the US and Europe, the necessity of having a separate record keeping obligation has become apparent. Therefore, in order to supplement each of the mandatory reporting, clearing and trading obligations, the Administration considers it necessary to introduce a record keeping obligation on prescribed persons, and hence will move CSAs to add the new section 101DA and make related consequential amendments under clause 9 to this effect. The regulators conducted soft consultation with the industry, including the Hong Kong Association of Banks, in early 2014 on the proposal of introducing the record keeping obligation. They have no objection in principle to the record keeping obligation. The Administration assures the Bills Committee that the record keeping obligation is in line with the practices of other major jurisdictions and aims to better ensure that adequate records are maintained to evidence compliance with the mandatory obligations which will be accessible by the regulators to assist the latter in carrying out their regulatory functions. In line with the existing structure of the Bill, details of the record keeping obligation will be prescribed by rules made by SFC under the new section 101MA after public consultation¹². The Bills Committee supports the proposed CSAs.

¹² See footnote 4 above.

Penalty for breaches of mandatory obligations

32. The Bills Committee notes that fines will be imposed for breaches of mandatory obligations. Under the proposed sections 101E to 101F, the Court of First Instance will be empowered to impose civil fines of up to \$5 million on any person who breaches the mandatory obligations. For breaches by AIs, AMBs or LCs, HKMA and SFC will also be empowered to take disciplinary actions against them, including imposing disciplinary fines of up to an amount that is the greater of (a) \$10 million or (b) three times the amount of the profit gained, or loss avoided, by the person as a result of the contravention, making public or private reprimand and prohibiting them from carrying on OTC derivatives business.

33. Regarding the proposed disciplinary fines, the Bills Committee is aware of the concern expressed by some deputations about the difficulty to quantify the profit gained, or loss avoided, in determining the penalties for non-compliance with the mandatory obligations. Members note the Administration's explanation that the proposed pecuniary penalty is consistent with the disciplinary sanctions that SFC may impose on licensed corporations or registered institutions under sections 194 and 196 of SFO.

Validity of a transaction which breaches the mandatory obligations

34. In response to market feedback, the Bills Committee notes that the Administration will move CSAs to the proposed sections 101B, 101C and 101D and through the new section 101DA to expressly clarify that even if a transaction contravenes the mandatory reporting, clearing, trading and record keeping obligations, this should not affect the validity and enforceability of the transaction unless the parties to the transaction have expressly agreed otherwise. The Bills Committee understands that the amendment is included to avoid any doubt or uncertainty, and is consistent with the approach taken in other jurisdictions such as the EU, Australia and Singapore. The Bills Committee supports the proposed CSAs.

Oversight of SIPs

35. Sections 101O to W of new Part IIIA of SFO provide for the oversight of SIPs, i.e. market participants which are not regulated by either HKMA or SFC, but whose positions and activities in the OTC derivative market are so large that they may nevertheless raise concerns of potential systematic risks. These include commercial entities who do not act as intermediaries but who are essentially price takers or end users.

36. The Bills Committee notes that the provisions require that any person whose OTC derivative positions reach certain specified thresholds¹³ ("SIP thresholds") should notify SFC. Different thresholds will be specified in respect of different classes of OTC derivative transactions. Failure to give such notification within a specified period, without reasonable excuse, will constitute a criminal offence and be subject to a fine up to \$5 million and seven years' imprisonment. The SIP thresholds will be set at fairly high levels such that only a handful of market players, if any, may be caught. SFC will keep a register of persons who have notified SFC that they have reached any SIP thresholds, or whom HKMA/SFC has reasonable cause to believe have reached any SIP thresholds. The SIP register will be open for public inspection. HKMA and SFC will be empowered to require registered SIPs to provide information. SFC may, with the consent or at the request of HKMA, require registered SIPs to take certain action in respect of their OTC derivative positions and transactions under certain circumstances.

Identification of and information to be collected from SIPs

37. As regards the assessment criteria for a SIP, the Bills Committee has enquired about the reason for adopting a quantitative approach (i.e. the SIP thresholds). The Administration has explained that the proposal will facilitate understanding by market participants, enhance efficiency of the notification process and keep the calculation for the assessment simple. The approach has taken into account industry's views during the public consultation conducted in July 2012.

38. The Bills Committee has expressed concern about the information to be collected from a SIP and disclosed in the SIP register. The Administration has explained that the information collected must be sufficient to ensure effective oversight. Public disclosure would be limited to the name of the SIP and the specific class of OTC derivative transactions in respect of which the notification level has been reached.

New and expanded RAs and related transitional arrangements

39. Clause 53 amends Schedule 5 to SFO to include two new RAs, namely (a) a new Type 11 RA to cover the activities of OTC derivative products dealers and advisers, and (b) a new Type 12 RA to cover the activities of persons providing client clearing services for OTC derivative transactions. The existing Type 9 RA (asset management) and Type 7 RA (providing ATS) will be expanded to cover OTC derivative portfolios and transactions respectively.

40. The Bills Committee notes that clause 55 adds a new Schedule 11 to SFO to provide for transitional arrangements for the new and expanded RAs.

¹³ See footnote 4 above.

The transitional arrangements will comprise (a) an application period (which will last three months from the date of implementation of the new RAs and during which persons must submit their application to be licensed for the new RAs if they wish to benefit from the transitional arrangements) and (b) a transitional period (which will last six months from the date of implementation, and during which anyone may carry on the new RAs without being licensed to do so.) A person who submits an application to be licensed for any of the new RAs during the application period and meets certain qualification criteria will be deemed to be licensed for the relevant new RAs with effect from the expiry of the transitional period. Similarly, persons seeking to be licensed/registered for the expanded Type 7/Type 9 RA, and who are not already licensed for such RAs will need to apply within the aforesaid three-month application period and meet certain qualification criteria in order to be deemed to be licensed/registered for the expanded RAs with respect to OTC derivatives activities. For persons who are already licensed/registered for Type 9 RA, and who wish to engage in the expanded Type 9 RA, they will only need to submit a notification and confirmation to SFC within the application period that they have fulfilled the relevant criteria. The notification and confirmation will be reviewed by SFC, and followed up on as necessary.

Scope of the new RAs and expanded RAs

41. As far as the scope of the new RAs and expanded RAs is concerned, members of the Bills Committee have enquired about SFC's considerations in introducing new types of RAs or expanding the scope of existing RAs as some industry players, in particular the small and medium securities firms, are concerned that they have to apply for several RAs under their licences to carry out their businesses.

42. SFC has explained that the intention is to regulate persons who serve as intermediaries in the OTC derivative market. As the existing licences for Type 1 and Type 2 RA cover dealing in securities and futures contracts respectively but not OTC derivatives, and in order to tie in with the requirements for the proposed mandatory clearing of OTC derivative transactions through designated CCPs, it is necessary to introduce the new Type 11 RA to cover the activities of dealers and advisers on OTC derivative products and the new Type 12 RA to cover the activities of persons who provide client clearing services for OTC derivative transactions. The services relating to the new Type 11 and 12 RA licences would mainly be provided by large financial institutions. On the other hand, the existing Type 9 RA (asset management) and Type 7 RA (providing ATS) will be expanded to cover OTC derivative portfolios and transactions respectively. The definitions of the new RAs are cast along the lines of the existing definitions of the relevant RAs and carve-outs are provided so that where the existing RAs overlap with the new RAs, a person engaging in such activities will not be required to be licensed or registered for both RAs. This

approach would keep the scope of the existing RAs intact, while also avoiding duplicate licensing or registration by market participants.

Transitional arrangements for the new RAs and expanded RAs

43. As regards the transitional arrangements for the new RAs and expanded RAs, the Bills Committee is concerned how they will work in minimizing disruption to the market. The Administration has advised that the purpose is to allow serving intermediaries in the OTC derivative market to continue their businesses for a limited period of time while their applications to be licensed or registered for the new or expanded RAs are being considered by SFC. This would facilitate market players to ease into the new licensing regime with minimum disruption to their existing businesses, as well as 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. The Administration has added that in response to the feedback from the public consultation, both the application and transitional periods have been lengthened to three months and six months respectively.

44. Members of the Bills Committee are concerned about the fees to be paid by applicants for licence or registration in respect of the new or expanded RAs, and whether SFC will take into account the actual duration of the deeming period to refund fees to the applicants if the applications are finally rejected. SFC has responded that applicants are required to pay application fees upon submission of the applications, which may also be regarded as the annual fees for the first year from the deeming date. As the annual fees on the licence or registration for any of the new or expanded RAs are only payable at the end of the first year from the deeming date, the applicants will not be required to pay the annual fees at all if their applications are rejected within the six-month transitional period. If the applications could not be determined by SFC within one year from the deeming date, the applicants concerned will need to pay the annual fees for continuing to carry on the new or expanded RAs in the second year. The annual fees, once collected, will not be refunded to the applicants if the applications are subsequently rejected within the second year. This is consistent with the current practice of regular licence applications.

Investigatory and disciplinary powers of SFC and HKMA under the proposed regulatory regime for the OTC derivative market

45. Clauses 15 to 37 amend Part VIII and Part IX of SFO to ensure that both HKMA and SFC have the necessary investigatory and disciplinary powers to oversee and regulate activities in the OTC derivative market. HKMA will be given new powers under SFO (mainly through amended section 178, new sections 184A to 184E, 186A of SFO) to investigate breaches of mandatory obligations by AIs and AMBs for OTC derivative activities, and to take

disciplinary action against them for such breaches (mainly through new sections 203A to 203F of SFO). SFC's existing investigation and disciplinary powers under SFO will also be extended as necessary so that they will cover breaches of the mandatory obligations by other persons, including LCs. SFC and HKMA would also share with other regulators information relating to transactions regarding OTC derivative products.

Investigations by SFC and HKMA

46. The Bills Committee notes that the new investigatory powers for HKMA under SFO in relation to contravention of mandatory obligations by AIs and AMBs are modelled on the comparable powers of SFC in existing sections 182 and 183 of SFO. Members are concerned about the procedures of investigation and rights and protections afforded to persons under investigation ("PUI") by SFC, including their right to be informed of the reasons for the investigations, right to claim privilege against self-incrimination and legal professional privilege ("LPP"), and obligation to observe secrecy or other legal obligations under a foreign law.

47. SFC has explained that in an investigation conducted by SFC under section 182 of SFO, the PUI or a person providing assistance to the investigation will be issued with a notice for production of records or documents under section 183 which will include a list of records or documents the person is required to provide relevant to the investigation. If the investigation conducted by SFC is to assist an overseas regulator, the notice will also include information on the identity of the overseas regulator, the reasons for the investigation (e.g. insider dealing, market manipulation, etc), the relevant overseas legislation, and the comparable provisions under SFO. As regards protection of the legal rights of the PUI, SFC has advised that SFO contains provisions to ensure SFC's investigations can be fairly conducted without prejudicing the legal rights and protection afforded to PUIs. These provisions include section 187 on inadmissibility of evidence against the PUI in criminal proceedings (except specified offences) if the PUI has made claims against self-incrimination before answering a question during the investigation, and section 380(4) expressly preserving the common law right to LPP. On protection for secrecy or other legal obligations under a foreign law, SFC has pointed out that a person may refuse to produce documents to SFC if he has a reasonable excuse not to do so. The question of whether an obligation of secrecy or confidentiality under a foreign law is a reasonable excuse under Hong Kong law is a matter for Hong Kong's courts to determine on a case-by-case basis.

Assistance provided by SFC and HKMA to overseas regulators

48. The Bills Committee notes that the amended section 186 and the proposed section 186A of SFO enable SFC and HKMA respectively to assist regulators outside Hong Kong in investigations of contravention of legal or regulatory requirements in relation to OTC derivative products. Members have examined the factors which SFC and HKMA will take into account in providing such assistance, including undertaking from the overseas regulators to pay the relevant costs and provide reciprocal assistance.

49. The Administration has advised that section 186(3) and the proposed section 186A(7) of SFO provide that SFC and HKMA will give investigatory assistance to an overseas counterpart if it is desirable or expedient that the assistance should be given in the interests of the investing public or in the public interest, or the assistance will enable or assist the recipient of the assistance to perform the recipient's functions and it is not contrary to the interests of the investing public or to the public interest that the assistance should be given. It should be noted that giving assistance to overseas regulators to combat cross-border financial crimes and misconduct is both in the interests of the investing public and in the public interest especially given the international character of Hong Kong's market and Hong Kong's position as an international financial centre. The above provisions set out the conditions, if satisfied, SFC and HKMA may give the assistance. Furthermore, section 186(4) and the proposed section 186A(8) of SFO provide that, before deciding whether to give the investigatory assistance, SFC and HKMA shall take into account whether the overseas counterpart will pay the costs and expenses incurred, and is able and willing to give reciprocal assistance in response to a comparable request for assistance from Hong Kong. These provisions set out the considerations that SFC and HKMA must take into account when deciding whether assistance should be given. In other words, if the overseas counterpart is not willing to pay the costs incurred, or not able or willing to provide reciprocal assistance, SFC and HKMA may refuse to give the requested assistance.

50. The Bills Committee has requested the Administration to consider imposing a pre-condition for the overseas regulators to provide reciprocal assistance before SFC or HKMA gives the assistance. For instance, it is suggested that SFC and HKMA can only give assistance to overseas regulators with whom they have entered into reciprocal or relevant legal agreements. Moreover, noting that SFC and HKMA will publish in the Gazette the names of overseas regulators to whom they will provide assistance to but such matters are not subsidiary legislation as specified in section 186(8) and the proposed section 186A(13), some members of the Bills Committee, including Hon James TO and Hon SIN Chung-kai have urged the Administration to consider subjecting the matters to the negative vetting procedure of LegCo.

51. The Administration has stressed that it is a common practice for international regulators to take into account reciprocity before giving assistance (e.g. section 169(4)(a) of the United Kingdom ("UK") Financial Services and Markets Act 2000) but it is not a common practice to make it a mandatory pre-condition. According to section 186(5) and the proposed section 186A(5), the overseas requesting authority must perform functions similar to the functions of SFC or HKMA or regulate, supervise or investigate banking, insurance or other financial services, and be subject to adequate secrecy obligations. These requirements can be satisfied if the overseas requesting authority is a member of IOSCO Multilateral Memorandum of Understanding ("MMoU") or has bilateral arrangements with SFC or HKMA in relation to investigatory assistance. However, this is not a legal prerequisite. SFC and HKMA may also give investigatory assistance to an overseas requesting authority that has no formal agreement with them as long as all the requirements set out in section 186 and the proposed section 186A are fully satisfied. The Administration stresses that it is important to retain this flexibility, because it usually takes time to enter into a formal agreement whereas it is desirable to be able to offer, and receive, investigatory assistance in a timely and efficient manner.

52. The Administration further advises that as at 13 February 2014, there were 100 signatories to the IOSCO MMoU, which included regulators from major financial markets, namely, Australia, Mainland China, France, Germany, India, Japan, Korea, Malaysia, Singapore, the UK and the US. As a member of the IOSCO, SFC gazetted the names of all 99 signatories to the IOSCO MMoU other than Hong Kong then. Where SFC has not yet entered into a Memorandum of Understanding ("MoU") with a requesting regulator, SFC may nevertheless give the requested assistance upon being satisfied that the conditions in section 186(3) and the criteria in section 186(5) of SFO are met, and then gazette the name of this new entity. The Bills Committee also notes that following the guidance and standards by the Basel Committee on Banking Supervision, HKMA has entered into a MoU or other formal arrangement with a number of banking supervisory authorities for general prudential supervisory cooperation purposes in respect of regulation of banks. As at 13 February 2014, these authorities were from jurisdictions such as Australia, Mainland China, France, Germany, Japan, the UK and the US. It is envisaged that HKMA could enhance the existing MoUs to cater for supervisory cooperation in respect of the regulation of the OTC derivative market under the new framework. It is also envisaged that HKMA could enter into new MoUs with other regulators specializing in regulation of the OTC derivative market.

Disclosure of information by HKMA to SFC and overseas regulators and sharing of information in HK-TR

53. Clause 40 adds a new Division 1A (new sections 381A to F) to Part XVI of SFO imposing a confidentiality requirement on HKMA and other persons involved in carrying out HKMA's functions under the proposed regulatory regime of OTC derivative market. But HKMA may disclose information under specified situations, for instance, to SFC and overseas regulators, which allow HKMA to share information in the HK-TR and other OTC derivative activities it has obtained with parties and overseas regulators who perform similar functions as HKMA.

54. As regards the sharing of information in the HK-TR, while members of the Bills Committee support that such information should be shared among market participants in a transparent and fair manner as it is of valuable reference to the market, they are concerned about the protection of privacy of parties involved in OTC derivative transactions, in particular HKMA may receive information on OTC derivative transactions from reporting entities who are individuals. Members have also sought information on the international standard and practice on the sharing of data stored in TRs among overseas regulators and TRs. The Bills Committee further considers it necessary to ensure protection of data privacy in the disclosure of information to overseas regulators under section 381F.

55. HKMA has pointed out that the data to be collected from mandatory reporting will be market sensitive and should be handled with care. Given that mainly institutional players (e.g. AIs, LCs, and funds) are involved in OTC derivative transactions, information kept by TR would include data relating to individual OTC derivative transactions conducted by these institutions, such as the types and amount of derivative transactions, their economic terms, and the counterparties concerned, etc. The Administration has added that to comply with the reporting obligation, a reporting entity will have to become a member of the HK-TR and to sign an agreement with HKMA. The HK-TR explicitly requires that no personal data should be reported. In compliance with the Personal Data (Privacy) Ordinance (Cap. 486), the HK-TR sets out its policies and practices with regard to personal data to be collected from the private individual in a personal information collection statement which will be available at the HK-TR's website.

56. Regarding international development in sharing of TR data, the Administration has advised that there are already guidelines and standards on related aspects provided by international regulatory bodies, such as the Financial Stability Board and the IOSCO. For instance, the Committee on Payment and Settlement Systems-IOSCO published a final report on authorities' access to TR data in August 2013 which provides guidance to TRs and

authorities on the principles that should guide authorities' access to data held in TRs. The Administration will monitor international discussions on TR data sharing and see if it is necessary to enter into an agreement for exchange of information or data sharing. As for specific agreements for regulatory cooperation and information sharing in respect of OTC derivative market, HKMA has started discussions with the European Securities and Markets Authority in the EU and the Commodity Futures Trading Commission in the US. It is anticipated that HKMA will enter into MoUs of this nature with other regulators in major financial centres.

57. The Bills Committee notes that while the proposed section 381F(4) requires HKMA to publish in the Gazette the names of such overseas persons if it is satisfied that they meet the requirements for disclosure of information, the matter in the Gazette is not subsidiary legislation. Some members of the Bills Committee, including Hon James TO and Hon SIN Chung-kai have urged the Administration to consider subjecting the matter to the negative vetting procedure of LegCo.

58. The Administration has explained that the purpose of publishing the names of overseas persons under section 381F(4) is to enhance transparency. Section 381F(2) already sets out the requirements (e.g. performing similar functions to HKMA, subjecting to adequate regulation under the respective law of the place) under which disclosure may be allowed and therefore provides the safeguard for such disclosure. Given that the international regulatory community is working together to ensure smooth and effective access to TR data to enhance transparency, the Administration is of the view that subjecting the disclosure mechanism to the negative vetting procedure of LegCo may create uncertainty in terms of mutual access to TR data and jeopardize the cooperative arrangement HKMA seeks from other jurisdictions. Moreover, HKMA is not aware that a similar requirement exists in other jurisdictions.

Protection for investors involved in OTC derivative transactions

Protection for retail investors

59. In view of the complexity of products the OTC derivative market, the Bills Committee has stressed the importance for the proposed regulatory regime to offer adequate protection for investors of OTC derivative products. The Administration reiterates that the Bill would enhance investor protection by introducing a regulatory framework for OTC derivative transactions, enhancing the transparency of these activities, enabling regulators to monitor build-up of exposures that might pose systemic risks to the market or the wider economy, thus reducing the contagion risk. While mainly institutional investors are involved in OTC derivative transactions, if OTC derivative products are offered to retail investors, they will be governed by the investor protection regime under

SFO. In this regards, public offer of OTC derivative products will continue to require SFC's authorization of the product documentation, and intermediaries involved in the sales process are subject to conduct regulation (e.g. the requirements on information disclosure and know-your-client).

Protection for investors on advising act carried out by a person through the media

60. The Bills Committee notes that the scope of the new Type 11 RA (dealing in or advising on OTC derivative products) does not include an advising act carried out by a person through the media (e.g. newspaper, magazine, television and radio broadcast) and expresses concern about SFC's regulation of such activities to ensure protection for investors. In order to enhance protection of interests of investors, Bills Committee members consider that SFC should review the need of extending the requirements under its Code of Conduct on disclosure of interests by licensed intermediaries in carrying out advising acts to cover non-licensed/registered persons carrying out advising acts on OTC derivative products.

61. SFC advises that the exclusion in question has made reference to existing exclusions under SFO in respect of advising on securities or futures contracts. Journalists and public commentators who publish financial research and recommendations in the media are not required to be licensed by SFC. This is to balance the interests of investors against the freedom of the press and the rights of journalists to express their views in the media. However, they are still subject to market misconduct and criminal provisions in SFO, including sections 277 and 298 regarding disclosure of false or misleading information inducing transaction. SFC further points out that while MMT has not heard any case concerning market misconduct acts associated with advising acts through the media, SFC has taken disciplinary actions against licensed commentators before, including cases under which the commentators' advising acts through the media involved conflict of interest. Given that mainly institutional investors are involved in OTC derivative transactions, SFC does not envisage that advising acts on OTC derivative products through the media targeting at the general investing public would be prevalent. SFC assures the Bills Committee that it is under SFC's ongoing initiatives to enhance investor education.

Other improvements to the regulation of the financial market (clauses 61 - 68)

62. In respect of the improvements to the regulation of the financial market, the Bills Committee supports the amendments to SFO in relation to requiring electronic filing of notifications and reports on disclosure of interests in listed corporations to the Stock Exchange of Hong Kong in order to enhance the

timeliness of publication of potentially market sensitive information. Members further agree to the needs to strengthen SFC's enforcement regime regarding market misconduct offences through enabling criminal courts to make disgorgement orders similar to MMT for the purpose of recouping illegal gains and loss avoided from committing market misconduct offences, as well as to demonstrate Hong Kong's commitment to fulfilling international obligations on anti-money laundering ("AML") and counter-financing of terrorism through enhancing the confiscation regime under OSCO.

Disgorgement orders for market misconduct offences

63. The Bills Committee has examined the rationale for the proposed amendments to section 303 of SFO (clause 66) relating to disgorgement orders for market misconduct offences and the scope of disgorgement orders.

64. The Administration has explained that currently, SFC is able to deal with six types of market misconduct offences (i.e. insider dealing, false trading, price rigging, disclosure of information about prohibited transactions, disclosure of false or misleading information inducing transaction, and stock market manipulation under Parts XIII and XIV of SFO) (referred to as "the six market misconduct offences" hereafter) either by criminal prosecution at the Court or civil proceedings at MMT. While section 257(d) of SFO empowers MMT to make an order that "*the person pay to the Government an amount not exceeding the amount of any profit gained or loss avoided by the person as a result of the market misconduct in question*", section 303 of SFO empowers the criminal court to impose maximum fines of HK\$10 million (on indictment) and HK\$1 million (on summary conviction). Given that market misconduct cases involving profits gained or loss avoided of more than HK\$10 million are not totally impossible, the Administration considers that amending section 303 of SFO to enable criminal courts to make disgorgement orders similar to MMT for the purpose of recouping illegal gains and loss avoided from committing market misconduct offences will strengthen the enforcement regime against such offences.

65. As regards the scope of disgorgement, the Administration has advised that it is limited to "*an amount not exceeding the amount of any profit gained or loss avoided by the person as a result of the commission of the offence in question*", which is similar to the existing fining power of MMT under section 257(d) of SFO.

Confiscation regime under OSCO

66. On the proposed amendments to Schedule 2 to OSCO (clause 68), the Bills Committee notes that the purposes are to add to the Schedule the six market misconduct offences to subject them to the confiscation regime under

OSCO in relation to the proceeds of, or property derived from, such offences with a view to implementing the AML standards set by the Financial Action Task Force ("FATF").

67. While expressing support for Hong Kong's AML standards to be in line with the international standards, the Bills Committee has examined the scope of offences on money laundering activities as prescribed by FATF, the justifications for including the six market misconduct offences under the confiscation regime of OSCO, and the types of market misconduct defined by other FATF member jurisdictions for similar purposes.

68. The Administration has responded that according to the relevant FATF's recommendations, member jurisdictions should adopt measures, including legislative measures, to freeze or seize and confiscate, among others, proceeds from, or instrumentalities used in, money laundering or predicate offences. To this end, FATF has designated certain categories of offences that should be subject to a member jurisdiction's domestic confiscation regime, and has asked each jurisdiction to define those offences in accordance with its relevant domestic laws. "Insider trading and market manipulation" is one of the 20 categories of offences listed as FATF's designated predicate offences to which the confiscation regime should be applicable. A number of FATF member jurisdictions, including the UK, Canada, Australia, Singapore and New Zealand have based on the relevant FATF recommendations to include relevant offences relating to "insider trading and market manipulation" in FATF's context in their own domestic legal confiscation regime, thus enabling the confiscation of proceeds in relation to or arising from the commission of such misconduct crimes in the securities and futures markets.

69. In respect of Hong Kong, the Administration has advised that as a member of FATF, Hong Kong is obliged to implement FATF's requirements and is subject to a process of mutual evaluations by FATF to monitor progress made in implementing AML requirements. It has been revealed during previous evaluations that while Hong Kong's confiscation provisions under OSCO were available to a broad range of specified offences, the set of specified offences did not cover fully all FATF's designated predicate offences. Thus, Hong Kong has been asked to seek further enhancement to its confiscation regime by, among others, including market misconduct offences under SFO in the confiscation regime under OSCO. To enable Hong Kong to fully meet FATF's requirements, the Administration has proposed adding the six types of market misconduct offences in Schedule 2 to OSCO to empower the Court to make a restraint order to prohibit any person from dealing with any realizable property associated with the offences before conviction (under section 15 of OSCO), a charging order on realizable property for securing the payment to the Government of the amount payable under a confiscation order (under section 16 of OSCO), or a confiscation order to confiscate the proceeds of the offences

when the Court has determined that the concerned person has benefitted from the relevant market misconduct offences (under section 8 of OSCO). The Administration has supplemented that this arrangement is on par with that applying to other specified offences listed in either Schedule 1 or 2 to OSCO, such as certain bribery offences under the Prevention of Bribery Ordinance (Cap. 201), certain gambling-related offences under the Gambling Ordinance (Cap. 148), certain drug trafficking offences under the Dangerous Drugs Ordinance (Cap. 134), and the relevant money laundering offence under OSCO.

Committee Stage amendments

Other major proposed CSAs to the Bill

70. The Bills Committee notes that apart from the proposed CSAs mentioned in paragraphs 19, 29, 30, 31 and 34 above, the Administration will move other CSAs to the Bill concerning matters as suggested by market players, relating to technical aspects to improve the drafting of provisions, or consequential in nature. The major CSAs include the followings:

- (a) CSAs to the proposed section 101O (clause 9) - to better clarify the ambit of persons who may fall within the definition of SIP, to extend the scope of the positions to be taken into account when determining if a person has reached the notification level for SIPs, to make the breach of the notification requirement by a SIP a continuing offence.
- (b) CSAs to the proposed section 101U (clause 9) - to enable SFC to require a registered SIP to reduce exposure arising from not only the positions the SIP holds but also those that it has guaranteed, and to restrict the type of collateral collected or posted by a SIP.
- (c) CSAs to Schedule 1 to SFO (clause 52) – to amend the definition of market contract in response to the suggestions made by HKEx.
- (d) CSAs to Schedule 5 to SFO (clause 53) – to clarify the scope of and to amend the description of the new or expanded RAs to avoid confusion or overlaps with existing RAs.
- (e) CSAs to Schedule 11 to SFO (clause 55) – to achieve better drafting consistency with existing provisions in Schedule 11, to avoid potential confusion regarding the scope of the existing Type 7 RA and the new Type 7 RA.

71. The Bills Committee has examined the Administration's proposed CSAs¹⁴. A full set of the draft CSAs proposed by the Administration to the Bill is in **Appendix III**.

Recommendation

72. The Bills Committee will not move CSAs to the Bill and supports resumption of the Second Reading debate on the Bill at the LegCo meeting of 26 March 2014.

73. Members are invited to note the deliberations of the Bills Committee above and the recommendation in paragraph 72.

Council Business Division 1
Legislative Council Secretariat
13 March 2014

¹⁴ Details of CSAs proposed by the Administration as marked-up on the original provisions of the Bill are in the Administration's papers LC Paper CB(1)874/13-14(03) and 1024/13-14(01)).

Bills Committee on Securities and Futures (Amendment) Bill 2013

Membership list

Chairman Hon CHAN Kam-lam, SBS, JP

Deputy Chairman Hon Christopher CHEUNG Wah-fung, JP

Members Hon James TO Kun-sun
Hon WONG Ting-kwong, SBS, JP
Hon Starry LEE Wai-king, JP (up to 2 October
2013)
Hon CHAN Kin-por, BBS, JP
Hon NG Leung-sing, SBS, JP
Hon Steven HO Chun-yin
Hon Kenneth LEUNG
Hon Dennis KWOK
Hon SIN Chung-kai, SBS, JP

(Total : 10 members)

Clerk Ms Connie SZETO

Legal Adviser Miss Winnie LO

Bills Committee on Securities and Futures (Amendment) Bill 2013

List of organizations from whom the Bills Committee has received views

1. Citigroup Global Markets Asia Ltd
2. Citibank N.A. Hong Kong Branch
3. Civic Party
4. CME Group Hong Kong Limited
5. Clifford Chance
(On behalf of Barclays Bank PLC, BNP Paribas, Citibank, N.A., Credit Suisse AG, Deutsche Bank AG, Goldman Sachs (Asia) LLC, The Hongkong and Shanghai Banking Corporation Limited, J.P.Morgan, Morgan Stanley and Standard Chartered Bank)
6. The Hong Kong Association of Banks
7. The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies
8. Hong Kong Bar Association
9. Hong Kong Exchanges and Clearing Limited
10. The Hong Kong Inter-Dealer Broker Association
11. Hong Kong Investment Funds Association
12. The Hong Kong Society of Financial Analysts
13. The Hong Kong and Shanghai Banking Corporation Limited
14. Law Society of Hong Kong
15. SinoPac Securities (Asia) Limited
16. TriOptima Group

Securities and Futures (Amendment) Bill 2013

Committee Stage

Amendments to be moved by the Secretary for Financial Services and the Treasury

<u>Clause</u>	<u>Amendment Proposed</u>
9	In the proposed section 101A, in the English text, in the definition of <i>prescribed person</i> , in paragraph (b)(iv), by deleting “and”.
9	In the proposed section 101A, in the definition of <i>prescribed person</i> , in paragraph (c)(iv), by adding “and” after the semicolon.
9	In the proposed section 101A, in the definition of <i>prescribed person</i> , by adding— “(d) in relation to the record keeping obligation, means— (i) an authorized financial institution; (ii) an approved money broker; (iii) a licensed corporation; or (iv) a person of a class or description specified in the record keeping rules as being subject to the record keeping obligation;”.
9	In the proposed section 101A, in the definition of <i>specified OTC derivative transaction</i> , in paragraph (b), by deleting “and”.
9	In the proposed section 101A, in the definition of <i>specified OTC derivative transaction</i> , in paragraph (c), by adding “and” after the semicolon.
9	In the proposed section 101A, in the definition of <i>specified OTC derivative transaction</i> , by adding— “(d) in relation to the record keeping obligation, means

a transaction specified in the record keeping rules for the purposes of that obligation;”.

9 In the proposed section 101A, by adding in alphabetical order—

“*record keeping obligation* (備存紀錄責任)—

- (a) in relation to a prescribed person that is an authorized financial institution incorporated in Hong Kong, means—
 - (i) an obligation imposed by section 101DA(1); or
 - (ii) an obligation imposed by section 101DA(3); and
- (b) in relation to any other prescribed person, means an obligation imposed by section 101DA(1);

record keeping rules (《備存紀錄規則》) means rules made under section 101MA;”.

9 In the proposed Division 2, in the heading, by deleting “**Clearing and Trading**” and substituting “**Clearing, Trading and Record Keeping**”.

9 In the proposed section 101B, by adding—

“(7) Subject to an express agreement to the contrary by the parties to the transaction, a contravention of the reporting obligation in relation to an OTC derivative transaction does not of itself invalidate the transaction or affect any rights or obligations arising under, or relating to, the transaction.”.

9 In the proposed section 101C, by adding—

“(7) Subject to an express agreement to the contrary by the parties to the transaction, a contravention of the clearing obligation in relation to an OTC derivative transaction does not of itself invalidate the transaction or affect any rights or obligations arising under, or relating to, the transaction.”.

9 In the proposed section 101D, by adding—

“(7) Subject to an express agreement to the contrary by the parties to the transaction, a contravention of the trading obligation in relation to an OTC derivative transaction does not of itself invalidate the transaction or affect any rights or obligations arising under, or relating to, the transaction.”.

9 By adding—

“101DA. Record keeping obligation

- (1) A prescribed person must keep, in accordance with the record keeping rules, records relating to an OTC derivative transaction to which subsection (2) applies.
- (2) This subsection applies to an OTC derivative transaction that—
 - (a) is specified in the record keeping rules—
 - (i) in relation to the prescribed person; and
 - (ii) as a transaction the records of which are required to be kept;
 - (b) falls within the circumstances and the criteria specified in those rules—
 - (i) in relation to the prescribed person; and
 - (ii) for the application of the requirement to keep record referred to in paragraph (a)(ii); and
 - (c) does not fall within the circumstances specified in those rules—
 - (i) in relation to the prescribed person; and
 - (ii) as circumstances in which the requirement to keep record is taken to have been complied with.

- (3) In addition, a prescribed person that is an authorized financial institution incorporated in Hong Kong must ensure that a subsidiary of that institution specified under subsection (5) complies in relation to an OTC derivative transaction with the requirement set out in subsection (4).
- (4) The requirement is that the subsidiary keeps, in accordance with the record keeping rules, records relating to an OTC derivative transaction—
 - (a) to which the subsidiary is a counterparty; and
 - (b) that is specified in those rules as a transaction to which subsection (3) applies.
- (5) The Monetary Authority may, by a written notice given to an authorized financial institution incorporated in Hong Kong, specify for the purposes of subsection (3)—
 - (a) a particular subsidiary;
 - (b) more than one subsidiary; or
 - (c) subsidiaries generally.
- (6) The Monetary Authority may specify under subsection (5) a subsidiary incorporated outside Hong Kong or a subsidiary incorporated in Hong Kong.
- (7) A person specified in subsection (9)(a) must, when requested by the Commission—
 - (a) give the Commission access to the records kept under this section; and
 - (b) produce the records to the Commission within the time and at the place specified by the Commission.
- (8) A person specified in subsection (9)(b) must, when requested by the Monetary Authority—
 - (a) give the Monetary Authority access to the records kept under this section; and

- (b) produce the records to the Monetary Authority within the time and at the place specified by the Monetary Authority.
- (9) The person specified—
 - (a) for the purposes of subsection (7) is—
 - (i) a prescribed person that is a licensed corporation; or
 - (ii) a prescribed person that is a person of a class or description specified in the record keeping rules as being subject to the record keeping obligation; and
 - (b) for the purposes of subsection (8) is—
 - (i) a prescribed person that is an authorized financial institution; or
 - (ii) a prescribed person that is an approved money broker.
- (10) Subject to an express agreement to the contrary by the parties to the transaction, a contravention of the record keeping obligation in relation to an OTC derivative transaction does not of itself invalidate the transaction or affect any rights or obligations arising under, or relating to, the transaction.”.

9 In the proposed section 101E(1), by deleting “obligation or trading” and substituting “obligation, trading obligation or record keeping”.

9 In the proposed section 101F(1), by deleting “obligation or trading” and substituting “obligation, trading obligation or record keeping”.

9 In the proposed section 101G(1)(a)(iii), by deleting “and”.

- 9 In the proposed section 101G(1)(a), by adding—
- “(iv) the record keeping obligation; and”.
- 9 In the proposed section 101H(1), by deleting “obligation or trading” and substituting “obligation, trading obligation or record keeping”.
- 9 In the proposed section 101K(7)(b), by adding “or on behalf of” after “operated by”.
- 9 In the proposed section 101K(8)(a), by adding “and” after the semicolon.
- 9 In the proposed section 101K(8)(b), by deleting “; and” and substituting a full stop.
- 9 By deleting the proposed section 101K(8)(c).
- 9 By adding—

“101KA. Rule making power—fees

- (1) The Chief Executive in Council may, after consultation with the Monetary Authority, make rules to require and provide for the payment to the Monetary Authority of the fees for using the electronic system referred to in section 101K(7)(b).
- (2) Rules made under this section may provide—
 - (a) that the amount of any fees may be fixed by reference to a scale set out in the rules;
 - (b) for the payment of different fees by or in relation to persons or cases of different classes or descriptions;
 - (c) for the time and manner of payment of the fees;
 - (d) that the payment of any fees may,

either generally or in a particular case, be reduced, waived or refunded;

- (e) that the Monetary Authority may recover any outstanding amount of the fees as a civil debt due to the Monetary Authority; and
- (f) for any other matters relating or incidental to a matter mentioned in paragraph (a), (b), (c), (d) or (e).

- (3) This section is in addition to and not in derogation of sections 29 and 29A of the Interpretation and General Clauses Ordinance (Cap. 1).”.

9 In the proposed section 101L(6)(d), by adding “and” after the semicolon.

9 In the proposed section 101L(6)(e), by deleting “; and” and substituting a full stop.

9 By deleting the proposed section 101L(6)(f).

9 In the proposed section 101M(6)(c), by adding “and” after the semicolon.

9 In the proposed section 101M(6)(d), by deleting “; and” and substituting a full stop.

9 By deleting the proposed section 101M(6)(e).

By adding—

“101MA. Rule making power—record keeping obligation

- (1) The Commission may, with the consent of the Monetary Authority and after consultation with the Financial Secretary, make rules—
 - (a) generally for the purposes of the record keeping obligation; and
 - (b) without limiting paragraph (a), to prescribe the particular matters set out in this section.
- (2) Rules made under this section—
 - (a) may specify for the purposes of paragraph (d)(iv) of the definition of *prescribed person* in section 101A, a class or description of persons; and
 - (b) must provide in relation to a person of such a class or description that the person is subject to the record keeping obligation only if the person is a counterparty to a specified OTC derivative transaction.
- (3) Rules made under this section may specify—
 - (a) generally, or with reference to a class or description of transactions, the OTC derivative transactions that are subject to the record keeping obligation;
 - (b) the records to be kept;
 - (c) different records to be kept under different circumstances or by different classes or descriptions of prescribed persons;
 - (d) the manner in which, the location at which and the minimum duration for which the records must be kept;
 - (e) the circumstances relating to a specified OTC derivative transaction in which the record keeping

obligation—

- (i) applies;
- (ii) does not apply; or
- (iii) is taken to have been complied with; and
- (f) any other matter relating to the records to be kept.”.

9 In the proposed section 101O(1)(a)(ii), by deleting “or”.

9 In the proposed section 101O(1)(a)(iii), by deleting “and”.

9 In the proposed section 101O(1)(a), by adding—

- “(iv) a recognized exchange company;
- (v) a recognized clearing house; or
- (vi) a person authorized under section 95(2) to provide automated trading services; and”.

9 In the proposed section 101O, by adding—

- “(2A) For the purposes of subsection (2), a reference to a person’s position includes the position of another person to the extent to which the performance of the obligations arising from that other person’s position is guaranteed by the person.”.

9 In the proposed section 101O(6)(a), by adding “and, if the offence is a continuing offence, to a further fine of \$100,000 for every day during which the offence continues, until the cut-off date for the further fine” after “7 years”.

9 In the proposed section 101O(6)(b), by adding “and, if the offence is a continuing offence, to a further fine of \$10,000 for every day during which the offence continues, until the cut-off date for the further fine” after “2 years”.

- 9 In the proposed section 101O, by adding—
- “(7) For the purposes of subsection (6), the cut-off date for a further fine for which the person is liable is the date on which the person, in writing, notifies the Commission in accordance with subsection (4) of the person’s position in that specific class.”.
- 9 In the proposed section 101Q, by adding—
- “(6A) For the purposes of subsection (6)(b), a reference to a person’s position includes the position of another person to the extent to which the performance of the obligations arising from that other person’s position is guaranteed by the person.”.
- 9 In the proposed section 101R, by adding—
- “(5) For the purposes of subsections (3) and (4), a reference to the position of a person or a person’s position includes the position of another person to the extent to which the performance of the obligations arising from that other person’s position is guaranteed by the person.”.
- 9 In the proposed section 101U(2)(a), by deleting “positions” and substituting “exposure arising from its positions”.
- 9 In the proposed section 101U(2)(d), by deleting “as specified in the notice”.
- 9 In the proposed section 101U(2), by adding—
- “(da) to restrict the type of collateral collected or posted;”.
- 9 In the proposed section 101U, by adding—
- “(2A) For the purposes of subsection (2)(a), a reference to the registered SIP’s exposure arising from its positions is a reference to the risk to which the registered SIP is exposed in respect of—

- (a) the positions of the registered SIP; and
- (b) the positions of another person to the extent to which the performance of the obligations arising from those positions is guaranteed by the registered SIP.”.

- 9 In the proposed section 101W(a)(ii), by deleting “and”.
- 9 In the proposed section 101W(a)(iii), by adding “and” after the semicolon.
- 9 In the proposed section 101W(a), by adding—
- “(iv) the conditions, circumstances and criteria for regarding a person’s position as reaching the notification level;”.
- 14 In the proposed section 145A(1), by adding “acts involving” after “engages in”.
- 18(3) In the proposed section 182(1)(b)(vii), by deleting “clearing agency” and substituting “client clearing”.
- 18(5) In the proposed section 182(1)(da), by deleting “obligation or trading” and substituting “obligation, trading obligation or record keeping”.
- 20 In the proposed section 184A(1), by deleting “obligation or trading” and substituting “obligation, trading obligation or record keeping”.
- 37 In the proposed section 203A(6), in the definition of *obligation*, by deleting “obligation or trading” and substituting “obligation, trading obligation or record keeping”.
- 40 In the proposed section 381B(1)(b), by adding “(Winding Up and Miscellaneous Provisions)” after “Companies”.

40 In the proposed section 381B(4), by deleting “, or the trading particulars,”.

40 In the proposed section 381F(4), by adding “reasonably” before “practicable”.

40 In the proposed section 381F, by adding—

“(5) A matter published under subsection (4) is not subsidiary legislation.”.

52(2) By deleting the proposed definition of *market contract* and substituting—

“*market contract* (市場合約) means—

- (a) a contract that is subject to the rules of a recognized clearing house and entered into by the clearing house with a clearing participant, whether or not pursuant to a novation, for the purpose of the clearing and settlement of a transaction in securities or futures contracts that is—
 - (i) effected on a recognized stock market or a recognized futures market; or
 - (ii) subject to the rules of a recognized exchange company;
- (b) a contract that is subject to the rules of a recognized clearing house and entered into by the clearing house with a clearing participant, whether or not pursuant to a novation, for the purpose of the clearing and settlement of an OTC derivative transaction; or
- (c) a contract that is—
 - (i) subject to the rules of a designated CCP (as defined by section 101A of this Ordinance) that is a provider of authorized automated trading services and specified by the Commission by notice published in the Gazette under section 1C; and

- (ii) entered into by the designated CCP with any one of its members, whether or not pursuant to a novation, for the purpose of the clearing and settlement of an OTC derivative transaction;”.
- 52(3) In the proposed definition of *providing clearing agency services for OTC derivative transactions*, by deleting “*clearing agency services for OTC derivative transactions* (為場外衍生工具交易提供結算代理人” and substituting “*client clearing services for OTC derivative transactions* (為場外衍生工具交易提供客戶結算”.
- 52(3) By adding in alphabetical order to the proposed definitions—
“*record keeping obligation* (備存紀錄責任) has the meaning given by section 101A of this Ordinance;”.
- 52(5) In the proposed section 1C(1), by deleting “paragraph (b)(ii)” and substituting “paragraph (c)(i)”.
- 53(2) In the proposed entry relating to Type 12, by deleting “clearing agency” and substituting “client clearing”.
- 53 By adding—
“(6A) Schedule 5, Part 2, definition of *advising on securities*—
Repeal
“such advice that”
Substitute
“such advice or issuing of such analyses or reports that”.”.
- 53(10) In the proposed paragraph (ba)(i), in the Chinese text, by adding “以某種方式” after “從而”.

- 53(20) By adding—
- “(xib) that is an act that constitutes entering into a market contract;”.
- 53(21) In the proposed definition of *advising on OTC derivative products*, by deleting “such advice that” and substituting “such advice or issuing of such analyses or reports that”.
- 53(21) In the proposed definition of *dealing in OTC derivative products*, in paragraph (a), by adding “or” after the semicolon.
- 53(21) In the proposed definition of *dealing in OTC derivative products*, by deleting paragraphs (c) and (d).
- 53(21) By deleting the proposed definition of *providing clearing agency services for OTC derivative transactions* and substituting—
- “providing client clearing services for OTC derivative transactions* (為場外衍生工具交易提供客戶結算服務), in relation to a person and subject to Part 2A, means providing services to another person for the clearing and settlement of OTC derivative transactions through a central counterparty (whether located in Hong Kong or elsewhere), whether or not as a member of the central counterparty;”.
- 53(22) By deleting the proposed section 2(g) and substituting—
- “(g) an act referred to in paragraph (a) of the definition of *dealing in OTC derivative products* in Part 2 that is carried out by a person as a price taker;”.
- 53(22) In the proposed section 4, by deleting “*clearing agency*” and substituting “*client clearing*”.
- 55 In the proposed section 3(1), by deleting “activity if” and

substituting “activity concerned if”.

- 55 In the proposed section 3(2), by deleting “activity if” and substituting “activity concerned if”.
- 55 In the proposed section 33(1)(b), by deleting “except to the extent that it also constitutes carrying on the new Type 7 activity”.
- 55 In the proposed section 33(4), by deleting “except to the extent that it also constitutes carrying on the new Type 7 activity”.
- 55 In the proposed section 33(5)(f), by deleting “except to the extent that it also constitutes carrying on the new Type 7 activity”.
- 55 In the proposed section 33(6)(b), by deleting “except to the extent that it also constitutes carrying on the new Type 7 activity”.
- 55 In the proposed section 38(1)(c)(i), in the Chinese text, by deleting “拒遭” and substituting “遭拒”.
- 55 In the proposed section 42(3)(a)(ii), by deleting “grant registration” and substituting “grant a certificate of registration”.
- 55 In the proposed section 42(3)(a)(iii), by deleting “a regulated activity” and substituting “the regulated activity specified in the licence or certificate of registration”.
- 55 In the proposed section 42(4)(b), by deleting “grant registration” and substituting “grant a certificate of registration”.
- 55 In the proposed section 42(4)(c), by deleting “a regulated activity” and substituting “the regulated activity specified in the licence or certificate of registration”.
- 55 In the proposed section 43(5), in the definition of *specified*

period, in paragraph (g)(ii), by deleting “grant registration” and substituting “grant a certificate of registration”.

- 57 By adding—
- “(1A) Section 18(1), definition of *defaulter*—
- Repeal**
- “a clearing participant who”
- Substitute**
- “a recognized clearing house, or a clearing participant, that”.”.
- 57(2) In the proposed section 18(7)(a), by deleting “the recognized” and substituting “the”.
- 57(2) In the proposed section 18(7)(b)(i), in the English text, by deleting “recognized”.
- 57(2) In the proposed section 18(7)(b)(ii), by deleting “recognized”.
- 58 By renumbering the clause as clause 58(1).
- 58(1) In the proposed section 40(2A)(a)(i), by deleting “recognized”.
- 58(1) In the proposed section 40(2A)(a)(ii), in the English text, by deleting “recognized”.
- 58(1) By deleting the proposed section 40(2A)(b) and (c) and substituting—
- “(b) taking proceedings or other action in relation to any contracts entered into between a clearing participant and its clients if—
- (i) the clearing participant appears to be unable, or likely to become unable, to meet its obligations in respect of all unsettled or open market contracts to which it is a party; and

- (ii) those contracts relate to such unsettled or open market contracts recorded in a client account;
- (c) taking proceedings or other action in relation to any positions or collateral relating to a contract entered into between a clearing participant and its clients referred to in paragraph (b) if—
 - (i) the clearing participant appears to be unable, or likely to become unable, to meet its obligations in respect of all unsettled or open market contracts to which it is a party; and
 - (ii) those positions or collateral relate to such unsettled or open market contracts recorded in a client account.”.

58

By adding—

“(2) After section 40(6)—

Add

“(7) In this section—

client account (客户帐户), in relation to a clearing participant, means an account held with a recognized clearing house in the name of the clearing participant, other than a house account in which positions or collateral are recorded;

house account (結算所帳戶), in relation to a clearing participant, means an account—

- (a) which is held with a recognized clearing house in the name of the clearing participant; and
- (b) in which the following are recorded—
 - (i) the clearing participant’s own positions or collateral;
 - (ii) the positions or collateral of other persons that are regarded by the rules of the recognized clearing house to be the clearing participant’s own

positions or collateral.”.”.

New By adding—

“58A. Section 45 amended (proceedings of recognized clearing house take precedence over law of insolvency)

After section 45(1)(d)—

Add

“(da) the provision of market collateral;”.”.

60 By deleting the proposed section 2 and substituting—

“2. If—

- (a) the RCH rules envisage that a clearing participant may record market contracts in separate capacities, as referred to in section 3; and
- (b) the recognized clearing house operates in such a manner that paragraphs (a), (b), (c), (d), (e) and (f) of section 1 may be complied with separately in respect of each of the capacities,

paragraphs (a), (b), (c), (d), (e) and (f) of section 1 must be complied with separately in respect of each capacity.”.

60 By deleting the proposed section 3(a) and substituting—

- “(a) a clearing participant will be regarded as recording market contracts in a separate capacity in respect of

its house accounts and each of its client accounts if—

- (i) for house accounts—transactions that are required or permitted by the RCH rules to be recorded in any of the clearing participant’s house accounts with the recognized clearing house have been so recorded; and
- (ii) for each client account—transactions that are required or permitted by the RCH rules to be recorded in any of the clearing participant’s client accounts with the clearing house have been so recorded.”.

60 In the proposed section 3(b), by deleting “client accounts,” and substituting “a client account,”.

60 In the proposed section 3(b), in the English text, by deleting “set off” and substituting “set-off”.

60 In the proposed section 3(c), in the English text, by deleting “set off” and substituting “set-off”.

60 In the proposed section 3(c), by deleting “permit.” and substituting “permit;”.

60 In the proposed section 3, by adding—

- “(d) any net sum payable to the clearing participant in respect of transactions recorded in a client account, as calculated under section 1(c), may not be set-off against any net sum payable by the clearing participant in respect of transactions recorded in any other client account, as calculated under that section, if the RCH rules so provide.”.

60 In the proposed section 4(b), by adding “or permitting” after “authorizing”.

60 By adding—

“5A. In this Part, a reference to a set-off or offset includes a netting arrangement.

5B. For the purposes of this Part, a sum of money payable by, or payable to, a person includes a value to be taken into account under a netting arrangement to which the person is a party.”.

60 In the proposed section 6, in the definition of *client account*, by deleting “recognized clearing house, means an account held by the recognized clearing house in the name of a clearing participant” and substituting “clearing participant, means an account held with a recognized clearing house in the name of the clearing participant,”.

60 In the proposed section 6, in the definition of *house account*, in paragraph (a), by deleting “held by the” and substituting “which is held with a”.

60 In the proposed section 6, in the definition of *house account*, in paragraph (b)(i), by deleting “and” and substituting “or”.

60 In the proposed section 6, in the definition of *house account*, in paragraph (b)(ii), by deleting “positions and” (wherever appearing) and substituting “positions or”.

60 In the proposed section 6, by adding in alphabetical order—

“*netting* (淨額計算) means the determination of a net balance by taking account of the values (whether positive or negative) attributed to an accelerated or terminated payment, or to a delivery obligation or entitlement;”.

60 In the proposed section 6, in the definition of *RCH rules*, by deleting “the recognized” and substituting “the”.