

## LEGISLATIVE COUNCIL BRIEF

### Securities and Futures Ordinance (Chapter 571)

#### Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) (Amendment) Notice 2018

#### Securities and Futures (OTC Derivative Products) Notice

### INTRODUCTION

For the purpose of adjusting the scope of over-the-counter (“OTC”) derivative products, which are regulated under the Securities and Futures Ordinance (Cap. 571) (“SFO”), the Financial Secretary has made –

- (a) the Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) (Amendment) Notice 2018 (“Amendment Notice”) at **Annex A** to prescribe additional markets and clearing houses so as to exclude products traded on those markets and cleared through those clearing houses from the scope of OTC derivative products; and
- (b) the Securities and Futures (OTC Derivative Products) Notice (“Notice”) at **Annex B** to exclude certain Delta One Warrants<sup>1</sup> from the scope of OTC derivative products.

### JUSTIFICATIONS

#### The Regulatory Framework

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<sup>1</sup> Delta One Warrants are warrants which give the holder the right to purchase the underlying asset(s) with a strike price set at zero or very close to zero. These warrants are intended to enable holders to be exposed to the risk and return of the underlying asset(s), in particular, in closed or difficult-to-access markets, without actually investing directly in the underlying asset(s). Please refer to **Annex B** for a detailed description of “Delta One Warrants” that will be excluded from the scope of OTC derivative products.

2. The Legislative Council (“LegCo”) has enacted the Securities and Futures (Amendment) Ordinance 2014 to provide for a regulatory framework for the OTC derivatives market in Hong Kong to meet the relevant commitments of the Group of Twenty. Among other things, the framework introduces mandatory obligations that require the reporting, clearing and trading of OTC derivative transactions. In line with other markets, the mandatory obligations are being implemented in phases. The first and second phases of mandatory reporting came into force on 10 July 2015 and 1 July 2017 respectively, and the first phase of mandatory clearing came into force on 1 September 2016.<sup>2</sup>

### **Requests from Market Participants**

3. In March 2017, market participants approached the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”) via an industry association<sup>3</sup> to request two adjustments to the scope of the term “OTC derivative product” under the SFO. They indicated that the adjustments were necessary to carve out certain products which were not typically regarded as OTC derivatives, and should therefore fall outside the OTC derivatives regulatory regime. After public consultation, the HKMA and the SFC propose to make the following adjustments to the term “OTC derivative product” by prescription under the SFO.

### **Prescription of Additional Markets and Clearing Houses**

4. The OTC derivatives regulatory regime is not intended to encompass traditional products that are traded on an exchange and cleared through a clearing house. Such exchange-traded products are already subject to adequate safeguards and protection. In the case of products traded on and cleared through exchanges and clearing houses in other jurisdictions, the exclusion only applies if the market on which they are traded and the clearing house through which they are cleared are prescribed under section 392A(a) of the SFO. The existing lists of stock markets, futures markets and clearing houses are prescribed in the

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<sup>2</sup> The first phase of mandatory reporting covered transactions in certain interest rate swaps and non-deliverable forwards. The second phase of mandatory reporting has expanded the scope to cover all OTC derivative transactions in the five key asset classes (interest rate, foreign exchange, equity, credit and commodity). The first phase of mandatory clearing covers transactions in certain interest rate derivatives between major dealers.

<sup>3</sup> The request was made by the International Swaps and Derivatives Association, Inc. in a letter sent to the HKMA and the SFC on 31 March 2017 after consulting its members in the Asia Pacific region.

Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) Notice (Cap. 571AM).

5. The HKMA and the SFC consider that markets and clearing houses for exchange-traded products should only be prescribed under section 392A(a) of the SFO if they meet all of the following criteria –

- (a) they operate in jurisdictions whose securities or futures regulator is a member of the International Organization of Securities Commissions;
- (b) they are regulated in their home jurisdictions by the relevant market regulator, banking regulator or government agency in that jurisdiction; and
- (c) their regulatory status is comparable to that of a recognized exchange company or a recognized clearing house (as the case may be) under the SFO. In the case of a market operator that operates several types of markets, only those markets that are traditional exchanges with a fairly established history should be prescribed.

6. The above criteria are intended to ensure that section 392A(a) is only used to exclude products that are – (a) genuinely exchange-traded rather than OTC in nature; and (b) traded on and cleared through adequately regulated exchanges and clearing houses.

7. Taking into account market feedback as well as the three criteria set out in paragraph 5 above, the HKMA and the SFC propose to prescribe additional markets and clearing houses as set out at **Annex A**.

### **Prescription of Delta One Warrants**

8. Section 392(1) of the SFO empowers the Financial Secretary to prescribe products so that they are specifically included in or excluded from the definition of “OTC derivative product”. This provides a degree of flexibility to refine the ambit of “OTC derivative product” over time as appropriate, and consequently adjust the scope of the OTC derivatives regulatory regime accordingly.

9. Market participants have requested that Delta One Warrants be specifically excluded from the definition of “OTC derivative product”. The rationale is that Delta One Warrants do not embody features

commonly associated with OTC derivatives and therefore do not pose systemic risk in the way that other OTC derivative products might. In particular –

- (a) a Delta One Warrant has a simpler counterparty risk than most OTC derivatives. The warrant issuer is not exposed to the credit risk of the warrant holder since the latter has already paid the warrant price in full and will be under no further obligation to the issuer;
- (b) the strike price of a Delta One Warrant (i.e. the purchase price for the underlying asset(s) which the warrant holder must pay when exercising the warrant) is set at zero or close to zero. This means that the holder of the Delta One Warrant has effectively paid for the warrant's underlying asset(s) in full when acquiring the warrant. The warrant issuer therefore does not provide any leverage to the warrant holder. In contrast, most OTC derivatives typically involve some leveraged exposure; and
- (c) investing in a Delta One Warrant is very similar in risks and returns to investing in the warrant's underlying asset(s), except that – (i) there is no need to be concerned about the clearing and settlement of the underlying asset(s); and (ii) the holder of the warrant does not have the same rights as the holder of the underlying asset(s) in so far as it is not the legal owner of the underlying asset(s) (e.g. where the underlying asset(s) are shares in a company, a warrant holder is not entitled to vote in the shareholders' meetings).

10. Retaining Delta One Warrants within the ambit of “OTC derivative product” may unnecessarily hinder market development and create undue compliance burden. Consequently, it is proposed that a Delta One Warrant which meets all of the following criteria be prescribed under section 392(1)(b)(vii) of the SFO, and thus excluded from the definition of “OTC derivative product”. It should be a structured product, as defined by the SFO, that –

- (a) gives its holder the right to purchase its underlying subject matter;
- (b) it is either settled in cash or physically settled;

- (c) if it is settled in a currency other than the currency or currencies in which the underlying subject matter is denominated — is settled at the exchange rate for the currencies involved prevailing at the time of the settlement;
- (d) has its strike price specified as, or in effect set at, zero or an amount close to zero;
- (e) is not subject to any restriction on its transfer (other than a restriction imposed solely for the purpose of complying with applicable legal or regulatory requirements); and
- (f) is documented in the form of a warrant.

11. These criteria aim to define and restrict the scope of Delta One Warrants so that market participants cannot bypass the OTC derivatives regulatory regime by simply labelling or describing their products as Delta One Warrants.

## **THE SUBSIDIARY LEGISLATION**

### ***Securities and Futures (Stock Markets, Futures Markets and Clearing Houses) (Amendment) Notice 2018***

12. The Amendment Notice prescribes additional markets and clearing houses as set out in **Annex A** under section 392A(a) of the SFO so as to exclude products traded on those markets and cleared through those clearing houses from the scope of OTC derivative product.

### ***Securities and Futures (OTC Derivative Products) Notice***

13. The Notice excludes Delta One Warrants that fall within the description of the product in the Notice from the scope of OTC derivative products pursuant to section 392(1)(b)(vii) of the SFO.

## **LEGISLATIVE TIMETABLE**

14. The two pieces of subsidiary legislation will be published in the Gazette on 23 February 2018 and tabled before LegCo at its sitting on 28 February 2018. Subject to negative vetting by LegCo, both pieces of subsidiary legislation will come into operation on 27 April 2018.

## **IMPLICATIONS OF THE PROPOSALS**

15. The Amendment Notice and the Notice are in conformity with the Basic Law, including the provisions concerning human rights. They will not affect the binding effect of the SFO. They have no productivity, environmental, family, gender or civil service implications. There will be no financial implications to the Government. As for economic implications, the Amendment Notice and the Notice will carve out certain products which are not typically regarded as OTC derivatives from the regulatory regime, and thus help reduce compliance cost. This would have a positive impact on market development.

## **PUBLIC CONSULTATION**

16. The HKMA and the SFC conducted a joint public consultation on the proposed adjustments in April 2017. Respondents generally supported the proposed adjustments and some provided comments on the criteria for defining Delta One Warrants. More recently, four market participants made a further request to add an entity to the list of markets and clearing houses prescribed under section 392A(a) of the SFO. The HKMA and the SFC have taken into account the responses in finalising the above proposals.

17. An information paper on the above proposals was circulated to the members of the LegCo Panel on Financial Affairs on 13 December 2017. Members did not raise any issues regarding the proposals.

## **PUBLICITY**

18. A press release will be issued on 23 February 2018 upon the gazettal of the Amendment Notice and the Notice. A spokesperson will be available to answer media enquiries.

## **ENQUIRIES**

19. Enquiries relating to this brief can be directed to Ms Ada Chan, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services), at 2810 2056, Ms Pansy Pang, Senior Manager of

the Financial Stability Surveillance Division of the HKMA, at 2878 1206  
or Ms Daphne Doo, Senior Director of the Supervision of Markets  
Division of the SFC, at 2231 1795.

**Financial Services and the Treasury Bureau  
Hong Kong Monetary Authority  
Securities and Futures Commission  
21 February 2018**

Securities and Futures (Stock Markets, Futures Markets and Clearing Houses)  
(Amendment) Notice 2018

Section 1

1

**Securities and Futures (Stock Markets, Futures  
Markets and Clearing Houses) (Amendment) Notice  
2018**

(Made by the Financial Secretary under section 392A of the Securities and  
Futures Ordinance (Cap. 571))

**1. Commencement**

This Notice comes into operation on 27 April 2018.

**2. Securities and Futures (Stock Markets, Futures Markets and  
Clearing Houses) Notice amended**

The Securities and Futures (Stock Markets, Futures Markets and  
Clearing Houses) Notice (Cap. 571 sub. leg. AM) is amended as set  
out in sections 3 and 4.

**3. Section 2 amended (prescribed markets)**

(1) Section 2, heading, after “markets”—

**Add**

“and clearing houses”.

(2) Section 2, after “the Schedule”—

**Add**

“(despite any subsequent change in their names)”.

**4. Schedule amended (prescribed markets)**

(1) Schedule, heading, after “Markets”—

**Add**

“and Clearing Houses”.

Securities and Futures (Stock Markets, Futures Markets and Clearing Houses)  
(Amendment) Notice 2018

Section 4

2

(2) Schedule, Part 1, after item 20—

**Add**

“20A. Main Securities Market operated by The Irish Stock  
Exchange plc”.

(3) Schedule, Part 1, item 40—

**Repeal paragraph (u).**

(4) Schedule, Part 1, before item 40(v)—

**Add**

“(ua) Hanoi Stock Exchange;

(ub) Hochiminh Stock Exchange;”.

(5) Schedule, Part 1, after item 40(zc)—

**Add**

“(zca) Miami International Securities Exchange, LLC;”.

(6) Schedule, Part 1, after item 40(zs)—

**Add**

“(zsa) Pakistan Stock Exchange;”.

(7) Schedule, Part 1, after item 40(zt)—

**Add**

“(zta) Shanghai International Energy Exchange Co., LTD;”.

(8) Schedule, Part 1, after item 40(zza)—

**Add**

“(zzab) Taipei Exchange (previously GreTai Securities  
Market);

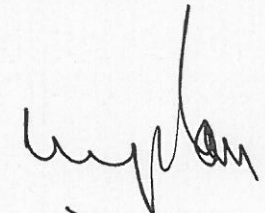
(zzac) Taiwan Stock Exchange Corporation;”.

(9) Schedule, Part 2, after item 16—

**Add**



- “16A. Clearstream Banking S.A.”.
- (10) Schedule, Part 2, after item 18—  
**Add**  
“18A. Euroclear Bank S.A./N.V.”.
- (11) Schedule, Part 2—  
**Repeal item 21.**
- (12) Schedule, Part 2, after item 40—  
**Add**  
“40A. National Clearing Company of Pakistan Limited”.
- (13) Schedule, Part 2, after item 46—  
**Add**  
“46A. Shanghai International Energy Exchange Co., LTD”.
- (14) Schedule, Part 2, after item 50—  
**Add**  
“50A. Taipei Exchange (previously GreTai Securities Market)  
50B. Taiwan Stock Exchange Corporation”.
- (15) Schedule, Part 2, after item 57—  
**Add**  
“57A. Vietnam Securities Depository”.



Financial Secretary

12 . 2 . 2018

### **Explanatory Note**

This Notice prescribes additional stock markets, futures markets and clearing houses for the purpose of section 1B(2)(c) of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) (*Ordinance*), so as to exclude products traded on those markets and cleared through those clearing houses from the scope of OTC derivative products, which are regulated under the Ordinance.

2. This Notice also amends the English name of a market operator and clearing house.

## Securities and Futures (OTC Derivative Products) Notice

(Made by the Financial Secretary under section 392 of the Securities and  
Futures Ordinance (Cap. 571))

### 1. Commencement

This Notice comes into operation on 27 April 2018.

### 2. Interpretation

In this Notice—

*underlying subject matter* (標的項目)—

- (a) in relation to a transaction in a structured product that falls within subsection (1)(a)(i) of section 1A of Part 1 of Schedule 1 of the Ordinance, means any type or combination of types of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;
- (b) in relation to a transaction in a structured product that falls within subsection (1)(a)(ii) of section 1A of Part 1 of Schedule 1 of the Ordinance, means any basket of more than one type, or any combination of types, of securities, commodity, index, property, interest rate, currency exchange rate or futures contract; and
- (c) in relation to a transaction in a structured product that falls within subsection (1)(a)(iii) of section 1A of Part 1 of Schedule 1 of the Ordinance, means any specified event or events (excluding an event or events relating only to the issuer or guarantor of the instrument or to both the issuer and the guarantor).

### 3. Structured product that is not regarded as OTC derivative product

The structured product set out in the Schedule is not to be regarded as an OTC derivative product for the purposes of the Ordinance.

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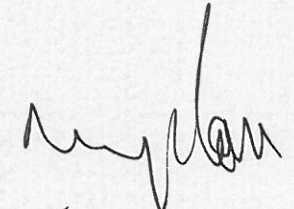
**Schedule**

[s. 3]

**Structured Product Not to be Regarded as OTC  
Derivative Product**

Any structured product that—

- (a) gives its holder the right to purchase its underlying subject matter;
- (b) is either settled in cash or physically settled;
- (c) if it is settled in a currency other than the currency or currencies in which its underlying subject matter is denominated—is settled at the exchange rate for the currencies involved prevailing at the time of the settlement;
- (d) has its strike price specified as, or in effect set at, zero or an amount close to zero;
- (e) is not subject to any restriction on its transfer (other than a restriction imposed solely for the purpose of complying with applicable legal or regulatory requirements); and
- (f) is documented in the form of a warrant.



Financial Secretary

12. 2 . 2018

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### **Explanatory Note**

This Notice prescribes that, for the purposes of the Securities and Futures Ordinance (Cap. 571) (*Ordinance*), any structured product set out in the Schedule to this Notice (*product*) is not to be regarded as an OTC derivative product so that the product will not be regulated as an OTC derivative product under the Ordinance. The purpose of this Notice is to exclude Delta One Warrants that fall within the description of the product from being regulated as an OTC derivative product under the Ordinance.