For information

Legislative Council Panel on Financial Affairs

Legislative proposal to refine the scope of regulated activities and provide for licensing fees under the Over-the-counter derivative regulatory framework in Hong Kong

PURPOSE

This paper briefs Members on the proposed refinements to the scope of regulated activities ("RAs") under the over-the-counter ("OTC") derivative regulatory framework including its licensing regime as provided for in the Securities and Futures Ordinance ("SFO") (Cap. 571). This paper also sets out the fee proposals in relation to the abovementioned licensing regime under the Securities and Futures (Fees) Rules ("Fees Rules") (Cap. 571 AF).

BACKGROUND

2. The Securities and Futures (Amendment) Ordinance 2014 ("SFAO 2014") was enacted to introduce an OTC derivative regulatory framework in Hong Kong. Among others, it establishes an OTC derivative licensing regime which includes the introduction of two new RAs under Schedule 5 to the SFO, namely (a) a new Type 11 RA (dealing in OTC derivative products or advising on OTC derivative products), and (b) a new Type 12 RA (providing client clearing services for OTC derivative transactions). Alongside with the above, the existing Type 9 RA (asset management) and Type 7 RA (provision of automated trading services ("ATS")) are expanded to cover OTC derivative portfolios and transactions respectively. Such licensing regime has yet to commence pending the enactment of relevant subsidiary legislation.

3. Section 53(23) of the SFAO 2014 prescribes a list of carve-outs from the OTC derivative licensing regime. In the process of preparing for the commencement of that licensing regime in consultation with market participants, they have raised with the Securities and Futures Commission ("SFC") some issues which may not have been clearly addressed by the current prescribed exceptions. Further refinements to the

scope of RAs are therefore necessary to provide more clarity about the exceptions and to better reflect the policy intent.

4. Separately, certain licensing fees, such as licence application fees and annual fees are prescribed on a "per RA" basis under Schedule 3 to the Fees Rules. Also, section 11(3) of the Fees Rules prescribes waivers of fees in certain circumstances in respect of Type 7 RA. In light of the introduction of new RAs and expansion of the existing Type 7 RA, we need to update the Fees Rules correspondingly.

PROPOSALS

(A) Proposed refinements to the scope of regulated activities

5. After a public consultation conducted during 2017-2018, we propose making the following amendments to Schedule 5 to the SFO in respect of the scope of the new Type 11 and Type 12 RAs, as well as the expanded Type 9 RA and the existing Type 3 RA (leveraged foreign exchange trading). The main purposes are to carve out activities that are not intended to be covered by the OTC derivative licensing regime and to provide clarity as to the scope of the relevant RAs.

(i) Corporate treasury activities of non-financial groups

6. It has always been our policy intention to exclude "price takers" as their transactions are not intended to affect or move the market price[1]. Consistent with this, it is also not our intention to regulate corporate treasury activities of non-financial groups so long as their activities remain akin to those of a price taker or end user as such activities are less likely to pose systemic risks.

7. However, market participants have raised concerns on whether certain specific corporate treasury activities of non-financial groups would fall within current carve-outs and hence whether such activities are to be caught under the scope of expanded Type 9 and Type 11 RAs[2]. Also, in light of market developments and the increasing

[1] See new section 2(g) of Part 2A, Schedule 5 to the SFO, to be inserted pursuant to section 53(23) of SFAO 2014, which excludes "price takers" from the scope of the "dealing" limb of Type 11 RA.

[2] For example, it is unclear whether both sides to an intra-group OTC derivative transaction can claim to be acting as price takers and thus benefit from the said "price-taker carve-out". Also, some affiliates in some jurisdictions may not be wholly-owned subsidiaries due to foreign ownership structure and thus may not benefit from the intra-group carve-out from the "advising" limb of Type 11 RA. This is because the intra-group carve-out is only available for advice given to affiliates by a corporation if the affiliate is a wholly-owned subsidiary of the corporation or vice versa, or if both are wholly owned by the same holding company (see new section 1(g) of Part 2A, Schedule 5 to the SFO, to be inserted pursuant to section 53(23) of SFAO 2014).

popularity of central clearing for OTC derivative transactions, the SFC notices that corporate treasury desk of non-financial groups may also provide clearing and settlement services to their respective affiliates. Given market participants' concerns and for clarity, we propose carving out corporate treasury activities of non-financial groups of companies from the expanded Type 9, new Type 11 and Type 12 RAs. The actual effect is that all corporate treasury activities of non-financial groups will be carved out entirely from the OTC derivative licensing regime to better reflect our policy intention.

(ii) Activities of providers of post-trade multilateral portfolio compression services

8. Multilateral portfolio compression services are common post-trade risk reduction services in the OTC derivative market. They facilitate modification, early termination, or replacement of OTC derivative transactions among multiple participants to a compression cycle so as to reduce the notional amount of their outstanding transactions, or the number of transactions among the participants or both, and as a result, they reduce or mitigate counterparty credit risk exposure and operational risk. In general, providers of multilateral portfolio compression services are not themselves contracting parties to the OTC derivative transactions which are subject to the compression cycle or that result from the compression process. They are also typically not involved in the execution or settlement of such transactions.

9. However, given the role that providers of multilateral portfolio compression services play, there is a chance that some of their activities in providing the service may fall under the "dealing limb" or "advising limb" of Type 11 RA. Considering that participants of multilateral portfolio compression services are typically sophisticated market participants, and the service is conducive to risk mitigation and should be encouraged, we propose carving out such activities from the scope of Type 11 RA.

(iii) Provision of portfolio compression services by central clearing counterparty ("CCP") and providers of client clearing services

10. Apart from the multilateral portfolio compression services mentioned in paragraph 9 above, the SFC notices that there are compression services provided by some CCPs on solo or bilateral[3] basis. Similar to multilateral portfolio compression services, such services provided by CCPs could reduce the notional value of, and / or

[3] Solo and bilateral portfolio compression means portfolio compression in respect of portfolios of only one person and two persons respectively.

the number of transactions in the portfolios of clearing members and their clients, thus enhancing capital and operational efficiency.

11. Since CCPs and providers of client clearing services are or will be subject to appropriate regulatory oversight, we propose a separate carve-out for portfolio compression services provided by a CCP or a provider of client clearing services from the scope of Type 11 RA to minimise repeated regulatory efforts.

(iv) Activities of overseas clearing members

12. SFAO 2014 currently excludes remote clearing members of a Hong Kong CCP meeting certain pre-requisites[4] from the scope of Type 12 RA. Such members are thus able to actively market their client clearing services for OTC derivative transactions to persons in Hong Kong via an authorized financial institution or a licensed corporation without having to be licensed for Type 12 RA.

13. However, there have been comments from the market as to why such carve-out cannot be extended to the activities of remote clearing members of overseas CCPs. Having reviewed the regulatory framework, the SFC agrees that subject to meeting certain prescribed pre-requisites, the geographical location of the CCP should not be a determining factor of the carve-out. Given central clearing via CCPs will reduce counterparty risk and interconnectedness among counterparties which should be encouraged, we propose expanding the carve-out to explicitly exclude overseas persons who are clearing members of any CCP from the scope of Type 12 RA. Consequently, dealing and advising activities incidental to client clearing services by these remote clearing members of overseas CCPs should be carved out from the scope of Type 11 RA. This will align with the carve-out to persons licensed for Type 12 RA already in SFAO 2014.

(v) Certain services provided by asset managers or other activities that are ancillary to clearing

14. Type 12 RA is intended to cover clearing and settlement services provided to another person through a CCP, whether directly (i.e. in the capacity of a clearing member) or indirectly (e.g. via another person which is a clearing member). However, given that the current definition of Type 12 RA is cast widely, there have been concerns from some market participants on whether activities which are

[4] For example, being regulated in a comparable overseas jurisdiction for providing client clearing services and marketing their services to persons in Hong Kong only through an authorized financial institution or a licensed corporation.

essentially ancillary to the clearing and settlement process would also be captured. To clarify our policy intention, we propose refining the scope of Type 12 RA so that it will not capture certain asset manager services or other activities which are only ancillary to the clearing and settlement process.

(vi) Portfolio management services for wholly-owned group companies

15. Currently, a corporation does not need to be licensed for Type 9 RA if it only provides portfolio management services (in respect of securities and futures contracts) for its wholly-owned group companies. However, this carve-out is not reflected in the expanded Type 9 RA (in respect of an OTC derivative transaction), except to the extent that the OTC derivative products in the portfolio also constitute "securities" or "futures contracts". In response to market feedback and to bring the OTC derivative licensing regime in alignment with the current practices for securities and futures contracts, we propose extending the existing carve-out under Type 9 RA for managing OTC derivative portfolio for wholly-owned group companies to cover all OTC derivative products.

(vii) Portfolio management activities by professionals

16. Similar to the portfolio management services for wholly-owned group companies as mentioned in paragraph 15, for professionals (i.e. solicitors, counsel, certified public accountants and trust companies registered under Part 8 of the Trustee Ordinance) who provide portfolio management in respect of OTC derivative products incidental to discharging their professional roles, the current carve-out from having to be licensed for Type 9 RA only applies to the extent that the OTC derivative products in their portfolio also constitute "securities" or "futures contracts". We propose a similar expansion of the carve-out under Type 9 RA to cover all OTC derivative products.

(viii) Leveraged foreign exchange trading by asset managers

17. Market participants have indicated in their feedback that they would like to have clarity on whether licensed asset managers managing a portfolio of OTC derivative products who wish to trade in a foreign exchange derivative transaction as part of their asset management strategy are required to be licensed for Type 3 RA. Given that the SFC has no regulatory intention to require licensed asset managers to be licensed for Type 3 RA if they deal in a foreign exchange derivative transaction solely for the purpose of managing assets, we propose providing a carve-out under Type 3 RA for better clarity.

(ix) General powers to prescribe further carve-outs from the scope of expanded Type 9 and Type 12 RAs

18. To provide the SFC with more flexibility to respond to market needs promptly, we propose building in a general power for the SFC to carve out further activities from the scope of the expanded Type 9 and Type 12 RAs by subsidiary legislation. This would be similar to the power already provided for by SFAO 2014 in respect of Type 11 RA[5].

(B) Fee proposals for the OTC derivative licensing regime

(i) RA-specific application fees and annual fees

19. At present, all RAs are subject to uniform licence application fees and annual fees (except for Type 3 RA). We propose that the same fee structure and fee levels set out in Schedule 3 to the Fees Rules currently charged in respect of all RAs other than Type 3 RA should apply to the new Type 11 and Type 12 RAs. Also, we do not propose any changes to the existing fees applicable to both Type 7 and Type 9 RAs even after their scope have been expanded. In other words, no amendments to the Fees Rules would be required to effect these proposals.

(ii) Waiver of fees in certain circumstances in respect of Type 7 RA

20. Currently, an intermediary licensed or registered for Type 7 RA is also required to be licensed or registered for Type 1 (dealing in securities) or Type 2 (dealing in futures contracts) RA. Fee waivers for Type 7 RA are already provided for these persons. Following the expansion of the definition of Type 7 RA to include electronic facilities for OTC derivative products, a person who is (or applies to be) licensed for Type 11 RA will also need to be licensed for Type 7 RA if they provide ATS in respect of OTC derivative products. In a similar vein, given certain leveraged foreign exchange contracts will constitute OTC derivative products, a person who is (or applies to be) licensed for Type 3 RA may also need to be licensed for Type 7 RA if they provide ATS in respect of leveraged foreign exchange contracts which also constitute OTC derivative products. We therefore propose that, similar to the prevailing arrangements for persons licensed or registered for Type 1 or Type 2 RA, an additional waiver should be provided to waive the application fee and annual fee in

[5] See new section 2(k) of Part 2A, Schedule 5 to the SFO, to be inserted pursuant to section 53(23) of SFAO 2014.

respect of Type 7 RA for persons who are also licensed for Type 3 or Type 11 RA if their carrying on of Type 7 RA is incidental to their carrying on of Type 3 or Type 11 RA.

PUBLIC CONSULTATION

21. The SFC conducted a public consultation on the proposed refinements to the scope of RAs under the OTC derivative licensing regime and the proposed fees arrangements between December 2017 and February 2018. Respondents generally supported the proposed refinements. We have taken into account the responses in finalising the above proposals.

WAY FORWARD

22. According to section 142 of the SFO, amendments to its Schedule 5 would normally require subsidiary legislation made by the Financial Secretary. However, since the provisions in the SFAO 2014 with respect to the licensing regime have not commenced, a primary legislative exercise will be required. We aim to incorporate the legislative amendments to Schedule 5 to the SFO and Fees Rules, together with those for implementing the uncertificated securities market regime, into the same Bill for introduction into the Legislative Council in the current legislative session.

23. Members are invited to note the content of this paper.

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