

# Hong Kong Proposes Changes to their Licensing Regime as the Region's OTC Derivatives Reform Continues to Develop

The Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**") have published their joint supplemental consultation conclusions (the "**Conclusions**") on the proposed scope of two new as well as two expanded regulated activities together with their proposal for the regulatory oversight of Systemically Important Participants ("**SIPs**").

The modifications to the existing licensing regime for regulated activities are expected to come into effect in early 2014, and will impact licensed corporations and banks as well as unlicensed entities dealing in or advising on OTC derivatives. Failure to comply with the new licensing regime may result in serious consequences for both the entity involved and individuals responsible for managing the entity. Annex A of this briefing provides examples of how the amendments to the licensing regime will affect market participants.

## Background

In July 2012, the HKMA and SFC consulted on (a) the modifications to the existing licensing regime for regulated activities and (b) regulatory oversight of SIPs in a supplemental consultation paper<sup>1</sup>. Following responses from a wide variety of market participants, the HKMA and SFC released the Conclusions on 6 September 2013.

The HKMA and SFC's proposals in relation to these two areas are already included in some detail in the Securities and Futures (Amendment) Bill 2013 (the "**Bill**") introduced to the Legislative Council on 28 June 2013<sup>2</sup>. While there is no specific

---

<sup>1</sup> See "[HKMA and SFC release joint consultation conclusions & supplemental consultation relating to the proposed regulatory regime for the OTC derivatives market in Hong Kong](#)" for further details.

<sup>2</sup> For a more detailed summary of the Bill, please see "[The Hong Kong FSTB publishes the amendment bill relating to the proposed regulatory regime for the OTC derivatives market in Hong Kong](#)".

timetable for the passage of the Bill, it is anticipated that the Bill will come into effect early next year.

The Conclusions focus on the licensing regime for dealing in or advising on OTC derivatives, providing clearing agency services for OTC derivative transactions, as well as the oversight of SIPs.

## Key Observations

Key observations of the Conclusions are:

1. Two new regulated activities – Type 11 (*dealing in OTC derivative products or advising on OTC derivative products*) and Type 12 (*providing clearing agency services for OTC derivative transactions*)

- (a) *Als and AMBs*: Authorized institutions ("**AI**") and approved money brokers ("**AMB**") will be exempt from the licensing requirements set out under the new Type 11 and Type 12 regulated activities as they will continue to be regulated by the HKMA.

However market participants should note that only OTC derivatives activities carried out by the AI itself will be exempt. AI groups should therefore consider their organisational arrangements in relation to OTC derivatives to identify if any non-AI entities within their group structure may be subject to this modified licensing regime in Hong Kong;

- (b) *Price Takers*: 'Price takers' will be exempt from obtaining a Type 11 license for dealing in OTC derivatives. The HKMA and SFC have determined that no definition of this term is necessary as in their view this term is widely used and understood in the OTC derivatives market. Instead, the HKMA and SFC have set out the key features of a 'price taker' as:
  - (i) they enter into derivatives contracts as principal to acquire directly a position or exposure – whether for hedging or other purposes - (as opposed to market makers or liquidity providers who stand ready to enter into any transaction);
  - (ii) they bid on the price offered; and
  - (iii) their transactions are not intended to affect or move the market price.

The scope of this exemption will be very relevant for many different types of end users including trading companies and investment funds. For investment funds entering into OTC derivatives through their investment manager, there is no specific exemption from the requirement to obtain a Type 11 license; instead they will need to carefully consider whether they are carrying on a business in Hong Kong of OTC derivatives trading or advising which does or does not fall under the undefined 'price taker' exemption;

- (c) *Non-exempt activity*: The HKMA and SFC have rejected calls made by market participants for certain exemptions from the requirement to obtain a Type 11 license. These include:

- (i) *Dealing as principal with PI*: The "dealing as principal with a professional investor" exemption available for Type 1 and Type 2 regulated activities has not been included for Type 11.

As a result, a firm currently relying on the "dealing as principal with a professional investor" exemption from Type 1 licensing requirements will not be able to do so for the Type 11 licensing requirements. Accordingly, a firm relying on this exemption from Type 1 licensing will need to obtain a Type 11 license to continue to deal as principal in OTC derivatives.

This is relevant, among others, for Hong Kong trustees of unit trusts. They are typically unregulated as they have traditionally relied on "dealing as principal with a professional investor" exemption for their trustee dealing activities;

- (ii) *Intra-group transactions*: The Conclusions clarify that the scope of Type 11 regulated activities will catch dealing in intra-group OTC derivatives transactions, although simply advising entities that are wholly owned within the group structure on their OTC derivatives transactions will be exempt for the advising group entities.

The HKMA and SFC have stated that this (A) mirrors the position under Type 1 regulated activities in relation to securities and (B) is appropriate in view of the regulatory aim of risk monitoring and control. Entities entering into intra-group OTC derivatives transactions will therefore need to consider whether their activity falls under any other exemption from the requirement to obtain a Type 11 license; and

(iii) *Futures contracts*: The Conclusions specifically provide that a Type 2 licensed corporation dealing in an OTC derivatives product that has an underlying futures contract is not necessarily exempt from the Type 11 licensing requirement. The HKMA and SFC have refused to make a general statement on whether an OTC derivatives product with a futures contract as the underlying asset falls within the definition of a futures contract. As a result, market participants will need to consider the structure and features of each OTC derivatives product with a futures contract as the underlying asset to determine any possible licensing requirements in relation to such a transaction; and

(d) *Experience requirement for Type 12*: As central clearing of OTC derivatives is a relatively new practice for many global markets as well as Hong Kong, the HKMA and SFC recognised that a two-years experience requirement for Type 12 licensing could result in a very limited number of successful applicants. Therefore, the experience requirements in relation to Type 12 regulated activities has been relaxed to include overseas experience, experience of affiliate companies and experience in clearing proprietary trades (even though the scope of Type 12 regulated activities does not cover clearing of proprietary trades).

## 2. Expanded regulated activities – Type 7 (*providing automated trading services*) and Type 9 (*asset management*)

(a) *Definition of 'portfolio'*: The existing Type 9 regulated activity is expanded to cover portfolio management of OTC derivatives transactions. This is quite helpful, as Type 9 licensing provides an incidental exemption from Type 11 licensing. However, the HKMA and SFC declined to take the opportunity to set a threshold for the level of OTC derivatives transactions within a portfolio before a licensed corporation is required to, or can, obtain the expanded Type 9 license;

(b) *No exemption for AIs*: AIs should note that, unlike the new Type 11 and Type 12 regulated activities, there is no exemption for AIs in relation to the expanded Type 9 (*asset management*) licensing requirements. As a result, any AIs that intend to carry on managing a portfolio of OTC derivatives products for third parties will need to go through a notification procedure in respect of their Type 9 registration within the prescribed period (as further described below under "*Transitional arrangements*"); and

(c) *Sub-investment managers*: Where an investment manager delegates the management of an OTC derivatives portfolio to a sub-investment manager, that investment manager may still need an expanded Type 9 license if it carries out any remaining functions that fall under the scope of the expanded Type 9 regulated activity. Furthermore, the investment manager may not rely on the qualifications of its sub-managers in complying with the relevant eligibility criteria. Equally, a sub-manager may not rely on its investment manager's license or qualifications and may need to obtain an expanded Type 9 license to carry out its functions.

Interestingly, the HKMA and SFC seem to suggest that an investment manager may not need to obtain the expanded Type 9 license if it does not have any remaining functions that fall under the scope of the expanded Type 9 regulated activities. However, even if an investment manager has delegated all of its functions to a sub-investment manager, the investment manager still has responsibility for and is holding itself out as being able to conduct such investment management activity. Therefore, it may be difficult in practice for an investment manager to argue that it does not need the expanded Type 9 license on the basis that it has delegated all of its functions to sub-investment managers.

## 3. Transitional arrangements

(a) *Framework*: The licensing requirements in relation to the new and expanded regulated activities commence from the date the Bill comes into effect. To minimise disruption to the market, transitional arrangements have been introduced by the HKMA and SFC;

- (b) *Application period*: There is a three month period from the date the Bill becomes effective for market participants to submit their application to be licensed for the new or expanded regulated activities (if they wish to benefit from the transitional arrangements).

The HKMA and SFC have taken the opportunity to ease the transitional requirements for existing Type 9 licensed corporations and AIs managing a portfolio of OTC derivatives products for third parties. As a result, such licensed corporations or AIs, as applicable, will only need to provide notification of their intention to continue to provide such services instead of submitting an application;

- (c) *Transitional period*: There is a six month period from the date the Bill becomes effective during which market participants may carry out the new regulated activities without being licensed to do so; and
- (d) *Winding down period*: If an applicant's application to be licensed for the new or expanded regulated activities is rejected, there will be a three month period to wind down or transfer their OTC derivatives activity.

#### 4. Systemically Important Participants

- (a) *Framework*: A requirement will be placed on Hong Kong persons whose OTC derivatives positions exceed specified thresholds to notify the SFC and be entered into the SIP register (which will be public). The SFC can also place an entity onto the SIP register if the HKMA and/or SFC has reasonable cause to believe that such entity may have exceeded the SIP threshold(s);
- (b) *Threshold*: In the Conclusions, the HKMA and SFC explain the approach to the SIP threshold as set out in the Bill. The SIP threshold will be set by reference to a person's position in a specific class of OTC derivatives transactions. However, details on how a person's positions in OTC derivatives is calculated still needs to be determined. For example, it is unclear whether positions refers only to transactions booked onto such person's balance sheet or whether it will include OTC derivatives entered into by such person's subsidiaries and affiliates; and
- (c) *Regulatory requirements*: The majority of the regulatory requirements placed on a SIP will not affect its OTC derivatives transactions with its counterparties (the exceptions are set out below). As a result, a market participant generally will not need to be concerned with whether their counterparty exceeds the SIP threshold.

Once a person is registered as a SIP, the HKMA and SFC may:

- (i) require the SIP to provide information on its OTC derivatives transactions and risk management systems and policies;
- (ii) impose position limits on a SIP with respect to OTC derivatives transactions; and
- (iii) require the SIP to unwind or request collateral in relation to certain OTC derivatives transactions.

The Conclusions do not specify that the HKMA and SFC's regulatory powers are restricted to only the asset class(es) in which the SIP exceeded the SIP threshold.

## Conclusion

In respect of the Bill, the modifications to the licensing regime will be the first of the regulatory reforms to impact the OTC derivatives market in Hong Kong. Any entity dealing in or advising on OTC derivatives transactions should now consider whether it falls under the scope of the new or expanded regulated activities. Failure to comply with the requirements set out under the new licensing regime will carry serious and costly consequences for the entity involved and any individuals responsible for managing such entity.

The introduction of SFC regulatory oversight for SIPs is an interesting area of development for the OTC derivatives markets which is not found in many comparable international financial centres and its real impact is yet to be clear. In the meantime, we recommend all market participants should use this opportunity to develop awareness of the changes to the Hong Kong licensing regime for OTC derivatives.

**Annex A**

If you are...	carrying on...	then you should consider...
an investment manager	the management of a portfolio of OTC derivatives products for third parties	whether you need to submit an application or provide a notification to the SFC for expanded Type 9
an entity relying on "dealing as principal with PI" exemption (e.g. a trustee)	entering into OTC derivatives over securities or futures contracts	whether another exemption is available or a Type 11 license is required
an entity that enters into futures contracts	dealing in a physically settled OTC derivative referencing a futures contract	whether you need a Type 2 license, Type 11 license or both
an adviser to a private equity fund	advising sub-funds on OTC derivatives (e.g. IRS)	whether you need a Type 11 license
an entity without an existing license	any form of OTC derivatives activity (whether dealing or advising)	whether any exemptions are available or if licensing is required

## Contacts

**Paget Dare Bryan**  
+852 2826 2459

**Francis Edwards**  
+852 2826 3453

**Mark Shipman**  
+852 2825 8992

**Matt Feldmann**  
+852 2825 8859

**Terry Yang**  
+852 2825 8863

**Hilda Loong**  
+852 2826 3493

**Viola Lui**  
+852 2825 8842

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

[www.cliffordchance.com](http://www.cliffordchance.com)

Clifford Chance, 28th Floor, Jardine House, One Connaught Place, Hong Kong

© Clifford Chance 2013

Clifford Chance

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Kyiv ■ London ■ Luxembourg ■ Madrid ■ Milan ■ Moscow ■ Munich ■ New York ■ Paris ■ Perth ■ Prague ■ Riyadh\* ■ Rome ■ São Paulo ■ Seoul ■ Shanghai ■ Singapore ■ Sydney ■ Tokyo ■ Warsaw ■ Washington, D.C.

\*Clifford Chance has a co-operation agreement with Al-Jadaan & Partners Law Firm in Riyadh.