

MAS consults on proposed regulatory framework for OTC Derivatives Intermediaries

On 3 June 2015, the Monetary Authority of Singapore (MAS) issued a policy consultation paper in respect of the proposed regulatory framework for intermediaries dealing in OTC derivative contracts.

This follows the February 2015 consultation paper proposing amendments to the Securities and Futures Act (SFA) to expand the scope of the SFA to regulate derivative contracts and to introduce the requirement for intermediaries dealing in OTC derivative contracts (OTC Intermediaries) to hold a Capital Markets Services (CMS) licence. The MAS has also taken the opportunity in the June 2015 consultation paper to propose changes to refine the rules governing execution-related advice and the marketing of collective investment schemes (CIS) under the Financial Advisers Act (FAA). These proposed changes are discussed in more detail below.

Proposals outlined in the Consultation Paper

Admission criteria

OTC Intermediaries will be required to hold a CMS licence to deal in capital markets products – OTC derivative contracts – unless exempted. The MAS proposes to subject OTC Intermediaries to the admission criteria in the *MAS Guidelines on Criteria for the Grant of a Capital Markets Services Licence other than for Fund Management*, except for the requirement relating to corporate track record.

Consistent with the approach adopted for CMS licencees in respect of fund management, the MAS proposes to require OTC Intermediaries to meet the minimum five-year track record requirement only if they serve retail (i.e. non-accredited, institutional or expert) investors.

Given the futurisation of OTC derivative contracts, the MAS also proposes to apply the same criterion to intermediaries dealing in exchange-traded derivative contracts (e.g. futures contracts), such that OTC Intermediaries dealing in OTC derivative contracts will need to apply for the necessary licence from the MAS (to deal in exchange-traded derivatives) may continue to deal in these contracts

Key proposals

- Regulatory framework for OTC derivatives intermediaries, including capital and business conduct requirements
- Risk mitigation requirements for OTC derivatives intermediaries dealing in non-centrally cleared OTC derivatives
- Exemption from FAA business conduct requirements for execution-related advice in respect of listed and unlisted excluded investment products
- Regulation of "marketing of securities" under the FAA to be subsumed within "dealing in securities" under the SFA

should they be converted to exchange-traded or futures contracts.

Business conduct requirements

The MAS has proposed that the following business conduct requirements, in particular certain requirements under the Securities and Futures (Licensing and Conduct of Business) Regulations (SF(LCB)R), be applied to OTC Intermediaries

and persons exempt from holding a CMS licence under section 99(1)(a), (b) and (c) of the SFA (i.e. banks, merchant banks and finance companies licensed in Singapore):

- **Risk management and controls:** MAS views it as important for OTC Intermediaries to have in place robust risk management systems and controls. As such, the MAS proposes to subject OTC Intermediaries to Regulation 13 of the SF(LCB)R, which amongst other things, requires a CMS licensee to implement effective written policies on all operational areas, put in place compliance functions and arrangements to protect investors and reduce the risk of incurring legal or regulatory sanctions and ensure effective controls and segregation of duties in order to mitigate potential conflicts of interest.
- **Advertisement requirements:** To ensure that advertising materials published or circulated by OTC Intermediaries present a fair and balanced view of the OTC derivative products, the MAS proposes to subject OTC Intermediaries to Regulation 46 of the SF(LCB)R, which stipulates that advertising materials must not contain any inaccurate or misleading statement or presentation, or any exaggerated statement or presentation that is calculated to exploit an individual's lack of experience or knowledge.
- **Risk disclosure:** The MAS proposes to require a CMS licensee dealing in capital markets products (such as OTC derivatives) to disclose to its customers the material risks (e.g. counterparty, market, liquidity, leverage risks) of the product and whether it is acting as a principal or an agent, in a form prescribed by the MAS. Prior to the CMS licensee entering into a contractual relationship with the customer, the risk disclosure must be furnished to and acknowledged by the customer in writing.
However, the MAS does not intend to prescribe the form of risk disclosure for OTC derivative contracts which are primarily transacted with non-retail counterparties and where there are established industry standards for risk disclosure. In addition, the aforementioned requirement will not apply where CMS licensees deal with their related entities or licensed financial institutions.
- **Handling and segregation of customers' moneys and assets:** The MAS proposes to extend Parts III (*Customer's Money and Assets*) and IV (*Conduct of Business*) of the SF(LCB)R to OTC Intermediaries that

deal in centrally-cleared OTC derivative contracts. Parts III and IV set out requirements governing the handling and treatment, lending, re-hypothecation and withdrawal of customers' moneys and assets received by a CMS licensee.

In relation to non-centrally cleared OTC derivative contracts, the MAS is currently reviewing the September 2013 recommendations by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions on margin requirements and will separately consult on such requirements in respect of non-centrally cleared OTC derivative contracts.

The MAS further proposes to require CMS licensees to disclose to customers the costs associated with and the level of protection accorded by individual client segregation vis-à-vis omnibus segregation when offering the former (in the context of centrally-cleared OTC derivatives). However, CMS licensees will not be required to deposit the moneys or assets of customers who have adopted individual client segregation in a trust account separate from other customers who have not opted so.

- **Record keeping:** In respect of OTC derivative transactions, the MAS proposes that CMS licensees be required to maintain, amongst others, (a) customer identification information and other documents relating to the establishment of business relations; (b) pre-execution, execution and post-trade information necessary to reconstruct the derivative transaction; (c) payments and interest received on the derivative transaction; and (d) the daily value of each outstanding derivative transaction. The MAS further proposes that these records be maintained for five years following the termination of the business relation or completion of the transaction and for one year in respect of oral communication relation to pre-execution information.
- **Risk mitigating requirements for non-centrally cleared derivatives:** The MAS proposes to introduce a set of risk mitigation requirements for OTC Intermediaries that deal in non-centrally cleared OTC derivative contracts, which will include trading relationship documentation, trade confirmation, portfolio reconciliation and dispute reporting:
 - **Trading relationship documentation:** The MAS proposes to require CMS licensees to have policies and procedures to execute written documentation of all material terms governing the trading relationship between the counterparties or

through other equivalent non-rewritable, non-erasable electronic means.

- **Trade confirmation:** The MAS proposes to require CMS licensees to execute trade confirmation of the terms listed in Annex 1 of the June 2015 consultation paper for non-centrally cleared OTC derivative transactions within a specified timeframe (e.g. two-way confirmation by T+1 for counterparties which are licensed financial institutions; one-way confirmation by T+1 for other counterparties). The MAS further proposes to phase-in trade confirmation requirements by asset class.
- **Portfolio reconciliation and dispute reporting:** Where the counterparty is a licensed financial institution, the MAS proposes that the CMS licensee be required to agree in writing with the counterparty on the terms of the portfolio reconciliation. For other counterparties, however, the MAS proposes that the CMS licensee be required to have in place policies and procedures which facilitate portfolio reconciliation between parties on a best effort basis. The minimal terms to be covered are set out in Annex 2 of the June 2015 consultation paper and the proposed frequencies of portfolio reconciliation are calibrated based on the volume of outstanding OTC derivative contracts and type of counterparty. The MAS also proposes to require CMS licensees to promptly report disputes exceeding S\$25m that remain unresolved beyond 15 business days.

Capital and financial requirements

With regards to CMS licensees dealing in OTC derivative contracts, the MAS proposes base capital requirements of S\$5m and S\$1m for members and non-members of an approved clearing house respectively. These requirements are consistent with the existing requirements for CMS licensees trading in futures contracts.

The MAS further proposes to require CMS licensees dealing in OTC derivative contracts (other than those dealing only with non-retail investors) to comply with ongoing risk-based capital requirements under the Securities and Futures (Financial and Margin Requirements) Regulations. In relation to CMS licensees dealing only with non-retail investors, the MAS will continue to monitor international developments before finalising the capital requirements for such licensees.

Representative notification requirement

The MAS proposes to extend the representative notification framework to OTC Intermediaries. Similar to CMS licensees, OTC Intermediaries must appoint representatives who engage in the regulated activities on their behalf. The MAS also intends to review the Capital Markets and Financial Advisory Services (CMFAS) examination requirements and consult on any proposed changes in due course.

Persons who are currently dealing in or advising on OTC derivative contracts and intend to continue doing so will need to be appointed as representatives of their principal companies under the new regime. However, the MAS proposes to grandfather such persons and persons who are appointed representatives of their principal companies in respect of the current regulated activities under the SFA or FAA in relation to the minimum academic qualifications and CMFAS examination requirements.

Transitional arrangements

The MAS proposes a one-year transitional period from the date that the new regime is effected. Entities and their representatives who are dealing in or advising on OTC derivative contracts must submit the relevant applications or notifications to the MAS within that period.

Key transitional arrangements:

- **CMS licensees and their representatives** are required to submit an application for variation of their CMS licence adding requisite derivative contracts and notifications for appointment of their representatives dealing in these derivative contracts.
- **Financial Advisers (FAs) and their representatives** are required to submit an application for variation of their FA licence adding requisite derivative contracts and notifications for appointment of their representatives dealing in these derivative contracts.
- **Persons exempt from holding CMS or FA licence and their representatives** are required to notify the MAS of the requisite class of OTC derivative contract they and their representatives are dealing in or advising on.

The above transitional arrangements do not apply to entities and their representatives who commence dealing in or advising on OTC derivative contracts only after the new regime comes into effect. Such entities and their representatives may only commence their OTC derivative activities after their CMS or FA licence applications or

notifications (as the case may be) have been approved or published by the MAS.

Foreign companies whose conduct of an SFA-regulated activity or FA service is effected under an arrangement with its related corporation

The MAS proposes to extend the application of paragraph 9 of the Third Schedule to the SFA (Para 9) and paragraph 11 of the First Schedule to the FAA (Para 11) to dealing in and advising on OTC derivative contracts respectively. Under Para 9, a foreign company whose conduct of an SFA-regulated activity is effected under an arrangement with its relation corporation which is a CMS licensee or exempt from the requirement to hold a CMS licence, is exempt from the requirement to hold a CMS licence in respect of that regulated activity. Para 11 grants a similar exemption in respect of FA services.

Existing exemptions granted by the MAS under Para 9 and Para 11 in respect of current regulated activities will not be affected by the redefinitions of capital market products and regulated activities that were proposed in the February 2015 consultation paper.

The June 2015 consultation paper is silent as to existing arrangements in OTC derivative contracts that do not fall within existing exemptions. It would appear that applications for extensions of existing exemptions to cover OTC derivative contracts would be required.

Execution-related advice under the FAA

Currently, execution-related advice (ERA) is regulated under the FAA as a type of financial advisory service. Dealers offering ERA (i.e. persons exempt from holding a FA licence under section 23(1)(a), (b), (c), (d) or (e) of the FAA, and their representatives in respect of their carrying on the business of providing ERA) must comply with the relevant business conduct rules contained in Part III of the FAA, such as having to have a reasonable basis for any recommendation made, taking into consideration the customer's investment objectives, financial situation and particular needs.

The MAS has agreed to alleviate the operational challenges of complying with Part III of the FAA by exempting the provision of ERA in respect of listed excluded investment products (EIPs) from the

aforementioned requirements. To benefit from this exemption, the dealer must:

- provide the customer with a written warning at account opening that ERA does not take into account the customer's investment objectives, financial situation and particular needs;
- highlight to the customer that it is the customer's responsibility to ensure the suitability of the product recommended; and
- ensure that it states the rationale for the ERA provided to the customer, so that the latter can make an informed assessment on whether to act on the dealer's advice.

However, this proposed exemption applies only to listed EIPs. The existing requirements in Part III of the FAA still apply to investors wishing to invest in unlisted EIPs and Specified Investment Products.

Subsuming "marketing of CIS" into "dealing in securities" under the SFA

"Dealing in securities" is currently regulated under the SFA, while "marketing of CIS" is regulated under the FAA. CMS licensees and FAA licensees benefit from licensing exemptions under the FAA and SFA, respectively. However, this has resulted in different business conduct requirements applying to marketing activities in respect of CIS, depending on the licence being held.

Therefore, the MAS proposes to remove the regulated activity of "marketing of CIS" under the FAA and subsume it within "dealing in securities" under the SFA. Relevant business conduct requirements contained in the Financial Advisers Regulations (FAR), in particular, Regulation 19 of the FAR (which governs the treatment of customer's moneys) will be ported to the SF(LCB)R.

Expanding the scope of the current licensing exemption for FAs who market or redeem units in a CIS

Pursuant to paragraph 2 of the Second Schedule to the SF(LCB)R, FA licensees or exempt FAs under section 23(1)(a), (b), (c), (d) or (e) of the FAA which market CISs are not presently required to hold a CMS licence in respect of dealing in securities if they merely market or redeem units in a CIS (Dealing Financial Advisers).

In response to criticisms that this exception is too narrow in its exclusion of transactions in listed CIS, the MAS proposes to expand the exemption to allow Dealing Financial Advisers to be exempted from this requirement for transactions in both listed and unlisted CIS if such dealing is incidental to their advisory activities. Dealing by the Dealing Financial Adviser is only considered incidental if the Dealing Financial Adviser helps a customer transact in a particular CIS which he had earlier recommended to the customer, who in turn accepted said recommendation.

While Dealing Financial Advisors and their representatives who rely on the aforementioned exemption will be excused from having to hold a CMS licence under the SFA, they will still have to comply with the relevant business conduct requirements for dealing in CIS as applicable.

Exemption from having to hold a CMS licence for licensed fund management companies (FMCs) and registered FMCs who deal in securities incidentally to funds managed by themselves or by related corporations

It is proposed that licensed FMCs and registered FMCs will benefit from an exemption from holding a CMS licence for the regulated activity of "dealing in securities" when marketing CISs which are managed by the FMCs themselves or by their related corporations.

Feedback on the Consultation Paper

The MAS consultation paper is available from the MAS' website and the closing date for the public to submit comments and feedback is **3 July 2015**

Contacts



Paul Landless

Partner

T: +65 6410 2235

E: paul.landless@cliffordchance.com



Lena Ng

Counsel

T: +65 6410 2215

E: lena.ng@cliffordchance.com

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

Clifford Chance Pte Ltd, 12 Marina Boulevard, 25th Floor Tower 3, Marina Bay Financial Centre, Singapore 018982

© Clifford Chance 2015

Clifford Chance Pte Ltd

516462-4-2473

Abu Dhabi ■ Amsterdam ■ Bangkok ■ Barcelona ■ Beijing ■ Brussels ■ Bucharest ■ Casablanca ■ Doha ■ Dubai ■ Düsseldorf ■ Frankfurt ■ Hong Kong ■ Istanbul ■ Jakarta* ■ 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.

*Linda Widyati & Partners in association with Clifford Chance.