

# Hong Kong enacts its primary legislation relating to the proposed changes to the regulatory regime for the Hong Kong OTC derivatives market

Hong Kong has now enacted its primary legislation concerning reform of the OTC derivatives market in line with the agenda set down by the G20. The Securities and Futures (Amendment) Bill (the "**Bill**") was enacted on 3 April 2014 as the Securities and Futures (Amendment) Ordinance ("**Amendment Ordinance**"). The Amendment Ordinance provides for a broad regulatory framework designed to implement the proposals set out in (i) the Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**") joint consultation conclusions for the new regulatory regime for the OTC derivatives market in Hong Kong published in 2012 ("**2012 Consultation Conclusions**") and (ii) the HKMA and SFC joint supplemental consultation conclusions published in 2013 ("**2013 Consultation Conclusions**"). While the Amendment Ordinance provides an outline of the mandatory reporting, clearing and trading obligations to be introduced for OTC derivatives, further details (in the form of subsidiary legislation) will be required before such mandatory obligations become effective.

## Objectives of the Amendment Ordinance

The main objectives of the Amendment Ordinance are as follows:

- a) to introduce the framework for mandatory reporting, clearing and trading of OTC derivatives;
- b) to introduce a licensing regime for dealing in and advising on OTC derivatives and providing clearing services for OTC derivatives;
- c) to clarify and extend insolvency protections for OTC derivatives cleared on a recognized clearing house as set out in Part III of the Securities and Futures Ordinance ("**SFO**"); and
- d) to introduce 'technical improvements' including (i) requiring certain notifications to be filed electronically; (ii) giving a power to the court to make disgorgement orders for market misconduct offences; (iii) making amendments to the Organized and Serious Crimes Ordinance concerning orders for market misconduct offences; and (iv) other related matters.

## Key Observations on the Amendment Ordinance

The Amendment Ordinance introduces several changes to the draft Bill (see below). For a more detailed summary of the draft Bill, please see our earlier client briefing "[The Hong Kong FSTB publishes the amendment bill relating to the proposed regulatory regime for OTC derivatives market in Hong Kong](#)".

■ Key observations are as follows:

### 1. Commencement Date

The Amendment Ordinance will come into operation on a day to be designated by the Secretary for Financial Services and the Treasury by notice published in the Gazette. Contrary to market expectations, the practical effect is that the transitional periods for the new regulated activities (Type 11 (*dealing in OTC derivative products or advising on OTC derivative products*) and Type 12 (*providing client clearing services for OTC derivative transactions*)) and the expanded regulated activities (the expanded Type 7 (*providing automated trading services*) regulated activity and the expanded Type 9 (*asset management*) regulated activity) will not begin from the passage of the Bill but will instead commence on a later date to be designated by the Secretary for Financial Services and the Treasury. This provides market participants with additional time to analyse whether the new/amended licensing regime for OTC derivatives will be applicable to them.

### 2. Protection of client clearing

Part III of the SFO has been amended to provide a framework for a recognized clearing house to make rules to extend the insolvency protections under Part III of the SFO to cover client clearing. This is an important development for OTC Clear, the clearing house established by The Stock Exchange of Hong Kong, as the protection of client clearing arrangements against the application of insolvency laws (such as clawbacks) is necessary in order to allow the wider market (and not just clearing members) to access OTC Clear with confidence. Furthermore, the protection of client clearing under the SFO means that Hong Kong is in a position to introduce mandatory clearing without requiring further primary legislation.

### 3. Changes to the definition of Type 12 Regulated Activity

Subject to carve outs, a technical amendment has been introduced to the new Type 12 regulated activity (*providing client clearing services for OTC derivative transactions*) definition such that a person is considered to be providing clearing and settlement services for another person where such services are provided:

- (a) in respect of OTC derivative transactions;
- (b) through a clearing house (whether incorporated locally or overseas); and
- (c) irrespective of whether or not such person is acting as a member of the clearing house.

### 4. Changes to the definition of Type 11 Regulated Activity

The new Type 11 (*dealing in OTC derivative products or advising on OTC derivative products*) regulated activity is a combined regulated activity including both 'dealing' activities and 'advising' activities. The Type 11 regulated activity definition has been amended such that 'dealing in OTC derivative products' broadly includes:

- (a) entering into or offering to enter into OTC derivatives transactions; or
- (b) inducing or attempting to induce another person to enter into or offer to enter into an OTC derivative transaction.

Under the Amendment Ordinance, 'dealing in OTC derivative products' no longer includes '*entering into, offering, inducing or attempting to induce another person to enter into an arrangement (on a discretionary basis or otherwise) to facilitate the entry into an OTC derivative transaction*'. We understand that this amendment is due to the fact that the Bills Committee is of the view that this limb overlaps with activities covered by Type 9 (*asset management*) regulated activity.

Despite continuous lobbying from different industry groups, the 'dealing as principal with a professional investor' exemption and the intra-group exemption for dealing in OTC derivative transactions have not been provided as exemptions in respect of Type 11 regulated activity. However, consistent with the 2013 Consultation Conclusions, price-takers will be exempt from obtaining a Type 11 licence for dealing in OTC derivatives. The Amendment Ordinance does not include a definition for 'price taker'. As the HKMA and the SFC have previously indicated<sup>1</sup>, they are of the view that no definition is required as this term is widely used and understood in the OTC derivatives market. Instead, the HKMA and the SFC have set out in the 2013 Consultation Conclusions the key features of a 'price taker' as follows:

- (a) 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);
- (b) they bid on the price offered; and
- (c) their transactions are not intended to affect or move the market price.

## 5. Record Keeping Obligations

In addition to providing the framework for introducing mandatory reporting, mandatory clearing and mandatory trading obligations, the Amendment Ordinance also introduces the framework for mandatory record keeping obligations. Of particular interest is that the HKMA has the power to require an Authorized Institution ("AI") (i.e. a regulated bank in Hong Kong) to ensure that specified subsidiaries of the AI also comply with the record keeping obligation.

## 6. Systemically Important Participants ("SIP")

- (a) **Framework:** As discussed in our client briefing published on 10 September 2013<sup>2</sup>, 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 a public register). The SFC can also place an entity onto the SIP register if the HKMA and/or the SFC has reasonable cause to believe that such entity may have exceeded the SIP threshold(s).
- (b) **Thresholds:** The Amendment Ordinance provides that the SIP threshold will be measured by reference to the size of a person's positions and includes the positions of other persons guaranteed by such person. The term 'guaranteed' has been defined under an unrelated section (Part IV) of the SFO. It will be interesting to see whether the HKMA and SFC will follow the approach taken in other international markets in providing further guidance in the form of subsidiary legislation on the definition of 'guarantee' for the purposes of calculating the SIP thresholds. The Amendment Ordinance does not include a definition of 'position'. This will need to be clarified in due course.

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<sup>1</sup> [Hong Kong Proposes Changes to their Licensing Regime as the Region's OTC Derivatives Reform Continues to Develop](#)

<sup>2</sup> [Hong Kong Proposes Changes to their Licensing Regime as the Region's OTC Derivatives Reform Continues to Develop](#)

## Looking Ahead and Next Steps

The Amendment Ordinance is the beginning of a new chapter for OTC derivatives regulation in Hong Kong. Detailed rules regarding mandatory reporting, mandatory clearing and mandatory trading are yet to come. Contrary to certain market expectations, we understand the HKMA and SFC are looking to introduce the mandatory obligations in the following order: firstly mandatory reporting, followed by mandatory clearing and finally the new and expanded licensing regime.

It will be interesting to see the timing for introducing the mandatory reporting obligations and how that fits in with the existing timetable for introducing mandatory reporting obligations in other Asia Pacific jurisdictions such as Australia, Japan and Singapore. Market participants should continue to maintain their awareness and understanding of the current changes to the OTC derivatives regime in Hong Kong and prepare for the upcoming reporting, clearing and licensing requirements for OTC derivatives.

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