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Hong Kong Regulatory Regime for Derivatives Covering Licensing, Clearing, Margining and Reporting

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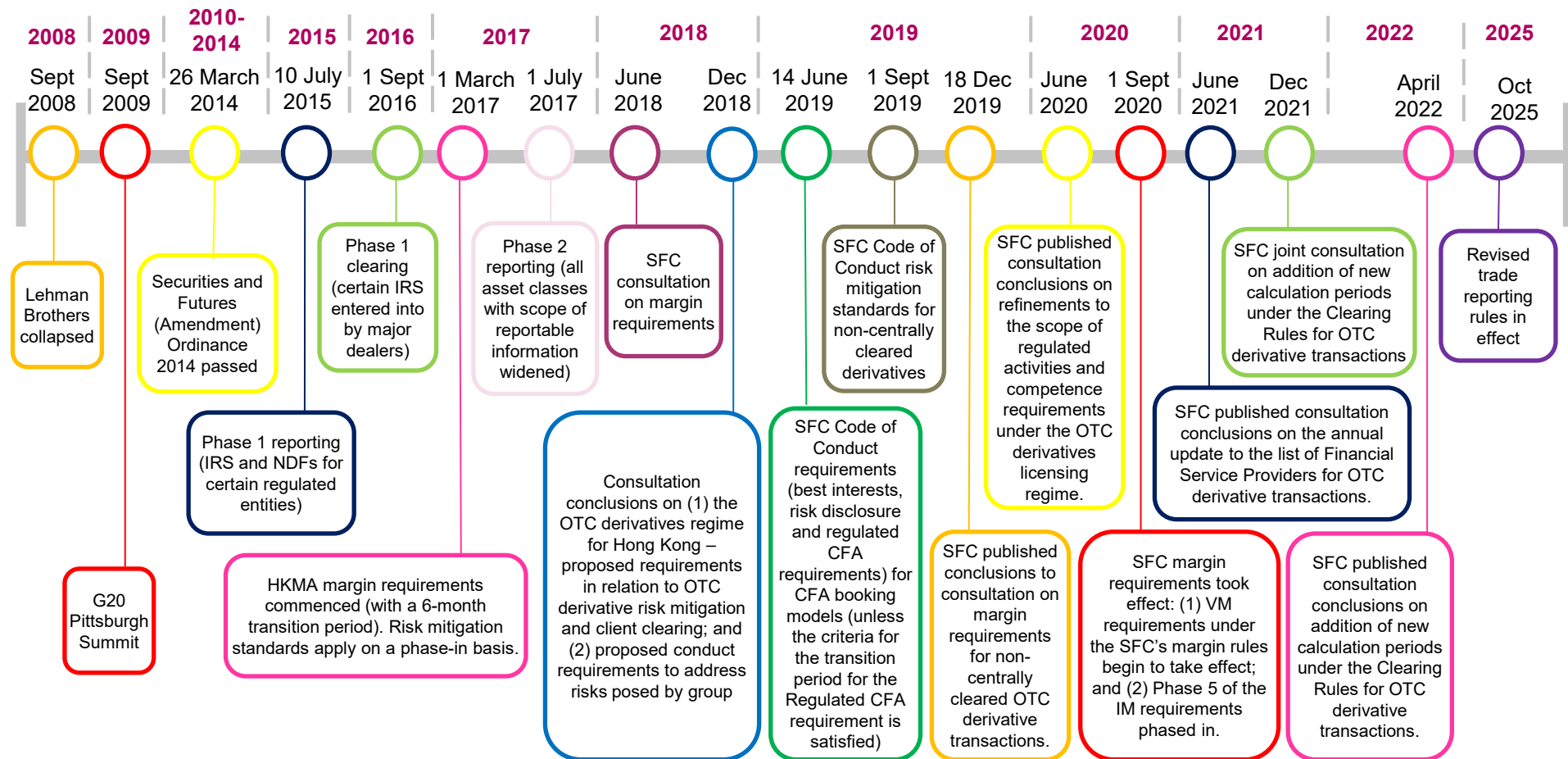
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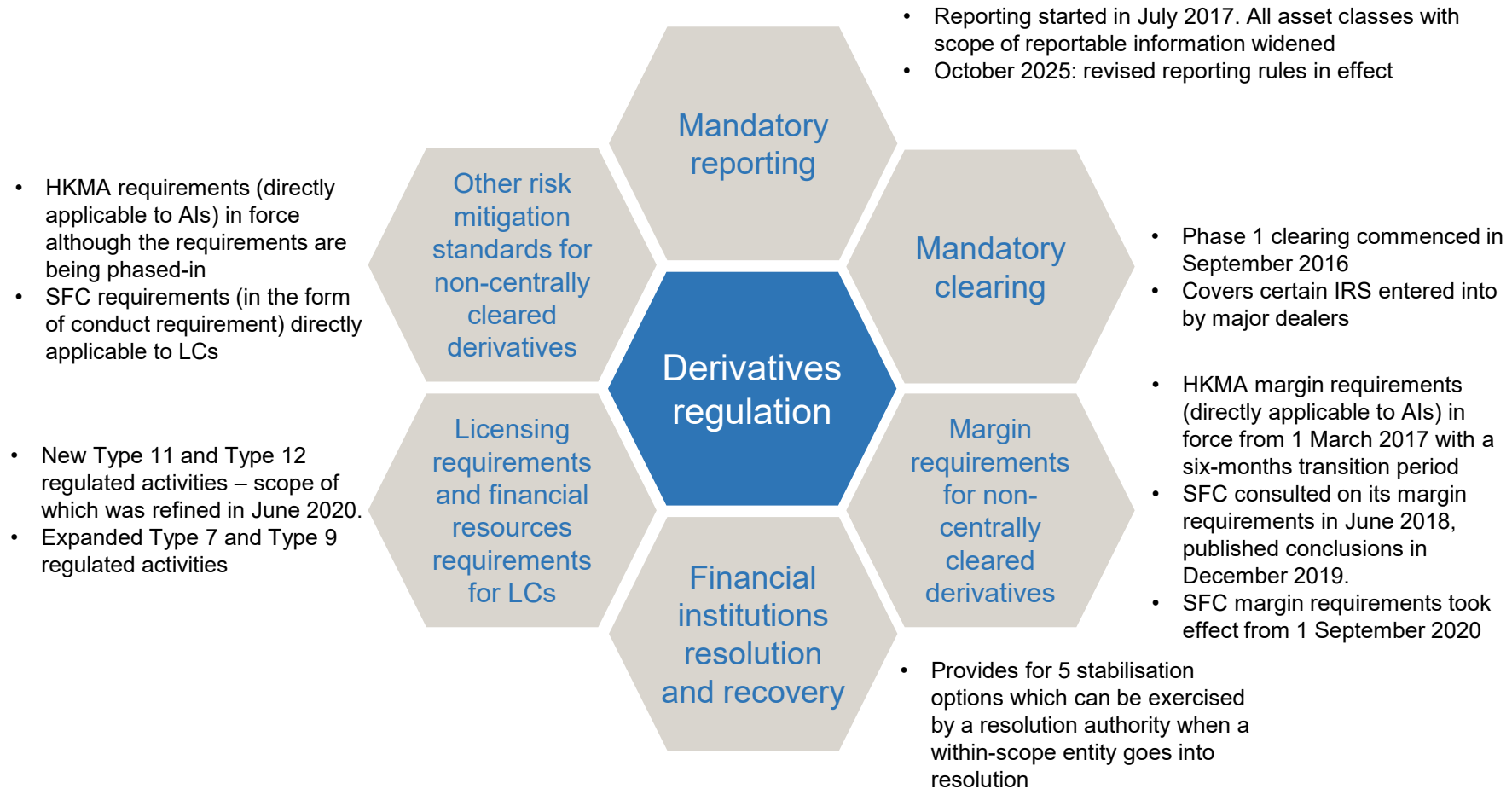
Agenda

- 1 Overview of derivatives regulation
- 2 Existing regulated activities as they relate to derivatives
- 3 OTC derivatives-related new licensing requirements (especially Type 11 regulated activity)
- 4 Mandatory obligations: reporting, clearing, margining and trading and the risk mitigation requirements

Timeline



Overview



OTC derivatives-related licensing requirements

SFO regulated activities (before SFAO)

License required for one of the Types of regulated activity).

Type 1 : dealing in securities

Type 2 : dealing in futures contracts

Type 3 : leveraged foreign exchange trading

Type 4 : advising on securities

Type 5 : advising on futures contracts

Type 6 : advising on corporate finance

Type 7 : providing automated trading services

Type 8 : securities margin financing

Type 9 : asset management

Type 10: providing credit rating service

SFO regulated activities

- > Section 114 SFO
 - > Persons carrying on or holding out as carrying on business in one or more of the regulated activities must apply for a license
- > Section 115 SFO
 - > A person will also require a licence if there it is “active marketing” to the public in Hong Kong services that, if carried on in Hong Kong, would be regulated activity
- > Consequences of carrying out regulated activity
 - > Two tiered licensing – corporate and representative licensing
 - > Code of conduct and various rules made under the SFO apply
 - > Continuing requirements (fit and proper criteria)
 - > Financial resources rules etc

Types 1 and 4: dealing in and advising on securities

Advising on securities	Dealing in securities
Advising as to whether, when, at what price or on what terms securities should be acquired/disposed of	Making or offering to make an agreement with another person, or inducing or attempting to induce another person to enter into specified types of agreement
Includes the provision of advice or the issuing of reports	(i) Agreements for or with a view to acquiring, disposing, subscribing for or underwriting securities, or (ii) agreements the purpose (or pretended purpose) of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities
Key exemptions: <ul style="list-style-type: none"> • advice given incidentally to Type 1 / solely for purpose of Type 9 • intra group advice • professionals acting in a professional capacity • not advice on corporate finance 	Key exemptions: <ul style="list-style-type: none"> • dealing “through” a securities dealer • dealing as principal with certain professional investors • solely for purposes of Type 9
Wide definition of “securities”, including: <ul style="list-style-type: none"> • shares, stocks, debentures, loan stocks, funds, bonds or notes issued by a corporation, government or municipal government authority • rights, options or interest in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes • Interests, rights or property, whether in the form of an instrument or otherwise, commonly known as securities • (and more) → includes equity derivatives 	

Types 2 and 5: dealing and advising in futures contracts

- Futures contracts: a contract or an option on a contract made under the rules and conventions of a futures market
- Futures market: places where facilities are provided for persons to negotiate or conclude sales and purchases of futures, or for bringing purchasers and sellers of futures together on a regular basis
- “Advising” – similar to Type 4...
- ...”Dealing” – definition potentially narrower than for securities?
- Exemptions for Type 2 also slightly different to Type 1
- Apply to exchange traded options and futures but how does this impact on OTC derivatives?
 - OTC option, swap or forward over futures contracts?
 - Price of futures contracts used in determining payment under an OTC option, swap or forward

Type 3 regulated activity: leveraged foreign exchange trading (LFET)

Leveraged Foreign Exchange Contract: a contract or arrangement the effect of which is that one party agrees or undertakes to:

- make an adjustment between himself and another person according to whether a currency is worth more or less, as the case may be, in relation to another currency or
- pay an amount of money or to deliver a quantity of any commodity determined or to be determined by reference to the change in value of a currency in relation to another currency or
- deliver to another person at an agreed future time an agreed amount of currency at an agreed price

LFET – application to derivatives

- > Must be considered wherever there is a **foreign-currency element** in a derivative transaction
 - > FX forward
 - > FX option
 - > Currency swap
 - > Non-deliverable FX
- > Not Spot FX; leveraging not needed
- > **Key exemptions**
 - > Authorized Financial Institutions
 - > Corporates the principal business of which does not include dealing in currency and hedging exposure in connection to currency exchange risk.
 - > Transactions arranged by approved money brokers
 - > Securities and Futures (Leveraged Foreign Exchange Trading – Exemption) Rules – Qualifying Corporation (or affiliates) with requisite credit rating whose business not in spot trading

SFO regulated activities (after SFAO)

License required for one of the Types of regulated activity.

Type 1 : dealing in securities

Type 2 : dealing in futures contracts

Type 3 : leveraged foreign exchange trading

Type 4 : advising on securities

Type 5 : advising on futures contracts

Type 6 : advising on corporate finance

Type 7 : providing automated trading services (amended to cover OTC derivative transactions)

Type 8 : securities margin financing

Type 9 : asset management (amended to cover OTC derivative transactions)

Type 10: providing credit rating service

Type 11: dealing in OTC derivative products and advising on OTC derivative products

Type 12: providing client clearing services for OTC derivative transactions

Do you need a Type 11 licence?

Type 11 – The Activity

- > Scope:
 - > Entering into or offering to enter into an OTC derivative transaction
 - > Inducing or attempting to induce another person to enter into, or offer to enter into, an OTC derivative transaction
 - > Giving advice on, or issuing reports or analyses, on whether derivative transactions should be entered into (or on the terms on which such transactions should be entered into)
- > Broad scope upon introduction (similar to existing dealing and advising activities), refined by the SFC in June 2020 in its published consultation conclusions in respect of the scope of regulated activities and competence requirements under the OTC derivatives licensing regime as follows:
 - > Corporate treasury activities for non-financial groups not captured;
 - > Providers of multilateral portfolio compression services not captured; and
 - > Portfolio compression services provided by CCPs or providers of client clearing services not captured.

What are “OTC Derivative Products/Transactions”?

- > **Wide definition** of “OTC derivative transaction” / “OTC derivative product”
- > Definition uses the definition of “**structured product**” with certain carve-outs:
 - > Securities traded on SEHK / futures contract traded on HKFE
 - > Structured products:
 - > Authorized by the SFC under s.105 of the SFC
 - > In the form of a debt security the payments under which are derived from cash flows generated from an underlying pool of assets - potentially aimed at repackagings
 - > Instruments in the form of shares, stocks, debentures, loan stocks, funds, bonds, notes, deposits, certificates of deposits that have an embedded feature making them structured products
 - > Offered within a maximum offer period of two weeks to multiple persons on identical terms (other than the consideration to be paid)
 - > Spot contracts
- > Difficult product types: repos, warrants

Type 11 - Exemptions

Dealing in OTC derivative products	Advising on OTC derivative products
Act that falls within T1, T2 or T3 RA by a person licensed for the relevant RA	Advice falling within T4 or T5 RA by a person licensed for the relevant RA
Act falling within the “dealing through” exemption from T1, T2 or T3 RA	Advice falling within incidental exemption from T4 or T5 RA for T1 or T2 licensed persons
Act carried out by an AI / AMB in the ordinary course of business	Advice given by an AI / AMB in the ordinary course of business
Act carried out by a T9 (expanded) licensed person solely for the purposes of providing the T9 service	Advice given by a T9 (expanded) licensed person solely for the purposes of providing the T9 service
Price taker exemption	Wholly-owned group exemption
“Dealing through”	
Dealing activities incidental to client clearing by overseas clearing members of overseas CCPs	Advising activities incidental to client clearing by overseas clearing members of overseas CCPs

Can you rely on your existing Type 1 licence?

What kind of OTC derivatives products will your business cover?

- > Type 1 (dealing in securities) and Type 4 (advising on securities) cover certain types of equity / bond derivatives only (which fall under the definition of “securities”)
- > Is your OTC derivatives business broader than equity / bond derivatives (e.g. commodities derivatives, interest rate derivatives?)

Are you relying on certain exemptions to carry on your existing business?

- > Question relevant even if your OTC derivatives business only comprise “securities”
- > The “dealing through” exemption for Type 1 is carried over as an exemption for Type 11
- > The “dealing as principal with a PI” for Type 1 is not carried over as an exemption for Type 11 however

Can you rely on an exemption for Type 11?

- > Price taker exemption
- > Is this a substitute for the “dealing as principal with a PI” exemption?
- > Corporate treasury activity of non-financial groups

The “price taker” exception: some issues

- > “Price taker” is not expressly defined
 - > Per SFC: a market maker is one who “either constantly quotes prices for entering into OTC derivatives transactions or responds with a price quote if requested and, typically profit from the price differentials between the transactions and hedges that it enters into.”
 - > Can you be a price taker for some trades and not for others?
 - > Can the exemption be used when hedging?
 - > Is there a carve out for intra group transactions?

The “dealing through” exception: some issues

- > An OTC derivative dealing act carried out by a person who is a Type 11 LC/AI/AMB etc
- > 20.2 of the Code of Conduct:
 - > *A licensed person, when soliciting or recommending its clients who are not group affiliates to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and its clients who are not group affiliates, should:*
 - > *(a) act in the best interests of the clients;*
 - > *(b) make such solicitation, recommendation or arrangement only if the group affiliate is a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD jurisdiction (Notes 1 and 2); and*
 - > *(c) if the group affiliate is not a licensed corporation, provide to the clients an appropriate risk disclosure statement in the client agreements which should, at a minimum, contain the risk disclosure in respect of the risk of entering into OTC derivative transactions with an unlicensed person as specified in Schedule 1 to the Code.*

Are these derivatives regulated?

- > Electricity
- > Freight
- > Weather
- > Cryptocurrency/digital assets
- > Carbon credits
- > Sustainability

Will you be providing client clearing services?

Type 12 – The Activity

- > Intended to cover provision of client clearing and settlement services where these are provided:
 - > to another person
 - > in respect of OTC derivative transactions
 - > through a CCP, whether local or overseas
- > Would apply to the following:
 - > Members of a CCP (CCP can be located in HK or overseas)
 - > A client of a member of the CCP (direct client), a client of a direct client (first direct client), a client of a first indirect client (second indirect client), a client of a second indirect client or a client, whether direct or indirect, of any of those persons.
- > Could also apply to remote members of a HK CCP unless an exemption applies
- > Does not apply to:
 - > certain fund managers' activities or other activities that are only ancillary to the clearing and settlement process
 - > Corporate treasury activities for non-financial groups

Type 12 - Exemptions

> CCPs

> AIs and AMBs in the ordinary course of business

> Acceptable participant of a HK CCP

> Does not have a place of business in Hong Kong

> Is or has applied to become a member of a HK CCP

> Does not market its services other than through an AI or LC

> Its provision of clearing/settlement services is governed by requirements of a “comparable overseas jurisdiction”

> Overseas clearing members of overseas CCPs (subject to certain prerequisites, e.g. being regulated in a comparable jurisdiction for providing client clearing services and marketing their services through an authorised institution or a licensed corporation.

Expanded Type 7 and Type 9

Expanded Type 7	Expanded Type 9
Expanded definition of ATS to include OTC derivatives transactions	Expanded to cover management of portfolios of OTC derivatives transactions
<p>Exemptions include:</p> <ul style="list-style-type: none"> • Clearing of OTC derivatives products falling within T12 and <ul style="list-style-type: none"> ▪ Provided by a person licensed for T12; OR ▪ Provided by an AI or an AMB • AIs and AMBs: <ul style="list-style-type: none"> ▪ ATS is provided by means of electronic facilities; and ▪ Wholly incidentally to OTC dealing activities 	<p>Exemptions:</p> <ul style="list-style-type: none"> • AIs and AMBs if management of portfolio of OTC derivatives transactions is wholly incidental to their carrying on of OTC derivatives dealing activities • Services provided by a T11 licence holder wholly incidentally to its T11 activities • Services constituting securities or futures contracts management but for the exemptions from these activities

Examples of other regulations

- > Banking Ordinance: no business of taking deposits shall be taken on except by an authorized institution:
 - > application to structured deposits?
- > Money Lenders Ordinance: business of money lending requires licence
- > Gambling Ordinance
 - > Gambling and lotteries are illegal unless authorised; gambling contracts unenforceable
 - > No statutory definition of gambling. Support in case law that derivatives are not gambling:
 - > Bona fide commercial or financial transaction
 - > Genuine commercial reasons
 - > Established market practice for that type of transaction
 - > Neither party is wagering (it takes two to tango)

Gambling Ordinance

- > Exclusions
 - > Authorized institutions; transactions regulated by or under, or carried out in compliance with, the SFO; contract for differences which is listed on any specified stock exchange or traded on any specified futures exchange

Mandatory reporting, clearing, margining and trading

Mandatory Reporting



- **“Prescribed persons”**: authorized institutions, approved money brokers, licensed corporations, recognised clearing house and ATS-CCP (when they are acting in their capacity as central counterparty)
- **“Specified OTC derivative transactions”**: All OTC derivatives transactions that fall within the five key asset classes (interest rate derivatives, FX derivatives, equity derivatives, credit derivatives and commodity derivatives)
- Report transaction information (which includes subsequent events) to the HKTR on a T+2 basis
- Can appoint a third party agent (e.g. DTCC) to report
- Exempt person relief
- For “conducted in Hong Kong” trades, if affiliate reports

Mandatory Clearing



- “Prescribed persons” over the clearing threshold (US\$20 billion) when it transacts with another prescribed person over the clearing threshold or a financial service provider (FSP)
- “Prescribed persons” are AIs, LCs and AMBs
- “Specified OTC derivative transactions”: certain plain vanilla interest rate swaps
- Clear through a designated CCP on a T+1 basis
- Intragroup exemption
- Exempt jurisdictions
- Substituted compliance available

Margin requirements for non-centrally cleared derivatives



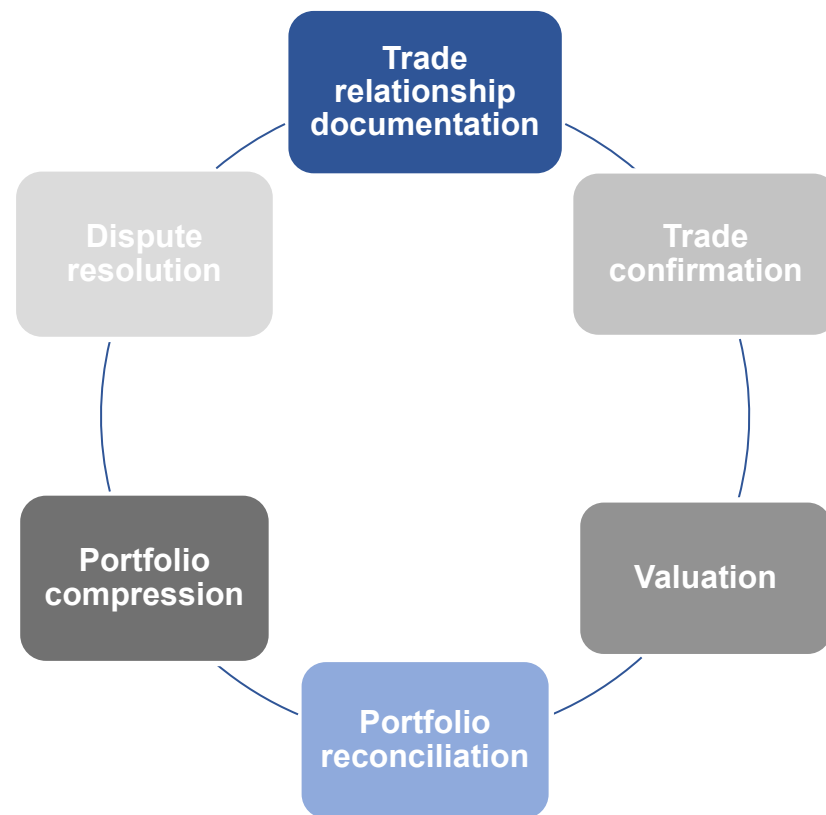
- > HKMA margin requirements (applicable to AIs) already in effect
- > SFC margin requirements (applicable to LCs) took effect on 1 September 2020 (VM requirements effective and phased in).

Mandatory trading

- > Trading of OTC derivatives through swap execution facilities
- > Not yet in force in Hong Kong

Risk mitigation standards

Risk mitigation standards



Purpose of risk mitigation techniques:

- > Promote legal certainty over the terms of the non-centrally cleared derivatives
- > Foster effective management of counterparty credit risk
- > Facilitate timely resolution of disputes

- > HKMA RMS requirements apply to all authorized institutions
- > SFC RMS requirements apply to (i) all LCs (regardless of the regulated activity the LC is licensed for) and (ii) Type 9 LC executing non-centrally cleared derivatives for a collective investment scheme it manages

Final observations