



# SFC Consultation on OTC Derivatives and Conduct Risks

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On 20 December 2017, the Securities and Futures Commission (SFC) released a consultation paper in relation to Hong Kong's OTC derivatives regime. The consultation encompasses risk mitigation, client clearing, record keeping and licensing matters, and proposes new conduct requirements to address risks posed by group affiliates. Our client update explores the impact the new requirements will have on Licensed Corporations (LCs) in Hong Kong.

## Proposed Conduct Requirements to address risks posed by Group Affiliates and Other Connected Persons

The SFC is proposing new conduct requirements for LCs with financial exposures to group affiliates or other connected persons as well as corporations adopting "client facing affiliate" (CFA) or "risk booking affiliate" (RBA) booking models. The rules aim to mitigate the potential risks such exposures and business models may pose to LCs and their clients. These requirements are proposed to be included in the Code of Conduct:

### Management of financial exposures to group affiliates and other connected persons

LCs shall properly manage financial exposures to group affiliates and other connected persons, including their shareholders, directors and employees. The same risk management standards, in respect of financial exposures to independent third parties undertaken by them on an arm's length basis, should be applied to minimise interconnectedness risks.

### Introducing clients to enter into OTC derivative transactions with CFAs

An LC, when soliciting or recommending a client to enter into an OTC derivative transaction, owes the client a duty to act in their best interests. LCs are expected to:

- Act in the best interests of their clients
- Solicit or recommend clients to enter into OTC derivative transactions with a group affiliate only if the group affiliate is an LC, an authorised financial institution, a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction<sup>1</sup>
- Include a specified risk disclosure statement in client agreements, reminding clients of the risks of entering into derivative transactions with an unlicensed person<sup>2</sup>

### LCs booking OTC derivative transactions in RBAs

An LC arranging OTC derivative transactions for group affiliates, which are not LCs, authorised financial institutions, corporations similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction, is required to:

- Ensure the risks undertaken by each group affiliate in the OTC derivative transactions are properly managed in the case where the LC has responsibility for or oversight of the management of such risks
- In any other case, take reasonable steps to ensure that the risks undertaken by each group affiliate in the OTC derivative transactions are covered by a risk management program whose standards should be in-line with those set by local regulators and regulators in a comparable overseas jurisdiction

<sup>1</sup>There is an exemption from this requirement but it only applies if the client is an LC, an AI or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable overseas jurisdiction.

<sup>2</sup>LCs would be exempt from the proposed risk disclosure requirement if the client is an institutional professional investor or a corporate professional investor whom the LC is exempt from the requirement to enter into a written client agreement with and to provide risk disclosure statements to under paragraph 15 of the Code of Conduct.

## LCs using unregulated entities as booking affiliates

Some market participants adopt a booking model whereby they undertake dealing in OTC derivatives activities in Hong Kong with clients that are booked in an unregulated affiliate domiciled either in Hong Kong or an overseas jurisdiction (i.e. the client and the unregulated affiliates are counterparties to the OTC derivative transaction with the LC acting as “arranger” or “introducing agent”). The SFC proposals will impact such arrangements in the following ways:

- A LC will be unable to book client OTC derivative transactions in an unregulated affiliate unless the clients themselves are regulated entities in a comparable overseas jurisdiction
- A LC will need to either stop undertaking these activities or change its booking model to book the activities in a regulated entity (either in Hong Kong or a comparable overseas jurisdiction), where they will be subject to regulatory capital requirements and other applicable regulations
- If a LC is not managing OTC derivative transaction risks with clients that are booked in the unregulated affiliate, it will be required to ensure that the risks are covered by a risk management program whose standards should be in-line with those set by the SFC for LCs, by the Hong Kong Monetary Authority for authorised financial institutions, or by a securities/futures/banking regulator in a comparable overseas jurisdiction for OTC derivative dealers or banks entering into similar transactions.

*“There will be a significant impact on certain booking models for OTC derivatives transactions. LCs booking such transactions in unregulated affiliates will need to move them to a regulated entity unless the clients are themselves regulated in a comparable overseas jurisdiction. Such activities will henceforth be subject to regulatory capital requirements and other applicable regulations such as mandatory trade reporting, mandatory clearing and margin requirements.”*

**– Tom Jenkins, Partner, Head of Financial Risk Management**

According to the SFC, jurisdictions that have implemented a regulatory framework on OTC derivative deal activities that is similar to that of Hong Kong will be considered as comparable overseas jurisdictions for the purpose of the above requirements. The list of jurisdictions will be published on the SFC's website.

## Proposed Risk Mitigation Requirements

LCs will also be required to comply with new Risk Mitigation Requirements. The requirements apply to non-centrally cleared OTC derivatives and do not apply to centrally cleared derivatives. All LCs, regardless of their non-centrally cleared OTC derivatives exposure, will be subjected to the proposed risk mitigation standards outlined in the consultation paper. Margin requirements for non-centrally cleared OTC derivative transactions will be announced in a separate consultation.



### Trading Relationship Documentation

An LC is required to execute written trading relationship documentation with each counterparty before executing a non-centrally cleared OTC derivative transaction.

The documentation should include all the agreed material rights and obligations of the counterparties, which are consistent with any applicable law or regulation to provide legal certainty.



### Trade Confirmation

Trade confirmation should be completed as soon as practicable after a transaction has been executed.

LCs are expected to track the status of unconfirmed transactions with a view to obtaining proper confirmation of all transactions in a timely manner.

Trade confirmation should be done in writing either electronically or manually. LCs should also confirm other changes made, such as termination prior to the scheduled maturity date.



### Valuation with Counterparties

An LC should agree with its counterparties the process by which the value of a non-centrally cleared OTC derivative will be determined throughout the lifecycle of a transaction.

Valuations should be performed on a fair value basis by marking to market where practicable.

An LC should perform independent periodic reviews and verifications of the model outputs.



### Portfolio Reconciliation

The material terms should be exchanged and valuations (including variation margin) should be reconciled with the counterparties for all non-centrally cleared OTC derivative portfolios at regular intervals. The frequency of the reconciliations should commensurate with the risk exposure profile of the counterparty.



### Portfolio Compression

LCs should regularly assess and, when appropriate, engage in portfolio compression. Portfolio compression may be performed on a bilateral or multilateral basis.



### Dispute Resolution

LCs should agree in writing with its counterparties on the dispute determination mechanism or process for discrepancies in material terms, valuations or margin calls.

# Proposed Refinements to the scope of Regulated Activities (RA) in response to market comments on the OTC Derivatives Licensing Regime

A number of further amendments to Schedule 5 of the Securities and Futures Ordinance (SFO) are proposed:

<b>Corporate treasury activities carve-outs</b>	<p>The scope of expanded Type 9 RA and the new Type 11 RA (which has not yet been activated) is to be narrowed such that corporate treasury desks of non-financial groups as derivatives market intermediaries benefit from the “price taker carve-out”. However, under the following circumstances, the carve-out will not apply:</p> <ul style="list-style-type: none"> <li>• Where a corporate treasury desk within a non-financial group engages in OTC derivative transactions with external counterparties (however, so long as the corporate treasury desk remains a price taker, it will still be able to benefit from the price taker carve-out)</li> <li>• Where a corporate treasury desk within a non-financial group engages in OTC derivative transactions for group companies, which are funds</li> <li>• Where the treasury activities are performed by a financial group – according to the proposals corporate treasury personnel of financial groups may not rely on the “corporate treasury carve-out”<sup>3</sup></li> </ul>
<b>Post-trade multilateral portfolio compression carve-outs</b>	<p>The provision of multilateral portfolio compression services is to be excluded from both “dealing in OTC derivative products” and “advising on OTC derivative products” under RA 11.</p> <p>Multilateral portfolio compression services will not be exempt from the scope of Automated Trading Services (ATS).</p>
<b>CCP and providers of client clearing services carve-out</b>	<p>Central Clearing Counterparties (CCPs) (i.e. Recognized Clearing Houses (RCH) or ATS providers acting in its capacity as a CCP (ATS-CCP), which offer clearing and settlement services in Hong Kong, are to be carved out from “advising on OTC derivative products” and “dealing in OTC derivative products”.</p> <p>OTC derivative advising activities carried out by persons licensed for Type 12 RA, provided such activities are wholly incidental to carrying on Type 12 RA, are to be carved out from “advising on OTC derivative products”.</p>
<b>Activities of overseas clearing members and their agents</b>	<p>The exemption of remote clearing members of a Hong Kong CCP, which meet certain pre-requisites under Type 12 RA, is to be expanded to cover overseas persons who are clearing members of any CCP. The carve-out from Type 12 RA shall be extended to “acceptable participants”.</p>
<b>Certain fund manager services and ancillary services</b>	<p>Under the current proposal, a fund manager does not need a Type 12 RA license as long as the services they provide are ancillary. However, if the services are not ancillary (e.g., if a fund manager is a clearing member or a client of a clearing member, and providing services in that capacity), it will need to be licensed for Type 12 RA.</p>
<b>Wholly owned group companies OTC derivative products management activities</b>	<p>The existing Type 9 RA carve-out for managing an OTC derivatives portfolio for wholly-owned group companies is to be expanded to cover all OTC derivative products, (i.e. the carve-out applies in respect of all OTC derivative products managed for wholly-owned group companies, and not only in respect of OTC derivative products which also constitute “securities” or “futures contracts”).</p>
<b>Professionals incidental portfolio management activities</b>	<p>The current carve-out, which exempts professionals who provide portfolio management in respect of OTC derivative products from having a Type 9 RA license, is to be expanded to cover all OTC derivative products.</p>
<b>“Leveraged foreign exchange contracts”</b>	<p>Licensed fund managers that deal in foreign exchange derivatives solely for the purpose of managing funds are to be carved out from Type 3 RA.</p> <p>Only products that constitute both “leveraged foreign exchange contracts” and “OTC derivative products” shall benefit from the carve-out.</p>

The SFC has stated that further carve-outs might occur within the scope of Type 12 RA.

<sup>3</sup>Nonetheless, they may still rely on other existing carve-outs for their corporate treasury activities where appropriate, such as the “price taker” carve-out, “dealing through” carve-out; and the “wholly-owned group companies” carve-out.

## When will the proposed requirements come into effect?

According to the SFC, the proposed Code of Conduct requirements on risk mitigation as well as conduct requirements to address risks posed by group affiliates and other connected persons shall take effect six months after the gazettal of the associated amendments.

Conduct requirements applicable to CFA and RBA arrangements will not be applied retrospectively to existing OTC derivative transactions that were entered into before the effective date. All other requirements will become effective when the new OTC derivatives licensing regime commences at a not yet specified date.

## How KPMG can help

KPMG can provide you with advisory assistance in relation to the implementation of the new OTC derivatives regime. KPMG will also work closely with various key stakeholders within your firm to assess, design and implement the changes required. Key activities for such advisory assistance include (but are not limited to):

### Impact analysis and road map

- Perform an analysis of the impact of proposed changes to booking models on capital requirements under the Financial Resources Rules
- Create a road map to meet key initiatives



### Risk mitigation

- Design and optimise risk models
- Design policies, procedures & internal controls
- Assist in trading relationship documentation and other business requirement documents
- Provide valuation support



### License application

- Provide guidance through the application process
- Explain regulatory requirements and expectations
- Assist in reviewing the application package
- Assist in communication with the SFC
- Provide post-submission support



### Conduct risk management

- Advise on governance structure and booking arrangement
- Assist in reviewing the requisite policies and identify possible gaps with regulatory requirements
- Conduct post-implementation reviews & testing



## Contact us



### Simon Topping

Principal, Head of KPMG's Asia Pacific Regulatory Centre of Excellence  
T: +852 2826 7283  
E: [simon.topping@kpmg.com](mailto:simon.topping@kpmg.com)



### Bonn Liu

Partner, Head of Financial Services and Head of Asset Management ASPAC  
T: +852 2826 7241  
E: [bonn.liu@kpmg.com](mailto:bonn.liu@kpmg.com)



### Vivian Chui

Partner, Head of Securities and Asset Management, Hong Kong  
T: +852 2978 8128  
E: [vivian.chui@kpmg.com](mailto:vivian.chui@kpmg.com)



### Tom Jenkins

Partner, Head of Financial Risk Management  
T: +852 2143 8570  
E: [tom.jenkins@kpmg.com](mailto:tom.jenkins@kpmg.com)



### Simmy Ko

Partner, Financial Services  
T: +852 2143 8697  
E: [simmy.ko@kpmg.com](mailto:simmy.ko@kpmg.com)



### Jennifer Teng

Director, Risk Consulting  
T: +852 2685 7546  
E: [jennifer.teng@kpmg.com](mailto:jennifer.teng@kpmg.com)

### [kpmg.com/cn](http://kpmg.com/cn)

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