KPMG

Regulated Activity 11

RA11: anticipating a new era of OTC derivative dealing in Hong Kong

July 2024

The SFC's anticipated RA11 regime

The market has long been expecting the implementation of the SFC's new licensing regime for over-the-counter derivative (OTCD) dealing, known as the regulated activity 11 (RA11) regime. Since 2011, the SFC has published a number of consultation and conclusions papers on the proposed new regulated activities as well as related regulatory standards. While an effective date for the RA11 regime has not yet been announced, impacted firms should nonetheless start to prepare to implement the necessary changes now, to ensure they fully comply with these new requirements when they are introduced.

Type 11 regulated activity	The proposed type 11 regulated activity encompasses dealing in and advising on OTCD products, and has been defined to mean: • Entering into or offering to enter into OTCD transactions • Inducing or attempting to induce another person to enter into, or to offer to enter into, OTCD transactions • Giving advice on, or issuing analyses or reports on, whether OTCD transactions will be entered into, as well as the time at which, or the terms or conditions under which, such OTCD transactions will take place
Type 11 regulated activity carve-outs	The SFC has proposed certain "carve-outs" to exempt qualified market participants from Type 11 RA license requirements. Key carve-outs include: • "Non-RA11 OTCD dealer and advisor": Applicable if the transaction already falls within one of the existing regulated activities • "Price taker": Applicable if the person is dealing in the transaction as a "price taker," such as engaging in hedging activities only, only bidding on price offered, and the transaction entered is not intended to affect or move the market price • "Dealings through": Applicable when the OTCD dealing act is carried out through another person who is licensed for Type 11 regulated activity (e.g. an unregulated entity entering into an OTCD transaction through a Type 11 licensed dealer in Hong Kong) • Dealing activities of a licensed fund manager: Applicable if OTCD dealing act is carried out by a Type 9 licensed fund manager and carried out solely for the purpose of providing services of managing a portfolio of OTCD products

New capital requirements for OTC derivative dealers

All type 11 license corporations will be subject to the new financial resources requirements (FRR) which have already been released for public consultation in 2015 and 2017, and which incorporate Basel 2.5 rules into the FRR's existing "liquid capital" regime. The new rules are more refined than the existing FRR rules:

Minimum capital requirements	Higher amount of floor required liquid capital (New)	"Tangible capital" (New)	New component of variable RLC with regard to OTCD transactions (New)
New market risk and new counterparty credit risk requirements	Standardised Market Risk Approach (SMRA) Standardised OTCD Counterparty Credit Approach (SOCCRA)	Default approach for type 11, expanded type 7 and type 9 licensed corporates (New)	More risk sensitive (New)
	Basic Market Risk Approach (BMRA) Basic OTCD Counterparty Credit Risk Approach (BOCCRA)	Default approach for other non-RA11 licensed corporations (New)	
	Internal model approach including IMA and IMM Under certain conditions, licensed corporations can opt out of the default approach		
Other requirements	Notification and other requirements (New)		

When entities become licensed, they must comply with OTC Derivative Transaction Reporting requirements

The Securities and Futures (OTC Derivative Transactions – Reporting and Record-keeping Obligations) Rules

The mandatory reporting and the related record-keeping obligations apply to an entity that is a) an authorised institution; b) an approved money broker; or c) a licensed corporation. The Rules covers transactions of all five asset classes of interest rate, foreign exchange, equity, credit and commodities, and covered transactions must be reported on a T+2 basis.
Daily valuation information related to reportable transactions that should also be reported are listed below.

General information	Clearing information
• the product class and product type to which the transaction belongs • the dates on which the transaction was entered into, starts or otherwise becomes effective, and matures • particulars of the counterparties to the transaction • the quoted price, details of the master agreement, etc	• whether the transaction has been, or is intended to be, cleared through a central counterparty • if applicable, the central counterparty through which the transaction was cleared or is intended to be cleared; and the client clearing services provider involved in, or intended to be involved in, clearing the transaction
Valuation information	**Subsequent event information**
• whether the transaction is valued on a mark-to-market basis, a mark-to-model basis or by the CCP • when the transaction was last valued and the valuation on that date; and the calculated valuation value and the currency used for valuing the transaction	• the date on which the event occurred and any agreement relating to the event; the nature of the event; changes to any of the matters described in any other item of this schedule as a result of the event • the outstanding notional principal amount etc.

Records of a reportable transaction must be kept while the transaction is outstanding and for a further five years after the transaction matures or is terminated

Entities licensed for Type 11 regulated activity will also need to comply with the SFC's code of conduct on margin requirements

SFC risk mitigation and requirements on non-centrally cleared OTC derivative transactions

- On a permanent basis, from 1 September 2022 for each subsequent 12-month period, the exchange of initial margin (IM) by a licensed corporation is required in a one year period where both the licensed corporation and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$60 billion on a group basis.
- Licensed corporations can calculate IM amounts by reference to a standardised margin schedule, or by reference to a quantitative portfolio margin model. A licenced corporation should obtain approval in writing from the SFC before using an internally developed or a third-party IM model (such as SIMM) and should comply with the relevant requirements as specified in the SFC code of conduct in terms of model applicability, data quality and process, model validation, calibration, performance, documentation and governance.

Regulator's key areas of focus when assessing licence applications

Based on our past experience, we expect the regulator will focus on the following areas when approving new licence applications

01 Financial strength

- Source of funding
- Ability to comply with ongoing financial resources requirements

02 Risk management

- Proper risk management processes including market risk, counterparty credit risk, liquidity risk are in place and effective

03 Internal control

- Corporate governance
- Internal controls to ensure checks and balances, deal with conflicts of interest, etc

04 Business

- Business model
- Operational model
- Clientele

05 Controller

- Business rationale
- Background of shareholders (including substantial shareholders)
- Compliance history

06 Management

- Directors, responsible officers (ROs)
- Managers-in-charge
- RO competence (at least two ROs and one executive director)

How can KPMG support you?

As licensed corporations plan for RA11 implementation, KPMG can provide support in areas including:

Planning

- Creating a roadmap to put in place a tactical plan taking into account the expected new SFC regulations
- Conducting awareness training across business lines and functional groups within corporations

Impact analysis

- Performing impact analyses based on the proposed changes under the new OTCD regime
- Advising on the optimal booking locations and structures by conducting a quantitative and qualitative analysis, which can include:
  - Regulatory capital implications under different jurisdictions (including market risk, counterparty credit risk, large exposure, liquidity risk)
  - Liquidity and funding implications
  - Compliance and infrastructure requirements

Implementation

- Updating policies, procedures and internal control measures
- Defining and documenting functional responsibilities for the licensed corporation and its group affiliates
- Preparing and updating trading relationship and business requirement documents
- Helping to identify any data or system gaps in order to calculate the regulatory capital requirements
- Performing independent validations of new risk models where necessary
- Advising on the reporting structure for regulatory reporting under the new requirements
- Conducting post-implementation reviews and testing

License application (once type 11 regulated activities commence)

- Advising on licensing requirements and assisting with the application process
- Facilitating communication with the SFC on application status
- Providing post-submission support

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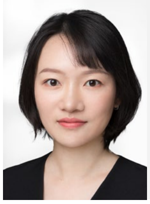

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