Regulating Intermediaries in the OTC Derivatives Market

Introduction

The 2008 financial crisis showed the need to regulate the over-the-counter ("OTC") derivative market. The Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") have jointly conducted few consultations since 2011 and included a regulatory regime for OTC derivatives in the Securities and Futures (Amendment) Ordinance 2014 (the "Amendment Ordinance").

Among other things, two new regulated activities will be introduced, namely type 11 regulated activities ("Type 11 RA") and type 12 regulated activities ("Type 12 RA", and together with Type 11 RA referred as the "new RAs"), to regulate persons who serve as dealers, advisers or clearing agents etc. in the OTC derivatives market. This new licensing regime has not come into operation yet.

Under Schedule 1 of the Securities and Futures Ordinance (Cap. 571) (the "SFO"), “OTC derivatives products” are widely defined to mean “structured products” with certain exclusions, exclusions include transactions in securities and futures contracts that are traded on a market operated by a recognized exchange company etc. Swaps and accumulators are some commonly known OTC derivatives products.

The new licensing regime

Type 11 RA

Type 11 RA means dealing in OTC derivatives products or advising on OTC derivatives products, it was proposed to cover the activities of dealers and advisers in relation to OTC derivatives transactions.

Therefore, under the Amendment Ordinance, there are two limbs for Type 11 RA:

1. The first limb is advising on OTC derivatives products, which include the following:
   a. giving advice on whether an OTC derivative transaction should be entered into, which transaction should be entered into, the time at which or the terms and conditions on which a transaction should be entered into; or
   b. issuing analyses or reports, for the purpose of facilitating the recipients to make decisions on whether an OTC derivative transaction should be entered into, which
transaction should be entered into, the time at which or the terms and conditions on which a transaction should be entered into;

2. The second limb is dealing in OTC derivatives products, which includes:
   a. entering into or offering to enter into an OTC derivative transaction; or
   b. inducing or attempting to induce another person to enter into or to offer to enter into an OTC derivative transaction.

Such definition of Type 11 RA is subject to various carve-outs, including but not limited to the following:

1. those that overlapped with existing regulated activities;
2. acts in the ordinary course of business by authorised financial institution and approved money broker;
3. OTC derivative advising act of corporations where advice is given solely to its wholly owned subsidiaries, holding company or other wholly owned subsidiaries of that holding company;
4. OTC derivative advising acts of solicitors, counsels, certified public accountants or trust companies which are wholly incidental to their practice or duty; and
5. OTC derivative advising acts conducted through published or broadcast media made available to the public.

Type 12 RA

Type 12 RA means providing client clearing services for OTC derivative transactions, which means providing services to another person for the clearing and settlement of OTC derivative transactions through a central counterparty (whether located in Hong Kong or elsewhere), whether or not as a member of the central counterparty. However, an act carried out by a central counterparty for the purpose of performing the person’s functions as a central counterparty and an act carried out by an authorized financial institution or an approved money broker in the ordinary course of business will not be captured by Type 12 RA.

Type 12 RA aims to regulate and supervise the activities of clearing agents in OTC derivatives, which is a relatively new service. Market participants started to clear their OTC derivatives transactions through a central counterparty (“CCP”) to manage the counterparty risk involved, however, not every market participant may become member of a CCP and clear directly, they may then engage third parties who provide clearing agency services to clear indirectly through a CCP. As part of the regulatory regime for the OTC derivative market, there will be a mandatory clearing obligation on OTC derivatives market participants and they will be allowed to discharge such obligation by indirect clearing through a clearing agent. Therefore, the new regime is needed to supervise these clearing agents to protect the interests of their clients.
Transitional Arrangements

Some transitional arrangements will be adopted to facilitate market players who have been engaging in OTC derivatives activities to move into the new licensing regime with minimum impact on their existing businesses.

Transitional Period

There will be a transitional period of six months beginning on the commencement date for the new RAs (the “Transitional Period”). During the Transitional Period, a person will not be regarded as having contravened any prohibition under section 114 of the SFO in respect of the new RAs, no matter whether the person has made application for license for carrying out such activities. During the Transitional Period, the SFC and the HKMA will not take action against any person for carrying on the new RAs.

The Transitional Period acts as a grace period for the winding down process or the transfer process for corporations who may not wish to, or are not able to, apply for the license for the new RAs.

Deeming mechanism

If applicants made applications for license in relation to the new RAs in the first three months from the commencement date for the new RAs (“Application Period”), provided that they have satisfied all requisite criteria, they will be deemed to be licensed after the Transitional Period until their application have been dealt with. The SFC or the HKMA will conduct initial screening on the applications.

If the applicants meet the relevant deeming criteria, the applicant will be deemed licensed for the relevant new RAs immediately after the end of the Transitional Period. Such deemed status will last until their applications have been approved, refused or withdrawn.

If the applicant did not meet the relevant deeming criteria, the SFC or the HKMA will issue a no-deeming notice to the applicant. After receiving the no-deeming notice, the ineligible applicant will have a grace period of three months from the date of the no-deeming notice to wind down their existing OTC derivatives business, close out existing positions, and/or transfer their business to another corporation that is entitled to carry on the relevant activities. They can only restart business regulated under the relevant new RAs after they are licensed.

The initial screening will not involve thorough consideration of the application itself, even an applicant might have been considered suitable for a deemed license, the SFC or the HKMA can subsequently refuse their application and brings the deemed license to an end.

If applicants failed to submit application during the Application Period, they will not be entitled to carry out activities regulated under the new RAs after the expiry of the Transitional Period.
until they are licensed under subsequent regular application procedures. Under such circumstances, if they continue to carry out such activities after the Transitional Period without license, the SFC or the HKMA may initiate actions against them.

Experience requirement for deemed status

As the transitional arrangements are designed to facilitate existing market participants but not intended to be a shortcut for “opportunists” without adequate and relevant experience, applicants need to fulfill certain experience requirements in order to be eligible for deemed license, i.e. at least two years of experience in such business before the commencement date of the licensing regime.

However, since the activities under Type 12 RA is a relatively new practice around the world and entirely new in Hong Kong, the applicants for license for Type 12 RA are likely to be newcomers. Therefore, the experience requirement for Type 12 RA would be relaxed, overseas experience, affiliates experience and experience in clearing proprietary trades will be recognized.

Conclusion

It has been years since the 2008 financial crisis and many jurisdictions have been working to develop regulatory regime for the OTC derivative market to reduce the risks involved and increase transparency. As an international financial centre, the introduction of the new RAs in Hong Kong is expected to give more confidence to investors to continue investing in the Hong Kong financial market.

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Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

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