



Consultation Paper on (1) the OTC derivatives regime for Hong Kong – Proposed refinements to the scope of regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters; and (2) Proposed conduct requirements to address risks posed by group affiliates

The Law Society's Submissions

The Securities and Futures Commission ("SFC") issued a consultation paper on 20 December 2017 on (1) the OTC derivatives regime for Hong Kong - Proposed refinements to the scope of the regulated activities, requirements in relation to OTC derivative risk mitigation, client clearing, record-keeping and licensing matters; and (2) Proposed conduct requirements to address risks posed by group affiliates ("**Consultation Paper**"). In response thereto, the Law Society provides the following submissions on the consultation questions posed.

Capitalized terms used but not defined herein have the meanings assigned to them in the Consultation Paper.

OVERALL VIEW

We consider the proposals to be broadly appropriate and proportional in nature, bearing in mind the IOSCO context and the novel issues created under the incoming regime. It will be important to monitor the new regime for unintended consequences and to remediate issues arising. Elements of the flexible approach intended and stated by the SFC are to be welcomed.

Q1a. Do you have any comments or concerns about how the SFC proposes to carve out corporate treasury activities conducted within non-financial groups from the scope of OTC derivative products management (ie, Type 9 RA)?

Law Society's response:

The proposals on the face of it satisfactorily cater for the concerns previously expressed. The issue needs to be monitored on an ongoing basis to assess whether there are any unexpected consequences of the approach in practice.

Q1b. Do you have any comments or concerns about how the SFC proposes to carve out corporate treasury activities conducted within non-financial groups from the scope of "dealing in OTC derivative products" (ie, the dealing limb of Type 11 RA)?

Law Society's response:

We repeat our response to Question 1a above.

Q1c. Do you have any comments or concerns about how the SFC proposes to carve out corporate treasury activities conducted within non-financial groups from the scope of "advising on OTC derivative products" (ie, the advising limb of Type 11 RA)?

Law Society's response:

We repeat our response to Question 1a above.

Q1d. SFC does not propose to carve out corporate treasury activities from Type 12 RA because we believe that corporate treasury personnel do not typically provide client clearing services. Do you have any comments or concerns in this regard? Please provide detailed reasons and justification if you believe such a carve-out is necessary or useful.

Law Society's response:

We agree, although a confirmatory provision for the avoidance of doubt may be helpful to head off any doubt.

Q1e. The term "affiliate" is proposed to be defined by reference to the terms "group", and hence "subsidiary", as defined in Schedule 1 to the SFO. Among other things, the latter is defined by reference to: (i) control of the composition of the board of directors; (ii) control of more than 50% of the voting power at general meetings; or (iii) ownership of more than 50% of the issued capital (excluding capital which carries no right to participate beyond a specified

amount on a distribution of profits or capital). Do you have any comments or concerns about defining “affiliate” in this way?

Law Society’s response:

It is appropriate to deal with “associate” in this way, not least to avoid a parallel but different treatment of the concept.

Q1f. Do you have any comments or concerns about how the SFC proposes to define “financial group” and “financial services”?

Law Society’s response:

In respect of “financial group” – a group of companies which is primarily engaged in the provision of, or in supporting the provision of, financial services or the conduct of financial activities – this presumably should say *financial services*?

No comment on *financial services*.

Q2a. Do you have any comments or concerns about the SFC’s proposal to carve out multilateral portfolio compression services from both “dealing in OTC derivative products” and “advising on OTC derivative products”?

Law Society’s response:

This seems a sensible approach.

Q2b. Do you have any comments or concerns about how the SFC proposes to define “multilateral portfolio compression services”?

Law Society’s response:

The definition appears appropriate, although the reference to *within risk tolerance levels set by the persons referred to in (b) below (participants)* will need to be carefully defined and clarified when the provisions are drafted for use in the legislation. The phrase as stated at the moment has no clear meaning.

Q2c. The SFC does not propose to amend the definition of “automated trading services”. If you disagree, please provide details of the amendment you consider to be necessary, together with supporting reasons and justification.

Law Society's response:

We agree that there is no need to amend the ATS definition.

Q2d. Other than portfolio compression services, are there other post-trade services which should also be carved out? If so, please provide detailed reasons and justifications.

Law Society's response:

No comment

Q3a. Do you have any comments or concerns about how the SFC proposes to carve out the provision of compression services by CCPs from the scope of "advising on OTC derivative products"?

Law Society's response:

Agree.

Q3b. Do you have any comments or concerns about how the SFC proposes to amend the carve-out for CCPs from the scope of "dealing in OTC derivative products"?

Law Society's response:

No comment

Q3c. Do you have any comments or concerns about how the SFC proposes to carve out persons licensed for Type 12 RA from the scope of "advising on OTC derivative products"?

Law Society's response:

Agree.

Q4a. Do you have any comments or concerns about how the SFC proposes to narrow the scope of Type 12 RA so as to align the position of overseas persons providing client clearing services irrespective of whether they do so as members of a local CCP or an overseas CCP?

Law Society's response:

We agree with the SFC's revised analysis.

Q4b. Do you have any comments or concerns about the SFC's proposal to narrow the scope of Type 11 RA (both dealing and advising) so that activities carried out by acceptable participants which are not licensed for Type 12 RA are carved out?

Law Society's response:

We agree with the proposals.

Q5a. Do you have any comments or concerns about how the SFC proposes to carve out clearing and settlement services provided by fund managers from the scope of Type 12 RA?

Law Society's response:

We agree with the policy and approach.

Q5b. Do you have any comments or concerns about how the SFC proposes to refine the definition of Type 12 RA to exclude services that are essentially ancillary to the clearing and settlement process?

Law Society's response:

We agree with the policy and the approach.

Q6a. Do you have any comments or concerns about the SFC's proposal to expand the carve-out for professionals so that it covers all OTC derivative products?

Law Society's response:

This seems to us entirely appropriate.

Q6b. Do you have any comments or concerns about how the SFC proposes to carve out licensed fund managers' from Type 3 RA?

Law Society's response:

We agree that this plugs a gap in the provisions.

Q7. Do you have any comments or concerns about the high-level, principles-based approach the SFC proposes to take in respect of applying the risk mitigation requirements, including the scope of application of our proposed requirements and the entities to whom our proposals apply? Are there specific challenges with respect to cross-border issues which may need to be taken into account under the SFC's proposed approach?

Law Society's response:

We agree that the high level principles-based approach is appropriate in the overall circumstances for the sake of flexibility in a fast-moving area.

We also agree with the scope of persons covered, on the basis that the relevant requirements should be applicable to all licensed corporations, including smaller non-centrally cleared OTC derivative exposure where, for example, such exposure does not exceed a quantitative threshold. The regulatory response/approach to lower levels of exposure, however, should be sensitively and proportionately applied in practice, as contemplated in paragraph 57 of the Consultation Paper.

Q8. Do you have any comments on the proposed risk mitigation requirements, including trading relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression or dispute resolution?

Law Society's response:

It is important that there remains a level playing field between licensed corporations and registered institutions, governed by rules which are synchronized effectively between the two regulators.

Q9. Are any of the risk mitigation requirements inappropriate for a corporation licensed for Type 9 RA which carries out OTC derivative products management, in respect of non-centrally cleared OTC derivative transactions executed by the licensed corporation on behalf of any CIS managed by it? If so, how should the corresponding risk be mitigated?

Law Society's response:

No. We consider the requirements should be applicable, although as mentioned above there should be a sensible approach to regulation applied in that regard. Valuation is a good example: a licensed corporation should have resources and capability to ensure proper valuation of proposed transactions/positions when entering into a trade on behalf of a CIS.

Q10. Will any established industry practice be adversely affected in a material respect by the proposed risk mitigation requirements?

Law Society's response:

No comment from legal perspective as this is more an industry point.

Q11. Is it appropriate to subject FX security conversion transactions only to the proposed risk mitigation requirements for trading relationship documentation and trade confirmation? If not, what are the reasons for exempting such transactions from these proposed requirements? How should the legal and operational risks of such transactions be mitigated?

Law Society's response:

We consider these requirements should not be overly burdensome in the context of ongoing businesses and we concur that notwithstanding the spot nature of the activities, there is an overall advantage to ensuring that they are properly managed within the context of the overall OTC derivatives business.

Q12. Do you agree with the SFC's proposed segregation and portability requirements? Where both individual client segregation and omnibus client segregation are offered by a CCP, should a licensed corporation which is a clearing member of the CCP be required to offer its clients both account structures? As part of the proposed disclosure requirements in relation to the risks of different account structures, should licensed corporations also be required to explicitly flag to clearing clients the risk that clients themselves may be exposed to losses as part of CCP recovery and resolution, eg, via variation margin gains haircutting?

Law Society's response:

No comment

Q13. Is it appropriate to prohibit the use of client assets for the benefit of the licensed corporation's affiliates? If so, is it appropriate to identify affiliates of a licensed corporation by reference to the concept of controlling-entity relationship as defined under the SFO?

Law Society's response:

Yes.

Q14. Do you agree with the SFC's proposed notification and information disclosure requirements in relation to indirect clearing?

Law Society's response:

The approach seems appropriate, given the need for clients to be aware of the basis of treatment of their assets.

Q15. Do you agree with the SFC's proposed clearing confirmation requirements?

Law Society's response:

We agree with the principle.

Q16. Are the proposed CMR and CSR requirements appropriate in the context of client clearing?

Law Society's response:

Yes.

Q17. Is the requirement to retain trading relationship documentation, trade confirmations and valuation processes agreed with counterparties for a minimum of five years after the termination, maturity, novation or assignment of OTC derivative transactions appropriate? Should this requirement be extended to any other record?

Law Society's response:

We agree that the requirement is appropriate for the documentation listed above. The general requirement to maintain appropriate and sufficient business records should otherwise suffice.

Q18. Do you agree with the SFC's proposal to require licensed corporations to properly manage financial exposures to group affiliates and other connected persons according to the same risk management standards they would apply in respect of exposures to independent third parties undertaken by the licensed corporations on an arm's length basis in order to minimise interconnectedness risk? If not, what other conduct requirements should be introduced in order to minimise the impact of interconnectedness risk?

Law Society's response:

We regard such measures as an essential element of the regulatory regime in the light of past failures.

Q19. Do you agree that licensed corporations should be allowed to i) solicit or recommend clients to enter into OTC derivative transactions with a group affiliate or ii) arrange for OTC derivative transactions to be entered into between its clients and a group affiliate 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 overseas jurisdiction subject to the exemption set out in paragraphs 136 and 139?

Law Society's response:

Yes.

Q20. Do you agree with the proposed risk disclosure requirement for licensed corporations using unlicensed CFAs?

Law Society's response:

Yes.

Q21. Do you agree with the proposed risk management requirements for licensed corporations arranging for OTC derivative transactions to be booked in RBAs?

Law Society's response:

Yes. While noting and agreeing with the SFC's point regarding the constraints on a licensed corporation in respect of an RBA, it remains the case that it is important for the relevant risks to be properly managed holistically by groups rather than

merely resorting to narrow arguments at a legal entity level.

Q22. Are the proposed licensing fees in relation to the new RAs appropriate? Do you have any comment on the proposed extension of the fee waiver for Type 7 RA which is conducted incidentally to Type 3 or Type 11 RA?

Law Society's response:

This is appropriate.

Q23. Is the proposed insured amount of "nil" for Type 10, Type 11 and Type 12 RAs appropriate? Please explain your views.

Law Society's response:

No comment

Q24. Are the proposed amendments to the competence and CPT requirements appropriate? Please explain your views.

Law Society's response:

We regard this as a sensible approach.

**The Law Society of Hong Kong
27 February 2018**