

# OTC derivatives reform in Hong Kong: Development Update

January 2019

On 12 December 2018, the Securities and Futures Commission (SFC) released a consultation conclusion paper on (i) Proposed requirements in relation to OTC derivative (OTCD) risk mitigation and client clearing and (ii) Proposed conduct requirements to address risks posed by group affiliates, which is under the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct). This client update explores the key amendments to the consultation paper issued in December 2017 and suggests actions to be taken by Licensed Corporations (LCs) in Hong Kong.

The consultation conclusion comprises four parts: (i) proposed risk mitigation requirements in relation to OTCDs; (ii) proposed requirements in relation to OTCDs on client clearing; (iii) proposed conduct requirements to address risks posed by group affiliates and other connected persons; and (iv) a proposed consequential amendment to client agreement requirements. The amendments to the Securities and Futures Ordinance (SFO) and subsidiary legislation with respect to the new Type 11 Regulated Activity (RA) and Type 12 RA will be published in due course.

Risk mitigation requirements in relation to OTCDs	Client clearing requirements for OTCDs	Client agreement requirements	Conduct requirements to address risks posed by group affiliates and other connected persons
<ul style="list-style-type: none"> <li>The proposed risk mitigation requirements cover trading relationship documentation, trade confirmation, valuation, portfolio reconciliation, portfolio compression and dispute resolution to address legal, operational and counterparty credit risks which exist in non-centrally cleared OTCD exposure.</li> <li>Substituted compliance of risk mitigation requirements <b>will not</b> be available.</li> </ul>	<p>Additional requirements will be applied to a corporation licensed to provide client clearing services for OTCD transactions, regardless of whether the LC itself is a clearing member of a central counterparty clearing house (CCP) on segregation and portability, indirect clearing, clearing confirmation to clients.</p>	<p>A consequential amendment will be made to the Code of Conduct such that the current client agreement requirements also cover the dealing in or advising on OTCD products (new Type 11 RA) and provision of client clearing services for OTCD transactions (new Type 12 RA).</p>	<ul style="list-style-type: none"> <li>An LC should manage financial exposure to group affiliates and other connected persons with the same risk management standards as if facing a third party.</li> <li><b>Regulated CFA Requirement:</b> A licensed person should solicit or recommend clients to enter into OTCD transactions with a group affiliate only if the group affiliate, as a client facing affiliate (CFA),<sup>1</sup> or the client themselves, is a regulated person.<sup>2</sup></li> <li>For each unregulated group affiliate of an LC that enters into OTCD transactions as a risk booking affiliate (RBA)<sup>3</sup> on a back-to-back basis against the client transactions, the LC should have the oversight responsibility for the management of the undertaken risks.</li> </ul>

## Implementation Timeline and Actions

The OTCD regime and the proposed conduct requirements may require LCs to undertake a substantial amount of work in a short timeframe, especially the compliance of legal entity booking in CFA requirements. LCs should therefore begin making any necessary changes to comply with the new requirements.

A transitional period will be given to existing CFAs<sup>4</sup> that fall outside the range of regulated persons set out in the requirements, where the period ends with the expiry of the transitional period for Type 11 RA.



The **risk mitigation requirement** in relation to non-centrally cleared OTCD transactions will come into effect on **1 September 2019**. No phase-in implementation is allowed.

The requirement for client clearing and the amendment to client agreement requirements set out will be effective **when the OTCDs licensing regime commences**.

The **proposed conduct requirements** to address risks posed by the group affiliates and other connected persons will become **effective 6 months after the gazettal of the Code of Conduct amendments**.

<sup>1</sup> A group affiliate enters into OTC derivative transactions with the client, which are induced by an agent or broker, is referred to as client facing affiliate.

<sup>2</sup> Regulated person includes an LC, an authorised financial institution or a corporation similarly regulated as an OTCD dealer or bank in a comparable OTCD jurisdiction.

<sup>3</sup> The CFA may offload the market risks to another group company (referred to as "risk booking affiliate").

<sup>4</sup> An existing CFA is defined as a CFA which has an ongoing introduction agreement with a licensed corporation within the same group which was established and in effect before the date of the release of this paper, ie, 12 December 2018, whereby the licensed corporation agrees to introduce clients to enter into OTCD transactions with the CFA.

# Proposed requirements in relation to OTCD risk mitigation, client clearing and client agreement amendment

The SFC's high-level, principle-based risk mitigation requirements are largely in line with the requirements implemented in other major jurisdictions, and some requirements have been essentially covered in existing regulatory requirements (e.g. Internal Control Guidelines). The details regarding the requirements are set out below:

Risk Mitigation Requirements	Substituted compliance	<ul style="list-style-type: none"> <li>• <b>Substituted compliance</b> of the proposed risk mitigation requirements <b>will not be available</b>.</li> </ul>
	Scope of risk mitigation requirements	<ul style="list-style-type: none"> <li>• <b>Applicable to all LCs which enter into a non-centrally cleared OTCD transaction</b>, irrespective of its outstanding notional amount, location of incorporation and whether or not the transaction is executed for hedging purposes. A principle-based approach will be utilised to assess an overseas incorporated LC.</li> <li>• Exception is given only when the Asset Managers' dealing desk executing the trade is <b>outside Hong Kong</b> or the Hong Kong dealing desk is executing the trade for its <b>overseas affiliates</b> on behalf of a <b>collective investment scheme</b>.</li> <li>• Applicable to discretionary accounts <b>to the extent practicable</b> as a matter of sound risk management, and to document the arrangements as agreed with their clients.</li> </ul>
	Trading relationship documentation	<ul style="list-style-type: none"> <li>• LCs should assess the adequacy of the ISDA documentation they adopt and whether the documentation contains sufficient terms and conditions on an ongoing basis while the contracting parties <b>should agree</b> on the <b>valuation process</b> and the <b>dispute resolution process</b>.</li> <li>• The requirements on trading relationship documentation apply <b>regardless of</b> whether or not the transaction is a <b>one-off</b>. A master agreement may be signed at the inception of the trading relationship when a series of transactions with a counterparty is expected.</li> </ul>
	Trading confirmation	<b>One-way trade confirmations</b> are allowed. Material terms of the trade should be exchanged. A list of possible material terms is provided in Appendix 2 of the Consultation Paper issued in Dec 2017.
	Valuation	<p>LCs should agree with their counterparties on the <b>process</b> (not model) by which the value of a non-centrally cleared OTCD will be determined throughout the lifecycle of the transaction.</p> <p>(A) <i>LCs using proprietary valuation model</i></p> <p>LCs can use a model which employs valuation methodologies with mainstream acceptance or consider new methodologies with a sound theoretical basis. The inputs feed should be appropriately verified and the model itself should be independently reviewed, validated and calibrated prior to use, periodically and when material changes are made to the methodology or the model.</p> <p>(B) <i>LCs outsourcing valuation to a third party</i></p> <p>Solely relying on a vendor's representation is not sufficient. LCs should understand the valuation methodology, risk factors used, model calibration, model testing and risk governance process of the model adopted by the vendor. LCs should also review and verify the model output regularly.</p> <p>The Asset Manager is required to exercise due skill, care and diligence in the selection of the third party pursuant to the revised <b>Fund Manager Code of Conduct (FMCC)</b> and remains responsible for the valuation of the fund assets.</p> <p>(C) <i>LCs using broker quotes</i></p> <p>Valuation model requirements would not apply. However, LCs should exercise due skill, care and diligence in sourcing and applying broker quotes for valuation purposes.</p>
	Portfolio reconciliation and compression	LCs should use a <b>risk-based approach</b> to determine the frequency of portfolio reconciliation and compression. Although the SFC sets a principle-based requirement, they expect the portfolio reconciliation to be more frequent than once a year.

## Proposed requirements in relation to OTCD risk mitigation, client clearing and client agreement amendment (continued)

Requirements for client clearing	Segregation and portability, indirect clearing	As long as the LCs segregate assets held for clients in separate accounts, they can <b>freely choose</b> whether they offer both individual and omnibus <b>client segregation accounts</b> when they are available at CCPs.
	Clearing confirmation to clients	<ul style="list-style-type: none"> <li>• LCs that provide client clearing services should provide a <b>clearing confirmation</b> to their clients no later than the end of the following business day after the client's OTCD transaction is accepted for clearing.</li> <li>• LCs are encouraged to adopt <b>straight-through-processing (STP)</b> for OTCD transactions where practicable.</li> </ul>
Client Agreement Amendment	Consequential amendment	Amendment to the Code of Conduct is made such that the current client agreement requirement also covers solicitations or recommendations of OTCD products under the new Type 11 RA and Type 12 RA.

## Proposed conduct requirements to address risks posed by group affiliates and other connected persons

Some market participants are currently adopting a “remote booking” model where the firm may introduce an unregulated overseas entity as the CFA. In such cases, these firms are likely to be impacted by the proposed conduct requirements regarding regulated CFAs and may need to change their booking models. The details regarding the requirements are set out below:

### A. Proposed conduct requirement for the management of financial exposure to group affiliates and other connected persons

- LCs should manage financial exposure to group affiliates and other connected persons according to the **same risk management standards** they would deploy in respect of financial exposure to independent third parties undertaken by them on an **arm's length basis**, and depending on the nature of the exposure.
- LCs are expected to **design and implement control and risk management programmes** which are commensurate with the scale and complexity of their operations.
- The requirement **ceases to apply** if its application to a financial exposure will have the effect of **overriding an applicable requirement** or exemption under any law, rule or regulation administered or issued by the SFC, the regulators (if any) of the group affiliate or other connected persons relating to the exposure or transaction giving rise to the exposure.

Scope of application	<ul style="list-style-type: none"> <li>• The requirement applies to <b>all LCs</b> with financial exposure to group affiliates and other connected persons, regardless of the number of group affiliates the LC has. The financial exposure includes on- and off-balance sheet exposure as well as exposure arising from OTCD activities.</li> <li>• Registered institutions or inter-branch transactions are not subject to the requirements.</li> </ul>
Scope of intra-group “financial exposure”	<b>Irrespective of the capital treatment</b> of their financial exposure (including intra-group financial exposure) in the capital rules, LCs have the responsibility to practice prudent risk management such that all exposure is managed prudently with regard to their underlying risks.

# Proposed conduct requirements to address risks posed by group affiliates and other connected persons (continued)

## B. Conduct requirements relating to the introduction of clients entering into OTCD transactions with a CFA

LCs should fulfil the Best Interest Requirement, Regulated CFA Requirement and Risk Disclosure Requirement when entering into a transaction with clients who are not group affiliates.

<b>Scope of application</b>	<ul style="list-style-type: none"> <li>The requirements <b>would not apply</b> to the referral of asset management services of group affiliates to clients</li> <li>Regulated client exemption <b>will not be expanded</b> to include professional investors.</li> </ul>															
<b>Best Interest Requirement</b>	LCs should act in the best interest of their clients. Compliance of this principles-based requirement varies on a case-by-case basis.															
<b>Risk Disclosure Requirement</b>	<ul style="list-style-type: none"> <li>LCs are <b>exempted from the client agreement and risk disclosure requirements</b> in respect of a client pursuant to paragraph 15.4 of the Code of Conduct.</li> <li>LCs from the proposed requirement in respect of CFAs which are regulated by regulators <b>other than the SFC are not exempted</b>.</li> <li>The scope of the exemption in paragraph 15.4 of the Code of Conduct relating to risk disclosure to clients to include the proposed requirement will be expanded.</li> </ul>															
<b>Regulated CFA Requirement</b>	<ul style="list-style-type: none"> <li>A licensed person may i) solicit or recommend clients to enter into OTCD transactions with a group affiliate; or ii) arrange for OTCD transactions to be entered into between a group affiliate and its clients. This is only if the group affiliate is an LC, an authorised financial institution or a corporation similarly regulated as an OTC derivative dealer, or a bank in a comparable OTCD jurisdiction, except that the client concerned is a regulated institution.</li> <li>The requirement would not affect intra-group transactions and the application of the exemption provisions in the definitions of various types of RAs to CFAs.</li> <li>No passporting regime similar to those for investment funds will be introduced.</li> <li>LCs are allowed a transitional period to comply with the proposed requirement in respect of existing CFAs which fall outside the range of regulated persons set out in the proposed requirement.</li> <li>The preliminary list of deemed comparable OTCD jurisdictions will include the securities, futures and banking regulators in the following jurisdictions:</li> </ul> <table border="1" style="width: 100%; border-collapse: collapse;"> <tbody> <tr> <td style="text-align: center;">1. Australia</td> <td style="text-align: center;">2. Canada</td> <td style="text-align: center;">3. Mainland China</td> <td style="text-align: center;">4. France</td> <td style="text-align: center;">5. Germany</td> </tr> <tr> <td style="text-align: center;">6. Italy</td> <td style="text-align: center;">7. Japan</td> <td style="text-align: center;">8. Netherlands</td> <td style="text-align: center;">9. the Republic of Korea</td> <td style="text-align: center;">10. Singapore</td> </tr> <tr> <td style="text-align: center;">11. Spain</td> <td style="text-align: center;">12. South Africa</td> <td style="text-align: center;">13. Switzerland</td> <td style="text-align: center;">14. the UK</td> <td style="text-align: center;">15. the US</td> </tr> </tbody> </table>	1. Australia	2. Canada	3. Mainland China	4. France	5. Germany	6. Italy	7. Japan	8. Netherlands	9. the Republic of Korea	10. Singapore	11. Spain	12. South Africa	13. Switzerland	14. the UK	15. the US
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## Proposed conduct requirements to address risks posed by group affiliates and other connected persons (continued)

### C. Proposed conduct requirements for LCs booking OTCD transactions in risk booking affiliates (RBAs)

- The proposed requirement applies to group affiliates for whom OTCD transactions are arranged by the LC which have a **direct or indirect relationship** with client transactions as described in the proposal.
- The proposed requirement **does not require** RBAs to be subject to capital requirements, but LCs should take into account the guidance on risk management provided by the SFC or the regulators (if any) of their RBAs or groups in designing their programmes.
- LCs should **exercise due care and diligence** in conducting business activities under the General Principles of the Code of Conduct when the LC is arranging OTCD transactions for the CFA with third parties.

## Key challenges faced by LCs

- Insufficient or incorrect knowledge of the compliance of risk mitigation and conduct risk requirements.
- Lack of detailed policies, procedures and internal controls to fulfil the high-level, principles-based risk mitigation requirements set out by the SFC.
- Lack of proper trading relationship documentation, trade confirmation or portfolio reconciliation of non-centrally cleared OTCD transactions.
- Insufficient or incorrect knowledge and application of the new licensing and CFA/RBA requirements.
- Ensuring all OTCD transactions fulfil the relevant risk management requirements of booking OTCD transactions in RBAs. LCs considering a potential change in trading flows and legal booking models should consider the pros and cons of alternative booking locations should the new Type 11 and 12 RA licenses become effective.
- LCs may be unable to continue to conduct certain client OTCD business if the transactions cannot be moved into a regulated entity.
- Profitability of existing business may change due to business now being subject to capital requirements.



## How can KPMG support you?

As LCs prepare for these new requirements, KPMG is well-placed to provide support in areas including but not limited to:

### Planning

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

### Impact Analysis

- Performing impact analyses based on the proposed changes under the new OTCD regime
- Advising on the optimal booking location(s) and structure(s) by conducting a quantitative and qualitative analysis, which can include:
  - Regulatory capital implications under different jurisdictions (incl. market risk, counterparty credit risk, large exposure, liquidity risk, etc.)
  - Liquidity and funding implications
  - Compliance and infrastructure requirements
  - Direct and indirect tax implications

### Implementation

- Updating policies, procedures and internal control measures
- Defining and documenting functional responsibilities for the LC and its group affiliates
- Preparing and updating trading relationship and business requirement documents
- Assisting to identify any data/system gaps in order to calculate the regulatory capital requirements
- Designing and developing new risk models where necessary
- Constructing the reporting structure for regulatory reporting under the new requirements
- Conducting post-implementation reviews and testing

### License application (once type 11 and 12 RA commence)

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

## Contact us



**Bonn Liu**  
Partner, Head of Financial Services, Hong Kong  
KPMG China  
T: +852 2826 7241  
E: bonn.liu@kpmg.com



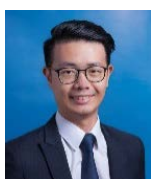
**Simon Topping**  
Partner, Regulatory Advisory  
KPMG China  
T: +852 2826 7283  
E: simon.topping@kpmg.com



**Tom Jenkins**  
Partner, Head of Financial Risk Management  
KPMG China  
T: +852 2143 8570  
E: tom.jenkins@kpmg.com



**Connie Kang**  
Associate Director, Financial Risk Management  
KPMG China  
T: +852 3927 4619  
E: cs.kang@kpmg.com



**Desmond Yu**  
Associate Director, Financial Risk Management  
KPMG China  
T: +852 2913 2591  
E: desmond.yu@kpmg.com



**Christine Wong**  
Senior Consultant, Financial Risk Management  
KPMG China  
T: +852 2978 8920  
E: christine.wong@kpmg.com

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

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