Update on Hong Kong OTC derivatives regulatory regime

Scott Carnachan and Isabella Wong

New reporting and clearing requirements

On 27 June 2018, the Hong Kong Monetary Authority (HKMA) and Securities Futures Commission (SFC) published joint consultation conclusions on their March 2018 consultation on OTC derivatives reporting, clearing and platform trading obligations. As set out in the consultation conclusions:

1. Effective 1 April 2019, reporting entities (those subject to the Hong Kong OTC derivatives reporting regime) will need to use Legal Entity Identifiers when reporting to the Hong Kong Trade Repository (a) information on new trades, and (b) daily valuation information for existing outstanding trades.

2. Standardized Australian dollar interest rate swaps will be subject to the Hong Kong mandatory clearing regime – this change is expected to take effect around Q4 of 2019, 12 months after the revisions to the Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules are gazetted.

3. An updated list of financial services providers for the purpose of the mandatory clearing regime will be gazetted.

Proposed margin requirements

On 19 June 2018, the SFC also issued a consultation paper on proposed margin requirements for non-centrally cleared OTC derivative transactions. The proposed margin requirements will be relevant to:

- SFC licensed corporations that are counterparties to non-centrally cleared OTC derivative transactions; and
• collective investment schemes that enter into non-centrally cleared OTC derivative transactions with SFC licensed corporations and that have an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion.

The consultation paper proposes that, from 1 September 2019, an SFC licensed corporation that is a counterparty to a non-centrally cleared OTC derivatives transaction will be required to exchange margin in relation to the transaction where (i) the other counterparty is a “covered entity”, and (ii) certain thresholds are met. Subject to the consultation conclusions, the proposed margin requirements will be reflected in a new Part II of Schedule 10 to the SFC Code and Conduct.

The proposed margin requirements mean that an SFC licensed corporation will need to:

• monitor the average aggregate notional amount of non-centrally cleared OTC derivatives of itself and of the group of which it forms part;

• where it manages one or more collective investment schemes and such collective investment schemes enter into non-centrally cleared OTC derivative transactions with SFC licensed corporations, monitor the average aggregate notional amount of non-centrally cleared OTC derivatives of each such collective investment scheme (in order to determine whether such collective investment schemes are “covered entities”); and

• for transactions to which it is a counterparty, (i) determine whether its counterparty is a “covered entity”, and (ii) if yes, obtain information from the counterparty on the average aggregate notional amount of non-centrally cleared OTC derivatives of the counterparty and of the group of which it forms part.

Meaning of “covered entity”

“Covered entity” includes a wide range of financial counterparties and significant non-financial counterparties, but excludes sovereigns, central banks, public sector entities and multilateral developments banks.

“Financial counterparty” includes:

1. banks, brokers, asset managers, insurers and money lenders regulated in Hong Kong;

2. entities that carry on business outside Hong Kong predominantly in one or more of banking, securities or derivatives business, insurance, asset management, money changing / remittance services or lending;

3. mandatory provident fund schemes and occupational retirement schemes;

4. collective investment schemes, including regulated and unregulated funds,

that have (or the group to which the relevant entity belongs has) an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion.

A “significant non-financial counterparty” is a counterparty other than a financial counterparty that has (or the group to which it belongs has) an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$60 billion.

Transactions covered

The proposed margin requirements apply to non-centrally cleared OTC derivative transactions, other than (i) transactions that are indirectly subject to the margin requirements of a central counterparty, (ii) physically settled FX forwards and FX swaps, (iii) excluded currency contracts, (iv) physically settled commodity forwards, and (v) on or before 29 February 2020, non-centrally cleared single-stock options, equity basket options and equity index options.
Thresholds to trigger margin requirements

The consultation paper sets out requirements for both initial margin and variation margin.

The obligation on an SFC licensed corporation to exchange initial margin with a covered entity only arises 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.

The obligation on an SFC licensed corporation to exchange variation margin with a covered entity only arises where the licensed corporation has (or the group of which it is part has) an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$15 billion.

Other provisions

The consultation contains proposals relating to the method and frequency of calculation of initial and variation margin, the timing for the exchange of margin, the types of assets that may be used as margin (including haircuts, where relevant), how margin should be held and minimum transfer amounts.

The consultation proposes that an SFC licensed corporation may only rehypothecate, repledge or reuse initial margin for the purpose of hedging the licensed corporation’s derivative positions arising out of transactions with the counterparty for which the initial margin was collected. Rehypothecation is also subject to a number of other proposed conditions relating to consent, segregation and eligibility of the entities that receive the rehypothecated assets.

The SFC proposes to permit substituted compliance where a transaction complies with the margin requirements of a comparable foreign jurisdiction (as determined by the SFC or the HKMA). The SFC proposes to deem member jurisdictions of the Working Group on Margin Requirements as comparable jurisdictions for this purpose.

Deadline for submissions on proposed margin requirements

Comments on the proposals in the consultation paper must be submitted to the SFC on or before 20 August 2018.

MPF update

Pauline Woo

Amendments to MPFA Guidelines

In June 2018, Hong Kong’s Mandatory Provident Fund Association (MPFA) issued four sets of revised Guidelines, namely Guidelines on Central Securities Depositories (Guidelines I.7), Guidelines on Approved Exchanges (Guidelines III.4), Guidelines on Index-Tracking Collective Investment Schemes (Guidelines III.10) and Guidelines on Default Investment Strategy (DIS) (Guidelines III.14). Portfolio managers should take note of the changes, especially the reclassification of certain asset classes as “higher risk assets” for the purpose of the DIS.

Amendments to Guidelines I.7, III.4 and III.10 are made to reflect the approval of a central securities depository (namely the “Shanghai Clearing House”) and the approval of a futures exchange (namely “ICE Futures Europe”) by the MPFA for the purpose of the MPF Regulation. Amendments to Guidelines III.14 relate to the classification of SFC authorised REITs, Value Gold ETF and SPDR Gold Trust as “higher risk assets” for DIS investment purposes.
**Enhancement to fee disclosures**

Recently the MPFA proposed to align the disclosure of fees for each constituent fund in the offering document with that for DIS constituent funds. The management fees of constituent funds and the underlying approved pooled investment funds should be disclosed separately, and where practicable, broken down by service function (e.g. trustee fee, administration fee, investment management fee). Trustees are expected to make a submission to the MPFA by the end of August 2018.

**Guidance on online client onboarding**

Rory Gallaher

On 12 July 2018 the SFC issued a circular to provide guidance to intermediaries which intend to onboard individual clients online in response to enquiries raised by the industry.

Onboarding a client who is not physically present poses a higher risk of impersonation.

Intermediaries are allowed to use certification services that are recognised by the Electronic Transaction Ordinance for client identity verification in an online environment. In order to provide more flexibility, the SFC will also accept the following procedures to verify clients’ identities when onboarding individual clients online:

1. Obtain a client agreement which is signed by a client by way of an electronic signature together with a copy of the client’s identity document;

2. Successfully transfer an initial deposit of not less than HK$10,000 from a bank account in the client’s name maintained with a licensed bank in Hong Kong (Designated Bank Account) to the intermediary’s bank account;

3. Conduct all future deposits and withdrawals for the client's trading account through the Designated Bank Account(s) only; and

4. Maintain proper records of the account opening process for each client which are readily accessible for compliance checking and audit purposes.

Intermediaries when onboarding overseas clients should be mindful of the requirements imposed by the domestic regulatory authorities.

The SFC may provide further guidance in the light of technological developments in the future.

**Implementation of amended professional investor rules**

Rory Gallaher

In our newsletter of June 2018, we reported on changes to the Securities and Futures (Professional Investor) Rules (PI Rules) which came into effect on 13 July 2018.

The amended PI Rules expand the categories of professional investors to include corporations which have investment holding as their principal business and are wholly-owned by one or more professional investors and holding companies of professional investors.
On 13 July 2018, the SFC issued a circular to intermediaries to remind them that they should, as part of their know-your-client procedures, obtain confirmations that the shareholders of such holding companies have been informed of the corporation’s status as a professional investor before providing services to that company.

The circular further states that directors of holding companies should ensure that shareholders are properly informed of the implications of the amended rules. This includes, for example, information about those responsible for making investment decisions for the holding company and clarity about the circumstances in which shareholders should be informed of an investment decision or where their consent should be sought. It is likely that the SFC will expect intermediaries relying on the expanded categories of professional investors to satisfy themselves that the directors of such holding companies have provided the relevant information to their shareholders.

**Mainland China briefing**

Yang Shen and Anita Hu

**Relaxation of QFII and RQFII rules**

On 12 June 2018, China’s foreign exchange regulator, the State Administration for Foreign Exchange (SAFE), released the *Provisions on the Administration of Foreign Exchanges in Domestic Securities Investments by QFII* (available here in Chinese), and China’s central bank, the People’s Bank of China (PBOC), released the *Circular of the PBOC and the SAFE on Issues Concerning the Administration of Domestic Securities Investment by RQFII* (available here in Chinese).

The key changes are as follows:

1. Removing the monthly 20% repatriation limit imposed under the QFII scheme.
2. Removing the lock-up restrictions applicable to the investment principal under both the QFII and RQFII schemes.
3. Allowing QFIIs and RQFIIs to enter into forex hedging transactions in China to hedge currency risks deriving from investing in China.

**MSCI index inclusion of China’s A-shares**

On 1 June 2018, 226 of China’s A-shares were officially included in the Morgan Stanley Capital International Emerging Markets Index (*MSCI index*), a widely-used index representing over 85% of all emerging market equity fund assets. Funds tracking the MSCI index need to buy the included A-shares to track the performance of the newly constituted index. Under the partial inclusion plan, the included A-shares currently represent 0.37% of the index; this September the weighting will be increased to 0.8%.

As China’s stock markets are not fully open to foreign investors, the main channels to purchase shares are the QFII, RQFII and the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect schemes. To embrace the inclusion debut, the daily quota for the respective northbound trading links under the Stock Connect schemes was quadrupled to RMB 52 billion in May, and the monthly 20% repatriation limit imposed under the QFII scheme and the three-month lock-up restrictions applicable to investment principal under both the QFII and RQFII schemes were removed in June.
**SFC licensing and compliance hints**

Rebecca Yip

**MIC regime on inspection agenda**

According to the latest SFC Annual Report (2017-18), during the last financial year, the SFC conducted 301 risk-based on-site inspections (312 in 2016-17), including thematic inspections on a range of issues. The SFC has enhanced the case management system and implemented a new risk assessment system to seek to improve the efficiency of inspections. The SFC will review firms’ compliance with the MIC regime during upcoming inspections as one of its strategic proprieties.

Another strategic priority is to release a revamped version of the Business and Risk Management Questionnaire for collection of data on licensed corporations’ business activities and risk exposures.

**Licence applications meet performance pledge**

According to the annual report, all new corporate, provisional representative and normal representative applications met the SFC’s performance pledges of 15 weeks, 7 business days and 8 weeks respectively. However, applications that had unresolved fitness and properness issues, outstanding vetting requests, applicants failing to provide essential information, or requests by applicants to delay the final approval were excluded from the statistics.

1% of applications for approval of responsible officers and 3% of applications for transfer of accreditation did not meet the performance pledges of 10 weeks and 7 business days respectively. This was mainly due to unexpected complications such as increases in the SFC’s workflow resulting in resourcing difficulties, but the consequential delay were usually short according to the annual report.

**Buying a licensed entity - having your cake and eating it?**

When a firm decides to acquire the shares of an existing company (and, if it’s an SFC licensed corporation, obtain the SFC’s approval of any new substantial shareholders) in preference to buying the assets of the business from the existing company and having them transferred into its own corporate vehicle (and, if the business is SFC regulated, getting the corporate vehicle licensed), it is impossible to do so without also automatically inheriting all the warts and skeletons of the existing company. In other words, the existing company (and therefore its owners) remains accountable for all problems it has ever had (including legal and regulatory issues) even if they occurred under a prior shareholder. This means that unless it is really worth taking over responsibility for all the prior sins of a company, it may be better to simply set up a new company to acquire the assets and start anew.

**NFA on-site inspections of Hong Kong asset managers**

Mary Nieto

There are industry press reports that the U.S. National Futures Association (NFA) is for the first time conducting on-site compliance examinations of NFA Hong Kong-based members which are registered with the Commodity Futures Trading Commission (CFTC). This only applies to firms that are registered with the CFTC, not those that have filed an exemption.

NFA members are required to comply with NFA Rules and CFTC Regulations. In order to monitor compliance, the NFA conducts periodic examinations. While all NFA members are subject to being examined, the timing and frequency of examinations vary depending upon:
• The amount of money the firm has under management;
• Customer complaints;
• Prior examination findings; or
• Concerns noted during the review of disclosure documents or financial statements filed with the NFA.

According to the NFA website, NFA examinations are conducted in three phases:

**Planning:** The NFA may contact the member firm to announce an upcoming examination. Following any initial contact, a formal announcement, known as a First Day Letter, will also be sent.

**Fieldwork:** During this phase, you can expect the NFA to:

• Interview key personnel;
• Review reports and documentation;
• Monitor firm operations; and
• Conduct an exit interview.

**Reporting:** Following fieldwork, the NFA will

• Hold an examination closing meeting to discuss findings; and
• Issue a written examination report.

Recent publications

Amended Hong Kong takeover rules effective from 13 July 2018

Countdown to Brexit - what will happen to my intellectual property?

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Hong Kong Stock Exchange proposes rule changes to tighten regulation of backdoor listing

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OFCs – A corporate fund structure for Hong Kong

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