

01 Background

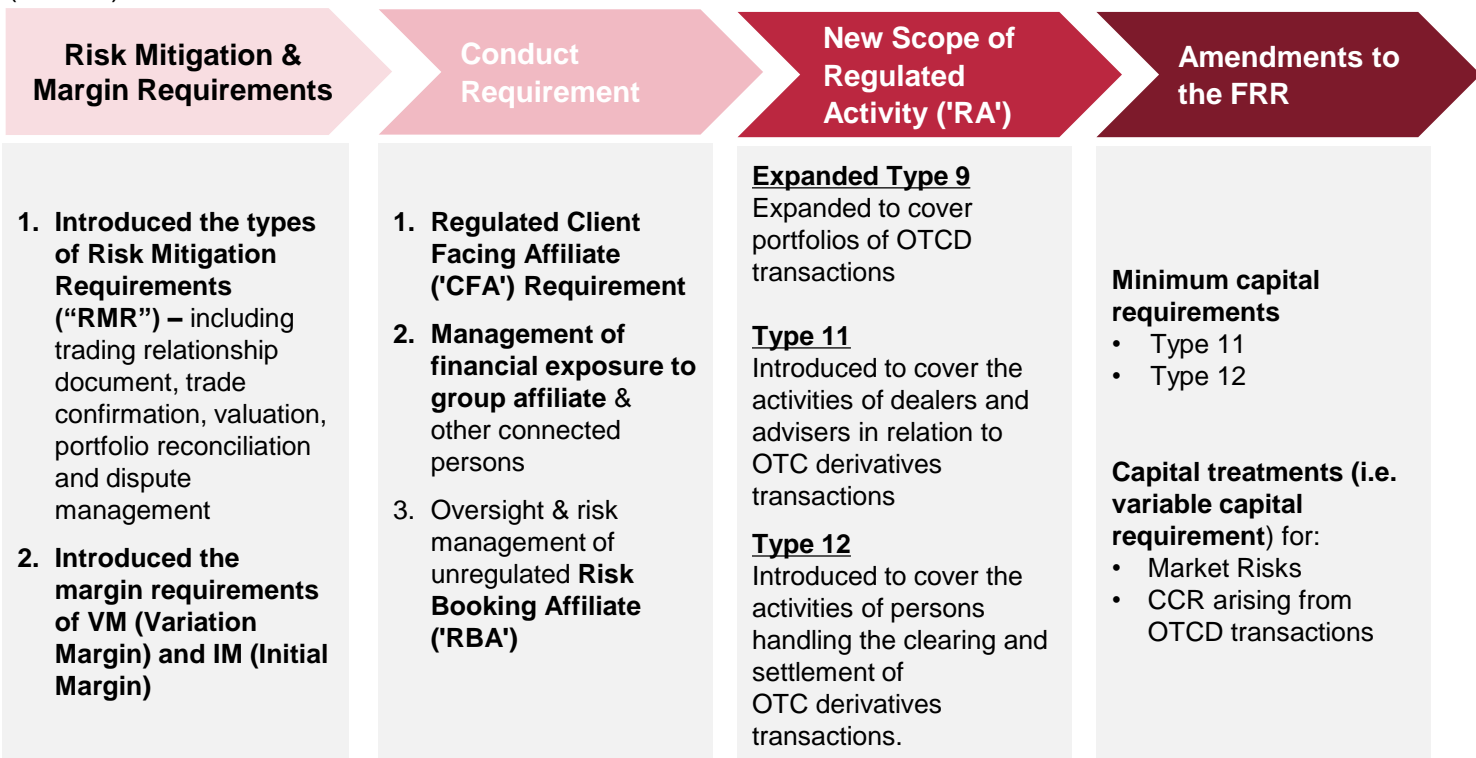
Since 2011, the Securities and Futures Commission ('SFC') has released a series of consultation conclusions by phases to strengthen the regulatory framework for the over-the-counter derivatives ('OTCD') market in Hong Kong. These consultations not only introduced **amendments to the Securities and Futures Ordinance (SFO)** and its subsidiary legislation to address **mandatory clearing and reporting obligations** but also proposed changes to the **licensing and capital regime**.

The changes introduced are expected to have a significant impact on Licensed Corporations (LCs) involved in over-the-counter derivatives (OTCD) activities. This paper **examines the implications of these reforms** from both business and compliance perspectives, highlighting the **potential need for LCs to reassess their current booking models and operational frameworks** to align with the new regulatory requirements.

02 Overview of the OTCD Regulatory Reform

In view of the global commitment to improve the transparency of OTCD markets, SFC has been putting continuous effort in re-shaping the OTCD regulatory landscape. The development of OTCD supervision has **further extended to enhance regulatory oversight in respect of systemically important players (SIPs)**, i.e. non-regulated players in Hong Kong, but whose positions and activities in the OTCD market may raise concerns of potential systemic risk.

In particular, we have summarised the series of consultation conclusions related to OTCD reform and highlighted the **major areas with significant changes**: Risk Mitigation & Margin Requirements, Conduct Requirements, Licensing Scope and (Financial Resources) Rules ('FRR') and Hong Kong Trade Repository ('HKTR').



Hong Kong Trade Repository ('HKTR')*

Introduced **OTCD products** related **data reporting requirements – critical data element (CDE), validation rules implementation and XML format reporting requirement.***

*Please refer to the publication *HKTR OTC Derivatives Reporting Reforms (2024)* for details.

03 Key Regulatory Requirements and the Implications

SFC has proposed a new governance framework to **address** the regulatory concerns brought by the **use of an unlicensed CFA to enter into OTC derivative transactions with clients** or the **use of an unlicensed RBA** to book proprietary OTC derivative transactions entered into by a LC.

Conduct requirements relevant to the licensing reform

Highlight of the Conduct Requirements

Requirements/ Scope

Regulated CFA Requirement

- LCs can **only introduce** (i.e. both solicit and advise) clients to enter into OCTD transactions **with a group affiliate (CFA)**, if the group affiliate is
 - 1) a **LC**
 - 2) an **authorised financial institution**
 - 3) a corporation **similarly regulated as an OTC derivative dealer**
 - 4) a bank in a **comparable OTCD jurisdiction**
- Such requirement is exempted from OTCD transaction entered with regulated client. However, the regulated client exemption **does not apply to professional investors**

Oversight & risk management of unregulated RBA

LCs are required to **review their own risk policies** and ensure the risks taken by RBA are covered by risk management standards that are consistent with the standard set by the relevant regulators.

Business Considerations/ Implications

- ✓ The Regulated CFA requirement significantly impacts the **current 'remote booking' model** due to significant **licensing, regulatory capital** implications.
- ✓ Remote booking model for OTCD business shall be discontinued if the transactions cannot be moved into a regulated entity, for which the application of **Type 11 license may be required**.
- ✓ LCs are expected to **review risk policies** and those of the RBA to ensure they are consistent with the standards set by the relevant regulators.
- ✓ The RBA requirement highlights the need for LCs to **review group risk management protocol** and evaluate group-wide risk allocation and capital optimisation across **intra-group entities**.

New scope of regulated activities under the licensing reform

Highlight of the New Type 9 RA

Requirements/ Scope

Scope Type 9 RA is **expanded to cover management of portfolios of OTCD transactions** on top of the original scope coverage of trading Securities and Futures, which essentially means OTCD products management.

Exemptions RMR Exemptions

- Exception only when the **Asset Managers'** dealing desk executing the trade is **outside Hong Kong** or the Hong Kong dealing desk is executing the trade for its overseas affiliates on behalf of a collective investment scheme.

Licensing Exemptions

- **Als and AMBs** if OTCD portfolio management is wholly incidental to their carrying on of OTCD dealing activities
- **Services provided by Type11 license holder** wholly incidentally to its Type11 activities

Business Considerations/ Implications

- ✓ Asset managers licensed for the **new Type 9 activity** will be subject to the **same minimum capital requirements** as those for the existing Type 9 RA.
- ✓ If their **dealing in OTC derivative products is incidental** to the new Type 9 activity, they are **exempt** from the licensing requirement for Type 11 RA.



New scope of regulated activities under the licensing reform (Cont.)

Highlight of the Type 11 RA

| Requirements/ Scope | | |
|---------------------|---|---|
| | Dealing Limb | Advising Limb |
| Scope | <ol style="list-style-type: none"> 1. Entering or offering an OTCD transaction; 2. Inducing or attempting to induce another person to enter or offer an OTCD transaction | Advising or issuing reports or analyses, on whether derivative transactions should be entered into (or on the terms on which such transactions should be entered into) |
| Exemptions | <ol style="list-style-type: none"> a. Authorised Institution / Approved Money Broker; b. Type 9 LC solely providing the expanded Type 9 dealing related services; c. Price taker exemption; and d. Dealing activities incidental to client clearing by overseas clearing members of overseas CCPs | <ol style="list-style-type: none"> a. Incidental exemption from Type 4 or 5 RA for Type 1 or 2 LCs; b. Authorised Institution / Approved Money Broker; c. Type 9 LC solely providing the expanded Type 9 advising related services; d. Wholly-owned group exemption; and e. Advising activities incidental to client clearing by overseas clearing members of overseas CCPs |

Business Considerations/ Implications

Along with '**Regulated CFA Requirement**', existing LCs may consider the need to obtain **additional license**:

- Type 1 and Type 4 RA cover only certain types of **equity/ bond derivatives** which fall under definition of 'securities'
- **Dealing in OTCD** that are not covered under existing RAs (e.g. commodities derivatives, IRS) may require additional Type 11 license
- Certain **licensing exemptions** to carry on existing business (i.e. the principal-to-principal exemption under Type 1 may not be applicable for Type 11



Higher capital requirements for OTCD activity participants

Highlight of Requirements

Capital Requirements for Type 11

Minimum Capital Requirement for LCs for Type 11 RA

| Activities | Types of OTCD Dealers | Paid-up Share Capital | Tangible Capital ¹ | Required Liquid Capital (RLC) | |
|------------|-----------------------|--|-------------------------------|-------------------------------|--|
| Type 11 RA | Dealing Limb | RCCP-cleared OTCD dealers | HK\$30 million | N/A | Higher of HK\$15 million & calculated variable RLC |
| | | Non RCCP-cleared OTCD dealer and qualifies for OTCD de-minimis reduction | N/A | HK\$500 million | Higher of HK\$78 million & calculated variable RLC |
| | | Any other OTCD dealers | N/A | HK\$1 billion | Higher of HK\$156 million & calculated variable RLC |
| | | Dealing in OTCD products and approved to use the Internal Models Approach | N/A | HK\$2 billion | Higher of HK\$156 million & calculated variable RLC |
| | Advising Limb | Subject to the licensing condition of not holding client assets | N/A | N/A | Higher of HK\$100,000 & calculated variable RLC |
| | | In any other circumstances | HK\$5 million | N/A | Higher of HK\$3 million & calculated variable RLC |

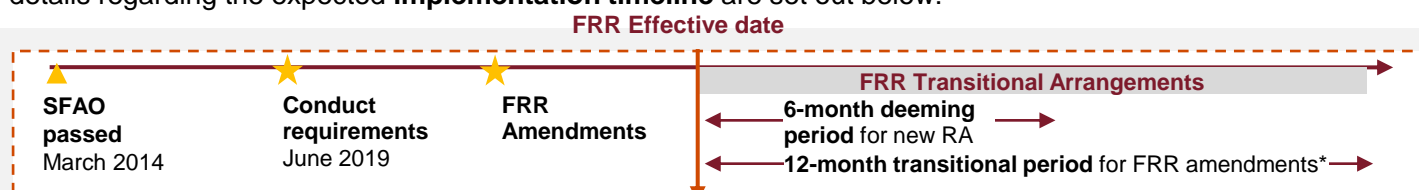
Capital Considerations

- ✓ Market participants may struggle to meet the **new capital requirements**, with non-centrally cleared OTC dealers facing a baseline capital requirement of HK\$1 billion—substantially higher than current RAs.
- ✓ LCs may be required to perform a **quantitative impact studies** to calculate the estimated liquid capital charges.
- ✓ Profitability of existing business may change given that businesses are now being subject to higher capital requirements.

04

Critical Timeline

To be better prepared for the upcoming heightened supervisions under the OTCD regime reform and proposed conduct requirements, LCs should **plan ahead for their readiness and make any necessary adjustments**. The details regarding the expected **implementation timeline** are set out below:



*The Client-Facing Affiliate (CFA) conduct requirements is expected to align with the FRR effective date

05

How We Can Help

| Modules | Scope of work |
|--|---|
| 1 IM and VM Target Operating Model Design (including RMS Implementation) | <p>IM and VM exchange TOM development</p> <ul style="list-style-type: none"> • Scoping assessment on counterparties and products • Support IM/ VM negotiation priority and implementation strategy on ISDA legal documentation • IM/ VM margin allocation methodology and develop calculation approach • IM/VM exchange procedures and workflow design <p>RMR implementation & utility function vendor selection</p> <ul style="list-style-type: none"> • Implement RMR mandatory components include trading confirmations, client statements, and relevant disclosures into the TOM • Support vendor selection for the corresponding utility function • Support arrangement of tri-party custodian services for collateral management |
| 2 Booking Model Assessment and Process Re-engineering | <p>Legal entity rationalization and Quantitative impact studies ('QIS') development Perform impact assessment considering different booking model options with qualitative considerations and quantitative capital impact analysis</p> <p>Business process re-engineering Identify and implement target state process and controls from front-to-end departments</p> |
| 3 HKTR Reporting | <p>Data assessment and exploration Conduct critical data element (CDE) data mapping and identify data transformation logic based on reporting requirements</p> <p>Automated Tool Development Implement automated trade reporting tool based on identified data infrastructure and mapping logic with data automation</p> |

For further details, please contact:

James Tam

Banking & Capital Markets Leader
PwC Hong Kong
+852 2289 2706
james.tam@hk.pwc.com

Jeff Lee

Partner, PwC Hong Kong
+852 2289 2440
jeff.cy.lee@hk.pwc.com

Albert Lo

Financial Services Consulting Leader
PwC Hong Kong
+852 2289 1925
albert.kh.lo@hk.pwc.com

Adams Chan

Partner, PwC Hong Kong
+2289 2784
adams.wf.chan@hk.pwc.com

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

©2022 PricewaterhouseCoopers Ltd. All rights reserved. PwC refers to the Hong Kong member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.