27th August 2012

Supervision of Markets Division
Securities and Futures Commission
8th floor Chater House
8 Connaught Road Central
Hong Kong

By email
otcconsult@sfc.hk

Dear Sir,

Supplemental Consultation on the OTC derivatives regime for Hong Kong (July 2012)

I refer to the captioned consultation.

I would like to provide the following comments regarding the proposed scope of new/expanded regulated activities.

Q1. Comments on the Casting and Exemption of the New Type 11 RA

A. Scope of a Type 1 License for Dealing in OTC Derivatives

Currently, a type 1 license holder may, whether as principal or as agent, deal in securities (which, according to the SFO, covers derivatives generally).

It is noted that paragraph 10(1) on P.4 of the Supplemental Consultation mentions that a type 1 license is good for agency dealing in OTC derivatives. For dealing as a principal, it is necessary to have a type 11 license.

It is suggested that this stance, when settled, be set out in certain FAQ for future reference and clarification.

B. License for Dealing in Multi Asset Derivatives

The licensing regime of non-equities derivatives is not clear from the Supplemental Consultation. For instance, for a prime broker, currently holding a type 1 license, to deal in OTC derivatives in equities, interest rate, and commodities for clients, what license(s) should he get?

i. is his type 1 license good enough because all sorts of derivatives are 'securities'?
ii. does he need to apply for a type 11 license because his type 1 license only covers equities derivatives?
iii. is type 11 license relevant to OTC derivatives in commodities, interest rate and currencies?
iv. does he have to go elsewhere for the dealing permit because some of the underlyings are outside the purview of SFC?

It would be helpful to hear of the SFC's clarifications regarding licensing for dealing in OTC derivatives in non-equity & non-debt assets, such as FX, interest rate, gold and silver, commodities, energy and credit.

C. Exemption re Dealing for / Advising Intragroup Companies as End Users

i. Dealing for intragroup companies : -

Paragraph 13(1) on P.8 of the Supplemental Consultation explains that under the 'price taker' exemption, group company "A" dealing in OTC derivatives transactions, for free, for group company "B" as a price taker or end user does not require a type 11 license. Paragraph 13(1) mentions that the same applies to transactions entered into by funds. Under this exemption, no 'wholly owned' relationship is required of these group companies.

ii. Advising intragroup companies :-

Paragraph 12(7) on P.8 of the Supplemental Consultation mentions that a group company giving advisory on OTC derivatives to its wholly owned subsidiaries, holding company or other wholly owned subsidiaries of that holding company does not require a type 11 license. Under this exemption, a direct or indirect 'wholly owned' relationship is required of these group companies.

It would be helpful to learn more about the rationale for this difference.

Moreover, this 'wholly owned' requirement has, in practice, limited the exemption in a lot of legitimate arrangements, particularly those involving listed groups. It is because listed companies as end users cannot satisfy the 'wholly owned' requirement.

Taking this opportunity of regulatory reform, I wonder if it may be appropriate time to also review this 'wholly owned' element in the context of exemptions under type 4 RA, type 5 RA, and type 11 RA for intragroup dealing and advisory.

Q4. Comments on Expanding the Scope of Existing Type 9 RA

D. What Constitutes 'a Portfolio of OTC Derivatives'

Firstly, I would like to point out that it is very common for fund managers to employ some forms of OTC derivatives in the day-to-day cash management, preparation for significant subscription or redemption, trading, hedging and risk control. Penetration of OTC derivatives in a portfolio is not a question of 'whether', but 'how much'. My bold guess is 3 - 25% for day-to-day portfolio management. This flexibility should be preserved for fund managers irrespective of their portfolio nature.

Secondly, to consider the proposed licensing condition, it would be helpful to understand SFC's take on what constitutes 'a portfolio of OTC derivatives', and the threshold involved.

It is submitted that 'a portfolio of OTC derivatives' should refer to synthetic portfolios or portfolios which invest substantially (say 70%+) in customized OTC derivatives. Examples are synthetic index funds and gold funds. It should not be interpreted to catch any portfolios with OTC derivatives positions, albeit very negligible ones. A de minimis line should be drawn. I would boldly suggest 25%.

Fund managers' continual use of a fair amount of OTC derivatives (say, 25%) in their portfolio management is very essential. SFC's endorsement of this flexibility would lubricate this process of change and provide a workable exit for fund managers not providing service of managing 'a portfolio of OTC derivatives". For instance :-

i. fund managers of non-synthetic portfolios, and those whose use of OTC derivatives is <25% would accept the proposed licensing condition because they do not provide a service of managing a portfolio of OTC derivatives;
ii. yet, they may continue to use OTC derivatives in their normal course of portfolio management of up to 25%;

iii. if subsequent change of circumstances cause their use of OTC derivatives to exceed 25%, they would need to comply with the relevant licensing requirements, namely

a) notifying the SFC of this business change;
b) submitting an acceptable internal control plan; and/or
c) applying to uplift the licensing condition.

Q5. Comments on Transitional Arrangements for the Expanded Type 9 RA

E. Synthetic Portfolios vs Non-synthetic Portfolios

The transitional arrangement as set out in paragraph 37 of the Supplemental Consultation should apply to fund managers managing (i) synthetic portfolios; and (ii) portfolios which invest substantially in OTC derivatives (say, 70%). They should satisfy the SFC regarding their relevant experience and competence in order to provide services of managing a portfolio of OTC derivatives.

For fund managers of non-synthetic portfolios, and those whose use of OTC derivatives is <25%, they do not provide a service of managing a portfolio of OTC derivatives and should be subject to the proposed licensing condition. Yet, the SFC should allow them to continue using OTC derivatives of up to 25% in the normal course of portfolio management.

It is hoped that this would save a lot of time and effort for the parties concerned.

Yours faithfully,

Lydia TAN