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Dear Sirs

Supplemental consultation on the OTC derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systemically important players

We welcome the opportunity to provide comment on the supplemental consultation paper on the proposed scope of new/expanded regulated activities and regulatory oversight of systemically important players (the "**Supplemental Consultation Paper**") issued by the Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission (the "**SFC**") in July 2012.

Following discussions with a number of our clients who will likely be subject to the proposed scope of the new/expanded regulated activities and/or regulatory oversight of systemically important players regime, we have provided responses to those questions posed in the Supplemental Consultation Paper on which we express our and our clients' general views.

We are happy to discuss any part of this Response with the HKMA and the SFC further or answer any questions you may have. Whilst several members of the Clifford Chance team have been involved in preparing this Response, in the first instance please feel free to contact

Yours faithfully

Clifford Chance

RESPONSE TO SUPPLEMENTAL CONSULTATION PAPER ON THE PROPOSED SCOPE OF NEW/EXPANDED REGULATED ACTIVITIES AND REGULATORY OVERSIGHT OF SYSTEMICALLY IMPORTANT PLAYERS

Terms defined or given a particular construction in the Supplemental Consultation Paper have the same meaning in this Response unless a contrary indication appears.

1. **Response to specific questions raised in the Supplemental Consultation Paper**

Q1. Do you have any comments or concerns about our proposals for how the initial ambit of the new Type 11 RA should be cast, and the specific activities to be excluded from its scope? If you consider additional carve-outs are needed, please elaborate with justification.

Introduction

1.1 Clifford Chance is generally supportive of the HKMA and the SFC's positions provided in the joint consultation conclusions on the proposed regulatory regime for the over-the-counter derivatives markets in Hong Kong (the "**Consultation Conclusions**") issued by the HKMA and the SFC in July 2012. In particular, Clifford Chance welcomes the HKMA and the SFC's proposal to (i) narrow the scope of the definition of "OTC derivatives transaction" and (ii) exclude any overlapping regulated activities ("**RAs**") under the Securities and Futures Ordinance (Cap. 571) ("**SFO**") from the scope of the new Type 11 RA.

1.2 We agree with the HKMA and the SFC that the definition of "OTC derivatives transactions" needs to be clearly defined as it will directly impact on the licensing and regulatory framework both for firms that are currently licensed under the existing regulatory framework and those currently unlicensed firms that will be brought into the licensing framework as a result of the proposed Type 11 RA. As such, subject to our comments below, we consider that the exclusions set out in paragraphs 79, 80 and 83 of the Consultation Conclusions strike the right balance between capturing all relevant types of OTC derivatives transactions (including potential market development of future products) and those that are already regulated under existing laws and regulations.

Proposed carve-outs applicable to Type 11 RA

Overlap with existing RAs

1.3 We note the HKMA and the SFC are of the view that an existing Type 1 RA licence would not suffice to permit a person to deal in OTC equity derivatives transactions as principal on the basis that the scope of the existing Type 1 RA licence does not cover dealing in such derivatives transactions on a principal-to-principal basis (*see*

paragraph 10(1) of the Supplemental Consultation Paper). We note further that the HKMA and the SFC do not consider it appropriate to preserve the "principal" carve-out under paragraph (v) of the "dealing in securities" definition (*see* paragraph 11 of the Supplemental Consultation Paper).

1.4 However, the "principal" carve-out under paragraph (v) of the "dealing in securities" definition is, in practice, relied upon only when the other party to the transaction (i.e. the counterparty) is a professional investor. (While there is a further exemption from Type 1 RA if the "dealing" involves only acquiring, disposing of, subscribing for, or underwriting securities, which applies even if the counterparty is a non-professional investor, in practice, we understand that this exception is of restricted application and is unlikely to be relied on by parties to OTC equity derivatives transactions.) Accordingly, if the counterparty is a non-professional investor, then, in practice, a principal-to-principal trade with such counterparty would likely fall within the scope of the existing Type 1 RA and an entity that deals with such counterparty would be required to obtain a Type 1 RA licence (if it is not already so licensed).

1.5 Following the introduction of the new regime, our understanding is that:

(a) since dealing in OTC equity derivative transactions as ***principal*** with ***non-professional investors*** is a Type 1 RA, an existing Type 1 RA licensed entity that deals in OTC equity derivatives transactions with such counterparties ***would not*** be required to obtain a new Type 11 RA licence; but

(b) by contrast, since dealing in OTC equity derivative transactions as ***principal*** with ***professional investors*** is ***not*** a Type 1 RA, an existing Type 1 RA licensed entity that deals in OTC equity derivatives transactions with such counterparties ***would*** be required to obtain a new Type 11 RA licence.

1.6 Moreover, it is also our understanding that:

(a) an existing Type 1 RA licensed entity that deals in OTC equity derivative transactions ***as agent*** (regardless of whether the counterparty is a professional investor or not) ***would not*** be required to obtain the new Type 11 RA licence; but

(b) by contrast, as mentioned in paragraph 1.5(b) above, the same entity, if it deals in OTC equity derivative transactions ***as principal with professional investors would*** be required to obtain the new Type 11 RA licence.

1.7 If our understanding is correct, we are concerned that the test for whether a new Type 11 RA licence is required or not would depend on whether the existing Type 1 RA licensed entity is dealing as principal or agent and whether the counterparty is a

professional investor or a non-professional investor. We believe this may lead to certain firms being subject to additional regulatory burden for arbitrary reasons. The only relevant criteria for the carve-out should be whether a person is already Type 1 licensed or not, and not in what capacity it acts. We strongly urge the HKMA and the SFC to consider the scope of its proposed "overlap" carve-out further to address these concerns.

1.8 Separately, we would also like to take the opportunity to seek clarification in respect of the ambit of the Type 2 RA. We understand there is currently some uncertainty in the market regarding whether OTC derivatives transactions that have a futures contract underlier would itself fall within the definition of "futures contract" and consequently whether a Type 2 licence is required for an entity to deal in such OTC derivatives transactions. Given the answer to this question will impact on whether an entity that is already licensed for Type 2 RA would be required to be licensed for the new Type 11 RA in order to deal in such OTC derivatives transactions, we would welcome the HKMA and the SFC's clarification on this point during this consultation period.

Intra-group exemption

1.9 We note that the HKMA and the SFC do not propose providing a separate exemption for intra-group transactions, and the proposed exemptions will not cover the full range of intra-group trades which are entered into by non-AIs and non-Type 11 RA licensed corporations. We also note that the HKMA and SFC are of the view that if an entity enters into an intra-group transaction as a dealer, then that entity would need to obtain a Type 11 RA licence (see paragraph 13(1) of the Supplemental Consultation Paper).

1.10 Our view is that the distinction between "dealer" and "end user" is not applicable in the context of intra-group transactions. These are essentially internal transfers within the same corporate group for risk booking purposes. Neither one of the parties to an intra-group transaction maintain "bid" or "offer" quotes in the traditional sense between two arms-length counterparties. Further, given the internal nature of the transactions, it is unclear to us how the regulation of such type of activities would further the HKMA and the SFC's goals of reducing counterparty risk, protecting against market abuse and mitigating and managing systemic risk in the wider OTC derivatives market.

1.11 The concern with the inclusion of such type of activities within the scope of Type 11 RA is that it would only serve to impose additional regulatory and compliance burdens for little or no benefit to the corporate group or the wider market. Accordingly, it is our view that a specific intra-group exemption should be introduced for the Type 11 RA.

Regulated function

1.12 We understand that employees and officers of an entity that needs to be licensed for the new Type 11 RA will also need to be licensed for such RA if their activities constitute a "regulated function" (see paragraph 14 of the Supplemental Consultation Paper).

1.13 Clifford Chance would be grateful if the HKMA and the SFC would clarify in the conclusions to the Supplemental Consultation Paper whether the employees and officers of such Type 11 RA licensed corporation would be subject to any special requirements (e.g. training or examination requirements, or if such licence would be provided to these employees and officers if they have been carrying out the activities for a certain period of time in line with the transitional period arrangements).

Q2. Do you have any comments or concerns about our proposals on how the provision of ATS (for OTC derivatives) by AIs and AMBs should be regulated?

1.14 No comment.

Q3. Do you have any comments or concerns about our proposals for how the initial ambit of the new Type 12 RA should be cast, and the specific activities to be excluded from its scope?

Introduction

1.15 Clifford Chance is supportive of the HKMA and the SFC's positions provided in the Consultation Conclusions. In particular, Clifford Chance agrees with HKMA and SFC's reasons for having a separate new Type 12 RA as stated under paragraph 227 of the Consultation Conclusions.

1.16 We agree with HKMA and SFC's clarification on how section 115 of the Securities and Futures Ordinance applies to the licensing requirement for the Type 12 RA as stated under paragraphs 248 to 251 of the Consultation Conclusions. We believe this approach provides an appropriate balance of ensuring that the Hong Kong public is adequately protected with the appropriate scope of regulations without creating the problem of over-regulation, especially with respect to such regulations with potential extra-territorial effect.

Proposed carve-outs applicable to Type 12 RA

1.17 We have raised our comments on the proposed carve-outs applicable to a Type 12 RA with the HKMA and the SFC separately.

Q4. Do you have any comments or concerns about our proposals for expanding the scope of the existing Type 9 RA?

1.18 No comment.

Q5. Do you have any comments or concerns about our proposed transitional arrangements for the new Type 11 and Type 12 RAs, and for the expanded Type 9 RA?

1.19 With respect to the proposed transitional arrangements, we are concerned that 4-6 weeks may not give applicants, especially those that are not current licensed corporations, enough time to put together a complete application pack, especially in light of the fact that should the application be rejected (which could occur for example if the application is not deemed complete), the applicant would have to immediately cease carrying out the relevant regulated activity. We consider that at least a grace period of 2 months be granted to submit the application, on the basis that no exam requirements are imposed on proposed responsible officers and licensed representatives other than HKSI Paper 1.

Q6. Do you have any comments or concerns about our proposals for how SIPs should be identified and regulated?

1.20 Clifford Chance understands the desire for the HKMA and the SFC to regulate SIPs and notes the parallels between this regime and the regulation of major swap participants under the Dodd Frank Act. We agree that a registration requirement based solely on quantitative criteria is necessary to give market participants certainty as to whether they are caught by the regulatory regime for SIPs.

1.21 We note that the HKMA and the SFC are still considering the quantitative criteria for measuring the SIP threshold. It is suggested under paragraph 42 of the Supplemental Consultation Paper that the SIP threshold may be set against an entity's aggregate holdings in all OTC derivatives transactions, and that this will be set at many times higher than the reporting and clearing thresholds. Under paragraphs 137 and 174 of the Consultation Conclusions, the reporting and clearing thresholds are set based on the average notional value of an entity's outstanding positions (on a per product class basis).

1.22 It is respectfully submitted to the HKMA and the SFC that the outstanding notional value of OTC derivatives transactions may not be the most appropriate measurement of whether an entity has "*the potential to threaten the financial market stability of Hong Kong*" (under paragraph 42 of the Supplemental Consultation Paper). In particular, an entity which has properly collateralised and/or hedged its large portfolio of outstanding OTC derivatives transactions may pose less of a threat to the OTC

derivatives market in Hong Kong when compared to an entity with a smaller portfolio of OTC derivatives transactions but which has not managed the risks arising from such positions.

1.23 We understand that such considerations led the relevant regulators in the United States to adopt a registration threshold for major swap participants based on, in very simplified terms, 'uncollateralised exposure' under their OTC derivatives transactions. While using 'uncollateralised exposure' as a measurement for SIP threshold, like any other quantitative criteria, will have its respective advantages and drawbacks, we would encourage the HKMA and the SFC to adopt a quantitative criteria which closely correlates to the risk such an entity poses to the wider financial market in Hong Kong.

1.24 Furthermore, we note that "*the objective is to capture only those end-users whose possible failure...could have significant implications for Hong Kong as a whole*". Given this statement, it would be very useful for the HKMA and the SFC to clarify whether existing unlicensed affiliates of licensed entities are intended to be covered by the SIP regime.