



Deacons

的近律師行

By e-mail otconsult@sfc.hk

Our Ref

27 August 2012

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

Dear Sir/Madam,

Supplemental consultation on the OTC Derivatives regime for Hong Kong – proposed scope of new/expanded regulated activities and regulatory oversight of systemically important players (“Supplemental Consultation”)

Thank you for the opportunity to comment on the Supplemental Consultation. Our responses to the questions in the Supplemental Consultation are enclosed.

If you wish to discuss our responses in more detail, please feel free to contact .

Yours sincerely,

Deacons

Encl.

Lawyers

5th Floor
Alexandra House
18 Chater Road
Central
Hong Kong
DX-00010 Central 1
Tel +852 2825 9211
Fax +852 2810 0431
www.deacons.com.hk

Representative

Offices in China
Beijing
Guangzhou
Shanghai

Partners

Lillian Chiang*
Lam Wing-Wo*
Simon Deane
Christina Hung*
Keith Cole
Frankl Cheung*
Alex Lai
Daisy Tong*
Michael Turnbull
Christopher Britton
Susan Gordon
Rory Gallaher
Jeremy Lam
Toh Quat Kim
Cheung Kwok Kit
Ronny Chow
Eugina Chen
Cynthia Chung
Linda Lee
Robert Clark
Annie Tsol
Edwardo Wobro
Joseph Kwan
Alfred Tam
Esther Lai
Charmaine Koo
Prudence Mak
Taylor Hui
Katherine Chu
Rodney Goh
Philip Gilligan
Gary Lui
Alexander Que
Rhoda Yung
Patsy Lau
Myles Goto
Richard Hudson
Paul Kwan
Karen Chan
Wallace Wong
Alwyn Li
Jane McBride
Declan McDaid
Sally Ip
Sabrina Fung
Catherine Zheng
Vivian Poon
Iris Cheng
Machluanna Chu
Hiroko Nakamura
Ronald Chu

Consultants

Wai-Pat Wong*
James Bertram*
John Rose*
John Richardson*
William Mackesy
Winnie Lai
David Lawrence*
Gavin Nesbitt
Scott Carnachan
Simon Lai

* Notary Public
* China-Appointed
Attesting Officer

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

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.

Deacons response:

We note the proposed ambit of the new Type 11 RA and the proposed carve-outs.

We recommend it is made explicit that a person or entity does not need to be licensed for Type 11 RA where (i) that person or entity has appointed a discretionary asset manager and (ii) the discretionary asset manager has entered into an OTC derivative on behalf of that person or entity i.e. as a result, that person or entity becomes a counterparty to the OTC derivatives transaction. For this purpose, the term discretionary asset manager should include both persons licensed or registered for Type 9 RA and persons carrying on an equivalent business and regulated under the law of any place outside Hong Kong.

The above can be included as a separate carve-out or can be included in the definition of "price taker". It would make it clear that investment funds, retirement funds, charities and others that appoint discretionary asset managers do not themselves need to be licensed for Type 11 RA. We note this carve out will not affect their obligations to report or clear OTC derivatives transaction, where appropriate.

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?

Deacons response:

We note that the proposals are consistent with and flow from the proposed split of regulation between the Hong Kong Monetary Authority and the Securities and Futures Commission.

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?

Deacons response:

We note the proposed ambit of the new Type 12 RA and the proposed carve-outs.

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

Deacons response:

We agree with the proposal to expand the scope of the existing Type 9 RA. We recommend the drafting of the expanded Type 9 RA makes it clear that a portfolio can include securities, futures and OTC derivatives.

It would be helpful if the Securities and Futures Commission can provide guidance on whether an asset manager that does not apply to modify its Type 9 RA licence can accept a mandate permitting the use of OTC derivatives, so long as it delegates management to an appropriately-qualified third party (which may be a group company in the United States, Europe or elsewhere). The answer will affect whether certain asset managers need to apply to modify their licences.

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?

Deacons response:

We support the proposed deeming arrangements. We have a number of comments on the other proposed transitional arrangements.

Transitional arrangements for expanded Type 9 RA

We expect the majority of entities licensed or registered for Type 9 RA currently use OTC derivatives (such as currency forwards) in the portfolios they manage. As a result, there are likely to be a large number of applications from asset managers to modify their licences to reflect the expanded Type 9 RA.

We have the following comments and suggestions on the proposed transitional arrangements for the expanded Type 9 RA:

1. Application period: The appropriate length of time for the transitional application period will depend on the information that needs to be submitted and the amount of prior notice industry participants are given of those information requirements. At this stage, given the lack of detail about the information requirements, it is difficult to say what period would be appropriate. But, a four to six week transitional application period appears short. It is likely only feasible if all that needs to be submitted is the name of the entity, the names of the responsible officers and the confirmation of relevant experience. The transitional application period should be expanded to, say, three to six months, if more substantive information will be required as part of the application.
2. Experience requirements: The proposed experience requirements are unduly restrictive in two respects.

First, the requirement that a corporate applicant must have engaged in the relevant activity for two years prior to commencement of the OTC derivatives regime discriminates against asset managers established within the last two years. What is relevant is the experience of the responsible officers. An asset manager that has been recently established should be entitled to benefit from

the transitional arrangements if its principals have sufficient experience managing OTC derivatives.

Second, the requirement that the experience must be gained in Hong Kong is too restrictive. As noted in the original consultation paper published in October 2011, the OTC derivatives market is global in nature and the local market is relatively small. Experience managing OTC derivatives that has been gained outside Hong Kong is relevant and should be taken into account. That is also consistent with other licence applications, where experience gained outside Hong Kong is relevant to the applications.

3. Consequence of rejection of application: The supplemental consultation proposes that an asset manager would need to immediately cease to use OTC derivatives in its portfolios if its application to modify its licence is rejected. That is problematic, because managing a portfolio is a dynamic process rather than a series of individual transactions. The interests of clients need to be taken into account. At the least, the risks arising from OTC derivatives positions already in the portfolios will need to be managed. It may be that the most effective way to manage those risks for clients is to enter into other OTC derivatives transactions. It may also be necessary to close out existing OTC derivatives, enter into offsetting transactions and the like. Ultimately, a new asset manager may need to be appointed to take over the portfolios. However, selection and appointment of a new asset manager, and transition of assets from one asset manager to another, all take time. During this period, the portfolio still needs to be managed.

Given the above, we recommend that, if an application is rejected, the asset manager is given a short period (say, three months) after notice of the rejection to either allow for clients to transition their portfolios to another asset manager or for the asset manager to agree with clients to change the terms of the relevant investment mandates to exclude OTC derivatives. During this period, the asset manager will continue to be permitted to include OTC derivatives in its clients' portfolios. We also propose an obligation on asset managers who have their applications rejected to notify their clients that, with effect from a specified date, they will no longer be able to include OTC derivatives in their clients' portfolios. That way, clients are able to consider what actions they wish to take.

Transitional arrangements for new Type 11 and Type 12 RAs

We have the following comments and suggestions on the proposed transitional arrangements for the expanded Type 9 RA:

1. Application period: Our comments in relation to the expanded Type 9 RA apply equally to the new Type 11 and Type 12 RAs.
2. Experience requirements: Our comments in relation to the expanded Type 9 RA apply equally to the new Type 11 and Type 12 RAs. In addition, given that clearing of OTC derivatives is a relatively new practice around the world (and even more so in Hong Kong), the two year experience requirement may have the practical effect of severely limiting the number of entities deemed licensed for Type 12 RA. That in turn will affect the timetable for implementing mandatory clearing in Hong Kong. It is important that asset managers and others have a reasonable choice of clearing agents at the time mandatory clearing is introduced.

3. Consequence of rejection of application: The proposal that applicants for the new Type 11 and Type 12 RAs must immediately cease to offer, advise on or clear OTC derivatives has less ongoing impact than where an application to modify a Type 9 RA licence is rejected. However, it should be made clear that:
- (a) any OTC derivatives transactions entered into or cleared through the applicant prior to the date of rejection remain valid and binding; and
 - (b) the applicant be permitted to enter into transactions incidental to the existing OTC derivatives transactions, in order to close out or novate those OTC derivatives transactions.

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

Deacons response:

No comment.