Comments and questions raised by HKIFA members on the supplemental consultation on proposals to regulate OTC derivatives market (August 2012)

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.

- The objective of the consultation is to set out new types of regulated activity for market players in Hong Kong who are not currently licensed or registered with either HKMA or SFC. Our members believe these new types of RAs should not be applicable to existing licensed persons who are not expressly restricted from dealing/advising in OTC derivatives. Please clarify that is the intention.

- Many international asset management companies would use their Hong Kong licensed entities as "central dealing desks" in Asia Pacific and such activities construed Type 1 (dealing in securities) or Type 2 (dealing in futures contracts) regulated activities ("RAs") under the current licensing regime (i.e. These international asset management companies and their affiliates/subsidiaries may manage portfolios that are investing in the Asia Pacific markets. If these overseas entities initiate any transactions in any instruments (including securities, futures contracts or OTC derivatives, etc.) related to Asia Pacific markets for their managed portfolios, their Hong Kong licensed entities will centralize these orders and place them with brokers in Asia Pacific for these portfolios managed by overseas entities.). As a result, these Hong Kong licensed entities would usually hold Type 1 and/or Type 2 SFC licenses, and rely on these SFC licenses to provide central dealing services for their international affiliates.

  To enable these international asset management companies to continue to use Hong Kong as their "central dealing hub" in Asia Pacific, our members strongly believe these existing licensed persons who deal in OTC derivative transactions (including execute OTC derivative transactions for their affiliates/subsidiaries and portfolios managed by their affiliates/subsidiaries) should be carved out from Type 11. Without such a carve-out, our members have grave concerns that international firms may have to look for alternative dealing hubs.

- It is recommended to make 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. This 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 understand this carve out will not affect their obligations to report or clear OTC derivatives transaction, where appropriate.

- Persons who are licensed for Type 4 RA can communicate offers of OTC equity derivatives without having to be licensed for the new Type 11 RA provided the communication complies with section 175 of the SFO. However, if the person wishes to communicate offers of interest rate derivatives, we understand the carve-out would not apply and the person would need to be licensed for Type 11 RA. Members do not see any compelling reason why the carve-out does not cover "communicating offers of interest rate derivatives"? They do not believe the risk of communicating offers of interest rate derivatives is higher than other types of structured products and therefore cannot benefit from the carve-out.

- Please clarify the carve-out relating to "price takers". For example if an entity is licensed under RA4 "advising in securities" and advises clients in relation to OTC derivatives, and that entity does not make markets nor offer price quotes, then we would expect that the advising entity would be covered by the "price taker" carve out. The entity is simply "taking the price" provided by other counterparties and advising its client whether to accept the price or not. Accordingly that entity should not be required to be licensed under RA11 and that the RA4 license is sufficient. Please confirm our understanding is correct.

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?

- 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?

- No comment

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

- Members welcome the proposal to expand the scope for Type 9 RA. However, it creates additional burden for existing licensed corporations ("LCs") to apply for modification given that they are currently performing this kind of activities. Our members believe the intention is to require LCs that currently have condition on managing portfolios with limited scope to apply for modification; but application for modification should not be necessary for existing Type 9 licensed persons that do not have a restriction to manage OTC derivative portfolios. Please clarify if this is correct.

- Members would like to seek clarification: where the investment manager of a fund delegates investment management responsibility to a sub-investment

manager, if the sub-investment manager is to use OTC derivatives, the top level investment manager would not need to obtain the expanded Type 9 RA. The sub-investment manager is already regulated according to the laws of its home jurisdiction, and thus the sub-investment manager also does not need to obtain the expanded RA9.

If it is really necessary for the top level investment manager to obtain the expanded Type 9 RA, can it rely on the experience of the sub-investment manager to meet the eligibility criteria, perhaps subject to the condition that it would not manage a portfolio of OTC derivatives independently without appointing sub-investment manager(s)?

This is particularly relevant in the context of MPF funds, where there is a requirement to have at least 30% exposure to HK$ and it may be necessary to use derivatives to hedge the currency exposure of the MPF fund to meet this requirement.

- The drafting of the expanded Type 9 RA should make it clear that a portfolio can include securities, futures and OTC derivatives.

- It would be helpful if the SFC 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.

- Some sales persons who "actively market" asset management services to investors (e.g. selling investment mandates to institutional clients) would need to hold Type 9 license, even though they do not manage any portfolios. It is because persons who "actively market" the service of a regulated activity also need to be licensed under s.115 of the SFO. In this case, under the new regime, do these sales persons need to obtain the expanded Type 9 licenses? If yes, it would be difficult for them to prove they have at least 2-year experience in managing portfolios of OTC derivatives transactions in Hong Kong. It is suggested that HKMA and SFC to remove the 2-year experience requirements. (Also see Q.5 below.)

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?

<u>Expanded Type 9 RA</u>

- As the finalised definition of 'OTC derivatives transactions' is not yet available, it is not clear to an existing Type 9 RA LC whether the firm and their ROs have relevant experience for 2 years immediately before the OTC derivatives regime comes into operation. Members suggest HKMA and SFC to:
  a) postpone the deadline of Supplemental Consultation from August 31, 2012 to sometime after 'OTC derivatives transaction' is clearly defined; or

b) remove the 2-year experience requirements.

- 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.

- 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.

- For new application of a licensed representative, it is not needed to prove someone has relevant experience to obtain an SFC license as long as he/she can meet the academic/industry qualification requirement and pass the local regulatory paper (Please refer to Appendix B of the Guidelines on Competence.) Therefore, it is suggested that HKMA and SFC to remove the 2-year experience requirements.

- 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. 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 only feasible if all that needs to be submitted is the name of the entity, the names of the responsible officers and 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.

- 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, members recommend that, if an application is rejected, the asset manager is given a reasonable 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. Members 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.

- The above comments in relation to the expanded Type 9 RA on application period, experience requirements and consequence of rejection of application apply equally to the new Type 11 and Type 12 RAs.

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

- No comment

(End)