

Client Alert

September 13, 2016

Expanded Licensing Regime for Asset Managers Managing OTC Derivatives Transactions

Key Points

- Amended Hong Kong Securities and Futures Ordinance expands existing type 9 Regulated Activity (Asset Management) to cover management of OTC derivative products.
- A Type 9 licenseholder managing OTC derivative products will be required to apply to the SFC and to meet new assessment criteria for such products (experience, internal compliance procedures), or will be required to close out of positions and/or discontinue existing OTC derivatives business.



Background

Following a two year consultation period, the SFC issued a Circular in October 2015 (“Circular”) setting out an expanded licensing regime covering over-the-counter (“OTC”) derivative transactions and products¹ (“Expanded OTC Regime”).

Amongst other regulatory changes summarized in the Circular is the SFC’s conclusion that certain activities relating to OTC derivatives (such as the management of OTC derivatives) are to be considered as “regulated activities”, and the corresponding implementation of an updated licensing regime to cover the carrying on, in Hong Kong, of such activities.

Expanded OTC Regime in Hong Kong

Under the Expanded OTC Regime, the scope of the existing regulated activity of “asset management” (資產管理) (Type 9 Regulated Activity for the purpose of the Hong Kong Securities and Futures Ordinance (Cap. 571) (“SFO”) has been revised. This now provides for the expansion of the existing Type 9 license to cover asset management activities with respect to OTC derivative products (alongside the more traditional “securities and futures contracts” asset management).

At the same time, separate amendments to the SFO were made in order to create the proposed new regulated activities of “dealing or advising on OTC derivatives products” (Type 11) and “providing client

¹ See <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=15EC53>

clearing services for OTC derivative transactions” (Type 12), as well as to expand the scope of the existing regulated activity of “providing automated trading services” (Type 7) to cover OTC derivative transactions or products.²

What is an OTC derivative product?

In order to take account of the Expanded OTC Regime, the SFO has been substantially amended³ in order to provide for a formal definition of “OTC derivative product”, and to provide for the corresponding regulatory framework.

An “OTC derivative product” (場外衍生工具產品) is defined in in Part 1B of Schedule of the SFO as a “structured product” (結構性產品) (as defined in Part 1A of Schedule of the SFO) that does not include:

- i. securities traded on a recognized exchange;
- ii. futures contracts traded on a recognized exchange;
- iii. securities or futures contracts that are traded through a market prescribed under section 392A of the SFO (as prescribed by the Financial Secretary) and cleared through a clearing house prescribed under that section;
- iv. structured products offered to the public and authorized under the SFO;
- v. structured products that are debt securities;
- vi. certain “spot contracts” (contracts for immediate delivery and payment normally two business days after the trade date) (as defined in the SFO);
- vii. certain structured products that are offered within a two-week offer period and on identical terms; and
- viii. structured products formally classified by notice issued by the Financial Secretary as falling outside of the definition of an OTC derivative product.

In addition, the Financial Secretary of Hong Kong has the power to determine, by notice, a product as being regarded as an OTC derivative product.

In practice, OTC derivative products will include over-the-counter instruments such as futures, swaps, options and other derivatives which fall outside of the “excluded items” listed in the SFO.

Why is this relevant to an existing Type 9 licenseholder?

The Expanded OTC Regime will introduce an enhanced regulatory regime for Type 9 licenseholders undertaking asset management with respect to OTC derivative products

With effect from commencement date (to be announced by the SFC, but expected to be during late 2016/early 2017) (the “Commencement Date”), licensed corporations wishing to engage in the

² It is intended that these developments would be addressed by way of a separate client alert.

³ By way of the Securities and Futures (Amendment) Bill 2015 – See <http://www.sfc.hk/web/EN/pdf/Gazette/Ord.%20No.%2019%20of%202015%20Legco%20Brief.pdf>

management of OTC derivative products will be required to be licensed for the expanded Type 9 Regulated Activity. This will require the filing of an application with the SFC in order to avoid the automatic imposition of a license condition that the licensed corporation may not manage OTC derivative products.

For new Type 9 applicants wishing to manage OTC derivative products, this will require the applicant to demonstrate to the SFC that it satisfies the SFC's additional requirements for the Expanded OTC Regime.

How will the SFC implement the Expanded OTC Regime?

The SFC has prescribed a six month grace period from the Commencement Date ("Transitional Period") in order to allow existing Type 9 licensed corporations to:

- i. apply to the SFC to register for the expanded Type 9 Regulated Activity (i.e., to allow the manager to undertake asset management with respect to OTC derivative products); or
- ii. manage out of existing positions and to wind up any OTC derivatives management activities (if any).

During the Transitional Period, market participants may continue to manage OTC derivative products without the need for an additional license/registration. However, immediately upon the expiry of the Transitional Period, existing licensed corporations will no longer be able to manage portfolios of OTC derivative products, unless:

- i. they have applied to the SFC (within the first three months of the Transitional Period (the "**Application Period**")) to register for the expanded Type 9 Regulated Activity (subject to an initial screening, and meeting minimum specified criteria (see below) an applicant will be deemed by SFC will be "deemed to be licensed for the expanded activity"), and
- ii. the SFC has subsequently approved the expanded Type 9 Regulated Activity for that licensed corporation.

Application Process

Existing Type 9 licensed corporations which wish to continue to perform activities that constitute the new or expanded Type 9 RA (i.e., management of a portfolio of OTC derivative products) ("**New Type 9 activities**") must file a notice with the SFC during the Application Period:

- i. stating the intention to continue with such activities;
- ii. providing a detailed business plan of the New Type 9 regulated activities, internal controls and operational procedures pertaining to such business (including human and technical resources), organizational structure, contingency plans and related matters; and
- iii. confirming that it employs at least one (1) Type 9 Responsible Officer in Hong Kong who has accrued a minimum of two (2) years of Hong Kong or overseas experience in New Type 9 Activities within the six (6) year period immediately prior to the Commencement Date, and that it

complies, or has arrangements in place to ensure compliance, with the new requirements under the SFO, related Codes and Guidelines that are or will be applicable to the related OTC derivatives activities.

Each Type 9 Responsible Officer (“RO”) of such a licensed corporation will also be required to file a prescribed notice to the SFC within the Application Period, confirming that he/she has satisfied the relevant experience requirement.

Deeming Mechanism and Assessment Criteria

A market participant that meets the SFC’s specified criteria (see below) and applies for a license or registration for the New Type 9 regulated activities during the Application Period will be deemed to be licensed or registered immediately after the end of the Transitional Period, while the SFC (or the HKMA) continues to process their application. The deemed licenses or registrations will continue to have effect until the application has been approved, denied or withdrawn.

In considering an application from an existing Type 9 licensed corporation, the SFC will base its assessment on the following criteria:

- i. **Experience Requirements:** corporate applicants and their proposed ROs should demonstrate that they have been carrying on a business in the new or expanded regulated activity in Hong Kong for at least two (2) years immediately prior to the commencement date of the OTC derivatives licensing regime.
- ii. **Existing Licensing and Regulatory Requirements:** all existing licensing and regulatory requirements will be generally applicable to corporate applicants and their proposed ROs, e.g. the requirements for at least two (2) ROs for each new or expanded regulated activity, with at least one (1) RO being an executive director.
- iii. **Application Documents:** in addition to the license or registration application documents, a corporate applicant will be required to submit a prescribed form confirming points (i) and (ii) (above), as well as confirming compliance with existing or new requirements under the SFO or the Banking Ordinance (“BO”), and related Codes and Guidelines applicable to the applicant’s OTC derivative activities.

What if an applicant fails to meet the SFC’s Assessment Criteria?

A Type 9 licenseholder failing to meet the SFC’s specified assessment criteria will be issued with a “no-deeming notice” by the SFC. Thereafter, such persons will be required to wind down the management of OTC derivative products and to close out of any positions and/or transfer the business to another corporation, within the period of three (3) months of the date of the “no-deeming notice”.

I am a Type 9 asset manager managing OTC derivative products. What should I do now?

The Commencement Date for the revised regime is expected to be announced by the SFC during late 2016/early 2017.

Upon the Commencement Date, the three (3)-month Application Period will immediately commence, during which time a Type 9 licensed corporation wishing to continue to manage OTC derivative products must submit an application to the SFC demonstrating compliance with the SFC's assessment criteria (see above).

This is a relatively short period in which to:

- i. collate and prepare evidence of the experience of the licensed corporation (and of the RO) for the purpose of meeting the SFC's minimum assessment criteria;
- ii. prepare updated drafts of internal operational documents (including the compliance manual) in order to reflect compliance with these new requirements.

In order to manage the risk of this short window, we consider that it is advisable for such Type 9 licensed corporations to take steps now, in advance of the Commencement Date, to:

- i. consider the experience of the licensed corporation (and the RO) and how this might be presented to the SFC as part of an application, and to collate all required supporting materials; and
- ii. consider necessary amendments to the compliance manual (and other internal operational documents) to address compliance with the new SFC requirements for the expanded Type 9 Regulated Activity.

An existing Type 9 licensed corporation that does not file a prescribed notice within the three (3) month Application Period will be automatically deemed to be subject to a license condition restricting it from managing portfolios of OTC derivatives products.

I am an asset manager managing only securities – how does this apply to me? Do I need to take any action?

For an existing Type 9 licensed corporation that does not manage (and does not intend to manage) OTC derivative products (as defined in the updated SFO), there will be no impact to the general power to undertake "securities or futures contracts" asset management.

However, with effect from the end of the Transitional Period, an existing Type 9 licensed corporation/Type 9 RO that does not file a prescribed notification form with the SFC within the Application Period will be automatically subject to the additional license condition that they may not manage OTC derivative products.

We consider that it will be advisable for such managers to:

- i. undertake a review of all current positions, in order to ensure that OTC derivative products are not being managed as part of any portfolio managed by the existing Type 9 licensed corporation; and

- ii. notify portfolio managers of the additional license condition that will be imposed following the end of the Transitional Period, in order to ensure that such personnel are fully aware that providing asset management services in respect of OTC derivative products is subject to additional regulation from the end of this period, and that an additional application to the SFC would be required in order to continue to manage such instruments.

Contact Information

If you have any questions regarding this alert, please contact the Akin Gump Strauss Hauer & Feld lawyer with whom you usually work or

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