HSBC

30th November, 2011

Feedback on Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

We, The Hongkong and Shanghai Banking Corporation Limited ("**HSBC**") welcome the opportunity to comment on the Consultation Paper on the Proposed Regulatory Regime for the Over-the-Counter Derivatives Market in Hong Kong (the "**Consultation Paper**") issued by the Hong Kong Monetary Authority ("**HKMA**") and the Securities and Futures Commission ("**SFC**") on 17 October 2011. We set out our responses to the questions posed in the Consultation Paper on which we, along with members of the HSBC Group (together, the "**Group**"), have specific comments on.

As a global financial institution with a substantial locally incorporated operating entity, many of our concerns echo that of other market participants, both domestic and international, and therefore we respectfully request that HKMA and SFC should fully consider the issues raised by various industry groups, including without limitation those raised by the International Swaps and Derivatives Association, Inc. ("**ISDA**"), the Hong Kong Association of Banks ("**HKAB**"), and the working group of dealers formed in connection with the setup of a Hong Kong-based over-the-counter ("**OTC**") derivatives central counterparty ("**CCP**") (as represented by Clifford Chance), each of which we are a member of. Thus, the focus of our submission is to draw attention to specific issues relating to the Group, being part of a global financial institution, and having, on the one hand, a substantial locally incorporated authorized institution ("**AI**") (being HSBC) with its branches and subsidiaries throughout the Asia-Pacific region, and on the other hand, with group members (specifically, HSBC Bank plc and HSBC Bank USA, N.A.) being foreign incorporated AIs with branches in Hong Kong. On issues where we may not have responded in the same degree of depth as the other respondents noted above, our brief response should not be read as giving any implication on the degree of severity that we would put on in relation to those issues; rather, for the sake of brevity, we would concentrate on the issues within the focus noted above while concurring, by and large, with the submissions made by the industry groups.

Capitalised terms not otherwise defined in this response have the same meaning given to them in the Consultation Paper.

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

HSBC

Q1: Do you have any comments on the proposed scope of the regulatory regime for the OTC derivatives market in Hong Kong and how it is proposed to be set out?

Key Consideration of Regime

The Consultation Paper's proposed approach is to adopt a very wide definition of 'OTC derivatives transactions' in the primary legislation, but at the same time provide that the mandatory obligations would only apply to those OTC derivatives transactions that are specified in subsidiary legislation, thus limiting the types of products that would actually be subject to such obligations.

We agreed that it would be unreasonable to expect that the primary legislation be able to set out all details, therefore this approach has the advantage of providing flexibility for future market changes, and takes into account the still-evolving international regulatory landscape. However, this approach also means that many key details that are important to understanding the scope and implications of the proposed regime are likely to remain unclear until the second phase consultation on the subsidiary legislation targeted in Q1 2012.

We suggested that primary legislation needs to define clearly all objectives for drafting the subsidiary legislation and provides clear definition on any terms that would impact on the scope of the regime especially the definition of "originate or execute" and threshold. That would help market participants to get clarity on the scope and impact.

While we appreciate HKMA and SFC's proposal to ensure that the scope of application for mandatory reporting and mandatory clearing should align, it is a practical matter that for mandatory clearing, the product must be of sufficient standardisation and liquidity in order to support a robust clearing operation. While it is open to HKMA and SFC to reflect this by imposing an overarching legal obligation in the primary legislation and create exemptions, the more prudent course to take would be to provide for a mechanism that the mandatory clearing obligation only becomes effective on categories of products specifically declared by the HKMA and SFC to be mandatorily cleared. We would also suggest a similar approach for mandatory reporting, on the basis that there may be some grey area in defining what a product is (e.g. a total return swap may also contain an interest rate element on one side, and there may be definitional issue on what constitutes an interest rate swap). The way individual products are defined should have certain industry input and therefore we would as an alternative like to see mechanics within the primary legislation supporting industry feedback prior to implementation.

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

HSBC

Definition of "OTC Derivatives Transaction"

The Consultation Paper proposes to define OTC derivatives transactions using the existing broad, all-encompassing 'structured products' definition in the Securities and Futures Ordinance ("**SFO**", Cap. 571, Laws of Hong Kong), but with carve outs for:

(1) Transactions in securities and futures contracts that are traded on a market operated by a recognized exchange company (i.e. Hong Kong Exchanges and Clearing Limited);

(2) Transactions in structured products that are offered to the public and the documentation for which is authorized under s.105 SFO (i.e. 'retail structured products'); and

(3) Transactions in currency-linked, interest rate-linked and currency and interest rate-linked instruments offered by authorized institutions to the public and the documentation for which is exempted from the prohibition under s.103 SFO by virtue of s.103(3)(ea) SFO.

The definition of "OTC derivatives" is somehow problematic, given it piggybacks on "structured products". Specifically, for funded instruments that are not "currency-linked instruments", "interest rate-linked instruments" or "currency and interest rate-linked instruments" which are not offered to the public (for example, an equity linked note which is placed with "professional investors" in reliance of the professional investor exemption under Section 103(3)(k) of the SFO) would nevertheless perversely be included as an "OTC derivatives transaction".

The bigger structural issue on relying on existing SFO definitional infrastructure is that "securities", "structured products" and "regulated investment agreement" are meant to be "wrapper neutral" i.e. a retail structured product provider was not meant to be able to avoid disclosure obligations under Section 103(1) SFO by merely offering the same product under another "wrapper". However (1) in respect of central clearing, a CCP would not be able to clear a structured product in the same sense as clearing an OTC derivative transaction; and (2) in respect of both regulatory initiatives, funded instrument such as structured notes, warrants and ELIs are never conceived to be in the same basket for "over the counter" anyway.

We suggested that the definitions tracks that of "derivative contracts" / "forward contract" / "option contract" / "swap contract" and "valid bilateral netting agreement" under the Banking (Capital) Rules (Cap. 155L, Laws of Hong Kong) with suitable amendments.

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

HSBC

Enforceability of uncleared or unreported OTC derivatives contracts

A related issue to the scope of the mandatory clearing obligation or the mandatory reporting obligation is the necessity for legislation to provide that even if an OTC derivatives contract which is subject to the mandatory clearing regime remains uncleared (or that the requisite reporting fails to take place), this will not affect the legal, valid and binding nature of such transaction.

We consider that a distinction needs to be drawn between, on the one hand, the imposition of the mandatory clearing or reporting obligation (which is a question of enforcement and the consequential penalty regime) and the effectiveness of the contracts concluded between two consenting parties. Therefore, we believe HKMA and SFC should address this issue in the legislation specifically, as arguments may be run that contracts which are in breach of legislation (in this case, the mandatory clearing obligation) may be treated as illegal and/or void. In order to prevent legal uncertainty in respect of such contracts, it is therefore necessary for HKMA and SFC to include a legislative provision which, apart from setting out the penalties for failing to comply with the mandatory clearing obligation, will also state that such uncleared trades will remain legal, valid and binding on both parties to the contract.

Q2: Do you have any comments on the proposed division of regulatory responsibility between HKMA and SFC?

We do not have any specific comments on the proposed division of regulatory responsibility between HKMA and SFC.

Q3: Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?

Mandatory Reporting Obligation

Given the extra-territorial impact of the mandatory reporting obligations, HSBC would like to emphasize that global trade repository ("**global TR**") will be the most effective solution for HSBC to provide all trades information to the Hong Kong regulators. This is because the Group, along with other international market participants, will in any event submit the majority of trades (including all overseas branches and subsidiaries of The Hongkong and Shanghai Banking Corporation Limited, as well as the foreign incorporated AIs within the Group, being HSBC Bank plc and HSBC Bank USA, N.A.) to the global TR, and then apply pre-defined criteria to filter data to send to the Hong Kong regulators as appropriate.

HSBC

We acknowledge that HKMA (as the operator of the HKMA-TR) will ensure the reporting standards and specifications adopted by the HKMA-TR are in line with those set by international standard setting bodies and major industry platforms. If the HKMA-TR and global TR aims to have similar standards and requirements, then we suggest HKMA and SFC should align the phased approach with the implementation schedule of the global TR. By doing so, banks which intend to use global TR as their agent would only need to develop a single interface to provide data to both TRs. In case the implementation schedule of HKMA-TR and global TR becomes different, banks would need to duplicate its effort to develop two different interfaces for the two different TRs. This would be especially inefficient considering that the two interfaces will eventually merge when the HKMA-TR and global TR requirements align.

If HKMA and SFC decide not to follow the implementation schedule of global TR, HSBC would need to spend a tremendous amount of effort to implement a solution for over 30 overseas branches and subsidiaries to provide data to HK-TR which may be redundant in a short timeframe. We therefore suggest a phased approach for local and offshore entities.

From HSBC's point of view, we prefer the order of implementation as follows:

1) Firstly, transaction that the Hong Kong head office of a locally incorporated AI/LC are a counterparty to, or one that it has originated or executed;
2) Secondly, transaction that an overseas branch/subsidiary of a locally incorporated AI/LC is a counterparty to, or one that it has originated or executed;
3) Thirdly, transaction that an overseas-incorporated AIs become counterparty to, or one that it has originated or executed, and in each case through their Hong Kong branch; and
4) Finally, transaction that an overseas-incorporated AI is a counterparty to (regardless of the location of the booking branch) and the transaction has a Hong Kong nexus.

Mandatory Clearing Obligations

We note that the Commodities Futures Trading Commission of the United States ("**CFTC**") has proposed a three-phase implementation plan that divides market participants entering into swaps subject to clearing or trade execution requirements into three categories. Each time the CFTC determines that a swap or group, category, type or class of swaps, must be cleared, it will have the discretion to phase in such requirements based on the classification of the counterparties executing the swap.

We would propose that the clearing and reporting obligations are introduced on a phased basis so that, initially, only trades between two 2 AIs/LCs are subject to the requirements.

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

HSBC

In phase 2, this could be extended to trades with other financial institutions (such as funds, insurance companies, etc). In phase 3, it could be further extended to trades with corporates (although our preference would be for trades with corporates to be specifically excluded, see our responses to Question 8 below). The phased approach is especially important given that the process of designing a robust client clearing framework and raising awareness amongst non-AIs/LCs, especially corporate end users, on the issues relating to mandatory clearing, will take time.

Q4: Do you have any comments on the proposal to initially limit the scope of any mandatory reporting and clearing obligations so that they apply in respect of certain IRS and NDF?

HSBC dos not have any comments in relation to the initial products proposed in the product.

Q5: Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?

Client Confidentiality & Other Host Country Obstacles

We are aware that in certain locations where we operate through branches or subsidiaries, local regulators of our overseas branches or subsidiaries may impose, amongst other requirements, client confidentiality and bank secrecy obligations, which may prevent the provision of information to trade repositories, and given the relevant regulation are local in nature, there is no assurance that even if Hong Kong law provides that the mandatory reporting obligation is a Hong Kong statutory requirement and couple that with client consent, these concerns may yet to be overcome. While discussions on host country obstacles have centred on client confidentiality and bank secrecy, other concerns such as restrictions against offshoring of data or general sensitivities for market positions to be reported to external parties may also be of concern.

Similarly, Hong Kong branches of foreign incorporated AI may in any event have some home country obligations to comply with, and such impact may need to be considered carefully. The likelihood for the local regulator to provide for a trade repository exception to an international solution is greater rather than a local solution.

Separately, identifying the issue of client confidentiality in the context of mandatory reporting and how they are to be mitigated (via obtaining client consent or change of law) is one thing, whether counterparties to AIs or LCs may have sensitivities in reporting is another. One category of clients which would be substantially impacted would be central banks, state foreign exchange managers and sovereign wealth funds. It is fair to argue that they would seek to have a greater degree of control over the positioning of their portfolio, by reasons of commercial or political sensitivities, and while there are technical aspects on the enforceability of confidentiality terms between a body of that nature and a dealer (by way of example, would an amendment of Hong Kong law abrogating dealers from confidentiality obligations owed to a central bank / sovereign wealth fund be effective in the context of confidentiality terms governed under a non-Hong Kong governing law? Would such body be able to invoke sovereign immunity against the imposition of the mandatory reporting obligations?), a more commercially astute question would be whether it is in the interest of the markets at large to impose mandatory reporting obligations on these bodies, in the interest of the AIs, LCs, these clients, and Hong Kong?

"Originated or Executed"

For trades "originated or executed" by locally-incorporated AIs or overseas-incorporated AIs through their Hong Kong office, they are usually booked in an offshore office of that entity. Through such offshore booking model, in respect of an overseas-incorporated AI, the Hong Kong office is only responsible to originate trades and remunerates with selling credit while the offshore office where the trade is booked will take up the risk of the trade. The systematic risk to Hong Kong is very minimal and it adds minimal value to the mandatory reporting in Hong Kong.

On the other hand, unless the relevant AI is incorporated in a jurisdiction which is not pursuing the G20 targets, those trades booked in such offshore entity are most likely to report to a TR pursuant to the mandatory reporting obligation in its home jurisdiction. While the offshore booking model is used in Hong Kong more than say the US and the EU, this does indeed lead to a overlapping of reporting coverage between different jurisdictions. As proposed, the mandatory reporting obligation in Hong Kong would require one trade to be submitted to multiple TRs and it will increase the cost of compliance for banks, and the overlapping coverage may also cause trade information to be duplicated, and therefore affecting the quality of the information especially when used in aggregate. We are of the view that regulators should promote data-sharing between TRs to limit the burden on international trading where a firm may have obligations to report to multiple TRs.

In conclusion, we strongly object to the proposal for the mandatory reporting obligation to extend to transactions that LCs and AIs have "originated or executed" but to which they are not a counterparty.

If HKMA and SFC insist on including the concept of "originated or executed" in the Hong Kong mandatory reporting regime, we consider that it is essential that the definition of "originated or executed" should be very clearly defined. As currently expressed in the Consultation Paper, the term "originated or executed" covers too broad a range of activities which can be carried out, and this will result in uncertainty as to whether a particular transaction will be subject to the mandatory reporting regime in Hong Kong. Given the consequences of a failure to comply with the mandatory reporting obligation and the overall intention of the mandatory reporting regime, such uncertainty would be very unfair to financial institutions using offshore booking models and would also be disproportionate to the intended benefits which mandatory reporting is designed to bring.

We support the proposal that, rather than using ambiguous expression like "originated or executed", that any such expanded scope beyond the booking office to reference specifically to functions carried out by personnel employed under a particular function, for example to members of a sales desk or a trading desk located in Hong Kong.

Q6: Do you have any comments on the proposal to adopt a specified reporting threshold for persons other than AIs and LCs, and how the threshold will apply?

HSBC supports the proposal to specify a specified threshold to all persons to limit the scope of the reporting obligation but regulator should precisely define whether such threshold is measured at legal entity level or at a group level.

Q7: Do you have any comments on the proposed grace periods and how they will apply?

HSBC has over 30 overseas branches or subsidiaries and given that tremendous efforts are already being required to implement the solution to provide trade feeds to the global TR in anticipation of the G20 commitments, the additional costs of providing feeds to HKMA-TR via the global TR would be even greater and to the extent the agency route is not capable to be used, for example if the HKMA timeframe runs ahead of the global steps, the impact would be greater still. Other than the phased approach suggested in Q3 to delay the implementation of reporting requirement for offshore entities, regulator can consider providing a longer grace period for offshore entities or overseas branches/entities.

In addition, we also suggest the regulator should allow at least 6 months grace period for the first time implementation due to the development of solution to feed data and get clearance from regulator of our overseas branches/subsidiaries to the extend necessary or desirable. As a bank with many branches in Asia-Pacific, regulatory certainty in these locations may be less than desired, and while the fundamental key to such uncertainty may be the promotion of greater cooperation between regulators, there will always be concerns "on-the-ground" and therefore a measured, phased approach in line with international schedules would reduce disruptions and unintended consequences of such implementation.

HSBC

Q8: Do you have any comments on the proposed mandatory clearing obligation, and how it will apply to different persons?

Overseas branches/subsidiaries located in closed markets

We understand that the submission made by other industry groups noted in the introduction would have already discussed the concerns of a proliferation of CCPs in the region, which we would not repeat here for the sake of brevity. However, as HSBC has a number of branches and subsidiaries located in the Asia Pacific region participating in local markets, we would like to highlight a particular instance in terms the application of the proposals which would impact on HSBC greatly, and perhaps due to our unique position, much greater than most market participants.

Based on the current proposals, the mandatory clearing obligations will also be applied to all overseas branches and subsidiaries of a locally-incorporated AI. At the same time, those overseas branches or subsidiaries may be either subject to any mandatory clearing requirement in their host jurisdiction which mandates local clearing, or in any event due to foreign exchange control and/or other regulations, be restricted in using a CCP located outside of the jurisdiction of that overseas branch or subsidiary, be that HKEx, LCH, or other CCPs.

We feel strongly that the imposition of a Hong Kong mandatory clearing requirement to the overseas branches and subsidiaries of a locally incorporated AI would cause a disproportionate impact to a locally incorporated AI vis-à-vis a foreign incorporated AI (where the coverage would only extend to trades booked (or subject to the comments in regards thereto, originated or executed) in Hong Kong).

Further and in the alternative, one may argue that the solution to the difficulty stated above is to provide that the relevant local CCP be recognized as a designated CCP (either as a RCH or as authorized ATS provider). However, this may not be a satisfactory solution because:

(1) there may not be a local CCP in that jurisdiction at all (but the relevant foreign exchange control or other relevant regulatory hurdle remains);

(2) such local CCP may not wish to apply to the SFC to be a RCH or a authorized ATS provider; and

(3) such jurisdiction may have a mandatory local clearing requirement with a product scope that overlaps with the Hong Kong mandatory clearing obligation, and even if the relevant CCP wishes to apply to SFC become an ATS provider, that local CCP may not meet the criteria set out by SFC (while comply with local criteria for local CCPs).

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

HSBC

We strongly believe it is for the good of the market that the SFC upholds robust, internationally aligned, standards for regulation of OTC derivatives CCPs (as noted in paragraph 144, and specifically guidelines published by CPSS-IOSCO), however the issue of defining what is a "good" CCP for regulatory capital and supervision purposes is a different from the issue of imposing the mandatory clearing obligation in locations mandating the use of "good" CCPs (or more precisely, Hong Kong-approved CCP) may not be possible (either by foreign exchange control, concerns regarding the robustness of the foreign CCP, or otherwise).

We therefore strongly recommend that the legislation provides for "closed market exemption" to the mandatory clearing obligation, separate from the process of recognizing foreign CCPs under Hong Kong. The benefit of this approach is that where there is a mandatory clearing requirement in a jurisdiction where a branch or subsidiary is located, an overseas CCP may not, for whatever reason, be recognized by HKMA or SFC align with international standards, institutions such as ourselves may still use such CCP in order to comply with such mandatory local clearing requirement.

On a broader level, given the tight timeline for the reforms, notwithstanding the above, we would strongly recommend that all regulators, not just the Hong Kong regulators and their US or EU counterparts, but also regulators around the region, to work together in the same pace in terms of laws and regulations enhancement, and in terms of timing of implementation of a local CCP and mutual recognition of CCPs. If that's not the case, it would create problem to overseas branches and subsidiaries of institutions such as us, especially for trades with customers facing our branches and subsidiaries.

"Originated & Executed"

As explained in Q5, under the offshore booking model which is primarily applicable to foreign Incorporated AIs and LCs, trades "originated & executed" by them are usually booked in offshore entities. If one considers the original driver behind central clearing, be that it reduces counterparty risks, by virtue of these counterparties being located offshore, and thus the risk on these trades being borne in an offshore office, these trades would, by definition, not be systematically important to Hong Kong. Therefore, we strongly object to the proposal for the mandatory clearing obligation to extend to transactions that LCs and AIS have "originated & executed" in Hong Kong, but to which they are not a counterparty.

Trades that are originated or executed in Hong Kong but booked elsewhere may already be mandated by the home country of the booking entity to clear in a CCP. The extraterritorial part of the Hong Kong mandatory clearing requirements, with its unique nexus of "originated or executed" has the potential to cause all sorts of conflicts whether a transaction has to be cleared, and if so, where. We acknowledge that overseas CCPs may be recognized to be a RCH or a authorized ATS provider for the purpose of Hong Kong clearing obligations, however since that is a process which may take time, there are transitional considerations to be taken into account.

Generally, the determination as to what combinations of product and counterparties falls under the mandatory clearing obligation should take into account whether the designated CCPs are accessible for both parties to a transaction, and such mandatory clearing obligation should not disadvantage any banks use of offshore entities to book trades.

Similar to mandatory reporting, If HKMA and SFC insist on including the concept of "originated or executed" in the Hong Kong mandatory clearing regime, the Group considers that it is essential that the definition of "originated or executed" should be very clearly defined.

Commercial End Users Exemption

Commercial end users have always used derivatives to hedge against price volatility and mitigate their day-to-day commercial risk, and these derivatives is not in the nature of speculation, investing or trading, and where appropriate their trades qualifies for hedging treatment for certain accounting purposes, and in any event they are economically appropriate swap used to hedge risks arising from potential changes in the value of assets, liabilities, services, inputs, products, commodities or interest/currency/exchange rates.

If mandatory clearing obligation is insisted on commercial end users, then it will increase cost for commercial end users as they need to post margins and pay other related costs to clearing member in order to clear trades via a CCP. Even banks can offer client clearing solution to assist clients to clear trade via a CCP, cost incurred to build the infrastructure is still massive. The increased cost for both commercial end users and banks might not out-weight the systematic risk of those derivatives.

Both the Dodd Frank Act and EMIR proposed to exempt any OTC derivatives of a commercial end user who used their swaps to hedge or mitigate commercial risk from mandate clearing obligation. Therefore, we also suggest the HKMA and SFC to follow the same approach to apply such exemption.

In case HKMA and SFC is uncertain whether commercial end users should be exempted or not, we would suggest the HKMA and SFC to rely on the mandatory reporting made to the appropriate trade repository and monitor the exposure to OTC derivatives by these commercial end users and understand the volume, trade profile and significance of the OTC derivatives due to commercial end users (corporate), before determining the threshold as well as the mandatory clearing obligation for this type of counterparty.

HSBC

Intra-Group Transaction Exemption

HSBC strongly recommends that there should be allowance for an exemption from the clearing obligation in relation to intra-group transactions. HSBC executes intra-Group trades to allow, on the one hand, local HSBC entities to provide OTC derivatives directly to clients, allowing the client to face an entity in the same jurisdiction as the client and an entity of which it is more familiar, while on the other hand, by "backing out" the market risk of that product to a risk management entity, the cost of risk management can be reduced as similar market risks are consolidated within the relevant central entity. Under this approach, the intra-Group trades pass market risk from the client facing entity to the entity responsible for managing the market risk on a portfolio basis. Centralisation of market risk facilitates a higher degree of efficiency in risk management.

Our view is that requiring intra-Group trades to be cleared would increase operational risk and costs, without an equivalent benefit. The counterparty risk between intra-Group entities can be effectively managed by bilateral collateral arrangements such as the Credit Support Annex to the ISDA Master Agreement. The imposition of intra-Group mandatory clearing obligation would lead to either (should institutions seek to maintain centralised risk management entities) multiple initial margins being required to be posted to effect the intra-Group transactions, or cease to conduct intra-Group transactions and have segregated risk management. In either case, the increase in costs (from clearing intra-Group trades or maintaining segregated risk management centres) would likely be passed on to corporate customers. We also note that for regulations in other comparable jurisdictions, such as in the EU, the current drafts of EMIR contain provisions to exempt intra-group trades from mandatory clearing requirements.

Conflicting Clearing Requirements

An important challenge in dealing with mandatory clearing is the possibility of conflicting clearing obligations. This may occur where OTC derivative transactions are entered into on a cross-border basis. For instance, if a Hong Kong counterparty transacts with a Singapore counterparty, both may be subject to mandatory clearing obligations in their respective jurisdictions. As the transaction can only be cleared through one CCP, there must be a mechanism for resolving this conflict. The issue may also arise as a result if laws have extra-territorial impact, for instance, if a mandatory clearing obligation were to catch transactions engaged in by an overseas branch of an entity, and that branch was also subject to a similar obligation under the law of the jurisdiction in which it is established.

Although the proposed Hong Kong mandatory clearing obligation contains some limits to its territorial scope, such as the exemption of transactions between two overseas persons, and provides that the clearing obligation applies only to transactions originated or

HSBC

executed by the Hong Kong branch of overseas AIs, there still remains scope for potential conflict with clearing obligations in other jurisdictions. A possible, but incomplete, solution to this is for regulatory frameworks to allow for clearing on overseas platforms subject to certain conditions.

It is not however clear to what extent regulators internationally are co-operating to devise practical solutions to these issues. The risk, especially given the tight timing for the reforms, is that regulators will press ahead with their own reform agendas without the appropriate solutions having been thought through and reflected in the relevant laws and regulations. This could create significant difficulties and challenges for market participants and for regulators further down the line.

De-Clearing

Trades that have been centrally clearing would remain there until maturity. It is worthwhile to note that hitherto major dealers have already been actually managing systematic risks through multilateral trade compressions. However it is worthwhile to note that the implementation of trade compression may be difficult in the context of central clearing, in light of the fact that operationally trades are novated to the central counterparty. As trade compression is an important tool currently used by industry players to manage counterparty exposure and reduce capital charges , the industry should be encouraged to conduct such exercises, including any de-clearing that may be necessary for the purpose of trade compression.

Q9: Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?

Definition of Threshold

HSBC supports the proposal to specify a specified clearing threshold to all persons to limit the scope of the clearing obligation but regulator should precisely define whether such threshold is measured at legal entity level or at a group level.

If it is measured at the group level, the regulator should consider whether it's practical to aggregate the exposure of any group companies in commercial world. If it's measured at legal entity level, a person might possibly split up their derivatives exposure into different smaller legal entities in order to bring each entity exposure level below the threshold to avoid any clearing obligation to kick in.

HSBC

Availability of Information

As mentioned in paragraph 132, AI or LC has originated or executed the transaction on behalf of one or both counterparties, then they will be responsible for ensuring compliance with the mandatory clearing requirement. In order to determine whether a trade with a non-AI/LC counterparty is mandated to clear or not, the bank needs to know whether the exposure of the counterparty exceeds the specified threshold or not.

We have major concerns regarding whether any AI or LC would be able to determine whether a counterparty has crossed the clearing threshold, because we would not be in possession of data relating to trades that the client had done with other banks, and it would be commercially unreasonable to demand clients to prove to us as to trades concluded with our competitors. It is particularly difficult for banks to check the derivatives exposure of a counterparty who are incorporated overseas where the awareness of the Hong Kong regulatory landscape would be lower.

Our preferred solution is that an express defense be made available against an AI or LC being liable for a breach of the obligation if it receives a representation from the client, in good faith, at the time of trading where the client confirms that they are within the mandatory clearing threshold and will not be crossing the threshold by conducting that trade. The regulators may obtain some comfort that a misrepresentation on that statement would, as a matter of contract under industry standard documentation, provide the AI or LC with rights of early termination.

Alternatively, the regulators may be minded to set up a database providing publicly available, reliable information on whether an entity would be beyond the mandatory clearing threshold, so that market participants may conduct a search at the time of trading in reliance thereof, however we note the great deal of difficulty in implementing this, specifically client confidentiality and the potential for misuse of the information.

In the absence of either any reliable source of information for an AI or LC to check whether the exposure of their counterpart exceeds the threshold or not, it would be unfair for banks to be responsible for ensuring compliance with the mandatory clearing requirement.

Q10: Do you have any comments on the proposed grace periods and how they will apply?

As explained in Q8, our overseas branches/subsidiaries will not be able to fulfill the mandatory clearing obligation if:
(1) No local CCP is available to support any OTC clearing
(2) Local CCP is not recognized as a designated CCP

(3) Local rules disallow any trades onshore to be cleared in any offshore CCP

Those constraints cannot be solved by market participant themselves and we would propose HKMA and SFC should either exempt them from mandatory clearing obligation as we suggested in Q8, or as an inferior fallback, provide for a longer grace period until there is a practical solution for those overseas entities to fulfill the mandatory clearing obligation, however noting that this would not actually resolve the issue at hand unless the relevant regulators do indeed arrive at some sort of resolution.

Q11: Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?

The important measures for financial stability are trade reporting (for regulators to see how interconnected the market is, and estimate potential for contagion) and to a lesser extent central clearing (to remove some of the interconnectedness). Mandatory trading on exchanges or other trading facilities is not necessary for financial stability, but could have a negative impact, for example, reduction of liquidity in the market where the mandatory trading applies. It is therefore a good approach to observe the effect that SEFs may have in the US and OTF/MTF in the EU on the market before implementing similar rules in Hong Kong.

Q12: Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?

Location requirement

Whilst we appreciate concerns of local regulators that they would not be able to supervise clearing of products beyond its jurisdiction as closely as otherwise allowed, such concern should be better resolved by closer co-operation between regulators rather than by forcing fragmentation of the marketplace. If each and every jurisdiction is to mandate local clearing of derivative products in their own currency, the clearing market would become fragmented and inefficient, netting sets would be further broken and in general more liquidity would be required of the dealers. In short, such a fragmented clearing landscape would introduce more risk to the system and should be avoided.

Overseas clearing members

If firms are mandated to clear centrally, they also should be allowed as members to the relevant CCPs. Without allowing overseas firms to become clearing members, they would be forced to clear via local entities, and competition would be reduced, leading to less efficient clearing. Also, the likely firms applying for membership at a local CCP usually have broad experience as clearing members in other jurisdictions and could

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

provide valuable experience to a CCP, e.g. by participating in risk committees and working groups.

Specifically, US clients can access CCPs only via Future Commission Merchants ("**FCM**") – were these FCMs not being allowed to become members of a Hong Kong CCP, the two extraterritorial rules between Hong Kong and the US would effectively inhibit central clearing of transactions between US entities and HK entities.

Capital Charges & Margin Requirements

We note that the Consultation Paper has not provided a great deal of detail about the implementation the G20 commitment regarding the imposition of higher capital requirements for OTC derivatives transactions that are not cleared through a CCP, other than a referral to Basel 3.

We support the implementation of Basel 3 in Hong Kong to make sure there is a level playing field with local firms. In general, Basel 3 seeks to provide incentives for centrally cleared transactions (to which judgment is reserved on whether sufficient incentive for central clearing has actually been provided).

The Consultation Paper also suggests that margin requirements be imposed for un-cleared transactions. Whilst such margin requirements may reduce counterparty risk, a high liquidity burden is introduced for market participants, and more specifically margining is problematic for transactions in jurisdictions where netting and collateral agreements are not enforceable and therefore any imposition of margining has to take such restrictions into account.

In case higher capital charges are imposed for OTC derivatives that are not centrally cleared, the capital cost for the relevant banks will be higher and it is only natural that such cost will be passed to commercial end users. Without specific threshold being named, it would however be reasonable to anticipate that the majority of medium-size corporate clients may not exceed the reporting threshold and/or mandatory clearing threshold. That means the cost for a medium-size corporate client to enter a derivative transactions will be higher and might force them not to enter hedge any commercial risk in their book and introduce additional systematic risk to the economy.

Q13: Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?

The proposed regime creates some complexity in the oversight regime for OTC derivatives transactions. The HKMA and the SFC will have joint oversight of the new OTC derivatives regulatory regime, with authorized institutions' OTC derivatives activity

HSBC

being regulated by the HKMA and the OTC derivatives activities of non-authorized institutions being regulated by the SFC. This is the existing framework for leveraged foreign exchange trading regulated activity but represents an expansion of the oversight of the HKMA into OTC derivatives transactions including those that are not currency-linked or interest rate-linked.

An AI that is dealing equity option and swap transactions will require a Type 1 licence for dealing in securities (and may require a Type 4 licence for any advising activity). However, under current proposal, equity option and swap transactions would also be an OTC derivatives transaction. Under the existing regime, authorized institutions will be subject to SFC regulation for the Type 1 regulated activity (but the HKMA acts as the frontline regulator). If the second approach proposed by the SFC and HKMA is adopted, authorized institutions will be exempt from licensing in respect of all OTC derivatives (including equity derivatives). Such activities will be regulated wholly by the HKMA which would represent a narrowing of the SFC's oversight over AIs as compared to the position currently. However, if the approach eventually adopted is that the Type 11 requirement would apply only to activities not caught by the existing regulated activities such as Type 1 and Type 3, the regulation of OTC derivatives transactions would be split between Type 1 (where authorized institutions are subject to the licensing of SFC) and Type 11 (as well as Type 3) (where authorized institutions are exempt from the licensing of SFC). The rationale for such division between Type 1 and Type 11 does not seem immediately obvious.

An alternative approach would be to use the reforms as an opportunity for eliminating (rather than extending) the differential treatment between the regulation of licensed corporations and authorised institutions in the conduct of OTC derivatives. This would ensure that conduct of business requirements are applied evenly across the industry and avoid the current (somewhat unsatisfactory) position where the HKMA expects AIs to observe standards equivalent to (and in some areas higher) than those set by the SFC, although they are not technically bound by them. Prudential supervision would of course remain split between the HKMA and the SFC, as it is currently.

Whichever approach is taken, it is important that the categories of regulated activity should be well thought through as this will have an impact not only on what exceptions apply but who the applicable regulator is. It is also currently unclear what exceptions, if any, will apply to the new Type 11 regulated activity.

Q14: Do you have any comments on the proposed regulatory oversight of large players?

We do not have any comments on the proposed regulatory oversight of large players.

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk

HSBC

****

As part of overall efforts to work in partnership with HKMA and SFC in reforming the Hong Kong OTC derivatives market for the future, HSBC would be very pleased to further discuss or develop the ideas elaborated in this response with you. Please do not hesitate to contact should you wish to discuss any of the above.

The Hongkong and Shanghai Banking Corporation Limited
Global Banking and Markets
Level 18, HSBC Main Building, 1 Queen's Road Central, Hong Kong
Tel: (852) 28221111
www.hsbc.com.hk