



30 November 2011

Mr Keith Lui
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Supervision of Markets
Securities and Futures Commission
8th Floor, Chater House
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Hong Kong

Dear Mr Lui

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

I refer to the above Consultation Paper and enclose HKEx's comments on the proposed reform for your consideration.

We agree with the objectives of the Consultation Paper in seeking to set up the appropriate market infrastructure to implement reforms contemplated by the G20 commitments and to improve the oversight of financial intermediaries in the OTC derivatives market. We look forward to working with the SFC and the HKMA in implementing these objectives and the related reforms.

Yours sincerely

Encl

香港交易及結算所有限公司
Hong Kong Exchanges and Clearing Limited



**Response of Hong Kong Exchanges and Clearing Limited on
Consultation Paper on the proposed regulatory regime for the
over-the-counter derivatives market in Hong Kong**

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Hong Kong Exchanges and Clearing Limited

Response on Consultation Paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong (the “Consultation Paper”)

1 Executive Summary

- 1.1 This Paper sets out the views of Hong Kong Exchanges and Clearing Limited (“HKEx”) on the Consultation Paper, which was released jointly by the Hong Kong Monetary Authority (“HKMA”) and the Securities and Futures Commission (“SFC”) on 17 October 2011.
- 1.2 HKEx agrees with the objectives of the Consultation Paper in seeking to set up the appropriate market infrastructure to implement reforms contemplated by the G20 commitments and to improve the oversight of financial intermediaries in the OTC derivatives market. HKEx looks forward to working with the SFC and the HKMA in implementing these objectives.
- 1.3 We have organized this Paper into two parts. In Part A, we provide our views on some of the key issues underpinning the Consultation Paper, a summary of which is set out below.
- “Systemically important OTC derivatives transactions”¹ should be regulated with a higher degree of vigilance than other OTC derivatives transactions subject to mandatory clearing. In order to enable Hong Kong regulators to apply the required level of oversight, systemically important OTC derivatives transactions should only be cleared through domestic central clearing counterparties (“CCPs”) incorporated in Hong Kong.
 - The Hong Kong dollar (“HKD”) OTC derivatives market, the Offshore Renminbi (“Offshore RMB”) (Chinese Yuan (“CNY”) deliverable in Hong Kong (“CNY(HK)”) derivatives market as well as the RMB non-deliverable markets are systemically important to Hong Kong. These markets are crucial to Hong Kong as a financial centre since a significant portion of their trading volume is provided by local institutions. In addition, special features of these markets (particularly, Offshore RMB and RMB non-deliverable products) demand close supervision and oversight by Hong Kong regulators. In the context of interest rate swaps (“IRS”) and non-deliverable forwards (“NDF”) which will be subject to mandatory reporting and clearing obligations in the initial phase, HKD and CNY(HK) single currency IRS, single currency basis swaps, overnight index swap as well as CNY non-deliverable IRS and NDF should specifically be designated as “systematically important transactions” and be regulated as such from the outset. Over time, the types of transactions that should be regulated as systemically important transactions can be extended or further designated depending on local circumstances and other factors as determined by regulators.
 - The close supervision and oversight by Hong Kong regulators in respect of systemically important OTC derivatives transactions can be achieved by leveraging off the existing “recognized clearing house” (“RCH”) regime. As RCHs are subject to

¹ By “systemically important OTC derivatives transactions”, we mean those transactions or “domestic products” which are of special systemic importance to the Hong Kong financial markets referred to in paragraph 148 of the Consultation Paper. These transactions are to be distinguished from other OTC derivatives transactions which are also subject to the mandatory clearing and reporting requirements proposed in the Consultation Paper.

a higher level of regulation under the Securities and Futures Ordinance (the “SFO”) than automated trading services (“ATS”) providers, they are better suited to deliver the required clearing solution in respect of systemically important OTC derivatives transactions.²

- In any event, there needs to be a more fundamental rethink of how overseas-incorporated CCPs will be regulated as ATS providers in light of the special considerations applicable to the clearing of OTC derivatives transactions, whether in respect of systemically important transactions or otherwise. Given that CCPs are themselves systemically important “financial market utilities”, regulators should place overseas-incorporated CCPs to be accepted as ATS providers in Hong Kong under a greater degree of oversight than they are at present.
- The definition of “OTC derivatives transaction” needs to be clear so that the regulatory regime for OTC derivatives can be as robust as possible.
- Given the breadth of the mandatory clearing obligation, client clearing plays a key part of the new regulatory regime and should be given insolvency protection in legislation.
- Notwithstanding any delays in international regulatory reforms, certain changes to the Hong Kong legislation are essential for the operation of an OTC derivatives clearing house and should be brought in by the third quarter of 2012.

Part B contains our response to the detailed questions in the Consultation Paper, which draws upon a number of our observations in Part A.

1.4 In submitting its comments, HKEx’s aim is to work with the SFC and the HKMA to ensure that Hong Kong has a regulatory framework that is comparable to international standards but takes into account local market conditions and characteristics.³ In particular, this response makes reference to the following:

- Committee on the Global Financial System Paper No 46 *The Macroeconomic Implications of Alternative Configurations for Access to Central Counterparties in OTC Derivatives Markets*, a Report submitted by a Study Group established by the Committee on the Global Financial System, November 2011, published by the Bank of International Settlements (the “BIS Paper”); and
- *Principles for Financial Market Infrastructures*, a Consultative Report jointly published by the Committee on Payment and Settlement Systems (“CPSS”) and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) dated March 2011 (the “CPSS-IOSCO Report”).

Where appropriate, this Paper also draws comparisons with or considers similar regulatory efforts in other jurisdictions to assist in the analysis, including the following:

- the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States (the “Dodd-Frank Act”);

² Paragraph 142 of the Consultation Paper states that the current thinking of the SFC and HKMA is that only an RCH or an ATS provider authorized under Part III of the SFO should be permitted to be designated as a CCP for the purposes of the mandatory clearing obligation.

³ Paragraphs 6 and 18 of the Consultation Paper.

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- the Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories⁴ (“**EMIR**”);
 - the Financial Instruments and Exchange Act in Japan (the “**FIEA**”); and
 - *Central Clearing of OTC Derivatives in Australia: a discussion paper issued by the Council of Financial Regulators*, published in June 2011 (the “**Australian Consultation**”) and *Review of Financial Market Infrastructure Regulations*, a paper published by the Council of Financial Regulators in October 2011 (the “**FMI Review**”).

⁴ COM(2010) 484/5.

Part A

In this Part A of our response, we provide our views on some of the key issues underpinning the Consultation Paper.

2 Key considerations for OTC market reform

2.1 *Location requirement: regulation of systemically important OTC derivatives transactions in Hong Kong*

Domestic CCPs

2.1.1 The Consultation Paper states that given the OTC derivatives market's global nature and the relatively small size of the Hong Kong OTC derivatives market, the Hong Kong regime will need to be in alignment with other major markets while also taking into account local market conditions and characteristics.⁵ To this end, the regulators have announced that a domestic CCP will be incorporated in Hong Kong as a clearing house for OTC derivatives market, in line with the development to set up domestic CCPs in other regional markets such as Japan, Australia and Singapore. There are significant benefits in having a domestic CCP and these have been summarized in the BIS Paper:

*"The establishment of domestic CCPs for some types of OTC derivatives may become an important part of the global infrastructure for clearing standardised contracts. A domestic CCP could strengthen the ability of local authorities to exercise oversight and regulation of derivatives trading activity in their own jurisdictions, as well as to perform crisis management and resolution if needed. Domestic CCPs are more likely to have significant benefits in markets where local participants are prominent or where there are special market needs."*⁶

What are systemically important markets?

2.1.2 Further, the Consultation Paper highlights that one important issue is whether certain types of OTC derivatives transactions are of such systemic significance or importance to the Hong Kong public, market participants and the financial system that they should only be cleared by domestic CCPs and be subject to heightened regulatory oversight. We agree that this is a critical question and note that this debate is already underway in Japan, Australia and in the EU:

2.1.2.1 in Japan, it is proposed that credit default swaps over the iTraxx Japan index should be mandatorily cleared in a domestic CCP;

2.1.2.2 in Australia, in the FMI Paper, the Council of Financial Regulators came to the conclusion that Australian-dollar interest rate derivatives are likely to be systemically important and be clearable only through Australian-domiciled CCPs;⁷ and

2.1.2.3 in the EU, the European Central Bank ("ECB") has highlighted the importance of CCP location in the recently published *Standards for the Use of Central Counterparties in Eurosystem Foreign Reserve*

⁵ Paragraph 6 of the Consultation Paper.

⁶ See Executive Summary of the BIS Paper.

⁷ See 5.1 and 5.2 of the FMI Paper.

Management Operations (November 2011), where the ECB states that the Eurosystem's location policy requires that "infrastructures clearing and settling sizeable amounts of euro-denominated securities and derivatives should be located in the euro area".⁸

- 2.1.3 Whether an OTC derivatives transaction is of systemic importance to Hong Kong and if so, how its associated risks should be managed is a policy question for the Hong Kong Government and regulators. In our view, where a large part of the trading volume in an OTC derivatives market is provided by Hong Kong-based or local institutions (rather than global dealers), or where special needs or circumstances apply to certain OTC derivatives transactions, such markets or transactions should be regarded as systemically important to Hong Kong. Accordingly, based on the reasons and data set out in "Systemic importance of the Hong Kong dollar market" and "Systemic importance of the Offshore RMB and RMB non-deliverable markets" below, HKEx submits that OTC derivatives transactions involving HKD, CNY(HK) and CNY should be regarded as systemically important⁹ and that these are the markets where the Government and regulators should exercise oversight and regulation and perform crisis management and resolution, if needed.¹⁰

Systemic importance of the Hong Kong dollar market

- 2.1.4 Although the HKD market is a small part of the global FX market, it constitutes a crucial part of the local FX market where there is significant focus on foreign exchange and interest rate derivatives with a HKD element.¹¹ In the local FX market, HKD ranked the second most heavily traded currency, with contracts involving the HKD on one side of the transaction constituting 30.6% of the total. HKD against the USD remained the most heavily traded currency pair, constituting nearly 30% of the total transactions in April 2010. In terms of interest rate derivatives, the average daily net turnover of transactions involving HKD constituted 17.4% (USD3.2 billion), ranking after USD transactions of 18.8%. It can be seen that the HKD market represents a significant proportion of the FX and interest rate derivatives traded locally.
- 2.1.5 The statistics also show a gradual expansion in the activities of local players, including non-financial institutions, both in the FX and the OTC interest rate derivatives areas. Based on HKMA statistics mentioned in 2.1.4 above, inter-bank dealing activity made up 75.7% and 75.4% of the turnover for FX and OTC interest rate derivatives transactions respectively in April 2010. While the 10 largest reporting dealers for that survey accounted for 82.2% of gross turnover, this was

⁸ Standard 4, paragraph 2.

⁹ In making the above observation, we have looked at empirical data. In the course of doing so, however, we note that publicly available and officially compiled information on each of these markets (whether by product, participant and currency type) is very limited. It is precisely because of such lack of transparency, coupled with the high relevance of these markets to the Hong Kong economy and the Hong Kong marketplace at large, that special attention should be paid to these product areas.

¹⁰ See Executive Summary of the BIS Paper.

¹¹ Based on *The Foreign-Exchange and Derivatives Markets in Hong Kong* published by the HKMA in September 2010, Hong Kong ranked 6th in terms of global FX markets but its global share increased to 4.7% in April 2010. Separately, Hong Kong accounted for 0.7% of the reported global turnover for OTC interest rate derivatives. However, it is worth noting that these statistics may understate the true position as they may only show transactions booked in Hong Kong – as the Consultation Paper acknowledges, most transactions are booked outside Hong Kong even if they are executed in or arranged out of Hong Kong.

down from 87.4% in 2007. Most notably, although overseas-incorporated authorized institutions ("AIs") remained active, their share of transactions decreased markedly from 61.8% in 2007 to 47.6% in 2010. By contrast, the share of transactions entered into by securities houses expanded from 17.3% in 2007 to 33.9% in 2010. In addition, transactions between dealers and non-financial institutions rose, from 1.7% in 2007 to 2.2% in 2010. The increasingly widespread use of FX and interest rate derivatives amongst different types of counterparties is also another factor pointing to their systemic importance.

- 2.1.6 This signifies that a large part of the trading volume in the local OTC interest rate derivatives market over HKD is provided by local participants.¹² Any disruption in this market would likely cause market-wide disruption in Hong Kong. Given market participants use these products (in part) for hedging business risks including domestic and cross-border borrowing, lending and business flows, any disruptions would have a knock-on effect on funding markets and in turn potentially affect asset pricing and other areas of the economy.
- 2.1.7 In addition, history has shown that the HKD market is not immune from attack via the use of OTC derivatives transactions. The concerted attack ("double play") against HKD in 1997-1998 involved the use of OTC currency swaps followed by the execution of short transactions on Hang Seng Index futures and stock markets. The Hong Kong Government stepped in to defend the currency peg and this in turn had an impact on bank lending rates and the Hong Kong stock market. Needless to say, any manipulation of the HKD will have a systemic impact on Hong Kong. Since 1997-1998, regulators have paid increased attention to the OTC HKD derivatives market and remain alert and vigilant to any signs of manipulation.

Systemic importance of the Offshore RMB and RMB non-deliverable markets

- 2.1.8 The Hong Kong Government has been promoting the development of Hong Kong's Offshore RMB business since 2004. Hong Kong's development as an Offshore RMB business centre is supported and promoted by the PRC Central Government and is in line with the gradual internationalization of the RMB. As a result, the Offshore RMB market in Hong Kong has grown exponentially in the past year.
- Hong Kong is the prime platform for RMB trade settlement with over 80% of the Mainland's RMB trade settlement being conducted through banks in Hong Kong. In the first eight months of this year, the amount exceeded RMB1.1 trillion, representing 10% of the total trade value.
 - Driven by RMB trade settlement, RMB financing activities increased significantly and CNY(HK) denominated deposits grew more than ten-fold from RMB60 billion in 2009 to over RMB600 billion in September 2011. CNY(HK) denominated deposits are expected to exceed RMB1 trillion by the end of this year. At present, Hong Kong has the largest pool of offshore RMB funds and since 10 July 2010, it has become the only jurisdiction where RMB is deliverable offshore.

¹² We note that there is currently no proposal to subject FX transactions to mandatory clearing and have focused our analysis on the HKD IRS market. In principle, however, the same policy argument would apply to FX transactions involving HKD if such FX transactions were to be subject to mandatory clearing in due course.

- Hong Kong is the largest Offshore RMB bond market with the total amount of RMB bond issuances increasing from RMB16 billion in 2009 to RMB35.8 billion in 2010. Up to the end of September 2011, there were 95 RMB bond issuances involving a total value of RMB159 billion.
- Hong Kong is the main offshore clearing centre for RMB: as of April 2011, there were 173 banks participating in Hong Kong's RMB clearing platform.¹³

2.1.9 There are also special features of this market which point to the special need for continued close supervision and oversight by Hong Kong regulators. The Offshore RMB market is a market of growing importance to Hong Kong and is one to which both the Hong Kong Government and the PRC Central Government attach a great deal of significance. RMB is the national currency of the People's Republic of China ("PRC") and a currency whose markets are very closely linked to the Offshore RMB market. The RMB market is going through the process of internationalization, with Hong Kong, and the Offshore RMB market, playing key roles in such process. The connection between Hong Kong and the Mainland and hence between the CNY and CNY(HK) has been a subject of recent commentary. The Government has affirmed that these two areas: (i) Hong Kong's development as China's global financial centre and the premier Offshore RMB business centre; and (ii) the "One Country, Two Systems" principle "*are not mutually exclusive, but deeply connected*".¹⁴

2.1.10 In response to a question posed by the Legislative Council on Hong Kong's role in the development of Offshore RMB business recently, the Government stated that an important function of Hong Kong as an Offshore RMB business centre is to provide an efficient market and financial platform to allow the effective circulation of RMB funds. The Government has further noted that as RMB is not yet freely convertible, "*Hong Kong will exercise caution in managing cross-border fund flows and promote the internationalization of RMB with sufficient protection of our country's financial stability*".¹⁵ This approach is in line with the measured and controlled approach which the PRC Central Government has taken in the internationalization of the RMB.

2.1.11 Consistent with this cautious approach and in light of the importance of RMB as a currency, the management of risks associated with the Offshore RMB OTC derivatives market should be handled with extra care, and policies and measures that may result in or have the effect of giving up, handing over or letting go of regulatory control or oversight in respect of the Offshore RMB market, whether in relation to the mandatory reporting or clearing obligation or otherwise, should be carefully thought through. In addition, given its close connection to the Offshore RMB as well as the onshore RMB markets, the RMB non-deliverable markets in Hong Kong should also be subject to similar control and oversight. In this connection, we note that if Offshore RMB derivatives products and RMB non-deliverable products were to be cleared outside Hong Kong, this could potentially be a matter of great policy concern to the PRC Central Government.

¹³ On the importance of the RMB market and RMB internationalization and the statistics referred to in this section, please refer to (i) the Financial Secretary's speech on "Hong Kong: a global financial hub: your offshore Renminbi centre" published by the Hong Kong Government on 8 November 2011; and (ii) the press release of the Financial Services and Treasury Bureau ("FSTB") on the development of RMB offshore business centre dated 22 June 2011.

¹⁴ Speech of the Financial Secretary referred to in (i) in footnote 13 above.

¹⁵ Press release of FSTB referred to in (ii) in footnote 13 above.

- 2.1.12 Although the Offshore RMB derivatives market appears “small” in global terms at this stage, it is growing at a rapid rate and has every potential to be significant going forward. The Offshore RMB derivatives market together with the RMB non-deliverable derivatives market (linked inextricably to the Offshore RMB as well as the onshore RMB market) is a key pillar of the Hong Kong financial markets. This is a “domestic” market in which a huge proportion of trading takes place locally among local participants based on the infrastructure in Hong Kong and Mainland China. As described in the preceding paragraphs, there are also special features of this market that necessitate the close and careful supervision and oversight by Hong Kong regulators so that this market should be designated as systemically important to Hong Kong.

Enhanced oversight of systemically important derivatives transactions

- 2.1.13 As illustrated above, given that HKD, CNY(HK) as well as CNY non-deliverable OTC derivatives transactions are systemically important to Hong Kong, Hong Kong regulation should seek to provide a heightened degree of vigilance and oversight in respect of these transactions. In the context of interest rate swaps and non-deliverable forwards which will be subject to mandatory reporting and clearing obligations in the initial phase, HKD and CNY(HK) denominated single currency IRS, single currency basis swaps, overnight index swap as well as CNY non-deliverable IRS and NDF should specifically be designated as systematically important transactions and regulated as such from the outset.
- 2.1.14 Over time, the markets will evolve and such designation should be reviewed on a regular basis, perhaps at least annually. The SFO should provide regulators with the flexibility to designate certain classes of OTC derivatives transactions as systemically important transactions so that the risks associated with them can be monitored and managed.

Importance of clearing through a domestic CCP

- 2.1.15 A domestic CCP incorporated in Hong Kong would be able to manage systemically important markets better than an overseas CCP incorporated outside Hong Kong. Notably, the BIS Paper¹⁶ acknowledges that a domestic CCP may be able to obtain better information about the risks that it is managing, including through the CCP’s relationships with other local financial institutions and market infrastructures. Better information on counterparty risks of local players might allow the domestic CCP to react pre-emptively to limit risk from members. Domestic CCPs may also have greater access to domestic liquidity suppliers so that, if a clearing member defaults, the collateral can be liquidated in an orderly manner. A domestic CCP may therefore be able to respond more effectively to liquidity shortfalls. Further, domestic CCPs may be better placed to manage settlement risk, as they generally have broader access to settlement in central bank money in their respective jurisdictions, compared to global CCPs that conduct business in several currencies.
- 2.1.16 Another important difference between clearing OTC derivatives transactions through a domestic CCP and an overseas CCP can be seen in a default situation, where a CCP is unable to perform for whatever reason. This could occur in a

¹⁶ See Paragraph 3.2.2 of the BIS Paper.

number of situations, which would indicate a market crisis or an underlying systemic weakness requiring regulatory intervention:

- The insolvency of a CCP: though it is unlikely that a CCP would become insolvent, this possibility cannot be dismissed entirely.
- After the default of a large participant, the CCP failing to recapitalize or to function effectively. While the insolvency of a large market participant would not necessarily lead to regulatory intervention if managed in accordance with the default rules of a CCP, it is still possible that the insolvency may trigger a large scale crisis necessitating regulatory intervention.
- A disruption to the provision of CCP services through an operational outage.
- The inability or unwillingness of a CCP to comply with regulatory requirements (including financial resources or liquidity rules) which leads to regulatory sanction, with the consequence that the smooth provision of services is disrupted.

Where any of the above situations arises, the market would be facing the prospect of a CCP failure. As all cleared market positions are effectively transactions with the CCP, in a worst case scenario, participants could face a close-out of all market positions. This would clearly create very significant implications for the financial stability of the participants.

2.1.17 If a situation mentioned above occurs in relation to an overseas CCP which is allowed to clear OTC derivatives transactions originated or executed in Hong Kong or involving Hong Kong counterparties, while Hong Kong regulators would have some degree of oversight over the CCP, primary regulatory oversight would likely remain with the regulator in the CCP's home jurisdiction. The SFC would, it seems, only be able to revoke the license of that CCP and seek to enforce whatever other conditions it has imposed under the license. It is less likely that the SFC would be able to take all such actions and exercise all such powers as it could have done had the CCP been incorporated in Hong Kong and were subject to the SFC's sole or principal jurisdiction. Any default management solutions would be likely to be governed by the laws of the CCP's home jurisdiction rather than Hong Kong law. While Hong Kong regulators would generally seek to co-operate with the home country regulator, the overall interaction would be indirect and possibly less effective. The Hong Kong regulators would not have full scope to oversee the overseas-incorporated CCP and mostly likely would not be able to obtain real-time information and respond in a timely manner. There may well be delays and the possibility of competing, if not conflicting cross-border solutions. Cross-border solutions to a crisis involve laws and courts of different jurisdictions and are likely to be less speedy or effective. An outcome that is beneficial to Hong Kong may not be guaranteed.¹⁷ Thus, it can be seen that more protection would be afforded to the local market and its participants if OTC derivatives transactions are cleared through a domestic CCP as opposed to an overseas CCP.

2.1.18 From the point of view of Hong Kong market participants, there are significant disadvantages in clearing through overseas CCPs. In a default situation, such Hong Kong market participants would be subject to the insolvency laws of the

¹⁷ We note that this was also the view of the Australian regulators in the Australian Consultation, paragraph 4.4.3.

relevant foreign jurisdiction. They would be subject to the actions taken by overseas regulators and may have to participate in expensive and potentially lengthy overseas litigation in order to secure the return of collateral assets, resulting in additional costs and unacceptable delays. This would expose Hong Kong participants to a host of uncertainties (including the contagion effect of overseas participant defaults) that are mostly likely not related to the Hong Kong or the Mainland China economy but to the economy or government policies of the overseas CCP's home jurisdiction. Even in a non-default situation, Hong Kong participants in an overseas-incorporated CCP may well be subject to factors in the prevailing economic environment in the home jurisdiction of such CCP. For example, the CCP could alter its membership or margining criteria to meet current political or economic conditions, adversely affecting Hong Kong market participants and in turn create potential market-wide impact. For such reasons, it is incumbent upon Hong Kong regulators to provide Hong Kong market participants with a solution that involves clearing such products domestically, through a properly-managed CCP which is (i) subject to the right level of regulation (see discussion on designation and regulation of CCPs in 2.2 below) and (ii) given adequate legislative protection (see discussion on market contracts and client clearing in 2.4 below).

- 2.1.19 While there may be concerns that a domestic CCP could have a lower potential for risk mutualisation and loss-sharing compared to global CCPs and less capacity to deal with defaults, many of these risks could be mitigated by the domestic CCP adhering to international standards (for example, CPSS-IOSCO standards) and maintaining appropriate risk controls. In addition, many of these risks could be further mitigated if the membership base includes large global dealers that have expertise and resources useful in managing the risks that arise upon a member default, including operational, business and legal risks. To address this point, regulators may wish to note that HKEx intends to admit as members global financial institutions, many of which have a local presence and are regulated in Hong Kong.

Regulation of domestic CCPs: recognized clearing houses

- 2.1.20 In Hong Kong, the RCH regime already provides a framework for regulation of domestic CCPs which delivers the necessary additional protection to and the closer supervision required by systemically important transactions.
- 2.1.21 Under the SFO, the following additional requirements or safeguards apply to the regulation of a domestic CCP as an RCH when compared to an overseas CCP as an ATS provider:
- (i) An RCH has the duty to ensure that there are orderly, fair and expeditious clearing and settlement arrangements for transactions to be cleared or settled through its facilities and that risks associated with its business and operations are managed prudently. In discharging such duties, an RCH must act in the interest of the public, having particular regard to the interest of the investing public; and must ensure that the interest of the public prevails where it conflicts with the interest of the RCH. The controller of an RCH has the duty to ensure that the RCH carries out its functions and in

the discharge of its duty, the controller must also act in the interest of the public.¹⁸

- (ii) The rules of an RCH must provide for the taking of proceedings or other actions if a clearing participant appears to be unable to meet its obligations in respect of unsettled transactions and such rules must comply with the prescribed requirements of the SFO. This ensures that risks of the RCH are managed in accordance with Hong Kong law.¹⁹
- (iii) The rules of an RCH and its controller must also be approved by the SFC prior to their becoming effective. Any application to make or amend rules must be accompanied by explanations of their purpose and likely effect on the investing public.²⁰
- (iv) An RCH and its controller will not be granted the necessary recognition status unless the Financial Secretary is consulted;²¹ and no one can be appointed as the chairman of an RCH controller without the approval of the Chief Executive of Hong Kong.²²
- (v) An RCH controller is prohibited from increasing or decreasing its interest in an RCH except with the prior approval of the SFC, and no person can become a minority controller of an RCH unless the Financial Secretary is consulted.²³
- (vi) An RCH controller must establish a risk management committee to formulate policies on risk management matters relating to the activities of the RCH. The Financial Secretary has the power to appoint the majority of members in the risk management committee. This effectively ensures that the policies approved by the committee will be those supported by the Government.²⁴
- (vii) Any fees imposed by the RCH and its controller must be approved by the SFC. In deciding whether to approve a fee, the SFC must have regard to the level of competition in Hong Kong and the level of fee imposed by clearing houses outside Hong Kong.²⁵ In practice, applications of an RCH on the imposition of a new fee or an amendment of an existing fee must contain such particulars as would enable the SFC to make the necessary decision.
- (viii) Where the SFC is satisfied that a conflict of interest may come into existence between (a) the interest of an RCH or its controller; and (b) the interest of the proper performance of the relevant functions under the SFO,

¹⁸ SFOs sections 37(2) and 62.

¹⁹ SFO section 40(2).

²⁰ SFO sections 41 and 67.

²¹ SFO sections 37(1) and 59(1).

²² SFO section 69.

²³ SFO sections 60 and 61; a "minority controller" is effectively any person who acquires a 5% or more voting power at general meeting of an RCH.

²⁴ SFO section 65.

²⁵ SFO section 76.

the SFC has the power to direct the RCH or its controller to take such steps as it may specify for the purposes of remedying the conflict of interest.²⁶

- (ix) The SFC has the ultimate power to make or amend the rules of an RCH, to require an RCH and its controller to produce books and records and to obtain such other information as it may specify. The SFC can issue restriction notices on an RCH and its controller to require them to take such action relating to the management, conduct or operation of their businesses as it may specify. It also has the power to issue suspension notices to bar an RCH and its controller from carrying on any of its functions. Further, the Chief Executive of Hong Kong has the power to remove the chairman of an RCH controller.²⁷

2.1.22 In view of the above, regulators should note that domestic CCPs as RCHs would be in a unique position to perform a distinct role in relation to the clearing of systemically important transactions. Their statutory duties require them to act in the interest of the Hong Kong public.²⁸ The controllers of RCHs are also subject to the statutory duty of acting in the interest of Hong Kong. In addition, an RCH would be located in Hong Kong and its operations and business conduct would be subject to Hong Kong law. This will enable regulators to obtain information and directly manage crises on a real-time basis. Cooperation with the RCHs in dealing with default scenarios will be closer and speedier, thereby avoiding the problems which local regulators will have to face when dealing with an overseas-incorporated CCP (see 2.1.17 and 2.1.18 above).

Market contract/client clearing

2.1.23 As mentioned in 2.4 below, the SFO currently provides insolvency protections to "market contracts". These have the effect of protecting an RCH in the event of an insolvency of a clearing member, and are in line with CPSS-IOSCO recommendations. Further, following the collapse of major financial institutions in the global financial crisis and the recent insolvency of MF Global, attention has focused on the possible systemic effects of an insolvency of a major clearing member on a CCP and in turn on market participants that clear as clients of such a clearing member. Such clients will wish to ensure that their OTC derivatives transactions with the clearing member are not subject to insolvency clawback, that default arrangements can be carried out in an orderly manner and that their collateral assets are safeguarded. If the "market contract" definition in the SFO were extended to protect client contracts, as explained in 2.4 below, RCHs would be in a strong position to safeguard against the systemic repercussions of the insolvency of a clearing member on the Hong Kong financial system.

Conclusion

2.1.24 Local participants play a significant role in the HKD and CNY(HK) market as well as the CNY non-deliverable market, and there are unique features of these markets that indicate special market needs. They should therefore be regarded as

²⁶ SFC section 75.

²⁷ SFO sections 40, 42, 69, 71, 91, 92 and 93.

²⁸ We note that Principle 2 in the CPSS-IOSCO Report states that "an FMI should have objectives that place a high priority on the safety and efficiency of the FMI and explicitly support financial stability and other relevant public interests".

systemically important. There should be flexibility in the proposed regime for the SFC and the HKMA to mandate that AIs, LCs and Hong Kong persons should clear OTC derivatives designated as systemically important through domestic CCPs as RCHs. Initially, these transactions should include the products set out in 2.1.13 above.

2.1.25 HKEx agrees with and supports the objectives of the Consultation Paper. As noted in the Consultation Paper, we are in the process of establishing a new clearing house for the clearing of OTC derivatives transactions and will apply to the SFC for the clearing house to be recognized as an RCH. HKEx is committed to building a CCP that serves the interests of local players, meets the expectations of global players and offers clearing solutions that match international standards and best practices. We note, however, that the Consultation Paper has not yet formulated policies on what specific role a domestic CCP should or is expected to play in the Hong Kong regime. We invite the Hong Kong Government and regulators to develop and specify clear policies on this.

2.1.26 We also invite regulators to consider the enhancement of the “market contract” insolvency protections in the SFO to safeguard against the systemic impact of the insolvency of a market participant.

2.2 Designation and regulation of CCPs

Regulating CCPs as systemically important financial institutions

2.2.1 As the Consultation Paper recognizes, whilst CCPs are designed to address counterparty risk management and the potential contagion effects of a participant default, their structure will have the effect of concentrating risk at the CCP. As a result, CCPs are highly systemically important and should be subject to stringent supervision.

2.2.2 This is consistent with the approach taken in other jurisdictions. For example, the Dodd-Frank Act in the United States has a procedure by which regulators can designate systemically important financial market utilities (“FMUs”). This Act contemplates that CCPs are systemically important and are capable of being designated as FMUs. This designation will give regulators²⁹ wide powers to prescribe detailed risk management standards governing the operations and conduct of such CCPs.³⁰

Regulation of overseas-incorporated CCPs as authorized automated trading services (“ATS”) providers

2.2.3 HKEx notes that the current proposal for Hong Kong is to allow OTC derivatives transactions to be cleared through Hong Kong-incorporated as well as overseas-incorporated CCPs. Subject to the observations in 2.1 above, HKEx welcomes this approach and notes that the Consultation Paper proposes regulating overseas-

²⁹ The Securities and Exchange Commission and the Commodity Futures Exchange Commission, in consultation with the Board of the Federal Reserve and FSOC.

³⁰ Section 805(b). Such standards may address such areas as risk management policies and procedures, margin and collateral requirements, participant or counterparty default policies and procedures, the ability to complete timely clearing and settlement procedures and capital and financial resource requirements.

incorporated CCPs as authorized ATS providers and leveraging off the existing regime.³¹

2.2.4 We have no objection to the acceptance of overseas-incorporated CCPs for the clearing of transactions which are not designated as systemically important to Hong Kong. However, while the scope and policy of the regulatory framework are matters for the regulators to decide, in light of the discussion of the special features of the OTC derivatives market and the systemic importance of CCPs themselves, we believe that regulators should consider whether the existing regulatory regime on ATS providers should be revamped and strengthened to cater for the regulation of CCPs for the clearing of OTC derivatives.

2.2.5 While we note the regulators' views that the ATS regime is "*more flexible*" and can be "*calibrated to apply, as appropriate, to overseas CCPs since they will remain primarily regulated in their home jurisdiction*", it seems to us that in the present form, the ATS regime under Part III of the SFO is too broad, relaxed and unfocussed, particularly with respect to clearing services providers. Specifically, the SFO does not currently require authorized ATS providers to have a business presence in Hong Kong;³² their rules and rule amendments do not have to be approved by the SFC;³³ their controllers and change of interest of controllers do not require prior approval of the regulators; and there are no clearly articulated, transparent and uniform guidelines, policies or provisions on how an ATS provider offering clearing services would be regulated. At present, if an ATS provider fails to carry out its duties, it appears that the most severe penalty that the SFC could impose is revocation of the license which may not be an effective sanction in practice, particularly in crisis situations. The current regulatory regime under the SFO largely depends on ATS providers' home regulators to supervise such providers. This opens the question of whether Hong Kong regulators have sufficient supervisory and enforcement powers and regulatory control over overseas-incorporated CCPs as authorized ATS providers.³⁴

2.2.6 We should also note here that we see ATS licensing and "mutual recognition" as separate issues, see 2.2.13 and 2.2.14 below.

Should additional location or other requirements be imposed on ATS providers to ensure that the Hong Kong market and its participants are protected?

2.2.7 Internationally, there has been debate as to whether particular aspects of overseas-incorporated CCPs should have a degree of local presence in order for

³¹ Paragraph 142 of the Consultation Paper states that the ATS regime will be "*particularly suited*" to overseas CCPs who wish to provide services to the Hong Kong market.

³² There is currently no local set-up or officer requirements applicable to overseas-incorporated CCPs that obtain authorization under SFO section 95(2) as an ATS provider although ATS providers that offer trading services are required to have terminals in Hong Kong or support services to enable Hong Kong institutions to make computer-to-computer connections pursuant to the Guidelines for the SFC Regulation of Automated Trading Services.

³³ We note that the SFC may impose a condition in this respect but we are not aware of a case where such a condition has been imposed.

³⁴ We note that in the UK, the Financial Services Authority has similar powers to supervise overseas recognized bodies to those it has to supervise UK recognized bodies. It may (in addition to any other powers it might exercise):

- (1) give directions to an overseas recognized body under section 296 of the Financial Services and Markets Act 2000 (the "Act") (Authority's power to give directions) if it has failed, or is likely to fail, to satisfy the recognition requirements or if it has failed to comply with any other obligation imposed by or under the Act; or
- (2) revoke a recognition order under section 297 of the Act (Revoking recognition) if an overseas recognized body is failing, or has failed, to comply with the recognition requirements or any other obligation in or under the Act.

local regulators to effectively regulate such CCPs even though its headquarters or place of incorporation is overseas. Indeed, unless an overseas-incorporated CCP has a local presence or local responsible officers subject to applicable fit and proper criteria, local regulation may not be effective and regulators may not be able to step in case there is a crisis. A summary is set out below.

- (i) ***Incorporation in local jurisdiction:*** Although the majority of jurisdictions do not insist that an overseas-incorporated CCP seek incorporation locally, in Europe, under EMIR, CCPs are not permitted to operate unless they are incorporated in Member States and so regulation of overseas-incorporated CCPs is not an issue.
- (ii) ***Presence in local jurisdiction:*** A number of jurisdictions require that an overseas-incorporated CCP establish a presence locally. This is true in the United States where both overseas-incorporated and U.S.-incorporated derivatives clearing organizations (“DCOs”) must have a principal executive office with a United States mailing address. This is also true in Japan where an overseas-incorporated CCP is required to have a local representative.
- (iii) ***Application process:***
 - (a) In the United States and in Japan, the application process for an overseas-incorporated CCP is the same as for a locally-incorporated CCP. In the United States, an overseas-incorporated DCO must in addition provide a memorandum of law from local counsel in the jurisdiction of incorporation providing analysis on insolvency issues in that jurisdiction.³⁵
 - (b) In Japan, the application process for both locally-incorporated and overseas-incorporated CCPs is similar. In each case, the rules of the CCP must be approved by the local regulator and amendments require prior approval by the Prime Minister. The Financial Services Agency will check whether the overseas CCP's risk management structure is appropriate before granting a license and supervise the overseas CCP by cooperating with the relevant offshore regulator which granted the license to the overseas CCP in the original jurisdiction.
- (iv) ***Duties of CCP:*** In the United States, both overseas-incorporated and U.S.-incorporated DCOs are subject to the same core principles.³⁶ This is also true in Japan.
- (v) ***Others:*** In Australia, though detailed rules have yet to be made, the FMI Review proposes that local regulators impose location requirements on CCPs and be given step-in powers to intervene in a crisis situation.

Location of collateral

2.2.8 More fundamentally, there is the concern as to where collateral posted by market participants to overseas CCPs is held. For example, if one of the default situations

³⁵ 17 CFR §39.27 and Exhibit R, Dodd-Frank Act.

³⁶ As set forth in Section 5b(c)(2) of the Commodity Exchange Act, as amended by the Dodd-Frank Act. These Core Principles set out wide-ranging standards for registered DCOs.

mentioned in 2.1.16 occurs in respect of an overseas-incorporated CCP that holds collateral offshore, local market participants that had cleared OTC derivatives transactions through the CCP would face difficulties in enforcing their rights in respect of the collateral. Their enforcement of rights would involve the laws of the relevant foreign jurisdiction and there may be delays and additional costs in enforcing claims overseas. As mentioned in 2.1.17 above, while Hong Kong regulators may seek to co-operate with overseas regulators in coming up with a solution for local market participants, they will be limited in what they can do. It may hence be worth mandating that an overseas-incorporated CCP authorized in Hong Kong as an ATS provider should retain assets, including margin provided by local counterparties, in Hong Kong. In a default situation, importantly, this would enable local regulators to step in to effectively regulate the situation, if needed, and to help devise a helpful and speedy solution for local market participants.

- 2.2.9 The location of collateral is also an important consideration in the case of insolvency of a clearing member through which Hong Kong market participants cleared their OTC derivatives transactions by way of “client clearing”. As discussed in 2.1.18 above, such market participants may face difficulties in enforcing their rights to the collateral in the jurisdiction of incorporation of the overseas-incorporated CCP. The actions that could be taken by Hong Kong regulators would also be limited. This is further discussed in 2.4 where it is noted that the failure of such clearing members is not uncommon, for example, in the case of MF Global.
- 2.2.10 We note that the collateral location requirement is implicit in the United States. While there is no express requirement to hold collateral onshore, we understand that as a matter of practice, it would be difficult to attract direct and indirect participants if this was not the case.

Conclusion

- 2.2.11 For systemic risk reasons, HKEx believes that the existing ATS regime should be strengthened. We suggest that consideration should be given to imposing local presence (for example, a local office, local directors and local responsible officers) and collateral presence requirements on overseas-incorporated ATS providers that are clearing houses for OTC derivatives transactions. Further, authorized ATS providers as overseas CCPs may be subject to less stringent regulation than that applicable to domestic CCPs in Hong Kong. In addition, there is the possibility that standards may be relaxed by an overseas regulator over time. The new ATS regime should contain provisions allowing Hong Kong regulators to remove the authorization of an authorized ATS provider if its home regulator significantly relaxes regulatory standards.
- 2.2.12 In considering the authorization of ATS providers to provide clearing services to Hong Kong market participants, the SFC should also consider certain other factors, such as (i) whether proper segregation of client collateral is available to Hong Kong market participants that clear as clients of clearing members (for example, on a fully segregated or a ‘legally segregated but operationally commingled’ basis), and (ii) whether Hong Kong market participants are able to perform clearing and settlement functions without being disadvantaged by location or time zone issues.³⁷

³⁷ As an equivalent, see section 229 of the UK’s Financial Services and Markets Act 2000.

Mutual recognition

- 2.2.13 Thus far, our discussion in this section 2.2 has been as to the licensing of overseas-incorporated CCPs. We note that although there has been ongoing discussion in the international sphere as to the mutual recognition of CCPs between different jurisdictions, the issue is not discussed in the Consultation Paper. We agree with the HKMA and the SFC's approach in dealing with the issue of licensing or CCP recognition first before tackling the implications of mutual recognition as these are two distinct concepts that should not be confused.
- 2.2.14 Mutual recognition refers to one jurisdiction permitting market participants to satisfy mandatory clearing requirements by clearing through a CCP regulated in another jurisdiction, provided that such CCP is subject to equivalent standards of regulation by the second jurisdiction.³⁸ For this to happen, there must first be a framework of international co-operation and agreement between jurisdictions whereby one jurisdiction agrees to recognize CCPs regulated in another jurisdiction in exchange for such other jurisdiction extending the same level of recognition to CCPs regulated in the first jurisdiction. On the other hand, licensing refers to the criteria that a CCP has to fulfill in order to be permitted to operate in a particular jurisdiction. As the international framework for mutual recognition is to be set up, it seems logical that discussion regarding licensing or recognition of CCPs should precede the debate on mutual recognition.

2.3 Definition of "OTC derivatives transaction"

- 2.3.1 The definition of "OTC derivatives transaction" is significant to the new regulatory regime because it will delineate the widest possible scope of the mandatory obligations. It will also be applied to determine who needs to be licensed with the SFC for the purpose of the proposed new Type 11 regulated activity in respect of OTC derivatives transactions. In view of this, it is HKEx's view that such definition will need to be as clear as possible so as to create a robust regulatory regime.
- 2.3.2 The term "OTC derivatives" is commonly understood to mean bilaterally privately negotiated derivatives (in direct contrast to embedded derivatives or exchange traded derivatives). The "structured products" definition upon which the "OTC derivatives transaction" definition is based is wider, and includes a whole range of embedded derivatives (for example, derivatives embedded in securities) as well as bilaterally negotiated contracts. The definition uses carve outs to further limit this term. However, this way of defining "OTC derivatives transaction" makes the definition difficult to understand and it would be preferable to define OTC derivatives transactions "positively", that is, by reference to what OTC derivatives transactions are rather than by what they are not.³⁹
- 2.3.3 For example, in EMIR, "over the counter (OTC) derivatives" means derivatives contracts whose execution does not take place on a regulated market, as defined by Article 4(1) point 14 of Directive 2004/39/EC.
- 2.3.4 In addition, the proposed carve-outs to the definition of "OTC derivatives transaction" are framed by reference to how products are marketed. This overly

³⁸ For example, in Article 23(2) EMIR.

³⁹ Particularly given that the Consultation Paper proposes that the mandatory reporting and mandatory clearing requirements will be applied to specific types of OTC derivatives transactions by way of subsidiary legislation.

complicates the definition. However, HKEx agrees that a specific exemption for futures contracts should be retained.

2.4 Protection of client clearing

Market contracts

2.4.1 The SFO contains insolvency protections for “market contracts” cleared through RCHs. As a starting point, certain amendments need to be made to the definition of “market contract” in the SFO to allow for OTC derivatives transactions to be cleared:

- extending the scope of the “market contract” definition so that this definition either expressly includes OTC derivatives in addition to securities and futures contracts or to make the definition generic so that it would be sufficiently wide to cover OTC derivatives. There should also be recognition that OTC derivatives may or may not be traded on any market, exchange or special execution facilities.
- removing the restriction that market contracts relating to OTC derivatives must be formed by “novation”. This can be achieved by expressly allowing market contracts to be formed in accordance with the rules of the CCP irrespective of whether the novation concept is used.

Client clearing

2.4.2 HKEx notes that due to risk management concerns, CCPs have to set minimum membership criteria for membership. The class of persons the mandatory clearing obligations will apply to is likely to be wider than the class of market participants that satisfy the minimum membership criteria. These are, for example, smaller local banks. Such market participants would have to clear by means of “client clearing” through other market participants that are existing members of CCPs.

2.4.3 HKEx’s intention is to offer client clearing when the new regulatory regime comes into effect so that such market participants will have access to a domestic CCP and this has been welcomed by banks in Hong Kong.

2.4.4 Client clearing can be categorized into two main sets of contractual relationships: firstly, the contracts between the clearing house and the clearing participant and secondly, the contracts between the clearing participant and its client. The former category would already be protected by the insolvency protections in the SFO given to “market contracts” if the above amendments are made to this definition. On the other hand, unless additional provisions to the SFO are introduced, the contracts between the clearing participant and the client would not be protected by the SFO provisions on “market contracts”.

2.4.5 It is noted that end clients currently enjoy such protections in the United States and there are discussions about protecting client contracts in other jurisdictions, for example, in Australia.

2.4.6 HKEx is of the view that the insolvency protections in the SFO for “market contracts” should be extended to contracts between the end clients of clearing participants and the CCP. This is for several reasons:

- Certain market participants that do not fulfill the minimum membership criteria set by the clearing house may nevertheless be subject to the mandatory clearing obligation. These may be, for example, smaller local banks. It would be unfair for the benefits in Part III of the SFO to only extend to clearing participants and not to such other market participants.
- Extending insolvency protections would ensure that insolvency protection in respect of the CCP is comparable to international standards, and would help ensure that the CCP fulfills its obligations under the CPSS-IOSCO Report.
- This would better enable the CCP to adopt clearing models that would allow it to clear different types of OTC derivatives products thereby promoting market development and enhancing systemic protection.
- In addition, putting in place a clear legislative framework for client clearing will incentivise clearing even when not mandatory.

2.4.7 This could be effected by inserting a definition of “client contracts” and providing protection to those aspects of client clearing that arise as a direct result of the operation of the rules of the CCP. It should be made clear that such protections would be limited to such aspects and these changes would not affect the substantive operation of Hong Kong insolvency law.

2.4.8 HKEx understands this is an important protection for the market since a number of financial institutions and market participants have emphasized to HKEx the need for insolvency protection to client contracts.

Collateral

2.4.9 Crucially, such insolvency protections will ensure that collateral provided by clients of clearing members are protected in the event of the insolvency of the clearing member. For example, in the insolvency of MF Global, one of the main complaints of the global clients of MF Global was that they faced significant difficulties in ensuring that their collateral was either returned or transferred to replacement clearing members in a timely manner. Extending insolvency protections to client clearing would help protect the interests of Hong Kong market participants in such a situation, particularly if the relevant CCP is an RCH in Hong Kong and hence subject to Hong Kong regulation as described in 2.1.20 to 2.1.22 above.

2.5 Timing

2.5.1 In order to be operationally ready for the implementation of the mandatory clearing obligation by the end of 2012, HKEx plans to launch a clearing house for OTC derivatives transactions, including client clearing, by the third quarter of 2012. This means that the legislative framework which enables the establishment of the OTC derivatives clearing house should be effective by no later than the third quarter of 2012. Such legislative framework should at least provide for the following:

- (i) introduction of the definition of “OTC derivatives transaction” mentioned in 2.3;
- (ii) amendment to the definition of “market contract” mentioned in 2.4.1; and
- (iii) introduction of protections for client clearing discussed in 2.4.2 to 2.4.7 above.

- 2.5.2** It must be noted that without these changes to the SFO, the clearing house cannot be established and OTC derivatives transactions cleared through the new clearing house would not have the benefit of insolvency protections and would be vulnerable to clawback. The mandatory reporting and clearing obligations can be effective slightly later than the establishment or launch of business of the clearing house but we wish to emphasize that the point with respect to the legislative timing is of paramount importance if Hong Kong is serious about OTC derivatives regulation and being ready for complying with the G20 commitments.

The phased approach mentioned above has been adopted in other jurisdictions, most notably, the United States, the EU and Singapore. CCPs in these jurisdictions were able to commence clearing OTC derivatives transactions voluntarily before implementation of the mandatory clearing regime.

- 2.5.3** HKEx is appreciative of the fact that the SFC and HKMA are very much aware of international developments and the need to develop a local regime that is in line with international regulations. While it is likely that implementation of the Dodd-Frank Act in the United States and EMIR in the EU may be delayed, aspects of the Hong Kong framework as mentioned in 2.5.1 should not be delayed by market reforms in other overseas jurisdictions. There should be a firm commitment by regulators and the Government to put these changes into effect by the third quarter of 2012 in order to encourage voluntary clearing of OTC derivatives pending final implementation of mandatory clearing, and for the new OTC derivatives clearing house to be operational as soon as practicable.

Part B

In this part of our response, we address each of the questions in the Consultation Paper. To the extent appropriate, we have also drawn upon a number of our observations in Part A.

3 Question 1: 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?

Please see 2.1 to 2.3 above.

4 Question 2: Do you have any comments on the proposed division of regulatory responsibility between the HKMA and the SFC?

The HKEx believes that a robust and clear regulatory regime is essential for a well-functioning OTC derivatives market. Whatever division of regulatory responsibility is adopted, there should be clear division of responsibility between regulators with consistent standards adopted across industry participants.

In addition, the categories of regulated activity should be thought through carefully to eliminate overlaps.

5 Question 3: Do you have any comments on the proposal to take a phased approach to extending any mandatory reporting and clearing obligations?

5.1 The HKEx supports the phased approach to extending mandatory reporting and clearing obligations in order to give the market time to become used to complying with the obligations.

There are a number of factors relevant to whether a class of OTC derivatives transactions are capable of being designated for clearing. These factors are as set out in Article 4(3) of EMIR and include:

- reduction of systemic risk in the financial system
- whether the relevant contracts are sufficiently standardised for clearing
- the liquidity of contracts
- availability of pricing information
- ability of the CCP to handle the volumes of contracts
- level of client protection provided by the CCP

The Consultation Paper has to some extent addressed the systemic risk point in paragraphs 53 and 54 by discussing the types of OTC derivatives transactions that are most widely traded in Hong Kong. However, other factors need to be taken into consideration. In paragraph 60, the Consultation Paper seems to indicate that both a “top down” and “bottom up” approach to designation will be adopted. This is consistent with the approaches taken in Europe and in Australia, amongst others. HKEx agrees with this approach of designating clearing eligible transactions and hopes to engage in a dialogue with the HKMA and SFC as to which transactions these are. In particular, it is hoped that a committee will be set up, with participation of the regulators, CCPs and market participants

to exchange views and lay down policies on how to determine which transactions should from time to time be designated as clearing eligible. This committee should also consider the liquidity of particular products and other factors relevant to determining if a product is sufficiently standardised to be suitable for clearing.

5.2 HKEx believes that at least the following types of interest rate swaps and non-deliverable forwards are sufficiently standardised to qualify as "clearing eligible transactions" and confirms that it is our intention to be operationally ready for and capable of clearing the following types of transactions by the third quarter of 2012:

- Interest rate swaps (IRS)
 - HKD and CNY(HK) denominated single currency IRS
 - HKD and CNY(HK) denominated single currency basis swap
 - HKD and CNY(HK) denominated overnight interest swap
 - CNY non-deliverable IRS (CNY 7-day repo)
- CNY Non-deliverable forward (NDF)

5.3 In particular HKEx believes that Non-Deliverable Interest Rate Swaps (IRS) should also be included as a type of clearing eligible transaction. Non-Deliverable IRS are commonly seen in Hong Kong and in the region.

5.4 In addition, HKEx believes that for the purpose of ensuring an orderly market, it is important that the SFC and HKMA give the market advance notice of the proposed timeline as to when a type or class of OTC derivatives transaction is to be subject to the mandatory clearing obligation. This is in order to give certainty and ample notice to the market and sufficient time for participants to plan, get operationally prepared for compliance, including by investing in the infrastructure if need be.

5.5 It should also be made clear in the legislation that if the parties to an OTC derivatives transaction that is not subject to the mandatory clearing obligation nevertheless opt to clear, they should still receive the benefits of clearing.

6 **Question 4: 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?**

Please see 5.2 and 5.3 above. Please also see 2.1 above and our response to Question 8 below for our response on the location requirements.

7 **Question 5: Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?**

Interconnectedness of the mandatory reporting and clearing obligations

7.1 While the mandatory reporting and clearing obligations have different aims, they are closely connected and should complement each other. To this end, the mandatory reporting obligation should aim to provide transparency to regulators to enable them to identify and assess risks and thus needs to be wider in scope than the mandatory clearing obligation so that adequate information can be captured at an early stage for risk analysis and determination of whether transactions should be subject to the mandatory clearing

obligation or other risk management measures. On the other hand, the mandatory clearing obligation should aim to mitigate identified risks, particularly contagion risk that may result from participant defaults.

- 7.2** It is our view that systemically important transactions should be covered by both the mandatory reporting and clearing obligations. However, as the OTC derivatives market is comparatively opaque, apart from the more obvious areas (such as those mentioned in 2.1 above), regulators may not currently have sufficient information to determine which type of transactions should be treated as systemically important. Because of this, the scope of the mandatory reporting obligation should be broader than the mandatory clearing obligation as one of the key reasons for the mandatory reporting obligation is to enable regulators to gather more information about trades and manage systemic risk. As part of this information gathering exercise, regulators should also be forward looking and seek to obtain information about types of OTC derivatives transactions that may be subject to the mandatory clearing obligation.⁴⁰ Once information is collected, it should be incumbent upon regulators to make full use of the data to understand and analyze the risks posed and consider the need to mandate central clearing or to put in place other measures to manage identified risks. Hence, the two obligations should work hand-in-hand in meeting the G20 objectives.

Scope of the mandatory reporting obligation

- 7.3** Paragraph 59 of the Consultation Paper sets out the proposed scope of the mandatory reportable transactions. It is not clear whether the proposed range of transactions (namely, single currency interest rate swaps, overnight index swaps and single currency basis swaps) will cover both HKD and CNY(HK) denominated transactions (as well as CNY in the case of non-deliverable interest rate swaps and non-deliverable forwards). As HKEx believes that the HKD, CNY(HK) and CNY markets are systemically important, the mandatory reporting obligation should at least cover all HKD and CNY(HK) denominated transactions as well as CNY non-deliverable transactions falling within the proposed product range.
- 7.4** Further, we note that the proposed reportable transactions do not include non-deliverable IRS as a product type. For example, CNY non-deliverable IRS are commonly seen and has been widely traded in the Hong Kong and in the region. In light of this and the reasons set out in 2.1.17 and 2.1.18 above, we recommend that the product should also be included in the mandatory reporting obligation from the start.
- 7.5** It should be noted that without mandating the reporting obligation to cover HKD and CNY(HK) IRS and CNY non-deliverable IRS and NDF (that is, the products mentioned in 2.1.13 above) and potentially other products which may be identified as systemically important in due course, regulators will not have sufficient information regarding these products. Consequently, regulators may not realize the systemic importance of such products and may fail to designate such products for mandatory clearing in a timely manner. There is an inherent connection between the reporting and the clearing obligation in the OTC derivatives market.

⁴⁰ For example, while regulators are of the view that FX derivatives do not currently pose a systemic risk, this should be monitored carefully in case circumstances change.

Dissemination of collected data

- 7.6** The HKEx recommends that the data collected could be made available to the public in a form that is usable in due course. In making this recommendation, we note that IOSCO and CPSS published⁴¹ a consultative report, *Report on OTC Derivatives Data Reporting and Aggregation Requirements* (the “**TR Report**”). The TR Report contemplates that a certain minimum level of data be reported to trade repositories and, where necessary, regulators should have the ability to request additional data. In addition, the TR Report states that public dissemination of TR data would improve transparency of OTC derivatives markets and thus promote understanding of OTC derivatives markets by all stakeholders, promote investor protection, facilitate the exercise of market discipline and underpin investor protection. Data that is disclosed to the public should cover two main aspects:

- aggregate information on the market activity that should enable an appropriate assessment of the geographical and currency distribution of activities and notional positions, including by types of counterparty; and
- aggregate state information (that is, a snapshot) that provides views of concentration of the market.

The TR Report recommends that, if publicly disseminated in a more granular way (such as on a trade-by-trade basis), information should be released in a format that allows aggregation of data by the users easily and that whatever the method of public dissemination, confidentiality of reporting firms should be maintained.

In addition, the data should be sufficiently detailed and updated regularly.

- 8** **Question 6: 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?**

HKEX does not have comments on the reporting threshold.

- 9** **Question 7: Do you have any comments on the proposed grace periods and how they will apply?**

HKEx supports the initial six months and the subsequent three months grace periods during the early phase. However, we recommend that the grace period of three months be reviewed about 18 months from the commencement date of the mandatory reporting and clearing obligations (that is, around the 1st anniversary of the end of the 6 months initial grace period) with the view to shortening and phasing out the grace period gradually. This is because by that time, more market infrastructure and experience should have been built up and the need for a grace period should correspondingly be reduced.

- 10** **Question 8: Do you have any comments on the proposed mandatory clearing obligation and how it will apply to different persons?**

- 10.1** HKEx is supportive of the mandatory clearing obligation as proposed and the categories of persons it will apply to, namely, LCs, AIs and Hong Kong persons. Given the crucial role played by central clearing to the new regulatory regime, it is important that this obligation is framed widely in the primary legislation and be applied more precisely in the subsidiary

⁴¹ In August 2011.

legislation to particular products/asset classes. In particular, as stated in 2.4 above, HKEx plans to offer client clearing as soon as the mandatory clearing obligation comes into effect. To that end, even if persons caught by the mandatory obligation do not fulfill the minimum membership criteria, such market participants would still have access to clearing facilities.

10.2 Please see 2.1 to 2.3 above. In addition, HKEx agrees with the approach in the Consultation Paper of imposing a mandatory clearing requirement on trades "originated or executed" in Hong Kong by a LC or the Hong Kong branch of an AI. As the Consultation Paper correctly points out, many trades arranged out of Hong Kong are booked elsewhere. To carve out such trades would create too wide an exception.⁴² In any event, we also note that the Consultation Paper already proposes an "overseas person" exemption where a transaction is between two overseas persons and the trade is already subject to, or exempt from, a mandatory clearing obligation under the laws of an acceptable overseas jurisdiction.

10.3 In relation to this "overseas person" exemption, however, we wish to point out that a carve-out from the exemption in paragraph 144 of the Consultation Paper should apply to the designated systemically important OTC derivatives transactions discussed in 2.1 above. This is because, in order to achieve the objective of protecting the Hong Kong financial markets, these systemically important OTC derivatives transactions should be cleared by a domestic CCP in Hong Kong and hence the "overseas person" exemption should not apply to such transactions.

11 Question 9: Do you have any comments on the proposal to adopt a specified clearing threshold, and how the threshold will apply?

11.1 We support setting the threshold in "absolute dollar terms" and "notional value and per product class basis" as set out in paragraph 120 of the Consultation Paper. With respect to determining the "suitable level" of the clearing threshold referred to in paragraph 121 of the Consultation Paper, we agree that impact on the market should be weighed against whether objectives of the obligation would be compromised. On this, our recommendation is to follow the principle or rationale adopted by CFTC in designing its large trader programme. We understand that the intention of that programme is to capture transactions representing a given percentage (currently 70 to 90 per cent.) of the total open interest in a given market. As the intention of mandatory clearing in Hong Kong is to reduce systemic risks with respect to transactions that are deemed sufficiently standardised for clearing, it seems sensible for the clearing threshold to be set in such a way (and perhaps somewhat more conservatively) so as to capture, for example, 80 to 95 per cent of outstanding transactions in the market. These thresholds should be subject to annual review.

11.2 HKEx notes that, as currently drafted, the clearing threshold applies to both counterparties to an OTC derivatives transaction, irrespective of whether they are AIs, LCs or Hong Kong persons. While we agree that clearing is a more onerous obligation than reporting, clearing is an important risk mitigating tool and therefore, this exception should be narrowly applied, if at all. In our view, the clearing threshold should not apply to an AI, LC or Hong Kong person which is a counterparty to a transaction.

It is worth noting that no similar exceptions apply in the following overseas jurisdictions:

⁴² That said, it may be helpful if the HKMA and SFC could provide more examples as to what is meant by 'originated and executed' in order to give the market greater clarity.

- United States

No clearing threshold applies to counterparties who enter into eligible transactions pursuant to the Dodd-Frank Act. There is a limited exception that applies to a limited category of end users that are not financial counterparties, that use swaps to hedge commercial risk and that satisfy certain notification requirements (sec 723(a)(3)(7)).

- EU

No clearing threshold applies to financial counterparties, which are subject to a clearing obligation in respect of all standardised OTC derivatives. Non-financial (i.e. corporate) counterparties will not be subject to the clearing obligations under EMIR unless their OTC derivatives positions reach a clearing threshold and are considered to be systemically important. The exact details of the clearing threshold are still being discussed.

- Australia

No clearing thresholds have as yet been established.

12 Question 10: Do you have any comments on the proposed grace periods and how they will apply?

Please see the response to Question 7 above. In addition, if the HKEx were to be approved by the SFC to clear OTC derivatives transactions, it would intend to offer client clearing and would also open membership to overseas participants.

13 Question 11: Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?

HKEx does not have comments on this proposal.

14 Question 12: Do you have any comments on any aspect of our proposals for the designation and regulation of CCPs?

14.1 Please see 2.1 and 2.2 above for a full discussion.

14.2 Indirect clearing: please see 2.4 above on client clearing.

14.3 *Acceptability of overseas clearing members:* HKEx is supportive of allowing overseas clearing members. Such members would include overseas-incorporated AIs with a Hong Kong branch as well as reputable and creditworthy financial institutions in acceptable jurisdictions which may not have a physical presence in Hong Kong.

15 Question 13: Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?

Please refer to our response to Question 2.

16 Question 14: Do you have any comments on the proposed regulatory oversight of large players?

HKEx does not have comments on this proposal.

17 Other comments

- 17.1** Timing: Please see our comments in 2.5 above to the effect that, notwithstanding any delays in international regulatory reforms, certain changes to the Hong Kong legislation are essential for the operation of an OTC derivatives clearing house and should be brought in by the third quarter of 2012.

HKE_x

30 November 2011