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Dear Sirs

Response on Consultation Paper on the Proposed Regulatory Regime for Over-the-Counter Derivatives Market in Hong Kong (the Consultation Paper)

Allen & Overy appreciates the opportunity to express its views on the Consultation Paper. Our responses to the questions set out in the Consultation Paper are set out below. We would be pleased to discuss the issues below further, or to assist in any way that the SFC and the HKMA deem appropriate.

All capitalised terms that are not defined in this letter will have the meanings given to them in the Consultation Paper.

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?

A: ***General comments***

We appreciate the underlying influences and reasons in respect of the initiatives taken by the SFC and the HKMA on regulatory reform of the OTC derivatives market in Hong Kong, in particular the increasingly globalised nature of the OTC derivatives market, the complexity and variety of OTC derivatives products and the importance of transparency in such market.

We believe this Consultation Paper is timely as Hong Kong works towards meeting the G20 commitments by the end of 2012. We agree that it is important to ensure that regulation of financial markets in Hong Kong is in line with international standards (and at the same time recognising that regulations on the global front are evolving and that the scale of the markets may be different). We are supportive of the principles underlying the proposals raised in the Consultation Paper of greater transparency and stability of the OTC derivatives market through appropriate regulation. We set out our comments below in relation to the Consultation Paper.

Comments on the proposed legislative framework

We support the proposed legislative framework of setting out the main obligations in the primary legislation and details of the scope of such obligations in subsidiary legislation to be introduced in phases. This flexibility will enable Hong Kong regulators to monitor the developments globally and consider these in the context of the Hong Kong market before we decide to specify new product classes (and applicable restrictions) for the purpose of mandatory clearing and reporting.

We agree that this flexibility is necessary bearing in mind that the global regulatory standards for OTC derivatives markets are still evolving and also because the timeframe for agreeing all details at the primary legislation stage is too tight. It is important to consider what needs to be set out in primary legislation – for example, we agree that this should include amendments to segregation and portability rules and related changes to the insolvency regime. However, these are complex matters that may take time.

Another potential drawback to this approach is that the key details, and the scope and implications of the regime can only be ascertained as and when the subsidiary legislation is drafted, which creates uncertainty and unpredictability for market participants. We have seen this approach taken in the United States through the Dodd Frank Act and the issues this could cause. As such, a clear timeframe and advance notification on how this legislative framework will be carried out is crucial, so as to give certainty and predictability to market participants (and to allow sufficient time for them to put in place internal policies, systems and infrastructure in order to comply with any changes in the rules). We note that if the timeframe were to slip at the global level, this is likely to push out the timing of implementation in Hong Kong, which would be sensible to ensure that Hong Kong keeps in line with global developments.

Scope of regulation – definition of "OTC derivatives"

We note that the Consultation Paper uses the same term "OTC derivatives" both for the purposes of determining (a) the potential scope of mandatory obligations and (b) the potential scope of licensing requirements. However, there is a carve-out for end-users in the case of the licensing regime. We would suggest that there should be a similar carve-out for end-users from mandatory obligations and in this respect, believe an exemption for hedging commercial risks should be included.

We note further the suggestion to define "OTC derivatives" by reference to "structured products". We are of the view that this definition could work but it is important to ensure that (a) the carve-outs from the definition of "structured products" are wide enough to cover all securitised products as these would not be appropriate for mandatory clearing or reporting and (b) it is clarified that all

derivatives traded on a REC should be excluded (this is in line with the proposal under European Market Infrastructure Regulation –EMIR).

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

A: We are of the view that the proposed division of regulatory responsibility between the HKMA and the SFC is a sensible one. It would however be prudent to review the existing Memorandum of Understanding between the SFC and the HKMA to determine whether any amendment is necessary in light of the current proposed division of regulatory responsibility.

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

A: We welcome the proposal to take a phased approach to extending any mandatory reporting and clearing obligations, as this allows flexibility in enacting legislation and enables monitoring of global developments and consideration of the needs of the Hong Kong market in light of these developments. However, it would be important to ensure that any proposals for extensions to the mandatory obligations are subject to appropriate market consultation.

We agree that the initial product types for mandatory obligations should be those that are widely traded in Hong Kong as well as satisfy the test of being systemically important to Hong Kong.

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?

A: As mentioned in Question 3 above, it makes sense to initially limit the scope of any mandatory reporting and clearing obligations to the products that account for a larger share of the OTC derivatives market in Hong Kong. However, even within such class, it is important to consider the liquidity in the product and the level of standardisation of contracts. We would suggest that more precise parameters be set in respect of the relevant IRS and NDF, both in terms of relevant currency as well as relevant tenor.

This is because it is important to ensure that the legislation ultimately provides a very clear scope as to which types of transactions and products are captured by the mandatory reporting and clearing obligations.

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

A: *General*

We note the reasons underpinning the proposal of setting up a Hong Kong trade repository for the purpose of mandatory reporting, recognising that this may help regulators to identify more promptly potential risks arising from the build-up of exposures and to take action to mitigate any threats to market stability.

However, it is important to ensure that the reporting standards and specifications adopted by the HKMA TR are in line with the international standard setting bodies and majority industry platforms, and that we should continue to work closely with other jurisdictions and TR operators to facilitate the sharing of data. We appreciate that regulators worldwide (including the HKMA and the SFC) are actively in discussions on agreeing the data sharing framework that governs the rules, format and level of data from TRs and CCPs through discussions at international forums such as the OTC Derivatives Regulators' Forum.

We also understand that these discussions include the concept of a global TR. We believe that this should be factored into the proposal for the following reasons: (a) this will remove the need for duplicate reporting, especially in the case of market participants with branches and subsidiaries in various jurisdictions and (b) this will ensure consistency in the method and the substance of reporting, which will ensure efficiency from a cost, timing and administrative perspective for market participants.

Reporting obligation for AIs and LCs – "originate and execute"

We note that LCs and locally and overseas incorporated AIs are required to report all reportable transactions that they have "originated or executed" (and, in the case of overseas AIs, where they have done so through their Hong Kong branch). The meaning of "originated and executed" is elaborated on in paragraph 64 of the Consultation Paper to cover the situations where the LC or AI has negotiated, arranged, confirmed or committed to the transaction on its own behalf or on behalf of any counterparty.

To the extent that the concept of "originate and execute" is to be retained in the proposed legislation, we would like to seek further clarity on the meaning of "having negotiated, arranged, confirmed or committed to a transaction". Without more precise meaning to the terms, it is unclear what degree of involvement is necessary before this obligation is triggered. Parties whose involvement was only peripheral would still be potentially caught. We query whether it is indeed, or ought to be, the intention to capture those transactions that may not have any significant Hong Kong connection. We would recommend that the legislation sets out definitions of the individual elements of this wording and that (in any event) the SFC and HKMA provide guidelines on the meaning of these terms to assist the market in respect of the inevitable areas of difficult interpretation. Only parties who have a real and significant involvement in the reportable transactions should be caught under the concept of "origination and execution" and those transactions where the parties may have merely acted as a 'post box' or performed a trivial or insignificant role should be eliminated. It is important to reflect on the purpose of the reporting obligation and to recognise that too much information from too many transactions may in itself be unhelpful to regulators.

There is also a practical consideration as we understand that the existing operations and infrastructure of some financial institutions are not set up to identify the originator or executor for a transaction, which adds to the difficulty in complying with this requirement.

Hong Kong nexus

We understand that the concept of "Hong Kong nexus" is to capture those products which may be systemically important to Hong Kong. We note that this definition as currently drafted is very broad and we would suggest that it be reconsidered to ensure that the definition is not a "hair-trigger" for any transaction that may reference a Hong Kong rate or share but that only those categories of transactions as more carefully defined are caught (for example, for equity derivatives, should only Hong Kong listed shares be caught rather than any shares of a Hong Kong incorporated company). We believe that further research should be undertaken in this area and that this category of transactions may be more appropriate to be included (at the secondary legislation level) in a later phase.

Other issues

On a practical level, the stipulated time for disclosure to be made (T+1) may be too short – reference may be made to the Disclosure of Interests under Part XV of the SFO which is T+3. It is likely that more time will be needed for large groups to verify their net positions. More time will also be needed for AIs or LCs who have originated or executed the reportable transaction to ascertain

whether the counterparty has in fact reported the relevant transaction to the HKMA-TR (and therefore discharging the AI or LC's reporting obligation).

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?

A: We note that the reporting threshold will be set on a per product class basis, and that each product class may cover a single product type or a group of product types. It is important that such classes be well thought through and clearly defined such that the product classes are not overly granular.

It is currently contemplated that all transactions falling within the same product class should be taken into account for the purposes of determining if the specified threshold has been exceeded, irrespective of whether or not they are reportable transactions and whether or not an exemption applies. However, we query whether the focus should be on the classes or types of transactions that will assist the regulators in monitoring systemic risks and those that are considered to be of concern. For example, we note that foreign exchange derivatives (which have been regarded as less risky from a credit perspective) have been excluded from the requirement of mandatory obligations. We query whether the same approach should be adopted here for the purpose of calculating the reporting threshold.

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

A: Grace periods are welcomed so as to allow time for market participants to adjust to the new regulatory regime. Taking into consideration the extensive infrastructure changes involved, the time required for system upgrades and training of internal staff to ensure compliance, the proposed grace periods of 3 months for setting up the reporting channel and 6 months for completing any back loading may be too short. We therefore suggest further review and market consultation on this after certain key concepts and issues are ironed out (for example, clarity on the concept of "execution and origination"). We also note that the grace periods should be in line with global standards and consideration should be given to any longer grace period to allow for a global TR to be put in place.

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

A: ***Conflicting Requirements/Overseas Membership***

We understand the reasons for the introduction of a local CCP for the purpose of carrying out the mandatory clearing obligation and we are supportive of accepting overseas membership. A challenge associated with mandatory clearing is the possibility of conflicting clearing obligations which may occur for transactions entered into on a cross border basis. For example, where a transaction involves a Hong Kong counterparty and a U.S. counterparty, both are likely to be subject to mandatory clearing obligations in their respective jurisdictions. A conflict may arise as the transaction can only be cleared through one CCP, unless there are rules to deal with this situation. Although the Consultation Paper provides for exemption to this clearing obligation where the counterparties are overseas persons and where the transaction is subject to or exempt from mandatory clearing under the laws of an acceptable overseas jurisdiction, there is still room for potential conflicts, for example, for the purposes of the Hong Kong regime, where one of the counterparties is viewed as having "originated or executed" through its Hong Kong branch, the overseas persons exemption would not be available.

It is therefore very important for regulators globally to co-ordinate and work together to identify any potential overlaps, gaps or conflicts and to find solutions to resolve these issues on a consistent basis. These inconsistencies, if not addressed, could compromise achievement of the G-20 objectives.

We believe that mutual recognition of CCPs between different jurisdictions will be important as one of the key ways to resolve conflicts in mandatory clearing requirements. Both the regulators in the United States and Europe recognise the potential issues caused by such conflicts and extra-territoriality. EMIR, for example, provides for mutual recognition of non-EU CCPs if certain criteria are met (including that the third country has (a) an authorised and effectively supervised CCP, (b) an equivalent legal and regulatory framework and (c) co-operation arrangements with relevant EU competent authorities). It is imperative that not only the concept of mutual recognition be accepted by regulators but detailed provisions on how a CCP can apply for recognition would be required. In the event that the details of how such mutual recognition regime are not in place by the end of 2012, we would suggest that exemptions or deferrals be provided to trades that are subject to conflict until such time as the mutual recognition regime is in place.

Issues relating to Origination and Execution

Please refer to our comments under Q5 above in relation to our various comments in relation to the concept of origination and execution.

Hedging Exemption

We note that in the United States and in Europe, there are exemptions available for non-financial entities or end-users hedging commercial risk from mandatory clearing requirements as long as certain notification requirements are satisfied. We would appreciate if the SFC and HKMA would consider granting a similar hedging exemption from the proposed mandatory clearing obligation. This may be as a carve-out to the definition of "OTC derivatives" – see our comments under Q1 above. If a hedging exemption is indeed made available, we would also suggest that clear parameters are provided on what constitutes "hedging commercial risk" such that participants are clear as to what transactions fall within such an exemption.

Both Parties Having Exceeded Specified Clearing Threshold

We note that for the clearing obligation to be triggered, both counterparties would have to exceed the specified clearing threshold in relation to the OTC derivative positions in the same product class. As a practical matter, we query how a counterparty can ascertain whether the other party has exceeded such a threshold.

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

A: Please refer to our comments under question 6 above.

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

A: Market participants are likely to prefer a longer grace period so that they have sufficient time to set up clearing relationships as well as to allow for the necessary infrastructure to support central clearing.

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

A: We agree with the proposal not to impose a mandatory trading obligation at the outset. Mandatory trading involves a high cost of compliance, and, therefore, this should only be introduced after careful assessment of the liquidity levels and number of potential trading venues available in the market.

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

A: Please refer to our comments under *"Conflicting Requirements/Overseas Membership" under Question 8.*

The current proposal provides that only an RCH or an ATS provider will be permitted to be designated as a CCP for the purposes of the mandatory clearing obligation. We agree with this approach. We note that the exact requirements are yet to be provided and further agree those requirements should be in line with international CCP requirements.

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

A: We agree that there are advantages and disadvantages to the two options proposed for the regulation of intermediaries as set out in paragraph 166 of the Consultation Paper. It is important that whichever option is adopted, there is a level playing field for AIs and LCs in the conduct of OTC derivatives regulation. We are of the view that option (2) is preferable since the various types of regulated activities will be keyed off the definition of "structured products" (but with different carve-outs for the different activities) and so it will be tidier and easier to monitor compliance under this option.

We consider that persons who would otherwise trigger a licensing requirement under Type 11 but solely act in the context of commercial hedging should for the avoidance of doubt be clearly excluded from the licensing regime. Please also refer to our response under Q8 above.

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

A: The Consultation Paper indicates that there will only be a very limited number of players that fall within the category of "large players". No specific details/thresholds have been provided at this stage as to who will be affected by this. We would suggest that both (a) the criteria for determining "large players" and (b) the manner of potential regulation (e.g. level of reporting) should be set out in detail as this category represents an exception to the general rule not to regulate end-users and so should be defined narrowly.

Please do not hesitate to contact us if you have any questions or wish to discuss any of the above matters.

Yours faithfully

Allen & Overy