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Supervision of Markets Division
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29 November 2011

Dear Sirs

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

LCH.Clearnet Group Limited ("LCH.Clearnet" or the "Group") is pleased to provide feedback to the HKMA and SFC report on the over-the-counter (OTC) derivatives market in Hong Kong ("the report").

LCH.Clearnet is the world's leading clearinghouse group and the most experienced provider of OTC clearing services globally. The Group's SwapClear service is the only truly global clearing service for interest rate swaps ("IRS"). Since launch in 1999, over 1.8 million IRS trades have been cleared through SwapClear. The service currently has 60 clearing members and a portfolio of 976,000 trades with a notional value in excess of US \$290 trillion (a further US \$85 trillion of cleared transactions have been removed through multilateral trade compressions). Crucially, SwapClear is also the only OTC clearing service to have successfully handled a significant default; its centralised and tested default-management process ensured that the unwind of the Lehman Brothers' US \$9 trillion IRS default proceeded smoothly and without loss or impact on surviving members or the wider marketplace.

LCH.Clearnet Limited, one of the CCPs operated by the Group, operates in Hong Kong to clear contracts on the Hong Kong Mercantile Exchange and is authorised as an automated trading services (ATS) provider by the SFC in respect of that business.

Consultation

The HKMA and SFC ("the authorities") are inviting comment on the proposed shape of regulation of the OTC derivatives market in Hong Kong. In response to the G20 commitments, the report sets out proposals for mandatory reporting and clearing obligations; the designation and

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regulation of CCPs; and the regulation of OTC market participants. LCH.Clearnet is providing a response in relation to certain aspects of the report, chiefly in relation to clearing obligations.

Mandatory obligations and the products to be covered (Q3-Q4)

LCH.Clearnet considers that the phased approach that the authorities are proposing is a sensible and practicable response to the question of identifying a set of instruments to be subject to mandatory clearing. The report identifies that decisions taken in other jurisdictions, for instance in relation to foreign exchange transactions, may be relevant in determining the scope and timing of the obligation being imposed.

Based on the data presented in the report, LCH.Clearnet agrees that the IRS and NDF markets would appear to be the most suitable for the application of mandatory clearing requirements in Hong Kong. LCH.Clearnet understands that the clearing obligation would apply to all IRS and NDFs, regardless of the underlying currency denomination(s), subject to the exclusions set out later in the document.

We note that the application of a mandatory clearing requirement will be dependent on the existence of a suitable clearing service offered by a designated CCP. The combined top-down/bottom-up approach to identifying instruments for mandatory clearing is consistent with approaches being taken elsewhere in the world.

Proposed mandatory clearing obligation (Q8-Q10)

The authorities' proposed approach to mandatory clearing sets out a series of tests to identify whether a transaction is captured. The inclusion of a decision tree in the report has been helpful in understanding the wider implications.

LCH.Clearnet interprets the proposed requirements as meaning that, subject to the exemptions below, any clearing eligible transactions where a Hong Kong entity is a counterparty, or a Hong Kong sales/trading desk arranged the transaction, would be captured by the obligation. These transactions would have to be cleared by a designated CCP (ie one authorised as an RCH or ATS in Hong Kong).

LCH.Clearnet understands the scope of the exemption to mean that where both counterparties to a clearing eligible transaction are overseas persons and the transaction is cleared, or exempt from clearing, under an overseas jurisdiction, then mandatory clearing under the Hong Kong regime would not apply, even if the transaction had been arranged by a party located in Hong Kong. LCH.Clearnet considers that, given the broad range of entities active in Hong Kong, as a global financial centre, it would also be appropriate to extend this exemption to cover AIs that are incorporated overseas, but acting through their Hong Kong branches.

LCH.Clearnet understands that transactions between overseas-incorporated AIs with Hong Kong branches, that are executed through locations other than Hong Kong would not be captured by the proposals.

LCH.Clearnet supports the decision not to extend the clearing obligation to transactions that are denominated in Hong Kong dollars but are not otherwise connected with Hong Kong (ie are not carried out by Hong Kong incorporated entities nor arranged by Hong Kong branches of overseas

entities). Transactions executed in other financial centres will be subject to mandatory clearing requirements (if any) in the relevant jurisdictions.

LCH.Clearnet considers that the proposed threshold mechanism, including the measurement of notional values and the planned provision of grace periods, are reasonable in principle although the impact on market participants can only be assessed once specific figures for the threshold levels are known.

Designation and regulation of CCPs (Q12)

LCH.Clearnet considers that the conditions set out for designation of CCPs in section G of the report are sensible extensions to the current policy. At a later stage of consultation it may be useful for the SFC to set out more fully where it intends to impose requirements for CCPs clearing OTC derivatives that go beyond existing requirements.

The report acknowledges that other jurisdictions have proposed, or are consulting on, location requirements for systemically-important financial market infrastructure. Whilst there may be legitimate concerns about offshore entities offering services to local institutions, LCH.Clearnet, as a global CCP, ensures that it complies with local regulatory requirements, and engages proactively with regulators in each jurisdiction where it is active. We do not consider that additional location requirements are necessary: they may even have counterproductive effects such as loss of efficiency.

Conclusion

We hope that the authorities find the above comments to be helpful and constructive. We believe that the depth of our experience, combined with our OTC market expertise and the wide geographic scope and deep product breadth of our activities, makes us uniquely well-qualified to comment on these matters.

LCH.Clearnet, as the world's pioneering OTC derivatives CCP group, fully shares the authorities' goals in ensuring a stable, safe and efficient global financial system. Please do not hesitate to contact us should you have any questions on our submission, or if you would like to discuss any of the matters raised in greater detail.

Yours faithfully