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Dear Sir/Madam

Thank you for the opportunity to comment on the consultation paper on the proposed regulatory regime for the over-the counter derivatives market in Hong Kong (October 2011) jointly issued by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC).

State Street is a leading financial services provider serving some of the world's most sophisticated institutions such as pension funds, mutual funds, endowments and sovereign wealth funds. State Street offers a suite of services that spans the investment spectrum, including investment management, research and trading, and investment servicing. As of 30 June 2011 State Street had US\$22 trillion in assets under custody and administration and US\$1.9 trillion under management as well as operations in 27 countries and a network which spans more than 100 geographic markets.

State Street is one of the world's largest processors of derivatives transactions and as such has been active in policy discussions about central counter party clearing of derivatives in the US, Europe and the Asia Pacific. We support derivatives clearing and execution which we believe will reduce global systemic risk and, properly implemented, benefit our institutional investor customer base. State Street is also well positioned to provide our clients with full-service clearing and other services that can help them realize the benefits of the new derivatives regime, through enhanced transparency, more open execution platforms and central clearing.

We agree with most of the proposals in the HKMA/SFC consultation paper relating to reporting and clearing, including the pragmatic approach to accepting overseas clearing in some instances. We do, however, have some concerns about the proposed joint regulation of the derivatives regime by the HKMA and SFC and the delayed introduction of mandatory trading. We also have some thoughts on the segregation and portability of client assets which may be useful as Hong Kong develops its thinking on these issues. In addition, we have provided some views on the membership of CCPs, an important issue which was not addressed in the consultation. Our detailed comments follow below.



Securities and Futures Ordinance (SFO)

We support the proposal to wait until key aspects of OTC derivatives reform are finalized in the global arena, particularly in the US and Europe, before finalizing Hong Kong's approach. In this regard, the proposal to set out the new OTC derivatives regime in primary legislation under the Securities and Futures Ordinance (SFO) and then to set out details in subsidiary legislation, including the key definitions that will delineate the scope of any mandatory reporting, clearing and trading obligations, makes sense.

Joint Regulation by the HKMA and SFC

We have some concerns about the proposed joint regulation of the derivatives regime by the HKMA and the SFC. Under this approach the market will be regulated by entity rather than by product. The two regulators will need to have similar, if not identical, rules otherwise there is a risk of regulatory arbitrage or worse, an advantage for one type of entity over another.

Reporting to a Trade Repository

On the reporting of transactions to a Trade Repository (TR), we do not have any issue with the proposal to initially report on four types of products, namely, single currency interest rate swaps, overnight index swaps, single currency basis swaps, non-deliverable forwards.

Reporting on transactions that were: (1) originated or executed through an overseas incorporated Hong Kong AI, or (2) where the overseas incorporated Hong Kong AI is a counter party, or (3) where the transaction involves a HKD asset, currency or rate is understandable. We do, however, encourage as much standardization in the HK reporting regime and other major international reporting regimes to reduce the compliance burden for international firms operating in many different markets.

The T+1 timeframe for reporting is also manageable as is the proposed three to six months grace period for existing or new transactions. We also support the proposal to report all transactions, rather than those an AI determines are not reported by others, as this will reduce the complexity and compliance burden for participants.

Care needs to be taken in determining the detail around the type of information required and the timing of the release of such information. The reporting should be sufficient to provide transparency but not provide information which can place anyone at a disadvantage. In addition, the timing needs to be fast enough to



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make it effective but not so fast as to allow the market to take advantage of any participant working on multi-leg trades. As recommended in the paper, cleared and bilateral trades should be reported to ensure transparency in the market is achieved.

Clearing

We look forward to further consultation on the products, as yet unidentified, that should be cleared.

We support the proposal that a mandatory clearing obligation should only apply if an overseas incorporated AI is a counter party to the transaction or originated or executed the transaction. We welcome the proposed exemption from mandatory clearing if : (I) both counterparties are overseas persons, and (II) the transaction has been cleared through a CCP in accordance with the laws of an acceptable overseas jurisdiction or is exempt from central clearing under those laws.

The proposal to allow the use of overseas CCPs and to recognize the laws of an acceptable overseas jurisdiction is particularly welcome as it would reduce concerns about how to manage a lack of liquidity in domestic markets for some products and the costs of posting collateral in multiple locations.

We note the preference in some jurisdictions to clear transactions in domestic products that are of systemic importance, such as domestic currency denominated products, through domestic CCPs which was discussed in the consultation paper. In considering domestic clearing for some products, the likely volume of transactions and extra costs associated with breaking up transactions and posting collateral in various locations needs to be considered carefully. The difficulty of ensuring domestic clearing for transactions involving two offshore parties also needs to be recognized.

We support the proposal for overseas incorporated AIs, such as ourselves, to operate under existing licenses and the licensing of other key players under the SFO if they serve as intermediaries.

Finally, we suggest that products that are identified for clearing be consistent on a global basis. For example, the US Treasury has proposed that FX forwards and swaps not be subject to the Dodd-Frank mandatory clearing requirement, and we urge HKMA/SFC adopt a similar approach.



Mandatory Trading Obligation

We note the proposal to defer mandatory trading obligations, and therefore electronic trading, and focus initially on clearing and reporting. Concerns about fragmentation and liquidity are cited as the key driver. While we understand that point of view, if clearing and execution is not simultaneously required, users could incur additional expenses related to clearing without the benefit of increased transparency, narrowed spreads and cost reductions for transactions that electronic trading would bring. Introduction of a simultaneous clearing and execution mandate will encourage new entrant market participants, increase competition, and better serve the goal of establishing robust CCPs.

In the US, under Dodd Frank, clearable trades will be required to be executed electronically through a Swap Execution Facility ("SEF") or exchange where available. Many existing electronic trading venues could be easily converted to execute derivatives. State Street, for example, operates a foreign exchange trading platform, and is evaluating whether to operate one or more swap execution facilities ("SEFs").

Segregation and Portability of Client Positions

As noted in the consultation paper (paragraph 154) a key aspect of indirect clearing (or client clearing) is to ensure portability and segregation of client positions and collateral. We note that Dodd Frank requires collateral segregation and portability to allow investors to move their positions in the case of a clearing broker default. We see benefits in this for clients as their risk will be reduced.

Custodians, such as State Street, may be able to play a role in ensuring collateral segregation and portability. The use of tri-party custody arrangements could provide buy-side counterparties higher levels of protection and greatly increase operational efficiencies compared to an environment where dealers are allowed broad use of comingled customer assets or where customer assets are held separately from the intermediary but comingled with other customers.

Membership of CCPs

An important issue not raised in the paper is the criteria for direct membership of CCPs. This has been a topic of discussion in the US and Europe. We support membership requirements that permit fair and open access (as under Dodd Frank). Open access will reduce systemic risk by avoiding concentration of clearing activity with a small number of existing dealer members, and benefit the buy-side by allowing netting across dealers on swaps that clear through the same clearinghouse.



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Clearing members must be required to demonstrate the necessary financial and operational resources to execute their duties to customers and the clearinghouse. Strong capital rules are important, but should be risk-based rather than arbitrary dollar amounts. Capital requirements could be linked to other risk-based clearinghouse measures, such as a multiple of default fund contributions. Other arbitrary requirements linked to a dealer-specific business model, such as a minimum swap book, are not risk-based and will prohibit membership by non-dealer firms. Outsourcing of certain functions should be allowed provided that the execution risk associated with such outsourcing rest with the member firm and not the clearinghouse.

Thank you again for the opportunity to comment on the consultation paper. Feel free to contact us should you have any questions about the above. We would like to stay engaged as Hong Kong develops its approach to central counter party clearing and offer the expertise we have gained in the derivatives market and through our participation in similar discussions overseas, particularly the US and Europe.

Yours sincerely

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