Alternative Investment Management Association

Supervision of Markets Division
Securities and Futures Commission
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Submitted via email
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7 December 2011

Dear Sirs,

HKMA and SFC consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to provide comments on the Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) (together, the Authorities) consultation on the 'proposed regulatory regime for the over-the-counter derivatives market in Hong Kong' (the Consultation).

AIMA summary of comments

- AIMA broadly supports the proposed regime for the over-the-counter derivatives market in Hong Kong;
- The HKMA and SFC should have joint regulation of the market, ensuring that all active market participants are subject to appropriate regulation and oversight;
- The mandatory reporting obligation should avoid unnecessary duplication where Authorities are able to obtain and rely on data reported to third country repositories;
- The final Hong Kong regime should align with, and conform to the regimes adopted by the major markets and not go any further;
- AIMA does not object to a phased in approach in Hong Kong restricted at the outset to interest rate swaps (IRS) and non-deliverable forwards (NDFs) but encourages later consideration of a full range of products as appropriate;
- The Authorities should have a clear regime for determining which classes of OTC derivative contracts should be subject to mandatory clearing;
- The mandatory clearing obligation should not be applicable to two non-Hong Kong Persons trading a class of eligible OTC derivatives;
- The Authorities should introduce an appropriate de minimus clearing threshold applicable only to Hong Kong Persons and other buyside firms but should allow those parties to clear on a voluntary basis if they chose (including voluntary backloading of outstanding trades);

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in over 40 countries.

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- In due course, the Authorities should implement a mandatory trading obligation for eligible transactions, although it is important that the effects on market liquidity are assessed and that the industry is consulted further about such a proposal;

- The Authorities should provide an appropriate regime for the regulation of recognised clearing houses (RCH) and automated trading services (ATS). This should provide suitable corporate governance arrangements which include buyside participants and should allow for the provision of client clearing full segregation and portability of assets and positions; and

- All active sell side market participants should be subject to appropriate regulatory regimes, including Large Players (not regulated as authorized institutions (AIs) or licensed corporations (LCs)) who have large gross outstanding uncollateralised exposures. Such requirements may, where appropriate, include: (i) reporting to the Authorities; (ii) appropriate margin and capital requirements; and (iii) position management agreements with the Authorities.

AIMA's comments

AIMA members are active participants in the global derivatives markets, using derivatives for investment and hedging purposes and have supported the commitments of the G20 leaders at the September 2009 Pittsburgh summit to mandate trading and clearing of suitable over-the-counter (OTC) derivative contracts[2]. As AIMA members are active in the Hong Kong market (both those established domestically and outside of Hong Kong) and wish to see an overall reduction in systemic risk, we support the proposals of the HKMA and SFC to implement the G20 commitments.

AIMA's hedge fund manager members are, in the majority of cases, clients of clearing members rather than direct clearing members of market central counterparties (CCPs). We, therefore, comment on issues raised within the consultation that are relevant to clients who trade OTC derivatives with derivative dealers and other market participants.

We set out our specific answers to the questions posed in the annex to this letter. However, in addition to the comments we make on the Consultation proposals, we believe that the Authorities should also keep in mind the potential need in due course for establishing a regime for those OTC derivatives that are not suitable for clearing. The Authorities should also work with the CCPs to give consideration to how collateral is calculated for eligible transactions and what form it may take for cleared OTC derivatives. The Authorities should also give consideration to whether clearing members and derivative dealers should be subject to specific capital charges and whether these capital charges should be higher for uncleared trades to encourage the take up of central clearing of eligible transactions. In each case, we agree that it will be important to continue consulting with relevant stakeholders and implement international standards as agreed by the Basel Committee on Bank Supervision and other international bodies such as CPSS/IOSCO.

We support the HKMA and SFC in their joint effort to address regulation of the OTC derivatives market and believe that robust coordination between the two Authorities, such that between them no active party escapes regulatory scrutiny. Each of the Authorities will have to give serious consideration to the expected timing for implementation of the new regime, given the internationally agreed 31 December 2012 deadline for implementation of

[2] The leaders of the G20 nations' commitment at the September 2009 summit in Pittsburgh that "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories."

OTC derivatives clearing. The Authorities should strive, where possible, to meet this deadline but we would encourage that the priority be for the regime to be implemented only when the crucial aspects of the regime have been fleshed out and consulted with the relevant stakeholders and firms are ready to meet new obligations.

To ensure proper implementation and minimise market disruption, market participants will need to be given adequate time to prepare for compliance with the new regime. The diversity of participants potentially subject to a mandatory clearing regime may also require a phasing in of the different obligations based on the category of participants. Clearing members, dealers and active traders may be able to take up central clearing earlier than other counterparties. However, phasing in of the clearing obligations in relation to various types of contract should be undertaken only to the extent some contracts may not be suitable for clearing or where CCPs have not yet developed a clearing solution.

Conclusion

AIMA supports the proposed regime discussed in the Consultation and believes that the reporting obligation should be extended to all parties for all OTC derivatives and that the clearing obligation should be extended to the vast majority of parties for all suitable OTC derivatives. All market participants, CCPs and trade repositories should be properly regulated to ensure the robustness of the proposed new regime. Any mandatory trading obligation for eligible transactions should be given additional consideration to ensure that its implementation in due course provides improvements to the market and does not negatively impact existing liquidity. In all aspects of the proposed regime, the Authorities should carefully consider how the new obligations will interact with parties established outside of Hong Kong, trades conducted on overseas exchanges by Hong Kong established entities and the OTC derivatives clearing and reporting regulatory regimes of other jurisdictions.

We thank you for this opportunity to respond to the Consultation and we are, of course, very happy to discuss with you in greater detail any of our comments.

Yours faithfully,

AIMA Hong Kong

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Annex

The Broad Framework

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?

Legislative Process

AIMA believes the Authorities have given much consideration to the broad framework for reporting and clearing of eligible OTC derivatives given their commitments agreed at the September 2009 G20 summit. As a matter of necessity, a regulatory regime for OTC derivatives will be detailed and complex. Therefore, we agree that primary legislation should be introduced that sets out the core obligations and the framework for regulation and that secondary legislation should be used to provide necessary detail for parties to meet their obligations. The obligations under the primary legislation should not become effective until the secondary legislation is complete. The definitions in secondary legislation will be key to the regime and these will have to be carefully considered as they will likely impact the scope of the regime and the obligations that will be applicable to different types of entity. Facilitating these changes by amending the Securities and Futures Ordinance (SFO) to leverage existing provisions and definitions is a sensible approach and one which we support, however, great care will be needed to ensure consistency within the revised legislation. As is recognised in the Consultation, the Authorities will need to review other pieces of primary legislation and make, and consult upon, necessary changes as a result of the amendments to the SFO. For example, the regulatory regime for RCH and ATS will need careful consideration and amendments to ensure those pieces of market infrastructure conform to the internationally agreed standards for CCPs and trade repositories (see below). Appropriate public consultation will be essential with respect to all legislative and regulatory changes.

Regarding the HKMA's and SFC's proposed timing on implementing the proposals, we are concerned that it is proposed that secondary legislation will be consulted upon in Q1 2012 ahead of the start of the legislative process for the primary legislation. Although we appreciate the ability to comment on the detail of the regime at an early stage, until the draft primary legislation is published, the industry will only be able to comment again on the high-level proposals in the current Consultation. We would welcome the opportunity to consider secondary legislation in Q1 2012, provided that the industry is further consulted on such secondary legislation in a meaningful way once the rest of the primary legislation has been agreed.

The G20 leaders in 2009 specifically called for action to reform OTC markets. Nevertheless, the Authorities could consider whether the scope of any proposals should be expanded to exchange traded derivatives so that the same regime for clearing and reporting applies to each. Given that many of the obligations (clearing, reporting) are already fulfilled in the exchanged-traded derivatives market, there should not be significant disruption to current market practices. This could also prevent any arbitrage opportunities opening up between OTC and exchange-traded products, which have similar economic effects and would create one regime, rather than two, for market participants to understand and comply with. Applying the reporting obligation to all derivatives, however traded, may be useful to the Authorities in gaining a complete picture of the risks across the Hong Kong derivative market.

Scope of the new regime - "OTC derivative transactions"

Whilst the use of the existing broad 'structured products' definition would ensure all major OTC derivatives are subject to the proposed new regime, we are of the view that there should be a new independent definition appropriate for the purpose of the proposed regime, and able to exist separate from the regulation of the offering of structured products. Further, it is important that the Authorities retain power to approve classes of eligible OTC derivatives and ensure that unsuitable OTC derivatives are not subjected to clearing.

We understand the Authorities' concern with wanting to include all parties who deal in or advise on OTC derivatives whether mandated for clearing or not, however, we are of the view that to do this the definition needs to be carefully considered together with the extent of its implications. In particular, the extent of the need for a Type 11 license should be related to the scope of transactions eligible for clearing.

We would welcome further clarity on the extent and nature of proposed carve outs to the existing definition of "structured products" as a way to define OTC derivatives. Furthermore, the current proposal to carve out retail structured products or those offered to the public would mean only dealers engaging in private placements of derivatives fall within the scope of the proposed Type 11 (see Question 13). We would welcome clarification as to whether this distinction between securities offered on the basis of private placement and public offer is appropriate in light of the way in which securities business is currently regulated.

Subject our comments below, we believe that the proposed legislation should include some regulation and obligations on (i) the key market participants (AIs), LCs and Large Players); and (ii) market infrastructure providers (RCH, ATS and trade repositories). Further, we support the creation of the Hong Kong Trade Repository (HKMA-TR) as the recipient of OTC derivatives information and the initial authorisation of the CCPs currently operated by the Hong Kong Clearing and Exchanges Limited (HKEx) for the clearing obligation. However, we would suggest that reporting of OTC derivatives may also be carried out with third country trade repositories where this makes sense for the market participants and where the local authorities will be capable to receive data from such third country repositories to fulfill their supervisory tasks. Counterparties should also be permitted to use other CCPs, including third country CCPs, where appropriate (see AIMA's response to question 12).

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

AIMA supports the proposed retention of the current division of supervisory responsibility between the HKMA and the SFC. We welcome the requirement for HKMA to consent to the subsidiary legislation as it will ensure legislation is aligned with the market as a whole. AIMA would, however, like to see further details on how the HKMA and SFC intend to align themselves in this context and how interaction between the Authorities is proposed to occur with respect to supervising the ongoing operation of the OTC derivatives clearing regime. We suggest further consultation is undertaken on the proposed supervisory details.

It is also worth noting that if existing regulated activities are amended to carve out Type 11 regulated activities, AIs will be exempt from licensing in respect of all OTC derivatives - and not just currency linked and interest rate linked instruments. Consequently, such

activities will be regulated wholly by the HKMA and the SFC's oversight over AIs would be more limited than in the current position - although in a similar regulatory position to that of an AI carrying on a leveraged foreign exchange business (Type 3). (See our response to Question 13).

Mandatory obligations and the products to be covered

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

AIMA in the context of the Hong Kong OTC derivative market, is not against a phased in approach for the clearing obligation restricted at the outset to interest rate swaps (IRS) and non-deliverable forwards (NDFs).

We understand the Authorities' argument for including two of the largest classes of derivatives traded in Hong Kong in the first phase, followed by smaller classes of derivatives, and accept that there are arguments for this process. That said the Authorities should give consideration to clearing of additional products at an appropriate time and in line with developments globally such that products considered suitable for mandatory clearing in those markets are also mandated to clear in Hong Kong.

Phasing should not discourage CCPs from a broader offering of contracts for clearing which may be undertaken on a voluntary basis. This will contribute to further reduction of counterparty credit risk in the market and will bring down the costs and improve the efficiencies involved with central clearing. We would also not want to create an impression in the market that all NDF and IRS contacts are suitable for clearing and all other contracts are not. Instead, we believe it is important that the Authorities give suitable consideration to additional types of OTC derivatives by looking at: (i) whether the industry is ready to clear a class of derivatives; (ii) whether a class of contracts is suitable for central clearing; and (iii) which contracts can safely be cleared.

Other product types should be brought into clearing and reporting as soon as appropriate after the first phase is successfully implemented.

Overall the Authorities should ensure that the new regulation does not lead to unreasonable charges and fees being passed on to buy-side clients, but rather that it promotes and ensures that buy side access to clearing in Hong Kong is provided in a fair, open and competitive environment.

Authorities should also consider a phasing approach based on the category of market participant, similar to the US proposals. Such an approach would see those with the necessary experience and resources complying with the obligations first. Those not able to comply within a short time frame should be given additional time. (see our responses to Question 10)

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?

As stated above, we are concerned by the possible effect of strictly limiting the scope of the reporting and clearing obligations to just certain IRS and NDF, although we appreciate

that there are arguments for this in the case of the clearing obligation.

We believe there is a difference in this regard between clearing and reporting obligations. Clearing addresses counterparty credit risk in the market and, therefore, must be margined to protect the CCP when the credit risk of the trade is transferred to it. For this reason, only certain asset classes will be suitable for the clearing obligation, for example, those that are liquid enough to be fairly valued in the market.

Mandatory Reporting

To limit the selection of information that the HKMA-TR (and, ultimately, the Authorities) receives could limit the oversight of the market as well as make it more difficult for authorities to assess whether new classes of derivatives contracts have become eligible for clearing. This would seem to go against the commitments and the spirit of the commitments Hong Kong has made at the G20 level. Reporting need not be particularly onerous on firms if it is well designed and if it is not duplicative in the sense that information is not required to be reported by both counterparties and, in certain circumstances, need not be reported to HKMA-TR where the Authorities are able to rely on data reported to overseas repositories.

Mandatory Clearing

As discussed above, not all derivatives within a class of derivatives will be suitable for clearing with a CCP. It is important that the Authorities retain control over which contracts are mandated for clearing to ensure they are suitable, and coordinate in this regard with CCPs. If, however, CCPs are able to clear (for example) a class of credit derivatives, the Authorities should give due consideration to whether and when that class of derivatives should be mandated for clearing. That said where a contract maybe cleared, a person should not be prohibited from doing so on a voluntary basis, on the basis it may be cleared with a CCP. As appropriate, the Authorities should seek to move as many suitable contracts as they can into central clearing to reduce credit risk for counterparties and, more generally, reduce financial stability risk brought about by the potential failure of a counterparty to an uncleared swap.

FX OTC derivatives

The issue of whether to include FX OTC derivatives within the scope of the clearing obligation has been considered by the Authorities' counterparts in the EU and US. The US has proposed that FX forwards and swaps will be exempted from the clearing obligation and this is expected to be approved by the US Treasury in due course. The EU has also recognised, as the Consultation does, that FX derivatives are generally short dated (and thus have reduced credit risk) and are settled via the CLS System. They have, however, left their decision on which classes of derivatives (including FX) are to be cleared to be made by the European Securities and Markets Authority (ESMA), giving consideration to a number of listed factors. The EU approach envisions that, although many FX derivatives will not require CCP clearing, certain long-dated FX swaps may do. Given the global nature and size of FX markets we would suggest that the Authorities adopt a similar approach to FX derivatives, and the provision accordingly. Regard should be had to the final positions taken in both the EU and US regarding inclusion of FX OTC derivatives within the clearing regimes.

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

Where both parties to a trade are required to report under this reporting obligation, the Authorities should establish rules so that only one party reports the details of a trade to avoid duplication of efforts to report and to avoid a situation in which trades are double counted. In addition, trading parties should be able to rely on third party providers or the CCPs and trading venues to provide trade reporting on their behalf.

We believe the proposal to apply the reporting obligation to overseas-incorporated AIs, including where they trade entirely outside of Hong Kong, perhaps with a overseas buyside counterparty, which have a 'Hong Kong nexus' will be burdensome for such firms. However, given that an overseas-incorporated AI is likely to be required to submit a report to its local trade repository, which the Authorities may access, it should be unnecessary for that party to also report to the HKMA-TR.

AIMA supports the Authorities' proposal to establish a local trade repository instead of relying purely on other internationally established trade repositories. However, we believe that the HKMA-TR should be used for trades of parties who are subject to the reporting obligation as a result of having executed a trade within the jurisdiction or who are executing reportable trades and are regulated by the Authorities. AIMA recognises the Authorities need to obtain relevant data and monitor trades to assess systemic risk, however, for trades conducted outside of Hong Kong by overseas-AIs and other overseas persons, which have a Hong Kong nexus, the reporting obligation should apply but parties should be able to use any trade repository established in a jurisdiction with which the Authorities have a information-sharing and cooperation agreement (e.g., the US DTCC for credit derivatives). This will avoid a party having to report to more than one depository and the double counting of trades internationally (ensuring the effective monitoring of cross-border systemic risks) and will reduce the compliance burden on firms.

For similar reasons we do not believe those LCs and AIs that only "originate" the contract should be subject to the reporting obligations. With regard to the definition of Hong Kong Persons, we would welcome clarification as to the scope of funds referred to in para 77(4). We do not believe this should include offshore hedge funds, as the relevant funds' managers are already regulated by the Authorities. Offshore hedge funds as oversees persons should not be required to report.
AIMA supports the proposal to have reporting of trades executed prior to the effective date of the legislation but which are still outstanding at the effective date of the legislation (i.e., backloading). To reduce the burden on the large amount of reporting this may entail, the process of backloading should be phased in over an appropriate period of time.

We note that there is no need to align the scope of the clearing and reporting obligations and our comments above relate only to the proposed reporting obligation and will be different for the clearing obligation (see below).

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?

As above, we do not believe that a reporting threshold is necessary and would potentially exclude large parts of the derivatives market from the Authorities' oversight. The Authorities should bear in mind the purpose of reporting - to gauge counterparty exposure. In the vast majority of cases, OTC derivatives will only be entered into by small market

players with counterparties who are AIs or LCs (or their overseas equivalents). In which case, the AIs and LCs will be required in any case to report the details of the trade to the HKMA-TR and, if the Authorities seek to avoid duplications as we have proposed, there should be no burden on the small market players. The only instance where this may be applicable is where an OTC derivatives trade is conducted between two small players, however, if they are subject to the clearing obligation, then they will still require two LCs to act as clearing members, who may report their trades for them. However, we believe these instances are sufficiently rare and the burden small enough that it is unlikely to be sensible to propose a complex reporting thresholds regime to cover the circumstances. For this reason, the EU and US regimes have no reporting threshold applicable to small market players (or any other parties).

If the Authorities believe that the reporting thresholds are, however, necessary, we believe the calculation of the threshold taking into account the absolute dollar value of the average notional value per class of product is likely to be sensible.

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

The use of a grace period once the reporting obligation becomes effective, to ensure parties can backload existing trades and establish sufficient reporting mechanisms, is supported. If the Authorities do phase the reporting obligations by different product types, we would also agree that such a grace period would be necessary after the date of each subsequent reporting obligation compliance date.

Proposed mandatory clearing obligation

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

AIMA supports the proposal to have a mandatory clearing obligation so that eligible trades are subject to the CCP clearing and counterparty credit risk in those contracts is actively reduced. It is important to note that the purpose of clearing of an eligible contract is to reduce counterparty credit risk for each of the parties, the risk that one party will face losses as a result of the failure of the other party. For this reason, we do not believe that AIs and LCs which only 'originate' contracts i.e. are not counterparties to the transaction, should be subject to the clearing obligation. As proposed, this is likely to make them, in addition to the two counterparties to the trade, subject to the clearing obligation. If, as the Consultation discusses, many trades are originated in Hong Kong but are booked by an overseas-AI, then it is likely that the overseas AI will be the one subject to the clearing obligation under the Hong Kong or its own regime. As a contract can only be cleared at one CCP (unlike reporting, which could be done more than once), the proposal puts additional requirements on the Authorities to approve overseas CCPs. Further, it is difficult to see why a trade would be originated in Hong Kong unless it was with a Hong Kong Person or another person executing the trade in the jurisdiction, in which case the trade would be subject to the local clearing obligation anyway.

AIMA believes it is important that the clearing obligation be limited to only those institutions which are either (i) located in Hong Kong; (ii) regulated by the Authorities; or (iii) a counterparty to an institution falling within (i) or (ii). We are concerned that the Authorities have proposed that a subsidiary of a local-incorporated AI may be required to force its overseas subsidiaries to clear their trades in eligible OTC derivative under the

regime, just by virtue of their relationship with the local AI. Subsidiaries should only be subject to the clearing obligation where they are located in Hong Kong or executing trades in Hong Kong (or with Hong Kong entities).

The Consultation proposes that where two overseas persons are counterparties to a clearing eligible trade, they will be exempt from the Clearing Obligation to the extent the transaction is either subject to the regime of an acceptable overseas jurisdiction or is exempt from the regime of such a jurisdiction. Similar provisions have been proposed in the US and the EU; however, we do not believe this type of provision is appropriate. It would first provide great uncertainty for overseas counterparties who are not active in the Hong Kong market and may not be aware that, due to executing a trade that happens to be on the Authorities' eligible trade list, they are required to clear a contract under the Hong Kong regime. It will be potentially burdensome and expensive for such overseas firms and many may seek to limit any contact with the Hong Kong market if they do not wish to be subject to the regime. Second, it is difficult to see how the Authorities would be able to enforce the clearing obligation where both parties are neither regulated by the Authorities in Hong Kong nor located in the jurisdiction and thus subject to local law. Third, the determination of what will be an 'acceptable overseas jurisdiction' must be correctly undertaken to ensure that overseas persons may use the exemption from the proposed Clearing Obligation. The Authorities have proposed that acceptable overseas jurisdictions will be those "on a par" with international standards and practices. We believe that, to provide certainty to such markets, the Authorities must make a clear determination of which jurisdictions are "on a par" with international practices and standards. "On a par" should take into account, broadly, whether the effect of the overseas jurisdiction's regime is the same as that for the Hong Kong regime, i.e., it provides for reporting of OTC derivatives trades and clearing of eligible trades with suitably robust CCPs. Compliance with the CPSS-IOSCO Final Report on Principles for Financial Market Infrastructure should be the benchmark standard for international practices and standards. If no such determination is possible for the largest global derivatives markets in Europe and the US, activity from overseas participants in eligible classes of contract may be withdrawn from the market where there are contradictory requirement that require them to clear in two locations.

It is important that the clearing obligation, when applied, is only applicable to contracts within an asset class which is suitable for clearing. Suitability will require an assessment of a class of contracts to ensure, among other things:

- a sufficient degree of standardisation in the contractual terms and operational processes needed for clearing the derivatives;
- sufficient volume and liquidity in the class of derivatives; and
- the availability of fair and reliable pricing information.

There is a mention at paragraph 60 of the Consultation that the Authorities will propose a 'top down' and a 'bottom up' procedure for determining which contracts are suitable for clearing. AIMA supports this approach, which will ensure that over time a significant percentage of the OTC derivatives market is centrally cleared. Under the bottom-up approach, by which the CCPs will propose that contracts they are offering for clearing should be subject to a clearing obligation, we feel the clearing obligation should, in time, apply to any contract which they are clearing. A CCP will only offer a product for clearing if they feel it is safe to do so. At this point, there is no reason why a product should not be subject to the mandatory clearing requirement if suitable for clearing. Under the top-

down approach, by which the Authorities designate contracts that are not being cleared by a CCP or proposed by a CCP for the mandatory clearing obligation, to be subject to the clearing obligation. This provides an important check preventing CCPs and clearing members from delaying the move of OTC derivatives on to CCPs. The Authorities must also consider the situation whereby a class of contracts is proposed to be cleared by the CCP but no CCP is yet offering those contracts for clearing on its platform. In this situation, it is important that the Authorities seek to encourage CCPs to offer the products where it is safe to do so. The Authorities should not consider limiting trading in a particular class of contracts if a contract is deemed eligible for the clearing obligation but no CCP is available to clear the trade. With regard to the bottom-up approach, have the Authorities considered whether the class of contracts would automatically become eligible following a CCP's application? We believe under both the bottom-up and top-down approaches, it is important that any eligibility decision of the Authorities is given careful consideration and subject to public consultation to help the Authorities decide whether a contract meets the eligibility criteria.

When determining whether a class of contracts should be eligible for clearing, it is important that this is done at a relatively granular level, as not all contracts within a broad class of derivatives (e.g., IRS) will be suitable for clearing, although many might be. The Authorities should try to define eligible classes of derivatives taking into account factors including: (i) maturity; (ii) method and form of settlement; (iii) common terms; (iv) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the derivatives clearing organization available to clear the contract; (v) the availability of a rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded; (vi) the effect on competition, including appropriate fees and charges applied to clearing; and (vii) the existence of reasonable legal certainty in the event of the insolvency of the relevant derivatives clearing organisation or 1 or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

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

AIMA recognises, as the Authorities do, that clearing increases the cost on some parties who are required to clear their contracts. The proposal to set a clearing threshold for all parties may therefore be warranted. However, any such threshold must be calibrated carefully so as not to jeopardise the basic objective of the regime - increased financial stability.

Hong Kong Persons should be able to use the clearing threshold to reduce their burdens and costs of clearing where they only undertake derivatives trades on a small-scale or occasional basis. Determining an appropriate threshold for these firms is likely to be difficult. In the EU, the European Market Infrastructure Regulation (EMIR) proposal includes a clearing threshold that is only applicable to non-financial counterparties for their trading beyond that which is otherwise objectively measurable as reducing risk relating to commercial activities or treasury financing activities. There has been concern from the European authorities on how they will calculate this threshold and no proposals have been forthcoming from the European authorities or industry to date. The US, alternatively, has no counterparty thresholds but exempts commercial end users who enter into derivative contracts purely for hedging purposes.

We agree that, if a party is exempt from clearing by having an average month-end position below the threshold, both parties to the trade will have to be exempt. However, we are concerned about the impact of the failure of a large AI or LC in the market, where they conduct trades with multiple parties all below the threshold. In such a situation, no central clearing would take place and the AI or LC may have a large aggregated counterparty credit exposure to those multiple parties. If the Authorities believe a clearing threshold is necessary, we believe it should only be applied to Hong Kong Persons and other buyside firms and should be set at a relatively low level that would prevent undue burdens being applied to firms with small-scale or infrequent derivatives operations.

Whether or not the clearing obligation applies to a firm, that firm should be provided with fair and open access to clearing services on a voluntary basis at any CCP it wishes to use, subject to any serious concerns about the risk of them clearing with the CCP. Voluntary clearing should also apply to pre-existing trades that are entered into before the Clearing Obligation is effected (i.e., backloading), as long as these are accepted by the CCP.

Where a clearing threshold is used, we believe the calculation of the threshold, taking into account the average notional value of a firm's month-end positions for the preceding six months, is sensible.

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

AIMA supports the proposed grace period for the clearing obligation to allow time for parties to make arrangements necessary for clearing their OTC derivatives trades. An alternative proposal may be to phase implementation of the clearing obligation by category of counterparty so that all of the most active participants in the market are required to clear at the first instance, followed by less active participants and finally occasionally active participants. This type of proposal is currently being discussed for the US regime.

Mandatory trading obligation

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

The Authorities will be aware that the commitments made at the G20 level include that all eligible OTC derivatives will be moved on to electronic exchange by the end of 2012. AIMA recognises the importance of the trading obligation, however, we believe that addressing counterparty credit and systemic risk by the mandatory clearing and reporting obligations are more important priorities.

Mandatory clearing will be a big change for the current markets, where derivatives are currently traded in a number of ways, broadly categorised as OTC. Significant debate is ongoing in the US and EU about what a trading venue for OTC derivatives can look like, each proposing a new regulated market type. We believe that it is both necessary and advisable for products to be moved on to exchange or a trading venue only once clearing infrastructure is in place and, thus, we believe that the Authorities should consider implementing the trading obligation requirements after the clearing obligation.

We would be interested to discuss mandatory trading obligations further with the Authorities and believe the Authorities should publicly consult the industry widely on any such proposed obligation. The Authorities will need to work with any exchanges or other trading venues to decide if contracts:

- trade sufficiently frequently;
- have sizable open interest;
- have minimum trading volumes;
- have minimum numbers of transactions over time;
- create a sustained presence of a two-way market; and
- have sufficient depth of the market.

Designation and regulation of CCPs

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

The Authorities are proposing a mandatory clearing obligation and, as such, it is important that parties are not being forced to use a single CCP without regard to price or the service that it provides. The best way to ensure that those subject to mandatory requirements receive fair market prices and good quality services is to introduce competition into the market. Whilst it is helpful that the Hong Kong market is already served by CCPs operated by HKEx, we believe that all firms subject to a mandatory clearing obligation should have a choice of domestic and international CCPs with whom they can clear their trades. This may further contribute to the risk reducing effects of central clearing where, for example, HKEx CCPs are currently not able or willing to clear a class of OTC derivatives and these, instead, can be cleared by an overseas CCP that is prepared to clear the contract. It would seem unnecessary to forgo the benefits of central clearing just because a local CCP is not in the position to offer its services at one time, whilst other CCPs can.

We agree that it is necessary for CCPs to be properly regulated, especially given the importance of their position in the market and the risk they will take on when clearing trades. We note that Hong Kong already has a regulatory regime for CCPs, where such parties are regulated as RCH or ATS providers under Part III of the SFO. Although this regime should be sufficient for the purposes of extending the scope of their clearing services to OTC derivatives, it is important that the Authorities give the SFO, subsidiary legislation and regulation a thorough review before implementation to ensure the regime is suitable for the new activities of the CCPs. The EU and US regimes also propose regulatory requirements on their CCPs and each has a third country CCP recognition regime. It is important that Hong Kong CCPs are regulated to such an extent that they can be considered 'equivalent' to EU CCPs or 'comparable' to US designated clearing organizations (DCO) so that they may provide clearing services to EU and US counterparties. Any proposed changes should be subject to public consultation to ensure that the regulatory regime is suitable for all relevant parties including the CCPs, the clearing members and the clients of those clearing members.

When the Authorities review the regime for RCH and ATS in the context of acting as a CCP for OTC derivatives clearing, we believe there are several key features which must be written into the regulatory requirements:

The first is that CCPs should have fair, open and objective membership criteria that encourages participation in a CCP as a clearing member, so long as those potential clearing members meet basic minimum safety requirements, including minimum capital and contributions to the CCP default fund. Having wide CCP participation adds to the expertise and resources of the CCP and generally improves the safety of the CCP and reduces the chances of its failure. For client clearing, wide CCP participation provides increased numbers of options of clearing members, increasing competition in the market, improving services and reducing clearing fees. We see no reason to restrict membership of a RCH or ATS to domestic clearing members and believe that, as long as the basic minimum requirements are met, overseas firms should also be able to become clearing members of a domestically regulated CCP. The basic minimum requirements should be risk-based and set by the CCP, but having in mind that the criteria must be fair and objective in the requirement and their application.

Second, clients of clearing members, who are also subject to the mandatory clearing obligation but either, cannot become or do not wish to become clearing members, should equally have fair and open access to clearing services. Without this, clients are likely to be restricted from trading or disadvantaged in the market when a mandatory clearing obligation applies for the contracts they trade.

Third, we particularly support the HKMA and SFC statement in the consultation that when offering indirect clearing services, a clearing member must provide for 'segregation and portability of client assets'. This has been a significant discussion to date in the EU and US. The buyside has long recognised that the large derivative dealer banks are not failure-proof and that, should they go into insolvency, there is a risk that collateral and other assets placed by buyside firms with those derivatives dealers may be written down or subject to losses. Therefore, in the current bilateral market, many firms have produced arrangements whereby collateral posted to cover the positions on the OTC derivatives will be held in individual accounts with third party custodians. This arrangement thereby prevents losses being caused to assets by a clearing member's failure. In the cleared OTC derivatives market, buyside firms now insist that that they are able to maintain this same high level of protection against loss. In the futures market, clearing members have been able to pool clients' assets together in 'omnibus accounts'. We do not believe that the same structure should be used for OTC derivatives, as omnibus accounts exposure clients collateral to 'fellow customer risk' - the risk that the total value of assets in the pool will be less than the combined client positions under the pool (i.e., due to the failure of a client at the same time as the clearing member) such that the CCP, upon failure of a clearing member, will require all clients of the pool *pro rata* to add additional assets to top up the value caused by the shortfall. This fellow customer risk is unacceptable and clients must be at least offered the option to have full segregation that offers the same high-level of individual account protection that they have negotiated for in the bilateral market. Having such segregation allows clients' collateral and positions to be easily transferred to other clearing members should the first clearing member default. This ultimately prevents runs on clearing members at the point of failure, as the clients are not exposed to any losses and client assets are prevented from being tied up in complex insolvency proceedings.

Fourth, to ensure that fair, open and objective access is provided in the market and that CCPs are operated in a way that benefits all, we believe it is essential that clients have

representation on both a CCP's governing Board and a CCP's risk committee/s. This allows them to contribute their views and expertise and prevents clearing members acting in a self-interested way. Clients role in CCP governance should be a substantive voting right (rather than mere consultation) that ensures they cannot be outvoted by the clearing members or the CCP.

Finally, without limitation of the foregoing, the provision of facilities to all eligible market participants for direct or indirect clearing, and elimination of barriers to access to such clearing and integrity of the cleared market, must include:

1. Real-time acceptance by CCPs and their respective clearing members of trades, for acceptance or rejection for clearing, regardless also of whether the trades are executed bilaterally or through a trading platform;

2. Open, non-discriminatory access for clearing of trades executed by voice or other bilateral means, as well as trades executed on a trading platform;

3. Anonymity between clearing members and such clearing members' customers' execution counterparties;

4. Elimination of structural barriers (such as for tripartite documentation) to access best execution;

5. Automatic compression (continuous or no less frequently than daily) of offsetting cleared positions held at the same CCP;

6. Facilities to permit prompt pre-default full and partial portability, on customer instruction and without inappropriate cost or delay;

7. Non-discriminatory real-time clearing of correspondently cleared (or "4-way") transactions;

8. Availability to all clearing participants of tools to estimate margin;

9. Segregation of customer positions and margin; and

10. Facilities for qualifying participants to become direct clearing members on the basis of non-discriminatory, objective, risk-based criteria.

We do not believe it is necessary or desirable to have certain OTC derivatives cleared only on domestic CCPs, as has been proposed in Australia and Japan. As indicated, this may be burdensome for direct clearing member firms that would need to be members of multiple CCPs and have increased resources to commit to those CCPs. For buyside firms, this would also reduce choice and competition in the market, increasing fees and concentrating risk in certain products in just one CCP. It is unclear which products would be deemed to be "of systemic importance" such that they should only be cleared domestically. As the HKMA and SFC will have both full oversight of the market in systemically important products and regulatory oversight and control of domestic market participants and overseas participants in the jurisdiction, it would seem unnecessary to have the products regulated specifically with domestic CCPs. If overseas CCPs are subject to a similarly high standard to the domestic CCPs, we see very little reason why the products should not be able to be cleared there. If 'systemically important' products are those that are likely to cause HK firms to default due to the size of the gross outstanding exposures created by

the contracts, then we would suggest that any CCP that can reduce the exposures would be desirable and that the clearing service need not be provided by a domestic CCP. If a domestic CCP is unable or unwilling to clear a class of derivatives that is deemed systemically important, we are concerned that if this cannot be cleared with a domestically regulated CCP, that the product would be unable to be traded in the market. Overall, we see no need for this requirement and do not believe it should be taken up by the Authorities.

The RCH and ATS regime should be such that, if a CCP established in another market wishes to provide clearing services in Hong Kong it can either register itself or seek recognition to provide clearing services in Hong Kong. Although, as suggested, an overseas CCP may be able to register as an ATS, this may not be possible in all cases if the CCP's local regulatory regime creates conflicting obligations to those in the proposed Hong Kong regime. Where the overseas CCP is subject to regulation in its country of establishment that has broadly equivalent effect, this should be sufficient to allow it to provide clearing services in the Hong Kong market. By provide clearing services in the Hong Kong market, we mean either accepting trades from (i) Hong Kong exchanges or from HKMA and SFC regulated entities that are subject to the mandatory clearing obligation; or (ii) other parties who wish to clear with the CCP on a voluntary basis.

We would also welcome the Authorities detailed thinking with regard to collateral and margin requirements, for example to minimise the impact of changes brought about by the introduction of a new regime.

Regulation of OTC derivatives market players

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

It is important that all derivatives dealers and clearing members are regulated appropriately, especially where they are not already subject to supervisory oversight. Such a regime should ensure they are subject to appropriate conduct of business and prudential requirements that provide for protection of clients to whom they provide services and ensure they do not add unnecessary risk to the market via their participation in central clearing. We understand that many of the largest investment banking groups will have subsidiaries or internal teams that provide both derivative dealing activities (as counterparties to trades) and clearing member services. Clients should have free choice over which dealers they transact with and with which clearing members they use. Clients should not, for example, be required to only use the clearing services of their derivatives dealer. This reduces competition in the market and adds a natural restriction to the number of clearing members that will be active in the market. In such a case, there should be a clear information divide that prevents clearing members knowing who a client's execution counterparty is and preventing a counterparty knowing which clearing member is used. In both cases, as the CCP will be the counterparty after the trade is executed and novated to the CCP, there is no reason why either party would need to know who the counterparty or clearing member is.

AIMA supports clear measures to ensure that there is no overlap of the proposed Type 11 regulated activities with existing regulated activities. If the approach to applying Type 11 to activities not caught by existing regulated activities is adopted (and which would be our preference), we suggest a carve out for asset managers who induce, advise on, intermediate, arrange or otherwise facilitate derivative transactions pursuant to a Type 9

regulated activity for which they are licensed.

Similarly, we would welcome confirmation that those trading as principal (subject to the proposed "large players" regulation) are excluded from requiring a Type 11 licence - similar to the exclusion that exists for Types 1 and 2 regulated activities. It is also worth noting that under this approach the SFC will have oversight of authorised institutions engaged in OTC derivative transactions for which a Type 1 license is required (e.g., equity derivatives or retail structured products) but not for Type 11 - which is not to apply to AIs or firms with a Type 3 licence (leverage foreign exchange trading). The rationale for this split is not apparent and we suggest further consultation is undertaken with regards to this aspect.

Furthermore, consideration should be given to any potential overlap between Type 1 (dealing in securities) and Type 2 (dealing in futures contracts) (where OTC derivatives become "novated or guaranteed by a central counterparty") regulated activities and Type 11 and make provision for a suitable carve out.

It will be essential that the scope of Type 11 and the products and classes are no broader than those mandated to report and clear, i.e., the carve outs proposed to the "OTC derivatives transactions" definition should equally apply to the scope of a Type 11 regulated activity. We understand the Authorities concern with regard to wanting to include all parties who deal or advise in OTC derivatives whether mandated for clearing or not, however, we are of the view that to do this the definition needs to be carefully considered together with the extent of its implications. Our view however is that the extent of the need for a Type 11 license should be related to the scope of transactions eligible for clearing.

AIMA agrees with the Authorities' that it is not necessary to regulate funds given that they are end users and price takers.

AIMA also welcomes confirmation as to whether, consistent with the scope of existing regulated activities, the proposed Type 11 licensing requirements will be limited to intermediaries carrying on a business in Hong Kong (as opposed to having extra-territorial effect) or actively marketing services to the Hong Kong public.

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

AIMA accepts that it is necessary for the Authorities to review and, where appropriate, regulate unregulated Large Players in the market where they would pose systemic risk should they fail. The concern is such that, should they fail, their likely position in the market could be so large that it would cause losses to their counterparties which would, in turn, cause those counterparties to fail. Their failure could also impact prices in the market, causing volatility and may, ultimately, impact on the financial strength of a CCP.

We support the Authorities view that only a very limited number of players would fall within this definition and that the best way to determine this is by looking at the information collected through the HKMA-TR. Those captured should be only those that are genuinely likely to cause a threat to the stability of the financial markets as a result of their failure. We believe the proposal is similar to the major swap participant regime proposed in the US, where certain unregulated market players will require additional regulation and oversight if they have a significant net uncollateralised exposure. For clarity, we would not expect any asset manager to have significant net uncollateralised exposure or fall within the definition of a large player, especially given that most are

required to fully collateralise their positions and will thus have zero uncollateralised exposure.

Those that are considered Large Players should rightly be required to provide any additional information about their activities that the HKMA or SFC needs in order to have proper oversight of the market. We agree that, should a Large Player's position in the market be such that they pose unacceptable risk to the stability of the market, they should enter into dialogue with Authorities regulator about reducing their positions to safe levels or increasing the amount of collateral they post or, where appropriate, the amount of capital they hold against their exposures.

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