

Subject Consultation paper on the proposed regulatory regime for OTC derivatives market in HK

Date 7 December 2011

To HKMA and SFC

We welcome the HKMA and SFC ("HK Regulators") initiative to set an OTC clearing & settlement infrastructure in Hong Kong. This is an initiative that aligns with ongoing regulatory reforms for the OTC markets in world's leading financial centres such as USA (Dodd-Frank Reform) and Europe (EMIR) and supported by the G20 Group of Leaders. We also note HK Regulators principle on developing a regime that is on par with international standards but take into account local market conditions and characteristics.

We note that HK Regulators initiative is based on four main pillars (consistent with the G20/ISOCO agenda and also consistent with existing/proposed frameworks in some key financial markets):

- a. Trade repository
- b. Mandatory clearing through a central CCP
- c. Mandatory trading of standardized OTC derivatives through electronic trading platforms
- d. Imposition of higher capital requirements for OTC trades that are not centrally cleared.

The proposed framework will work with relatively ease with domestic counterparties trading in local markets; however, we do have some observations when it comes to cross-border activity.

We have compared HK Regulators OTC initiative against those known OTC clearing operations such as those by SGX and LCH.Clearnet (where ...); we have also consulted our peers in ... who are familiar with the LCH set-up.

These are our observations:

Mandatory clearing for Cross-Border Transactions:

The HK Regulators proposed mandatory clearing and reporting for trades: a) executed by a Hong Kong based entity, or b) when one of the counterparties is a Hong Kong based entity. These two options will certainly include cross-border transactions between domestic and non-domestic counterparties. We will appreciate if HK Regulators can elaborate on how they plan to address margining and reporting requirements for cross-border trades that a) may be subject to separate domestic clearing requirements or b) may be subject to netting principles.

We also ask for HK Regulators to elaborate on the different claim/payments routes in an event of any cross-border counterparty defaults. We like to seek clarification if the clearing house will unconditionally guarantee all payments under the cleared transaction and what are the different mechanisms being contemplated to cushion default losses. We understand the HKEx is presently contemplating several models which may include trade novation (HKEX clearing house undertaking trades on a principal basis), agency role (HKEx acting as a settlement agent) or a hybrid between the two.

Designated Offshore CCP (DOCCP):

We understand from the paper that HK Regulators intend to recognize CCP of certain overseas jurisdictions for clearing; however, we appreciate if HK Regulators can elaborate on the extent of such recognition. For example, we understand that certain clearing houses in different locations have entered into legal agreement such as cross-margining agreements and cross-guarantee agreements (e.g. CME Clearing with Options Clearing Corp, agreement amongst CME Clearing, LCH.Clearnet and the Fixed Income Clearing Corp) to facilitate trans-national activity. Is the plan for HK Regulators or the HKEx to contemplate on entering into similar arrangements with overseas peers?

It is important for HK Regulators to address the fact that large conglomerates may choose to clear and consolidate activities in jurisdiction other than Hong Kong. The paper does note this point; however, we will like to get a better understanding on how mandatory clearing will cater for cross-border transactions.

We are of the opinion that HK Regulators should give even regulatory treatment to trades that may be cleared through a DOCCP regardless if the trade fits for local clearing. These DOCCPs, however, should adhere to minimum quality and credit standards (eg: subject to a rating) that should align fully with the ISOCO/G20 agenda.

Legal Framework:

We will also like HK Regulators to elaborate on the proposed legal framework for the clearing house. We understand several options may be considered - a) trade novation, b) clearing acting on an agency basis (no novation), or c) a hybrid between the two.

Currently, the large majority of OTC transactions are under ISDA legislation, which is a language that tends to be flexible, especially for counterparties with sound creditworthy standings. ISDA agreements have noteworthy advantages such as standard-law enforceability (for both parties), netting clauses, multiple events of defaults, credit support annexes (one/two way agreements, thresholds, independent amounts, etc).

Location Requirement:

We certainly understand the reservations made by jurisdictions like Japan and Australia (and we will not be surprised if other jurisdictions opine similarly on the matter). We are of the opinion that this topic of what constitutes a "systematically important domestic product" should be discussed among regulatory bodies across leading financial markets or brought up to the IOSCO committee for their consideration.

Our main concern on the new OTC framework is that it invites regulatory and/or operational arbitrage if there is not sufficient active coordination and cooperation amongst global clearing houses and their respective regulatory bodies. We do foresee space for plenty product overlapping between exchanges, which may open the door for aggressive competition/arbitrage among clearing houses.

Sincerely,