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30 November 2011

Dear Sirs,

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

The Group welcomes the opportunity to provide comment on the Consultation Paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong (the "**Consultation Paper**") issued by the Hong Kong Monetary Authority ("**HKMA**") and Securities and Futures Commission (the "**SFC**") on 17 October 2011.

Following consultation with a number of our clients, whose names are set out in Schedule 1 of this response (this working group is together referred to in this Response as the "**Group**"), we have provided responses to those questions posed in the Consultation Paper on which the Group has particular views (the "**Response**").

The Group has been established to collaborate and present their views in relation to the establishment of a mandatory clearing framework in Hong Kong. As such, this Response focuses on (a) the proposed mandatory clearing obligation to be introduced in Hong Kong and (b) the establishment of a central counterparty ("**CCP**") for clearing of OTC derivatives in Hong Kong, as set out in the Consultation Paper.

As major financial institutions who will be subject to the regulatory reforms in respect of the OTC derivatives market in Hong Kong (as outlined in the Consultation Paper), the Group has prepared this Response as interested stakeholders with the aim of assisting the HKMA and SFC in creating a functional, efficient and appropriate mandatory clearing framework that will enhance the safety and stability of the OTC derivatives market in Hong Kong.

The Consultation Paper, and correspondingly this Response, covers many varied issues. The Group is happy to discuss any part of this Response with the HKMA and SFC further or answer any questions you may have. Whilst there has been a team of individuals with experience in the areas covered by the Consultation Paper working with the Group in preparing this response, in the first instance please feel free to contact

Yours faithfully

Clifford Chance

RESPONSE TO CONSULTATION PAPER
ON THE PROPOSED REGULATORY REGIME FOR THE OVER-THE-COUNTER DERIVATIVES MARKET IN HONG KONG (ISSUED IN OCTOBER 2011)

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1. Executive Summary

The Group recognises the need for Hong Kong to introduce a regulatory regime for the over-the-counter ("**OTC**") derivatives market as part of its commitment to the objectives announced by the G20, and supports the HKMA and SFC's efforts in making Hong Kong a safer and stronger international financial centre.

In the Group's view, the core objective of the HKMA and SFC in relation to the establishment of a mandatory clearing framework must be to ensure that such regime will enhance the stability and efficiency of the OTC derivatives market in Hong Kong in a proportionate manner. A balance needs to be achieved between the benefits obtained through central clearing of OTC derivatives and the burden which such clearing obligation will place on both central counterparties and market participants. In addition, the HKMA and SFC must ensure that any CCP established in Hong Kong will be in compliance with the international standards to be set out by CPSS-IOSCO in the near future, including so that clearing members of the CCP are able to benefit from the favourable regulatory capital treatment which applies to qualifying CCPs under Basel III.

Furthermore, as acknowledged in the Consultation Paper, the HKMA and SFC must ensure that the regulatory standards for the OTC derivatives market in Hong Kong are aligned with the standards being developed in other major jurisdictions (including the United States, the European Union and the Asian jurisdictions).

Although the Group shares the view that central clearing can be beneficial to the management of systemic risk in the OTC derivatives market, the Group also understands that the HKMA and SFC are aware that central clearing can become a source of systemic risk in the absence of appropriate regulation and prudent risk management. As market participants who will be directly subject to the mandatory clearing framework in Hong Kong, the Group understands that it is important to work together with the HKMA and SFC in considering the issues raised in this Response and welcomes the opportunity to do so.

The Group summarises below their views on several key issues relating to the mandatory clearing regime to be established in Hong Kong.

Part 3A of this Response – Response to specific questions raised in the Consultation Paper

Scope of mandatory clearing regime (see paragraphs 39 to 90 of this Response)

A key concern of the Group is the extra-territorial scope of the clearing regime to be established in Hong Kong, which may potentially result in a foreign market participant being subject to conflicting mandatory clearing obligations (both in Hong Kong and in its home jurisdiction). The HKMA and SFC must be careful to avoid such regulatory overlap between jurisdictions due to the damaging consequences this may have on affected foreign market participants and also on the development of the OTC derivatives market in Hong Kong.

In particular, the Group is of the view that the concept of "originated or executed" is not appropriate since the purpose of mandatory clearing is to reduce systemic risk through the management of counterparty credit risk. Therefore, the scope of the mandatory clearing regime should be defined by reference to the counterparties of an OTC derivatives transaction (which is where the credit risk arises), and not in relation to where such transaction was originated or executed.

Furthermore, the HKMA and SFC are strongly urged to consider providing an exemption from the mandatory clearing regime in Hong Kong where one of the counterparties to the trade is an overseas person who is already subject to a mandatory clearing obligation in an acceptable overseas jurisdiction (or is exempt from clearing under the clearing regime in such acceptable overseas jurisdiction). This exemption is appropriate because the objective of the G20 commitments will be achieved since such overseas person will already be subject to a mandatory clearing obligation which is appropriate for the purposes of the G20 commitments. The imposition of a second overlapping, and potentially conflicting, obligation on market participants who are already subject to a robust mandatory clearing regime in their home state may create significant regulatory uncertainty, dislocations in prudent risk management, market inefficiency and additional compliance burdens, with no measurable benefit to the management of global systemic risk in the OTC derivatives market.

If this exemption is not provided, the HKMA and SFC must ensure that an appropriate process for recognition of foreign CCPs is adopted in Hong Kong in order for foreign market participants subject to conflicting mandatory clearing obligations (both in Hong Kong and in its home jurisdiction) to be able to comply with both regimes. The Group notes that approximately 50% (by volume) of all Hong Kong dollar interest rate swaps are currently cleared through LCH.Clearnet, and therefore the process for recognition of foreign CCPs in Hong Kong will be very important to ensure that there is a smooth transition for participants in the Hong Kong OTC derivatives market following the introduction of a mandatory clearing regime in Hong Kong.

Following from the above, the Group strongly recommends that the HKMA and SFC should not insist on the use of domestic Hong Kong CCPs as the only way to comply with the mandatory clearing obligation in Hong Kong. The Group considers that it is not necessary or desirable for the mandatory clearing regime in Hong Kong to require domestic clearing for compliance since this will result in fragmentation of liquidity and the breaking of netting sets and which will in turn entail higher costs for end users of OTC derivatives products in Hong Kong.

Furthermore, the Group does not recommend that domestic clearing be mandatory since this would remove the ability of market participants to select the most appropriate CCP for the clearing of their OTC derivatives transactions and may over time also lead to the excessive build up of systemic risk in Hong Kong with respect to the Hong Kong CCP, which may ultimately result in the need for HKMA support if there is ever a failure of the Hong Kong CCP.

In any event, the imposition of such a requirement would only be practical if CCPs based in Hong Kong were able to obtain recognition under all major foreign jurisdictions (such as the United States and the European Union). This is because many foreign market participants are likely to be subject to conflicting mandatory clearing regimes, and will therefore need to clear through a CCP which is recognised in all of the relevant jurisdictions in order to comply with their various clearing obligations. Unfortunately it seems inevitable that the process through which a CCP in Hong Kong will obtain recognition in foreign jurisdictions will be a difficult and time consuming process which is very unlikely to be completed prior to the introduction of the clearing regime in Hong Kong and may in fact take many years to achieve. As a result the Group strongly recommends that the HKMA and SFC must allow market participants to clear OTC derivatives transactions in a CCP of their choice (subject to the CCP completing appropriate procedures to be recognised by the HKMA and SFC in Hong Kong) rather than

compel market participants subject to the clearing regime in Hong Kong to clear trades through a domestic Hong Kong CCP.

Products covered by mandatory clearing regime (see paragraphs 9 to 33 of this Response)

The Group believes that the HKMA and SFC must carefully consider, when formulating the scope of the mandatory clearing framework in Hong Kong, the relationship between (a) what OTC derivatives products need to be cleared and (b) where such OTC derivatives products need be cleared. This is because determinations made in respect of which types of products should be subject to mandatory clearing will directly influence the regulation of where such products need to be cleared and vice versa. The Group therefore considers that close co-operation and engagement between the regulators, Designated CCPs and market participants will be essential when determining which OTC derivative products should be subject to the mandatory clearing regime in Hong Kong.

Furthermore, the Group considers that a carefully balanced combination of the "top down" and "bottom up" approach suggested by the HKMA and SFC in the Consultation Paper is required when determining whether a new OTC derivatives product should be covered by the mandatory clearing regime in Hong Kong. In order for the HKMA and SFC to assess whether such extension of the clearing regime will have a beneficial effect on the management of systemic risk in the OTC derivatives market, they must work closely with CCPs and market participants to consider whether the OTC derivatives product in question has a sufficient degree of liquidity and standardisation to enable successful clearing of such transactions. The Group strongly recommends that the HKMA and SFC take a prudent and risk focussed approach to this determination process.

Remote Membership (see paragraphs 111 to 113 of this Response)

The Group considers that it is important for CCPs based in Hong Kong to allow remote membership as it would be inconsistent with the systemic risk reduction objectives of mandatory clearing (due, for example, to the breaking of netting sets) and very inefficient from both a capital and cost perspective to require all foreign market participants to establish a new fully capitalised entity in Hong Kong purely for the purposes of becoming a clearing member to a CCP in Hong Kong.

However, the HKMA and SFC must also be vigilant in relation to the potential challenges arising from remote membership, particularly with respect to whether the default management processes established by a CCP based in Hong Kong will be valid and enforceable against an insolvent remote clearing member in its home jurisdiction.

Without the protection of "clean" netting, collateral and insolvency opinions in respect of the jurisdiction of each remote clearing member, a CCP based in Hong Kong may be exposed to risk on the default of such remote clearing members, with potentially adverse consequences for the OTC derivatives market in Hong Kong. In addition, without such opinions, a Hong Kong CCP would not be able to comply with CPSS-IOSCO standards.

Part 3B of this Response – Additional issues relevant to the legislative framework for the mandatory clearing regime in Hong Kong

Consequence of breach of mandatory clearing regime (see paragraphs 137 to 142 of this Response)

The Group believes the HKMA and SFC should recognise that an AI or LC should not be subject to any penalties for failure to comply with the mandatory clearing regime where such failure was beyond the control of such AI or LC. For example, where an AI or LC has entered into an OTC derivatives contract with a foreign counterparty, it is possible that the foreign counterparty may refuse to co-operate, or may even resist, the submission of such trade to clearing with a CCP. Under such circumstances, the Group's view is that the AI or LC can do little to compel the foreign counterparty to comply with the mandatory clearing regime in Hong Kong and therefore a grace period should be granted to the AI or LC in order for them to terminate and unwind the trade with the foreign counterparty, for example in circumstances where a foreign counterparty refuses to clear a trade which is subject to the Hong Kong mandatory clearing regime.

Furthermore, in the event that an OTC derivatives transaction is not submitted for clearing in breach of the mandatory clearing regime, the HKMA and SFC should ensure that the legislation provides that the validity and enforceability of such transaction as between the two parties to the transaction is not affected.

Market participant involvement in risk management (see paragraphs 128 to 136 of this Response)

The Group strongly believes that it is vital to the safety and risk management of a CCP based in Hong Kong for market participants to be closely involved in the governance and default management of such CCP. As losses suffered by a CCP will be borne by its clearing members, it is both fair and appropriate for clearing members to have detailed input into the risk management processes of a CCP, and for this feature to be expressly provided for through legislation in Hong Kong. It should be noted that the Dodd Frank Act (including implementing rules) and EMIR (the latest draft) both require the participation of independent directors on the board of a CCP and for clearing members to be represented on the risk committee of a CCP.

Part 3C of this Response – Structural issues relevant to the establishment and regulation of CCPs in Hong Kong

The Group considers that there are various additional issues which, although not directly relevant to the establishment of the legislative framework relating to the mandatory clearing regime in Hong Kong, nevertheless will be extremely important when considering the establishment of CCPs based in Hong Kong. While the Group may not have formed a definitive view on the (non-exhaustive) list of issues set out below, the Group highlights to the HKMA and SFC that these topics will be highly relevant for establishing a safe, secure and workable CCP in Hong Kong and are therefore subject to detailed analysis and consideration by members of the Group:

- Clearing model: Principal vs. Agency;

- Default of clearing members;
- Capital requirements for CCPs;
- Corporate governance of CCPs;
- Ownership criteria for CCPs;
- Risk management of CCPs;
- Managing insolvency of CCPs;
- Treatment and use of collateral at both CCP and clearing member level;
- Segregation and portability; and
- Client clearing.

2. Structure of Response

To assist the HKMA and SFC in reviewing this Response, the Group has set out its response in three separate parts:

1. *Response to specific questions raised in the Consultation Paper:* In Part 3A of this Response, the Group has presented its views on the following questions relating to the mandatory clearing regime which were raised in the Consultation Paper:

   Q1, Q2, Q3, Q4, Q8, Q9, Q10 and Q12;

2. *Additional issues relevant to the legislative framework for the mandatory clearing regime in Hong Kong*: In Part 3B of this Response, the Group has raised several additional issues which, while not the subject of any specific questions in the Consultation Paper, the Group regards as very important for the HKMA and SFC to consider when establishing the legislative framework for the mandatory clearing regime in Hong Kong; and

3. *Structural issues relevant to the establishment and regulation of CCPs in Hong Kong*: In Part 3C of this Response, the Group has set out certain structural issues in relation to the establishment and regulation of CCPs in Hong Kong which, while not necessarily the subject of specific legislation, should nevertheless be considered by the HKMA and SFC at this stage in order to ensure that a safe, secure and workable CCP is established in Hong Kong.

3A. Response to specific questions raised 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?

Legislative Framework

1. The Group is supportive of the HKMA and SFC's efforts in aligning Hong Kong's financial markets regulation with that of other international financial centres by meeting the commitments made by the G20.

2. The Group considers that the approach proposed by the HKMA and SFC to set out the main obligations under the new OTC derivatives regime in primary legislation, with details to be set out in subsidiary legislation (as set out under paragraph 26 of the Consultation Paper), is appropriate. This reflects the approach that has been adopted by various other jurisdictions (including the United States and the European Union).

3. The benefit of this approach is two-fold in the opinion of the Group:

   (a) first, limiting the primary legislation to establishing the main obligations under the new OTC derivatives regime will allow such legislation to be passed within the legislative timetable next year (2012); and

   (b) second, providing the details of the main obligations under the new OTC derivatives regime in subsidiary legislation allows the HKMA and SFC to align the regime in Hong Kong with the regulatory standards of other major jurisdictions (including the United States, the European Union and other Asian jurisdictions), in step with such other jurisdictions as they establish their new regulatory frameworks for OTC derivatives over the next few years.

Definition of OTC Derivatives Transactions & Scope of Type 11 Regulated Activity

4. The Group understands from the Consultation Paper that the HKMA and SFC propose defining "OTC derivatives transactions" by reference to the definition of "structured products" (introduced under the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011) with carve outs for (a) listed securities and futures contracts; (b) structured products authorized for retail distribution under section 105 of the Securities and Futures Ordinance ("**SFO**"); and (c) transactions in currency-linked instruments, interest rate-linked instruments or currency and interest rate-linked instruments offered by Authorised Institutions ("**AIs**") to the public (for which documentation is exempt from the prohibition under s103(1) of the SFO).

5. The Group agrees that the definition of "OTC derivatives transactions" should be drafted widely to provide flexibility and cater for the evolving nature of OTC derivatives. It is also understood that the definition of "OTC derivatives transactions" will be connected with the introduction of a new Type 11 regulated

activity which will be based upon a similar approach to the existing dealing and advising definitions under the SFO.

6. The Group has seven principal comments on the proposed definition of "OTC derivatives transactions" and the regulation of a new Type 11 regulated activity, which are set out below:

(a) *Securitized/embedded derivatives to be excluded*: The Group is strongly of the view that the proposed definition of "OTC derivatives transactions" should exclude securitised/embedded derivatives such as structured products and that a new definition, specifically designed to capture bilateral OTC derivatives should be included in the new legislation. This is because, generally speaking, in the context of the G20 OTC derivatives reforms, there seems to be a consensus amongst global regulators, that the relevant OTC derivatives transactions are bilateral transactions that do not include securitised derivatives and/or embedded derivatives. It should be noted that neither the Dodd Frank Act in the United States nor the latest draft of the European Market Infrastructure Regulation ("**EMIR**") in the European Union appear to be adopting a definition of OTC derivatives which includes securitised or embedded derivatives. The reason for this is that securitised and embedded derivatives products are not appropriate for clearing since they are not bilateral OTC derivatives.

The Group understands that the intention of the G20 reforms relating to clearing is to address the systemic risks relating to the OTC derivatives market, in particular in relation to the counterparty risk that exists in the OTC derivatives market. Therefore, the mandatory clearing obligation is intended to be imposed on the OTC derivatives market and not on securitised derivatives, embedded derivatives or structured products. This is because these products are not necessarily bilateral (for example, they can be owned by more than one holder) and in addition, there is one-way credit risk since the issuer of the product does not generally have credit risk on the holder of the product. As a result, such products are not appropriate for clearing.

(b) *Overlap with existing regulated activities*: Relating to the comment above, there are many instruments that fall within the existing definition of "securities" under the SFO. The Group believes there will be a significant overlap between the new proposed Type 11 regulated activity and existing regulated activities, such as dealing in securities (Type 1) and leveraged foreign exchange trading (Type 3). For example, a firm trading in a non-authorised unlisted equity linked note may potentially require licensing for both Type 1 as well as the new Type 11 regulated activity. Similarly, a Licensed Corporations ("**LCs**") trading in FX linked swaps may potentially require licensing for both Type 3 as well as the new Type 11 regulated activity. This overlap creates complexity and confusion. It is noted that the HKMA and SFC propose to carve out listed securities from the definition of "OTC derivatives transactions". The Group recommends that the HKMA and SFC should carve out all securities from the definition of Type 11 regulated activity to avoid regulatory overlap.

(c) *How to address the regulatory overlap*: The Group understands the HKMA and SFC have asked for views on how to address the regulatory overlap with existing regulated activities. Since market participants are familiar with the existing regulated activities and have been operating their businesses in accordance with the existing delineation for many years, the Group recommends that HKMA and SFC should adopt the first approach set out in paragraph 166(1) of the Consultation Paper, which is not to amend the scope of the existing regulated activities and instead to incorporate appropriate carve outs so that if a person's activities fall within the scope of an existing regulated activity, then they should be able to continue on the basis of their existing licence and not need to apply for a new Type 11 licence.

(d) *Combining advising and dealing definitions*: The existing regulated activities are generally split between advising in the regulated activity and dealing in the regulated activity (attracting 2 separate licensing requirements). The Group understands from paragraph 162 of the Consultation Paper that the current thinking of the HKMA and SFC is to combine the advising and dealing of OTC derivatives into the same regulated activity. This needs to be well thought out.

(e) *Existing carve-outs under other regulated activities to be included*: The Group is of the view that the carve-outs for existing regulated activities (such as dealing as a principal with professional investors exemption available under Type 1 regulated activity and intra-group exemption available under Type 4 regulated activity) should also be available for the new Type 11 regulated activity. This is also relevant to (b) a bove. In particular, we understand that the intra-group exemption is currently only available for advising in the regulated activity but not dealing in the regulated activity. Given the prevalence of intra-group transactions to manage risk exposure (as mentioned in paragraphs 145 to 148 below), we are of the view that the intra-group exemption should be available for "dealing" in OTC derivatives irrespective of whether there will be a combined dealing in and advising on Type 11 regulated activity or split regulated activities for "dealing in" OTC derivatives and "advising on" OTC derivatives. The Group is also of the view that, where necessary, it should be made clear that end-users are carved-out from the definition for Type 11 regulated activity.

(f) *Type 9 (asset management)*: It is unclear from the proposals in the Consultation Paper whether an asset manager dealing in a portfolio of OTC derivatives would require a Type 11 licence. The Group recommends that either (i) the existing definition of Type 9 (asset management) regulated activity should be amended to include managing a portfolio of OTC derivatives transactions or (ii) the definition of Type 11 regulated activity should include an express carve out for asset managers.

(g) *Section 115 ("active marketing")*: It is unclear whether there will be any changes to the current delineation between section 114 of the SFO (where a person carries on a business in Hong Kong) and section 115 of the SFO (where a person actively markets services to the public in Hong Kong). The

Group recommends that the current delineation should be maintained so as not to interfere with the offshore booking model where the offshore entity would not be required to obtain a license in Hong Kong because (i) the services of the offshore entity are not being actively marketed to the public in Hong Kong – there is no prohibition on an offshore entity providing services to persons in Hong Kong; (ii) the offshore entity is "dealing through" an onshore licensed/registered entity; or (iii) the offshore entity is dealing with the onshore licensed/registered intermediary who would in turn be entering into a back to back transaction with the end client in Hong Kong where the onshore licensed/registered intermediary actively markets its services.

7. The Group considers that it is essential that the definition of "OTC derivatives transactions" and in turn categories of regulated activities should be carefully designed and clearly drafted as this will have an impact on the licensing and regulatory framework both for firms that that are currently licensed under the existing regulatory framework and those currently unlicensed firms that will be brought into licensing framework as a result of the proposed legislative reform.

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

8. The Group understands the necessity for joint oversight and the division of regulatory responsibility between the HKMA and SFC. The Group considers the regulatory framework set out in the Consultation Paper to be acceptable, provided that the division of responsibility is clear and there is no overlap of regulatory jurisdiction between the HKMA and SFC which would result in "dual" regulation.

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

9. The Group is of the view that the scope of the mandatory clearing regime in Hong Kong needs to be defined carefully given the onerous nature of a clearing obligation. The HKMA and SFC should recognise that AIs and LCs which are subject to the clearing regime in Hong Kong may be at a competitive disadvantage in comparison with equivalent entities of jurisdictions which do not impose such a mandatory clearing obligation. Therefore, the Group recommends that the HKMA and SFC must adopt an appropriate balance in developing a safer and more stable OTC derivatives market, where needed, without creating a clearing obligation which would stifle the competitiveness of the financial markets in Hong Kong. The Group believes that close co-operation and engagement between the regulators, Designated CCPs and market participants will be essential when determining which types of OTC derivative products should be subject to the mandatory clearing regime in Hong Kong.

10. As a starting point, the Group believes that the HKMA and SFC must carefully consider, when formulating the scope of the mandatory clearing framework, the

relationship between (a) what OTC derivatives products need to be cleared and (b) where such OTC derivatives products need be cleared. This is because determinations made in respect of which types of products should be subject to mandatory clearing will directly influence the regulation of where such products need to be cleared and vice versa.

11. The HKMA and SFC will need to carefully balance the scope of the mandatory clearing framework in Hong Kong (with respect to the types of OTC derivatives products covered) against the requirements (if any) which such regime may impose on market participants in respect of the location where such mandatory clearing must take place. The Group has set out its responses to the issue of domestic clearing under paragraphs 70 to 73 below.

12. With respect to the types of OTC derivative contracts proposed in the Consultation Paper to be the initial product types subject to the mandatory clearing obligation in Hong Kong, we have set out the Group's comments below in paragraphs 34 to 38.

Top Down and Bottom Up Approach

13. Although the Group understands the HKMA and SFC's proposal to adopt a "top down" and "bottom up" approach for determining whether the mandatory clearing regime in Hong Kong should be expanded to cover new OTC derivatives products, the Group's view is that the optimal method should involve a carefully balanced combination of both the "top down" and "bottom up" approach.

14. As a general rule and regardless of the approach which is adopted, the Group considers that it is important from a risk management perspective that, when determining whether the scope of the mandatory clearing obligation in Hong Kong should be extended to cover additional OTC derivatives products, the HKMA and SFC should adopt a prudent approach which gives due consideration to the systemic risks which may be created by clearing OTC derivatives in CCPs.

15. Although the Group understands that a prudent and risk focussed approach may be regarded by some (principally those not actively participating in the OTC derivatives market or involved in the risk management of OTC derivatives) as inappropriate as it may be seen as possibly delaying the benefits associated with clearing in respect of additional OTC derivatives products, the Group is strongly of the view that the premature imposition of a mandatory clearing obligation may significantly increase systemic risk for any Designated CCPs and/or market participants required to clear such products and, by implication, the financial markets in Hong Kong.

16. In respect of a "top down" approach (that is, where the HKMA or SFC determines whether a type of OTC derivatives contract should be subject to mandatory clearing), the Group's view is that, while the HKMA and SFC may consider that it is important to have the ability to directly control the scope of the mandatory clearing obligation, this approach has the potential to increase systemic risk as the HKMA and the SFC may not be in the best position to determine whether Designated CCPs are sufficiently prepared to provide clearing services in respect of such products. As further referred to below, this determination relates in a

large part to such risk management issues as the liquidity of the product and the valuation and margining of the product, which may be more appropriately determined in conjunction with Designated CCPs and market participants.

17. Under a "bottom up" approach, the HKMA and SFC will be required to consider the merits of any applications from Designated CCPs to expand the mandatory clearing regime to new OTC derivatives products in respect of which such Designated CCPs propose offering clearing services.

18. However, systemic risk may also arise in a "bottom up" approach because Designated CCPs may not be in a position to properly consider and address the impact that an extension of the mandatory clearing obligation to a new OTC derivative product would have on the wider OTC derivatives market (such as the effect on systemic risk, the implications for market liquidity of the OTC derivatives product and/or whether market participants are sufficiently prepared from an operational and risk management perspective to clear su ch products through Designated CCPs). This risk is especially pronounced where a Designated CCP may be set to profit from an extension of its clearing services, since incentives may exist for it to take on more risk than is appropriate.

19. Therefore the Group considers it very important that any change in the scope of the mandatory clearing regime in Hong Kong should be made through a carefully balanced combination of the "top down" and "bottom up" approach, where the HKMA and SFC would be required to work closely with Designated CCPs and market participants to determine the suitability of including an OTC derivatives product in the mandatory clearing regime.

20. Furthermore, market participants, who, after all, are the ones who are most subject to the risks associated with inappropriate clearing, need to be provided with an appropriate period of consultation to allow them to comment on any potential extension of the mandatory clearing regime in Hong Kong under both the "top down" approach and the "bottom up" approach[1].

21. The Group has set out below some of the factors which should be carefully considered and addressed by the HKMA and SFC when determining whether a product is suitable for mandatory clearing.

Factors relevant to determining the suitability of OTC derivatives products for mandatory clearing

22. When considering the suitability of OTC derivatives products for mandatory clearing, the Group believes it to be essential that the HKMA and SFC should consider whether the following criteria[2] are fulfilled in respect of each product:

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[1] In addition, the Group believes that any submission made by a Designated CCP to the HKMA and/or SFC for mandatory clearing of a new type of OTC derivative product should be made available to the public concurrently for their consideration.

[2] Similar factors are also set out under (a) Section 723 of the Dodd Frank Act (in respect of the "bottom up" approach where a derivatives clearing organization submits an application to the CFTC and/or SEC for the right

(a) there are substantial notional exposures, liquidity and the availability of market data in respect of such product;

(b) the Designated CCPs and market participants are able to properly and suitably determine the exposures created under and risk manage the type of OTC derivatives product under consideration for mandatory clearing;

(c) an appropriate infrastructure framework (such as operational expertise and margining capabilities) is in place in respect of the trading and settlement of such product;

(d) there are anticipated positive effects on the OTC derivatives market if such product becomes subject to mandatory clearing;

(e) there are no projected harmful effects on CCPs if such product becomes subject to mandatory clearing; and

(f) there is a reasonable level of certainty as to the legal treatment in event of insolvency of any CCP or its clearing members.

23. The above criteria should be interpreted strictly by the HKMA and SFC when determining whether a type of OTC derivatives contract should become subject to the mandatory clearing obligation in Hong Kong in order to properly manage the risks associated with inappropriate mandatory clearing.

24. Furthermore, the HKMA and SFC should also give consideration to the following factors:

(a) the cross-regional aspects of such product (if any) and whether any cross-jurisdictional issues arise;

(b) the costs of submitting such products to clearing which will be passed on to market participants;

(c) the costs for market participants and end users resulting from a potential fragmentation of the OTC derivatives market with respect to such types of products and from inefficient use of regulatory capital as a result of such fragmentation; and

(d) the availability of other CCPs which already offer clearing services in respect of such products in an acceptable overseas jurisdiction.

As set out under footnote 1 above, similar factors are also to be considered by the relevant regulators in the United States and the European Union when assessing the suitability of OTC derivatives products for mandatory clearing. Although the Group recommends that these factors should be considered by the HKMA and SFC, it should be noted that suitable adjustments will need to be made for Hong Kong, bearing in mind features which may be unique to this jurisdiction and the

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to clear a type of swap) and (b) Article 4 of the latest draft of the comprise text on the EMIR as published by the Council of Ministers.

relatively small size of the OTC derivatives market in Hong Kong when compared to the OTC derivative markets in the United States and the European Union.

25. The Group notes that the Consultation Paper states that the degree of standardisation of a product will be considered when determining whether a mandatory clearing obligation will apply (cf. paragraph 57(2) of the Consultation Paper).

26. The Group considers that any assessment of the standardisation of a product can be appropriately split into three categories: 'product' standardisation, 'operational' standardisation and 'contractual' standardisation. The Group's perspective on each form of standardisation is as follows:

    (a) Product standardisation should refer to the existence of market standards for pricing and associated pricing models, payment structures, payment dates and determinations (such as rate resets) for trades in respect of a product;

    (b) Operational standardisation should refer to the existence of uniform standards in the market in relation to the matching, confirming, settling and closing out of trades in respect of a product; and

    (c) Contractual standardisation should refer to the existence of market standard documentation and definitions in respect of a product, with limited or no variation in relation to the key provisions of such OTC derivatives contracts (including events of default, termination events and close-out valuation methodology).

Proposed Future Products subject to the mandatory clearing obligation - Equity Derivatives

27. The Group notes that the HKMA and SFC have specifically proposed to focus on equity derivatives as the next category of products which may become subject to the mandatory clearing obligation (under paragraph 56 of the Consultation Paper).

28. The Group understands that the HKMA and SFC's reason for implementing this proposal is to assist the HKMA and SFC in monitoring and reducing any systemic risk to which the Hong Kong stock market may be exposed as a result of equity derivatives transacted by AIs and LCs, which may in certain circumstances help to enhance the risk management of equity derivatives.

29. However, the Group considers that, in respect of the majority of equity derivatives transactions in Hong Kong, there is an insufficient degree of standardisation in the documentation used for such products to allow for the introduction of mandatory clearing in the near term.

30. It should be noted that one of the main motivations for market participants to develop and publish documentation establishing a new architecture for equity derivatives was due to a perceived lack of standardised documentation for use in the equity derivatives market. This is because the majority of equity derivatives transactions currently traded are still documented under the current market

documentation, which contains a wide range of terms and optionality and results in a diverse range of terms applicable to transactions. As a result, the Group's view is that these trades will not fulfil the criteria set out under paragraphs 22, 24 and 26 above and therefore should not be included in the scope of the mandatory clearing regime. Furthermore, the Group considers that even when OTC equity derivatives transactions documented under the new documentation architecture begin to be traded, the HKMA and SFC should first observe the performance of such products (especially through a period of market stress) in order to determine whether such products are appropriate for mandatory clearing.

31. The Group believes that, even under the new documentation architecture for equity derivatives transactions, such products will only be capable of becoming standardised to a limited extent. The reason for this is that, unlike interest rate products or credit derivatives products, equity derivative products contain many unique risk allocation provisions which need to be bilaterally negotiated between two counterparties. In the sphere of equity derivatives, there are many different events which can occur to the underlying reference asset during the duration of the trade (such as bankruptcy of the issuer, de-listing, merger or tender offer, increased cost of hedging, inability to stock borrow and so on) under which the counterparties may elect to adjust the trade or to terminate it.

32. The ability for market participants to negotiate and tailor such provisions in an equity derivatives transaction allows flexibility as to the pricing and the consequences of events in respect of a trade. If, as a result of mandatory clearing, market participants are not able to bilaterally negotiate equity derivatives transactions (since the terms of such trades would need to be standardised), it is possible that end-users would be required to pay a higher price to counterbalance the fact that dealers would have less flexibility in their ability to control or hedge their risk in respect of an equity derivatives transaction. The Group is therefore concerned that if mandatory clearing applied to equity derivatives transactions, the benefit gained through uniformity and price transparency may be offset by higher prices and lower liquidity in the equity derivatives market.

33. In addition, the Group highlights the fact that there has been little discussion in other important jurisdictions (such as the United States and the European Union) in relation to mandatory clearing of equity derivatives, and nor have any major CCPs elected to provide clearing services in respect of OTC equity derivatives products. Although clearing services for exchange-traded options are offered in many jurisdictions, it should be noted that such markets often co-exist with a robust OTC derivatives market where options remain bilaterally negotiated and traded. The continuation of the OTC derivatives market despite the availability of centrally clearable exchange traded options demonstrates that there are strong commercial reasons for allowing market participants to continue customising the risk allocation and pricing terms in relation to equity derivatives transactions, and as a result the Group believes that it would be potentially damaging to the equity derivatives market in Hong Kong if the HKMA and SFC were to require mandatory clearing of equity derivatives products.

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?

34. The Group understands that the HKMA and SFC are proposing to limit the initial mandatory clearing obligation to certain types[3] of the following classes of OTC derivative contracts (as set out under paragraph 59 of the Consultation Paper):

    (a) interest rate swaps ("**IRSs**"); and

    (b) non-deliverable forwards ("**NDFs**").

35. In determining whether the types of derivatives above are suitable for clearing, we refer you to the factors set out in paragraphs 22, 24 and 26 above, particularly in relation to the degree of standardisation and the liquidity of the product.[4]

36. The Group considers it essential that the HKMA and SFC should carefully consider, when determining the initial scope of the mandatory clearing regime in Hong Kong, whether the imposition of such mandatory clearing obligation in respect of certain products will negatively impact the ability of market participants to risk manage their businesses efficiently and/or result in increased systemic risk to the OTC derivatives market.

37. For example, if the market in a certain type of product spans across several jurisdictions, it would be counterproductive to the risk management of such product for each jurisdiction to impose its own mandatory clearing obligation on this product as this may result in the break-up of netting sets among market participants (which such market participants rely on to manage their counterparty credit risk) and a fragmentation of the market in such type of product across each jurisdiction. This may hinder the ability of the market to effectively and efficiently manage its risk in respect of such product.

38. In addition, this may lead to a reduction in the liquidity of a product which may in turn result in a reduction in the market efficiency in respect of such product with the knock-on effect that the costs of such products may increase. These increased costs will inevitably be borne by end users of such transactions in Hong Kong thereby reducing the ability of end users to use derivatives efficiently to risk manage their businesses and further damaging the liquidity of the Hong Kong OTC derivatives markets. Given the recognised importance of the OTC derivatives market for the economic development of Hong Kong as well as Asia, this may have an unintended and damaging effect on the development of the Asian economies.

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[3] The Group understands that the HKMA and SFC will frame such types of OTC derivatives products by reference to certain relevant characteristics, such as tenor and currency pairs.

[4] For example, it has been noted by market participants that the liquidity in respect of INR NDFs is lower in Hong Kong than for the comparable product in Singapore. In relation to such products, the HKMA and SFC should consider whether it is appropriate to include such OTC derivative contracts under the mandatory clearing obligation, since to do so may further split the liquidity of this product in the Asian markets.

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

"Originated or Executed"

39. Given the booking model of many of the major international banks in Hong Kong, the Group understands the HKMA and SFC's desire to expand the mandatory clearing regime to cover transactions which have been negotiated, arranged, confirmed or committed in Hong Kong, as otherwise the regime in Hong Kong would not apply to major international banks which book their OTC derivatives transactions to a foreign entity (such as an affiliate established in London or New York) to foreign head office or branch.

40. As stated at the outset of this Response, the Group does not comment in this Response on issues relating to the mandatory reporting regime as outlined in the Consultation Paper. While members of the Group have well developed and considered views on the mandatory reporting obligation, these views will be communicated to the HKMA and SFC through other appropriate channels. Therefore the Group expresses no view in the Response as to the application of the concept of "originated or executed" to the mandatory reporting obligation.

41. However, in respect of the mandatory clearing framework, the Group understands that the primary purpose of mandatory clearing is to prevent systemic risk by managing counterparty risk, that is the risk of default by a market participant. As a result, it seems difficult to justify why the mandatory clearing regime in Hong Kong should be extended to cover OTC derivatives transactions which were "originated or executed" by an AI or LC if such AI or LC is not a counterparty to the OTC derivatives contract. Instead, the focus of the mandatory clearing obligation should remain on the location, and credit risk, of the two counterparties to the trade.

42. Where an OTC derivatives contract has been booked to an overseas entity, such overseas entity is already likely to be subject to a mandatory clearing obligation in its home jurisdiction and in these circumstances the trade will be cleared through a CCP in any event. In such a scenario, the central aim of mandatory clearing, which is to reduce systemic risk to the OTC derivatives market, is already achieved. The Group therefore does not consider that there is a good reason for introducing the concept of "originated or executed" to capture OTC derivatives transactions which are likely to be centrally cleared in any event.

43. As the HKMA and SFC have mentioned in the Consultation Paper, "originated or executed" is not a concept adopted in the United States or European Union (see paragraphs 64-68 of the Consultation Paper) most likely for the reasons set out above.

44. Furthermore, the HKMA and SFC should recognise that many international banks currently centralise many of their functions within their Hong Kong offices, which may include structuring, legal, back office, collateral management and trading. As a result, many transactions which were negotiated and executed by offshore

marketers with offshore clients may nevertheless involve Hong Kong-based personnel. The Group considers that the centralisation of functions in a regional hub in this way is important for the efficient management of international banks, and the fact that international banks have chosen Hong Kong as a regional hub for the performance of such functions should not result in them being subject to onerous and uncertain legislation as to the scope of their clearing obligation under the Hong Kong clearing regime. This would not be good for Hong Kong's status as an international financial centre and as a preferred regional hub for business in Asia. Instead, the Group recommends that the HKMA and SFC should focus on the regulation of the two counterparties to an OTC derivatives transaction (which is where the credit risk arises) rather than the location in which such trade was "originated or executed".

45. However, if the HKMA and SFC insist on including the concept of "originated or executed" in the Hong Kong mandatory clearing regime, the Group considers that it is essential that the definition of "originated or executed" should be very clearly defined.

46. As currently expressed in the Consultation Paper, the term "originated or executed" covers too broad a range of activities which can be carried out by an AI or LC, and this will result in uncertainty as to whether a particular transaction will be subject to the mandatory clearing regime in Hong Kong. Given the consequences of a failure to comply with the mandatory clearing obligation and the overall intention of the mandatory clearing regime, such uncertainty would significantly disadvantage financial institutions using offshore booking models and would be disproportionate to the intended benefits which mandatory clearing is designed to bring.

47. The Group notes that the Consultation Paper refers specifically to functions carried out by a relevant sales desk or trading desk. Therefore, the Group strongly recommends that the new legislation might be drafted such that the concept of "originated or executed" will track the language used in defining the scope of activity under the new proposed Type 11 regulated activity (but refined in the manner set out under paragraph 49 below).

48. The advantage of tracking the language used in defining the scope of activity under the new proposed Type 11 regulated activity is that any interpretation of the meaning of terms used in the new legislation defining the concept of "originated or executed" can be consistent with the approach of the SFC to the new Type 11 regulated activity.

49. However, a definition of "originated or executed" which only tracks the scope of activity under the new proposed Type 11 regulated activity would still cast the net too wide, and would need to be carefully and clearly refined to ensure that it was clear to AIs and LCs what activity would result in an OTC derivatives transaction being "originated or executed" in Hong Kong. For example, the Group suggests that such activity might be restricted to:

    (a) in respect of a sales desk of an AI or LC, if such sales desk had a direct client facing role in a transaction and such role was performed in Hong Kong; and

(b) in respect of a trading desk of an AI or LC, if such trading desk in Hong Kong committed the client and/or the booking entity to the transaction either as a principal or as an agent of either party (for example, by making entries into a booking system in Hong Kong).

50. The Group considers that any other activities other than sales or trading (as outlined above) should not cause a transaction to be "originated or executed" by an AI or LC in Hong Kong, regardless of the level of involvement by any Hong Kong-based personnel of such AI or LC.

51. However the details of any such regime would need to be the subject of further consultation by the HKMA and SFC to ensure that it achieved the requisite level of legal and regulatory certainty and did not result in irreconcilable conflicts between the legal and regulatory obligations applicable to market participants in Hong Kong and their equivalent obligations in other jurisdictions.

Exemption for mandatory clearing regimes in acceptable overseas jurisdictions

52. The Group strongly supports the exemption proposed by the HKMA and SFC in paragraph 110(2)(b) of the Consultation Paper which covers the scenario where both counterparties to a transaction are overseas persons and the transaction is either (a) subject to mandatory clearing under an "acceptable overseas jurisdiction" or (b) exempt from mandatory clearing under those laws. In addition the Group strongly recommends that this exemption should be expanded to cover the scenario where only one party is an overseas person.

53. This will be even more important if Hong Kong's mandatory clearing regime will cover any transactions "originated or executed" in Hong Kong. This is because it would be possible for such a regime to cover transactions which are booked by an AI or LC to, for example, their London or New York affiliate, head office or branch. Under this scenario, the Group is very concerned that such London or New York entity may be subject to conflicting mandatory clearing obligations under both the laws of its home jurisdiction as well as the obligation under Hong Kong law.

54. As the HKMA and SFC has recognised, unlike a mandatory reporting obligation, where an entity subject to two distinct mandatory reporting regimes may comply with both regimes by reporting the relevant transaction to multiple trade repositories, it is not possible to submit a transaction to central clearing through two separate CCPs.

55. The Group therefore considers it extremely important that the mandatory clearing regime in Hong Kong should provide an exemption to an overseas person where a transaction is already subject to mandatory clearing under the laws of an acceptable overseas jurisdiction (or, alternatively, is exempt from clearing under the laws of such acceptable overseas jurisdiction). This should be the case even where the counterparty to such overseas person may be an AI, LC or Hong Kong person.

56. If the HKMA and SFC do not expand the scope of the exemption contained under paragraph 110(2)(b) of the Consultation Paper in such a manner, the Group is very concerned that a booking entity in a foreign jurisdiction may be placed in an impossible situation where it is subject to competing mandatory obligations in multiple jurisdictions and is not able to comply with the laws of each jurisdiction to which it is subject.

57. The Group considers that this potential overlap in regulation between the regime in Hong Kong and overseas jurisdictions may be damaging to the Hong Kong derivatives market, as such a transaction may (a) simply not happen, since it would otherwise not be possible to comply with the mandatory clearing obligation in both jurisdictions or (b) become more expensive for end users in Hong Kong due to the increased cost of compliance with conflicting mandatory clearing regimes of market participants. Again, this seems disproportionate given what is the overall intention of the imposition of a mandatory clearing regime.

58. The Group recognises that the HKMA and SFC are very aware of this issue and that the SFC and HKMA have, accordingly proposed a mandatory clearing regime in Hong Kong where foreign CCPs may become Designated CCPs for the purposes of Hong Kong regulation, thereby allowing a foreign entity to comply with competing mandatory clearing obligations both in its home jurisdiction as well as under Hong Kong law. However, the Group considers that this is not the most practical solution (as discussed in paragraphs 75 to 85 below). The Group is strongly of the view that the most proportionate and fair solution is for a foreign entity which is already subject to a mandatory clearing obligation in an "acceptable overseas jurisdiction" to be exempt from the mandatory clearing regime in Hong Kong.

59. In respect of what should constitute an "acceptable overseas jurisdiction", the Group agrees that such jurisdiction should have regulatory standards in respect of the OTC derivatives market which is on a par with international standards and practices as set out under paragraph 116 of the Consultation Paper, including by the imposition of a mandatory clearing regime which is broadly consistent the G20 commitments on mandatory clearing.

Closed market jurisdictions

60. In addition to the discussion on "acceptable overseas jurisdiction" under paragraphs 52 to 59 above, the Group considers that it is very important for the HKMA and SFC also to introduce an exemption for both counterparties to a OTC derivatives transaction from the mandatory clearing regime in Hong Kong where one of the counterparties to an OTC derivatives transaction is subject to a mandatory clearing obligation in a "closed market jurisdiction".

61. In the context of this Response, the term "closed market jurisdiction" refers to any jurisdiction which has a material level of foreign exchange control, confidentiality or bank secrecy laws and/or other local regulatory restrictions which would make it impractical to require clearing to take place in any jurisdiction other than such "closed market jurisdiction".

62. The Group recommends that, where such "closed market jurisdiction" already imposes a mandatory clearing obligation on market participants, a CCP based in such jurisdiction would in all likelihood represent the most suitable (and probably, the only) location for the clearing of the relevant OTC derivatives products.

63. Although the Group acknowledges that such "closed market jurisdiction" may not yet have aligned itself fully with global regulatory standards (such as under the CPSS-IOSCO report on Principles for financial market infrastructures (March 2011) (the "**CPSS-IOSCO Report**") or Basel III), the Group considers that it would be potentially problematic for the OTC derivatives market in Hong Kong for the HKMA and SFC to insist that trades involving a counterparty from a "closed market jurisdiction" should nevertheless be cleared in accordance with the laws of Hong Kong.

64. Depending on the market structure of the particular "closed market jurisdiction", it may be the case, for example, that the counterparty to the AI or LC may have no option but to clear the product in the "closed market jurisdiction". This might be because:

    (a) the resident of such "closed market jurisdiction" is only permitted by the laws and regulations of the "closed market jurisdiction" to transact such a product domestically or to clear such a transaction domestically; or

    (b) alternatively, because the relevant Hong Kong AI or LC must accommodate the request from such resident of the "closed market jurisdiction" to transact or clear the transaction domestically in the "closed market jurisdiction" in order for such Hong Kong AI or LC to be competitive with local domestic players in the "closed market jurisdiction".

    In such a case, a relevant AI or LC seeking to do OTC derivatives business in such "closed market jurisdiction" might have no choice but to clear the relevant OTC derivatives transaction in the "closed market jurisdiction".

    Clearly this would be very undesirable for Hong Kong as a whole, given the economic importance which is placed on Hong Kong's success as a hub for providing financial services across Asia, including in economically and strategically important "closed market jurisdictions" in Asia or, alternatively, to make sure that such transaction was not "originated or executed" in Hong Kong or booked to an entity established or licensed in Hong Kong.

    This also highlights an additional issue which may arise if the proposals for the "originated or executed" regime are adopted in Hong Kong, where an OTC derivatives contract is transacted with an entity located in a "closed market jurisdiction". In such a scenario, it may only be possible to clear the OTC derivatives transaction in the relevant "closed market jurisdiction". Therefore an AI or LC that, for example, had booked the transaction to one of its affiliates or branches outside Hong Kong (and perhaps in the relevant "closed market jurisdiction") would be put in a difficult, if not impossible, situation if, as a result of the transaction being deemed to have been "originated or executed" in Hong Kong, the transaction was subject to a mandatory clearing obligation in Hong Kong which could not be complied with.

65. The Group considers that the exemption in respect of a "closed market jurisdiction" should be treated separately from the exemption in respect of an "acceptable overseas jurisdiction" as this would allow the HKMA and SFC to differentiate for risk management purposes between CCPs which comply with global regulatory standards (such as the standards to be set out by CPSS-IOSCO and Basel III) and CCPs from "closed market jurisdictions" (which may not comply with all such standards).

Recognition of foreign CCPs

66. As mentioned above under paragraphs 39 to 51 above, the potential extra-territorial impact of the proposed mandatory clearing regime in Hong Kong (coupled with the extra-territorial scope of the mandatory clearing regimes introduced in foreign jurisdictions such as the United States and European Union) will result in many foreign booking entities of AIs and LCs becoming subject to conflicting mandatory clearing obligations in several jurisdictions in respect of one OTC derivatives transaction.

67. In such circumstances, the Group believes that such entities should benefit from an exemption to the mandatory clearing regime in Hong Kong (as set out under paragraphs 52 to 59 above). However, if the HKMA and SFC do not grant such an exemption to the affected entities, the Group considers that there are only two appropriate fallback methods by which this overlap of mandatory clearing obligations imposed by different jurisdictions can be resolved:

    (a) Hong Kong may allow foreign entities subject to the mandatory clearing regime both in Hong Kong and its home jurisdiction to clear the relevant OTC derivatives transactions through a foreign CCP that has become a Designated CCP in Hong Kong; or

    (b) Hong Kong may establish a CCP which becomes recognised in the relevant foreign jurisdictions as a valid CCP through which the affected entities subject to conflicting mandatory clearing regimes may clear their trades.

68. By way of illustration, an AI or LC in Hong Kong may "originate or execute" an OTC derivatives transaction between its London booking entity and a Hong Kong incorporated company. If the clearing threshold for both parties is exceeded, the trade will be subject to the mandatory clearing regime in Hong Kong. However, the London booking entity will also likely be subject to the mandatory clearing regime in the European Union.

69. Under this scenario, the London booking entity would be put in an impossible position by the mandatory clearing regimes in Hong Kong and the European Union unless either: (a) one or both jurisdictions provide an exemption from clearing for trades entered into by overseas persons; (b) the London entity is permitted by the mandatory clearing regime in Hong Kong to clear the trade through a CCP which is also acceptable to the European Union OTC derivatives regime; or (c) the London entity can clear the trade in a CCP established in Hong Kong in circumstances where such CCP has gained recognition as a recognised clearing house with the relevant competent authority in the United Kingdom.

Location requirement / Domestic clearing

70. From the comments made under paragraphs 54 to 57 above, it therefore follows that the Group strongly recommends that the HKMA and SFC should not insist that the only way to comply with the mandatory clearing obligation in Hong Kong would be to use a domestic (that is, Hong Kong established) CCP. This is because the imposition of a domestic clearing requirement would inevitably result in fragmentation of liquidity and the breaking of netting sets for market participants (which may currently be clearing OTC derivatives transactions through foreign CCPs) and will entail higher costs for end users of OTC derivatives products in Hong Kong.

71. Furthermore, the Group does not recommend that domestic clearing be mandatory since this would remove the ability of market participants to select the most appropriate CCP for the clearing of their OTC derivatives transactions. It may over time also lead to the excessive build up of systemic risk in Hong Kong with respect to the Hong Kong CCP, which may ultimately result in the need for HKMA support if there is ever a failure of the Hong Kong CCP.

72. It is also important for the HKMA and SFC to recognise that domestic clearing would only be practical if CCPs based in Hong Kong were able to obtain recognition in major foreign jurisdictions (such as the United States and the European Union). This is because, as discussed above, many foreign market participants will likely be subject to conflicting mandatory clearing regimes and will therefore need to clear their trades through a CCP which is recognised in all the relevant jurisdictions in order to satisfy their clearing obligations in all such jurisdictions.

73. However, as can be seen from paragraphs 86 to 90 below, it is essential that the HKMA and SFC bear in mind that the time frame required for a CCP established in Hong Kong to gain recognition in foreign jurisdictions such as the United States (as a derivatives clearing organization or a clearing agency) or England (as a recognised clearing house) will be prohibitive if the HKMA and SFC wishes to introduce a mandatory clearing obligation in Hong Kong before the end of 2012. Therefore, the Group's carefully considered conclusion is that the HKMA and SFC should not mandate domestic clearing as to do otherwise would likely have very detrimental consequences for the OTC derivatives market in Hong Kong, which would not be in the interests of Hong Kong's status as an international financial centre.

Reciprocal recognition

74. As a starting point for the recognition of foreign CCPs, the Group believes that it is important for the HKMA and SFC to understand that it would be inappropriate to insist that foreign jurisdictions provide reciprocal recognition for CCPs based in Hong Kong when establishing a process for such recognition of foreign CCPs. This is because it would be likely to take a very considerable amount of time to implement such a reciprocal arrangement with foreign regulators, and if this process were not completed prior to the establishment of the mandatory clearing framework in Hong Kong, market participants might have no option but to arrange for its OTC derivatives transactions to be outside of the clearing regime in

Hong Kong in order to avoid conflicting mandatory clearing obligations. Again this would have considerable negative consequences for the financial markets in Hong Kong.

Automatic recognition of foreign CCPs versus application as RCH or ATS

75. If the exemption which has been described under paragraphs 52 to 59 above is not granted, the Group considers that the only practical solution to prevent an overlap of the mandatory clearing regimes imposed in different jurisdictions will be for Hong Kong to allow OTC derivatives transactions that are subject to the mandatory clearing regime in Hong Kong to be cleared in foreign CCPs (as described under paragraph 58) that have become Designated CCPs in Hong Kong.

76. The Group notes that approximately 50% (by volume) of all Hong Kong dollar interest rate swaps are currently cleared through LCH.Clearnet, and therefore the process for recognition of foreign CCPs in Hong Kong will be very important to ensure that there is a smooth transition for participants in the Hong Kong OTC derivatives market following the introduction of a mandatory clearing regime in Hong Kong.

77. There are two methods by which a foreign CCP may become a Designated CCP in Hong Kong:

    (a) A foreign CCP may apply to become a RCH or ATS under Part III of the SFO (as described under paragraphs 142 to 145 of the Consultation Paper) (the "**Application Approach**"); or

    (b) The HKMA and SFC may provide a 'grandfathering' period for certain foreign CCPs to hold a temporary licence as a Designated CCP' for the purposes of the mandatory clearing regime in Hong Kong (the "**Grandfathering Approach**"), with such temporary licence expiring when the foreign CCP either completes its application to become a Designated CCP or fails to complete its application for a full licence within a certain specified timeframe.

78. With respect to the Application Approach, the Group considers the dual system of allowing a foreign CCP to apply for recognition as either a RCH or ATS to be eminently sensible and in line with the SFC's approach to date. It is noted that offshore exchanges have consistently been permitted to be licensed as an ATS under Part III Division 7 of the SFO and it seems to be a natural extension of that to treat foreign CCPs in the same manner. The Group understands that this is a way for the HKMA and SFC to encourage foreign CCPs to register in Hong Kong, rather than stay offshore, because the ATS regime is more flexible (the SFC can provide for customised and appropriate conditions and set them out in correspondence) and involves relatively lower levels of regulation by the SFC, leaving the primary regulatory role to the home-country regulator of the foreign CCP.

79. Furthermore, the Application Approach would assist the SFC by alleviating the increased supervisory burden of having to regulate a significant number of additional RCHs. The Group also observes that by encouraging the introduction of

foreign CCPs as RCHs or ATSs, this will assist the competitiveness of the market for the provision of clearing services in Hong Kong.

80. However, the Group does not believe that at the initial stages of the imposition of the mandatory clearing regime in Hong Kong it will be either necessary or efficient for the HKMA and SFC to conduct full due diligence (for example, in respect of compliance with the principles set out in the CPSS-IOSCO Report on, without limitation, governance, risk management, ownership and operations) on all foreign CCPs applying for recognition in Hong Kong as a RCH or ATS in order to determine whether such CCP is suitable for offering clearing services in Hong Kong. This is because full due diligence in respect of each foreign CCP would be a very time consuming process for the HKMA and SFC, and therefore it may not be possible for such foreign CCPs to become Designated CCPs prior to the implementation of the mandatory clearing obligation.

81. It is imperative for the HKMA and SFC to complete its process for recognition of foreign CCPs from certain major jurisdictions (such as the United States and the European Union) at the same time that the mandatory clearing obligation is implemented in Hong Kong in order for the affected booking entities of AIs and LCs (which are likely to be subject to the mandatory clearing regimes in both Hong Kong and abroad) to have the ability to comply with both regimes.

82. However, the fact that the Application Approach relies on foreign CCPs to apply to the HKMA and SFC for recognition, combined with the fact that the recognition process under the SFO may be a time-consuming process, means that the HKMA and SFC run the significant risk that some major foreign CCPs may not have become Designated CCPs when the mandatory clearing regime in Hong Kong takes effect.

83. The Group considers that such a result would be detrimental to the reputation of the regulatory regime in Hong Kong and would cause additional systemic risk to the OTC derivatives market in circumstances where certain banks with international operations were put in an impossible position with respect to the mandatory clearing regime imposed in Hong Kong because certain foreign CCPs had not yet achieved the status of a Designated CCP. Furthermore, any increased costs suffered by such banks would inevitably be borne by end users in Hong Kong which would likely hamper the development the local OTC derivatives market.

84. Therefore, the strong recommendation of the Group is that the HKMA and SFC should develop a Grandfathering Approach whereby certain foreign CCPs, by virtue of their regulation by "acceptable overseas jurisdictions" in accordance with the principles set out under the CPSS-IOSCO Report, are provided a temporary licence to offer clearing services in Hong Kong as if they were a Designated CCP for the purposes of the mandatory clearing regime in Hong Kong without the need for such foreign CCP to have completed the process for recognition as a RCH or ATS in Hong Kong.

85. The Group strongly suggests that the HKMA and SFC initially adopt a Grandfathering Approach to the recognition of foreign CCPs as Designated CCPs for the following reasons:

(a) the Grandfathering Approach will ensure that foreign entities which are subject to conflicting mandatory clearing regimes (both in Hong Kong and in its home jurisdiction) will have a method of complying with both clearing regimes by clearing its trades through a foreign CCP that has been granted a temporary licence as an ATS by the HKMA and SFC;

(b) the Grandfathering Approach should require less resources and less time from the HKMA and SFC to implement (compared to the Application Approach) as the licence to operate as a Designated CCP will only be temporary. If the HKMA and SFC intend to introduce the mandatory clearing regime in Hong Kong before the end of next year (2012) in line with the G20 commitments, the Grandfathering Approach is a necessary complement to the Application Approach in allowing the HKMA and SFC to complete recognition of sufficient foreign CCPs (at least on a temporary basis) to avoid creating a scenario where foreign entities are unable to comply with conflicting mandatory clearing regimes (as described under paragraphs 52 to 59 above); and

(c) the HKMA and SFC will still retain full control of the recognition process for foreign CCPs under the Grandfathering Approach as the HKMA and SFC could determine the duration of any temporary licence it grants to foreign CCPs to operate as Designated CCPs in Hong Kong. If, at the end of such time period imposed by the HKMA and SFC, the foreign CCP has still not completed its application to become a RCH or ATS, the temporary licence would then expire and such foreign CCP will no longer be considered a Designated CCP for the purposes of the mandatory clearing regime in Hong Kong. In respect of transactions which are already cleared with such foreign CCP which loses recognition as a Designated CCP, the Group is of the view that the mandatory clearing regime in Hong Kong should not require such transactions to be "de-cleared" from such foreign CCP and re-submitted for clearing in a Designated CCP as this may involve an onerous process without providing substantial benefits to the risk management of the OTC derivatives market in Hong Kong.

Recognition by foreign jurisdictions of CCP established in Hong Kong

86. As mentioned in paragraph 73 above, the Group considers that it will be an extremely challenging process for a CCP established in Hong Kong to achieve recognition in a foreign jurisdiction such as the United States and European Union within the requisite timeframe (that is, by the end of 2012).

87. The HKMA and SFC should recognise that the resources of the relevant foreign regulators may already be spread very thinly as many other CCPs worldwide are also applying for recognition in the jurisdictions of such foreign regulators. This will increase the time required for a CCP established in Hong Kong to complete the difficult process for achieving recognition in such foreign jurisdictions.

88. Furthermore, it is very likely that a CCP based in Hong Kong applying for recognition in the European Union will need to show that the Hong Kong legal framework is equivalent to the European Union legal framework, which is not yet finalised and will depend to a significant extent on implementing or delegated

regulation adopted under EMIR. Furthermore, under the latest draft of EMIR, one of the conditions for the European Union to grant recognition to a CCP based outside of the European Union is for the home jurisdiction of such CCP to provide reciprocal recognition to CCPs established in the European Union. As such, the HKMA and SFC will need to ensure that the process for recognition of foreign CCPs in Hong Kong will comply with the requirements under EMIR.

89. Similarly, in order to obtain and maintain registration as a derivatives clearing organization with the CFTC in the United States, a CCP based in Hong Kong will need to demonstrate compliance with certain core principles which include, among other things, (a) maintenance of adequate financial, operational and managerial resources, (b) standards for participant and product eligibility, (c) risk management capabilities and disaster recovery procedures, (c) procedures for protecting customer and member funds (such as, for example, ensuring proper segregation), (e) default, enforcement and dispute resolution procedures, (f) reporting and recordkeeping procedures, (g) settlement capabilities and (h) governance standards. The CCP based in Hong Kong will also be required to enter into appropriate co-operation arrangements with United States regulators.

90. As a result, the requirements outlined above will be difficult to achieve for any Hong Kong CCP and it is therefore expected that it will be a substantial amount of time before any CCP established in Hong Kong will be able to achieve recognition in a foreign jurisdiction. Therefore, if the exemption described under paragraphs 52 to 59 above is not granted, the Group considers that it is essential for the HKMA and SFC to allow foreign entities to fulfil their mandatory clearing obligation under Hong Kong laws through foreign CCPs which have become Designated CCPs (either through a temporary licence under the Grandfathering Approach or as a RCH or ATS under the Application Approach), and it is crucial for such recognition by the HKMA and SFC to be completed by the time that the mandatory clearing regime in Hong Kong comes into effect.

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

91. The Group supports the HKMA and SFC's proposal to adopt a specified clearing threshold in respect of the mandatory clearing obligation to be introduced in Hong Kong given the otherwise onerous nature of clearing OTC derivatives transactions. As a starting point, the Group considers that a distinction should be drawn between "financial counterparties" and "non-financial counterparties"[5].

92. The Group believes that non-financial counterparties should benefit from the introduction of a clearing threshold as the imposition of mandatory clearing on such parties will be disproportionate to the systemic risk posed by such parties to the OTC derivatives market of Hong Kong, since such non-financial counterparties will generally use OTC derivatives transactions for managing

[5] A similar distinction is included under the latest draft of EMIR.

commercial risk and should not form a significant part of the OTC derivatives market in Hong Kong.

93. However, with respect to financial counterparties, the Group considers that the clearing threshold should not apply as the interconnectedness of financial counterparties (due to their function as intermediaries in the Hong Kong OTC derivatives markets) creates systemic risk regardless of the size of such financial counterparties. This is consistent with the end-user exemption which is contained in both the Dodd Frank Act as well as EMIR, which applies to non0financial counterparties but not to financial counterparties. In this context, the Group considers that "financial counterparties" should include all AIs and LCs (but carving out market participants who are only licensed to carry out Type 9 regulated activities since they do not generally perform an intermediary function). Furthermore, careful consideration will also need to be given in respect of counterparties with sensitive commercial status, such as central banks, state foreign reserve managers or sovereign wealth funds (which may be foreign persons or acting through Hong Kong persons). Where the mandatory clearing requirements may be inconsistent with the special status of such entities, the mandatory clearing regime may need to provide for flexibility, for example, in respect of the applicable thresholds or by making certain exemptions available.

94. As a result, the Group believes that more detail must be provided in relation to this clearing threshold mechanism, both in relation to how the threshold levels will be set and how the threshold levels will be calculated. Therefore, the Group strongly urges the HKMA and SFC to conduct further consultation in relation to this issue once further details about this proposal are available.

Method of determining value of outstanding positions

95. Like the HKMA and SFC, the Group considers that calculating the outstanding positions of a market participant on the basis of the average notional value of such positions for the previous six months (based on the month-end position) (as described under paragraphs 92 to 95 of the Consultation Paper) may not in all cases reflect the true level of risk to which such market participant is exposed, but the Group is also of the opinion that any determination based on the mark-to-market value of outstanding positions would be difficult to implement.

96. As the HKMA and SFC point out under paragraph 93 of the Consultation Paper, the mark-to-market value of outstanding positions may fluctuate frequently and therefore make calculations difficult. Furthermore, the Group considers that there may be some variation in the methodologies used to calculate mark-to-market valuations, which may limit the practical application of mark-to-market valuations in determining whether a clearing threshold has been exceeded.

97. In respect of the HKMA and SFC's proposals under paragraphs 124 to 125 of the Consultation Paper to include non-clearing eligible transactions in the calculation of the clearing threshold, the Group is of the view that this is not appropriate and only clearing eligible transactions should be taken into account. The implementation of such a calculation methodology could lead to the unsatisfactory result that a market participant may have only one clearing eligible transaction,

but be required to clear such trade (and suffer all associated infrastructure costs) by virtue of the size of their non-clearing eligible transactions.

98. Furthermore, one advantage of calculating the clearing threshold by reference to clearing eligible transactions only is that market participants would be able to easily determine the OTC derivatives transactions which it would need to include in the determination of its outstanding positions in relation to a product class (as described under paragraph 120 of the Consultation Paper) and how it should measure the notional amount of such outstanding position. If non-clearing eligible transactions are taken into account, there may be confusion among market participants as to which transactions fall within a product class, as certain OTC derivatives transactions may belong to more than one product class[6], and as to how to measure the notional amount of such positions.

Monitoring value of counterparty's outstanding positions

99. As mentioned above, the Group is very concerned by the HKMA and SFC's proposal to hold an AI or LC responsible for ensuring compliance with the mandatory clearing regime where the AI or LC originated or executed the transaction (see paragraph 133(3) of the Consultation Paper).

100. In the case of the application of clearing thresholds, this is because, in order for mandatory clearing to apply, both counterparties to an OTC derivatives transaction will need to exceed the specified clearing threshold (as described under paragraph 133(3)(a) of the Consultation Paper).

101. However, the Group believes that it will not be possible for an AI or LC to determine whether a counterparty has exceeded the clearing threshold as such counterparty will be likely to have entered into OTC derivatives transactions with many other market participants.

102. In such a scenario, although the AI or LC could obtain a contractual representation that the counterparty has not breached the clearing threshold and an associated contractual undertaking from the counterparty that it shall notify such AI or LC in the event that the counterparty exceeds the clearing threshold, it would seem to be impossible for the AI or LC to independently determine whether the clearing threshold has been exceeded if the counterparty (in breach of contract) has misrepresented its position in respect of the clearing threshold or fails to notify the AI or LC.

103. Under such circumstances, the Group believes that the HKMA and SFC must surely recognise that it cannot be fair or proportionate for the AI or LC to be penalised for a failure to submit the relevant OTC derivatives transaction involving such counterparty for clearing in a Designated CCP.

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[6] For example, guidance would need to be provided in respect of hybrid products, such as whether an equity derivatives transaction with an imbedded interest rate swap element is included in the calculation of the clearing threshold for interest rate swaps.

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

104. The Group supports the initial grace period proposed by the HKMA and SFC as well as the grace period proposed in respect of new OTC derivatives products subject to the mandatory clearing obligation (as set out under paragraphs 128 to 129 of the Consultation Paper). The 3-month/6-month periods compare favourably with the time frame proposed by the Commodity Futures Trading Commission (the "**CFTC**") in respect of Section 745 of the Dodd Frank Act.

105. The grace period proposed by the HKMA and SFC in the Consultation Paper represents a practical and realistic time frame within which the relevant CCPs and the relevant entities subject to the mandatory clearing obligation can implement the necessary infrastructure and processes as well as to prepare the contractual documentation required to allow the safe and successful clearing of the relevant OTC derivatives product.

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

106. In respect of the designation and regulation of CCPs in Hong Kong, the Group highlights at the outset the importance of requiring any CCP established in Hong Kong to be in compliance with the international standards to be set out by CPSS-IOSCO next year. As the HKMA and SFC are no doubt aware, this is very important because:

(a) the CPSS-IOSCO standards will be an internationally accepted set of principles which promote the establishment and operation of a structurally robust and safely managed CCP;

(b) clearing members will only benefit from the favourable regulatory capital treatment which applies to qualifying CCPs under Basel III if the relevant CCP has been determined to be in compliance with the CPSS-IOSCO standards; and

(c) compliance with the CPSS-IOSCO standards will be one of the requirements that a CCP based in Hong Kong will need to meet in order to achieve recognition in other major jurisdictions.

Recognition of foreign CCPs

107. Please see the Group's comments in relation to this issue under paragraphs 66 to 69 above.

Automatic recognition of foreign CCPs versus application as RCH or ATS

108. Please see the Group's comments in relation to this issue under paragraphs 75 to 85 above.

Recognition by foreign jurisdictions of CCP established in Hong Kong

109. Please see the Group's comments in relation to this issue under paragraphs 86 to 90 above.

Location requirement / Domestic clearing

110. Please see the Group's comments in relation to this issue under paragraphs 70 to 73 above.

Acceptability of overseas clearing members / Remote Membership

111. The Group believes that it is imperative for CCPs based in Hong Kong to allow remote membership. This is because if remote membership to a CCP in Hong Kong is not possible, interested foreign entities would be required to establish an AI or LC in Hong Kong specifically for the purposes of becoming a clearing member to a CCP based in Hong Kong. Such a requirement would be very undesirable as it may potentially (a) break netting arrangements in respect of the foreign entity (as trades subject to the mandatory clearing regime in Hong Kong will need to be booked to the Hong Kong-based AI or LC), which would have the counter-productive effect of increasing the systemic risk in the OTC derivatives market (along with the increased cost consequences as described under paragraph 70 above) and (b) unnecessarily impose additional capitalisation costs on such foreign entity (as the newly established AI or LC will require sufficient capital in order to become a clearing member of the CCP based in Hong Kong). The Group is therefore strongly of the view that remote membership of a Hong Kong CCP is necessary and desirable to achieve the objectives of the mandatory clearing initiatives.

112. Furthermore, as set out under paragraphs 150 to 152 of the Consultation Paper, there may be compelling commercial reasons for any CCP established in Hong Kong to seek to widen the scope of potential clearing members that may directly clear OTC derivative transactions through such CCP.

113. However, it is also extremely important from a risk management point of view and for the safe functioning of a CCP in Hong Kong to ensure that all clearing members of such CCP are based in suitable jurisdictions from a legal and regulatory perspective. The Group has summarised below some of the key issues that would need to be addressed in determining which jurisdictions are suitable:

(a) Legal Opinions

(i) First, as the HKMA and SFC are aware principle 1 of the CPSS-IOSCO Report states that a CCP must have a "*well-founded, clear, transparent, and enforceable legal basis...in all relevant jurisdictions*".

(ii) The HKMA and SFC should ensure that any CCP based in Hong Kong which allows remote membership must (A) have obtained 'clean' netting, collateral and insolvency opinions in respect of all of the jurisdictions from which it has admitted clearing members;

(B) update these opinions regularly to address any changes in law; and (C) share these legal opinions with the clearing members of such CCP.

(iii) The Group considers that this is essential because, although there will be legislative protections available in Hong Kong to safeguard the application of the default rules of a CCP against a defaulting clearing member based in Hong Kong (see paragraphs 114 to 122 below), this may not be the case in respect of remote clearing members (as the default procedure of such CCP may not be similarly protected under the insolvency laws of the relevant foreign jurisdiction).

(iv) The HKMA and SFC should carefully guard against the scenario where a CCP in Hong Kong is unable to enforce with sufficient finality its default procedures in respect of transactions cleared by a defaulting remote clearing member, as this may potentially have financial consequences for such CCP (since the capital reserves of the CCP itself will likely form part of the default waterfall) and, in a worst case scenario, result in a CCP being unable to meet its obligations to other clearing members. This could, in turn, result in serious systemic risk to participants in the Hong Kong OTC derivatives market, since any losses suffered by the CCP in such an event may be mutualised among all clearing members of such CCP.

(v) By way of further illustration, risks may arise on the default of a remote clearing member, where the CCP based in Hong Kong seeks to arrange for the porting of client positions in respect of such defaulting clearing member to a back-up clearing member as required by the default rules of the CCP. In such circumstances, grave risks may result if the transfer of trades (and collateral in respect of such trades) from the defaulting clearing member to the back-up clearing member (in accordance with the default rules of the CCP) may be subject to challenge under the insolvency laws of the jurisdiction of the defaulting clearing member.

(vi) In their role as guardians of the Hong Kong financial markets and of the financial stability of Hong Kong, the HKMA and SFC will need to carefully guard against the risks which may arise from allowing CCPs based in Hong Kong to admit remote clearing members from jurisdictions where such CCPs are unable to obtain 'clean' netting, collateral and insolvency opinions.

(vii) The Group understands and appreciates that the HKMA and SFC are very aware that mandatory clearing carries risks as well as benefits for the OTC derivatives market in Hong Kong.

(viii) With respect to the issue of remote clearing, the Group is also concerned that if a CCP in Hong Kong is considered not to have complied with principle 1 of the CPSS-IOSCO Report (due to an inability to obtain 'clean' legal opinions with respect to its remote

clearing members), this may prevent (A) the CCP from obtaining recognition in foreign jurisdictions (the importance of this is described in paragraphs 86 to 90 above) and (B) clearing members from obtaining preferential regulatory capital benefits under Basel III in respect of transactions cleared through such CCP.

(b) Co-ordination with foreign regulators

(i) Second, the Group believes that the HKMA and SFC must first conduct their own assessment of, and form a relationship with, the relevant overseas regulators that regulate potential remote clearing members before allowing such foreign entities to become eligible clearing members to CCPs established in Hong Kong.

(ii) The Group considers that this is extremely important in order to establish a level playing field between clearing members regulated in Hong Kong and remote clearing members in overseas jurisdictions which will not be regulated directly by the HKMA or SFC.

(iii) The HKMA and SFC should establish a memorandum of understanding with such foreign regulators to, for example, provide for similar risk management standards to be imposed and to manage how disciplinary proceedings are conducted in respect of remote clearing members.

Indirect clearing / Client clearing

114. The Group strongly supports the availability of indirect clearing under the mandatory clearing regime in Hong Kong, and also acknowledges the concerns raised by the HKMA and SFC under paragraphs 154 to 155 of the Consultation Paper in relation to the legal framework surrounding indirect clearing.

115. The Group suggests that an important way of ensuring that client clearing is successful in Hong Kong is to provide for special legislation which would ensure that, as a matter of Hong Kong law, client clearing arrangements, and in particular, the rules, and other arrangements, which apply on the default of a clearing member, would be enforceable in Hong Kong in accordance with their terms.

116. This is because, while Part III of the SFO provides that any actions taken by a Hong Kong CCP under the rules of the CCP as they relate to clearing members, including under the default management procedures applicable to clearing members, will be protected from insolvency challenges and other attacks on enforceability, Part III of the SFO does not extend such protection to the contract between clearing members and the clients to whom they provide clearing services.

117. Accordingly, in circumstances where clients of a clearing member might seek to enforce the terms of their arrangements with a defaulting clearing member, such arrangements might be subject to the usual challenges which may arise on insolvency. While these challenges are similar to those which may apply to other contractual arrangements (including collateral arrangements) in Hong Kong, the

result of this is that while, as a matter of Hong Kong law, there will be full settlement finality in respect of the arrangements between the Hong Kong CCP and any defaulting clearing member, the clients of such clearing member will not have similar protections.

118. It should be noted that, in comparison to, for example, the European Union which has the Financial Collateral Directive (2002/47/EC) and associated implementing legislation in European member states, Hong Kong does not currently have any equivalent legislation in respect of financial collateral arrangements which provides for special protection to be given to financial collateral arrangements, including protection from insolvency challenges.

119. Accordingly, the Group suggests that the HKMA and SFC consider extending similar legislative protections to client clearing arrangements as those which apply under Part III of the SFO to the arrangements between a CCP and its clearing members.

120. It should be noted that while such protections could be applied to prevent insolvency or other enforceability challenges being brought in a Hong Kong court, the cross-border nature of the relationship between clients and clearing members may mean that, for example, as a matter of the conflict of laws, other laws (for example the law governing any insolvency proceedings of a defaulting clearing member) may be relevant to the determination of whether client clearing arrangements are enforceable. If this is the case, then any Hong Kong legislation may not be able to give full protection to clients, however, it could help to protect clients from any challenges being brought in Hong Kong courts.

121. Amongst other things, such legislation might provide for:

    (a) the protection of client clearing arrangements against insolvency challenges;

    (b) the removal of any restrictions on enforcement of client clearing arrangements in insolvency situations;

    (c) where necessary, confirmation of rights of close-out netting and set-off between parties;

    (d) the removal of formalities in respect of the creation of collateral rights; and

    (e) where relevant, clarification of conflicts of law issues in respect of collateral over book entry securities.

122. The existence of such legislation might greatly assist market participants to give confidence to potential clients that the client clearing arrangements of the Hong Kong CCP which are designed to protect clients from the insolvency of clearing members will be enforceable under the laws of Hong Kong.

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

123. The Group believes that further consideration is required in respect of the proposed regulation of "large players" in Hong Kong, particularly in respect of the "quantitative and/or qualitative criteria"[7] which will set the parameters for what entities will constitute a large player. These parameters, along with any requirements or obligations to be imposed on large players, should be developed by the HKMA and SFC in close consultation with market participants due to their potential impact on the OTC derivatives market.

124. It should be noted that a similar concept of "major swap participant" has been included under the Dodd Frank Act[8], which covers:

    (a) entities which maintain a "substantial position" in swaps (excluding hedging);

    (b) entities which hold outstanding swaps that create "substantial counterparty exposure" that can have serious adverse effects on the financial stability of the United States; and

    (c) highly leveraged financial entities which are not subject to capital requirements by any federal bank regulator and maintain a substantial position in any major swap category.

    While the HKMA and SFC must adapt the parameters for defining a "large player" to the circumstances existing in the OTC derivatives market in Hong Kong, the Group believes that consideration needs to be given to how similar concepts are being developed in other major jurisdictions. Nevertheless, the number of large players identified by the HKMA and SFC should be kept to a minimum to avoid extra-territorial overreaching which would not be beneficial for the financial markets of Hong Kong or the status of Hong Kong as a major financial centre.

125. The Group notes in particular that the Consultation Paper states that the SFC shall have the power to require large players to "take steps to reduce their positions in such transactions if so requested"[9]. The SFC should clarify under what circumstances this power may be exercised, as consideration must be given to the fact that such reductions may cause a large player to breach its own risk management policies as well as having a potentially detrimental effect on the stability and liquidity of the OTC derivatives market in Hong Kong.

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[7] Paragraph 172(1) of the Consultation Paper

[8] See Section 761 of Dodd Frank Act

[9] Paragraph 172(3)(b) of the Consultation Paper

3B. Additional issues relevant to the legislative framework for the mandatory clearing regime in Hong Kong

Legislative changes required in relation to the mandatory clearing framework

126. As a general observation, the Group considers that once a CCP obtains recognition as a RCH in accordance with Section 37 of the SFO, the insolvency ring-fencing provisions of the SFO under Section 45 (in relation to insolvency laws in Hong Kong) and Section 54 (in relation to insolvency laws in other jurisdictions) are robust and comprehensive enough that few additional amendments are required.

127. However, the Group sets out below some minor caveats in relation to the general view above:

(a) Section 52(2) of the SFO provides a carve-out in relation to market collateral where a CCP had prior actual notice of any interest, right or breach of duty at the time the property was provided as market collateral. Although this exception is restricted to prior equitable or constructive trust based interests only, the Group considers that the removal of this carve-out is desirable to ensure the ability of a CCP to utilise the market collateral in any default scenario;

(b) A statutory provision may need to be introduced (similar to Section 378 of the SFO) to permit information to be provided to the proposed new trade repository (whether directly or through the SFC). This provision should allow the relevant data to be disclosed regardless of (a) any duty of confidentiality and (b) any breach of any data privacy laws;

(c) The HKMA and SFC should also consider whether it is desirable to introduce legislation to safeguard the ability of clearing members to initiate and enforce close-out netting against the CCP under Hong Kong law as mentioned in the CPSS-IOSCO Report as follows:

"Netting arrangements should be explicitly recognized and supported under the law and enforceable against an FMI and an FMI's failed participants in bankruptcy." (emphasis added)

Although it should be possible for clearing members to obtain comfort on this issue through obtaining a netting opinion, having legislation in place to specifically address this issue would create better certainty as to the treatment of netting on the insolvency of the CCP;

(d) The HKMA and SFC should ensure that the definition of "market contracts" as set out under the SFO is sufficient to cover "OTC derivatives transactions"; and

(e) Further consideration is needed on whether Section 54 of the SFO is 'too' robust and may cause issues when attempting to gain recognition as a CCP in foreign jurisdictions as the complete exclusion of foreign insolvency

law (particularly in relation to clearing members incorporated in such foreign jurisdiction) may cause concerns for foreign regulators.

Involvement of market participants in operations of CCP

128. As part of the HKMA and SFC's regulation of CCPs established in Hong Kong, the Group considers that it is essential for the appropriate risk management of such CCPs for market participants to be involved in the following roles in relation to the operation of such CCPs:

    (a) determination of whether the CCP should apply to the HKMA and SFC for approval in relation to the clearing of new OTC derivatives products;

    (b) participation in the governance committee; and

    (c) participation in the default management committee.

129. The Group considers that, in order for a CCP to effectively and appropriately manage its operations and risks, it is extremely important that market participants should have a substantial degree of involvement in all three areas listed above. Furthermore, as any loss suffered by a CCP will ultimately be borne by all of its clearing members (the principle of loss mutualisation), the Group believes that it is only fair and appropriate for market participants to have the opportunity to provide input into certain decision-making processes of CCPs, especially those involving risk management.

130. The Group also notes that both the United States and the European Union are currently considering specific rules in relation to the composition of a CCP's board of directors and risk management committee. For example:

    (a) Under the European Commission's proposals:

        (i) the board of a CCP should have at least one-third, and no less than two, independent members[10]; and

        (ii) the risk committee of a CCP should be composed of representatives of its clearing members and independent members of the board of such CCP[11].

    (b) Under the latest rules proposed by the CFTC on the governance of DCOs in January 2011 (which are yet to be finalised):

        (i) the risk management committee of a DCO needs to be composed of at least 35% independent directors and 10% representatives of customers of clearing members[12]; and

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[10] See Article 25(2) of the latest draft of the European Commission's proposals

[11] See Article 26(1) of the latest draft of the European Commission's proposals

[12] See Title 17 Code of Federal Regulations Part 39.13(d)

(ii) a requirement that the governing board or committee of a DCO includes market participants[13]; and

131. Given the level of detail which can be found in the legislation and rules of the United States and the European Union in relation to the participation of independent parties and clearing members in the risk management processes of a CCP, the Group considers that it is vital for the HKMA and SFC to also contemplate the introduction of rules which serve a similar function in either primary or secondary legislation.

132. With respect to determining whether the CCP should apply to the HKMA and SFC for approval in relation to the clearing of new OTC derivatives products, it is extremely important that the CCP should first consult with market participants in order to determine the level of liquidity, volume and standardisation of such products. Although a certain amount of this information may be available through the trade repository to be established in Hong Kong, the Group considers that the only method to prudently and appropriately manage the scope of the mandatory clearing regime in Hong Kong is through close co-operation between the HKMA and SFC, the Designated CCPs and the market participants in Hong Kong.

133. With respect to the governance committee, the Group believes that the CCP in Hong Kong will need to develop its governance standards over time in line with market developments abroad and emerging international standards. Market participants, including those which are subject to regulation in multiple jurisdictions, will serve an essential role in assisting CCPs in Hong Kong to achieve equivalent standards of governance when compared to CCPs in other jurisdictions. It is extremely important from a risk management perspective for the Hong Kong OTC derivatives market to align its regulatory requirements with that of other jurisdictions and to avoid the potential for regulatory arbitrage by market participants.

134. With respect to the default management committee, the Group considers that this committee serves an essential function in the risk management of the CCP when there is a default by a clearing member. Accordingly clearing members should be allowed to be closely and fully involved in the activities of the default management committee, including by being given appropriate representation on the default management committee. The successful application of the default management rules of the CCP in distress scenarios will involve close collaboration between the CCP and clearing members in order to achieve portability, trade allocation, close-out and/or any other default management processes. As a result, the Group strongly recommends that market participants should be involved from an early stage in the establishment and development of default management rules for CCPs in Hong Kong.

135. All of the Hong Kong communities have painful memories from the market crash and CCP failure in 1987, and like the HKMA and SFC, would never want this to happen again. Clearly the highest risk management standards must be at the centre of any mandatory clearing regime in Hong Kong. Accordingly, the Group believes

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[13] See Title 17 Code of Federal Regulations Part 39.26

that all stakeholders, including the HKMA, the SFC, the Designated CCPs and market participants, should work closely together to ensure that the mandatory clearing regime achieves its central purpose which is to reduce the systemic risk of the OTC derivatives market in Hong Kong. Since those that will suffer the most if there is ever a failure of a Hong Kong CCP are the market participants themselves (since it is their positions that will not be performed by the CCP) it is essential that market participants, in particular clearing members of the CCP, should be entitled to have a central role in the risk management of the CCP.

136. Therefore, the Group considers that the involvement of clearing members at the outset by representation on the default management committee of a CCP is essential in order to (a) avoid distress scenarios to the extent possible and (b) manage such distress scenarios in the most efficient and orderly manner possible when the situation arises.

Penalties for breach of mandatory clearing obligation

137. In relation to penalties for any breach of the mandatory obligations (as set out under paragraph 27(2) of the Consultation Paper), the Group is concerned that a market participant should not be subject to a penalty for failure to comply with the mandatory clearing obligation where the failure of such market participant to clear an OTC derivatives transaction was beyond its control.

138. For example, where a market participant enters into an OTC derivatives contract (which is subject to the mandatory clearing obligation in Hong Kong) with a foreign counterparty, such foreign counterparty may choose not to co-operate, or may even resist, the submission of such transaction to clearing with a recognised clearing house ("**RCH**") or authorised automatic trading service ("**ATS**") in Hong Kong (a CCP which is either a RCH or ATS will be referred to in this Response as a "**Designated CCP**"). This situation may arise, for example, where the foreign counterparty is not itself subject to a mandatory clearing obligation, or alternatively is subject to a different mandatory clearing obligation which is not compatible with the mandatory clearing regime in Hong Kong.

139. In this scenario, there is very little which the market participant can do to force the co-operation of the foreign counterparty in complying with the mandatory clearing regime in Hong Kong. While the market participant can include a contractual provision in the OTC derivatives contract requiring the foreign counterparty to co-operate with the market participant to fulfil any clearing obligation which arises under the laws of Hong Kong, a breach of such provision would only result in contractual remedies for the market participant against the foreign counterparty (such as the right to close-out the transaction) and it is unlikely that specific performance would be awarded by a court.

140. Consequently, the Group considers it to be essential that the HKMA and SFC provide a grace period for compliance with the mandatory clearing regime in Hong Kong in such scenarios before any penalties for breach of the mandatory clearing obligation may be imposed (which is separate from the grace period described under paragraphs 128 to 130 of the Consultation Paper). This would

provide sufficient time for the market participant in the above scenario to terminate the OTC derivatives contract[14] and unwind it if the foreign counterparty does not co-operate in submitting the relevant OTC derivatives contract for clearing with a Designated CCP as required by its contract with the market participant.

141. On a related note, the HKMA and SFC should also provide a grace period where an OTC derivatives transaction has been executed but has not been matched or accepted for clearing by the time the relevant Designated CCP closes for the day (that is, where the trade is only accepted for clearing on the next working day).

142. In addition, the HKMA and SFC should ensure that the proposed legislation in respect of the mandatory clearing framework should include a provision expressly stating that no liability for damages will arise from a party's failure to comply with the clearing regime in Hong Kong.

Enforceability of uncleared OTC derivatives contracts

143. A related issue to the scope of the mandatory clearing obligation is the necessity for legislation to provide that even if an OTC derivatives contract which is subject to the mandatory clearing regime remains uncleared, this will not affect the legal, valid and binding nature of such transaction.

144. The Group considers that legislation needs to address this issue specifically as contracts which are in breach of legislation (in this case, the mandatory clearing obligation) may be treated as illegal and/or void. In order to prevent legal uncertainty in respect of such contracts, it is therefore necessary for the HKMA and SFC to include a legislative provision which, apart from setting out the penalties for failing to comply with the mandatory clearing obligation, will also state that such uncleared trades will remain legal, valid and binding on both parties to the contract.

Exemptions for intra-group trades

145. Apart from the exemption discussed under paragraph 110(2) of the Consultation Paper, the Group requests the HKMA and SFC to consider granting an additional exemption from the mandatory clearing obligation in respect of intra-group trades.

146. The Group notes that financial services groups will often enter into OTC derivative contracts on an intra-group basis in order to appropriately manage their risk exposure. If such trades were subject to mandatory clearing, this would have a negative impact on market participants which have, entirely appropriately, centralised their risk management in one entity in order to most efficiently and effectively control the level of exposure across the whole of its group.

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[14] Under the standard terms of the ISDA Master Agreement (both 1992 version and 2002 version), the AI or LC can call an event of default against the foreign entity for breach of agreement and close out the OTC derivatives contract following a 30 day grace period.

147. This is because mandatory clearing in such a scenario would result in the imposition of an additional layer of complexity (by inserting a CCP in between the trades of two group companies) and the reduction of capital in the corporate group (due to the initial margin requirements of cleared trades) for little or no reduction in risk for the corporate group as a whole.

148. In addition, the Group strongly recommends that intra-group trades should also be exempt from any additional margin requirements which may be imposed by the regulatory framework in Hong Kong in respect of uncleared trades for similar reasons as outlined above.

Minimum Capital Requirements

149. The Group considers that it is very important for the HKMA and SFC to prudently and appropriately regulate the minimum capital requirements in respect of clearing members of any CCP established in Hong Kong. Establishing a minimum capital requirement standard for clearing members is a critical factor in ensuring the safe operation of the CCP since ultimately any losses of such CCP will be mutualised among all of the clearing members of such CCP.

150. Since loss mutualisation forms one of the fundamental tenets of mandatory clearing through CCPs, each clearing member must have the financial resources required to meet (a) calls for variation margin on a regular basis in respect of cleared trades and (b) calls for contributory funds to the CCP's default fund (up to any relevant cap) in the event that such default fund requires replenishment.

151. Although the Group recognises that there may be some potential policy benefits in allowing AIs and LCs with smaller capital reserves to still be able to directly access CCPs in Hong Kong as clearing members, the Group considers that this approach needs to be carefully balanced against the importance of ensuring that (a) a CCP established in Hong Kong will not be exposed to additional risk by the admission of smaller market participants with insufficient capital reserves as clearing members of such CCP and (b) in the event that a CCP suffers losses due to a clearing member defaulting, its remaining clearing members are sufficiently robust from a financial perspective to bear such losses.

152. Furthermore, as set out under paragraphs 128 to 136 above, it is imperative for clearing members to become involved in and support the default management process of a CCP, which means that it is important for clearing members to be financially robust and have sufficient economic resources to assist in a default scenario.

153. In addition, the Group believes that it may be more appropriate for AIs and LCs with lower capitalisation levels to access a CCP in Hong Kong through indirect clearing, that is, by clearing OTC derivatives transactions through a clearing member rather than by becoming a clearing member to the CCP itself. The Group notes that this approach has been contemplated by the HKMA and SFC in the Consultation Paper under paragraphs 153 to 155. The Group considers that indirect clearing for market participants with lower capitalisation levels is necessary and appropriate from a risk management perspective and will ensure that, while the benefits of central clearing remain available to all market

participants, a CCP will not be exposed to additional risks of default by clearing members with lower capital reserves.

3C. Structural issues relevant to the establishment and regulation of CCPs in Hong Kong

154. The Group considers that there are various additional issues which, although not directly relevant to the establishment of the legislative framework relating to the mandatory clearing regime in Hong Kong, nevertheless are extremely important when considering the establishment of CCPs based in Hong Kong.

While the Group may not have formed a definitive view on all of the issues set out below, nevertheless the Group considers that it will be helpful for the HKMA and SFC to be aware of the Group's current thinking in relation to these topics.

Clearing model: Principal vs. Agency

155. Although the Group is still discussing whether the appropriate clearing model for Hong Kong is the principal model, the agency model or the "principal model with agency features", there is consensus that this issue is extremely important given that the clearing model adopted in Hong Kong will have enormous influence on the legal rights arising from, and the operations of, the CCP established in Hong Kong.

156. The Group also notes that the clearing model adopted in Hong Kong may also influence the ability of such CCP to obtain recognition in certain foreign jurisdictions such as the United States. Therefore, it is imperative that the HKMA and SFC, in conjunction with the Hong Kong Stock Exchange and discussions with market participants, should carefully consider the implications of the structure of the CCP established in Hong Kong.

Default of clearing members

157. The Group is carefully considering what are the most appropriate structural features to include in a CCP established in Hong Kong in order to address the scenario where a clearing member is in default. While the Group is still considering the issues and has not formed a consensus view, the Group's current thinking is that the following features would be necessary:

(a) there must be a cap on the liabilities of non-defaulting clearing members in relation to their obligations to replenish the default fund of a CCP;

(b) the CCP must bear some of the losses arising from the defaulting clearing member prior to the application of contributions from non-defaulting clearing members to the default fund;

(c) an appropriate balance must be struck between the amount of initial margin called for by the CCP in respect of trades and the amount of contributions required for the default fund of such CCP;

(d) the CCP should not implement any compulsory allocation process in respect of trades of a defaulting clearing member; and

(e) if an auction process is established for non-defaulting clearing members to bid for the positions held by the defaulting clearing member, the prices for

such positions must be set by bids from non-defaulting clearing members (rather than be prescribed by the CCP).

158. *Liability of non-defaulting clearing members*: With respect to the cap on the obligation of non-defaulting clearing members to replenish the default fund in the event of a default by a clearing member, the Group considers that this is a vital feature given the difficult regulatory capital issues under Basel III which clearing members will face if they have potentially unlimited liability to a CCP. This is because they will have to set aside capital against its exposure to the CCP.

159. On a related point, the Group also considers that it is extremely important for any CCP established in Hong Kong to take great care when setting rules in relation to the liability of clearing members which resign from such CCP. It should be noted that the rules in relation to this issue can create powerful incentives for clearing members to remove themselves from a CCP when there are perceived market difficulties (for example, by allowing a resigning clearing member to cap the level of its obligation to replenish the default fund by freezing such clearing member's exposure to the CCP at the time of resignation), and this may be further exacerbated if clearing members believe that they will be at a disadvantage in comparison to other clearing members if they resign later.

160. If the rules of a CCP in relation to the liability of resigning clearing members encourage a "stampede" effect for clearing members to resign as quickly as possible in times of market stress, this will have a very detrimental effect on the CCP.

161. *Liability of CCP on default of clearing member*: The Group feels that it is very important from a risk management perspective for the CCP to first absorb a certain amount of the losses arising from the default of a clearing member from its own capital (that is, shareholders' funds) before the funds contributed by other clearing members are applied (sometimes referred to as "skin in the game"). This feature can be found in several other major CCPs in other jurisdictions[15]. The Group believes that this feature encourages CCPs to manage the risk of clearing members in a more prudent fashion since its own financial resources (and those of its shareholders) are at stake. If clearing members are confident that a CCP is properly incentivised to reduce its risk, then a CCP will also appear more attractive to market participants in the OTC derivatives market.

162. *Balance of initial margin and default fund*: In order to provide financial resources for CCPs in the event of a default by a clearing member, CCPs will require clearing members to contribute funds in the form of initial margin and payments to the default fund. It is important for CCPs to recognise that consideration must be given to the balance struck between the amount of initial margin required and the amount of contributions to the default fund required from clearing members.

163. For example, if the amount of contributions of a clearing member to the default fund is calculated by reference to the volume of trades of such clearing member, it may be beneficial in such a case for the CCP to demand higher amounts of initial

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[15] For example, LCH.Clearnet

margin and reduce the size of contributions required to the default fund. This is because in the event of a default by a clearing member, it may be most advantageous to port the client positions of such defaulting clearing member to a back-up clearing member in order to minimise systemic risk. However, portability may be hampered if the back-up clearing member would be required to contribute a large amount of additional funds to the default fund as a result of adopting the client positions of the defaulting clearing member. Therefore, the CCP should consider reducing the burden of default fund contributions in order to promote portability, and instead increase the initial margin payments required from clearing members.

164. *Compulsory allocation*: The Group is firmly of the view that CCPs should not compulsorily allocate the trades of a defaulting clearing member to a non-defaulting clearing member unless the consent of such non-defaulting clearing member is first given. This is because the CCP is not in the best position to judge the impact which such compulsory allocation of trades may have on the relevant non-defaulting clearing member, and therefore such a process may amplify systemic risk in the OTC derivatives market if it results in the destabilisation of such non-defaulting clearing member.

165. *Auction*: Where a CCP implements an auction process in respect of the open positions of a defaulting clearing member, the Group believe that the price for such trades should be determined purely through market forces (that is, by competitive bidding amongst non-defaulting clearing members). If the CCP attempts to set or determine parameters for the price for such open positions, this will represent a distortion of the genuine market price of such trades and the Group considers that this may either (a) prevent the transfer of such trades (if non-defaulting clearing members do not agree with the price set by the CCP) or (b) increase systemic risk in the OTC derivatives market (if a non-defaulting clearing member bids for an open position at a distorted price and suffers a loss as a result).

Capital Requirements

166. The Group understands that the HKMA and SFC are considering the imposition of higher capital requirements for OTC derivatives transactions which are not cleared through a Designated CCP (see paragraph 156 of the Consultation Paper). The Group considers that it will be important for the HKMA and SFC to consult with market participants before introducing such higher capital requirements so that they can assess the impact that these higher capital requirements will have on the Hong Kong OTC derivatives market and participants in that market.

Legal Entity Identifier

167. The Group considers that it will be important for the HKMA and SFC to continue to work closely with the entities responsible for establishing the system in relation to the Legal Entity Identifier for Financial Contracts (such as the Depository Trust & Clearing Corporation). Global co-ordination in respect of this issue will be essential to ensure that a smooth transition for market participants can be achieved following the introduction of the new regulatory regime for reporting and clearing of OTC derivatives transactions in Hong Kong.

Other structural issues

168. The Group sets out below a (non-exhaustive) list of other structural issues which are currently under consideration by the Group and which it believes is important for the HKMA and SFC to also be aware of. These issues are highly relevant to the establishment of any CCP based in Hong Kong and the Group would welcome the opportunity to share its views on these topics at the appropriate time:

    (a) Capital requirements for CCPs;

    (b) Corporate governance of CCPs;

    (c) Ownership criteria for CCPs;

    (d) Risk management of CCPs;

    (e) Managing insolvency of CCPs;

    (f) Treatment and use of collateral at both CCP and clearing member level;

    (g) Segregation and portability; and

    (h) Client clearing.

SCHEDULE 1

Participants in the Consultation

Bank of America Merrill Lynch

Barclays Bank PLC

BNP Paribas

Citibank, N.A.

Deutsche Bank AG

Goldman Sachs (Asia) LLC

The Hongkong and Shanghai Banking Corporation Limited

JPMorgan

Morgan Stanley

UBS AG