



31 October 2015

Via online submission

Financial Stability Surveillance Division  
Hong Kong Monetary Authority  
55/F Two International Finance Centre  
8 Finance Street, Central  
Hong Kong

Supervision of Markets Division  
The Securities and Futures Commission  
35/F Cheung Kong Center  
2 Queen's Road Central  
Hong Kong

**Re: Submission in response to *Consultation paper on introducing mandatory clearing and expanding mandatory reporting***

Dear Sir or Madam:

CME Group Inc. ("CME Group"), on behalf of its clearinghouses and exchanges ("Exchanges")<sup>1</sup>, appreciates the opportunity to provide comments on the joint consultation of the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") (collectively, the "Authorities") regarding the introduction of mandatory clearing for over-the-counter ("OTC") derivatives and the expansion of mandatory reporting for OTC derivatives (the "Consultation Paper").

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<sup>1</sup> CME Group consists of four separate U.S.-based Exchanges: the Chicago Mercantile Exchange, Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX") and one UK-based exchange, CME Europe Limited. These Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

CME Group's Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated transactions. CME Group also owns CME Clearing, one of the largest central counterparty clearing services in the world, and CME Clearing Europe, which each provide clearing and settlement services for exchange-traded contracts, as well as for over-the-counter derivatives transactions.

## I. CME Group's General Comments

CME Group applauds the Authorities' continued efforts to implement the G20 OTC reforms with an overarching objective of ensuring that derivatives markets continue to meet the needs of the regional and global economy while increasing transparency and the use of centralized clearing of OTC derivatives. Given CME Group's history and presence in Asia and our commitment to the continued growth of Hong Kong as a global center for trading and risk management, we appreciate the Authorities' interest in harmonizing its derivatives regulatory regime with other important centers of global derivatives market activity while also ensuring that the markets can continue to evolve. While the United States and Europe are further along in their implementation of OTC regulatory reform, neither regime is complete. Thus, the Authorities have a unique opportunity to influence the final details of global regulators' implementation of the G20's OTC regulatory mandates, and ultimately positively impact global derivatives markets. We provide our detailed comments below.

CME Group strongly supports the Authorities' proposal to implement mandatory clearing requirements that are consistent with those imposed in other jurisdictions and the Authorities' proposed approach to cross-border regulatory oversight, which would eliminate unnecessary conflicts with other jurisdictions' regulations.

In response to concerns about systemic risks in over-the-counter (OTC) derivatives markets, the G20 committed in 2009 to a comprehensive reform agenda to improve transparency in these markets, mitigate systemic risk, and protect against market abuse. Importantly, given the global nature of the financial markets in 2008 (which remains today), the G20 also undertook to 'take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage'. Thus, for the G20 commitments to work globally, each member nation needs to have a workable cross-border regulatory framework, and we support the Authorities' efforts to implement a regulatory regime for OTC derivatives in Hong Kong that is in line with the G20 commitments to reform the OTC derivatives market.

An effective cross-border regulatory framework does not require each nation's law to be identical to that of the others; CME Group, from its experience in international expansion, recognizes that this is unrealistic and is not the approach taken in other areas of law and regulation impacting global markets. We believe, instead, the goal of an effective cross-border regulatory framework should be for nations to adopt frameworks that lead to consistent regulatory results and allow for appropriate substituted compliance.

CME Group has long been a supporter of cross-border regulation through substituted compliance, where appropriate. We believe, in general, an effective cross-border regulatory framework should provide a holistic, global solution that (i) eliminates legal uncertainty, (ii) allows cross-border markets to continue operating without actual or threatened disruption, (iii) affords local and non-local markets and market participants the same degree of flexibility today and on an ongoing basis and (iv) balances the need to do business with overarching regulatory obligation and creates a fair compliance cost to participants. Indeed, the US and Hong Kong have successfully implemented a cross-border regulatory framework that promotes cross-border access between both jurisdictions, based in significant part on a substituted compliance regime.

CME Group believes that extending the US's and Hong Kong's approach to cross-border regulation of the global OTC markets would be the most effective way to strengthen and grow the markets subject to our

respective jurisdictions. Additionally, we think such an approach would meet the G20 commitment to a consistent implementation of regulation to ensure a level playing field and avoid fragmentation of markets, protectionism, and regulatory arbitrage. To this end, we recommend the Authorities designate offshore CCPs as automated trading systems (ATS) as soon as possible to ensure local market participants have certain access to the risk management services of these CCPs, and to extend statutory insolvency protection to such ATS to ensure offshore CCPs are not disadvantaged as against local CCPs.

CME Group's responses to questions presented in the Consultation Paper are set forth below.

## II. CME Group's Detailed Comments

### KEY PROPOSALS ON MANDATORY CLEARING

#### *A. Products to be subject to mandatory clearing*

**Q2: Do you have any comments or concerns about our proposals on the types of IRS that should be subject to mandatory clearing? If you do, please provide specific details.**

Imposing a clearing obligation on fixed-to-floating swaps, basis swaps and overnight index swaps is consistent with clearing mandates in other major jurisdictions. We defer to the Authorities as to whether local forward rate agreement activity levels justify imposing a local clearing obligation, notwithstanding that other jurisdictions have mandated such instruments for clearing.

CME Group supports the implementation of a mandatory clearing framework in Hong Kong that is consistent in scope with the frameworks in other major jurisdictions. CME Group recommends that the Authorities' consideration of expanding the clearing obligation to other instruments and asset classes be done in coordination with other jurisdictions, including the US and EU. A coordinated approach will facilitate global harmonization and furthering G20 objectives, such as adopting a global framework that mitigates potential for regulatory arbitrage. Disparities in the currencies, types, indexes, tenors of instruments subject to clearing obligations across jurisdictions create such potential. While we generally defer to the Authorities on the appropriate scope of local clearing obligations, we suggest that activity levels in instruments not subject to clearing obligations in Hong Kong but mandated in other jurisdictions should be monitored for signs of regulatory arbitrage and brought into the scope of the Hong Kong clearing mandate as necessary to ensure the G20 commitments are not undermined.

**Q4: Do you have any comments or concerns about our proposal to include IRS denominated in any of the G4 currencies under phase 1 clearing? If you do, please provide specific details.**

We agree with the proposal that the Authorities mandate IRS denominated in the G4 currencies consistent with other major jurisdictions. The CFTC has imposed mandatory clearing requirements on these currencies and CME Group supports a harmonized global approach. A full list of the products subject to the clearing mandate by the CFTC is available here: <http://www.cftc.gov/PressRoom/PressReleases/pr6429-12>.

**Q5: Do you have any comments or concerns about our proposal to mandate HKD denominated IRS for clearing under phase 1 clearing? If you do, please provide specific details.**

We agree with the premise that currencies of systemic importance to Hong Kong are appropriate for mandatory clearing in Hong Kong and defer to the Authorities as to whether it is appropriate at this time to mandate HKD-denominated IRS.

**Q6: Do you have any comments or concerns about our proposal to only cover IRS that feature the indexes set out in the two tables above? If you do, please provide specific details.**

CME Group supports the Authorities' inclusion of the G4 instruments in its mandate as these are currently subject to the CFTC's clearing mandate. We defer to the Authorities as to the appropriate floating rate index for HKD-denominated IRS.

**Q7. Do you have any comments or concerns about our proposals on whether OIS should be covered under phase 1 clearing, and in what circumstances? If you do, please provide specific details.**

Please refer to our comments in response to Q1, above.

**Q8: Do you have any comments or concerns about our proposal that mandatory clearing should apply to IRS that feature the range of tenors described above? If you do, please provide specific details.**

Please refer to our comments in response to Q1, above.

**Q9: Do you have any comments or concerns about our proposal not to cover NDF transactions under phase 1 clearing? If so, please provide specific details.**

Please refer to our comments in response to Q1, above.

*B. Only dealer-to-dealer transactions to be subject to mandatory clearing in first phase*

**Q10. Do you have any comments or concerns about our proposal to restrict mandatory clearing to only dealer-to-dealer transactions in the first phase? If you do, please provide specific details.**

CME Group strongly believes that customers should be given the right to choose the clearing house where their trades will be cleared. A regime that phases in clearing obligations by applying such requirements on dealer banks first will ultimately impede customer choice, and may impede customer preparation for the clearing obligation due to legal uncertainty.

Moreover, once dealer banks have established meaningful swap open interest in a particular clearing house, the economics of network effects will drive customers to that clearing house. Customer choice of clearing venue will also allow customers to avoid building up to directional exposures and maximize margining efficiencies.

We urge the Authorities to designate offshore CCPs from jurisdictions that have implemented client clearing in order to provide Hong Kong clients access to the risk management benefits of central clearing as soon as practicable.

**Q11. Do you have any comments or concerns about our proposed criteria for scoping dealer-to-dealer transactions? If you do, please provide specific details.**

The SFO defines prescribed persons to include authorized institutions, approved money brokers, licensed corporations or “a person of a class or description prescribed by subsidiary legislation.” The Authorities’ proposal for the first phase of clearing is to limit prescribed persons to only the first three categories; however, CME Group submits that any expansion of the proposed clearing rules, including scope of products or participants, should be subject to the consultation process.

The Consultation Paper notes that only prescribed persons—by definition local participants—will have a clearing obligation under the Clearing Rules. Many financial service provider counterparties to trades required to be cleared under the Clearing Rules will be subject to clearing obligations under frameworks of other jurisdictions. It is therefore critical that the Authorities designate offshore CCPs so that prescribed persons with a clearing obligation under the Clearing Rules as well as financial service providers with a clearing obligation under the framework of a foreign jurisdiction may elect to fulfill their clearing obligations at offshore CCPs under a substituted compliance framework.

**Q12. Do you have any comments or concerns about our proposed scope for “prescribed persons” and “financial services providers”? If you do, please provide specific details.**

CME Group strongly supports the stated approach of the HKMA to focus its regulatory oversight of overseas incorporated entities on the basis of their Hong Kong activities. We further agree with the Authorities’ proposal that the clearing obligation should only apply to overseas ‘prescribed persons’ in respect of transactions booked in their Hong Kong branch. We note, however, that other jurisdictions, including the US, have a slightly different approach to assessing the scope of entities subject to their clearing mandates, as well as other new OTC regulations, e.g., under current CFTC regulations, if a person located in the US facilitates a cross-border trade or such a trade is guaranteed by a US entity – even if the trade is booked abroad – US rules apply to that transaction. As a practical matter, we do not believe these differences create obstacles in the context of an effective cross-border regulatory framework that includes a substituted compliance regime.

#### *C. Clearing threshold and its calculation*

**Q19: Do you have any comments or concerns about our proposal that only future transactions should be subject to mandatory clearing? If you do, please provide specific details.**

The Consultation Paper does not address the rationale for not including a backloading requirement in the Clearing Rules. We respectfully request clarification on this point as other major jurisdictions have taken a different approach to backloading when implementing their clearing mandates.

#### *D. Complying with the clearing obligation*

**Q23: Do you have any comments or concerns about the proposed T + 1 timeframe for clearing, and our proposal to define “business day” to mean a business day in Hong Kong? If you do, please provide specific details**

CME Group is concerned about the potential for an un-level playing field due to defining business days in reference to the Hong Kong calendar. While CCPs will generally accept a trade for clearing on a day that is a business day for the relevant product in question, market participants may favor clearing at local CCPs if only out of concern that a one-day lag when clearing at an offshore CCP may be insufficient to ensure compliance with the clearing obligation. The Authorities note in regard to substituted compliance that they “will look to the laws of the relevant comparable jurisdiction to determine how the transaction

should be cleared." CME Group agrees with this principle and suggests that local timeframes for clearing apply where the clearing obligation is fulfilled under the substituted compliance framework.

*E. Exemptions from the clearing obligation*

**Q25: Do you have any comments or concerns regarding our proposed intra-group exemption or any aspect of it?**

CME Group supports the Authorities' proposal to exempt intra-group transactions from the clearing obligations.

*F. Position on de-clearing*

**Q27: Do you have any comments or concerns regarding our proposal not to cover de-clearing and trade compression expressly under the rules? If you do, please provide specific details.**

We support this approach as it does not unnecessarily prescribe the types of trade compression services that market participants are able to utilize.

*G. Substituted compliance*

**Q28: Do you have any comments or concerns about our proposed substituted compliance framework, or any aspect of it? If you do, please provide specific details.**

CME Group strongly supports a substituted compliance framework for cross-border regulation of clearing activities. We also support the continued efforts of regulators to strive for a harmonized global regulatory regime to avoid the potential for regulatory arbitrage and to permit local participants to satisfy their Hong Kong clearing obligation through substituted compliance at an offshore ATS.

**Q29: Do you have any comments or concerns about our proposed list of "comparable jurisdictions"? If you do, please provide specific details.**

We support the inclusion of the United States on the list of comparable jurisdictions.

*I. Designation and regulation of CCPs*

**Q31: Do you have any comments or concerns about our proposed processes for designating CCPs or for revoking a CCP designation? If you do, please provide specific details.**

CME Group has long been a strong supporter of a global framework whereby jurisdictions have the authority to authorize or grant access to offshore markets and clearing services under the concepts of equivalence and mutual recognition. CME Clearing is recognized or exempted from recognition in many jurisdictions outside of the US, including its recently granted authorization as an ATS in Hong Kong for exchange-listed derivatives, and permitted to provide clearing services in those jurisdictions pursuant to a recognition process.

The PFMI is an important step to setting reinforced and strengthened international standards that should be used as important guideposts for CCP best practices, and the recognition of third-country clearing houses where those clearing houses are subject to comprehensive supervision and regulation by

a competent regulator and information-sharing arrangements between competent national regulatory authorities are in place. An effective and harmonized cross-border regulatory framework with an appropriate substituted compliance regime would facilitate greater access to markets for local participants while reducing needless complexity and/or duplicative regulatory obligations.

CME Group urges the Authorities to designate additional CCPs where appropriate, including offshore ATS, to facilitate market participants' ability to meet their clearing obligations. Designation of offshore CCPs expands customers' optionality and mitigates the potential for fragmented liquidity in certain markets while bolstering the G20 goal of mitigating counterparty risk by moving standardized instruments to central clearing.

CME Group also urges designation of offshore CCPs in advance of the commencement of the clearing obligation. This will also help facilitate any required on-boarding of membership or establishment of client clearing arrangements. Moreover, designation of offshore CCPs prior to commencing the clearing obligation would permit participants the option to choose to clear transactions through multiple CCPs, which is beneficial to avoid concentration risk in a small number of CCPs or directional risk at any particular CCP and to facilitate competition globally.

We encourage the Authorities to clarify the information CCPs will be required to provide in connection with the designation process and to provide guidance as to when such designation may be revoked, in order to better ensure a level playing field and the continuity of CCP services.

**Q32: Do you have any comments or concerns about our proposal to implement only the clearing leg of the extended definition of "ATS" at this stage? If you do, please provide specific details.**

CME Group urges the Authorities to extend the definition as necessary to ensure CCPs are eligible to be authorized as ATS sufficiently in advance of the commencement of the clearing obligation, as noted above in response to Q31.

**Q33: Do you have any comments or concerns about our proposal to defer implementation of the changes to the definition of "market contract" to cover CCPs that are authorized ATS providers and designated CCPs? If you do, please provide specific details.**

CME Group disagrees with the proposal to defer implementation of the changes to the definition of "market contract" to cover designated CCPs that are ATS providers, a category which will include offshore CCPs that seek designation for the clearing of mandated instruments:

(a) This outcome differs from that in other major jurisdictions, where comparable statutory insolvency protections exist for local and offshore CCPs.

(b) The unavailability of a statutory insolvency protection and transaction costs associated with determining the applicable insolvency position may reduce offshore participation, which would undermine the Hong Kong's position as a global center for OTC derivatives clearing. Para. 152 of the Consultation Paper suggests that overseas CCPs are likely to apply to become designated CCPs in Hong Kong and therefore be able to provide clearing services for local participants essential to the operation of the substituted compliance regime. It is not clear however, whether overseas CCPs would in fact apply to become designated CCPs in Hong Kong if, as proposed, the statutory insolvency protection that had been contemplated from the outset was withdrawn, thereby putting OTC Clear in a position of greater

advantage. Should overseas CCPs decline in significant numbers to apply to become designated CCPs in Hong Kong, the substituted compliance regime may not be viable.

The possibility of ambiguities and uncertainties in terms of how the statutory insolvency protection set out in the current legislation may operate where CCPs manage risks of futures and OTC derivatives together on a portfolio basis does not justify deferral of that protection by deferring implementation of the changes to the definition of "market contract". To the contrary, CME Group submits that the possibility of such ambiguities and uncertainties dictates that immediate steps should be taken to extend the scope of the present statutory insolvency protection to include futures and the delivery of collateral securing both OTC derivatives and futures. The G20 commitment to more widespread central clearing is designed to mitigate systemic risk and to reduce the uncoordinated default management witnessed in the 2007-2008 crisis events. To that end, the regulations and rules for CCP default management have undergone substantial changes in the intervening years and numerous CCPs currently offer a range of clearing and risk management services for both futures and OTC derivatives. CCPs require certain, unimpeded access to collateral in the event of a clearing member default, regardless of whether the default involves futures, OTC derivatives or both. Substantially different treatment and insolvency protections for futures and OTC derivatives introduces uncertainty in the default management process, which by itself may be sufficient to discourage or even prohibit CCP participation in such a market or limit the accessibility to clearing for market participants. This in turn undermines the aims of the G20 commitment to increased central clearing and systemic risk mitigation. Whilst common law mechanisms are available to provide insolvency protection, the absence of extended statutory insolvency protection creates unnecessary uncertainty and transaction costs.

In making the above submission, we understand the Amendment Ordinance was intended to focus only on OTC derivatives. However, it is clear that whatever the original legislative intent, the immediate demands of managing systemic risk require a flexible approach that meets present needs. Systemic risk cannot be better managed by deferring implementation of statutory insolvency protection available under the legislation today. It can be better managed by using the full range of tools available under the legislation today. To this end:

(a) We urge the SFC and the HKMA to implement the statutory insolvency override contemplated in the Amendment Ordinance and to use the forthcoming designation rules to make it clear that the statutory insolvency protection provided as a result of the expanded definition of "market contract" will apply to all OTC products cleared by a designated and specified ATS CCP, whether or not subject to mandatory clearing.

(b) We urge the SFC to work with the Financial Secretary to prescribe futures contracts cleared by designated and specified ATS CCPs as OTC derivatives purely for the purpose of the expanded definition of "market contract" so that, for the interim period pending more permanent legislation, they will be entitled to statutory insolvency protection under the current legislation.

The implementation of an interim solution does not preclude a fuller consideration of any possible issues that may arise from extended statutory insolvency protection. It is possible and indeed, we urge the Authorities and the Financial Secretary to deliberate and consult more widely and more carefully on legislation to implement a permanent extended statutory insolvency regime that protects the delivery of collateral and takes into account concerns that may not be presently contemplated.



A published forward path as described above would encourage overseas CCPs to participate in the substituted compliance regime.

CME Group's view is that the Hong Kong insolvency framework should result in equal treatment across all types of designated CCPs, whether onshore RCH or offshore ATS, and that the insolvency protection offered should meet international standards and best practices. There is no good policy reason why any clearing activities should be excluded from statutory insolvency protection given that all clearing activities give rise to systemic risks and there is no good policy reason why clearing operations of ATS CCPs should be treated differently from clearing operations of RCHs.

It seems fair that all designated CCPs enjoy comparable simplicity, certainty and clarity in the provision of their clearing services and CME Group believes the failure to extend statutory insolvency safe harbor protection will ultimately limit the growth of the OTC derivatives clearing in Hong Kong as well as local participants' access to global liquidity.

#### **KEY PROPOSALS ON EXPANDING MANDATORY REPORTING**

**Q38: Do you have any comments or concerns about our proposal to only set out the information categories in the subsidiary legislation, and separately publish, by way of a (non-statutory) Gazette notice, the specific data fields to be completed when reporting transaction information to the HKTR? If you do, please provide specific details.**

CME Group believes the opportunity for public notice and comment prior to data field changes is necessary to ensure that market participants' views are adequately addressed and that proposed changes are consistent with industry practice and international best practices. Market participants require time to weigh cost-benefits and impacts to their systems and to implement changes, the timelines for which may vary depending on the field(s) in question.

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CME Group thanks the Authorities for the opportunity to comment on this matter. We would be happy to discuss any of these issues with the HKMA, SFC or their staff. If you have any comments or questions, please feel free to contact

CME Group