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Comments by the International Swaps and Derivatives Association, Inc. (ISDA) on the Consultation Paper on the Proposed Regulatory Regime for the Over-the-Counter Derivatives Market in Hong Kong

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Dear Sir/Madam,

The International Swaps and Derivatives Association, Inc. (ISDA) welcomes the opportunity to respond to the Consultation Paper on the Proposed Regulatory Regime for the Over-the-Counter Derivatives Market in Hong Kong ("Consultation Paper") issued by the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") jointly in October 2011.

Since 1985, ISDA has worked to make the OTC derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 825 member institutions from 57 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, central counterparties ("CCPs") and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA is actively engaged with providing input on regulatory proposals in the United States, Canada, the European Union and in Asia. Our response is derived from these efforts and from consultation with ISDA members operating in Hong Kong. Accordingly, our response draws on this international experience and dialogue and is not focused on technical aspects of Hong Kong law relating to the implementation of reform. Individual members will have their own views on different aspects of the Consultation Paper, and may provide their comments to the HKMA and SFC independently.

ISDA commends the HKMA and SFC for their careful consideration of these issues which would facilitate Hong Kong meeting G20 commitments regarding central clearing and trade reporting of OTC derivative transactions by the end of 2012. We also appreciate and support the regulators' objectives to reduce counterparty risk, improve overall transparency, protect against market abuse and ultimately reduce systemic risk in the OTC derivatives market.

Given the efforts being made to increase the use of CCPs, which will profoundly affect the role of the CCP in the broader financial infrastructure, effective CCP regulation, prudential supervision and oversight is critically important. If this is not achieved, CCPs will themselves become a major source of systemic risk. Thus, it is highly important that comprehensive analysis and consultation occurs on the design of the market structure and the implications for financial stability.

Before we address the questions posed in the discussion paper, we would like to make a few general observations.

Global Markets, Regulatory Coordination and Timing

The HKMA and SFC recognise in the Consultation Paper that given the global nature of OTC derivatives and the relatively small size of Hong Kong's OTC derivatives market, the regulatory regime here will need to be in alignment with other major markets and it is not for Hong Kong to drive the reform initiatives. Indeed, the proposed reforms to the functioning of these markets are, to a large extent, more relevant for Europe and the United States than for smaller markets such as Hong Kong. Given that context, we strongly urge the regulators to gather the necessary information on the impact of the reforms in the US and EU markets prior to implementing substantial reforms in Hong Kong. In that regard, it should be acknowledged that the implementation of key financial market reforms in the US and EU, due to their scale and complexity, is facing delay. The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") has been put back by approximately six months, after the Commodity Futures Trading Commission and the Securities and Exchange

Commission agreed to delay implementation from a deadline set by the U.S. Congress of July 15 to the end of the year. Similarly, the European Parliament, in early July 2011, postponed finalisation of the European Market Infrastructure Regulation ("EMIR"), which contains similar provisions on clearing of OTC derivatives to the Dodd-Frank Act.

In addition, we urge that the regulators consider the global nature of the markets when creating regulations for OTC derivatives so that the regulation does not restrict the ability of Hong Kong entities to continue participating in and be competitive in the global derivatives market. To this end, it is vital that the regulators seek to avoid mandating duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist.

General Observations on Trade Repositories

Trade repositories ("TRs") are being created to meet the G-20 Commitments on OTC Derivatives. Given that final regulations, rules and standards globally are yet to be defined, ISDA strongly recommends that TRs are developed with significant flexibility so that they can quickly react to new or changing requirements.

The use of global TRs should be encouraged because of their comprehensiveness in trade data capturing (reporting by all global dealers) and the ease by which all regulators can access the data simultaneously without the need to refer to various individual geographic TRs. However, the industry recognises that issues such as data confidentiality and the potential requirement under the Dodd-Frank Act for foreign regulators to provide indemnification to global swap data repositories[1] before information can be shared, might lead home country regulators to prefer having their own TRs. Home country regulators may also wish to collect all relevant trade data in a single repository rather than collating data by asset class as planned at the global TR level.

If a local TR requires market participants to provide the trade data separately, not utilising the global TRs, it is important that the local TR allows trade feeds from existing commonly used electronic confirmation platforms. The trade data that is required should also specifically follow global standards (including the reporting fields), as this will lead to significant cost savings for all market participants.

Scope of the Mandatory Clearing Obligation

According to the Consultation Paper, the HKMA and SFC are considering imposing mandatory reporting and clearing obligations not only on derivatives transactions with Hong Kong counterparties (including transactions entered into by overseas-incorporated authorised institutions ("AIs") through the Hong Kong branch) but also transactions between two overseas entities which are "originated or executed" by regulated entities in Hong Kong.[2]

ISDA thinks that the proposed regime in respect of clearing is casting the net too widely and is likely to conflict with regulatory requirements in other jurisdictions. ISDA believes that it makes the most sense for mandatory clearing to apply only to trades to which an AI, a licensed corporation ("LC") or Hong Kong person is a counterparty for reasons that will be elaborated on later in this paper.

If the HKMA and SFC were to decide to regulate cross-border and offshore trades, close coordination with foreign regulators would be essential to establish effective international minimum risk management standards, avoid regulatory arbitrage, and mitigate systemic risk and adverse spill-over across countries. Diverse and inconsistent requirements between different

[1] See comments by CFTC Commissioner Gensler that suggest flexibility in avoiding this indemnification: http://www.cftc.gov/pressroom/speechestestimony/opagensler-86.html

[2] Paragraph 7(7) of the Consultation Paper.

supervisors will increase costs and make it less likely that robust international standards can be developed. Close international cooperation between various supervisory bodies including banks, CCPs, and systemic risk supervisors would mitigate these risks.

ISDA also notes that the CCPs that have been built in Asia have generally taken longer than expected to achieve operational status and cautions that meeting an end 2012 deadline may cause stakeholders to rush Hong Kong's CCP set up when it is imperative that each step in the building process is thoroughly deliberated and stress tested. Market safety must come before expediency.

The remainder of this letter sets out our comments in relation to the specific questions posed in the Consultation Paper. Our response is set out underneath each question. Capitalised terms used but not defined herein have the meaning given to such terms as set out in the Consultation Paper. The headings used below correspond to the headings used in the Consultation Paper.

A. Key aspects of the regime being consider

> "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?"

We are supportive of the proposed approach that the mandatory reporting, clearing and trading obligations should be set out in the primary legislation, but the details of the scope of such obligations and related matters should be in subsidiary legislation. As noted in the Consultation Paper, this approach will give the regulators the flexibility to introduce changes as needed in a relatively timely manner to keep in step with market developments and evolving global regulatory standards and practices.

As the definition of "OTC derivative transaction" is key to the new regime, it is important that it be as clear as possible. The current approach of using the existing 'structured products' definition and providing exceptions to that definition does not seem to achieve that aim.

As a start, it is not entirely clear from the Consultation Paper whether carve-out (1) is intended to cover securities (both exchange-traded and otherwise) and futures contracts traded on exchange, or if it is meant to refer to securities and futures, each traded on exchange. This is an ambiguity which should be clarified.

In addition, carve-outs (2) and (3) relate to the marketing of derivatives, i.e. how derivatives and their documentation are authorised when offered for sale to the public. This is distinct from the licensing of intermediaries carrying on the business of dealing in OTC derivatives transactions. Since the 'OTC derivatives transactions' definition is used to determine who needs to be licenced for the proposed Type 11 regulated activity, the definition as proposed would mean that a dealer engaging in private placements of derivatives would be required to be licenced for a new Type 11 regulated activity, but a dealer engaging in the public offer of derivatives does not need to because it falls within carve-out (2). By contrast, this is certainly not how the securities business is currently regulated - the licensing of securities business does not depend on whether the securities are offered on the basis of private placement or public offer (as distinct from the marketing of securities).

It would instead seem logical to define "OTC derivative transaction" by reference to what these are as opposed to what they are not. The new definition can be drafted concisely and yet broadly enough to cover all types of OTC derivatives transactions.[3] As to the scope of its

[3] As an example, in EMIR, over-the-counter derivatives is defined as "derivative contracts whose execution does not take place on a regulated market as defined by Article 4(1) point 14 of Directive 2004/39/EC."

application in relation to the mandatory obligations, we support the proposal that the obligations should not apply to all OTC derivatives transactions, but only to those OTC derivatives transactions specified in subsidiary legislation.

In the event that the proposed definition of "OTC derivative transactions" were adopted notwithstanding our submission, we would support the proposal to carve out the transactions set out in paragraph 38 of the Consultation Paper provided the necessary clarification mentioned above is made.

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

We do not have any comments on the proposed division of regulatory responsibility between the HKMA and SFC.

B. Mandatory obligations and the products to be covered

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

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?"

We welcome the proposal to take a phased approach to extending any mandatory reporting and clearing obligations. We also support the proposal to limit initially the scope of any mandatory reporting and clearing obligations to certain IRS and NDF.

We note that the Consultation Paper sets out the list of reportable transactions, however the list of clearing eligible transactions is yet to be determined. On the criteria for determining clearing eligible transactions, the Consultation Paper proposes to adopt both a top down and bottom up approach, i.e. taking into consideration what regulators consider as products suitable for central clearing as well as products proposed by designated CCPs for central clearing.[4]

CPSS/IOSCO papers have highlighted clearly that products eligible for clearing must be both highly standardised and liquid:

> "CCP clearing seems to be an effective way of reducing systemic risk and a safer way of mitigating counterparty risk. Counterparty risk can have a destroying effect on firms as was experienced in the AIG case during the recent crisis. In order to increase the usage of CCP clearing, regulators and market participants should jointly work on defining the products to be eligible for CCP clearing. On the other hand, there are some discussions around CCP clearing on whether to mandate the CCP clearing or not for the defined products. However, not all of the overall derivative market products have the same liquidity and due to the need for tailor-made products for hedging reasons, it is not possible to centrally clear all types of products."[5]

We urge regulators to conduct further study to determine if there is sufficient liquidity with respect to each type of products before imposing mandatory clearing obligations on the product. Certain parameters for liquidity for each product are a minimum number of market makers, frequency of trading (daily) and depth of market (daily trading must be in sizes that are not

[4] Paragraph 60 of the Consultation Paper.
[5] IOSCO Report, OTC Markets and Derivatives Trading in Emerging Markets, July 2010, Page 32.

insignificant). Some products may meet these requirements, or not, depending on tenor. For example, 5 year fixed income swaps may be traded daily in significant sizes but the same swap with a 30 year term may not trade frequently enough to be considered liquid. The CCP must have the power to refuse clearing any trades that do not meet these criteria and regulators must ensure that the CCP applies these product suitability criteria.

When considering clearability, it is also practical to recognise that the margin model of leading OTC derivatives CCPs employs historical market data to compute initial margin. Where historical data is not available, it will be necessary to perform analysis to verify that the proxies adopted provide a conservative representation of the underlying risk including adverse market conditions.

Regulators should also consider the costs of establishing regionally-based CCPs, which may or may not be further bifurcated by asset class, as well as the availability of international CCPs to meet the needs of market participants in Hong Kong. In this regard, it should be noted that if clearing of certain IRS and NDF increases at international CCPs or other regional CCPs,[6] this is likely to reduce the viability of centrally clearing in Hong Kong.

The review of OTC derivatives in order to determine whether to impose a mandatory clearing requirement is, of course, extremely consequential. If the relevant clearing solution fails to establish an operationally sound and robust risk management framework, or captures an inappropriate category of OTC derivatives, the consequences for the CCP and for the market could be significant.

In terms of the factors that should be taken into consideration by regulators in identifying contracts appropriate for mandatory clearing in order to best achieve the goals of mandatory clearing and to mitigate adverse effects, we consider that the five factors outlined in Section 723 of the Dodd-Frank Act are a preferable starting point. The five factors are:

(I) The existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data.

Some types of OTC derivatives (for example credit default swap ("CDS") contracts in standard tenors and coupons referencing the on-the-run major traded indices) have a ready market of buyers and sellers, as evidenced by bids and offers that change throughout a trading day. By contrast, more complex products are frequently tailored to a counterparty's risk management needs and thus may be less liquid. A good example here would be a CDS on a bespoke portfolio of credits: it may be difficult to obtain daily market prices for this product. Further, the bespoke nature of products like these means that reliable pricing data may not be available, and this can lead to significant model and parameter risks in a models-based valuation.

It is critical that a CCP has the capacity and expertise needed to manage all of the risks associated with the products that it clears. These risks include potential valuation error, which can in turn lead to errors in estimates of initial or variation margin requirements and/or guaranty fund obligations. Since margin must be calculated at least daily, and since daily (or more frequent) market prices form the best basis for valuation, the availability of daily market prices for cleared products must be assured in all market conditions, including stressed markets. This is crucial, since if the amount held as margin turns out to be inadequate to cover the liquidation of a portfolio, then the CCP itself may be endangered.

[6] In this respect, we note that IRS (except CNH swaps) which are proposed to be subject to the mandatory clearing requirement are already cleared at the LCH. Clearnet Limited ("LCH."). For NDF, the Singapore Exchange ("SGX") recently announced the launch of its clearing service for OTC traded NDF covering Chinese Yuan, Indian Rupee, Korean Won, Indonesian Rupiah, Malaysian Ringgit, Philippine Peso and Taiwanese Dollar. We understand that the NDF products cleared by SGX essentially cover the products which the HKEx is considering clearing.

Based on the foregoing, it is clear that the size of the relevant OTC derivative market and its depth are crucial properties in the determination of the scope of mandatory clearing, and a conservative interpretation is required here. ISDA would be happy to provide expertise to assist in the definition of appropriate measures of the liquidity required for clearing, for mandatory clearing, and for contract market execution.

(II) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are consistent with the material terms and trading conventions on which the contract is then traded.

This addresses two important and related points. First, it reinforces the importance of assessing the financial integrity and operational competence of a CCP. In this context, the determination must also take into account, in assessing the enumerated factors, whether these factors can be satisfied by the CCP given the potential volumes which it would clear under a mandatory clearing requirement.

Second, the evaluation should be premised on the determination that the terms and conditions of the cleared OTC derivatives and the terms and conditions on which they are cleared are consistent with the material terms and trading conventions on which the relevant OTC derivatives are then traded.

These determinations are essential to ensure that the imposition of a mandatory clearing obligation for OTC derivatives will, in practice, actually achieve the objectives of increasing market liquidity and reducing risk in the financial system rather than increasing it.

(III) The effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the CCP available to clear the contract.

Like the preceding factors, this factor is intended to examine whether a mandatory clearing requirement with respect to the relevant OTC derivative would decrease systemic risk. This, in turn, requires an assessment of the size of the market for the relevant OTC derivative, the risk attributes of the OTC derivative, the scope and risk profile of other products cleared by the CCP, and the aggregate amount (and terms of availability) of the CCP's financial and credit support resources. Other risks, such as settlement and operational risks that can contribute to a clearing failure must, of course, also be considered.

Finally, the current and likely future importance of a CCP to the market it serves must be considered together with the extent to which the failure of a CCP will itself contribute meaningfully to systemic risk.

(IV) The effect on competition, including appropriate fees and charges applied to clearing.

This issue is important as while competition is desirable in principle, it also exposes CCPs to new risks. Thus an assessment of a clearing application should address the potential conflict of interests between owners and management of CCPs and the wider financial system with particular sensitivity to risk management standards.

Here, regulation has an important role in correcting the effect whereby low margin and guarantee fund levels may win a CCP business in the short term at the expense of wider financial stability. Lower margin and guarantee fund requirements should only be allowed where a CCP possesses sufficient alternative resources to support itself to a robust standard and where such a reduction does not materially increase systemic risk.

(V) The existence of reasonable legal certainty in the event of the insolvency of the relevant CCP or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property.

Financial stability requires legal certainty of outcome in insolvency. This is essential to ensuring, that, upon insolvency, the assumptions on which credit support levels and default management procedures were structured are well founded and reliable. It is also essential in order to mitigate concerns that may deter participation in the market or in available clearing solutions. In particular, confidence in the portability of customer accounts upon the insolvency of a clearing member is extremely important to market participants.

These five criteria, if taken together and conservatively applied, make it highly likely that a CCP will be able to value, call for margin on, and risk manage all cleared products. Therefore we submit that these criteria should be interpreted strictly, and only to mandate clearing for a particular product where they are clearly met at the time of the relevant application, and are highly likely to continue to be met in the future, including during future stressed periods. Such an approach will ensure adequate clarity and decrease the risk of inconsistent impositions of the clearing obligation.

C. Proposed mandatory reporting obligation

"Q5. Do you have any comments on the proposed mandatory reporting obligation, and how it will apply to different persons?"

ISDA would be very happy to assist the HKMA in the delivery of an effective TR infrastructure and to help develop the building blocks for appropriate data aggregation.

Client confidentiality

The industry understands the importance of properly-managed TRs in providing supervisors with trade data, including client names, to enable them to develop a more complete view of OTC derivatives market activity and thereby enhance their ability to oversee the market and its participants. The industry is committed to providing as much of the required data to TRs as it is legally able to do. At the same time, it is important that dealers be protected from the potentially severe legal consequences of providing confidential client trade details to TRs arising from local data protection and client confidentiality laws. Obtaining the client's consent (which in many cases must be informed consent) can overcome this in most jurisdictions. However, ISDA's discussions with members indicate clearly that clients will be reluctant to give that consent. In particular, the ultimate clients of a fund manager will probably have stringent confidentiality requirements in their investment mandates that would prohibit such disclosure. Dealers may be under similar constraints vis-à-vis their own clients. The best solution is ultimately changing the relevant laws to permit disclosure in certain specified circumstances regardless of legal or contractual restrictions. EMIR includes such a provision. ISDA is working with supervisors to identify other jurisdictions where such legislative change should be prioritised, though legislative changes may require long lead times. In the interim, industry is faced with the difficult prospect of having to manage conflicting regulatory requests and requirements and contractual obligations. We understand that a number of jurisdictions may impose additional restrictions in terms of allowing their banks or financial institutions to disclose their counterpart's trade details to foreign TRs. This is particularly problematic for trades between two overseas entities which are subject to the proposed reporting requirement solely because a Hong Kong regulated entity has originated or executed the trades. Given the challenges posed by local confidentiality laws, we would propose that an exemption from the reporting obligation should apply when local laws prohibit trade reporting into the HKMA-TR.

Except to the extent that a legal framework – involving both contractual consent and broad-based, consistent legislative change – permitting the contemplated disclosures is put in place, firms may have to screen data that they have for each customer (or class of customer) and manually block its disclosure, and will therefore not be able to provide client names. It should be noted in this regard that the provision of client data, even on a no-names basis, involves legal, relationship and reputational risks to firms. Some firms currently providing trade data to TRs on a no-name basis face the risk that doing so may breach contractual confidentiality obligations to their clients.

We believe that confidentiality is the cornerstone of the data reporting system. It should therefore be expected that any relevant regulators seeking access to information from TRs should publicly commit themselves to following high standards, as well as to publishing information on the relevant legal framework regarding their confidential use of information. Additionally, we believe that any public reporting of market activity - aggregated or otherwise - should not cause inappropriate or commercially sensitive information to be disclosed, undermining the safe and effective performance of financial markets. In particular, if there is going to be public reporting of reported trades, every effort should be made by TRs to avoid impacting the reporting entity's ability to properly hedge itself for the reported trades in the market. Preferably, any public reporting should be made with sufficient time lag to allow the market participant involved sufficient time to properly hedge itself in the market. Moreover, if the time delay for public reporting proposed by any TRs is not sufficient for certain large or more structured trades to be fully hedged, then certain exceptions should be granted to such trades to allow adequate time delay for appropriate hedging. There needs to be further clarity around the type of data that is legally required for publication, and this data should only be published by those legally entitled to publish it.

Hong Kong nexus

In the case of an overseas-incorporated AI, we note that the Consultation Paper proposes to apply the mandatory reporting obligation to transactions which have a Hong Kong nexus and the AI is a counterparty to.[7] We appreciate the regulators' concern that those transactions may have an implication for the monetary and financial stability of Hong Kong. However, members have some concerns about the extraterritorial reach of this proposal. This is broad enough to potentially capture transactions that may have a Hong Kong underlying between an offshore branch of the AI with an offshore counterparty, where the Hong Kong branch of the AI was not involved at all. This would require the Hong Kong branch of the AI be responsible for ensuring that all transactions by its offshore head office/branches with a Hong Kong nexus are reported into the HKMA-TR, even though the Hong Kong branch had nothing to do with the transactions and may not even be aware of them. Members question the means by which they could comply with this obligation and how it is proposed to be enforced. We would urge the regulators to discuss with overseas-incorporated AIs (and possibly the home regulators of these AIs) further about the feasibility and the cost implication of this proposal.

Reporting via overseas TRs

We welcome the regulators' proposal to allow the HKMA-TR to accept reporting via agents that may be trade matching and confirmation platforms or overseas TRs.[8] We believe that the regulators should promote data-sharing between TRs to limit the burden on international trading where a firm may have obligations to report to multiple repositories. To this end, should ensure that the implementation plan of the HKMA-TR is synchronised with the development of global TRs. In this respect, we noted that, although DTCC will be able to provide event based data for IRS by June 2012, it will not be providing this service for NDFs until 2013 at the earliest. Before

[7] Paragraph 69(1) of the Consultation Paper.

[8] Paragraph 50 of the Consultation Paper.

then, it will only be providing end of day / snap-shot information. We would encourage that the HKMA-TR is aligned with DTCC so that the market participants are not required to provide event based data for NDFs to the HKMA-TR before such data is available from DTCC.

In addition, our members would like to submit that the any mistake committed by these reporting agents (that may be trade matching and confirmation platforms or overseas TRs) should not be attributable to the Hong Kong entities or lead to penalties unless the mistakes are due to willing breach or gross negligence of those entities. Imposing a strict liability on the entities which are subject to the reporting requirement will only discourage the use of reporting agents and increase compliance costs for Hong Kong financial institutions.

"Q6. Do you have any comments on the proposal to adopt a specified reporting threshold for persons other than AIs and LCs, and how the threshold will apply?"

We welcome the regulators' proposal to adopt a specified reporting threshold for persons other than AIs and LCs. Regarding the calculation of the threshold, paragraph 97 of the Consultation Paper proposes that "all transactions falling within the same product class should be taken into account for the purposes of determining if the specified reporting threshold has been exceeded, i.e. irrespective of whether or not they are reportable transactions and whether or not an exemption applies." Members are concerned about the mandatory reporting obligation applying where the reporting threshold has been exceeded taking into account all transactions falling within the same product class rather than just the reportable transactions. Given that the mandatory reporting obligation only applies to certain transactions, it should only be those transactions which ought to be taken into account in assessing the reporting threshold. Otherwise there is uncertainty over which products fall into the "same product class". Likewise, where transactions have been exempted from reporting, one should not be required to take them into account for the purposes of calculating the reporting threshold.

"Q7. Do you have any comments on the proposed grace periods and how they will apply?"

Members generally support the grace period proposed by the HKMA and SFC.

D. Proposed mandatory clearing obligation

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

According to the Consultation Paper, an AI or LC will be required to clear all clearing eligible transactions whenever the AI or LC is a counterparty to the transaction, or the AI or LC has originated or executed the transaction (and in the case of overseas-incorporated AIs, its involvement as a counterparty or person originating or executing the transaction must be through its Hong Kong branch) subject to the clearing threshold and exemption as set out in the Consultation Paper. [9]

"*Originated or executed*"

The Consultation Paper explained that by "originated or executed" the regulators mean that "the AI or LC has negotiated, arranged, confirmed or committed to a transaction on behalf of itself or

[9] Paragraph 110 of the Consultation Paper.

any counterparty to the transaction, and in the case of an overseas-incorporated AI, that this has been done through its Hong Kong branch." [10]

We appreciate the regulators' concern that Hong Kong's market is unique in the sense that much of the OTC derivatives activity conducted by AIs or LCs in Hong Kong is not booked here. However, we believe that the requirement to clear trades "originated or executed" by LCs or AIs will only serve to increase operational and compliance cost for AIs and LCs without the benefit of mitigating systemic risk of the OTC derivatives market in Hong Kong. We do not see a compelling reason for covering those trades given that those trades are booked offshore and the relevant counterparty credit risk existing in those trades does not lie with the Hong Kong entities (except in the case of locally incorporated AIs which we will discuss below).

The Consultation Paper mentioned that capturing trades "originated or executed" in Hong Kong has "added benefit of preventing AIs and LCs from circumventing the mandatory obligation by arranging an overseas affiliate to enter into the transaction on their behalf." [11] We doubt whether this added benefit can be substantiated. Originating or executing trades in Hong Kong and booking trades in offshore entities is a practise mainly used by the dozen or so global dealers. The G-14 financial institutions which are the biggest players in the OTC derivatives market are either headquartered in the US or EU and will be subject to comprehensive clearing requirements as set out in the Dodd-Frank Act and/or EMIR. In other words, most of the trades which are originated and executed in Hong Kong and booked offshore will be required to be centrally cleared. In the case of an overseas-incorporated AI, the clearing obligation in respect of trades booked offshore seems to be at odds with the international protocol on banking regulation which HKMA and SFC espouse. [12] As to locally incorporated AIs, they will not have any incentive to book trades in their offshore subsidiaries to circumvent the clearing obligations given that the mandatory clearing obligation will apply in respect of all its activities in clearing eligible transactions irrespective of whether such activities are conducted through their Hong Kong office or through any overseas branch.[13] Additionally, the HKMA may require a locally-incorporated AI to: (i) take into account positions held by one or more of its subsidiaries when determining if the AI has exceeded the specified clearing threshold, and (ii) procure that clearing eligible transactions entered into by the AI's subsidiaries are centrally cleared through a designated CCP.[14]

We believe that this proposal to cover trades "originated or executed trades" by AIs and LCs in Hong Kong has broad extra-territorial reach and may subject market participants to potential conflicting regulatory obligations. The exemption considered by the regulators will reduce but cannot eliminate potential regulatory conflicts. For example, the exemption fails to take into account the jurisdictions which do not have mandatory clearing requirement for OTC derivatives. A transaction which has been executed or originated by an LC or AI in Hong Kong and entered into between two persons from those jurisdictions will not qualify for the exemption proposed in the Consultation Paper. Indeed, before the regulators clearly indicate which jurisdictions will qualify as "acceptable overseas jurisdictions", it would be difficult for the industry to evaluate how useful this exemption would be.

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[10] Paragraph 111 of the Consultation Paper.

[11] Paragraph 66 and 112 of the Consultation Paper.

[12] Paragraph 70 of the Consultation Paper mentioned that under the international protocol on banking regulation: "(1) the host regulator mainly regulates the activities of the domestic branch of an overseas bank (i.e. the branch that operates in the host regulator's jurisdiction); (2) the home regulator exercises consolidated supervision over the bank's group as a whole (including therefore all of its subsidiaries and overseas branches), and (3) there are cooperative arrangements between the home and host regulators to ensure that a cross-border banking group is effectively supervised."

[13] Paragraph 113(2) of the Consultation Paper.

[14] Id.

In addition, this requirement also introduces confusion and complexity to the proposed regulatory regime for the OTC derivatives market in Hong Kong. The explanation in paragraph 64 of the Consultation Paper is helpful in understanding the meaning of "originated or executed", however it does not provide enough guidance to identify what trades will fall within this category. For example, if an AI or LC has an operational team in Hong Kong which manages and produces confirmations for transactions with Asian counterparties, does this mean that the trades are "confirmed" by the bank's Hong Kong entity and thus are subject to the mandatory clearing requirement notwithstanding the employees in Hong Kong have no other connection to those trades? What about the involvement of other back office functions (such as credit or legal) located in Hong Kong? What does "arranged" (which is normally used in securities offerings) mean in the context of OTC derivatives transactions? Would a trade be captured by this requirement if an employee of a bank's Hong Kong branch explained some provisions in the term sheet or confirmation to a client even if the employee does not negotiate or market the trade? If the regulators were to impose the clearing requirement on trades originated or executed by LCs and AIs, the regulator need to clearly define these terms in order to help the industry to determine which transactions are subject to the mandatory clearing obligation.

We urge the regulators to re-consider whether it is necessary to apply the mandatory clearing obligation to trades originated or executed by LCs or AIs. In the event that the regulators were to decide to adopt this proposal notwithstanding our submission, a regime for mutual recognition of third country CCPs and an agnostic approach to where clearing takes place would be essential for avoiding regulatory conflicts with other jurisdictions. In this respect, we would also like to submit that the clearing requirement should focus on systemically important institutions, and end-user exemption that recognised in the Dodd-Frank Act and EMIR should be incorporated into the regulatory regime in Hong Kong (see the discussion on the end-user exemptions set out below).

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

We welcome the regulators' proposal to introduce a clearing threshold in respect of all persons. As to the specified clearing threshold for a product class, we would urge the regulators to conduct a cost benefit analysis (e.g., who gets exempted, how much systemic risk does that exempt) and consult with the industry prior to setting the threshold. We agree with the HKMA and SFC that clearing entails significantly higher costs, accordingly, it is important to ensure that any mandatory clearing requirement is appropriate, take into account the necessary commercial concerns, and is proportional to achieve the goal of reducing systemic risk in the market.

Calculation of the clearing threshold

Paragraph 124 of the Consultation Paper proposes that "all transactions falling within the same product class should be taken into account for the purposes of determining if the specified clearing threshold has been exceeded, i.e. the calculation should not be limited to only clearing eligible transactions." Members are concerned about the mandatory clearing obligation applying where the clearing threshold has been exceeded taking into account all transactions falling within the same product class rather than just the transactions eligible for clearing. Given that the mandatory clearing obligations only apply to certain transactions, it should only be those transactions which ought to be taken into account in assessing the clearing thresholds. Otherwise there is uncertainty over which products fall into the "same product class". In addition, this calculation method may subject a market participant which has entered into very few clearing eligible transactions to the mandatory clearing obligation. Central clearing is intended to reduce systemic risks in the financial system. Requiring such a market participant to clear the few clearing eligible transactions will entail high cost but without much benefit.

Likewise, in respect of the proposal set out in paragraph 125 of the Consultation Paper, members are of the view that where transactions have been exempted from clearing, one should not be required to take them into account for the purposes of calculating the clearing threshold.

Responsibility for ensuring compliance with the mandatory clearing obligation

Our members have concerns about the proposal to make an AI or LC responsible for ensuring compliance with the mandatory clearing obligation. An AI or LC may not be in a position to determine whether a client meets the clearing threshold given that the client may have entered into transactions with other counterparties which the AI or LC is not aware of. We believe that the regulators should allow AIs and LCs to rely on a representation from their clients, in good faith, at the time of trading in which the clients confirm that they do not meet the clearing threshold. Alternatively, we would urge the regulators to set up a public database listing all entities that meet the clearing threshold so that Als and LCs could do a search at the time of trading to determine whether the trade is subject to the mandatory clearing obligation.

Exemptions

In addition to the clearing threshold, we urge the regulators to consider exempt certain market participants from the mandatory clearing requirement. We believe that not all participants in Hong Kong's OTC derivatives market should be subject to mandatory clearing. Market participants, and in particular end-users that rely on OTC derivatives to manage efficiently the risks inherent in their core economic activities, should maintain the ability to bilaterally transact tailored hedging and other risk-management products. Exceptions for certain classes of end-users should be publically disclosed and coordinated on an international basis to avoid regulatory arbitrage.

We encourage the HKMA and SFC to consider the following exemptions:

(a) Exemptions for commercial end-users*:* We believe that affordable access to appropriate methods of hedging, including the use of OTC derivatives, is vital to end-users as they seek to mitigate risks and maintain their economic viability. We caution against implementing regulation that would make access to these critical risk management tools either too difficult or too expensive to attain. Commercial end-users often have risk-management needs that are unique to their individual situations. For example, the location (basis), volume, timing and duration of derivatives required may vary from party to party, depending on individual hedging needs. Standardised offerings alone, therefore, are rarely adequate. Requiring such standardisation could expose participants to additional market risk. Also, commercial end users generally do not have the systems in place to manage CCP margining requirements and may opt not to hedge rather than tie up working capital. Legislation should not provide a disincentive to hedge commercial risks. This is recognised in end-user clearing exemptions proposed under the Dodd-Frank Act and EMIR.

(b) Limited, proportionate exemptions for non-systemic financials*:* We are concerned that requiring non-systemic end-users to use CCPs will have liquidity effects which are insufficiently understood at present, and, given the way that derivatives are used to manage overall portfolio risk, may artificially and inefficiently isolate derivatives components from the rest of these portfolios, requiring posting of high levels of margin on derivatives and not net exposures. This could, for example, have significant effects on savings and pensions.

(c) Exemptions for intra-group transactions*:* We would propose that there should be allowance for an exemption from the clearing obligation in relation to transactions with affiliates. For example, this will be important as in many cases there may be legal requirements that affect which group companies can face counterparties though the risks may be hedged or managed in

another group company, requiring intra-group risk transfer. A failure to provide this exemption – and a requirement for intra-group transactions to be cleared at CCPs will imply

- An increase in operational risk: clearing of one intra-group transaction - implying limited counterparty risk - would require 4 transactions between the clearing house and counterparties involved in the transaction; and

- Prohibitive costs (clearing membership, sourcing and posting of liquid collateral on an intra-day basis), ultimately passed on to the end user. If the end user is discouraged from hedging by this cost, this would increase market risk and discourage business investment and employment.[15]

In this respect, we note that the EU has decided to exempt intra-group transactions from the mandatory clearing obligation provided that certain conditions are fulfilled.

Allowing de-clearing and trade compression

Trade compression is viewed as an effective means of managing counterparty exposure and reducing capital charges, as well as proving the operational benefits of fewer transactions and a lower outstanding notional amount. Some established CCPs, in which a number of market participants are clearing their trades (including HKD trades), require such cleared transactions to be de-cleared (i.e. a trade that was novated to CCP upfront is then assigned back to the bilateral trading counterparties) in order to perform trade compression (the transactions after the trade compression process will be re-cleared). We believe that de-clearing (prohibited as per paragraph 130) should be allowed for such purpose.

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

Members generally support the grace periods proposed by the HKMA and SFC as set out under paragraphs 128 to 129 of the Consultation Paper.

We note that the Consultation Paper does not mention whether there will be a transition period when a clearing eligible product becomes subject to the mandatory clearing requirement. We recommend an extended period between a CCP being given permission to clear a product and clearing becoming mandatory on that product. Further, ISDA would recommend transparency during any such period. This will provide important notice and information for affected parties on the relevant margin and default fund calculations, what pricing requirements will be set by the CCP, and how default management will operate.

E. Mandatory trading obligation

“Q11. Do you have any comments on the proposal not to impose a mandatory trading obligation at the outset?”

ISDA welcomes the regulators’ proposal not to impose a mandatory trading obligation at the outset. ISDA supports allowing participants to determine whether or not to trade on an organised

[15] For detailed discussion on why an exemption for intra-group transactions is necessary, see “ISDA/AFME briefing: Why EMIR must apply a proportionate, internationally coherent approach to regulation of intra-group transactions (10 May 2011)”, available at http://www2.isda.org/attachment/MzYxMA==/11ISDA_AFME_case_for_proportionate

trading platform. While increased use of trading platforms will bring benefits for particular derivative product types that are suitable for such venues, we believe that mandatory or incentivised use of such platforms where such products are not suitable to their use will not reduce risk and will negatively affect market participants and markets in general.

As the G20 recognised, it is not always appropriate for derivatives trading to take place on organised trading platforms even if the transactions have become relatively standardised. There are many differing models for negotiating and executing a derivative transaction and market participants should retain a choice between these different models to reflect their particular needs.

If mandating electronic trading or, for that matter, any type of trading requirement that is inflexible in its design and/or promoted too aggressively for products currently traded OTC, then the following risks could materialise[16]:

- **The inability to customise:** Overly-ambitious promotion of a particular venue would likely concentrate trading activity in a subset of existing contracts, weakening the ability of market participants to customise contracts. More importantly, concentrating the market into a more narrow range of products linked to particular venues could potentially increase systemic risk, as clients would not have the ability to hedge and appropriately manage their unique risks.

- **(Associated) basis risk and earnings volatility**: If counterparties who wish to hedge are prevented from being able to enter into contracts that are customised to hedge the specific risks they face, they will face basis risk (a mismatch between the risks they face and the contracts they have to use), and earnings volatility, as it will be more difficult to qualify for hedge accounting treatment.

- **Loss of the means to manage risk**: The public transparency criteria associated with organised venues could prove problematic for market participants, particularly hedging counterparties, who could find the market more likely to move against them when they trade. For example, for some commodity contracts, where the number of participants is very low, disclosing the transaction, even on an anonymous basis, would be sufficient to identify the participants in the transaction and would not result in useful market information due to the specificity of the price.

  A further reason for maintaining alternative methods of negotiating or executing trades is to allow for the possibility of significant drops in liquidity (such as where there is a jump in volatility). In those circumstances, market participants will wish to be able to seek out and negotiate with the available sources of liquidity on a bilateral basis. Constraints on their ability to do so will exacerbate market disruptions by restricting alternative sources of liquidity. For example, during the financial crisis there was a significant drop in volumes in standardised, plain vanilla exchange traded contracts.

- **Loss of market efficiency:** The unit size of OTC trades are typically larger than those on-exchange, reflecting (a) the professional nature of the market (exchanges often have a significant retail level of participation – at least for some types of instrument) and (b) the customised nature of the product (it is easier for counterparties to agree to one deal, than

[16] For an in-depth discussion and analysis of the impact of electronic execution requirements on OTC derivatives markets that were mandated by the Dodd-Frank Act, see "Costs and Benefits of Mandatory Electronic Execution Requirements for Interest Rate Products," published by ISDA on November 10, 2011, available at http://www2.isda.org/news/isda-publishes-discussion-paper-on-costs-and-benefits-of-mandatory-electronic-execution-requirements-for-interest-rate-products.

for a counterparty to have to purchase many units of smaller-denominated exchange-traded contract). Mandatory use of organised venues could therefore make risk transfer less efficient. At a minimum, regulators should make an independent assessment as to whether a swap should be executed on an organised trading platform separate from its clearing determination with respect to the same swap. In this respect, we note that under the Dodd-Frank Act, the fact that a swap is required to be cleared is not dispositive of whether such swap should be executed on a Swap Execution Facility.

We strongly believe that regulators should allow participants to determine whether or not to trade on an organised trading platform. In the event that regulators pursue the regulatory authority to impose a mandatory trading requirement, we would strongly caution against any rule that would mandate trading of all OTC derivatives on an organised platform, and would suggest that, at a minimum, regulators make an independent assessment as to whether a swap should be executed on an organised trading platform separate from its clearing determination with respect to the same swap.

G. Designation and regulation of CCPs

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

We would like to make the following submissions on the questions raised by the regulators regarding designation and regulation of CCPs.

CCP licensing and membership criteria

ISDA believes that requiring the CCP to comply with CPSS-IOSCO standards[17] is an important additional criterion that should be imposed before granting a licence. CPSS-IOSCO is the most authoritative voice on CCP standards and meeting these standards would ensure that Hong Kong's CCP meets or exceeds international benchmarks for CCP management.

At the operational level, best practise CCP risk management starts with stringent requirements on becoming a clearing member ("CM") in terms of sufficient financial resources, robust operational capacity, and business expertise. We suggest that any CCP solution adopt CM requirements that are clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of CMs to the CCP.

CCPs typically seek to ensure that their CMs are creditworthy by establishing a set of financial requirements for membership. Usually CMs are required to meet, both initially and on an ongoing basis, minimum capital requirements, often stated as the larger of a fixed amount and a variable amount that depends on some measure of the scale and riskiness of the CM's positions with the CCP and in other financial markets. In most cases, membership is restricted to regulated entities that meet regulatory minimum capital requirements. CMs that carry client accounts are often required to meet capital standards that are more stringent than regulatory minimum requirements. Clearing membership should be non-discriminatory: Foreign market participants should be allowed to be CMs if they meet the publicly stated CM criteria.

In addition to financial requirements, leading CCPs establish standards of operational reliability for CMs. CCPs typically impose tight deadlines for the submission of trade data and for completing various settlement obligations. The failure of a CM to meet these tight deadlines could significantly increase the CCP's risk exposures to that CM and possibly to other CMs as well. Compliance with operational deadlines must be closely monitored on a day-to-day basis.

[17] CPSS-IOSCO consultative report, Principles for Financial Market Infrastructures, March 2011.

Furthermore, in recent years many CCPs have been paying greater attention to the backup systems that CMs would have available if their primary operating systems were disrupted.

Hong Kong regulation should require that a CCP legally separates its OTC derivative clearing activities from its other businesses. This prevents the commingling of default and guarantee funds across products, ensures that a CCP's OTC derivatives clearing activities are independently managed and there is no conflict of interest or exposure to these activities from its other businesses and that the CCP has dedicated resources to manage its OTC clearing activities, which is particularly important in the event of a default. There may be limited circumstances where a combined entity could prevail, including where the entity covers both OTC and listed products with similar hedging properties.

Second, CMs should only be able introduce risk commensurate with their capital position. Further, entities that become CMs of OTC derivatives CCPs must have the ability to participate in the CCP default management process including the ability to bid for the portfolios of other CMs of the CCP. If a CCP admitted a CM (or a group of CMs) that was unable to participate fully in default management of the product it clears, there could be significant negative repercussions for the CCP and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the CCP would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the CCP's risk management process would be effective. Moreover, for there to be the right level of incentives for active participation in default management, there needs to be enough 'skin in the game', which suggests not only that that the default fund needs to be allocated proportionally to risk introduced; but also that the default fund to initial margin ratio should reflect the estimated percentage of market risk remaining following the completion of the default management hedging phase.

Location requirement

The Consultation Paper asks for input on whether only domestic CCPs should be designated for the purpose of any mandatory clearing obligation under Hong Kong law. We think that the regulators should be very cautious about imposing a location requirement as the result is extremely consequential. We strongly urge the regulators to conduct a thorough cost benefit analysis regarding central clearing in Hong Kong and also gather the necessary information on the impact of the reforms in the US and EU markets prior to making any decision on this issue. Without the benefit of this information, we consider it is too early to determine whether any derivative or market in Hong Kong is systemically important enough to justify a mandatory local clearing requirement. In this respect, useful data will become available from TRs to inform analysis and ultimately decisions on the regulatory settings for the Hong Kong market.

Derivative markets are global in nature and impediments to cross-border trading could be highly damaging. Consider the example of a Hong Kong financial institution that is required to clear trades in Hong Kong. If it were to enter into a cross-border trade with another Asian bank that was also required to clear in its home jurisdiction, this trade could not take place as trades can only be cleared in one clearing house. Any rules that made it impossible for Hong Kong financial institutions to execute such cross-border trades would be bad for the Hong Kong market.

We note that the European Union's envisaged standards for accrediting third-country CCPs are stringent. Regulatory powers have been given to the European Securities and Markets Authority ("ESMA"). ESMA may recognise a third country CCP if the European Commission has determined that:

(a) the third country's legal and supervisory arrangements ensure that its CCPs comply with legally binding requirements that are equivalent to the EU's;

(b) these CCPs are subject to effective supervision and enforcement in the third country on an on-going basis; and

(c) the third country's legal framework provides for effective reciprocal access of EU CCPs.

This could potentially lead to regulatory conflict. If it were to be mandated that Hong Kong dollar trades must be cleared in Hong Kong and a European-domiciled CCP also offers Hong Kong dollar clearing (which is currently the case – it is estimated that over 50% of all Hong Kong dollar swaps are cleared currently through LCH.), then not providing reciprocal access to that European clearing solution could result in ESMA deciding not to recognise Hong Kong's CCP for the purpose of clearing by European banks. In the extreme case, all of the liquidity that European banks provide to Hong Kong's OTC markets could disappear as a result.

Mandating that onshore swaps denominated in other currencies, such as Euros or US dollars, must be cleared in Hong Kong, would immediately cause conflict with ESMA as European-based clearing houses already offer clearing of those products and reciprocal access would be expected.

It is worth noting that concerns also arise from the Dodd-Frank Act. A potential Hong Kong CCP might possibly gain blanket recognition from US regulators, though the criteria for that recognition is not clear at this moment. Instead, a Hong Kong CCP may be required to register as a derivative clearing organisation ("DCO") in the US, subjecting the Hong Kong CCP to potentially conflicting regulation between US and Hong Kong regulators. Failure to register as a DCO would result in US banks not being able to clear through the Hong Kong CCP. Instead, US banks could be required under the Dodd-Frank Act to treat the CCP as a bilateral trading counterparty and require a Hong Kong CCP to post margin to the US bank. Otherwise, US banks may not be permitted to trade with this counterparty. In the extreme case, all of the liquidity that American banks provide to Hong Kong OTC markets could disappear as a result.

These issues can be addressed by convergence/alignment of rules, limited exemptions for cross-border business and (mutual) recognition arrangements. However, while solutions for these issues remain unresolved as between the United States, the European Union and other jurisdictions, it might be premature to implement any regulations that restrict Hong Kong's ability to be flexible and require a long lead to time to change.

Below we highlight a few of the key considerations that may inform the optimal solution for accessing CCPs and allowing for the most efficient use of capital.

Multiple CCPs:

The CCP industry typically exhibits network externalities, in that the value of the services offered depends on the number of participants and contracts cleared. In other words, an increase in the number of CMs will have benefits that accrue to existing CMs, as they will be able to clear with more counterparties. In addition, the CCP industry exhibits important economies of scale, which means that the average cost per transaction declines with an increase in the number of transactions. Staffing, premises, and information technology infrastructure, such as the database engine, the clearing platform, networks, and interfaces have high fixed costs. Also, CCP multilateral netting efficiencies diminish as the number of CCPs clearing the same product type increases. In sum, a single CCP has potentially the lowest costs.

It is worth noting, in this context, that some of the benefits of a single CCP can be achieved by connecting several CCPs through links (where CCPs cooperate with each other). The regulatory, operational and legal demands of this interoperability are, however, substantial.

Interoperability:

Interoperability presents formidable challenge for OTC derivatives CCPs. Senior executives from major OTC derivatives central counterparties have said as recently as June 2011 that interoperability between CCPs for OTC derivatives "…will not happen in our lifetime"[18]. Currently, OTC derivatives clearing is not fragmented along national lines but centralised and international, and the tailored nature of the product compared to more standardised cash asset classes makes it less suitable for interoperability. However, we would be supportive of proposals to give CCPs the right to interoperate and right of access to relevant data and systems – and believe this could help to bring clearing costs down for end-users – providing a thorough review is conducted first by engaging with all market participants and performing in depth analyses of the potential risks this may pose to the stability of the proposed (global) CCP operational solutions for OTC derivatives clearing and the additional risks arising from interoperability are properly managed.

Leveraging global technology systems and platforms

ISDA highly recommends mandating globally-tested vendor technology solutions for the CCP rather than developing bespoke applications. This includes both the CCP's risk management system and the middleware used for connecting CMs to the CCP.

All CCPs in existence globally have chosen from among a select few providers of risk management technology.[19] Confidence in a Hong Kong CCP would be highest if it also selected a risk management system provider with a proven track record.

Equally important is the middleware systems platform by which CMs connect to the CCP. Many Hong Kong market participants participate as CMs in several CCPs globally and have already made significant investment in middleware systems. Recognising this, CCPs in Japan and Singapore have also ensured that banks can connect to them via these platforms. We understand that Hong Kong's CCP will offer connectivity both via a global vendor solution and a bespoke local solution in order to provide a lower cost for local market participants who are not active in other markets. ISDA supports this approach. A local market only solution would require internationally active CMs to make discreet local technology investments in bespoke systems that are incompatible with the systems they employ globally. This would lead to additional expenses that must also inevitably be passed on to end clients.

Indirect clearing

ISDA believes that indirect clearing should be available, though CCPs should support position and margin portability to ensure that a party's exposure is always to the CCP and not to the clearing member.

The impact from a Basel 3 point of view for banks that are clients of clearing members is substantial. A bank doing client clearing through a CM would only be able to enjoy the lowest CVA charge if:

> "(a) the CCP and/or the clearing member, as applicable (i.e. depending on who has control of the assets and collateral posted by the client) identifies and segregates the positions and assets belonging to the client from those of the CCP and the clearing member, and such segregation results in bankruptcy remoteness should the clearing member become insolvent; and

[18] "No CCP interoperability in our lifetime – clearing houses", International Financing Review, 12 July 2011, available at http://www.ifre.com/derivatives-no-ccp-interoperability-in-our-lifetime-%E2%80%93-clearing-houses/639106.article

[19] Murex, Calypso Technology and Razor Risk systems are among those commonly used in existing CCPs for OTC derivatives.

> (b) relevant law, regulation, rules and contractual arrangements ensure that the client's contracts with the defaulted or insolvent clearing member will be taken over by another clearing member, and thereby continue to be indirectly transacted through the CCP, should the clearing member default or become insolvent."[20]

Regarding which model to use in respect of segregation and portability, we do not consider that regulators should set a particular model as a minimum requirement. There is a strong argument to be made for permitting market participants to contract on segregation and portability, as opposed to prescribing a method via regulation. One possibility would be to establish omnibus segregation as a default standard, but permit clearing members and their clients to negotiate to create individually segregated accounts to contract around the standard. This would permit those who value segregation more highly than it costs CMs to segregate, to negotiate mutually beneficial arrangements with CMs. Such contracts would reflect information available only to the contracting parties, but which regulators would not know when setting a one-size-fits-all standard. That said, end-users will need to be educated as to the trade off between highly segregated collateral and less segregation.

In addition, there are many different ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. This is critical in relation to whether customer positions and related margin are likely to be successfully ported.

One variable in margin posting is whether a CCP collects margin from CMs on a gross basis (i.e. the CCP collects from each CM all margin posted by the CM's customers on account of CCP-imposed margin requirements) or on a net basis (i.e. the CCP collects from each CM a level of margin sufficient to account for the net risk to the CCP of the combined customers' positions, with offsetting customer positions resulting in a corresponding reduction in the aggregate margin requirement).

An important consideration in how margin is held is the degree to which the margin is commingled with other assets and where the margin is held. Customer assets may be comingled with the CM's proprietary assets or segregated from the CM's proprietary assets in an omnibus or on an individual client basis. Margin may be held at the CCP (in the client's name or in the CM's name), at the CM, or at a third-party custodian. In a situation where margin is posted by the client on a gross basis, but collected by the CCP on a net basis, it is possible that client margin is held at both the CCP and the CM.

Legal certainty and insolvency law considerations

Ensuring the effectiveness of segregation and portability provisions and mechanisms is a substantial challenge and work in these areas continues in the US and the EU. For example, in order to provide further certainty of the effectiveness of segregation and portability provisions in the EU, recent texts of EMIR contain the provision that "The [segregation and portability] requirements set out in paragraphs… shall prevail over any conflicting laws, regulations and administrative provisions of the Member States that prevent the parties from fulfilling them".

We welcome the regulators' undertaking to review whether and to what extent the insolvency override provisions and other protections under Part III of the SFO need further amendment to support client clearing.[21] In this respect, we note that the insolvency protections given to

[20] Capitalisation of bank exposures to central counterparties, Basel Committee on Banking Supervision, Page 11, 4 February 2011.

[21] Paragraph 155 of the Consultation Paper.

"market contract" under Part III of the SFO currently does not extend to contracts between a CM and its clients.[22]

We believe that the definition of "market contract" should be extended to cover contracts entered into by CMs with their clients for the purposes of the clearing and settlement of OTC derivatives transactions on CCPs. In addition, the definition of "market contract" should be amended as follows to take into account features of OTC derivatives:

(a) To remove the restriction that market contracts relating to OTC derivatives must be formed by "novation". This can be achieved by expressly allowing market contracts to be formed in accordance with the rules of the CCP whether or not the novation concept is used. This change is necessary because contracts between an OTC derivatives clearing house and clearing participants may not be formed by novation as is demonstrated in the UK and US.

(b) To extend the scope of this definition so that it either expressly includes OTC derivatives in addition to securities and futures contracts or to make it generic so that it would be sufficiently wide to cover OTC derivatives. There should also be recognition that OTC derivatives may or may not be traded on any market, exchange or special execution facilities.

In addition, there should be thought given as to protections in the SFO for aspects of client clearing which arise as a direct result of the operation of the rules of the CCP. For example:

- **Deemed ISDA Master Agreement**: prior to the registration of the relevant OTC derivatives transactions to the CCP for clearing, the client and the clearing participant will already have entered into a bilaterally negotiated ISDA Master Agreement (the "Non Clearing ISDA Master Agreement") that governs non-cleared OTC derivative trades between the parties. Consistent with the approach taken in the UK, the rules of the CCP would "deem" in place a new or a further ISDA Master Agreement between the client and the clearing participant (the "Clearing ISDA Master Agreement"). The Clearing ISDA Master Agreement is an important document that will govern the rights and obligations of the client and the clearing participant in respect of the transactions to be cleared by the CCP and will be on similar terms as the Non Clearing ISDA Master Agreement, amended to reflect the relevant clearing requirements. This should be given express statutory booking to avoid any argument that transactions to be cleared are not properly transferred to the Clearing ISDA Master Agreement for central clearing and to eliminate any uncertainty that may otherwise arise from the pure contractual nature of the CCP rules.

- **Automatic transfer**: in addition, upon the registration of a transaction with the CCP for clearing, the CCP rules would also "deem" the automatic transfer of transactions from the Non Clearing ISDA Master Agreement to the Clearing ISDA Master Agreement to take place. This should also be given express statutory protection for the reasons above.

- **Margin**: when a clearing member becomes a member of the CCP, it will be asked to post initial margin to the CCP. As part of the protections given to clients of such member, the clearing member will normally be required to enter into a deed of assignment as security for the performance of its obligations to the client under the Clearing ISDA Master Agreement. Under the assignment, the clearing participant will assign its rights against the CCP in relation to its client account (including the right to the return of initial margin) to the client. This assignment is a key part of client protections as it gives the client a

[22] The definition of "market contract" is set out in Schedule 1 of the SFO:
"Market contract means a contract subject to the rules of a recognised clearing house entered into by the clearing house with a clearing participant pursuant to a novation which is both in accordance with those rules and for the purposes of the clearing and settlement of transactions in securities or futures contracts effected on a recognised stock market or a recognised futures market or subject to the rules of a recognised exchange company."

direct contractual right to enforce against the CCP in the event when the clearing member becomes insolvent. Therefore, it is particularly important to ensure that the assignment is free from challenge, particularly on the grounds of non-registration.[23]

Failure to register a registrable charge under the Companies Ordinance would have the serious consequence that the charge will be void as against the liquidator of the clearing participant and any creditors (e.g. clients). To ensure protection to the client and leave no doubts as to the need for registration of the charge, it would be desirable for the SFO to give legal certainty to the validity of the charge by clearly providing that the charge created pursuant to the CCP rules for the purposes of protecting the client against a clearing participant's default is not subject to registration in any event.

- **Default arrangements**: to protect clients, a CCP will effect "porting" of the client positions of a defaulting clearing market to a replacement clearing member. In order to do this, there will need to be steps such as the automatic termination of transactions between a defaulting clearing member and its client, the transfer to a replacement clearing member of transactions as part of "porting" and the "writing up" and writing down" of margin balances and the valuation of terminated transactions. These steps should also be given protection in the SFO.

Regulators should consider how these amendments can be framed, but one option would be to give protection to aspects of client clearing that arise as a direct result of the rules of the CCP.

These amendments to the SFO are proposed to give legal certainty and insolvency protection to client clearing. Should these amendments be accepted, we believe that Hong Kong would have a regime that offers more certainty and protection to client clearing when compared to other jurisdictions in the region. Further, giving express protection to these issues would provide a well-founded and enforceable legal basis to client clearing, as recommended in the CPSS-IOSCO Report.

Margin and default fund considerations

We note that Basel 3 proposes different CVAs for margin and joint compensation fund contributions. If the CCP meets CPSS-IOSCO standards, the CVA for margin contributions is 2%, while it is 20% for joint compensation fund contributions. This is one reason why industry participants prefer that a CCP protects itself through stringent initial margin requirements rather than higher compensation fund contributions.

The industry also highly recommends that the number of times that a CCP can call on a CM to replenish the compensation fund should be capped. Otherwise, CMs face potentially unlimited liability and may be restricted by home country regulators from becoming a CM of such a CCP. We note that foreign bank participation in Japan's CCP was held up until the issue of uncapped liability could be satisfactorily resolved.

H. Capital charges and margin requirements

ISDA welcomes the regulators' proposal to align themselves with internationally agreed standards regarding capital and margin requirements for uncleared OTC derivatives transactions. ISDA urges the regulators to consult the industry before releasing any detailed rules in this area. Sufficient time should be given to market participants to analyse the impact of the higher requirements on their entities and prepare for compliance.

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[23] As the assignment normally takes effect as a legal charge, where the charge is created by a clearing participant that is a Hong Kong-incorporated company, a question arises as to whether it is a registrable charge under section 80 of the Companies Ordinance.

ISDA supports capital requirements that are risk sensitive and defined to a precisely articulated soundness standard. Thus higher capital requirements are appropriate for uncleared exposures only where these have greater risk than cleared exposures. This may or may not be the case depending on various factors including but not limited to the financial resources of the CCP, CCP and bilateral margin requirements, segregation, CCP products cleared, and documentation, operational and other risks. If higher margin requirements are applied without regard to these factors they may provide an incentive to use central clearing even when clearing members are unconvinced as to the safety of the CCP. Further they may encourage some CCPs to clear products which are not sufficiently liquid or otherwise unsuitable for central clearing. Thus we encourage a proportionate use of capital requirements which is fully cognizant of the variety of risks in cleared and uncleared models.

ISDA believes that imposing mandatory collateral requirements for non-financial entities for non-cleared trades is inappropriate.

Increasing the costs associated with using OTC derivatives will hamper the ability of small and mid-sized companies to manage their business risks. Non-financial entities, which make use of customised derivatives, are not geared up to routinely post margin. The costs and demands of managing margin requirements on a daily basis are extremely prohibitive. Instead, they customarily collateralise as part of their overall banking relationship.

If margin were made a matter of law or regulation, the cost of funding collateral calls might be sufficient to lead non-financial entities to reduce their hedging activities and thereby increase their financial risk exposures. In essence, the proposal sets up a trade-off between arguably reducing the limited counterparty credit risk posed by non-financial entities' use of OTC derivatives, which may be addressed via alternative credit risk mitigation arrangements, while increasing business risk for non-financial entities (i.e., currency, rate, price risks) by discouraging the use of OTC derivatives. Financial entities, who are in the business of extending credit, should be able to manage their counterparty credit risk on an individual counterparty basis rather than by product or in accordance with mandatory collateral requirements.

I. Regulations of OTC derivatives market players (other than AIs)

"Q13. Do you have any comments on the proposed regulation of intermediaries in the OTC derivatives market?"

As noted by the Consultation Paper, the scope of the new regulated activity will overlap with that of some of the existing regulated activities, such as dealing in securities (Type 1) or leveraged foreign exchange trading (Type 3). For example, a firm that is trading in equity option and swap transactions would potentially require licensing for Type 1 as well as the new Type 11 regulated activity. How to address the regulatory overlap needs to be well thought out.

The proposed regime creates some complexity in the oversight regime for OTC derivatives transactions. An AI that is dealing in equity option and swap transactions will require a Type 1 licence for dealing in securities (and may require a Type 4 licence for any advising activity). An equity option or swap transaction will also be an OTC derivatives transaction. Under the existing regime, AIs will be subject to SFC regulation for the Type 1 regulated activity (but the HKMA acts as the frontline regulator). If the second approach proposed in paragraph 166 of the Consultation Paper is adopted, AIs will be exempt from licensing in respect of all OTC derivatives (including equity derivatives). Such activities will be regulated wholly by the HKMA which would represent a narrowing of the SFC's oversight over AIs as compared to the position currently. However, if the approach eventually adopted is the first approach proposed in paragraph 166 of the Consultation Paper, the regulation of OTC derivatives transactions would be split between Type 1 (where AIs are subject to the licensing of SFC) and Type 11 (as well as

Type 3) (where AIs are exempt from the licensing of SFC). The rationale for such division between Type 1 and Type 11 does not seem immediately obvious.

An alternative approach would be to use the reforms as an opportunity for eliminating (rather than extending) the differential treatment between the regulation of LCs and AIs in the conduct of OTC derivatives. This would ensure that exceptions are applied reasonably, that conduct of business requirements are applied evenly across the industry. Prudential supervision would of course remain split between the HKMA and the SFC, as it is currently.

If members would have to choose between option (1) and (2), the majority would prefer the first approach set out in paragraph 166(1) as option (1) will keep the scope of the existing regulated activities largely intact.

In addition, members are of the view that the exemptions 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. Given that dealers in the OTC derivatives market often use intra-group transactions to manage risk exposure, members are of the view that the intra-group exemption should also be available for dealing in OTC derivatives.

The Consultation Paper does not mention whether an asset manager dealing in a portfolio of OTC derivatives will be affected by the new Type 11 licensing requirement. Members are of the view that persons who are licensed or registered for Type 9 (asset management) regulated activity and deal in OTC derivatives mainly for the purposes of carrying on that regulated activity should be exempt from the Type 11 licensing requirement.

Last but not least, members would like to emphasize that whatever approach the regulators decide to adopt in respect of the new Type 11 regulated activity should not affect the offshore booking model which is permissible under the existing regime.

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

We agree with the regulators that the proposed regulation of large players should only apply to those which may raise concerns of potential systemic risk. We urge the regulators to consult market participants on the definition, specific obligations and requirements for large players. Market participants also need to understand the circumstances under which the SFC can request large players to reduce their positions[24] as this may result in the large players breaching their own risk management policies. If the circumstances are not appropriately defined, this may have a detrimental effect on the development and liquidity of the derivatives market.

ISDA appreciates the opportunity to provide comments on the Consultation Paper and looks forward to working with the HKMA and SFC as the regulators continue the regulatory process. If you have any questions on this submission, please feel free to contact any of the undersigned at your convenience.

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

Yours sincerely,

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