

**立法會**  
**Legislative Council**

LC Paper No. CB(1)2569/11-12  
(These minutes have been seen  
by the Administration)

Ref : CB1/SS/14/11/2

**Subcommittee on Securities and Futures (Futures Contracts) Notice 2012**

**Second meeting on**  
**Monday, 4 June 2012, at 2:30 pm**  
**in Conference Room 2A of the Legislative Council Complex**

- Members present** : Hon James TO Kun-sun (Chairman)  
Hon CHIM Pui-chung  
Hon KAM Nai-wai, MH
- Member absent** : Hon Audrey EU Yuet-mee, SC, JP
- Public officers attending** : Mr Anthony LI  
Principal Assistant Secretary for  
Financial Services and the Treasury (Financial Services) 2
- Mr Daryl HO  
Head, Market Development Division  
Hong Kong Monetary Authority
- Attendance by invitation** : Mr Keith LUI  
Executive Director, Supervision of Markets  
Securities and Futures Commission

Mr Rico LEUNG  
Senior Director, Supervision of Markets Division  
Securities and Futures Commission

Ms Daphne DOO  
Director, Supervision of Markets Division  
Securities and Futures Commission

Mr Gerald D GREINER  
Chief Operating Officer  
Hong Kong Exchanges and Clearing Limited

Mr Kelvin LEE  
Vice President, Platform Development and Strategy Department  
Hong Kong Exchanges and Clearing Limited

Mr Ketan PATEL  
Senior Vice President  
Head of OTC Clearing Risk Management  
Hong Kong Exchanges and Clearing Limited

**Clerk in attendance** : Ms Anita SIT  
Chief Council Secretary (1)5

**Staff in attendance** : Miss Evelyn LEE  
Assistant Legal Adviser 10

Mr Hugo CHIU  
Council Secretary (1)5

## **I Meeting with the Administration**

### Follow-up to issues arising from previous meeting

(LC Paper No. CB(1)2079/11-12(01) — List of follow-up actions arising from the discussion at the meeting on 22 May 2012

LC Paper No. CB(1)2079/11-12(02) — Administration's response to issues raised at the meeting on 22 May 2012)

Other relevant papers

- (issued on 2 May 2012)
- Legislative Council Brief on Securities and Futures (Futures Contracts) Notice 2012 issued by the Financial Services and the Treasury Bureau, Hong Kong Monetary Authority and Securities and Futures Commission
- L.N. 81 of 2012
- Securities and Futures (Futures Contracts) Notice 2012
- LC Paper No. LS60/11-12
- Report of the Legal Service Division on subsidiary legislation gazetted on 4 May 2012
- LC Paper No. CB(1)1933/11-12
- Background brief prepared by the Legislative Council Secretariat)

Discussion

The Committee deliberated (Index of proceedings attached at **Appendix**).

Follow-up actions to be taken by the Administration

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2. The Administration and the Hong Kong Exchanges and Clearing Limited ("HKEx") were requested to:
- (a) consider the request that the HKSAR Government makes a public statement that the Government will not in any circumstances use public money to bail out any central counterparty ("CCP") established in Hong Kong for clearing of over-the-counter ("OTC") derivatives transactions as a recognized clearing house ("RCH") under the Securities and Futures Ordinance (Cap. 571)("SFO");
- (b) provide financial information regarding the OTC CCP that has been established by the Hong Kong Exchanges and Clearing Limited ("HKEx") as a new Hong Kong-incorporated subsidiary of HKEx, including but not limited to –

- (i) the estimated capital investment and recurrent expenditure; and
  - (ii) the fees to be charged and their respective levels, the estimated turnover, the projected break-even point and the projected profit or loss situation for the initial years of operation;
- (c) provide the fees information of overseas CCP that HKEx would make reference to in determining the fee levels of its OTC CCP subsidiary;
- (d) given the various risk management measures that would be put in place by the established OTC CCP, as detailed in paper LC Paper CB(1)2079/11-12(02), provide information on under what circumstances the following scenario would occur: the financial resources of a local OTC CCP are not enough to absorb losses incurred by the CCP due to one or more clearing members' default and the CCP has to wind down all positions with a final mark to market settlement cycle; and if such an event occurs, which party will be responsible for taking forward the insolvency procedures in respect of the CCP

Members agreed that if necessary, the information requested under items (b) and (c) should be provided in the form of a confidential paper.

- ALA10 3. The Legal Adviser to the Subcommittee was requested to review whether section 39 of SFO had the effect of ensuring the immunity of the HKSAR Government and HKEx as an RCH from any liability to the losses sustained by parties due to one or more clearing members' default.

*(Post-meeting note: The notes of the Powerpoint presentation (LC Paper No. CB(1)2108/11-12(01)) were issued to members vide Lotus Notes e-mail on 5 June 2012.)*

### **III Any other business**

#### Date of next meeting

4. The Chairman remarked that an additional meeting should be held. He requested the Clerk to check whether it was in order for the Subcommittee to continue the scrutiny of the Securities and Futures (Futures Contracts) Notice

2012 if he was not able to move the motion to extend the scrutiny period of the Notice to 27 June 2012 at the Council meeting of 6 June 2012.

5. There being no other business, the meeting ended at 4:45 pm.

Council Business Division 1  
Legislative Council Secretariat  
11 September 2012

**Proceedings of the  
Subcommittee on Securities and Futures (Futures Contracts) Notice 2012  
Second meeting on Monday, 4 June 2012, at 2:30 pm  
in Conference Room 2A of the Legislative Council Complex**

<b>Time Marker</b>	<b>Speaker</b>	<b>Subject(s)</b>	<b>Action Required</b>
000358 – 000643	Chairman	Opening remarks	
000644 – 000827	Administration	Briefing by the Administration on LC Paper No. CB(1)2079/11-12(02)	
000828 – 001558	Hong Kong Exchanges and Clearing Limited (HKEx)	Powerpoint presentation by the Hong Kong Exchanges and Clearing Limited ("HKEx")	
001559 – 004910	Administration Securities and Futures Commission (SFC)	Briefing by the Administration, the Securities and Futures Commission ("SFC") and HKEx on LC Paper No. CB(1)2079/11-12(02)	
004911 – 010748	Mr CHIM Pui-chung SFC Chairman Administration HKMA	Mr CHIM made the following remarks:  (a) During the 1987 Stock Crash, the ICCH (Hong Kong) Ltd which engaged in the clearing of futures contracts was liquidated. However, the Administration did not keep proper records on the liquidation process;  (b) It was doubtful whether the "limited recourse" arrangement mentioned in Annex 2 of LC Paper No. CB(1)2079/11-12(02) could be enforced in practice, as the arrangement would likely discourage banks and financial institutions from using the clearing service of the central counterparty for over-the-counter derivatives transactions established by HKEx ("the OTC CCP"). Resources would be wasted if the usage of the OTC CCP was low;  (c) Some large international financial institutions might deliberately conduct huge amounts of trading in OTC derivatives and make use of the clearing service of the OTC CCP for the OTC derivatives transactions in such a way that the OTC CCP would be forced to compensate for their losses. The Government might be forced to bail out the OTC CCP under such situation; and	

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		<p>(d) The Administration should provide information on (i) the estimated fees of the local OTC CCP; and (ii) how the initial investment and recurrent expenditure of the local OTC CCP would be borne by market participants.</p> <p>SFC and the Hong Kong Monetary Authority ("HKMA") replied as follows:</p> <p>(a) The ICCH (Hong Kong) Ltd was liquidated during the 1987 Stock Crash because its risk management was inadequate and was not up to the then international standard. The Government had implemented measures to improve risk management of the securities and futures markets after the 1987 Stock Crash;</p> <p>(b) To tackle the chaos arising from the liquidation of the ICCH (Hong Kong) Ltd, the Government gathered a total of \$4 billion to stabilize the market. Of this \$4 billion, only \$1.8 billion was actually used, with the Exchange Fund and the market contributed \$0.8 billion and \$1 billion respectively. The Government subsequently recouped this sum by imposing a special levy in the securities and futures markets till 1992; and</p> <p>(c) The arrangement of "limited recourse" was also present in a number of overseas CCPs.</p> <p>In response to the Chairman's enquiry on whether the Government would be liable to the loss of the local OTC CCP, SFC advised that:</p> <p>(a) in the extreme event that the local OTC CCP's financial resources were not enough to absorb losses incurred by the OTC CCP due to one or more clearing members' default, the OTC CCP could wind down all positions with a final mark to market settlement cycle; and</p> <p>(b) members of the local OTC CCP would be banks and financial institutions, which were</p>	

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		<p>also subject to the regulatory regimes for the relevant industries.</p> <p>The Chairman remarked that the information provided by the Administration implied that the Government was not legally liable to losses of the local OTC CCP. However, it might need to bail out the local OTC CCP for political reasons.</p> <p>The Administration remarked that:</p> <ul style="list-style-type: none"> <li>(a) One of the main considerations of the establishment of the OTC CCP was to address the systemic risks associated with OTC derivatives through the risk management framework set out in LC Paper No. CB(1)2079/11-12(02);</li> <li>(b) HKEx could suspend the clearing of a member of the local OTC CCP if necessary;</li> <li>(c) Given the robust risk management framework, it was highly unlikely that the OTC CCP's financial resources would be insufficient to absorb losses incurred by the OTC CCP due to one or more clearing members' default and had to wind down all positions with a final mark to market settlement cycle; and</li> <li>(d) There were established mechanisms to tackle collusion among members of the OTC CCP.</li> </ul> <p>The Chairman and Mr CHIM requested the Administration to consider the request that the Government made a public statement that the Government would not in any circumstances use public money to bail out any recognized OTC CCP in Hong Kong.</p>	<p>The Administration to take action as per paragraph 2 of the minutes.</p>
010749 – 010943	Chairman Mr CHIM Pui-chung HKEx	<p>In response to members' enquiry about the fees of the OTC CCP, HKEx advised that:</p> <ul style="list-style-type: none"> <li>(a) it would make reference to the fees of relevant overseas CCPs like LCH.Clearnet and CME in determining the fees of the local OTC CCP;</li> </ul>	



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		<p>(b) the fees had to be approved by SFC, which would take into account the fees of similar services in Hong Kong and other relevant jurisdictions; and</p> <p>(c) a precise estimate of the volume of transactions could not be made at the moment. Currently, OTC derivatives transactions in Hong Kong accounted for less than 1% of the global OTC derivatives market share.</p> <p>The Chairman declared that he hold some shares of HKEx.</p>	
010944 – 012357	Mr CHIM Pui-chung Chairman HKEx SFC	<p>The Chairman and Mr CHIM enquired (i) whether the establishment of the OTC CCP had been endorsed by HKEx's shareholders; and (ii) whether the establishment of the OTC CCP was prompted by the Administration.</p> <p>HKEx responded as follows:</p> <p>(a) According to the Listing Rules, endorsement by HKEx' shareholders of the establishment of the OTC CCP was not required. HKEx also had no plan to obtain such endorsement. However, HKEx had previously announced the initiative in its strategic plans; and</p> <p>(b) The initiative had been endorsed by the Board of Directors of HKEx.</p> <p>The Chairman remarked that the best professionals should be engaged for drafting the clearing rules of the OTC CCP. HKEx responded that it would accord top priority to the drafting of the clearing rules. Reference would also be made to the clearing rules of relevant CCPs like LCH.Clearnet and CME.</p> <p>The Chairman suggested that the Administration consider specifying the immunity of the Government from liability to the loss of the OTC CCP in a separate piece of legislation, which took precedence over the common law and contract law.</p> <p>HKEx advised that SFO had provisions on the immunity of an RCH. The Chairman requested</p>	ALA10 to take action as per

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		<p>ALA10 to examine whether such provisions had the effect of ensuring the immunity of the Government and HKEx as an RCH from any liability to the losses sustained by parties due to one or more clearing members' default.</p> <p>The Chairman remarked that his main consideration was whether the Government would have to bear the loss of the OTC CCP as in the case of the liquidation of the ICCH (Hong Kong) Ltd in 1987. As such, the Government should made a public statement that the Government would not in any circumstances use public money to bail out any CCP established in Hong Kong for clearing of OTC derivatives transactions as a RCH under the SFO. The Chairman also enquired whether such statement would be inconsistent with any agreement of the G20.</p> <p>SFC advised that the international community was studying the establishment of a resolution regime for CCPs and would announce the details soon. As a member of the G20, Hong Kong would have to be subject to requirements of the regime. Relevant information of the regime would be provided to the Legislative Council (LegCo") in due course. SFC also advised that the statement suggested by the Chairman would not be inconsistent with the relevant agreement of the G20 at the moment.</p>	<p>paragraph 3 of the minutes.</p>
<p>012358 – 013157</p>	<p>Chairman HKEx SFC</p>	<p>At the Chairman's request, HKEx and SFC explained the operation of netting and how it could reduce systemic risk, as set out in Annex 2 of LC Paper No. CB(1)2079/11-12(02).</p>	
<p>013158 – 013433</p>	<p>Chairman SFC</p>	<p>The Chairman enquired whether the guarantee fund mentioned in Annex 2 of LC Paper No. CB(1)2079/11-12(02) would be insufficient to absorb the loss of the OTC CCP under the following scenario: owing to extreme financial turmoil, all CCPs in the world faced losses due to one or more clearing members' default and had to make margin calls. The Chairman also enquired whether there existed a global forum for CCPs of different markets to discuss cross-boarder issues.</p> <p>SFC advised that a bank's participation in a CCP would not only be monitored by the CCP</p>	

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		<p>concerned but also by the bank's own regulator. SFC also pointed out that after the default of Lehman Brothers, a global forum had been set up to discuss the issue of cross-boarder crisis management.</p>	
013434 – 014005	Chairman Administration HKMA	<p>The Chairman enquired whether the following arrangement would be inconsistent with the relevant agreement of the G20: the Government imposed mandatory clearing obligation on OTC derivatives transactions in Hong Kong yet Hong Kong did not set up a local OTC CCP.</p> <p>The Administration and HKMA advised as follows:</p> <p>(a) Members of the G20 were not obliged to set up local OTC CCPs; and</p> <p>(b) Members of the G20 had to fulfill G20's requirement of implementing mandatory clearing obligation on OTC derivatives transactions. As the OTC derivatives market of Hong Kong was relatively small, clearing services of certain types of OTC derivatives specific to Hong Kong might not be available in overseas CCPs. Besides, a number of market participants of the local OTC derivatives market were small in size and might not be able to meet the entry requirements of the overseas CCPs to become their members.</p>	
014006 – 015036	Mr CHIM Pui-chung Chairman HKEx	<p>Mr CHIM and the Chairman requested the Administration to provide financial information regarding the OTC CCP established by HKEx, including :</p> <p>(a) the estimated capital investment and recurrent expenditure; and;</p> <p>(b) the fees to be charged and their respective levels, the estimated turnover, the projected break-even point and the projected profit or loss situation for the initial years of operation.</p> <p>HKEx's requested and the Chairman agreed that item (b) could be provided in the form of a confidential document if necessary.</p>	The Administration to take action as per paragraph 2 of the minutes.

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		<p>Mr CHIM remarked that the OTC CCP would have few members if its fee levels and services were not competitive.</p> <p>HKEx advised that the financial information on the OTC CCP had been submitted to HKEx's Board of Directors. The initial capital investment and recurrent expenditure were around \$160 million and \$60 million respectively. It would take a few years for the OTC CCP to become break-even. As for the fees arrangement, HKEx was inclined to make reference to that of the LCH.Clearnet.</p> <p>Noting that the fees information of other CCPs might not be open information, the Chairman requested HKEx to provide, in the form of a confidential document, the fees information of overseas CCP that HKEx would make reference to in determining the fee levels of its OTC CCP subsidiary.</p> <p>The Chairman remarked that the risk management framework had the effect of imposing a cap on the transaction volume of members of the OTC CCP as trades without sufficient collateral would be put on pending status and a margin call would be issued. SFC clarified that more stringent requirements would be imposed if the risks of the members concerned increased. However, this was not equivalent to putting a cap on the transaction volume per se.</p>	<p>The Administration to take action as per paragraph 2 of the minutes.</p>
015037 – 015405	Chairman Mr CHIM Pui-chung	<p>Pointing out that (a) the Securities and Futures (Futures Contracts) Notice 2012 ("the Notice") was subject to the negative vetting of LegCo and the expiry of the scrutiny period was 6 June 2012; and (b) it was possible that he could not move a motion at the Council meeting on 6 June 2012 to extend the scrutiny period to 27 June 2012, the Chairman enquired whether members had any views on the Notice which they wished to be recorded in the minutes.</p> <p>Both the Chairman and Mr CHIM considered that the Administration should make a commitment that it would not in any circumstances use public money to bail out any CCP established in Hong Kong for clearing of OTC derivatives transactions as a RCH under the SFO.</p>	

Time Marker	Speaker	Subject(s)	Action Required
015444 – 015722	ALA10 HKEx Chairman	In response to ALA10's enquiry, HKEx advised that the legislation on the immunity of an RCH was mentioned earlier in the meeting was section 39 of SFO.	ALA10 to take action as per paragraph 3 of the minutes.
015723 – 020115	Chairman SFC	<p><b><u>Section-by-section examination of the Notice</u></b></p> <p><u>Section 1 – Commencement</u></p> <p><u>Section 2 – Structured product to be regarded as futures contract</u> (a) to (d)</p>	
020116 – 020448	Chairman SFC	<p>The Chairman enquired how the clearing participants would be regulated. SFC advised that clearing participants would consist of banks and licensed corporations, and their main line of business would be subject to the regulation of HKMA and SFC.</p> <p>The Chairman enquired whether the phrase "the definition of clearing participant in" in section 2(d)(iii) was superfluous. SFC advised that the Notice had limited application. If the phrase was removed, the Notice had to specify the items in section 1 of Part 1 of Schedule 1 that were to be excluded from section 2(d).</p>	
020449 – 020853	Chairman SFC	<p><u>Section 2 – Structured product to be regarded as futures contract</u> 2(e)(i) to (iv)</p> <p>Section 2(e)(iv) referred to general defences to insider dealing offence that was provided in section 291. The Chairman enquired why section 2(e)(iv), which excluded insider trading from the Notice, was needed. SFC advised that the term "market contract" referred to a contract made between a RCH and its member(s). Such dealing would be outside the scope of insider trading.</p>	
020854 – 021149	Chairman SFC	<p><u>Section 2 – Structured product to be regarded as futures contract</u> 2(e)(v)</p> <p>In reply to the Chairman's enquiry, SFC advised that section 2(e)(v) referred to Part 5 of Schedule 3 to the SFO, which specified the requirements for default rules of recognised clearing houses.</p>	

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		In the event of the default of one or more members of the local OTC CCP, the provision would prevent the creditors of the member(s) concerned from interfering with the OTC CCP's operation.	
021150 – 021505	Chairman SFC	<p><u>Schedule – Structured Product to be Regarded as Futures Contract</u></p> <p>The Chairman expressed concern that the description of "structured product" in the Schedule might be too broad. SFC responded that although the description was broad when read on its own, the actual application would be confined to products for which an OTC CCP recognized as a RCH would provide clearing service, which was subject to the approval of SFC. Moreover, the Notice would be repealed upon implementation of the full-fledged regulatory regime for the OTC derivatives market, for which a separate Bill would be introduced to provide for the relevant legislative framework.</p>	
021506 – 021621	Chairman	Next meeting	