

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

**Further information provided by the Administration in response to
issues raised at the meeting on 13 June 2012**

- 1. To confirm that the HKSAR Government will not in any event or circumstances be liable in tort for any losses sustained by any over-the-counter central counterparty ("OTC CCP") approved as a recognized clearing house ("RCH") or for any losses sustained by the clearing members of such OTC CCP**

Other than the requirement in section 37 of the Securities and Futures Ordinance (SFO) to consult the Financial Secretary as part of the process of recognition of an RCH, the HKSAR Government has no statutory functions or duties in relation to RCHs and is not involved in regulating the conduct of their clearing and settlement activities. Therefore, the question of civil liability on the part of the HKSAR Government in relation to losses sustained by any OTC CCP approved as an RCH, or losses sustained by the clearing members of such OTC CCP, does not arise.

In the highly unlikely event that a claim were filed against the Government arguing that an OTC CCP or its clearing members or other third parties have suffered losses as a result of the exercise of statutory functions by the Government under the SFO, the immunity provision in section 380(1) of the SFO would apply. Please see Item 2 below for further discussion of section 380(1) of the SFO.

- 2. To examine whether the existing provisions under the Securities and Futures Ordinance (Cap. 571) ("SFO") and/or other ordinances provide sufficient protection for the Government and the Securities and Futures Commission as well as their officers from any legal liability for losses sustained by any person attributable to an act interfering the operation of a RCH made by the Government or SFC or an officer of the Government/SFC pursuant to the powers conferred on them under the relevant statutes**

Section 380(1) of the SFO confers immunity on any person, from civil liability, whether arising in contract, tort, defamation, equity or

otherwise, in respect of anything done or omitted to be done by reason of, amongst other things, his performance in *good faith* of any function under the relevant provisions¹.

We are not aware of any incident where the operation of an OTC CCP in an overseas market has been suspended by its regulator. We expect the robust risk management framework and default management procedures including the limited recourse winding down process of the proposed OTC CCP in Hong Kong to minimise any potential impact to the financial market arising from default of one or more of its clearing members. The SFC's powers to withdraw the recognition of an RCH under section 43, to issue a restriction notice under section 92 or to issue a suspension order under section 93 are in the nature of emergency measures that we do not expect to use under normal circumstances.

3. To examine whether SFC, under the existing legislation, has the authority to implement the limited recourse winding down arrangement as specified in the Administration's further response to issues raised at the meeting on 4 June 2012 (LC Paper No. CB(1)2155/11-12(03))

The limited recourse wind down process is a contractual arrangement between the OTC CCP and its members, as set out in the rules of the OTC CCP. Hence the limited resource wind down process will be implemented by the OTC CCP if necessary after its rules have been approved by the SFC without the need for any further approval or intervention by the SFC.

¹ "Relevant provisions" means the provisions of the SFO and Parts II and XII of the Companies Ordinance (CO) in so far as those Parts relate to prospectuses, the purchase of a corporation of its own shares and a corporation giving financial assistance for the acquisition of its own shares and Parts II and XII of the CO for the purposes of section 213 of the SFO in so far as those Parts relate to an advertisement mentioned in section 38B (1) of the CO.

4. To consider the feasibility of specifying the liability and any immunity of liability of a RCH for the losses of its members through legislation instead of the RCH's clearing rules/contracts

Section 39 of the SFO confers immunity on an RCH and any person acting on its behalf, from civil liability, in respect of anything done or omitted to be done in good faith in the discharge of the RCH's duties under sections 38 and 47 of the SFO, or in the performance of its functions under the RCH rules, including its default rules made under section 40(2) of the SFO.

In the highly unlikely event that the HKEx's proposed OTC CCP has to wind down its operation through a limited recourse wind down process, the shortfall due to defaults by individual clearing members will be mutualised among all other clearing members and the amount owed by the OTC CCP to each clearing member would be the reduced amount calculated by the OTC CCP only. The limited recourse wind down process will be conducted without the need to initiate insolvency proceedings against the OTC CCP. Under the OTC CCP's rules, all clearing members will contractually agree not to take steps to wind up the OTC CCP.

The liability of the OTC CCP and its shareholder, i.e. HKEx, in respect of any losses sustained by the OTC CCP or its clearing members is limited. Firstly, the OTC CCP will contractually agree with its clearing members to only pay out of funds available to it under the limited recourse wind down process. Secondly, the liability of OTC CCP, a limited company, to any claims is restricted to its assets. The liability of HKEx as the shareholder of the OTC CCP is restricted to the value of shares to which it subscribes. We do not see the need to stipulate additional provisions in the law that the RCH will be immune from the liability for the losses of its members.

5. To clarify the effect of section 380 and any other relevant provisions in SFO regarding the immunity of the HKSAR Government from any liability to the losses sustained by parties due to the default of one or more clearing members of HKEx's OTC CCP

Please see Items 1 and 2 above.

6. To explore the feasibility of introducing arrangements similar to the practice of reinsurance in the insurance industry in the proposed regime (e.g. HKEx's OTC CCP reduces its risk exposure by becoming a member of an overseas CCP), and advise on the relevant practice in other major international financial centres

The concept of reinsurance does not apply in the context of OTC CCP. Since the market risk of a derivatives CCP must be neutral (i.e. holding a long position for every short position and short position for every long position), the aggregate cleared portfolio of one CCP cannot have a market risk to set-off. The HKEx's OTC CCP manages its credit exposure towards its clearing members through its robust risk management and default management measures. This is similar to practices of other OTC CCP in major international financial centres. Furthermore, in the event that there is a non-default wind down of a clearing member and the member wants to keep its original portfolio, it would be more effective if the clearing member de-clears its portfolio from the existing OTC CCP and re-clears its portfolio at another CCP.

No OTC CCP is currently a member of another CCP, and it is not necessarily beneficial for the HKEx OTC CCP to join another CCP. Here are some points to consider:

- i) **Credit Risk of one CCP to another.** The HKEx OTC CCP will bear the credit risk of the overseas CCP and similarly the overseas CCP will need to bear the credit risk of OTC CCP. The HKEx has been very meticulous in setting up its risk management framework and the six layers of financial resources to set-off a default loss, as discussed previously.
- ii) **Collateral policies and operations may not be uniform.** Different CCPs have different collateral policies and this might mean a certain type of local collateral (e.g. Exchange Fund Notes and Bills) may be acceptable by the HKEx OTC CCP but may not be eligible collateral in the eyes of other overseas CCPs due to time zone differences. In addition, different operations procedures might create extra operations burden for both the OTC CCP and the overseas CCP.

- iii) **Product Coverage may be different.** HKEx OTC CCP will have a natural advantage to develop and manage the risk of RMB-related products. This is likely not to be the case for another CCP and the other CCP may not even be able to support RMB products which would create additional systemic risk.
- iv) **Membership may be different.** There could be difference in membership admission criteria such as capital requirement, guarantee fund requirement and risk management requirement. These will all have impacts on HKEx OTC CCP from a risk management perspective.
- v) **Insolvency law inconsistency.** There could be insolvency law inconsistency between HKEx OTC CCP and the overseas CCP as well as in the jurisdictions where clearing members reside. This might have an issue in an event of default where default losses are applied and mutualised among CCPs and clearing members.

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
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