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Subcommittee on Securities and Futures (Futures Contracts) Notice 2012

Purpose

This paper reports on the deliberations of the Subcommittee on the Securities and Futures (Futures Contracts) Notice 2012 ("the Subcommittee").

Background

2. The global financial crisis of late 2008 highlighted the structural deficiencies in the over-the-counter ("OTC") derivatives market, and the systemic risk it poses for the wider market and economy. In the wake of the crisis, G20 Leaders have committed to reforms that would require –

(a) the mandatory reporting of OTC derivatives transactions to trade repositories;

(b) the mandatory clearing of standardized OTC derivatives transactions through central counterparties ("CCPs");

(c) the mandatory trading of standardized OTC derivatives transactions on exchanges or electronic trading platforms, where appropriate; and

(d) the imposition of higher capital requirements in respect of OTC derivatives transactions that are not centrally cleared.

3. These requirements aim to reduce counterparty risk, improve overall transparency, protect against market abuse, and ultimately enable regulators to better assess, mitigate and manage systemic risk in the OTC derivatives market.

4. In line with the G20 Leaders' commitment, the Administration, the Hong Kong Monetary Authority ("HKMA") and the Securities and Futures Commission ("SFC") have been developing a regulatory regime for the OTC derivatives market in Hong Kong. The Administration's plan is to introduce the relevant Bill into the Legislative Council in 2012/2013 to provide for the regulatory framework for the OTC derivatives market in Hong Kong. Among other things, the new regime will introduce a mandatory clearing obligation whereby market participants will be obligated to clear certain OTC derivatives through a designated CCP.

5. According to the Administration, notwithstanding that mandatory clearing has yet to be implemented, market participants are already moving towards clearing their OTC derivatives transactions through a regulated CCP on a voluntary basis. This is already the case in the United States, Europe and Singapore. A key consideration for market participants when deciding which CCP to use for voluntary clearing is whether the transactions cleared through that CCP enjoy insolvency override protection.[1] The insolvency override protection must be conferred by law. The laws of many major markets already confer such protection in respect of transactions cleared through CCPs in their jurisdictions. In the case of Hong Kong however, such protection is only conferred in respect of securities and futures contracts but not in respect of OTC derivatives transactions. If this remains unchanged, market participants in Hong Kong who wish to opt for voluntary clearing of OTC derivatives transactions will have no option but to clear through an overseas CCP.

Securities and Futures (Futures Contracts) Notice 2012

6. To support voluntary clearing of OTC derivatives transactions, pending the introduction of a full-fledged regulatory regime for the OTC derivatives market in Hong Kong, the Financial Secretary has made the Securities and Futures (Futures Contracts) Notice 2012 ("the Notice"), which was gazetted on 4 May 2012, under section 392 of the Securities and Futures Ordinance (Cap. 571) ("SFO") to prescribe that any structured products set out in the Schedule to the Notice is to be regarded as a futures contract for the purpose of certain provisions of the SFO. The overall effect of the Notice is to –

(a) enable such a structured product to become a "market contract" if it is –

[1] Transactions that enjoy insolvency override protection are not susceptible to being undone pursuant to general insolvency law. Such protections have to be conferred by statute, and are typically conferred on transactions cleared through a regulated CCP. The objective of such protection is to provide legal certainty of settlement finality for transactions cleared through the CCP.

(i) cleared and novated through a recognized clearing house ("RCH"); and

(ii) either effected on, or subject to the rules of, an REC, and thereby

(b) enjoy the insolvency override protection conferred under Division 3 of Part III of the SFO.

The Subcommittee

7. At the House Committee meeting held on 11 May 2012, Members agreed to form a subcommittee to study the Notice. Hon James TO was elected chairman of the Subcommittee, and the membership list of the Subcommittee is in **Appendix I**. The Subcommittee has held three meetings to meet with the Administration and scrutinize the Notice.

Deliberations of the Subcommittee

8. The main issues deliberated by the Subcommittee include the benefits of establishing a local CCP for voluntary clearing of OTC derivatives, the procedure and critieria for approving a local CCP as a RCH, risk management measures to be implemented by the proposed local CCP for OTC derivatives clearing, possible liability of the Government and SFC in respect of the proposed local CCP, and whether the Government should bail out any local CCP. The ensuing part of the report summarizes the Subcommittee's deliberations.

<u>Mandatory clearing of over-the-counter derivatives</u>

9. As the proposed voluntary clearing arrangement for OTC derivatives transactions is to pave way for the future introduction of a full-fledged regulatory regime for the OTC derivatives market in Hong Kong, the Subcommittee has examined the following issues –

(a) Whether it is mandatory for Hong Kong to follow the "G20 requirements" and pursue mandatory clearing of OTC derivatives through CCPs; and

(b) What will be the loss to or impact on Hong Kong, should Hong Kong choose not to follow the "G20 requirements".

10. The Administration has advised the following –

(a) The G20 requires consistent implementation of mandatory clearing, trading and reporting requirements on standardized OTC derivatives, and imposition of higher capital and margin requirements in respect of OTC derivatives transactions that are not centrally cleared. The objectives are to improve market transparency, mitigate systemic risk and prevent market abuse. The G20 has authorized the Financial Stability Board ("FSB")[2] to monitor the progress of members in implementing the reforms on regulatory measures. As a member of the FSB, Hong Kong has the responsibility to comply with the guidelines set by them so as to achieve the goal of financial stability. These measures are also critical to strengthening Hong Kong's position as an international financial centre.

(b) The reform measures on the OTC derivatives market including mandatory clearing will help improve market transparency, mitigate systemic risk and prevent market abuse. Implementation of such reform measures will enable Hong Kong to better manage the risks relating to the OTC derivatives market.

(c) Given the global and cross-border nature of OTC derivatives markets, if the G20 requirements are not to be followed, such OTC derivatives transactions may turn to unregulated markets due to tightening of regulations in other markets, thus incurring a risk of regulatory arbitrage. As a member of the FSB, Hong Kong has the responsibility to comply with the guidelines set by them so as to achieve the goal of financial stability.

<u>Benefits of establishing a local central counterparty for voluntary clearing of over-the-counter derivatives</u>

11. While Hong Kong has the responsibility to follow the G20 requirements on mandatory clearing, trading and reporting of standardized OTC derivatives, members of the Subcommittee have queried whether it is necessary or desirable for Hong Kong to establish a local CCP to provide OTC derivatives clearing services. In this regard, the Subcommittee has asked the Administration to explain the benefits of establishing a local CCP and pursuing the voluntary clearing arrangement.

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[2] The Financial Stability Board (FSB) is an international organization established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. The Hong Kong Monetary Authority is one of its members.

12. The Administration has affirmed that there are significant benefits in having a local CCP, and highlighted the following -

(a) Clearing through a local CCP regulated by SFC will have a number of operational advantages for market participants in Hong Kong. It could facilitate communication since the CCP operates in the same time zone, and enable collateral to be held locally and thus be more readily accessible. In the event of default, SFC and HKMA could more effectively assist local participants and monitor any potential systemic implications for the local market.

(b) A CCP is a necessary market infrastructure to improve the resilience of the OTC derivatives market. The establishment of this critical market infrastructure in Hong Kong would help maintain the stability of the local financial system as well as strengthen Hong Kong's status as an international financial centre.

(c) The establishment of a local CCP could support the clearing of niche market products unique to the local/regional market, for which most of the global CCPs are not covering at this stage. This would not only cater for the local/regional market need, but also attract overseas financial institutions that are interested in participating in the local/regional OTC derivatives market to become members of the local CCP. In addition, a local CCP would be better able to manage risks specific to the local market or risks relating to local players.

(d) A local CCP would be an important part of Hong Kong's infrastructure to maintain maximum readiness to capture potential business opportunities arising from further Renminbi liberalization and facilitate Hong Kong's role as an offshore Renminbi centre. As some CCPs in other jurisdictions are already providing central clearing for Hong Kong Dollar and Renminbi OTC derivatives products, allowing voluntary clearing of these products in Hong Kong will enable Hong Kong to compete with overseas markets and strengthen Hong Kong's position as an offshore Renminbi centre.

(e) In view of the tremendous growth of Renminbi activities, there is an increasing need for appropriate infrastructure to facilitate intermediation and to cope with risk management, in particular, in the OTC derivatives market. Major financial centres, such as Singapore and London, are striving to capture the potential business growth in this area, including revising legislation and developing infrastructure. It is critical for regulators in Hong Kong to take prompt action and necessary steps to facilitate the development of relevant regulatory framework and infrastructure to meet with the challenge and maintain Hong Kong's financial competitiveness, so that Hong Kong will not lose its competitive edge and business potential in the absence of a local CCP.

(f) Asian markets are often characterized by the presence of a number of relatively smaller, local players, such as the local banks who act as intermediaries, where OTC derivatives activities, in particular interest rate swaps and foreign-exchange derivatives, are part of their integrated banking business. The development of a local CCP may enable access by such players which may not be able to satisfy the membership criteria of global CCPs. It may also enable the local market participants to have easier access to their collateral. It should be noted that members of the local CCP will nevertheless be subject to stringent access criteria and risk management of the local CCP which will be required to be on a par with international standards.

13. As regards the reasons for introducing the voluntary clearing arrangement pending the implementation of mandatory clearing, the Administration has pointed out that international trends and experience show that market participants are already moving towards clearing their OTC derivatives transactions through a regulated CCP on a voluntary basis. Market participants recognize that the earlier they start central clearing, the more prepared they will be when the mandatory clearing obligation is implemented. They also recognize that centrally clearing their OTC derivatives transactions helps mitigate risks and brings benefits and protection for both themselves and the market as a whole. From the CCP's perspective, the ability to offer voluntary clearing prior to the mandatory clearing obligations coming into effect will also provide the CCP with a phase-in period to work closely with market participants for the purpose of ensuring the smooth functioning of the CCP in preparation for the final implementation of mandatory clearing.

<u>Plans for and processes involved in establishing a local CCP for provision of clearing services for OTC derivatives</u>

14. In respect of the proposed voluntary clearing arrangement for OTC derivatives, the Subcommittee has examined the following issues -

(a) the steps that have been and will be taken by the relevant authorities/parties for the establishment of a local CCP for the voluntary clearing of OTC derivatives transactions, and the expected timeframe;

(b) the types of products that are intended to be covered under the voluntary clearing regime; and the

(c) estimated volume of OTC derivatives transactions and the percentage of such volume out of the global transaction volume of OTC derivatives.

15. To address members' concerns, the Administration has provided the following information –

(a) The Hong Kong Exchanges and Clearing Limited ("HKEx") has established a new Hong Kong-incorporated subsidiary to provide clearing services and to act as a CCP for the clearing of OTC derivatives transactions ("the OTC CCP"). The CCP will be operated independently of HKEx's existing clearing houses, and supported by its own OTC-clearing focused operations department and risk management department.

(b) The OTC CCP will have its own set of clearing house rules and procedures and membership agreement. HKEx has prepared draft rules taking into account the latest recommendations published by the Committee on Payment and Settlement Systems ("CPSS")[3] and the Technical Committee of the International Organization of Securities Commissions ("IOSCO") in their report entitled *Principles for Financial Market Infrastructures* dated April 2012 ("the PFMI Report")[4], which reflect lessons learnt from the recent financial crisis and represent international regulators' consensus on the standards that should apply to CCPs and other financial market infrastructures around the world in order to improve financial stability. SFC and HKMA are members of the CPSS-IOSCO steering group on the PFMI report. The OTC CCP has also taken into account the rules of comparable CCPs in overseas jurisdictions where appropriate, as well as the rules and provisions, layout and drafting convention of HKEx's existing derivatives clearing houses.

(c) On development of the clearing platform, HKEx has entered into an agreement with a system vendor, Calypso Technology Inc ("Calypso") to implement the OTC derivatives clearing system

[3] CPSS is a committee set up by the Bank for International Settlements.

[4] The Administration has provided an extract of the overview of principles and responsibilities of the PFMI report vide Annex 1 to LC Paper No. CB(1)2079/11-12(02).

for HKEx. Calypso is selected as the system vendor after careful screening and its clearing house system is widely used in other markets. Hence, some market participants are familiar with Calypso's system functions. The system implementation is in good progress and the vendor is now working on the design and development phases. According to the system implementation schedule, user acceptance testing will start in the third quarter of 2012. This will be followed by market rehearsals involving all potential clearing members in September, and the production go-live date of the system is targeted to take place in the fourth quarter of 2012.

(d) To enable the OTC CCP to commence operation by the end of 2012, the following key processes and milestones would be essential in meeting the timetable –

Event	Targeted date
Enactment of the Securities and Futures (Futures Contracts) Notice 2012	June 2012
Negotiation with potential clearing members	June-August 2012
Finalization of the operational model, risk management framework, and documentation including its rules, procedures and membership agreement	July 2012
Completion of the clearing platform development	Fourth quarter 2012
Recognition of the OTC CCP by the SFC	Fourth quarter 2012

(e) Asset classes to be cleared by the OTC CCP at the commencement of its business would be interest rate swaps ("IRS") and non-deliverable forwards ("NDF"), which are liquid and standardized OTC derivatives products. In determining the product coverage, the OTC CCP's priority and emphasis are on the Hong Kong dollar OTC derivatives market, the Offshore Renminbi (i.e. Renminbi deliverable in Hong Kong) derivatives market as well as the Renminbi non-deliverable markets, as these products are systemically important to Hong Kong. These markets are crucial to Hong Kong as a financial centre since a significant portion of their trading volume is provided by local and mainland institutions.

(f) According to the survey data of 2009, the volume of OTC derivatives transactions in Hong Kong was estimated to be USD 16,620.79 billion (by gross notional amount). It was estimated that the OTC derivatives transactions in Hong Kong accounted for less than 1% of the global OTC derivatives market share.

16. The Administration has stressed that the enactment of the Notice is key to the above timetable, because it would establish a legal framework for the regulation of CCPs established in Hong Kong for clearing of OTC derivatives transactions as a "recognized clearing house" ("RCH")[5] under the SFO, and ensure that clearing of OTC derivatives transactions with the recognized CCPs would benefit from the insolvency protections offered to RCH under the SFO. Such legal framework and insolvency protections are key factors in market participants' decision to join a CCP for the voluntary clearing of OTC derivatives transactions. Market participants may not seriously consider joining the OTC CCP as clearing members until such fundamental legal and regulatory aspects governing the OTC CCP are in place. Without the active participation or commitment from potential clearing members at an early stage, the OTC CCP would find it difficult to complete its clearing member on-boarding process in time for launch at the end of this year, since the review of clearing rules and procedures and the on-boarding process require significant commitment of time and resources on the part of the prospective clearing members, and the process is likely to take several months to complete. As such, any delay to the enactment of the Notice could lead to potentially significant delays to the timetable of the OTC CCP's establishment.

<u>Financial information regarding the OTC CCP</u>

17. To understand the investment made by HKEx in establishing the OTC CCP and the latter's business prospect, the Subcommittee has reviewed the estimated capital investment in and recurrent expenditure of the OTC CCP. The Subcommittee has received a close door briefing on the relevant information, including fees to be charged by the OTC CCP 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 of the CCP, as well as the fees information of overseas CCPs.

[5] A "recognized clearing house" means a company recognized as a clearing house under section 37 of SFO.

Procedures for approving a local CCP for provision of clearing services for OTC derivatives

18. As the OTC CCP is subject to the recognition of SFC as a clearing house under section 37 of the SFO before it may come into operation, the Subcommittee has sought details of the procedures for SFC to approve a local CCP and authorize the latter to provide clearing service for specific types of OTC derivatives, and the relevant considerations and criteria involved.

19. The Administration has advised that -

(a) CCPs established in Hong Kong for clearing of OTC derivatives transactions as RCHs are subject to the regulation of SFC under the SFO.

(b) Under section 37 (1) and (2) of the SFO, before approving a CCP as an RCH, SFC must be satisfied that it is appropriate to do so in the interest of the investing public[6] or in the public interest, or for the proper regulation of markets in securities or futures contracts. SFC may also attach conditions to the approval as it considers appropriate. Before granting such approval to a CCP, SFC must first consult the Financial Secretary.

(c) Rules of an RCH or any amendment thereto must be approved by the SFC, as provided under section 41 of the SFO. A key consideration of SFC in approving a CCP as an RCH is the robustness of the CCP's risk management measures as well as operational capability. SFC will not approve a CCP unless SFC is satisfied that its risk management measures are robust, such that the risks it bears can be prudently managed.

(d) SFC will require the OTC CCP to comply with the new global standards in the PFMI report and to have in place plans that cater for distressed market conditions.

How risks can be reduced through the establishment of a CCP

20. On the notion that central clearing of OTC derivatives can effectively mitigate and manage systemic risk in the OTC derivatives market, the Subcommittee has examined how the risks associated with OTC derivatives transactions can be reduced through the establishment of a local CCP for voluntary clearing.

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[6] The Administration has pointed out that the OTC derivatives market is primarily a wholesale market.

21. According to the Administration, the clearing of OTC derivatives transactions through a CCP helps reduce risk within the market by putting a robustly-managed CCP between parties, in order to manage the closing out of transactions in the case of a market participant default and maintain stability in the market. A CCP stands between two parties, acting as the counterparty to each side of the trade. This allows the CCP to perform multilateral netting, which could facilitate the reduction of counterparty risk. With a robust risk management framework, a CCP could manage and mitigate risk effectively, for example, by requiring clearing members to post collateral as margin and to contribute to the guarantee fund. It could also contribute to a reduction of systemic risk, through mutualization of losses across all clearing members in the event of the failure of a clearing member.[7]

22. The Administration has further advised that with a more streamlined and automated trade process, clearing through a CCP could reduce operational risk. It could also further improve operational efficiency through more efficient collateral management and the standardization of risk management. The existence of the relevant CCP has proved to help reduce risk in the event of Lehman's failure. In September 2008, LCH.Clearnet[8] successfully managed Lehman Brothers' US$9 trillion interest rate swap default without causing losses to other clearing members and the CCP. The default was resolved within the margin held by LCH.Clearnet.

<u>Risk management measures to be implemented by the OTC CCP as a recognized clearing house</u>

23. The Subcommittee notes that as a CCP stands between two parties, acting as the counterparty to each side of the trade, it in effect assumes the legal counterparty risk for the trade it clears. The Subcommittee is therefore seriously concerned about the risks that the OTC CCP will be exposed to. In this regard, the Subcommittee has examined in detail the risk management measures that will be implemented by the OTC CCP.

24. The Administration has assured the Subcommittee that the OTC CCP will implement robust risk management measures to ensure that the risks it bears can be prudently managed. The size of OTC derivatives transactions cleared through the OTC CCP will be subject to certain inherent limits as part of the OTC CCP's capital and margin requirements. Such risk management measures include –

(a) Only highly liquid and standardized products will be accepted for clearing. Subject to SFC approval, the OTC CCP will

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7 HKEx has provided further details of how the OTC CCP's risk management framework reduces risk, vide Annex 2 to LC Paper No. CB(1)2079/11-12(02).

8 LCH.Clearnet is a CCP located in London. It is the largest CCP for interest rate swaps.

initially only provide clearing service for two types of plain vanilla products, i.e. IRS and NDF. Before any new product launch, the OTC CCP will go through a stringent decision-making process to check whether the product has sufficient liquidity and standardization for central clearing, including approval by the board of the OTC CCP, its risk management committee and its product advisory committee. In particular, the OTC CCP's risk management committee and product advisory committee will have non-executive and clearing member representation. In addition, any new product launch will be subject to SFC approval, and when considering whether to clear a new product, the OTC CCP as a RCH under the SFO will have to have regard to its statutory duties under section 38 of the SFO to ensure that risks associated with its business and operations are managed prudently, and act in the interest of the public.

(b) Market participants can only be admitted as a clearing member, and continue to remain as a clearing member, for so long as it complies with OTC CCP's strict prudential membership criteria. The OTC CCP's membership criteria will follow internationally accepted risk management and internal control practices, with the aim of safeguarding the OTC CCP to avoid exposure to excessive risk beyond its financial capability, and are expected to include the following requirements –

(i) Clearing members are expected to be authorized institutions ("AIs") under the Banking Ordinance (Cap. 155) or licensed corporations under the SFO, or similarly regulated entities in acceptable overseas jurisdictions.

(ii) The minimum capital requirement for clearing members is HK$10 billion in tier 1 capital for AIs or HK$10 billion in liquid capital for licensed corporations, or such higher capital level as may be required by the clearing member's regulator from time to time.

(iii) In addition to the minimum capital requirement above, a clearing member will need to maintain capital in proportion to its business size, to ensure it has the ability to meet its obligation to contribute to the guarantee fund and to meet replenishment calls. The OTC CCP will ensure each clearing member's current capital is prudential relative to stress losses, either by raising the capital requirement of a clearing member where appropriate or requiring additional margin to be posted.

(c) Each trade submitted by a clearing member will only be accepted for clearing if the trade details match the product eligibility requirements of OTC CCP, if credit limits are satisfied, and if the clearing member has posted sufficient collateral to cover OTC CCP's potential future losses on that trade in normal circumstances if that clearing member defaults (i.e. Initial Margin). The requirement to collateralize the trade prior to clearing is even more stringent than the on-exchange traded derivatives clearing systems.

(d) Once a trade is cleared, a clearing member is also subject to posting additional collateral at any time to cover the daily change in marked-to-market value of the trade (i.e. Variation Margin), to ensure that OTC CCP does not accumulate losses over time.

(e) In addition to the Initial Margin and Variation Margin, the OTC CCP will have a dynamic guarantee fund that is sized in accordance with the amount of risk that the OTC CCP is exposed to at the relevant time, which will comprise funds contributed by clearing members and by the OTC CCP to absorb any losses due to the default of clearing members. In the case of a shortfall in the guarantee fund, the OTC CCP may make replenishment calls to clearing members to demand additional contribution to the guarantee fund. The amount of guarantee fund required will be risk-based and sized using modeling and stress testing methods in accordance with international standards.

(f) The OTC CCP's management of a clearing member default will be done in accordance with procedures designed with the support of clearing members and external consultant with the relevant expertise and experience, and will be similar to those successfully used by other CCPs before, for example during the Lehman Brothers default.

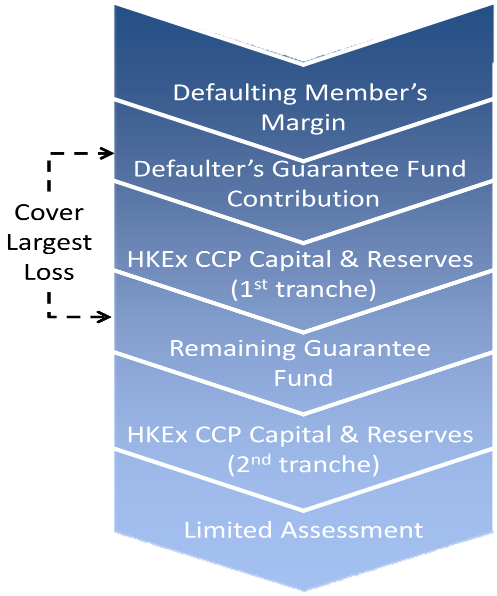
Limited recourse winding down process

25. Taking note of the various risk management measures that will be put in place by the established OTC CCP, as detailed in paragraph 24 above, the Subcommittee has asked the Administration to elucidate the arrangements that will be put in place by the OTC CCP to cater for, as described by the Administration, the unlikely but plausible situation where 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. The Subcommittee has also examined, where such an event occurs, whether it would be necessary to trigger any insolvency procedures in respect of the CCP and if so, which party will be responsible for taking forward the insolvency procedures.

26. The Administration has explained that –

(a) The OTC CCP will have six layers of financial protection to absorb losses from one or more clearing members' default. The OTC CCP will utilise a defaulting clearing member's margin and Guarantee Fund contribution as the first two layers. The third layer will be contributions made by the OTC CCP and will initially be sized at HK$150 million. The fourth layer will comprise Guarantee Fund contributions from non-defaulting clearing members. The fifth layer will be the OTC CCP's second tranche of contribution, while the sixth layer will comprise potential assessments against all non-defaulting clearing members.



(b) The OTC CCP's Guarantee Fund will mutualize losses under extreme, but plausible, scenario. Examples of these scenarios include the following: i) 1987 Stock Crash; ii) 1998 Asian Financial Crisis; iii) 2003 SARS; and iv) 2008 Global Financial Crisis. The OTC CCP will gauge the adequacy of the Guarantee Fund daily and will resize the Guarantee Fund, as well as the required contributions from each clearing member, on a regular basis. Each clearing member's proportionate share of the Guarantee Fund will be based on the stress testing losses of its portfolio. This will ensure that each clearing member contributes to the Guarantee Fund based on the risk exposure it brings to the OTC CCP.

(c) After the application of a defaulting clearing member's margin and Guarantee Fund contribution, the OTC CCP's 1st tranche of contribution, the respective Guarantee Fund contributions of non-defaulting clearing members, and the OTC CCP's 2nd tranche of contribution, the OTC CCP will make assessment against all non-defaulting clearing members of up to 200% of their Guarantee Fund requirement whereby the remaining losses are shared among those clearing members.

(d) If a default loss exceeds all the funds in the six layers of financial protection available to the OTC CCP, it will be able to wind down all the cleared positions through a limited recourse process. The OTC CCP will determine for each clearing member a total 'payable' obligation to, or 'receivable' expectation from, the OTC CCP. Non-defaulting clearing members will be subject to haircuts (or discount) on their 'net receivable' (i.e. gains) from the OTC CCP. The table in **Appendix II** illustrates how this process works.

(e) Under the clearing rules, all clearing members will contractually agree not to take steps to wind up the OTC CCP, and that the amount owed by the OTC CCP to each clearing member would, in the event of a shortfall in the financial resources of the OTC CCP, be the reduced amount calculated by the CCP pursuant to the limited recourse wind down provisions only. Thus, the limited recourse wind down procedures will be conducted without the need to initiate insolvency proceedings against the OTC CCP.

(f) The fact that all accounts of non-defaulting clearing members with a net receivable expectation will mutualize the shortfall allows for a wider loss sharing, which in turn minimizes systemic risk and contagion since there is a broader set of accounts to share the final loss. It provides non-defaulting clearing members total clarity beforehand as to the nature of their potential liabilities and also a speedier resolution process, and in doing so, it will minimize the impact on the market. As a result, the limited recourse model minimizes any unnecessary market disruption and destruction of value that would be involved through an OTC CCP insolvency.

<u>Imposing restriction on the volume of transactions to be handled by the OTC CCP as a recognized clearing house</u>

27. Notwithstanding the Administration's assurance that the OTC CCP will implement robust risk management measures to ensure that the risks it bears can be prudently managed, members of the Subcommittee have expressed concern that the OTC CCP may be exposed to excessive risks if the transaction volume handled by the CCP is too large and/or certain market players are allowed to hold very large positions in OTC derivatives that are cleared through the OTC

CCP. Moreover, as the failure of the OTC CCP may cause further failures or disruption to other financial institutions and/or market infrastructure, thereby posing systemic risk, the Subcommittee has requested the Administration to consider imposing a cap (say, on a daily basis or otherwise) on the transaction volume of OTC derivatives to be handled by the OTC CCP and/or specifying a cap on the face value of each OTC derivative transaction that may be cleared through the OTC CCP.

28. In response, the Administration has advised that the size of OTC derivatives transactions cleared through the OTC CCP will be subject to certain inherent limits, as part of the OTC CCP's capital and margin requirements in the proposed risk management framework. For example –

(a) A clearing member must have posted sufficient collateral to cover the Initial Margin and Variation Margin of its cleared transactions plus the Initial Margin of any new trade submitted for clearing, before such new trade is accepted for clearing by the OTC CCP. If a clearing member does not deliver sufficient collateral to satisfy such margin requirement, it will not be able to submit the new transaction for clearing and the OTC CCP's exposure to such clearing member will be limited to such clearing member's existing portfolio of cleared transactions;

(b) The OTC CCP has the right to impose additional concentration margins on clearing members with portfolios where five days of margin coverage is not sufficient due to portfolio concentration risk in one or more positions. Again, if a clearing member does not deliver collateral to satisfy such additional concentration margin, it will not be able to submit new transactions for clearing and the OTC CCP's exposure to such clearing member will be limited to such clearing member's existing portfolio of cleared transactions.

(c) In addition to the minimum HK$10 billion capital requirement that the OTC CCP imposes on all clearing members, the OTC CCP may impose additional capital requirements based on relative risk. This effectively means that, unless the relevant clearing member increases its capital level, the total size of the OTC CCP's trade exposure to that clearing member will be capped.

(d) The limits set by the OTC CCP in relation to the margin and capital requirements above are proportionate to the level of risk relating to the relevant clearing member and/or its transactions, which is determined by the OTC CCP based on daily stress testing modeled on worst case scenarios to ensure that the OTC CCP has sufficient financial resources to withstand losses from the cleared transactions even in extreme but plausible situations.

29. The Administration has further advised that SFC has the power to impose position limits pursuant to section 35 of the SFO. The OTC CCP will also, as part of its risk management framework, have powers to impose position limits on its clearing members under its proposed clearing rules. This would be a more practical and effective way to introduce limit on clearing members as and when the situation warrants such action, rather than imposing a limit on total daily turnover or notional amount per transaction. Imposing such restrictions will create practical difficulties for the OTC CCP as other jurisdictions such as the United States, European Union and Japan currently do not impose similar limits on the clearing of OTC derivatives transactions. If position limits are set on the number of transactions that can be cleared, then any transactions exceeding such limits will have to remain as bilateral OTC derivative transactions between market participants, with the risk that the insolvency of one or more market participants (such as Lehman Brothers) involved in the web of bilateral OTC derivative transactions could trigger a disorderly unwind process affecting multiple market participants and cause market dislocations throughout the financial system.

30. Taking note of the Administration's response, the Subcommittee has urged SFC and HKEx to ensure that the clearing rules of the OTC CCP were drawn up with extra care and by the best professionals.

Legal liability of the Government and SFC

31. A major issue of the Subcommittee deliberations is the respective roles of the Government and SFC under the proposed voluntary clearing arrangement, and any possibility liability they may incur in respect of the operation of the OTC CCP as a RCH. Specifically, the Subcommittee has examined –

(a) whether the HKSAR Government would in any event or circumstance incur civil liability for any losses sustained by the OTC CCP or for any losses sustained by the clearing members of the OTC CCP, due to the default of one or more clearing members of the OTC CCP;

(b) whether the existing provisions under the SFO and/or other ordinances provide sufficient protection for the Government and SFC as well as their officers from any legal liability for losses sustained by any person attributable to an act interfering the operation (e.g. ordering suspension of 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; and

(c) whether there is the need to stipulate in the law that the Government shall not have any liability to the OTC CCP or its clearing members under all circumstances.

32. The Administration has advised the following –

(a) Under section 37(1) of the SFO, SFC must consult the Financial Secretary before approving a CCP as an RCH. A clearing member who chooses to clear the OTC transactions through the OTC CCP under the proposed voluntary clearing arrangement may claim against the OTC CCP under the contract between the clearing member and the OTC CCP in respect of the OTC derivatives transaction clearing. The Government is not a party to the contract.

(b) The OTC CCP is established as a wholly owned subsidiary of HKEx that is dedicated to OTC derivatives clearing. The OTC CCP will operate independently of HKEx's existing clearing houses. As such all risks and liabilities relating to OTC derivatives clearing will be confined to the OTC CCP subsidiary level. In the extreme event that the OTC CCP's financial resources are not enough to absorb losses incurred by the OTC CCP due to one or more clearing members' default, then the OTC CCP will wind down all positions with a final mark to market settlement cycle. Following payments determined in such final settlement cycle, there will be no further amounts owed to the clearing members, and there will be no impact to HKEx or its other on-exchange clearing houses.

(c) Other than the requirement in section 37 of the 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.

(d) 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.

(e) 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 provisions[9].

33. The Administration has advised that it is not aware of any incident where the operation of an OTC CCP in an overseas market has been suspended by its regulator. The Administration expects that the robust risk management framework and default management procedures including the limited recourse winding down process of the proposed OTC CCP in Hong Kong can minimize any potential impact to the financial market arising from default of one or more of its clearing members. 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 SFC does not expect to use under normal circumstances.

34. The Administration has further advised that in the highly unlikely event that the OTC CCP has to wind down its operation through a limited recourse process, the shortfall due to defaults by individual clearing members will be mutualized 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 Government is not a party to the contract between the clearing members and the OTC CCP and does not have any legal obligation to provide any financial assistance to the OTC CCP or its clearing members. The Administration therefore does not see the need to stipulate in the law that Government shall not have any liability to the OTC CCP or its clearing members under all circumstances.

35. The Administration has further pointed out that 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 SFC without the need for any further approval or intervention by SFC.

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[9] Under section 1 of Schedule 1 to SFO, "relevant provisions" means: (a) the provisions of the SFO; (b) Parts II and XII of the Companies Ordinance (Cap.32) (CO) in so far as those Parts relate to prospectuses, the purchase by a corporation of its own shares and a corporation giving financial assistance for the acquisition of its own shares; and (c) 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.

Bailing out the OTC CCP as a recognized clearing house by the Government

36. The Subcommittee has examined whether the Government should use public money to bail out the OTC CCP in the event of the latter's failure to meet all its obligations to its clearing members. The Subcommittee notes that the Government is not a party to the contract between the clearing members and the OTC CCP, and therefore does not have any legal obligation to provide any financial assistance to the OTC CCP or its clearing members. On the other hand, the Subcommittee also notes that during the 1987 Stock Crash, the Government had deployed funds from the Exchange Fund to help stabilize the market. Subcommittee members are therefore concerned that in the event of the failure of the OTC CCP, the Government would for political reasons or other unwarranted reasons deploy substantial public funds to bail out the CCP. As such, Subcommittee members have requested the Administration to consider making a public statement that the Government will not in any circumstances use public money to bail out any OTC CCP recognized as an RCH.

37. The Administration has responded that the Administration does not consider it appropriate to make such a statement as the Government has the responsibility to ensure the stability and integrity of Hong Kong's financial system, and any such statement will compromise the Government's position in the discharge of its function in maintaining the stability and integrity of the financial system. This, however, will not commit the Government to use public money to bail out any recognized OTC CCP established in Hong Kong or otherwise. With the robust risk management measures of the OTC CCP in place, the Administration considers it highly unlikely that the OTC CCP has to initiate the limited recourse procedures. Even in such a very remote scenario, the Administration believes that the winding down of a CCP through the default management process in an orderly manner would minimize the impacts on the financial market.

Liability of the OTC CCP as a recognized clearing house

38. According to the Administration, 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.

39. Although the contractual arrangement between the OTC CCP and its members will afford immunity for the OTC CCP from the liability for the losses of its members, in view of the uncertainty about the possible implications of the default of one or certain large market players who have chosen to use the

clearing services of the OTC CCP and the constraints of the OTC CCP's guarantee resources, the Subcommittee has requested the Administration 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 relying on the RCH's clearing rules/contracts.

40. The Administration has advised that in the highly unlikely event that the 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.

41. The Administration has also affirmed that 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. As such, the Administration does 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.

Applicability of the "reinsurance" concept

42. The Subcommittee has requested the Administration to advise on the applicability of the practice of reinsurance in the insurance industry in the OTC derivatives clearing regime, as a measure to mitigate the risk exposure of OTC CCPs, and the relevant practice in other major international financial centres.

43. The Administration has advised that 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. The Administration understands that currently, no OTC CCP in other jurisdictions is a member of another CCP and it is not necessarily beneficial for the HKEx OTC CCP to join another CCP for various considerations[10].

Structured product to be regarded as futures contract

44. To enable the insolvency override protection to extend to OTC derivatives transactions, the Notice prescribes that any structured product that satisfies the requirements set out in the Schedule to the Notice is to be regarded as a futures contract, for the purpose of the definition of market contract and some other provisions (including provisions which concern insider dealing, exchange controller and clearing house) in the SFO. According to the Schedule to the Notice, any structured product that –

(a) does not fall within the definition of securities in section 1 of Part 1 of Schedule 1 to the SFO; and

(b) is not a contract or an option on a contract made under the rules or conventions of a futures market

is to be regarded as a futures contract.

45. On members' concern that the above description of "structured product" in the Schedule to the Notice may be too broad, SFC has explained that the actual application will be confined to products for which an OTC CCP recognized as a RCH will provide clearing service, which is subject to the approval of SFC. Moreover, the Notice will be repealed upon implementation of the full-fledged regulatory regime for the OTC derivatives market, for which a separate Bill will be introduced to provide for the relevant legislative framework.

Commencement of operation of the Notice

46. The Subcommittee notes that as provided under section 1 of the Notice, the Notice has come into operation on 27 June 2012. To allow time for the Subcommittee to deliberate before the commencement date, the Subcommittee had decided to seek extension of the scrutiny period of the Notice from 6 June 2012 to 27 June 2012. However, the relevant motion was not moved at the Legislative Council meetings of 30 May 2012 and 6 June 2012 as the Council business that took precedence over the motion was not completed at these Council meetings. The Chairman has expressed concern about the problem

[10] The Administration has set out the relevant considerations in its paper LC Paper No. CB(1)2255/11-12(01).

with the extension of the scrutiny period of the Notice and noted that the same problem was encountered by some other subcommittees formed to scrutinize subsidiary legislation subject to similar scrutiny expiry dates. The Chairman has therefore suggested that the issue be referred to the Committee on Rules of Procedure for examination.

47. The Chairman has expressed the view that although his worries about the impacts of a possible crisis situation in respect of any OTC CCP that may be approved as a RCH have not been fully addressed, having regard to the information and explanations provided by the Administration, he considers it acceptable for Hong Kong to pursue the voluntary clearing arrangement and for the OTC CCP established by HKEx to be operated on a trial basis, subject to its satisfying the relevant criteria for approval by SFC. While the Administration has declined to make a public statement that the Government would not in any circumstance use public money to bail out any recognized OTC CCP, he believes that the Government would be prudent in making any such decision in order to maintain the stability and integrity of HK's financial system. As the Government is not legally liable to losses sustained by any party attributable to the failure of a recognized OTC CCP to meet all its financial obligations, the Chairman does not consider that the Government would have sufficient grounds to support any Government intervention action requiring substantial public funds. Taking into account the novel characteristic of the infrastructure for central clearing of OTC derivatives in Hong Kong and the limited capability of Hong Kong's financial system to withstand high uncertainties/risks that may be entailed by the new infrastructure, the Chairman has urged the Administration and SFC to further examine whether there is a need to strengthen the protection in the laws for the Government, SFC and any future RCH.

48. Other members of the Subcommittee have not indicated objection to the commencement of operation of the Notice.

Advice sought

49. Members are requested to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
5 July 2012

Appendix I

Subcommittee on Securities and Futures (Futures Contracts) Notice 2012

Membership list

Chairman	Hon James TO Kun-sun
Members	Hon Audrey EU Yuet-mee, SC, JP Hon CHIM Pui-chung Hon KAM Nai-wai, MH (Total: 4 Members)
Clerk	Ms Anita SIT
Legal Adviser	Miss Evelyn LEE

Appendix II

Limited Recourse Winding Down Process

(extract from LC Paper No. CB(1)2155/11-12(03))

Clearing Member	Member Receivable / (Member Payable)	Member Receivable with Limited Recourse	Member Payable with Limited Recourse
A	2,000	2,000 x (1-6%) = 1,880	-
B	1,000	1,000 x (1-6%) = 940	-
C (Default)	(300)*	-	-
D	(2,500)	-	(2,500)
E	(2,200)	-	(2,200)
F	2,000	2,000 x (1-6%) = 1,880	-
Total		4,700	(4,700)

*Assuming no Collateral Remaining to Cover Deficit

Clearing Member Net Receivable:	5,000	(Member A + B + F)
Clearing Member Net Payable:	(4,700)	(Member D + E)
Shortfall Amount:	300	
Shortfall % (Shortfall Amount/Member Net Receivable)	6%	

<u>With Limited Recourse</u>

Clearing Member Net Receivable:	4,700
Clearing Member Net Payable:	(4,700)