HKEx's Proposal 2: Introduce Margining and Dynamic Guarantee Fund in HKSCC

Questions

3. Do you agree with the proposed margining arrangements at HKSCC?

☑ Yes

☐ No

Please provide reasons for your response and include any other suggestions or comments you may have on this question:

Under section 2508 (Replenishment of Contributions) of the General Rules of CCASS, HKSCC shall require and the Clearing Participant shall promptly replenish the deficiency of its Contributions as a result of the payment made in accordance with Rule 2507 in respect of the defaults of Clearing Participant. If it were not decided by the HKEx Board that no set off is to apply in respect of the default of Lehman Brothers Securities Asia Limited ("Lehman"), non-defaulting Clearing Participants have to top up all losses of the Guarantee Fund whether they are big or small. Lehman had sophisticated business operations inclusive of the issuing of derivative products with high degree of risks. We consider that the present arrangement of sharing of losses is not fair and the principle of "user to pay" must be applied for a player to bear the risks in proportion to the size and nature of its business.

The fundamental problem leading to the heavy losses in Lehman can be ascribed to present way execution of trade on the Exchange by Participant in the manner like doing margin account trading without any collaterals and settlement can be made on T + 2 day after the horse has gone. The proposed margining arrangement will correctly address this problem to a certain extent.

While we are in favor of the proposed margining arrangement as well as the Dynamic RF, the support of [redacted] is not unqualified without the easing of its concerns in the following matters;

(1) **Non-classification of Dynamic GF/RF as liquid capital**: Since contribution must be made by all Participants, the healthier guarantee arrangement will mean that Dynamic GF will be subject to lesser risk exposure than the old ones. Accordingly the amount of Dynamic GF/RF paid should be treated as liquid capital under the FRR, at least, a portion of it in order to relieve burden of the Participants in their capital requirements.

(2) **Lock-up of cash balance and sudden effects on FRR position**: Idle cash has to be kept in order to meet margin call from the HKSCC. In case of a sudden increase in transaction volume, the amount of cash position required will be difficult to predict as well as the effects on the FRR;

(3) **Fundamental issue remained to be solved**: The losses caused to the Guarantee Fund in the past have been due to the business that the Participants carried for themselves. In the case of Lehman, its involvement in derivative product operations boosts the heavy losses to the Guarantee Fund as well as leaving least assets to be recovered by its receivers. Though margin has to be paid by all Participants under the proposal system, paragraph 74 of Proposal 2 (Introducing Margining and Dynamic Guarantee Fund in HKSCC) still requires non-defaulting Participants to replenish the Dynamic GF. While on pro rata basis, the failure of a "too-big-to-fail' broker with huge sophisticated derivative operations will still cause huge absolute amount of replenishment from non-defaulting Participants, under the proposed new system, who merely carry on business on agency basis without any house position.

(4) **The Need for differentiation between Broker and Dealer**: The present licensing regime does not differentiate between the business of broker, who merely trade on behalf of his client, and dealer who will carry out house transactions inclusive of sophisticated derivative operations. These two types of operation pose different degrees of risk to the guarantee arrangement as well as the overall risk exposure to the whole securities business. It is time to think about whether these two types of Participants should be differentiated in their registration status. For brokers who merely trade on behalf of clients without any house position posing lesser risk exposure to the guarantee arrangement, they should be subject to lesser margin requirements that the dealers. This arrangement shall be more justified under the "user-to-pay" that the new system apparently intend to implement.