SECTION 2: QUESTIONS FOR RESPONSE

Please indicate your views by providing comments as appropriate. Where there is insufficient space, please use additional sheets of paper as necessary.

HKEx's Proposal 1: Revise HKEx Stress Testing Assumptions

Questions
1. Do you support the proposed revision of the Price Movement assumptions in stress testing? ☑ Yes ☐ No Please provide reasons for your response and include any other suggestions or comments you may have on this question: We support the rationale for the change to the stress test assumptions and the delineation between index stress levels (HKCC) and single stock stress levels (SEOCH and HKSCC). However, in the case of the latter, we do not support the proposal to move to "no cross-stock netting among different stocks". The reason being that a "portfolio" of buys and sells across different stocks implies a higher requirement than that of a long-only or a short-only portfolio, each of which carries more price gap risk. As an alternative to the current proposal we would like to suggest a two-tiered approach that explicitly captures price gap risk as well as dispersion risk, i.e., the higher of (i) ±20% / ±22%, say, price move applied to the net portfolio (cross stock netting of longs and shorts); or (ii) ±5% (for example) of each stock/underlier, netting by underlier. In support of this, Section 3.6.12 of the consultative report published by IOSCO, Principles for Financial Market Infrastructures report (March 2011) states: *"In calculating margin requirements, a CCP may allow offsets or reductions in required margins between products for which it is the counterparty if the price risk of one product is significantly and reliably correlated with the price risk of another product."*

2. Do you support the proposed revision of the Counterparty Default assumption in stress testing?

☑ Yes

☐ No

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

We agree with the removal of the "30% of loss making positions" on the basis that it is an arbitrary measure. We agree in principle with a revision of the current counterparty default assumption but we are unclear on the rationale for the choice of largest and fifth largest counterparty. The choice of this seems to be arbitrary.

In theory, all counterparties' exposure should contribute to this calculation. We could account for all counterparties' exposure by weighting their respective contribution by probability of default. In the absence of differentiated counterparty default probabilities, a simplifying assumption of a default being equally likely across all counterparties, i.e., the arithmetic mean of all other counterparty exposures (excluding the largest), plus the largest default exposure, could be considered as an alternative.

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:

We do not oppose the introduction of volatility/VaR based margin, but we believe its implementation would introduce "pro-cyclicality". The consultative report published by IOSCO, Principles for Financial Market Infrastructures report (March 2011) recommends that the "*CCP should adopt forward-looking and relatively conservative and stable margin requirements that are specifically designed to avoid the need for destabilising, procyclical changes.*" We therefore assume that the proposed floor of the Margin Rate at 5% is a protection for the CCP (and by extension, clearing participants) during periods when volatility is cyclically low. Conversely, if VaR or volatility based margin is introduced, we would advocate a cap on the Margin Rate of 10% (for example), as it is currently structured, to protect clearing participants (and by extension, the CCP) against the adverse effects of pro-cyclicality during periods when volatility is cyclically high.

Furthermore, we recommend a pro-rated reduction of margin rate based on Net Exposure (see below) rather than applying it to the Margin Positions (as it is currently defined).

An alternative to volatility or VaR based margin scheme is one based on both Net Exposure and Gross Exposure. Rather than applying volatility based margin rate to the Margining Position, where Margining Position is currently defined as the higher of (x) the total cross-day net long CNS position; or (y) the total cross-day net short CNS position. Instead, Margining Position would be in two parts: (i) Gross Exposure is the sum of (x) and (y); and (ii) Net Exposure is the absolute value of the difference between (x) and (y). The Margin Requirement would then be, for example, Margin Rate 1 * Gross Exposure + Margin Rate 2 * Net Exposure, where Margin Rate 1 and Margin Rate 2 are fixed percentages and Margin Rate 1 < Margin Rate 2. For example, Margin Rate 1 = 3% and Margin Rate 2 = 4%.

This addresses:

a) the need for a reasonable compromise between simplicity and accuracy;
b) margin requirements that are risk-based (Net and Gross exposure being proxies for risk);
c) the pro-cyclicality issue; and
d) the more burdensome requirement on [some] Participants to replicate a VaR/volatitility based margining methodology (as opposed to a simpler "rules-based" methodology).

The implementation of the volatility or VaR based margining proposal poses potential problems for our Operations team to validate the daily margin calls from HKEx unless we are able to replicate internally the same methodology. The industry may require system tools or other forms of assistance from the HKEx on the margin calculation.

We understand the proposed margining arrangement requires margin be payable in the denominated currency of the CNS positions. A CP that holds CNS positions in foreign currencies, e.g., RMB, would require funding in the respective currencies to meet its margin payments. Given a volatility or VaR based margin may translate into a higher cost of conducting business, we would like to explore the option of posting margins in different currencies and/or different asset classes.

In addition, we would like to gain a better understanding on the refund mechanism in the case where the posted margin exceeds the required margin on any given day.

4. Do you agree with the proposed Dynamic GF model at HKSCC?

☑ Yes

☐ No

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

In principle, we support the approach of the first loss being borne by the "non-pooled upfront margin", and second loss being borne by the "pooled default fund", provided the bulk of any projected losses be borne by the first-loss tranche. In practice, our understanding is that the second loss tranche is in fact a composite of the Fixed Guarantee

Fund and the Dynamic Guarantee Fund, the former being first loss (after Margin).

Additionally, we understand that "non-pooled upfront margin" is classified as "Liquid Assets" under the SFC Financial Resources Rules, whereas contributions to the current Guarantee Fund do not qualify. Therefore, we support the HKEx petition to SFC to reclassify the Guarantee Fund, or at a minimum, the Dynamic portion of Guarantee Fund as "Liquid Assets" for the purposes of the FRR calculation.

Again, we would like to gain a better understanding on the refund mechanism in the case where our previously contributed portion of Dynamic Guarantee Fund exceeds the Dynamic Guarantee Fund requirement in any given period.

HKEx's Proposal 3: Revise HKCC Reserve Fund Calculation

Questions
5. Do you support the proposed revisions to the HKCC Collateral assumption? ☑ Yes ☐ No Please provide reasons for your response and include any other suggestions or comments you may have on this question: Please refer to Q1 and Q2 for our comments in regards to the revisions of the price movement assumption and counterparty default assumption. However, we agree with the exclusion of assumed credits given to IDM from daily RF calculation.
6. Do you support the use of HKCC Contingent Advance in relieving burden of CPs? ☑ Yes ☐ No Please provide reasons for your response and include any other suggestions or comments you may have on this question: We do not have any comment on this.
7. What is your view on allowing RF contribution to be counted as liquid capital? Will this help your company in terms of reducing liquid capital funding burden? Because the Reserve Fund ("RF") is dynamic and based on risk exposure (and therefore can be readily scaled by a Participant), we agree that the RF contribution, like margin, should be classified as "Liquid Assets" for the purposes of the FRR.

HKEx's Proposal 4: Revise SEOCH Reserve Fund Calculation

Questions
8. Do you support the proposed revisions to the SEOCH Collateral assumption? ☑ Yes ☐ No Please provide reasons for your response and include any other suggestions or comments you may have on this question: Please refer to Q1 and Q2 for our comments in regards to the revisions of the price movement assumption and counterparty default assumption. However, we agree with giving credit to risk margin deposit and surplus fund in daily RF calculation given that it should be consistent across all three clearing houses.