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: **Please see the attached.**
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: **Please see the attached.**

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: **Relief measure to reflect proper risk managements and control measures of individual broker is suggested. Please refer to the attached for details.**
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: **Please refer to the attached for details.**

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 the attached for details.**
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: **Please refer to the attached for details.**
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? **We support this proposal. It will help reduce liquid capital burden. Alternatives to reduce extra capital needs due to supervision under SFC and HKEx are also suggested. Please refer to the attached for details.**

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 the attached for details.**

We welcome HKEx Clearing House's proposal to strengthen the central clearing position as to mitigate risk of defaults. We appreciate the objective and are positive towards the measures. Equally, we are also very concern about own liquidity and risk of defaults. But, the question is to whom those measures should apply. There are some areas that may need thoughtful consideration. The following are our high level comments:

a) Clearing Participants (CPs) are Securities and Futures Commission (SFC) regulated entities. It is required to maintain sufficient liquid capital for regulatory capital purposes. By way of sufficient regulatory capital, it ensures the creditworthiness of a regulated entity. Now, another regulator, i.e. HKEX Clearing House in the present case, is asking for another kinds of liquidity reserve/ contribution from CPs. It will create extra funding and capital requirement for CP. From capital perspective, it would be double counted unless both regulators (i.e. SFC and HKEX Clearing House) could harmonize capital calculation rules.

b) In general, the risk of defaults is mainly due to 2 areas, capital insufficiency and liquidity problem. Agency business should not bear the risks of their clients in terms of liquidity and capital loss. CPs which are only doing agency business should be of less concern on capital sufficiency and liquidity provided that they have reasonable control on provision of credit to clients. As far as CPs are not trading on its own book, capital sufficiency is not a particular concern.

   On this basis, CPs which provide pure agency services (i.e. cash are held in the trusted bank accounts of CP when placing buy order and stock are in the custody account of CP when placing sell order) should have low risk of defaults. This concept should also apply to omnibus accounts and other accounts (such as DVP[1]) of similar characteristic. It is suggested that CPs contribute less to liquidity reserve requirement of clearing house if they are within this category. On the other hand, if CPs are having house position or trading position by group companies, margin lending to clients and/ or having loose control on the provision of credit, they could follow the proposed risk management measures. It could help if securities accounts of CPs are categorized to house accounts[2] and clients accounts etc so that the risk management measure could only be applied to those accounts carrying higher risk than pure agency accounts.

   The key message is that it is not fair for low risk agency CP (provided that they have reasonable control on credit policy) to compensate CP of high risk business model. The proposed risk management measures have the assumption that the market movement will hit the financial position of CPs. It holds only if CPs or its group companies are taking proprietary position in the underlying transactions, or the CPs are loosely managing its agency business.

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[1] DVP is generally adopted by funds to mitigate exposure to broker in course of settlement.

[2] A detail analysis on segregation house or group account from those pure agency house/ group will be required when it is implemented.

c) And, it is not fair to base on sizes of CP for the amount of contribution to the proposed risk measures. Again, it should be the effectiveness of internal control, business model (i.e. high risk or low risk) and resources allocated for business management (say better operating system support, proper segregation of duties and sufficient risk management people) etc to determine the risk of defaults and liquidity problem. Otherwise, it will discourage CPs to attain economy of scale and offer better services to clients by means of a bigger size. Usually, a bigger size could mean more resources allocation and better services.

d) For funding, it would help minimize funding needs if the proposed contributions are able to be served by bank guarantee. Given there is a guarantee acceptance policy of HKEx Clearing House, sizable CPs which already have had many banking facilities in place with commercial banks may have difficulty in obtaining additional bank guarantee from commercial banks. It is suggested that HKEx Clearing House review its bank guarantee acceptance policy as to provide reasonable flexibility to accommodate needs of sizable CPs which may have its own difficulty in extending extra banking facilities by commercial banks. Given the size banking facility, CPs are likely to gain sufficient support by its connected banking vehicle, mainly being the bank holding company.

   Besides, by the introduction of new capital rules to banking industry (i.e. BASEL III), the borrowing costs (including cost for bank guarantee) will be costly. The operating costs of CPs are, inevitably, increased.

e) Should collateralized accounts be devised to help CPs evidence its liquidity to clearing house prior to the settlement date, implications on SFC's clients' money rules and clients' securities rules are needed to take into consideration. Potentially, some special circumstances may have implications on stamp duty rules. For example, clients securities under custody are moved to a collateralized account with clearing house by error. Stamp duty may have implications in this aspect. Exemptions in stamp duty rules, if stamp duty does applicable, should be allowed for such unfortunate circumstances.

f) Operating system changes will be needed if any proposed measures will be made on the daily operating model. Sufficient time should be allowed for related operating system changes.

HKSCC

Margining

Margining is set up on top of the marks. It means there is extra funding requirement for CPs. It will penalize a CP which has very tight credit policy towards its clients including both cash and margin clients. A CP of tight credit policy aims to ensure it could settle without risk. Now, by margining, it appears to be a one-size-fit-all policy. Is there any ways to provide more relief to CP which has better credit control?

If margining allows the undue portion of client money or client assets to be used for reducing the amount of margining (such as collateralized accounts), the SFC rules governing clients' money and clients' assets are needed to incorporate the changes. So, CP (including the omnibus accounts) would be of granted authority under SFC rules to handle clients assets and money for such specific margining purpose.

To the end of dealing with clients under Omnibus Accounts and DVP accounts, should there be special rules to allow for any kinds of pre-settlement measures as to reduce the margining with respect to those accounts provided that reasonable credit control is in place?

Potential stamp duty implication should be accounted for when clients assets are allowed to use to meet certain margining obligations. In particular, it would be a case of deemed change of beneficial interest under stamp duty if an operational error is occurred to place one of the clients assets for another client.

HKCC and SEOCH

Again, the question is to whom the risk management measure should apply. For clients transactions, they are under margining control where open position is supported by sufficient margin position with clearing houses. The risk of defaults is manageable.

However, the risk of defaults would largely come from house position of CPs themselves or group companies due to contagion effect. We suggested that the risk management measures should be applied to these circumstances only, instead of applying to CPs which only carry agency trades for clients. In practice, there are a mix of accounts (both house and agency client accounts) in one CP. It could be segregated into house accounts (including group accounts) and customer accounts so that the risk management measures are merely applied to house accounts only.