

Chapter 8

Default Management

8.1 Interpretation and Overview

The procedure set out in this Chapter 8 is aimed at reducing and neutralizing the overall risk arising out of the occurrence of a DMP Event with respect to one or more Defaulting Clearing Members.

8.2 Member Obligations

Each Clearing Member has provided an undertaking to discharge its obligations in participating in the Default Management Process pursuant to Clearing Rule 1609.

Non-Defaulting Clearing Members shall provide market access for OTC Clear to execute Hedging pursuant to Clearing Rule 1801 and section 8.5. Each Non-Defaulting Clearing Member shall support the Hedging or risk neutralization process by promptly providing the Default Management Group with competitive pricing for hedging trades upon request. OTC Clear will consult with the Default Management Group in determining the range of competitive pricing for a Hedging transaction. If Non-Defaulting Clearing Members who have executed Hedging transactions with OTC Clear subsequently enter into other swap transactions to further hedge or offload their risk exposure created by such Hedging transactions, such Non-Defaulting Clearing Members shall disclose the terms of such swap transactions to OTC Clear.

If a DMG Delegate is no longer an employee or a director of the Clearing Member that nominates the DMG Delegate or the Clearing Member becomes aware that its DMG Delegate's employment or directorship will be terminated, such Clearing Member shall notify OTC Clear in writing as soon as practicable and such DMG Delegate will be removed from the Default Management Group. Such Clearing Member shall then nominate another employee or director to be a DMG Delegate.

8.3 Scope and Responsibility of Default Management Group

OTC Clear will convene a meeting of the Default Management Group in accordance with the Default Management Group's terms of reference.

The Default Management Group will, among others, provide advice to the OTC Clear on market conditions including liquidity and also on construction of separate Auction Portfolios. OTC Clear will oversee the Hedging and Auction processes.

8.4 Suspension of Activities

Upon the occurrence of a DMP Event with respect to a Defaulting Clearing Member, the Defaulting Clearing Member's clearing activities with OTC Clear will be suspended.

8.5 Hedging (Risk Neutralizing)

The objective of Hedging is to mitigate, to the extent commercially practicable, any risk or economic exposure which arises as a result of the occurrence of a DMP Event.

OTC Clear will apply a risk based approach to hedging i.e. neutralizing exposures most vulnerable to market risk. Market risk may be expressed and measured in deltas across all the available tenor points. In respect of each Default Management Process and the related Hedging, the Default Management Group will present proposed Hedging strategies to OTC Clear. Once the Hedging strategies have been approved by OTC Clear, the Default Management Group is primarily responsible for execution of the Hedging strategy for OTC Clear.

Hedging will continue until such time as OTC Clear, in consultation with the Default Management Group, is reasonably satisfied that the risk arising out of the relevant DMP Event has been suitably reduced. OTC Clear will use reasonable endeavours to limit erosion of Margin Balances.

8.6 Auction

8.6.1 Auction Protocol

The entire Auction process may take a number of days, but is expected to be completed as soon as reasonably practicable. Auction Portfolios may be auctioned at different times. Each Auction Portfolio shall be subject to its own Auction.

In respect of each Auction, DMP Information relating to such Auction will be provided to each Non-Defaulting Clearing Member participating in such Auction and the Special Clearing House Participant for dissemination to its clearing participants who have voluntarily agreed to participate in such Auction. The information provided will allow the Non-Defaulting Clearing Members and clearing participants of the Special Clearing House Participant to assess the risk in the Auction Portfolio and value the same.

8.6.2 Construction of Auction Portfolio

OTC Clear will, in consultation with the Default Management Group, construct various Auction Portfolios in respect of the Auction Book relating to a Defaulting Clearing Member. Clearing Rules 1902 to 1904 set out the general principle in constructing such Auction Portfolios, and OTC Clear, in consultation with the Default Management Group, will review the Transaction Categories that the Defaulting Clearing Member had registered with OTC Clear immediately before the occurrence of the DMP Event. An Auction Portfolio may contain Auction Positions belonging to more than one Transaction Category.

The following example illustrates how the Auction Portfolio construction process works:

Assuming OTC Clear has four Clearing Members: Clearing Member A "CM-A", Clearing Member B "CM-B", Clearing Member C "CM-C", and Clearing Member D "CM-D". Assuming further that CM-D is in default and immediately prior to default, it had registered Contracts with OTC Clear belonging to the following Transaction Categories: Rates Derivatives Contracts denominated in CNY (offshore) ("**CNY IRS**"), FX Derivatives Contracts denominated in CNY ("**CNY NDF**") and Rates Derivatives Contracts denominated in HK\$ ("**HK\$ IRS**").

In the example above, subsequent to the creation of the Auction Book relating to CM-D on the Special Default Account, three Auction Portfolios may be constructed for CM-D:

- (i) CNY IRS = 50%
- (ii) CNY NDF = 40%
- (iii) HK\$ IRS = 10%

In the event that OTC Clear, in consultation with the Default Management Group, determines that the likelihood of successfully disposing all Auction Positions on the Auction Book relating to CM-D will be increased by combining CNY IRS with CNY NDF, it may do so as follows:

- (a) CNY IRS + CNY NDF = 90%
- (b) HK\$ IRS = 10%

In either of the above examples, the percentages marked against each of the three Auction Portfolios is the RAP (please refer to Clearing Rule 1913) determined in respect of each such Auction Portfolio by OTC Clear in consultation with the Default Management Group.

8.6.3 Bidding Process

8.6.3.1 Bids

In respect of each Auction, once the timeframe for submitting Bids as notified by OTC Clear to Bidders has drawn to a close, no further Bids will be accepted. OTC Clear will examine all Bids submitted as follows:

- (i) the highest Bid received by OTC Clear is expected to be the Successful Bid of the Auction, provided that OTC Clear will not accept a Bid if accepting such Bid can potentially, without limitation, (a) cause OTC Clear to breach any legal or regulatory requirement applicable to it, (b) lead to legal action or proceedings to be taken against OTC Clear or (c) be disadvantageous or have a material adverse effect on OTC Clear; and
- (ii) in the event that the two (or more) highest Bids received by OTC Clear are of exactly the same value, the relevant Bidders will be invited to submit revised Bids. If no revised Bids have been received by OTC Clear within 10 minutes following the invitation of Bid re-submission, the relevant Bidder who submitted its original Bid first is expected to be the Successful Bidder.

Once the Successful Bid has been confirmed, OTC Clear will verbally notify the Successful Bidder or the Special Clearing House Participant (in case where the Successful Bidder is a PRC Bidder), followed by a written confirmation of the same.

In respect of each Auction, details of the Bids will be kept confidential so that a Bidder will not have knowledge of the Bid prices submitted by other Bidders.

For the avoidance of doubt, OTC Clear shall not be liable for any damages against it if a Bid fails to reach OTC Clear due to operational, technological or any other reasons.

8.6.3.2 Unsuccessful Auction

In the event of an unsuccessful Auction, further round(s) of Auction may be held until all the Auction Portfolios have been disposed of or have been the subject of a Contract Termination Event. OTC Clear will consult the Default Management Group prior to determining whether an Auction is unsuccessful. Without prejudice to the generality of the immediately foregoing, an Auction shall be deemed to be unsuccessful if:

- (i) no Bids have been received prior to the close of an Auction due to operational or technological issues, including but not limited to corruption of auction file data;
- (ii) any other operational issue which OTC Clear, in consultation with the Default Management Group, deems appropriate; or
- (iii) no Bids or insufficient number of Bids have been received prior to the close of an Auction as determined by OTC Clear, in consultation with the Default Management Group.

8.6.3.3 Registration of Auction Portfolios (non-PRC Bidders)

Upon completion of a successful Auction, OTC Clear will register the relevant Auction Contracts to the Successful Bidder in accordance with Clearing Rule 1921. OTC Clear will liaise with both the relevant Approved Trade Registration System and the relevant Clearing Member to ensure the records relating to all Auction Contract(s) are updated on the Approved Trade Registration System. This update will automatically enable the recalculation of the Successful Bidder's Margin requirements and / or and its

CM Funded Contribution Amount, reflecting the impact of the acquisition of the Auction Contract(s) by the Successful Bidder.

OTC Clear will liaise with a Successful Bidder for booking relevant Auction Contract(s) into its systems so that the systems and records kept by such Successful Bidder will be aligned with those of OTC Clear.

The timing of transfer of any Auction Payment or Auction Receivable is set out in Clearing Rules 1922 and 1923, respectively.

8.6.3.4 Registration of Auction Portfolios (PRC Bidders)

If the Successful Bidder is a PRC Bidder, the provisions set out in Rule 21M04 will apply.

The timing of transfer of any Auction Payment or Auction Receivable is set out in Clearing Rule 21M07.

8.6.4 Tranching Methodology

To incentivize competitive bidding during an Auction, and pursuant to Clearing Rules 1913 to 1916, OTC Clear will implement the Tranching Methodology which seeks to allocate the relevant proportion of the Rates and FX Contribution Balance of a Non-Defaulting Clearing Member in respect of its CM Funded Contribution Amount into one of three Tranches: the Senior Tranche, Middle Tranche and Junior Tranche. Pursuant to Clearing Rule 1919, upon the expiry of a Capped Liability Period, with respect to each Auction Portfolio constructed as a result of the occurrence of the DMP Events during such Capped Liability Period that was the subject of a successful Auction, OTC Clear will notify all relevant Bidders for each such Auction Portfolio the result of the application of the Tranching Methodology.

The following provides an example to illustrate the working mechanisms around the Tranching Methodology:

Using the hypothetical RAP figures mentioned in sections 8.6.2(i) to (iii) and assuming OTC Clear does not combine CNY IRS and CNY NDF Auction Portfolios, if:

Tranching for CM-A based on its Bids for the three Auction Portfolios:

- (i) CM-A is the Successful Bidder for the CNY IRS Auction Portfolio, 50% of CM-A's CM Funded Contribution Amount will be allocated to the Senior Tranche;
- (ii) CM-A is a Lower Bidder for the CNY NDF Auction Portfolio 40% of CM-A's CM Funded Contribution Amount will be allocated to the Middle Tranche; and
- (iii) CM-A is a Poor Bidder for the HK\$ IRS Auction Portfolio, 10% of CM-A's CM Funded Contribution Amount will be allocated to the Junior Tranche.

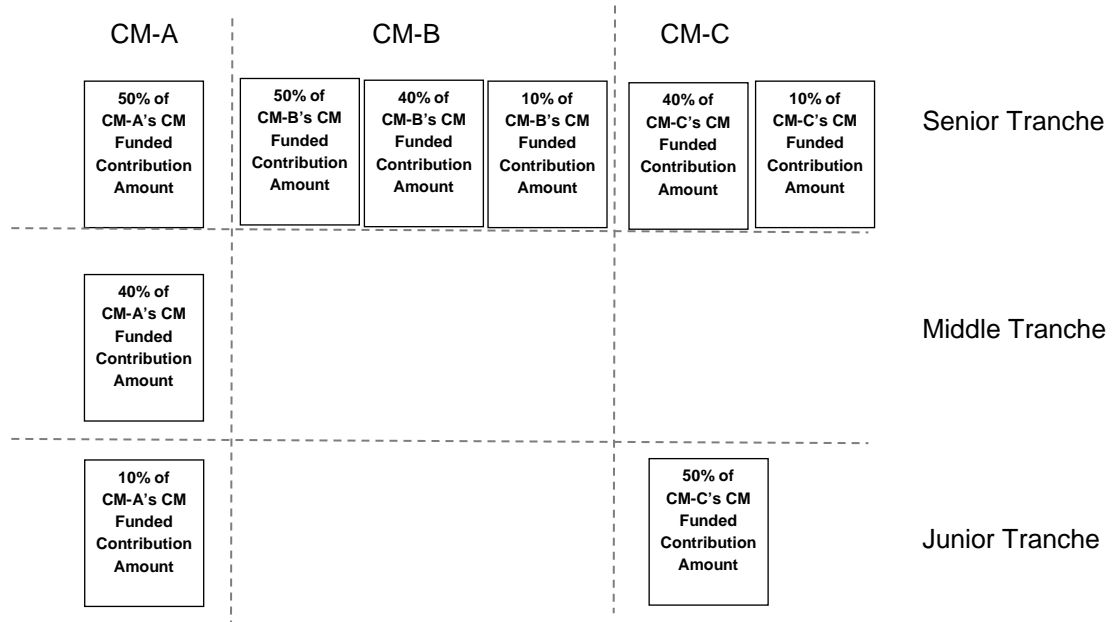
Tranching for CM-B based on its Bids for the three Auction Portfolios:

- (i) CM-B is an Equal Bidder for the CNY IRS Auction Portfolio, 50% of CM-B's CM Funded Contribution Amount will be allocated to the Senior Tranche;
- (ii) CM-B is the Successful Bidder for the CNY NDF Auction Portfolio, 40% of CM-B's CM Funded Contribution Amount will be allocated to the Senior Tranche; and
- (iii) CM-B is the Successful Bidder for the HK\$ IRS Auction Portfolio, 10% of CM-B's CM Funded Contribution Amount will be allocated to the Senior Tranche.

Tranching for CM-C based on its Bids for the three Auction Portfolios:

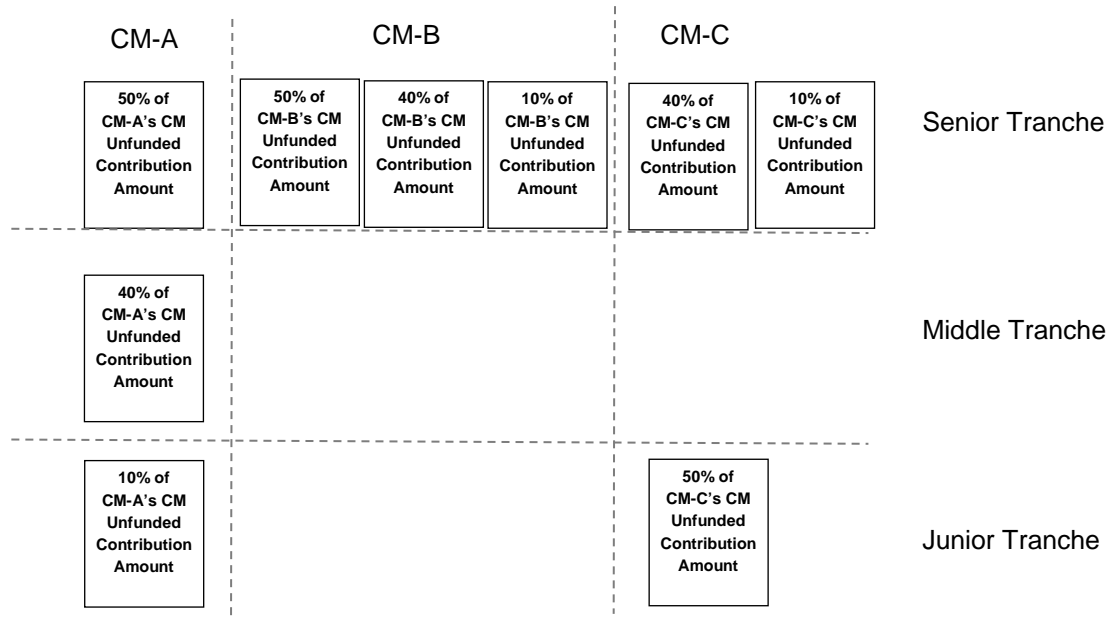
- (i) CM-C is a Non-Bidder for the CNY IRS Auction Portfolio, 50% of CM-C's CM Funded Contribution Amount will be allocated to the Junior Tranche;
- (ii) CM-C is a No Position NDCM for the CNY NDF Auction Portfolio, 40% of CM-C's CM Funded Contribution Amount will be allocated to the Senior Tranche; and
- (iii) CM-C is a Better Bidder for the HK\$ IRS Auction Portfolio, 10% of CM-C's CM Funded Contribution Amount will be allocated to the Senior Tranche.

The following diagram summarizes the Tranching Methodology described in the immediately foregoing:



8.6.5 Tranching for Rates and FX Assessments

The utilization of each Non-Defaulting Clearing Member's Rates and FX Contribution Balance in respect of its CM Unfunded Contribution Amount will be applied using the same Tranching Methodology. Using the same figures provided in the example given in section 8.6.4, the following diagram summarizes the application of the Tranching Methodology as applied to the CM Unfunded Contribution Amount of each of CM-A, CM-B and CM-C:



In respect of an Auction, the allocation of Tranches in respect a Non-Defaulting Clearing Member's Rates and FX Liability will only apply to such Auction.

8.7 Portfolio Splitting and Re-composition

In case of an unsuccessful Auction, in order to enhance the likelihood of success of a subsequent Auction, OTC Clear has the flexibility to, in consultation with the Default Management Group, combine Auction Portfolios of different Transaction Categories or further sub-divide a previously constructed Auction Portfolio into multiple Auction Portfolios. The prime considerations for portfolio splitting and re-composition include, but are not limited to, the size of the Auction Portfolio(s).

8.8 Cost of Default and Loss Attribution

OTC Clear will assess its Rates and FX Loss incurred as a result of the occurrence of the DMP Event. Any Margin Balance of the Defaulting Clearing Member in excess of the full settlement of the default (but excluding any Client Entitlement which will be paid to the relevant Non-Porting Client of the Defaulting Clearing Member in accordance with Clearing Rule 1309) will be redelivered to the Defaulting Clearing Member as part of the net sum payable to the Defaulting Clearing Member pursuant to Clearing Rule 1307, or be returned in accordance with the relevant security document. Any Rates and FX Contribution Balance of the Defaulting Clearing Member in excess of the full settlement of the default will be redelivered to the Defaulting Clearing Member in accordance with Clearing Rule 1547.

In the event that the Rates and FX Loss exceeds the Defaulting Clearing Member's Rates and FX Contribution Balance, OTC Clear will satisfy the losses in accordance with Clearing Rule 1516.

8.9 Post Auction Communication

Upon disposal of all Auction Portfolios by way of Auction or by the declaration of a Contract Termination Event following the occurrence of a DMP Event with respect to the Defaulting Clearing Member or the Defaulting Special Clearing House Participant, OTC Clear will announce the completion of the Default Management Process by notifying the Clearing Members and will provide a summary of the steps taken during the Default Management Process, such summary will be published on the HKEX website, a copy of which will also be provided to the SFC.

8.10 Review

Upon the completion of the Default Management Process in respect of each occurrence of DMP Event, OTC Clear will review the process and may put forward recommendations to change the process.

OTC Clear will also, at a minimum of once every year, conduct review of the process set out in this Chapter 8 to ensure it is adequate, practical and effective. In doing so, OTC Clear will involve Clearing Members by inviting them to participate in fire drills as referred to in Clearing Rule 1611. OTC Clear will provide the results of any fire drills of the Default Management Process to the Risk Management Committee. OTC Clear will also publish the results of the fire drills on the HKEX website.

8.11 Porting of Affected Contracts and Collateral to a Replacement Clearing Member

OTC Clear will facilitate porting of Affected Contracts in a Client Position Account (and Collateral in its corresponding Client Collateral Account) of a Defaulting Clearing Member if all of the following conditions are satisfied:

- (i) original valid and complete Porting Instructions* are received by 17:00 hours Hong Kong Time on the OTC Clear Clearing Day immediately following the occurrence of the relevant DMP Event;
- (ii) no DMP Event has occurred with respect to the relevant Replacement Clearing Member;
- (iii) in respect of each Client Position Account, the relevant Replacement Clearing Member has consented (in writing) to accepting the porting of all Affected Contracts and Collateral in the corresponding Client Collateral Account by 17:00 hours Hong Kong Time on the OTC Clear Clearing Day immediately following the occurrence of the relevant DMP Event;
- (iv) the relevant Replacement Clearing Member's standard settlement instruction for each relevant Contractual Currency of the Affected Contracts being ported is in place;
- (v) the Replacement Clearing Member's standard settlement instruction for each relevant Eligible Currency of cash Collateral being ported is in place;
- (vi) the Replacement Clearing Member's standard delivery instruction for each relevant non-cash Collateral being ported is in place;
- (vii) the Replacement Clearing Member's standard settlement instruction for the relevant currency of denomination of the coupon (interest) of each relevant non-cash Collateral is in place;
- (viii) the Replacement Clearing Member fulfills its revised Margin requirements and successfully passes its margin and credit checks at 19:00 hours Hong Kong Time on the second OTC Clear Clearing Day following the occurrence of the relevant DMP Event;
- (ix) all amounts that have become due and payable by the relevant Defaulting Clearing Member to OTC Clear in respect of Contracts recorded in the relevant Client Position Account (including, for the avoidance of doubt, any Non-Porting Contracts recorded in that Client Position Account) have been paid or otherwise fully and finally discharged to the satisfaction of OTC Clear; and
- (x) no Rates and FX Clearing Termination Event has occurred.

In respect of each Porting Instruction, each Defaulting Clearing Member and the Replacement Clearing Member named therein are deemed to acknowledge, represent and undertake that:

- (a) they are jointly responsible for the accuracy and completeness of the information contained in such Porting Instruction;
- (b) OTC Clear is entitled to rely conclusively on the instructions and information provided in such Porting Instruction without further enquiry; and
- (c) OTC Clear shall incur no liability for any delay, rejection, loss, cost, claim, action, demand or expense in the processing of such Porting Instruction and in effecting the porting of Affected Contracts and Collateral in reliance on the information contained in such Porting Instruction.

If any information and/or instructions provided by the relevant Client in a Porting Instruction is incomplete, inaccurate or inconsistent with its records, OTC Clear may, in its sole and absolute

* Forms are provided to Clearing Members as part of their onboarding process and thereafter are available from OTC Clear upon request.

discretion, reject such Porting Instruction or liaise with the Defaulting Clearing Member and/or the Replacement Clearing Member to rectify the relevant information/instruction.

8.11.1 Porting Instructions

Requirements for valid and complete Porting Instructions:

- (i) Porting Instructions must contain:
 - (a) the name, address and contact details of the Client;
 - (b) the name, address, contact details of the Defaulting Clearing Member, and the reference number of the relevant Client Accounts held by the Defaulting Clearing Member on behalf of the Client or identified as being shared with the Client; and
 - (c) the name, address and contact details of the Replacement Clearing Member;
- (ii) Porting Instructions must be signed by the Client, the Defaulting Clearing Member and the relevant Replacement Clearing Member;
- (iii) Porting Instructions submitted by Client Clearing Category 2 Clients sharing the same Client Clearing Category 2 Accounts must nominate the same Replacement Clearing Member; and
- (iv) the relevant Replacement Clearing Member that has been nominated has been approved by OTC Clear to provide Client Clearing Services to the relevant Client(s).

8.11.2 Update of Records

The status of each relevant Contract successfully ported to and registered in the Replacement Clearing Member's relevant Client Position Account will be flagged as "CLEARED" in the "OTC Clear Trade Report for Client (Report Number TDRP01_C, TDRP02_C or TDRP11_C)" and Collateral records in the relevant Replacement Clearing Member's relevant Client Collateral Account will be updated accordingly and reflected in the "OTC Clear Risk Management Report (Report Number RMRP05)".

8.11.3 Unsuccessful Porting

If porting cannot be completed successfully, the Affected Contracts of each Non-Porting Client will be subject to the Default Management Process relating to the relevant DMP Event.