

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 AIMA's comments in the response letter 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 AIMA's comments in the response letter 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:

Please see AIMA's comments in the response letter attached.

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 see AIMA's comments in the response letter attached.

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 see AIMA's comments in the response letter attached.

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 see AIMA's comments in the response letter attached.

Questions

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?

Please see AIMA's comments in the response letter attached.

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 see AIMA's comments in the response letter attached.



Alternative Investment Management Association

Corporate Communications Department
Hong Kong Exchanges and Clearing Limited
12th Floor, One International Finance Centre
1 Harbour View Street
Central
Hong Kong

By email to: response@hkex.com.hk

28 October 2011

Dear Sirs,

HKEx clearing house risk management reform measures

The Alternative Investment Management Association (AIMA)¹ welcomes the opportunity to comment on the Hong Kong Exchanges and Clearing Limited (HKEx) consultation on clearing house risk management reform measures (the 'Consultation').

AIMA members are active participants in the global derivatives markets, using derivatives for investment and hedging purposes and have supported the commitments of the G20 leaders at the September 2009 Pittsburgh summit to mandate trading and clearing of suitable over-the-counter (OTC) derivative contracts². As AIMA members are active in the Hong Kong market and wish to see an overall reduction in unnecessary systemic risks, we support the proposals of HKEx to the extent that they allow the risks of their systemically important clearing houses³ (CCPs) to be effectively managed.

AIMA's hedge fund manager members are, in the majority of cases, clients of clearing members rather than direct clearing members of the HKEx CCPs. We, therefore, limit our comments to issues raised within the consultation that are relevant to clients, although, as a general point, we support all proposals that reduce the risk of failure of the HKEx CCPs. For each proposal, we encourage the HKEx to take account of industry feedback and comments.

AIMA's comments

AIMA supports the HKEx review of the HKEx CCPs to ensure that their risk management measures and procedures are sufficient, that those measures and procedures can pass appropriate stress tests and that the HKEx CCPs have adequate financial resources to ensure that they can meet all of their obligations. In particular, the HKEx CCPs should ensure that the required contributions from their clearing members towards a guarantee fund are of a sufficiently large size. The default fund is an important risk reducing measure both in terms of the actual and perceived stability of a clearing house. As buy-side firms, AIMA's members will benefit from having their trades cleared with the HKEx CCPs due to the reduction of their counterparty credit risk and the added transparency and stability which central clearing brings to the market. Therefore, buy-side firms have a strong interest in ensuring

¹ AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector - including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,300 corporate bodies in over 40 countries.

² The leaders of the G20 nations' commitment at the September 2009 summit in Pittsburgh that "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories."

³ The Hong Kong Securities Clearing Company Limited (HKSCC), The HKFE Clearing Corporation Limited (HKCC) and The SEHK Options Clearing House Limited (SECH) (hereafter, the "HKEx CCPs").

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA

Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: <http://www.aima.org>



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that risks are properly mitigated, that the HKEx CCPs are able to remain solvent even in periods of financial stress and that they are able to guarantee the obligations of the contracts they clear.

International standards and requirements

As is acknowledged in the Consultation, it is particularly important that the HKEx CCPs meet both the requirements of the Securities and Futures Commission (SFC) and the international principles set out by the Committee on Payments and Settlement Systems and the International Organization of Securities Commissioners (IOSCO)⁴ if they are to ensure the competitiveness of the HKEx CCPs and to ensure the stability of the HKEx CCPs. Further, it is important that standards are sufficiently high so that buy-side firms in Europe and the United States may execute trades in the Hong Kong market and clear trades with the HKEx CCPs. In the proposed EU Regulation on OTC derivatives, central counterparties and trade repositories (commonly referred to as the European Market Infrastructure Regulation or 'EMIR'), European financial and non-financial companies may only enter into certain types of derivative contract, if that contract is cleared with a CCP that is either authorised or recognised under EMIR.

EU based CCPs may be 'authorised' under EMIR, whilst third-country CCPs may be 'recognised' under EMIR, subject to certain conditions. Whilst EMIR is still being debated in the European Parliament (the EP) and the Council of Ministers (the Council), and these conditions are still one of the outstanding topics of debate, both the EP and the Council have retained the European Commission's original proposal that, to be recognised, a third country CCP must be subject to 'equivalent' regulation and supervision by their home country supervisor. If a third country's regime is not deemed 'equivalent' by the European authorities, European entities will not be allowed to enter into a contract that requires clearing on a third country's CCP, such as the HKEx CCPs. Please see the Annex of this letter for AIMA's summary of the latest positions of the European Parliament and Council regarding EMIR.

The US Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), at Title VII, has similar provisions that state that US counterparties may only use a CCP that is registered with, or exempt from the registration requirements of, the US Commodity Futures Trading Commission (CFTC). Again, the Dodd-Frank Act requires the foreign derivatives clearing organisation to be subject to 'comparable' regulation in their home country if they are to be exempted. It is currently unclear what specific requirements will allow a decision to be made that a third country regime is equivalent or comparable with that of the EU or the US, partly because the legislation in both jurisdictions has not yet been finalised or implemented.

Compliance with international principles set by CPSS and IOSCO are likely to help the HKEx CCPs towards achieving such recognition so that non-Hong Kong entities may trade and clear derivative contracts in Hong Kong⁵. For this reason, it is important that HKEx reviews its proposals in light of the CPSS-IOSCO Principles for Financial Market Infrastructures and similar proposed requirements in Europe and the US. If the HKEx CCPs are not able to align their requirements, it is possible that the HKEx CCPs will not be able to accept trades from any US or EU entities, including as clearing members or clients of clearing members, putting the HKEx CCPs at a competitive disadvantage to their competitors who can gain such recognition.

Pooled margin accounts

As well as financial resources provided by clearing members, clients of clearing members are also required to post collateral as initial margin to cover their exposures. Through arrangements with a CCP and its clearing members, this margin may be held with the CCP so that, should a clearing member default, the collateral and the position which it backs can be transferred to a new clearing member. We note that, on page 32 of the Consultation, it

⁴ Those in the 2004 CPSS-IOSCO 'Recommendations for central counterparties' and those in the recently proposed 'CPSS-IOSCO Principles for Financial Market Infrastructures', that update the 2004 Recommendations.

⁵ It should be noted that under EMIR, the requirement for recognition may apply equally to CCPs clearing OTC derivatives and listed derivatives, as well as equity securities, bonds and other financial instruments. The US requirements only apply to clearing of 'swaps'.

The Alternative Investment Management Association Limited
167 Fleet Street, London, EC4A 2EA

Tel: +44 (0)20 7822 8380 Fax: +44 (0)20 7822 8381 E-mail: info@aima.org Internet: <http://www.aima.org>



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states that “a pooled margin model might not be appropriate for margins related to clients’ futures and options positions at HKCC and SEOCH”.

We agree that pooled margin accounts may not be appropriate for certain clients and that it may be more appropriate to segregate each client’s collateral in an individual account. By pooling the margin of all of the clients of a particular clearing member, each client is exposed to the risk that they will have to make up any short fall in the pooled account caused by the default of a client at the same time as the clearing member defaults (known as “fellow customer” risk). Individual account segregation provides buyside firms with greater confidence that their assets and positions will be protected upon insolvency and can be transferred to a new clearing member, so that they can maintain their market positions. They are, therefore, less likely to withdraw from the market in times of market stress, which act would add to the losses and precipitating the downfall of weakened or failing clearing members.

For this reason, we believe that the HKEx CCPs should, where they do not do so already, at least offer clients the option of having assets and positions segregated in individual accounts at the CCP level on reasonable commercial terms. The regulatory regimes in both the EU and the US are, when finalised, likely to require CCPs to offer some form of individual account segregation, at least on an optional basis. As discussed above, if the HKEx CCPs wish EU and US clearing members and clients to use its services and trade in the Hong Kong market, providing segregated individual accounts should be seriously considered by HKEx.

Conclusion

AIMA supports the HKEx in reviewing and seeking to improve risk management and stress testing at the HKEx CCPs. We emphasise in particular that, when the HKEx reviews its risk management policies and procedures, these are amended, where appropriate, to meet the highest internationally agreed standards.

We thank you for this opportunity to comment on the Consultation and we are, of course, very happy to discuss with you in greater detail any of our comments. [REDACTED]

Yours faithfully,

[REDACTED]