

財經事務及庫務局局長

香港金鐘添美道二號
政府總部二十四樓



SECRETARY FOR FINANCIAL
SERVICES AND THE TREASURY

24/F, Central Government Offices,
2 Tim Mei Avenue, Admiralty
Hong Kong

傳真號碼 Fax No. : 2537 1736

電話號碼 Tel. No. : 2810 2280

27 August 2012

The Honourable Gary Gensler
Chairman
U.S. Commodity Futures Trading Commission
Three Lafayette Centre 1155 21st Street, NW
Washington, DC 20581
USA

Dear Gary,

We appreciate an opportunity to comment on the Commodity Futures Trading Commission (“CFTC”)’s draft interpretative guidance on the “Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act” (the “Proposed Guidance”) in July 2012. We are writing to express our concerns and to seek clarification on various aspects of the Proposed Guidance as raised by our regulators and the industry.

2. The Proposed Guidance indicates that the CFTC intends to regard non-US persons as being subject to the CFTC registration requirements under certain conditions. We are concerned that such an approach to extend the CFTC’s jurisdiction to the operation of foreign financial institutions would result in such institutions having to meet overlapping, and possibly conflicting, regulations in the US and their home jurisdictions, and would undermine regulatory reform efforts currently under way in other jurisdictions including Hong Kong. Moreover, the proposed extension of the CFTC’s jurisdictional reach would increase compliance costs for global market participants and more importantly, may discourage market participants from entering into Over-the-counter (“OTC”) derivatives transactions with US persons, resulting

in market fragmentation and liquidity withdrawal. Particularly for those provisions that may be in conflict with local legislation, enforceability is called into question.

Defining “US Persons”

3. Regulators in Hong Kong, the Securities and Futures Commission (“SFC”) and the Hong Kong Monetary Authority (“HKMA”), have examined the Proposed Guidance with market participants operating in Hong Kong with the view to assessing the impact that such guidance may have on them and their operations here. The general feedback is that there is insufficient clarity as to how the US rules and regulations will be applied to non-US based swap dealers (“SDs”) and non-US major swap participants (“MSPs”), leading to concerns about the practical implementation issues arising from the Proposed Guidance. A major area of concern is how the term “US person” will be construed. As you will agree, it is critical for a non-US person to be able to independently determine if it falls within the registration requirements of the CFTC rules. As we understand it, this hinges on whether the non-US person’s counterparty is a “US person”. In this regard, our market participants are concerned that the Proposed Guidance does not provide sufficient clarity or specificity to enable them to ascertain whether their counterparties will be construed by the CFTC as US persons. Consequently, it is also difficult for them to assess the full impact of the registration requirements on them and their operations. This also hampers the ability of global players in the OTC derivatives market to streamline their structure and operations when dealing with both US and non-US counterparties.

Enforceability Issues

4. Besides, financial institutions registered as non-US based SDs are required to report all OTC derivatives transactions to a Swap Data Repository (“SDR”). Market participants are concerned about whether they could legally transfer customer data to the foreign SDRs to meet CFTC’s reporting requirements, given that the client account opening documents are governed by the local laws and in the context of fulfilling the reporting obligations, the US authorities are neither the banks’ home or host regulators. Therefore, for the avoidance of legal risk, non-US based SDs may be unable to

continue dealing with non-US customers in the OTC derivatives market unless these customers provide explicit consent to release their data to meet the US reporting requirements or substituted compliance is permitted. This places them at competitive disadvantage versus peers which are not subject to the same restriction.

“Substituted Compliance”

5. The Proposed Guidance indicates that the CFTC will allow for “substituted compliance”, i.e. compliance with local laws and regulations will be regarded as sufficient if such laws and regulations are comparable to US rules and regulations. In the extreme cases, such requirements may force financial institutions to refrain from certain OTC derivatives activities, thus hampering liquidity in the global markets. However, it isn’t clear how the CFTC will assess comparability for the purposes of allowing “substituted compliance”, making it rather difficult for market participants and foreign regulators to understand how comparability will be applied in practice.

Regulatory Cooperation on Cross-Border Transactions

6. We believe the international community should work together to build a cooperative framework for the regulation of OTC derivatives market on the global basis. As the OTC derivatives market is a global one, it is important that regulators adopt comparable rules based on guidance and standards set by international standard setting bodies. International standards and principles serve to harmonise regulatory standards and minimise regulatory arbitrage, while also respecting jurisdictional authority. Regulators in major markets have been working together through international standard setting bodies (such as the International Organisation of Securities Commissions and the Committee on Payment and Settlement Systems of the Bank for International Settlements) to agree on common standards and principles for regulating the OTC derivatives market. Reform efforts in individual markets, including Hong Kong, have also been progressing by reference to these international standards and principles.

7. As foreign jurisdictions would have primary responsibilities in developing and implementing the regulatory frameworks for the OTC derivatives market participants and their transactions in their own jurisdictions. To avoid regulatory overlap and in the spirit of international comity, we propose that foreign jurisdictions be responsible for the regulation of OTC derivatives activities in their home jurisdictions in accordance to international standards. Under this framework, the application of the CFTC's rules to non-US persons, e.g. foreign banks, should only be confined to their legal entities based in the US (i.e. US branch or subsidiary). In this connection, we would like to request the CFTC to reconsider the need and the implication of the extraterritorial application of the US derivative regulations, including swap dealer registration requirement for non-US persons (including Hong Kong financial institutions).

8. We understand and appreciate CFTC's concerns over the activities of US persons and their overseas branches and subsidiaries conducted outside the US that may have a significant connection and impact on the US markets and thus giving rise to CFTC's proposal for cross-border application of their regulations. We should continue to explore how foreign subsidiaries of US entities could meet the CFTC's rules on swap without coming into conflict with local regulations. Before international consensus is reached on this important matter, we would like to propose that CFTC defers application of its regulation with respect to non-US person so that regulators in international forum could work out the arrangement for regulating cross-border OTC transactions in a coordinated manner.

Central Clearing of OTC Derivatives

9. Furthermore, under the Proposed Guidance, non-US based SDs in order to comply with CFTC requirements, will be compelled to clear their OTC derivatives transactions through a US regulated central counterparty ("CCP") in certain cases. Specifically, non-US based SDs who transact with US counterparties, or counterparties guaranteed by US persons, will have to clear their OTC derivatives transaction through a CCP that is either registered in the US as a Derivatives Clearing Organization ("DCO"), or exempted from having to be registered as a DCO. This requirement has significant implications because it means non-US based SDs who want to clear through

their local (non-US) CCPs, some of which provide service for unique local products, could do so only if such CCPs would have been registered (or exempted from being registered) as DCOs before the implementation of the clearing obligations under the Dodd Frank Act. If the CCPs fail to obtain such registration or exemption status in good time, there will be significant disruption to the global OTC derivatives market. For example, many market participants will need to establish in short time new clearing arrangements with CCPs which are US-regulated DCOs, or already registered as such. Otherwise, they may have no choice but stop transacting with US persons at all to avoid risking non-compliance. Either way, the consequences for market participants will be significant.

10. It is believed that the above unintended and undesirable consequences can be avoided or minimised. In this regard, I urge the US authorities to consider the following:-

- i. **Transitional arrangement.** Allow OTC derivatives transactions conducted outside the US to carry on as usual during the processing period for a DCO application or a “substituted compliance” application;
- ii. **Exempting foreign CCPs.** Provide exemption from the DCO registration if a foreign CCP is not systemically important to the US market. For example, a de minimis exemption could be provided (similar to the de minimis threshold for the SD registration) such that foreign CCPs that clear OTC derivatives transactions for US persons below a certain threshold, may be exempted from the DCO registration; and
- iii. **Recognising foreign CCPs.** Develop a simplified process for recognising foreign CCPs that are regulated by competent authorities subscribing to international standards.

11. In conclusion, we call for greater coordination internationally on implementation of OTC regulations, particularly those with cross border implications. We hope that the CFTC, SEC and the US Treasury will defer the application of the US rules and regulations over non-US persons and work with the international community on a coordinated framework on regulatory

cooperation in cross-border OTC transactions. We also hope that US authorities would provide greater clarity to the Proposed Guidance and to recognize the OTC derivatives regulatory regimes of overseas jurisdictions on the basis of international standard.

Yours Sincerely,



(Professor K C Chan)
Secretary for Financial Services and the Treasury

c.c. Secretary of the Treasury, USA
(Mr Timothy Geithner)

Chairman, U.S. Securities and Exchange Commission
(Ms Mary L. Schapiro)

Consul General of the United States of America in Hong Kong
(Mr Stephen Young)

Chief Executive, Hong Kong Monetary Authority
(Mr Norman Chan)

Chief Executive Officer, Securities and Futures Commission
(Mr Ashley Alder)

Hong Kong Commissioner for Economic and Trade Affairs, USA
(Mr Donald Tong)