

OTC Clearing Hong Kong Limited
(A subsidiary of Hong Kong Exchanges and Clearing Limited)

By Commission Website

11 November 2019

Mr. Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW,
Washington, DC 20581

Re: Exemption from Derivatives Clearing Organization Registration (RIN 3038-AE65)

Dear Mr. Kirkpatrick,

OTC Clearing Hong Kong Limited (“OTC Clear”) appreciates the opportunity to submit this letter to the Commodity Futures Trading Commission (“Commission” or “CFTC”) with respect to the supplemental notice of proposed rulemaking (“SNPR”) regarding Exemption from Derivatives Clearing Organization Registration¹. OTC Clear is a Hong Kong-incorporated company limited by shares and a majority-owned subsidiary² of Hong Kong Exchanges and Clearing (“HKEX”). OTC Clear was established for the purpose of providing clearing services for OTC derivatives as a central counterparty. It has been recognized as a clearing house by the Securities and Futures Commission (the “SFC”), Hong Kong’s statutory regulator for the securities and futures market. Pursuant to Section 5b(h) of the Commodity Exchange Act, OTC Clear has been granted an order of exemption from registration as a derivatives clearing organization (“DCO”) on the basis that it is subject to comparable, comprehensive supervision and regulation by the SFC³.

OTC Clear welcomes the proposal to codify the exempt DCO framework and to further enable U.S. customers to clear swaps at an exempt DCO subject to demonstration of requisite collateral protections. Consistent with the objectives and benefits stated in the SNPR, we believe that the proposed amendments will provide greater access to cleared products to U.S. customers while also increasing the number of clearing members available to U.S. customers, thereby helping to reduce increasing concentration risk among FCMs (as well as among DCOs). In addition, it would lift constraints on exempt DCOs to provide central clearing to U.S. customers for swaps (thereby offering greater options for diversification and risk management purposes) and further incentivize customers to voluntarily clear swaps in support of the stated G20 objectives.

¹ Exemption from Derivatives Clearing Organization Registration, Vol. 84, Federal Register 35456, 23 July 2019

² HKEX holds 75.96% of the issued share capital of OTC Clear and has 100% of the voting rights.

³

<https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/otcclearcoexemptorder12-21-15.pdf>

OTC Clear believes it would be beneficial to give U.S. customers the choice to access the broadest range of central clearing services and financial products (such as products which can only be cleared at the regional CCP for U.S. customers) that would meet standards for a Qualified CCP. This would allow customers to construct an optimal business solution and to hedge their risk accordingly. OTC Clear provides central clearing for a broad range of USD, HKD, EUR, offshore Renminbi (i.e. CNH) OTC interest rate swaps (IRS)⁴ and OTC currency products between USD and HKD, CNH, INR, KRW and TWD which would allow customers to better realize these benefits.

Assessing Substantial Risk to the U.S. Financial System

OTC Clear appreciates the motivation of the proposal to determine whether an exempt DCO poses substantial risk to the U.S. financial system. However, we believe that basing such determination solely on initial margin should be supplemented and viewed from the perspective of actual exposure and realizable risk to the U.S. financial system rather than a comparative measure of risk under management.

OTC Clear would propose further discussion and consideration to the following points:

1. Initial Margin as the sole measure of 'substantial risk': We agree that the relative amount of initial margin can be a measure of relative risk for a CCP, however we question whether it is appropriate as the sole measure to determine substantial risk, particularly given the collateral protections in place (and required vis-a-vis the SNPR) by an exempt DCO or DCO as may be the case. The relativity of initial margin amounts can generally represent market share.

Furthermore, we believe that some components of initial margin calculations (e.g., methodology, product type swap account structure (gross vs net), margin add-ons (credit add-on, concentration margin), additional MPOR to assist with default management for client-cleared positions) should be adjusted for when assessing the initial margin under the SNPR. The adjustments are needed to appropriately account for relative market share, i.e., we recommend an "apple to apple" comparison on initial margin. It would appear counterintuitive that additional margin collected by a DCO that provides greater protections to the CCP, clearing members and their clients could lead to a breach in a threshold.

Moreover, we believe a holistic assessment would be ideal whereby the CFTC test would consider a risk-based method to determine significant exposure to the U.S. financial system. Such metric is already computed by CCPs globally (i.e., potential future exposure or stress loss after application of collateral), consistent with the requirements of the CPMI-IOSCO Principles for Financial Market Infrastructures ("PFMI"). We further note that the definition of risk exposure is already defined by bank capital regulations in relation to cleared exposures at a Qualified CCP as agreed among international regulators (i.e., Basel Committee on Banking Supervision ("BCBS"), Financial Stability Board ("FSB"), Committee on Payments and Market

⁴ Including single currency rate swaps, single currency basis swaps, non-deliverable interest rate swaps, cross currency interest rate swaps and cross currency basis swaps
(https://www.hkex.com.hk/Products/OTC-Derivatives/Eligible-OTC-Clear-Products?sc_lang=en)

Infrastructures (“CPMI”) and International Organization of Securities Commissions (“IOSCO”))⁵ and implemented by the U.S. Agencies (i.e., the Federal Reserve Board (“FRB”), Office of the Comptroller of the Currency (“OCC”), Federal Deposit Insurance Corporation (“FDIC”)). This framework defines exposure for (a) cleared exposures based on a risk-based method and (b) states the capital treatment for collateral posted in support of central clearing.

2. Definition of a U.S. Clearing Member for purposes of the threshold test: The SNPR proposes that a U.S. Clearing Member be defined as a clearing member organized in the U.S. or whose parent company is organized in the U.S. While we recognize the interest to have an aggregate view of initial margin placed at foreign CCPs, we are concerned that applying a threshold test at this level does not appropriately consider the extent of regulatory and legal safeguards that have been put in place for cross-jurisdictional entities and could misrepresent the actual risk exposure to the U.S. financial system. Especially as many of the controls were directly targeted to safeguard against systemic risks both domestically and internationally consistent with the G20 mandates⁶. We believe that the proposal should take into account such existing safeguards when applying a threshold test.
3. Distinction between clearing member proprietary initial margin and customer initial margin for purpose of the threshold test: The SNPR appears to apply the threshold test to the aggregate of proprietary and customer initial margin whereas the current exempt DCO framework does not apply a threshold for proprietary initial margin. This approach, together with (a) the current definition of substantial risk and (b) the broad definition of a U.S. Clearing Member (and the fact that U.S. banking entities operate many affiliated entities globally) could lead to a scenario where foreign DCOs need to limit and/or constrain clearing services for U.S. clearing members and U.S. customers only to avoid breaching the threshold test. For example, the threshold test could constrain trading in regional OTC derivatives which are used for hedging activities. The institution may be forced either not to invest further in those regional assets or leave the risk unhedged (which may pose more risk to those U.S. financial institutions). We believe such result is not intended and therefore suggest consideration to apply the threshold test only to positions directly attributable as cleared by U.S. customers.

Assessing Conditions for Exemption re: Customer Collateral Protections

OTC Clear agrees that it is important for clearinghouses to have robust collateral protections that ensure adequate regulatory and legal protections for both clearing members and clients. The CPMI-IOSCO PFMI have set out international best practices to ensure that clearinghouses demonstrate appropriate segregation of clearing participant collateral as well as legal and regulatory safeguards to protect collateral in the event of the default or insolvency of a clearing participant. Furthermore, we agree that all market participants should be aware of the nature and extent of such protections in the event of a default event.

⁵ BCBS, Capital Requirements for bank exposures to central counterparties (<https://www.bis.org/publ/bcbs282.pdf>)

⁶ https://www.mofa.go.jp/policy/economy/q20_summit/2009-2/statement.pdf

Legislation in Hong Kong provisioned in the Securities and Futures Ordinance (Cap. 571) includes legally binding requirements which requires segregation of client assets from the assets of the clearing member at Hong Kong CCPs and provides for proceedings (such as default) of such Hong Kong CCPs to take precedence over law of insolvency. Moreover the existing customer collateral protections framework⁷ of OTC Clear provides certainty as to the segregation of client collateral as well as rule provisions that would require OTC Clear to pay net sums to clients of a defaulting clearing member in the event of a default event. The account structure clearly segregates client contracts and collateral in a given position account from other clients and the clearing member's proprietary account through separate books and records.

Modification or Termination of Exemption

OTC Clear requests further discussion and clarification on the scenario where an exempt DCO nears or exceeds the threshold test. The SNPR does not provide sufficient information or technical detail on this point nor how it would be implemented into the regulatory framework (e.g., MOU, cross-jurisdictional agreements, grace period, transition period to apply for full registration), therefore we are unable to provide substantial feedback at this time. We strongly recommend the supplemental detail be discussed with CCPs prior to formalization and implementation.

We note, that under the current draft of the SNPR, if an exempt DCO were to approach or breach the threshold tests, it would require the exempt DCO to either liquidate positions of a clearing participant (proprietary and/or U.S. customer) to a level below the threshold, or even the entire portfolio of U.S.-affiliated clearing participants should the exempt status be revoked. As participation in international markets is common in today's markets, it is envisaged that the proportion of clearing activity related to U.S. clearing member (as currently defined to include all affiliates/subsidiaries) at an exempt DCO could quickly and/or easily breach the second threshold, potentially resulting in termination of swap clearing services to U.S. clearing members and U.S. customers.

⁷ See, OTC Clear Rates and FX Derivatives Clearing Rules Chapter 8, 9 and 13, available at https://www.hkex.com.hk/Services/Rules-and-Forms-and-Fees/Rules/OTC-Clear/Rules?sc_lang=en

Conclusion

OTC Clear supports the CFTC initiative to codify the SNPR that will enable U.S. customers to access an exempt DCO, however with consideration to the comments provided in this letter. In addition, OTC Clear supports the CCP12 industry response⁸ which supports deference to jurisdictions that offer comparable legal and regulatory protections for collateral.

We appreciate the opportunity to provide these comments and look forward to an opportunity to discuss our comments directly with the Commission. Should you have any questions on our views in this letter, please do not hesitate to contact Mr. Ketan Patel, Head of FIC and OTC Clearing Risk Management (by email to ketanpatel@hkex.com.hk) or Mr. Jacky Mak, Head of OTC and FIC Business Development (by email to jackymak@hkex.com.hk).

Sincerely,



Mr. Calvin Tai
Chief Executive
OTC CLEARING HONG KONG LIMITED

⁸ See, website link to CFTC Comments for Proposed Rule 84 FR 35456:
<https://comments.cftc.gov/PublicComments/CommentList.aspx?id=3009>