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Consultation paper on introducing mandatory clearing and expanding mandatory reporting

London, October 31st 2015

Dear Sirs,

We welcome the publication of the *Consultation paper on introducing mandatory clearing and expanding mandatory reporting* (the "***Consultation Paper***") by the SFC and the HKMA (the "***Authorities***") and we appreciate the opportunity to provide you with our comments.

Introduction

Markit[1] is a leading global diversified provider of financial information services.[2] Founded in 2003, we employ over 4,000 people in 11 countries and our shares are listed on Nasdaq (ticker: MRKT). Markit has been actively and constructively engaged in the debate about regulatory reform in financial markets, including topics such as the implementation of the G20 commitments for OTC derivatives and the design of a regulatory regime for benchmarks. Over the past years, we have submitted more than 120 comment letters to regulatory authorities around the world and have participated in numerous roundtables.

Markit's derivatives processing platforms provide middleware services[3] to numerous participants in the global OTC derivatives markets and play an important role in supporting firms' compliance with regulatory requirements including central clearing, confirmation, straight-through-processing and reporting. Specifically, the MarkitSERV platforms facilitate the electronic confirmation of a significant portion of OTC derivatives

[1] Please see www.markit.com for further details.
[2] We provide products and services that enhance transparency, reduce risk and improve operational efficiency of financial market activities. Our customers include banks, hedge funds, asset managers, central banks, regulators, auditors, fund administrators and insurance companies. By setting common standards and facilitating market participants' compliance with various regulatory requirements, many of Markit's services help level the playing field between small and large firms and herewith foster a competitive marketplace. For example, Markit's KYC Services provide a standardised end-to-end managed service that centralizes "Know Your Client" (KYC) data and process management.
[3] In the trade workflow model prevalent in the OTC derivatives markets the MarkitSERV platforms provide "middleware" services that generally occur post-execution and pre-clearing.

transactions, submit them for clearing to 16 CCPs globally, and, for many counterparties, report their details to trade repositories ("***TRs***") in the United States, Europe, Hong Kong, Japan, Singapore, Australia and Canada.[4]

Such services, which are offered also by various other providers, are widely used by participants in these markets today and are recognised as tools to increase operational efficiency, reduce cost, and secure legal certainty. With globally over 1,500 firms using the various MarkitSERV platforms that process, on average, 80,000 OTC derivative transaction processing events per day our legal, operational, and technological infrastructure plays an important role in supporting the global OTC derivatives markets.

Comments

We welcome the publication of the Consultation Paper by the Authorities and we appreciate the opportunity to provide you with our comments.

We note that the Authorities have built on their regulatory regime for OTC derivatives by proposing the introduction of mandatory clearing rules and expanded reporting rules, following the first phase of the reporting rules which came into effect in July 2015. We very much appreciate that the Authorities "welcome market views on where proposals may be problematic or result in unintended consequences"[5] and their intention to "maintain a close dialogue with the industry and provide market participants with sufficient lead time to prepare for the implementation of the requirements".[6] Mandatory clearing and reporting rules have been implemented in several other jurisdictions already[7] and various elements of the requirements have been reviewed or are currently under review by local regulators. We therefore urge the Authorities to consider the experiences made and the lessons learned in such other jurisdictions.

Please find below Markit's responses to several of the questions the Authorities asked in the Consultation paper. Our comments are based on the experience we have gathered in facilitating market participants' compliance with clearing and reporting requirements, similar to the one proposed by the Authorities, in several other major jurisdictions. Our recommendations are designed to allow for a smooth and timely implementation of the clearing and the Phase 2 reporting requirements in Hong Kong, while avoiding unnecessary burden or imposing requirements that provide little benefit.

Specifically, we recommend that the Authorities, (1) in relation to the clearing requirement: (a) do not require any backloading of existing transactions; (b) only consider mandating clearing for products that are offered by more than one CCP and make every effort to recognize and authorise international CCPs before the start of the clearing requirement; (c) allow firms to exit the clearing requirement when they fall below the clearing threshold; (d) review clearing of NDFs in the next phase given the relevance of these products in Hong Kong; and (e) provide certainty for smaller firms by establishing a clearing exemption for them; and (2) in relation to the reporting requirement: (a) allow for the use of a minimum remaining maturity for the backloading of outstanding transactions; (b) clarify that the reporting of "dead" transactions is not required; (c) extend implementation timing to 12 months or make use of an implementation that is phased-in by asset class; and (d) design valuation reporting to reflect market practices, e.g. by allowing for the reporting of valuations that are provided by third parties.

[4] Globally, we currently report transactions to TRs for over 100 firms and more than 1,000 entities, including most of the large, globally active dealers.
[5] CP Par 206
[6] CP Par. 208
[7] Mandatory clearing requirements in the US (Category 1 participants from March 2013), Japan (Phase 1 clearing from December 2014); the EU (Category 1 participants expected from May 2016); and reporting requirements live for all major jurisdictions including the US, the EU, Australia, Singapore, Japan.

1. Clearing requirement

Question 1. Do you have any comments or concerns regarding the proposed clearing determination process, or any of the factors included in that process? If so, please provide specific details.

Question 4. Do you have any comments or concerns about our proposal to include IRS denominated in any of the G4 currencies under phase 1 clearing? If you do, please provide specific details.

We appreciate the decision of the Authorities to follow a clearing determination process that is consistent with other jurisdictions.[8] We believe that this will help avoid inconsistencies with other regimes and herewith reduce implementation burden for market participants, many of which operate on a global basis. We further welcome the Authorities' reference to and incorporation of reports by international bodies and standard setters, such as the FSB and IOSCO,[9] in their decision making process.

We generally agree with the proposed top-down and bottom-up approach, the factors being considered in the determination, and with the Authorities' conclusion that, considering the Hong Kong market, only certain IRS contracts should be mandated to be cleared at the current stage. However, we believe that proper consideration of CCP access (elaborated upon below) will be crucial for a successful implementation of the clearing requirement in Hong Kong.

Backloading

The Authorities state that there will be "no requirement to clear historical transactions, i.e. when a person crosses the clearing threshold, it will only need to clear future transactions entered into after the relevant prescribed day".[10]

We welcome the Authorities' decision to not require entities to clear derivative transactions that have been executed before the Authorities determined that such products have to be centrally cleared. Our experience has shown that mandating the backloading of transactions into CCPs can result in significant commercial and operational complexities[11] and should therefore be avoided.

Access to CCPs

The Authorities state that they will consider a number of factors when determining whether a particular category of derivative product should be subject to the clearing obligation.[12] One of the factors is "whether any Hong Kong-authorized central counterparty (CCP) provides services for clearing the product"[13] or "whether there are any authorised CCPs that provide, or are proposing to provide, services for clearing them".[14]

We believe that the Authorities will need to appropriately address the question of CCP access to ensure the successful introduction of a clearing requirement in Hong Kong. In this context we urge the Authorities to consider the following issues:

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[8] CP Par. 55
[9] FSB October 2010 report on Implementing OTC Derivatives Market Reforms and IOSCO's February 2012 report on Requirements for Mandatory Clearing
[10] CP Par. 14 (e)
[11] For example, bilateral trades may have been priced on the basis that they would not be cleared (e.g. as part of a portfolio). Compelling the clearing of such trades at a later stage may disrupt netting sets, as well as trigger their re-pricing.
[12] See CP pages 1-2, 6 (a) – (g)
[13] CP Par. 6 (g)
[14] CP Par. 56

- Given the complexities of central clearing, many derivative products are only offered for clearing by a small number of CCPs, and some only by one. However, mandating the clearing of a derivative product that is offered only by a single authorized CCP could result in significant unintended and undesirable consequences. For example, a CCP might be encouraged to employ aggressive risk management practices to start clearing a product ahead of competing CCPs in anticipation that this product will be subject to a clearing mandate at a future date. Also, mandating the clearing of a category of derivative that is offered only by a single CCP would naturally push business towards this single CCP. This would have a detrimental impact on competition in the market for clearing services and the pricing of these services. It would also lead to a concentration of risk in a small number of CCPs and thereby raise systemic risk, which would be in stark contrast to the regulatory intention when mandating central clearing.

  We hence recommend that the Authorities clarify this factor to state that, to be considered for mandatory clearing, a category of derivative product needs to be offered for clearing by "*more than one"* Hong Kong authorised CCP.

- The Authorities note that derivative products denominated in some currencies "are not supported by regional CCPs".[15] However, a number of global CCPs already actively clear interest rate swaps in the G4 currencies. We believe that the authorization of and access of Hong Kong based counterparties to these CCPs will be integral to the implementation of the clearing mandate in Hong Kong. As the Authorities are aware, the authorization and recognition of offshore CCPs that stems from equivalence and substituted compliance determinations between jurisdictions has recently garnered a lot of attention and has turned out to be more problematic than expected. This has resulted in significant concerns and uncertainty for market participants, many of whom operate globally and clear their products in foreign CCPs.

  We therefore urge the Authorities to make every effort to recognize and authorize foreign CCPs that clear relevant products well in advance of the effective date of mandatory clearing.

Parties subject to the clearing requirement

The Authorities proposed that "initially" only transactions between major dealers would be subject to mandatory clearing and that a list of such dealers would be made available to the industry and updated on a regular basis.

We welcome the Authorities' decision to focus, in phase 1 of the clearing requirement, on clearing for the market participants whose activity poses the greatest systemic risk. We further believe that any compliance dates for the clearing requirement, particularly for other, less active market participants in later stages of the implementation, must be set such that relevant market participants have sufficient time to analyse, build, test and adjust their systems and procedures before they are required to be in compliance with these requirements. The need to provide sufficient time to prepare for central clearing has also been recognized by regulatory authorities in other major jurisdictions, including the European Union, Australia and Singapore.[16]

Timing of the clearing obligation

The Authorities proposed that, once a firm had exceeded the thresholds, it would need to start clearing within 7 months.[17]

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[15] CP Par. 8 (b)
[16] For example, in the final rules for the IRS clearing obligation the EC has given due consideration to the preparation time for market participants for the frontloading obligation. See *http://ec.europa.eu/finance/financial-markets/docs/derivatives/150806-delegated-act_en.pdf*
[17] CP Par. 14 (b)

In this context, the Authorities should note that, while many financial firms with derivatives activities would generally have knowledge of clearing, their actual ability to clear will differ. We believe that the proposed period to start clearing will generally be sufficient for major sell-side firms, in particular the ones that are internationally active. However, as the Authorities plan to expand the clearing mandate in the future to also apply to other, less active firms, we recommend they consult on the appropriate time needed for these other participants to prepare for clearing and potentially provide them with a longer lead time.

Exemptions from the clearing obligation

The Authorities proposed to provide two categories of exemptions from the clearing obligation, namely an intra-group exemption and a jurisdiction-based approach to harmonize the HK regime with other major jurisdictions.

However, the proposal is silent on providing a general exemption from the clearing requirement for smaller firms. In this regard, we urge the Authorities to consider adding a third category of exemption from the clearing requirement to apply to market participants whose exposure to the relevant derivative products is small. Specifically, such exemption could incorporate a de-minimis threshold based on the Authorities' assessment of the Hong Kong market. It would provide relief on a permanent basis to smaller entities, which would apply also at the point in time when the Authorities subsequently lower the Phase 1 thresholds. We believe that smaller market participants should be exempted from the clearing obligation given the cost of clearing they would need to bear vis-à-vis the systemic risk posed by such entities. Providing such exemption now would create legal certainty for these entities who might otherwise be concerned to be captured in future phases of the clearing requirement, which could result in them deciding to discontinue their use of derivatives for risk management purposes.

Question 9. Do you have any comments or concerns about our proposal not to cover NDF transactions under phase 1 clearing? If so, please provide specific details.

The Authorities discussed the "appropriateness of mandating NDF for central clearing" and have also monitored "discussions in other major jurisdictions on whether it is appropriate to mandate NDF for central clearing".

We welcome this approach pursued by the Authorities' and their decision not to include NDFs in Phase 1 of the clearing requirement, which is also consistent with the approach taken by other jurisdictions However, the Authorities should note that NDFs in Asian currencies are quite actively traded in Hong Kong. The Authorities may therefore wish to consider whether NDF activity in Hong Kong, also given systemic risk considerations, meets the criteria set out in the clearing mandate for consideration in the next phase of the clearing mandate.

Question 20. Do you have any comments or concerns about our proposal not to include an exit threshold? If you do, please provide specific details.

The Authorities proposed that there would be no exit thresholds for counterparties once they had crossed "the applicable clearing threshold".[18] They further state that such a policy will be "good for market participants who are ready for central clearing to continue to clear transactions".[19] The Authorities further state that their policy of not using an exit threshold would also be "in line with global initiatives to implement mandatory clearing to the fullest extent possible".

We agree with the Authorities that staying in the clearing system might be "more cost efficient" for some counterparties that had passed the clearing threshold even if they were below the threshold it at a later stage. However, we believe that there is little justification to still subject a firm that has significantly shrunk the size of

[18] CP Par 84 (e), 105f.
[19] CP Par. 106

its activity to the clearing obligation, while a firm with similar activity that had never exceeded the clearing threshold would not be subject to it. Such approach might prevent the former firm from offering competitive prices to its end user clients, resulting in an unlevel playing field.

We therefore recommend that the Authorities no longer subject a firm to the clearing requirement if it has significantly reduced its activity to below the relevant threshold. The Authorities should note that commercial and regulatory capital considerations would, in any case, continue to be material factors in influencing the clearing behaviour for such firms.

2. Reporting obligation

Question 34. Do you have any comments or concerns about our proposal to include all OTC derivative products in the next phase of mandatory reporting? If you do, please provide specific details.

Backloading

The Authorities proposed that "both historical and new transactions should be reported under phase 2, as should all subsequent events".[20] They also proposed requiring the backloading of transactions that were not reported under phase 1, to the extent that these "were entered into before the commencement of phase 2 and are still outstanding at that time" and are reportable under phase 2 requirements.[21]

Our experience has shown that requiring the reporting of already outstanding ("historical") transactions significantly complicates the implementation of a reporting requirement. We therefore encourage the Authorities to reduce the burden created by this requirement on market participants. This could be achieved by allowing for the use of a minimum remaining maturity for transactions that would need to be backloaded, which should not have a significant impact on the value of the reported information from the Authorities' perspective.

We are further concerned that the Authorities' proposals as drafted may even require the reporting of some "dead" transactions, i.e., transactions that no longer exist at the time of reporting because they have expired or have been unwound in the meantime. This is because the obligation to report refers to transactions that are outstanding at the "commencement of phase 2" with a 6 month period being provided for the actual reporting, plus a potential grace period of 3 months.[22] We believe that requiring the reporting of dead trades is highly problematic as transactions that have expired or have been unwound are typically not maintained in internal systems of firms. Retrieving them for reporting purposes is therefore a challenging task while their reporting does not offer any corresponding benefit from the perspective of the Authorities. We therefore urge the Authorities to clarify that they do not require the reporting of dead trades. This would also be in line with the approach taken by regulators in other jurisdictions.[23]

Question 37. Do you have any comments or concerns about our proposal to do away with the concession period and defer commencement of phase 2 reporting until 6 months after the rules are enacted? If you do, please provide specific details.

[20] CP Par. 37 (c)
[21] CP Par 203 (e)
[22] CP Par. 205 (c)
[23] For example, ESMA, in its report to the European Commission on the EMIR Review, has recommended waiving the requirement to backload trades that were terminated before the reporting start date. See: *http://www.esma.europa.eu/system/files/2015-1260_esma_recommends_changes_to_emir_framework.pdf*

The Authorities proposed to "do away with the concession period" and, instead, "defer commencement of phase 2 reporting by 6 months (from the day the amended rules are enacted)" to provide market participants with sufficient time to prepare.[24]

We are concerned that such timeframe might not be sufficient to allow all affected firms to get ready. This is because the intention of the Authorities is to go for big bang approach where, in phase 2, the scope of the reporting would significantly expand in terms of number and type of transactions and firms. We therefore recommend the Authorities provide either a phased-in implementation that differentiates by asset class, or a general extension of the timeframe to 12 months.

Question 40. Do you have any comments or concerns about our revised proposal on the reporting of valuation transaction information? If you do, please provide specific details.

The Authorities proposed establishing a coherent framework for the reporting of valuation data including particular data fields in relation to the valuation as well as the nature of the reported valuation.

We believe that the details of the valuation data that the Authorities propose to be reported could be further refined to ensure the consistency in reporting of valuations across participants and reflect established market practices. Specifically, we suggest that, in addition to the reporting of the value of the transaction, the Authorities consider the use of additional data fields, for example to allow the reporting party to specify whether the price is dirty or clean and whether the valuation is represented as a price or an amount.

The Authorities also consider two separate cases for the reporting of valuations for non-CCP cleared transactions where the nature of the valuation would need to be reported, i.e. where margin collection is based on a mutually agreed valuation and where "internal valuations" are reported. In both such cases, we recommend the Authorities allow also for the use of "valuations provided by independent third parties" to reflect market practice. The Authorities should further note that even for CCP cleared transactions many market participants perform their own valuations or use valuations that are provided by independent third parties.[25] We therefore recommend that the Authorities explicitly allow for the reporting of internal or third party valuations also for transactions that are CCP cleared.

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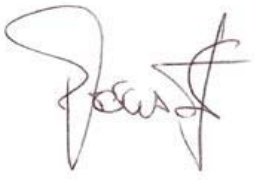
We hope that our above comments are helpful to the Authorities. We would be more than happy to elaborate or further discuss any of the points addressed above in more detail. In the event you may have any questions, please do not hesitate to contact us.

Yours sincerely,



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[24] CP Par. 37 (f)
[25] Such approach is justified also because different CCPs produce different valuations for the same product given differences in their methodologies and inputs.