5 June 2012

Mr. Shen Wei

Vice General Manager

Shanghai Clearing House

Oriental International Financial Plaza

No 318 ZhongNan Road, Shanghai, 200010

Re: Clearing proposal regarding interest rate swaps (IRS) denominated in RMB

Dear Mr. Shen,

The International Swaps and Derivatives Association, Inc. (ISDA) welcomes the opportunity to respond to the proposal regarding central clearing of RMB interest rate swaps (IRS) (the "Proposal") issued by the Shanghai Clearing House (SCH).

Since 1985, ISDA has worked to make the OTC derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 830 member institutions from 59 countries. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, central counterparties ("CCPs") and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

ISDA is actively engaged in providing input on regulatory proposals including central clearing in the United States, Canada, the European Union and the Asia-Pacific region. In the past year, we have made a number of submissions to the regulators in Hong Kong, Singapore and South Korea regarding various legislative proposals on central clearing and we have built up a strong working relationship with HKEx and SGX. Accordingly, our response draws on this international experience and dialogue with ISDA members operating in China. We understand that individual members may have their own views on different aspects of the Proposal and may provide their comments to SCH independently.

ISDA commends SCH on the Proposal which would facilitate China meeting its G20 commitments to offer central clearing for standardized and liquid OTC derivatives by the end of 2012. Given the efforts being made to increase the use of CCPs, which will profoundly affect the role of the CCPs in the broader financial infrastructure, effective CCP regulation, prudential supervision and oversight is critically important. If this is not achieved, CCPs will themselves

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become a major source of systemic risk. Thus, it is highly important that comprehensive analysis and consultation occurs on the design of the market structure and the implications for financial stability.

ISDA also notes that the CCPs that have been built in Asia have generally taken longer than expected to achieve operational status and cautions that meeting an end 2012 deadline may cause stakeholders to rush China's CCP set up when it is imperative that each step in the building process is thoroughly deliberated and stress tested. Market safety must come before expediency.

1. Global markets, regulatory coordination and timing

OTC derivatives are traded on global markets, the proposed reforms to the functioning of these markets are significant and to a large extent the proposed reforms are more relevant for Europe and the United States than for markets such as China that held up well during the financial crisis and in any case have significantly less OTC derivatives activity. Given that context, we strongly urge regulators and SCH to gather the necessary information on the impact of the reforms in the US and EU markets prior to embarking on comparable and substantial reforms in China. In that regard, it should be acknowledged that the implementation of key financial market reforms, due to their scale and complexity, is facing delay.

In addition, we urge that regulators and SCH consider the global nature of the markets when creating regulations for OTC derivatives so that the regulation does not restrict the ability of Chinese entities from continuing to participate and be competitive in the global derivatives market. To this end, it is vital that regulators seek to avoid mandating duplicative, overlapping requirements and/or infrastructure where sufficient alternatives exist. Regulators should consider which products a Chinese CCP could clear that are not already cleared by a global CCP. For example, physically settled RMB IRS trades are not cleared by foreign CCPs, but USD IRS trades are cleared by foreign CCPs.

2. Recognition of third-country CCPs

Precipitated by the financial crisis that began in 2007, regulators in both the US and the Europe have been increasing their level of oversight and regulation of the OTC derivatives markets. In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was passed in July 2010 which empowers the Commodity Futures Trading Commission (CFTC) and the Securities Exchange Commission (SEC) to draft rules regulating the OTC derivatives markets. In Europe, the European Council issued a proposal for a Regulation on OTC derivatives, CCPs and trade repositories (EMIR) which was approved by European Parliament on 29 March 2012.

Both the EU and the US regimes aim to impose clearing and reporting on a broadly defined class of OTC derivatives (with differences for some classes of derivatives) and give regulators the ultimate decision on when the clearing obligation applies. These requirements are likely to affect the trading activities of offshore branches and subsidiaries of US or EU banks, although the extra-territorial reach of the US/EU legislation is still not entirely clear at the moment. In order to attract EU or US-headquartered banks to join SCH as clearing members, SCH may need to consider the requirements in the EU and US regarding recognition of third-country CCPs.

The European Union's envisaged standards for accrediting third-country CCPs are stringent. Regulatory powers have been given to the European Securities and Markets Authority (ESMA). ESMA may recognise a third country CCP if the European Commission has determined that:

(a) the third country's legal and supervisory arrangements ensure that its CCPs comply with legally binding requirements that are equivalent to the EU's;

(b) these CCPs are subject to effective supervision and enforcement in the third country on an on-going basis; and

(c) the third country's legal framework provides for effective reciprocal access of EU CCPs.

This could potentially lead to regulatory conflict. If it were to be mandated that USD IRS trades must be cleared in China and a European-domiciled CCP also offers USD IRS clearing (which is currently the case), then not providing reciprocal access to that European clearing solution could result in ESMA deciding not to recognise China's CCP for the purpose of clearing by European banks. In the extreme case, all of the liquidity that European banks provide to China's OTC markets could disappear as a result. The same issue might also arise for RMB derivatives. Although currently, there are no foreign clearing houses offering central clearing services in respect of RMB derivatives, the increasing internationalization of RMB might lead to such services being offered offshore in the future.

In the US, if the requirements under the Dodd-Frank Act were to cover offshore branches, subsidiaries and affiliates of US banks, the CCP based in China may have to register as a derivatives clearing organization (DCO) in the US before a US bank's branch/subsidiary/affiliate may participate in central clearing in China. In order to obtain and maintain registration as a DCO with the CFTC (or SEC as the case may be) in the US, the CCP based in China will need to demonstrate compliance with certain core principles which include, among other things, (a) maintenance of adequate financial, operational and managerial resources, (b) standards for participant and product eligibility, (c) risk management capabilities and disaster recovery procedures, (d) procedures for protecting customer and member funds (such as, for example, ensuring proper segregation), (e) default, enforcement and dispute resolution procedures, (f) reporting and recordkeeping procedures, (g) settlement capabilities and (h) governance standards. The CCP based in China will also be required to enter into appropriate co-operation arrangements with US regulators.

3. Product eligibility considerations

CPSS/IOSCO papers have highlighted clearly that products eligible for clearing must be both highly standardized and liquid. "CCP clearing seems to be an effective way of reducing

systemic risk and a safer way of mitigating counterparty risk. Counterparty risk can have a destroying effect on firms as was experienced during the recent crisis. In order to increase the usage of CCP clearing, regulators and market participants should jointly work on defining the products to be eligible for CCP clearing. On the other hand, there are some discussions around CCP clearing on whether to mandate the CCP clearing or not for the defined products. However, not all of the overall derivative market products have the same liquidity and due to the need for tailor-made products for hedging reasons, it is not possible to centrally clear all types of products."[1]
Certain parameters for liquidity for each product are a minimum number of market makers, frequency of trading (daily) and depth of market (daily trading must be in sizes that are not insignificant). Some products may meet these requirements, or not, depending on tenor. For example, 5 year fixed income swaps may be traded daily in significant sizes but the same swap with a 30 year term may not trade frequently enough to be considered liquid. The CCP must have the power to refuse clearing any trades that do not meet these criteria and regulators must ensure that the CCP applies these product suitability criteria.

4. CCP licensing and governance considerations

ISDA believes that requiring the CCP to comply with CPSS-IOSCO standards[2] is an important additional criterion that should be imposed before central clearing is implemented. CPSS-IOSCO is the most authoritative global voice on CCP standards and meeting these standards would ensure that China's CCP meets or exceeds international benchmarks for CCP management.

At the operational level, best practice CCP risk management starts with stringent requirements to becoming a clearing member (CM) in terms of sufficient financial resources, robust operational capacity, and business expertise. We suggest that any CCP solution adopt CM requirements that are clear, publicly disclosed, objectively determined, and commensurate with risks inherent in the cleared products and the obligations of CMs to the CCP.

CCPs typically seek to ensure that their CMs are creditworthy by establishing a set of financial requirements for membership. Usually CMs are required to meet, both initially and on an ongoing basis, minimum capital requirements, often stated as the larger of a fixed amount and a variable amount that depends on some measure of the scale and riskiness of the CM's positions with the CCP and in other financial markets. In most cases, membership is restricted to regulated entities that meet regulatory minimum capital requirements. CMs that carry client accounts are often required to meet capital standards that are more stringent than regulatory minimum requirements. Clearing membership should be non-discriminatory: Foreign market participants should be allowed to be CMs if they meet the publicly stated CM criteria.

In addition to financial requirements, leading CCPs establish standards of operational reliability for CMs. CCPs typically impose tight deadlines for the submission of trade data and for completing various settlement obligations. The failure of a CM to meet these tight deadlines could significantly increase the CCP's risk exposures to that CM and possibly to other CMs as

[1] IOSCO Report, "OTC Markets and Derivatives Trading in Emerging Markets" July 2010, Page 32.
[2] CPSS-IOSCO "Principles for Financial Market Infrastructures" April 2012.

well. Compliance with operational deadlines is closely monitored on a day-to-day basis. Furthermore, in recent years many CCPs have been paying greater attention to the backup systems that CMs would have available if their primary operating systems were disrupted.

A CCP should legally separate its OTC derivative clearing activities from its other businesses. This prevents the commingling of default and guarantee funds across products and ensures that a CCP's OTC derivatives clearing activities are independently managed and there is no conflict of interest or exposure to these activities from its other businesses and that the CCP has dedicated resources to manage its OTC clearing activities, which is particularly important in the event of a default.

CMs should only be able introduce risk commensurate with their capital position. Further, entities that become CMs of OTC derivatives CCPs must have the ability to participate in the CCP default management process including the ability to bid for the portfolios of other CMs of the CCP. If a CCP admitted a CM (or a group of CMs) that was unable to participate fully in default management of the product it clears, there could be significant negative repercussions for the CCP and for the market. In particular, the unexpected failure of one or more CMs to participate in default management at a moment of severe stress for the CCP would reduce available resources and liquidity, place heightened burdens on other CMs, and reduce the likelihood that the CCP's risk management processes would be effective. Moreover, for there to be the right level of incentives for active participation in default management, there needs to be enough "skin in the game", which suggests not only that that the default fund needs to be allocated proportionally to risk introduced; but also that the default fund to initial margin ratio should reflect the estimated percentage of market risk remaining following the completion of the default management hedging phase.

5. Basel III and capitalisation of bank exposures to central counterparties

Whether a CCP complies with the CPSS-IOSCO standards has significant implication for banks which participate in central clearing from a regulatory capital perspective. According to the consultative paper on "Capitalisation of bank exposures to central counterparties" released in November 2011, the Basel-proposed framework for capitalizing exposures to a CCP relies on the new and more demanding CPSS-IOSCO Principles for Financial Market Infrastructures (FMIs). When a CCP complies with the CPSS-IOSCO Principles ("QCCP"), the CCP will receive preferential treatment compared with CCPs that do not comply ("NQCCPs"). Basel expects that all large CCPs will be compliant with these new CPSS-IOSCO principles, since the framework provides incentives to the CM (thorough capital rules) to deal with these safer and more robust CCPs.

When a bank enters into bilateral OTC derivative transactions, Basel III introduced the concept of credit valuation adjustment (CVA) which is the capital that banks are required to hold to protect against the risk that the counterparty defaults. However, banks will not be required to hold capital for CVA risk for derivatives that are centrally cleared.

Under Basel III, the exposure will be measured using the Current Exposure Method (CEM), Internal Model Method (IMM) or the Standardized Method (SM). The risk weight for a QCCP is 2% and if collateral is posted in a CCP-bankruptcy remote manner, the risk weight will be 0%. If it is a NQCCP, the risk weight will be the bilateral risk weight of the CCP. As such, the applicable risk weight will be set at least 20% (if the relevant CCP is a bank) or 100% (if the relevant CCP is a corporate financial institution as per Basel II guidelines).

For a client of a CM, the client can use the same risk weights, only if, certain segregation and continuity requirements are met. The risk weight for a QCCP is 2% if the CM guarantees that the client will not suffer any losses due to changes in the value of its transactions in the event of a CCP default. If collateral is posted in a bankruptcy remote manner from CCP, the risk weight will be 0%. Otherwise, the client will need to capitalise the exposure to the CM as a bilateral trade. However, if a client is not protected from loss in the case of a joint default of both the CM and other clients, but meets all other requirements for segregation and continuity of accounts, a risk weight of 4% has been proposed for such cases. If collateral is held at the CCP on behalf of the client and is not on a bankruptcy remote manner, depending on the varying degree to which the conditions are met, a 2% or 4% risk weight will be applied. Otherwise, the risk weight of the collateral will be as applicable in a bilateral trade.[3]
In addition, banks must apply a risk weight of 1250% to their default fund contributions to a NQCCP which could potentially be a lot higher than the risk weight applied to default fund contributions to a QCCP.[4]

We understand that the Administrative Measures on Commercial Banks' Capital (Consultative Draft) (the "Administrative Measures") issued by the China Banking Regulatory Commission on August 15, 2011 have similar requirements.[5] Although the Administrative Measures do not elaborate on what is a "qualifying CCP", we believe the CPSS-IOSCO standards are likely to be the benchmark for all CCPs including any CCP in China.

ISDA believes that it is vital for SCH to meet the CPSS-IOSCO standards in order to attract banks to participate in the voluntary central clearing solution offered by SCH.

6. Portability and segregation

We understand that the Proposal only covers direct clearing. Nonetheless, we would like to touch on client clearing in this letter given that client clearing will be the next step which SCH needs to consider after the implementation of direct clearing.

[3] See paragraph 114 of "Capitalisation of bank exposures to central counterparties" released by Basel Committee on Banking Supervision in November 2011, page 14.
[4] For a QCCP, the default fund exposures is determined according to a risk sensitive formula that considers (i) the size and quality of a QCCP's financial resources, (ii) the counterparty credit risk exposures of such CCP, and (iii) the application of such financial resources via the CCP's loss bearing waterfall. See "Capitalisation of bank exposures to central counterparties released by Basel Committee on Banking Supervision" November 2011, page 14.
[5] See annex 7 of the Administrative Measures.

As pointed out in the CPSS-IOSCO report, “A CCP should have rules and procedures that enable the segregation and portability of positions of a participant’s customers and the collateral provided to the CCP with respect to those positions”. [6]

There is a strong argument to be made for permitting market participants to contract on segregation and portability, as opposed to prescribing a method via regulation. One possibility would be to establish omnibus segregation as a default standard, but permit clearing members and their clients to negotiate to create individually segregated accounts to contract around the standard. This would permit those who value segregation more highly than it costs CMs to segregate, to negotiate mutually beneficial arrangements with CMs. Such contracts would reflect information available only to the contracting parties, but which regulators would not know when setting a one-size-fits-all standard. That said, end-users will need to be educated as to the tradeoff between highly segregated collateral and less segregation.

In addition, there are many different ways that margin can be segregated depending on how the margin is posted and held and the segregation in place in a given situation. This is critical in relation to whether customer positions and related margin are likely to be successfully ported. The impact from a Basel III point of view for banks that are clients of clearing members is substantial.

7. Margin and default fund considerations

As we mentioned above, Basel III proposes different capital charges for trade exposures, collateral exposures and default fund exposures to a CCP. If the CCP meets CPSS-IOSCO standards, the capital charge for a trade exposure is 2%, while the capital charge for the default fund exposure varies depending on the comparison of the CCP’s default resources to the Basel defined “CCP hypothetical capital requirement” – due to the use of the risk insensitive Current Exposure Method many default fund contributions could face a risk weight in excess of 100%. This is one reason why industry participants and CCPs are considering amending CCP financial resources such that a CCP protects itself through higher initial margin requirements rather than through risk mutualisation in the default fund.

The industry also highly recommends that the number of times that a CCP can call on a CM to replenish the compensation fund should be capped. Otherwise, CMs face potentially unlimited liability and may be restricted by home country regulators from becoming a CM of such a CCP. ISDA notes that foreign bank participation in Japan’s CCP was held up until the issue of uncapped liability could be satisfactorily resolved.

8. Local law considerations

As pointed out in the CPSS-IOSCO paper, legal risk is an important issue to consider when a country sets up a CCP. Legal risk may arise from an unexpected application of a law and regulation which may render contracts illegal or unenforceable. Legal risk also includes the risk

[6] CPSS-IOSCO “Principles for Financial Market Infrastructures” April 2012, page 82.

of loss resulting from a delay in the recovery of financial assets or a freezing of positions resulting from a legal procedure. Principle 1 of the "CPSS-IOSCO Principles for financial market infrastructures" is that "a FMI should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions." [7]

The legal basis consists of the legal framework (e.g., general laws and regulations that govern property, contracts, bankruptcy, corporations, securities, banking and secured interested) in the relevant jurisdictions and the CCP's rules, procedures and contracts. We would urge SCH to establish rules, procedures and contracts that are clear, understandable, and consistent with the legal framework and provide a high degree of legal certainty. We believe that a CCP should also consider whether the rights and obligations of the CCP, its participants and other relevant parties, as set out in its rules, procedures and contracts are consistent with relevant industry standards and market protocols. We understand that SCH has been consulting a number of market participants on the draft Proposal. We commend SCH for actively engaging the industry in the discussion.

Regarding China's legal framework for central clearing, our members have identified several issues which we would like to share with you in this letter. We understand that resolving these legal issues may require further legislation and/or regulations and thus are not within SCH's control. Nonetheless, we hope that SCH would look into these issues and work with the industry and relevant authorities to identify possible solutions.

(1) Enforcement of collateral

We understand that under current Chinese law, cash margin may be posted as a pledge of a fixed amount deposit or specified physical cash. [8] We understand from our members that any collateral posted to SCH will be subject to a pledge created under China's Security Law. Our members have raised several questions regarding enforceability of a pledge created over cash collateral in the event of a default by a CM.

Firstly, we understand that a valid pledge under Chinese law must be created over certain specified asset. When parties conduct OTC derivatives transactions, collateral often needs to be exchanged on a frequent basis according to the mark-to-market value of the transactions between the parties. This means that the amount in the collateral account will fluctuate and hence a question arises as to whether it is possible to create a valid pledge over such a fluctuating pool of cash which does not satisfy the requirement of "specified asset".

Secondly, without any express provision of law, it is unclear whether SCH (or a CM in the case of client clearing) will be able to enforce against the collateral posted by a defaulted CM (or a CM's client in the case of client clearing) without going through a court proceeding. We understand that rights of enforcement are limited under China's Security Law. When entering into a pledge contract, the pledgor and pledgee may not provide in such contract for the transfer of ownership of the pledged property to the pledgee in the event that the pledgee has not received

[7] See CPSS-IOSCO "Principles for Financial Market Infrastructures" April 2012, page 21.
[8] See article 85 of the Supreme People's Court Interpretation on the Security Law.

payment in full by the end of the period for repayment of the obligation (i.e. foreclosure on default). When the pledgee has not received payment at the end of the repayment term, the pledgee's remedies are with the agreement of the pledgor to receive repayment by: (a) converting the pledged property into value (i.e. transferring the property into the name of the pledgee); or (b) obtaining the proceeds from the auction or sale of the pledged property. In the event of failure to reach an agreement at the time of the pledgor's default, the pledgee can file an action in courts. Thus the enforcement rights of pledgees are relatively weak under Chinese law, as there is no contractual power of sale capable of being exercised independently by the pledgee as in many other jurisdictions. Enforcement against collateral is particularly problematic when a CM (or a CM's client in the case of client clearing) becomes insolvent and the administrator of the insolvent company requests the collateral posted by the CM (or the client) be returned to the administrator as part of the bankrupt property.

Furthermore, it is also unclear whether the collateral posted by a CM to the CCP (or the collateral posted by a client to the CM) is subject to a court freeze or transfer order made pursuant to the application of a creditor of the CCP (or the CM).

We understand that most OTC derivatives transactions in China's inter-bank market are not collateralized and the issues set out above are partially responsible for the lack of collateralization in the market. In order to resolve the issues regarding enforceability of collateral, we would urge regulators and courts to give central cleared OTC derivatives transactions the same protections as those given to futures contracts. [9]

(2) Close-out netting

The benefits of close-out netting are risk reduction and cost reduction. Close-out netting reduces credit risk by allowing a party to calculate its exposure to a particular counterparty on a net basis. Close-out netting will also result in cost reduction, allowing parties to use credit lines more efficiently and to maintain lower reserves to cover exposure. Enforceable netting arrangement is also a crucial part of the legal basis on which an CCP operates. The CPSS-IOSCO paper pointed out that:

> "*Netting arrangements should be explicitly recognised and supported under the law and enforceable against an FMI and an FMI's failed participants in bankruptcy. Without such legal underpinnings, net obligations may be challenged in judicial or administrative insolvency proceedings. If these challenges are successful, the FMI and its participants could be liable for gross settlement amounts that could drastically increase obligations because gross obligations could be many multiples of net obligations.*"[10]

[9] Article 40 of the Regulations on Futures Trading provides that a futures exchange or futures company (as the case may be) may enforce against the collateral posted by its members or client (as the case may be) when the member (or the client) is in default. The Supreme People's Court Provisions on Several Questions regarding Trial of Disputes on Futures Transactions prohibits courts from issuing a freeze or transfer order in respect of collateral posted by a futures company with a futures exchange or by a client with a futures company, or funds in a futures company's settlement account in certain circumstances.

[10] See CPSS-IOSCO "Principles for Financial Market Infrastructures" April 2012, page 24.

China does not have any netting legislation. Close-out netting is not a recognized legal concept under Chinese law, thus the enforceability of the close-out netting provisions is likely to be considered in the context of insolvency set-off under Chinese law. Article 40 of the 2006 Enterprise Bankruptcy Law provides that a creditor may apply to the administrator to set off what it owes an insolvent company against the debts owed to it by the insolvent company.[11] The provisions regarding set-off after the commencement of insolvency proceedings have rarely been tested in China and there appear to be some areas of uncertainty with respect to their interpretation and operation. For example, it is not wholly clear from Article 40 whether the administrator will be obliged to allow set-off if all conditions under these provisions are satisfied, or what other criteria the administrator could take into account in a decision. In addition, under the 2006 Enterprise Bankruptcy Law, the possibility of the administrator cherry-picking certain transactions, rather than looking at the net exposures, cannot be ruled out.[12] It is this lack of legal certainty that introduces unwanted risks to China's OTC derivatives industry with Chinese banks potentially suffering the most since they will not be able to get any regulatory capital relief for their netted exposures under Basel II or III. The Chinese domestic master agreement (NAFMII agreement) very much mirrors the ISDA master agreement in the import it places on the legal certainty of close-out netting. Nevertheless, transactions currently conducted under this agreement also provide no surety to the counterparties involved that they could net their exposures in the event of a default by the other counterparty.

The CPSS-IOSCO standards and the proposed Basel III framework regarding CCPs assume that netting is enforceable against the CCP and all CMs of the CCP. Without the legal certainty of enforceability of close-out netting, it is questionable whether a CCP is able to eliminate counterparty credit risk and reduce systemic risks in the financial system.

(3) Settlement finality and insolvency claw-back risk

Settlement finality is emphasised in the CPSS-IOSCO paper as an important building block for an effective risk management system.[13] A key question to settlement finality is whether transactions of an insolvent participant will be honored as final or could be found void or voidable by the liquidator or relevant authorities.

Many insolvency statutes provide for hardening periods and claw-backs.[14] Participants in a CCP system need assurance that transactions which have been novated to the CCP, payments and

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[11] Article 40 of the Enterprise Bankruptcy Law also provides that a debtor of the insolvent company cannot set off its credits if it has obtained such credits through assignment after the court accepts the insolvency case, or if the debtor has obtained such credits after knowing that the company is incapable of paying its debts or the company has filed an insolvency petition, unless such credits are incurred pursuant to law or by reason of events that take place more than one year before the insolvency petition. This limitation on insolvency set-off also applies to a creditor of the insolvent company who becomes indebted to the insolvent company under the same circumstances.

[12] Article 18 of the Enterprise Bankruptcy Law provides that the administrator of a bankrupt enterprise may decide to cancel or continue performing the executory contracts which were entered into before the bankruptcy petition is accepted by court.

[13] See CPSS-IOSCO "Principles for Financial Market Infrastructures" April 2012, page 22.

[14] For example, article 31 and 32 of the Enterprise Bankruptcy Law allow the administrator of an insolvent company to void certain transactions entered into within a specific time period prior to the acceptance of the bankruptcy petition by court.

settlements and loss allocations effected through the CCP are effective and irrevocable notwithstanding that one or more of the participants is impacted by insolvency or analogous proceedings. This usually requires the enactment of special legislation over-riding the application of the insolvency regime, e.g., the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 implementing the EU Settlement Finality Directive.[15] Where participants include entities incorporated in jurisdictions outside of the CCP jurisdiction, conflicts of laws issues (i.e., whether the special legislation will "trump" the foreign participant's insolvency laws) would also need to be considered.

To achieve one of the main objectives of clearing – reducing counterparty credit risk in the event of a default of a clearing participant, it is crucial that cleared contracts enjoy insolvency protection so that the settlement of such contracts will be final and irreversible, and payments under such contracts will not be subject to avoidance or clawback by a liquidator under insolvency law.

We understand that there are no laws or regulations providing for settlement finality in respect of centrally cleared OTC derivatives transactions in China. Accordingly, transfers made by an insolvent CM may be subject to the challenge of its administrator in the bankruptcy proceeding. We understand that there is some level of protection under China's Securities Law for transactions conducted on securities exchanges.[16] We believe that similar protection should also be given to OTC derivatives transactions cleared through CCPs.

(4) Insolvency of CCPs

Financial stability requires legal certainty of outcome in insolvency. This is essential to ensuring, that, upon insolvency, the assumptions on which credit support levels and default management procedures were structured are well founded and reliable. It is also essential in order to mitigate concerns that may deter participation in the market or in available clearing solutions.

The existence of reasonable legal certainty is essential in the event of the insolvency of the relevant CCP or one or more of its clearing members with regard to the treatment of customer and swap counterparty positions, funds, and property. ISDA believes that contingency plans for the wind up of a CCP in the event of insolvency must exist from the outset and that there must be legal certainty in place.

We believe that SCH is a well capitalised institution and the risk of SCH becoming insolvent is remote. Nonetheless, absent any explicit guarantee from the central bank, market participants

[15] The Directive lays down common rules stipulating that:

- transfer orders and netting must be legally enforceable;
- transfer orders may not be revoked once they have been entered into the system;
- the insolvency of a participant may not have retroactive effects; and
- the insolvency law applicable is the law of the Member State whose system is involved.

It further stipulates that collateral security provided to a system by a participant may not be affected by the opening of insolvency proceedings against that participant.

[16] Article 120 of the Securities Law provides that "any trading result of a transaction which has been conducted in accordance with the trading rules formulated according to law shall not be changed."

will have to consider the insolvency risk of SCH when evaluating whether they should become a clearing member. Pre-planning for the orderly unwinding of CM positions in the event of the CCP becoming insolvent, could reduce market volatility and expedite necessary risk management measures at a time when the financial system would likely be under a great deal of stress.

ISDA appreciates the opportunity to provide comments on the Proposal and looks forward to working with SCH to provide effective central clearing solution to China's OTC derivatives market. If you have any questions regarding this letter, please feel free to contact any of the undersigned at your convenience.

Yours sincerely,

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