SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Guidelines on the application of the CPSS-IOSCO Principles for Financial Market Infrastructures

August 2013

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1. Introduction

1.1 On 28 March 2013, the Securities and Futures Commission ("**SFC**") and the Hong Kong Monetary Authority ("**HKMA**") jointly announced their commitment to adopt the "Principles for financial market infrastructures" ("**PFMIs**")[1] issued by the Committee on Payment and Settlement Systems ("**CPSS**") of the Bank for International Settlements and the International Organization of Securities Commissions ("**IOSCO**") in April 2012[2]. The PFMIs are the latest international regulatory standards for financial market infrastructures ("**FMIs**") including central counterparties and clearing houses[3]. The PFMIs comprise 24 principles for observance by FMIs and 5 responsibilities for central banks, market regulators and other relevant authorities in their regulation of FMIs.

1.2 These Guidelines are published by the SFC pursuant to Section 399(1) of the Securities and Futures Ordinance (**"SFO**") to articulate the SFC's expectations with regard to the implementation of the PFMIs by recognized clearing houses in the discharge of their duties under the SFO.

1.3 Unless otherwise specified or the context otherwise requires, words and phrases in the Guidelines should be interpreted by reference to any definition of such word or phrase in the SFO.

1.4 These Guidelines shall come into effect on 9 August 2013.

2. International Standards for Financial Market Infrastructures

2.1 The 24 principles for FMIs set the latest international benchmark for the regulation, governance and risk management of systemically important FMIs. An overview of the 24 principles for FMIs is provided in the Annex. The key considerations and accompanying explanatory notes of each principle can be found in the PFMIs report[4].

2.2 These principles replace, harmonise and, where appropriate, strengthen the three pre-existing standards for FMIs[5]. They are designed to ensure that the infrastructure supporting global financial markets is robust and thus well placed to withstand financial shocks. All FMIs that are regarded as systemically important are expected to observe these principles.

2.3 The main policy objectives of the CPSS and IOSCO in laying down these principles for FMIs are to enhance the safety and efficiency of FMIs and, more broadly, to reduce systemic risks and promote transparency and financial stability[6]. In this regard, the PFMIs provide guidance to FMIs on identifying, monitoring and managing the full range of risks

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[1] http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=13PR28

[2] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377.pdf

[3] Financial market infrastructure is defined as a system that facilitates the clearing, settling, or recording of payments, securities, derivatives or other financial transactions. There are five major types of FMIs: payment systems, central securities depositories (CSDs), securities settlement systems (SSSs), central counterparties (CCPs) and trade repositories (TRs).

[4] Please refer to footnote 2.

[5] The previous standards for various FMIs were: the "Core Principles for Systemically Important Payment Systems" issued by CPSS in 2001, the "Recommendations for Securities Settlement Systems" issued by CPSS-IOSCO in 2001, and the "Recommendations for Central Counterparties" issued by CPSS-IOSCO in 2004. Trade repositories were not covered in these standards.

[6] As noted in the PFMIs report, these objectives are consistent with the public policy objectives of previous standards and recommendations developed by the CPSS and IOSCO.

that may arise in the FMI or through interdependencies with other FMIs or market participants, and risks that are transmitted by the FMI. These risks include legal, credit, liquidity, general business, custody, investment and operational risks.

2.4 The principles also address efficiency in FMIs. As noted by CPSS-IOSCO in the PFMIs report, inefficient FMIs may distort financial activity and the market structure, thereby affecting market participants and their customers which may, as a result, bring about increased risks within the broader financial system.

2.5 The SFC, being a member of IOSCO, fully supports the PFMIs. Prior to the release of the PFMIs, the SFC had applied the Recommendations for securities settlement systems developed by the CPSS and IOSCO in 2001 in its regulation and supervision of securities settlement systems in Hong Kong.

3. Application of the PFMIs to Recognized Clearing Houses

3.1 The regulatory objectives of the SFC under the SFO[7] are, among others, to:

- Maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry; and
- Reduce systemic risks in the securities and futures industry.

3.2 In furtherance of these regulatory objectives, one of the SFC's functions[8] is to supervise, monitor and regulate the activities carried on by recognized clearing houses. The SFO also stipulates specific duties[9] of a recognized clearing house[10], including the duty to ensure orderly, fair and expeditious clearing and settlement arrangements, and that risks associated with its business and operations are managed prudently. In discharging its duties, a recognized clearing house has to (a) act in the interest of the public, having particular regard to the interest of the investing public; and (b) ensure that the interest of the public prevails where it conflicts with its own interest.

3.3 While the SFO does not set out detailed regulatory requirements in respect of recognized clearing houses, the SFC has always made reference to international best practices and standards for the purposes of carrying out its functions in relation to recognized clearing houses. The SFC also notes that the main policy objectives behind the PFMIs are consistent with the regulatory objectives of the SFC under the SFO. Moreover, the specific duties of recognized clearing houses, as stipulated in the SFO, are also in line with the PFMIs. The SFC considers that all recognized clearing houses are systemically important FMIs in Hong Kong. Therefore, the SFC has adopted the PFMIs as benchmarks against which to assess recognized clearing houses in the course of carrying out its function to supervise, monitor and regulate them.

3.4 Most of the PFMIs are applicable to all types of FMIs but there are a few principles that are only relevant to specific types of FMIs[11]. The PFMIs report provides specific guidance

[7] Section 4(a) and (e)
[8] Section 5(1)(b)(i)
[9] Section 38
[10] The term "clearing house" as defined in section 1 of Part 1 of Schedule 1 to the SFO includes SSSs and CCPs.
[11] For example, Principle 24 of the PFMIs which relates to disclosure of market data is only relevant to trade repositories.

on the application of each of the PFMIs to different types of FMIs[12]. However, to take into account FMIs' differing organizations, functions, and business models and the different legal, market and regulatory circumstances in which FMIs operate, the manner in which the PFMIs are to be implemented was left open.

3.5 The SFC expects recognized clearing houses to observe the PFMIs where applicable (including any related supplemental guidance on observance of the PFMIs issued by CPSS-IOSCO from time to time) on an on-going basis. The SFC will take such observance into account in assessing if recognized clearing houses have discharged their duties under the SFO. In this regard, the SFC appreciates that the way the PFMIs are implemented by recognized clearing houses may vary depending on the nature of their operations, functions, activities and services provided.

3.6 The SFC will monitor the recognized clearing houses to ensure that they observe the PFMIs. The SFC also expects that an applicant to become a recognized clearing house should demonstrate its ability to observe the PFMIs, and in this connection, the applicant will be required to submit a self-assessment report on compliance with the PFMIs based on the Disclosure framework and Assessment Methodology published by CPSS- IOSCO[13] in December 2012 to support its application.

[12] See paragraphs 1.21 and 1.22 of the PFMIs report.

[13] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD396.pdf

Annex

Overview of Principles for Financial Market Infrastructures

General Organisation

Principle 1: Legal basis

An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions.

Principle 2: Governance

An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.

Principle 3: Framework for the comprehensive management of risks

An FMI should have a sound risk-management framework for comprehensively managing legal, credit, liquidity, operational, and other risks.

Credit and liquidity risk management

Principle 4: Credit risk

An FMI should effectively measure, monitor, and manage its credit exposures to participants and those arising from its payment, clearing, and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. In addition, a CCP[14] that is involved in activities with a more-complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. All other CCPs should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.

Principle 5: Collateral

An FMI that requires collateral to manage its or its participants' credit exposure should accept collateral with low credit, liquidity, and market risks. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.

[14] Central Counterparty

Principle 6: Margin

A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.

Principle 7: Liquidity risk

An FMI should effectively measure, monitor, and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.

Settlement

Principle 8: Settlement finality

An FMI should provide clear and certain final settlement, at a minimum by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.

Principle 9: Money settlements

An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.

Principle 10: Physical deliveries

An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor, and manage the risks associated with such physical deliveries.

Central securities depositories and exchange-of-value settlement systems

Principle 11: Central securities depositories

A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.

Principle 12: Exchange-of-value settlement systems

If an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.

Default management

Principle 13: Participant-default rules and procedures

An FMI should have effective and clearly defined rules and procedures to manage a participant default. These rules and procedures should be designed to ensure that the FMI can take timely action to contain losses and liquidity pressures and continue to meet its obligations.

Principle 14: Segregation and portability

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.

General business and operational risk management

Principle 15: General business risk

An FMI should identify, monitor, and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialise. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services.

Principle 16: Custody and investment risks

An FMI should safeguard its own and its participants' assets and minimise the risk of loss on and delay in access to these assets. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.

Principle 17: Operational risk

An FMI should identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures, and controls. Systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity. Business continuity management should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale or major disruption.

Access

Principle 18: Access and participation requirements

An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access.

Principle 19: Tiered participation arrangements

An FMI should identify, monitor, and manage the material risks to the FMI arising from tiered participation arrangements.

Principle 20: FMI links

An FMI that establishes a link with one or more FMIs should identify, monitor, and manage link-related risks.

Efficiency

Principle 21: Efficiency and effectiveness

An FMI should be efficient and effective in meeting the requirements of its participants and the markets it serves.

Principle 22: Communication procedures and standards

An FMI should use, or at a minimum accommodate, relevant internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing, settlement, and recording.

Transparency

Principle 23: Disclosure of rules, key procedures, and market data

An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks, fees, and other material costs they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.

Principle 24: Disclosure of market data by trade repositories

A trade repository should provide timely and accurate data to relevant authorities and the public in line with their respective needs.

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