

## CHINA HONG KONG SWAP CONNECT TO LAUNCH ON 15 MAY 2023

The People's Bank of China ("PBOC"), the Hong Kong Monetary Authority and the Securities and Futures Commission jointly announced on 5 May 2023 that northbound trading under the mutual access arrangement between the Mainland and Hong Kong interest rate swap markets (generally known as the "Swap Connect" programme) would commence on 15 May 2023.

Swap Connect is an extremely innovative programme involving a trading link (similar to that under the Bond Connect programme) and a clearing link, under which OTC Clearing Hong Kong Limited ("OTCC") becomes a special clearing house participant of the Shanghai Clearing House ("SHCH"), and SHCH becomes a special clearing house participant of OTCC. This form of interoperability between two clearing houses for OTC derivatives is the first of its kind globally, and raises a number of novel legal and regulatory issues which are explored in this briefing.

At this initial stage, Swap Connect will create a new channel and allow overseas investors to participate in the PRC<sup>1</sup> OTC derivatives market ("northbound" Swap Connect). This channel may be further expanded in the future to allow PRC market participants to participate in the Hong Kong OTC derivatives market ("southbound" Swap Connect).

This briefing will cover (a) an overview of Swap Connect, (b) the rules and regulations underpinning Swap Connect, (c) the key legal and regulatory issues relating to Swap Connect which clearing members and end users should be aware of and (d) key documentation involved in Swap Connect.

### OVERVIEW OF SWAP CONNECT

International investors in the PRC bond markets traditionally identified a number of areas that could be enhanced in order to further encourage foreign participation in such markets. These include, amongst others, the ability to hedge Renminbi ("RMB") foreign exchange and interest rate risk in relation to PRC bonds and the ability to use PRC bonds for repurchase transactions or other types of securities financing transactions.

#### Key issues

- Swap Connect marks an exciting and innovative development in the PRC and Hong Kong derivatives market. This form of interoperability between two clearing houses for OTC derivatives is the first of its kind globally.
- Regulatory institutions in both the Mainland and Hong Kong have published rules to support this initiative. We have provided an overview of these rules in this briefing.
- Market participants need to consider documentation issues (both for trading and clearing) when accessing Swap Connect.

<sup>1</sup> References in this briefing to "PRC" are to The People's Republic of China (which for the purposes of this briefing shall exclude Hong Kong, Macau and Taiwan).

Before the launch of Swap Connect, international investors could only access the RMB interest rate derivatives market in China if they were, generally speaking, a direct participant in the China inter-bank bond market (the "**CIBM**", and this access channel is often referred to as "CIBM Direct") or a Qualified Foreign Institutional Investor ("**QFI**") who has successfully filed with the PBOC to trade in CIBM. Under the Swap Connect programme, it will be possible for international investors not falling into any of the above categories to also trade RMB interest rate swaps ("**IRS**") through the China Foreign Exchange Trade System ("**CFETS**"), and to clear such RMB IRS through OTCC.

The clearing link between OTCC and SHCH is a highly novel interoperability arrangement which has not been set up before between two derivatives clearing houses. In addition, differences between the distinctive legal systems of both clearing houses mean that market participants will need to consider the potential consequences arising from a clearing house default, and how margin and default fund contributions are protected in both the PRC and Hong Kong.

## **RULES AND REGULATIONS UNDERPINNING SWAP CONNECT**

On the PRC side, the Swap Connect programme is underpinned by the *Interim Measures on the Mutual Access between the Mainland and Hong Kong Interest Rate Swap Markets* (the "**PBOC Measures**")<sup>2</sup> issued by the PBOC on 28 April 2023, which is accompanied by a set of FAQ (the "**PBOC FAQ**")<sup>3</sup> published on the same day.

With respect to the trading link, CFETS published the *National Interbank Funding Center Northbound Trading of Swap Connect Interest Rate Swap Trading Rules* (the "**CFETS Trading Rules**")<sup>4</sup> on 28 April 2023. In addition, the market entry guidance has also been published by CFETS on 5 May 2023 (the "**CFETS Guidance**")<sup>5</sup>.

With respect to the clearing link:

- (a) OTCC published its amended Clearing Rules and the Clearing Procedures of OTC Clear (the "**OTCC Clearing Rules**")<sup>6</sup> on 8 May 2023, which come into effect on 15 May 2023<sup>7</sup>; and
- (b) SHCH published the *Business Rules for Central Clearing in the Mutual Access between the Mainland and Hong Kong Interest Rate Swap Markets (For Trial Implementation)* (the "**SHCH Clearing Rules**")<sup>8</sup> on 28 April 2023 which became effective on the same day.

<sup>2</sup> A copy can be accessed here: <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4868907/index.html>

<sup>3</sup> A copy can be accessed here: <http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4868910/index.html>

<sup>4</sup> A copy can be accessed here: <https://www.chinamoney.com.cn/chinese/rdgz/20230428/2617455.html#cp=rdgz>

<sup>5</sup> A copy can be accessed here: <https://iftp.chinamoney.com.cn/chinese/rszn2/20230505/2621056.html#cp=rszn2>

<sup>6</sup> A copy can be accessed here: <https://www.hkex.com.hk/-/media/HKEX-Market/Services/Clearing/OTC-Clear/Special-Topics/Swap-Connect/OTC-Clear--Proposed-Amendments-to-the-Clearing-Rules-and-Procedures.pdf>

<sup>7</sup> It is expected that OTCC will further publish a FAQ on Swap Connect but this is not yet available at the time of writing.

<sup>8</sup> A copy can be accessed here: [https://www.shclearing.com.cn/cpyyw/tzgg/detail\\_38.html?productDocClient/detail/4028528187a4ff770187c74868cc667b](https://www.shclearing.com.cn/cpyyw/tzgg/detail_38.html?productDocClient/detail/4028528187a4ff770187c74868cc667b)

We are happy to provide English translations of the relevant PRC regulations upon request.

One critical document that we understand will not be made available for review by market participants is the clearing link agreement (the "**Clearing Link Agreement**") between OTCC and SHCH. This agreement is important as it sets out the default triggers for the RMB IRS transactions entered into between OTCC and SHCH, and the basis on which netting of these transactions will take place. We understand that market participants will receive some form of comfort on the enforceability of the Clearing Link Agreement in due course.

## **KEY LEGAL AND REGULATORY ISSUES OF SWAP CONNECT**

We set out below our observations on some key aspects of each of the rules and regulations in respect of Swap Connect.

### **PBOC MEASURES AND FAQ**

#### **Scope of eligible investors**

On the scope of eligible investors, the PBOC makes it clear that the Swap Connect is open to overseas institutional investors who meet PBOC's requirements and have completed filings for participating in the CIBM. This means that, at this stage, investors who invest in the CIBM through CIBM Direct, as a QFI, or through the Bond Connect programme, may trade RMB IRS under Swap Connect. Prior filing with CFETS will need to be completed pursuant to the CFETS Guidance.

#### **Trading quota**

Quotas will be imposed both in respect of the net exposure of all outstanding RMB IRS contracts (at RMB4 billion, to be monitored by SHCH and OTCC) and the daily net trading volume (at RMB20 billion, to be monitored by CFETS). Trades executed after the quota is used up will be rejected.

#### **Not mandatory to execute master agreement**

Under the PBOC Measures, the signing of a master agreement between the trading parties is not mandatory. Partly due to the reason that the products traded under Swap Connect must all be centrally cleared, market participants can choose to trade RMB IRS directly without having a master agreement in place. That said, market participants would need to consider the appropriate form to document the counterparty relationship, as a trade under Swap Connect can only be reached between parties that have established a counterparty relationship.

If market participants prefer to sign a master agreement with its counterparty, PBOC confirmed that the recognised master agreements for Swap Connect include NAFMII Master Agreement, ISDA Master Agreement and the ISDA/FIA Cleared Derivatives Execution Agreement. NAFMII is also working on a template Swap Connect master agreement, which will be published in due course.

#### **Reporting obligation**

During the consultation period of the PBOC Measures, some market participants expressed concerns about the reporting obligations that they would need to comply with when trading under Swap Connect. PBOC

explained in the PBOC FAQ that overseas investors do not need to perform additional reporting obligations because trades are executed through CFETS and CFETS will collect the relevant trade information as a recognised trade repository.

### **Risk management purpose**

While PBOC has provided useful guidance through the PBOC FAQ, there are certain concepts under the PBOC Measures that still require interpretation. One particular example is the use of the term "risk management purposes". Based on PBOC Measures, overseas investors should trade under Swap Connect only for "risk management purposes". To what extent the RMB IRS positions under Swap Connect should correlate to an investor's investments in the CIBM and whether any due diligence obligations are imposed on the trading counterparty or the OTCC clearing member to confirm the satisfaction of this requirement are among the questions that need to be clarified.

### **CFETS RULES ON TRADING**

The trading link of Swap Connect is very similar to that of Bond Connect. In short, overseas investors can choose to trade through either the "request for quote" route or the "click to trade" route. Currently, overseas investors can use Bloomberg and/or TradeWeb to send instructions and trades will be executed on the CFETS platform. Once a trade is executed on the platform, CFETS will notify SHCH, OTCC, the offshore trading platform (i.e. TradeWeb/Bloomberg) and onshore/offshore trading participants.

Currently, the eligible products for northbound Swap Connect are:

Currency	Reference rate	Time to maturity
CNY	SHIBOR_3M	10 years
	SHIBOR_O/N	3 years
	FR007	10 years

Investors should agree on the approach if a trade is rejected from clearing under Swap Connect. Under the CFETS Trading Rules, there are two options: "Resubmit" or "Cancel". One of the options needs to be specified by investors before concluding a RMB IRS trade on CFETS:

- "Resubmit" means that the transaction is still valid after being rejected from clearing and will be resubmitted by the trading parties for clearing on the next working day; and
- "Cancel" means that the transaction shall be automatically cancelled after being rejected for clearing and becomes void.

CFETS is also responsible for monitoring any abnormal trading activities under Swap Connect. Among others, trades or quotes that are at a price which severely deviates from fair market value, repeatedly rejected from clearing, or suspected of insider dealing and/or market manipulation, will be closely monitored by CFETS.

### **OTCC RULES ON CLEARING**

Under the OTCC Clearing Rules, once the relevant RMB IRS is registered for clearing, it will be novated into three contracts:

- (a) a contract between the clearing member (either as the party to the original trade or in relation to a client clearing client) and OTCC (which is subject to the OTCC Clearing Rules);
- (b) a contract between OTCC and SHCH (which is subject to the Clearing Link Agreement); and
- (c) a contract between the SHCH and the PRC onshore dealer (which is subject to the SHCH Clearing Rules).

Where the OTCC clearing member clears for its client, the contractual relationship between the clearing member and its client will be governed by the relevant client clearing documentation as further discussed below.

The default risk in the link between OTCC and SHCH will mainly be mitigated through the maintenance of an inter-clearing house fund (referred to as the "**Inter-CCP Margin Amount**" in the OTCC Clearing Rules). This Inter-CCP Margin Amount will be the higher of the net exposure of the transactions under Swap Connect as calculated by each of OTCC and SHCH based on the relevant rules. Each clearing house will contribute 50 per cent. to the Inter-CCP Margin Amount based on what is referred to as a single lockbox structure.

In respect of OTCC's portion, it will contribute an initial CNY100 million and will require the clearing members who participate in Swap Connect to contribute the balance (referred to as "**Participating Margin**" in the OTCC Clearing Rules). The OTCC Clearing Rules contain detailed rules on how such balance would be assigned among the clearing members and how the funds will be deployed. Market participants will need to consider the treatment of the Participating Margin for the purposes of regulatory capital rules (if applicable).

## **SHCH RULES ON CLEARING**

As explained in the PBOC FAQ, OTCC's contribution to the Inter-CCP Margin Amount will be held in an account opened within the PRC and in the name of SHCH. The SHCH Clearing Rules do not expressly set out details on how this contribution will be held, but does provide some general protection on the Inter-CCP Margin Amount:

- Article 8 provides that until the relevant clearing and settlement are completed, the Inter-CCP Margin Amount cannot be seized, frozen or enforced, other than to fulfil the relevant settlement obligations; and
- Article 19 provides that the default fund contribution from OTCC will not be used to absorb loss resulting merely from the default of clearing members of SHCH.

Despite the above, a relevant issue is the effect of the SHCH Clearing Rules and its relationship with mandatory PRC laws. Market participants may also need to come to a view as to whether the Inter-CCP Margin Amount could

constitute the settlement assets (结算财产) as protected under Article 37 of the PRC Futures and Derivatives Law<sup>9</sup>.

On the issue of default of either OTCC or SHCH, the SHCH Clearing Rules provide that, upon the default of either clearing house, including failure to pay or insolvency, the non-defaulting clearing house can make determinations and take actions pursuant to the Clearing Link Agreement. Although the Clearing Link Agreement is not publicly available, SHCH clarified in the SHCH Clearing Rules that close-out netting upon clearing house insolvency is expressly protected.

## **DOCUMENTATION ISSUES FOR SWAP CONNECT**

For end users seeking to clear RMB IRS through Swap Connect, it is very likely that their OTCC clearing member will require such end users to sign up for additional clearing documentation that addresses specific issues relating to Swap Connect.

Clifford Chance has been fortunate to be assisting the International Swaps and Derivatives Association ("**ISDA**") and Futures Industry Association ("**FIA**") in preparing an appendix to the ISDA/FIA Client Cleared OTC Derivatives Addendum (the "**Swap Connect Appendix**") to provide a market standard starting point for Swap Connect related client clearing documentation.

The Swap Connect Appendix incorporates the relevant Swap Connect rules into the clearing relationship between the OTCC clearing member and its client, and in particular, provides for documenting the contribution (if any) from the client towards the Participating Margin that the clearing member will be required to transfer to OTCC. It also contains various risk disclosures that are related to Swap Connect, such as exposure to the risk of SHCH default and the use of NAFMII Interest Rate Derivatives Definitions in respect of the RMB IRS entered into under Swap Connect.

## **CONCLUSION**

The launch of the Swap Connect programme marks an exciting development in the PRC and Hong Kong derivatives market. While certain legal and regulatory issues will need to be considered by market participants due to the novel nature of Swap Connect, the programme nevertheless represents how far the derivatives market has evolved in Greater China.

Since the passage of the Futures and Derivatives Law in China in 2022, we continue to observe PRC regulators working towards improving the PRC derivatives market to facilitate the activities of international investors, and we look forward to continuing our support to market participants in understanding and guiding the evolution of this market.

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<sup>9</sup> Article 37 of the PRC Futures and Derivatives Law provides that, for centrally cleared derivatives transactions, no one is allowed to use settlement assets for any purpose other than to clear and settle derivatives and that central clearing will not be suspended, invalidated or revoked due to the enter into bankruptcy of any party to the clearing and settlement (in Chinese: "衍生品交易, 由国务院授权的部门或者国务院期货监督管理机构批准的结算机构作为中央对手方进行集中结算的, 可以依法进行终止净额结算; 结算财产应当优先用于结算和交割, 不得被查封、冻结、扣押或者强制执行; 在结算和交割完成前, 任何人不得动用。依法进行的集中结算, 不因参与结算的任何一方依法进入破产程序而中止、无效或者撤销。").

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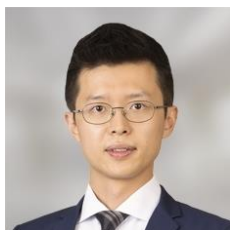
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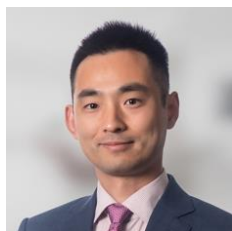
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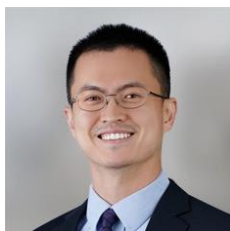
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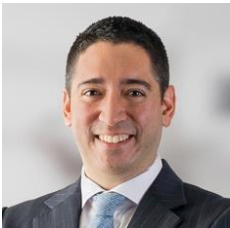
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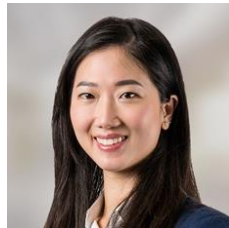
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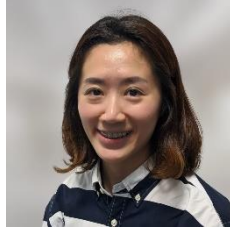
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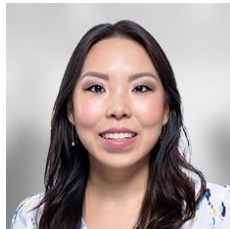
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