

Bills Committee on Securities and Futures (Amendment) Bill 2013

Amendments relating to protections under Part III of the Securities and Futures Ordinance

Purpose

This paper sets out the Administration's response to the questions raised by the Assistant Legal Adviser to the Bills Committee on the Securities and Futures (Amendment) Bill 2013 ("the Bill") regarding amendments relating to protections under Part III of the Securities and Futures Ordinance (Cap. 571) ("SFO").

Rationale for the proposed amendments to Part III of the SFO

Clauses 56 – 60

2. The existing section 40 of the SFO only provides for default rules to be made by a recognized clearing house ("RCH") in the event that a clearing participant (i.e. a clearing member of an RCH) defaults. The amendments seek to extend the scope of the default rules of an RCH and thereby the coverage of the insolvency override protections under Part III of the SFO, so that they also apply to: (a) defaults of the RCH itself, and (b) certain client clearing arrangements for over-the-counter ("OTC") derivative transactions supported by the RCH. With respect to (b), the intention is to ensure that if a clearing participant who provides client clearing services to its own clients for OTC derivative transactions ("OTC client clearing service provider") defaults, then –

- (i) related contracts between the OTC client clearing service provider and its clients, and
- (ii) arrangements relating to the handling of the positions and collateral of the OTC client clearing service provider's clients in the event of such default,

can benefit from the insolvency override protection. Further details are provided in paragraphs 3 – 5 below.

3. We need to ensure that if an OTC client clearing service provider defaults, its client's positions and collateral will not be frozen in the insolvency of the OTC client clearing service provider nor recoverable by the liquidator. For example, under a typical client clearing arrangement in relation to an OTC derivative transaction, if the OTC client clearing service provider defaults, the clients' positions and collateral will either be ported (i.e. moved) to another OTC client clearing service provider who is willing to take them up, or else liquidated (i.e. the transaction will be terminated) by the RCH and any remaining collateral returned to the client.¹ These arrangements will usually be reflected in the RCH's rules.

4. For a client's positions and collateral to be ported in the event of an OTC client clearing service provider's default, the following criteria must be met: (a) the OTC client clearing service provider's clients must have provided porting instructions (i.e. nominated alternative OTC client clearing service providers to which positions and collateral are to be ported) prior to the occurrence of the default, and (b) the alternative OTC client clearing service providers that have been nominated must agree to accept the porting and they themselves must not also be in default. If the positions cannot be ported, the RCH will liquidate the client positions and any losses will be offset by the collateral provided by the clients. If there is any surplus left, the RCH will return it to the client directly (e.g. based on a deed between the RCH, the OTC client clearing service provider and the clients signed at the outset when the defaulting OTC client clearing service provider started providing client clearing services to the clients). If there is any shortfall, the RCH will offset it with the collateral of the defaulting OTC client clearing service provider.

5. By bringing such client clearing arrangements within the definition of "default rules", and thus subject to the insolvency override protection conferred by the Part III insolvency override provisions (e.g. section 45(1)(e) and (f) of the SFO which say that the default rules and proceedings under them are not to be regarded as invalid on the ground of inconsistency with insolvency laws), the positions and collateral of the client will not be included among the assets of the defaulting OTC client clearing service provider and will not be used to repay creditors of the defaulting OTC client clearing service provider. They can therefore be ported to another OTC client clearing service provider, or disposed of and the balance returned to the client, as initially envisaged.

¹ For completeness, a client's positions and collateral may also be ported voluntarily in a non-default situation – e.g. because the client wishes to switch to another OTC client clearing service provider.

6. Different clearing houses may provide for different client clearing arrangements under their rules. In any event, the rules of a clearing house that is an RCH have to be approved by the Securities and Futures Commission under section 41 of the SFO. As a clearing house will want to ensure that their participants' clients (i.e. the OTC client clearing service providers' clients) can benefit from the insolvency override protection in respect of any OTC client clearing arrangements put in place, they will have the incentive to ensure that the provisions are appropriately and adequately drafted. Moreover, international standards jointly set by the Committee on Payment and Settlement Systems ("CPSS") and the International Organization of Securities Commissions ("IOSCO") require a central counterparty ("CCP") to ensure that there is a high degree of legal certainty as regards the enforceability of its rules, including in the case of insolvency. In most cases, we believe a clearing house will obtain a legal opinion on such enforceability.

Clause 58

7. The new section 40(2A) aims to extend the insolvency override protections under Part III of the SFO so that they also apply in respect of: (a) client clearing arrangements, and (b) actions following a default of the RCH itself. The CPSS-IOSCO Principles for Financial Market Infrastructure – which apply to all CCPs and not just CCPs for OTC derivatives – advocate the need for such protection and for legal certainty in this regard. The new section 40(2A) is therefore intended to cover all CCPs and not just those clearing OTC derivatives.

**Financial Services and the Treasury Bureau
Securities and Futures Commission
13 February 2014**