

For discussion  
on 23 April 2004

**Bills Committee on  
Clearing and Settlement Systems Bill**

**Policy Issues and General Principles  
Part 3 of the Bill**

**Purpose**

This paper explains the policy intent and relevant crucial clauses of the Clearing and Settlement Systems Bill (the “Bill”) in relation to settlement finality (Part 3 of the Bill).

**Finality of Transactions and Proceedings**

*Policy intent*

2. The proposed settlement finality regime is to provide statutory protection of the integrity of transfer orders settled through designated systems from the insolvency and other laws in Hong Kong and overseas. This is to ensure that transfer orders settled through designated systems are irrevocable and not disrupted by the insolvency of participants, whereas any rights resulting from the underlying transactions of such transfer orders will not be affected. Besides transfer orders, the proposed ordinance provides legal certainty on the netting arrangements in designated systems. Netting arrangements are protected from the risk of unwinding arising from the insolvency and other laws in Hong Kong and overseas. Participants’ interests in collateral security under the default arrangements of designated systems are also protected.

3. The proposed settlement finality regime would –
- (a) enable Hong Kong to give effect to the International Monetary Fund’s recommendation on providing statutory certainty of settlement finality, which is conducive to enhancing Hong Kong’s status as an international financial centre; and
  - (b) facilitate the admission of the Hong Kong Dollar into the Continuous Linked Settlement System which is a global clearing and settlement system for cross-border foreign exchange transactions.

*Issuance and revocation of certificate of finality*

4. The Bill proposes that the Monetary Authority (MA) is empowered to issue a certificate of finality to a designated system (clause 14) if the system effects ultimate settlement of transfer orders and is in compliance with the requirements in the proposed ordinance (clause 6(1)) regarding, mainly, the safety and efficiency of the system (clause 7 ). This certificate of finality can be revoked or suspended by the MA if either of the above conditions cannot be met, or if there has been any contravention of certain requirements under the Bill (clause 15).

*Modification of the law generally and the law of insolvency in particular*

5. Transactions effected through a designated system with certificate of finality are final and irrevocable as they are protected from the law of insolvency or any other law, which may give effect to the unwinding of transactions in the designated system. The transactions include the transfer orders or action (such as disposition of property) taken under the operating rules (including default arrangements) with respect to such orders, as well as provision of collateral security (clause 16(1)). The finality of transactions within designated systems (Division 3 of Part 3) applies only to bankruptcy and winding up proceedings, and only where those proceedings are in respect of a participant to the designated system (clause 16(2) and (3)).

6. To ensure settlement finality, the transactions mentioned in paragraph 5 effected in designated systems may not be reversed, repaid, or set aside, or rectified or stayed by a court order because such application of the law on such transactions has been modified to give this effect (clause 17). Focussing on the insolvency law, which is of crucial importance in this context, clause 18 provides that certain transactions within a designated system shall take precedence over the law of insolvency. Such transactions are exempted from the application of the law of insolvency regarding the distribution of the assets of an insolvent participant.

7. Clause 18 is further supplemented by clauses 19, 20 and 21 which deal with the dis-application or modification of certain statutory provisions forming part of the law of insolvency. Clause 22 provides that Part 3 of the Bill does not apply in relation to transfer orders that are entered into a designated system after a point in time specified in that provision, essentially after insolvency has “occurred”.

*Netting of obligations of insolvent participants*

8. The netting arrangements in designated systems with certificate of finality are immune from insolvency proceedings. Obligations

that are netted shall be disregarded in bankruptcy or winding up proceedings. Clause 23 provides for recognition at law of any netting, effected by a system operator, of the obligations of an insolvent participant.

*Law of insolvency in other jurisdictions*

9. Clause 24 requires a court in Hong Kong not to recognize or give effect to orders of foreign courts, or acts of foreign insolvency office holders, made or done under foreign laws of insolvency, where the order or act would be prohibited under the Bill if made or done by a court or a relevant insolvency office holder in Hong Kong.

*Underlying transactions*

10. The Bill only protects transfer orders, action taken under the operating rules with respect to such orders, provision of collateral security and netting arrangements. Falling short of reversing the transfer orders etc, an insolvency office holder still has the right to go after the underlying transactions. Clause 25 clarifies that the Bill does not affect rights arising under the underlying transactions in respect of transfer orders, except where expressly provided otherwise in the Bill. The Bill has specifically addressed two types of situations –

- (a) clause 26 addresses the situation where a participant who subsequently becomes insolvent has entered into a transaction at an undervalue with another participant and confers on a relevant insolvency office holder the right to recover from the other participant the amount of any gain made from the transaction; and
- (b) clause 27 addresses the situation where a participant who subsequently becomes insolvent has made a transfer that gives an unfair preference to another participant and confers on a relevant insolvency office holder the right to recover from the other participant the value of the transfer.

*International precedents*

11. Statutory protection to ensure settlement finality has been provided in various overseas jurisdictions. These include the Payment Systems and Netting Act 1998 in Australia, the Payment Clearing and Settlement Act 1996 in Canada, the Directive 98/26/EC of the European Parliament and of the Council of 19<sup>th</sup> May 1998 on settlement finality in payment and securities settlement systems in the European area, the Reserve Bank of New Zealand Amendment Act 2003 in New Zealand, Payment and Settlement Systems (Finality and Netting) Act 2002 in

Singapore and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 in the United Kingdom. A comparison of the various legislative frameworks in relation to settlement finality is attached at the **Annex**.

Hong Kong Monetary Authority  
Financial Services and the Treasury Bureau  
20 April 2004

**International Comparison on Settlement Finality**

Annex

Jurisdiction	Australia	Canada	European Community	Hong Kong	New Zealand	Singapore	United Kingdom
Authority	The Reserve Bank of Australia (RBA)	The Bank of Canada (BOC)	European Central Bank/National central banks	The Hong Kong Monetary Authority	The Reserve Bank of New Zealand (RBNZ)	Monetary Authority of Singapore (MAS)	The Bank of England (BoE)/Financial Services Authority (FSA)
Legislation on Settlement Finality	Payment Systems and Netting Act 1998	Payment Clearing and Settlement Act 1996	Directives on settlement finality in payment and securities settlement systems (98/26/EC)	The Clearing and Settlement Systems Bill	The Reserve Bank of New Zealand Amendment Act 2003	Payment and Settlement Systems (Finality and Netting) Act 2002	The Financial Markets and Insolvency (Settlement Finality) Regulations 1999
Legislation Objective	This Act empowers the RBA to approve payment systems and multilateral netting arrangements for settlement finality	Under the Act, the BOC is empowered to designate payment and other clearing and settlement systems for settlement finality	The Directive covers systems of a domestic as well as cross-border nature. Member states may apply the settlement finality provisions of the Directive to their domestic institutions	Settlement finality is provided to transfer orders effected through designated systems, which obtain the certificate of finality issued by the MA	Settlement finality is provided to settlement that is effected in a system designated by the RBNZ	Settlement finality is provided to transfer orders effected through systems designated by the MAS	The Regulations specify the BoE and FSA as the relevant designating authority for settlement finality
Application / Designation	By application	By designation	Subject to individual national authority in EC	By designation	By application	By designation	By application
Cover transfer orders	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Covers netting arrangements	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Covers collateral security in pursuance of default arrangements	No	Yes	Yes	Yes	Yes	Yes	Yes