Clearing and Settlement Systems Bill

Summary of Comments and Responses – Hong Kong Society of Accountants ("HKSA")'
Comments in letter dated 6 February 2004 as discussed at Meeting with the Administration on 4 March 2004

Bill Clause	Comments	Paragraph no. of HKSA's letter	Responses
Purpose	HKSA agrees that the Bill should preserve the integrity of the transfer orders and not subject the settlements thereof to challenge both under the general law and/or on the insolvency of a counterparty. However, it believes that the rights of an insolvency office holder ("IOH") under the general law to challenge the underlying economic transaction being effected by the transfer order should remain, albeit with modifications to ensure that any action taken by the IOH does not interfere with or challenge the integrity of transfer orders effected by a designated system, which HKSA believes is also the intended effect of the Bill.	2-3	HKSA's understanding of the policy intentions of the Bill is correct. It is the policy stance that the Bill is to preserve the integrity of the transfer orders from the law of insolvency but with minimal disruption to the law of insolvency as far as possible so modification to such law is only made to that extent necessary. Agreed. The Bill does not intend to create a further and separate insolvency regime. This goal is also agreed. However, we consider that the Bill as currently drafted has the effect of creating a further separate insolvency regime. If the Bill is enacted as currently drafted we consider that there will be three separate insolvency regimes: • The insolvency regime under the general law; • The insolvency regime for transactions governed by the SFO; and • The insolvency regime for transactions

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			governed by the Bill as enacted
16-18	The definition of insolvency has been expanded to include analogous insolvency proceedings in other jurisdictions (clause 13(c)) and the definition of designated system now includes systems outside Hong Kong if they accept trades denominated in Hong Kong Dollars (clause 3(2)(b))(an amendment which in itself appears fine). As currently drafted, the Bill now purports to disapply all insolvency laws (i.e. multi-jurisdictional laws) in relation to transfer orders settled through a designated system. Certain clauses of the Bill seem to be drafted in what HKSA would suggest is an appropriate way to deal with conflict of laws/jurisdictional matters (which mirrors the approach taken in the Securities and Futures Ordinance ("SFO") (in particular, section 54 in relation to the law of insolvency in other jurisdictions) and in the UK Statutory Instrument 1999 No.2979 ("UK SI")). For example, clauses 19 and 24 of the Bill work by clause 19 disapplying certain relevant domestic Hong Kong insolvency legislation and clause 24 confirming that the Hong Kong courts shall not give effect to orders of courts of other competent jurisdictions if the effect of this would be to affect the integrity of the transfer orders. This drafting should be reflected throughout the Bill.	26-28	We will review clauses 16-18 to see if there is any unintended extra-territorial application. This approach is appreciated – we propose to revert with any further comments after reviewing any amendments in the next draft that is circulated.

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19(b)	HKSA agrees that clause 19(b) is an essential provision to preserve the integrity of a designated system and the transfer orders settled through it. However, the drafting of clause 19(b) is considered to be too wide as it validates not only the relevant transfer order but also the underlying transaction (i.e. the disposition of property).	11	It was agreed at the meeting that the current drafting "disposition of property in pursuance of such [a transfer] order" confined its application to the immediate disposition of property necessitated by the relevant transfer order, not the underlying economic transaction. Whilst we accept that the aim of the Bill is as stated above and we do not consider that the current drafting necessarily fails to achieve this aim, we consider that the Bill could be even clearer in its drafting and should contain a provision (not necessarily at clause 19) which has "for the avoidance of doubt" type wording in order to provide express and unequivocal recognition of the differences between the transfer orders and other transactions effected through the clearing system (which are to be preserved) and those transactions falling outside these protected clearing house transactions which are still subject to challenge by the IOH – a definition / clear distinction of the concept of "underlying economic

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			transaction" may assist in this regard. At the meeting we also discussed the concept of the third type of transaction – the hybrid transaction not effected wholly within the clearing house but which was also to be protected – it might also be useful to ensure such type of transaction is expressly protected. We propose to review this point after we have reviewed the next version of the revised draft Bill.
20	Clause 20 purports to remove the powers of the court under sections 49 and 50 of the Bankruptcy Ordinance, section 266 of the Companies Ordinance and section 60 of the Conveyancing and Property Ordinance in making any order in respect of any transfer order or any disposition of property "in relation to" any transfer order or disposition of property. The use of the words "in relation to" and inclusion of "or disposition of property" are believed to be sufficiently wide to catch the underlying transaction as well as the transfer order and property disposition effected by a designated system pursuant to the transfer order itself.	14	It was agreed at the meeting that reference to "disposition of property" must be read in its context, namely, "disposition of property in pursuance of a transfer order", and that these words alone would not extend to include the underlying transaction. However, we will consider whether the wording "in relation to" in the phrase "in relation to a disposition of property in pursuance of a transfer order" could be construed as admitting the application of

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			the provision to the underlying transaction, and if so, consider appropriate wording to ensure that the provision will not cover the underlying economic transaction. Please see the additional comments in relation to the preceding point – we should appreciate the opportunity to review this point after circulation of the revised draft. We still consider that clarification wording in the Bill would be useful to avoid uncertainty.
25	Whilst clause 25 purports to preserve right of the IOH in relation to the underlying economic transactions, clause 25(1) begins "Except to the extent that it expressly provides, this Part…….". This qualification renders clause 25 ineffective as, arguably, the provisions of clauses 19(b) and 20 are worded so that they prevent a claim in relation to the underlying economic transaction as well as the transfer orders.	12-13	It was clarified at the meeting that clauses 19(b) and 20 were only intended to cover a transfer order and the immediate "disposition of property" as a result of the transfer order. The right of an IOH in relation to the underlying transaction would not be affected. We agree that this is the intended aim of these sections.

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			Nevertheless, we appreciate HKSA's concerns about the wording "Except to the extent that it expressly provides" and will consider a suitable amendment with a specific reference to the relevant clauses instead. We appreciate this approach and look forward to reviewing your further drafting on this point.
26, 27	Under clauses 26(2) and 27(2) of the Bill, the IOH is entitled to recover from the counterparty the gain made by that counterparty, i.e., an immediate debt claim against that counterparty. This is significantly different from the position under the general law: transaction at an undervalue claims and preference claims require an order of the court to create a debt claim. Additionally, the scope of the court order available under the general law is wider than under the Bill in that it can potentially effect parties other than the counterparty. HKSA suggests to consider adopting the UK model as in the UK SI. The UK SI does not remove existing transaction at an undervalue and preference claims and replace them with alternative claims. Instead, the UK SI restricts the orders available to the court and limits the powers and duties of an IOH in order that the integrity of transfer orders is	7-9	The Bill aims to achieve similar results to the UK SI. These two clauses are designed to minimize the impact of the rights and remedies of an IOH taken away by clauses 19 and 20. We do not accept that aim is achieved by the Bill as currently drafted. The Bill in its current form largely mirrors the approach of the SFO in creating an additional insolvency regime. The UK SI does not do this – it does not remove the underlying insolvency regime and provide for replacement provisions –

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	safeguarded. Such an order would preserve (and not unwind) transfer orders but adjust the underlying transaction by making an order to reverse its economic effect.		instead it merely limits the IOH's rights under UK insolvency law and prevents UK insolvency law from operating in a way that might affect the integrity of the clearing system settlement. It was agreed at the meeting that it was a policy decision whether to retain the current approach in the Bill (which followed the approach taken in the SFO), or to adopt that in the UK SI. This point is agreed – we do not accept that the Bill follows the UK SI but whether or not it should do so is indeed a policy matter. HKSA suggested that the concept of a "transaction at an undervalue" in clause 26 be amended by replacing the expression "significantly less" in subclause (3)(b) with the expression "less". HKSA was concerned that the inclusion of the term "significantly" would create uncertainty as to whether a right of action under the clause existed,

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			or could be proved in court. We consider that this is a significant point in practice and that this proposed change is necessary. The suggested change would bring the concept of "gain" in clause 26 more in line with the concept of gain in the corresponding section of the SFO. HKSA pointed out that the context of section 49 of the Bankruptcy Ordinance, where the expression "significantly less" also appeared, was different from that in clause 26 of the Bill. This is correct – this is because the Bill as currently drafted has the effect of creating a debt claim whilst in the context of the Bankruptcy Ordinance the phrase is used in a context where a debt claim is not being created – merely the right to apply to the Court for the Court to order a remedy if appropriate.

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			We will review the wording of clause 26 in the light of HKSA's comments. We appreciate this approach and look forward to reviewing any drafting changes in due course.
28(1)(a)	The clause 28(1)(a) refers to "any indication in writing by a creditor of the participant of his intention to pass a creditor's voluntary winding-up resolution". This is not technically possible – a creditor's voluntary liquidation is commenced by the passing of a winding up resolution by the members of the company, not by a creditor or creditors of the company.	17	We will make a suitable amendment to clause 28(1)(a). Noted and appreciated. We will also revise the reference to "statutory declaration" in clause 28(1)(e) to take account of recent amendments to the Companies Ordinance. Again, noted and appreciated.
29	The clause proposes that in order to be released from compliance with the duties of his office to the extent that those duties are affected by any action under default arrangements, an IOH must make an application to the court to be released from compliance with such duties or for his duties to be	18	It was clarified at the meeting that the approach in the Bill was similar to that under the SFO (section 46(1)) which aimed to provide relief to an IOH.

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	altered. In order to prevent the delay and expense of such applications, it is suggested that the Bill be amended to state that the duties of an IOH will be deemed not to be applicable to the extent that the actions of an IOH otherwise required by such duties would conflict with the Bill. Clause 29 reflects an IOH's common law position and might only be relevant to a receiver as a receiver is not a court-appointed officer so that he does not have the inherent right to go to court for directions when in doubt as to the extent of his duties. It is proposed that clause 29 might be revised to include a deeming provision that an IOH's duties would be deemed to be modified to the extent affected by the Bill.		HKSA pointed out that under the common law all IOHs other than a receiver had an inherent right to apply to the court for directions as to the extent of their duties. HKSA also considered that the section could be read as providing that action taken under the Bill would not have the effect of releasing an IOH from compliance with the functions of his office unless and until an order had been made by a court under the section. Agreed. We will review the wording of clause 29 in the light of HKSA's suggestion. Noted and appreciated. We suggest that the provision should address two issues: • The automatic variation of the IOH's duties to the extent they conflict with the Bill; and • The provision of the right of an IOH

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			(principally a receiver) to apply to Court for directions (to the extent the IOH is not already entitled to do so) to request clarification and/or variation of his duties to the extent that they conflict with the Bill and the power of the Court to make any consequential order it sees fit.
30	This clause provides that the enforcement of execution/judgment or other legal process over assets provided as collateral security or held by a system operator or settlement institution of a designated system as collateral security is made subject to the consent of the systems operator or settlement institution (although this does not apply to anyone seeking to enforce any existing interest in or security over the property). This provision is not limited in time. HKSA suggests that it may be useful to add an "exit" provision if, following the insolvency of a counterparty, the settlement institution or systems operator does not enforce against the asset within a reasonable timescale (say one year). This is particularly important where the asset may have a value that provides surplus realisations over and above the amounts needed to collateralise the obligations for which it was provided, and that the IOH should have the ability to request that the court order the asset to be sold and the proceeds used first to pay the amount of the	19	It was agreed at the meeting that, in practice, the "exit" provision would not be necessary as the system operator would liquidate the collateral in a short period of time, if not within a day. We agree that in practice a situation where this might be an issue is unlikely to arise and therefore the point made was in essence a reference to a theoretical problem/exceptional circumstances rather than a known and substantial risk. The Bill does not address this problem. We consider that whether or not to address this issue is a policy decision and

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	collateralised obligation and the surplus paid to the estate of the insolvent counterparty.		it is unlikely to have practical effect if this is not addressed in amended drafting in the Bill. However, if the drafting is not amended, the theoretical risk will remain.
Definitions	The Bill refers to a number of terms that are not defined. This leads to some repetition and also perhaps even some inconsistencies as to their scope. It might be useful for the terms "Insolvency", "Insolvency Proceeding" and "Insolvency Office Holder" to be defined.	20-25	It was agreed at the meeting that the suggested definitions would not be required in this Bill. The term "relevant insolvency office holder" has been defined in clause 2. We agree that such changes are probably not necessary but would like to review this point once the revised draft is circulated.
	The definition of "law of insolvency" in clause 13 of the Bill is suggested to be amended. Clause 16 of the Bill refers to "the general law of insolvency" which is not clearly defined law. The "law of insolvency" is in HKSA's view a concept incorporating concepts from many other areas of law, in particular the law relating to the ownership of property and security and other interests.		See the response to clauses 16-18. Agreed – we will revert with any comments once the revised draft Bill is circulated.