

**Information Note for**  
**Legislative Council Panel on Financial Affairs**

**Clearing and Settlement Systems Bill**

**Purpose**

1. This paper seeks to brief Members on the need for a Clearing and Settlement Systems Bill and its salient features.

**Objectives of the Bill**

2. The objectives of the Bill are to confer upon the Monetary Authority (MA) the powers to -
  - (a) designate important clearing and settlement systems for funds or securities as “designated systems” subject to oversight by the MA;
  - (b) grant such designated clearing and settlement systems statutory protection from insolvency regime to ensure settlement finality as appropriate; and
  - (c) provide for an oversight regime for such systems and the assurance of settlement finality with a view to maintaining the monetary and financial stability of Hong Kong and also the functioning of Hong Kong as an international financial centre.

## **Justification**

3. Clearing and settlement systems for funds or securities constitute an essential foundation for the smooth functioning of an advanced economy. Given the MA's role to maintain and promote the stability and the integrity of the monetary and financial systems of Hong Kong, the MA has been acting as a de facto overseer for the following important clearing and settlement systems in Hong Kong, although there is no express statutory backing for the MA to take on such role -

- (a) Hong Kong Dollar (HKD) CHATS<sup>1</sup> – HKD payments are transferred electronically between members of the Clearing House (banks and restricted licence banks) on a real-time and gross basis;
- (b) US Dollar (USD) CHATS – USD payments are transferred electronically between its members on a real-time and gross basis;
- (c) Euro CHATS – Euro payments are transferred electronically between its members on a real-time and gross basis;
- (d) Central Moneymarkets Unit (CMU) – a clearing and settlement system operated by the MA for debt securities (including Exchange Fund Bills and Notes) traded “over-the-counter”, i.e., not through a recognised stock market;
- (e) settlement of paper cheques (Cheque Clearing); and

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<sup>1</sup> Clearing House Automated Transfer System (CHATS), also known as Real Time Gross Settlement System or RTGS

- (f) cash settlement leg for Central Clearing And Settlement System (CCASS) in respect of equities and other securities listed and traded on the Hong Kong Stock Exchange.

4. The MA derives this oversight role from a number of sources such as the Exchange Fund Ordinance (EFO), the MA's holdings in the Hong Kong Interbank Clearing Limited (HKICL) and contractual obligations with certain system operators.

5. However, there are some shortcomings under this framework of oversight. First, there is no express statutory backing for the MA's oversight role in payment systems. Also, there is no statutory backing for finality of settlement, i.e. protection of settled transactions through payment systems against unwinding from insolvency laws.

#### *Support from the IMF*

6. These problems are identified by the International Monetary Funds (IMF) in its recent assessment of the relevant financial systems in Hong Kong. The IMF specifically recommends that there should be explicit legislative provisions for clearing and settlement system oversight and for settlement finality in Hong Kong's CHATS and netting arrangements. Hong Kong's failure to conform to such recommendations will be detrimental to Hong Kong's standing as an international financial centre. Hence, it is in Hong Kong's interest to enact legislation to provide express statutory backing for the MA's oversight on clearing and settlement systems, and to provide for legal certainty of settlement finality as appropriate.

Admission into the Continuous Linked Settlement System

7. We are seeking admission of HKD into the Continuous Linked Settlement (“CLS”) System in 2004. The CLS system is a global clearing and settlement system for cross-border foreign exchange transactions. Many major international currencies have been admitted into the system. The participation of HKD in the system would be crucial to Hong Kong’s functioning as an international financial centre. The CLS system requires Hong Kong to confer settlement finality under Hong Kong law with respect to payments made through the CHATS as a pre-condition for admitting HKD into the CLS system. It would be highly desirable to put in place the necessary legislative provisions to facilitate the early admission of HKD into the CLS System.

International precedents

8. Many other advanced economies have introduced similar legislation covering payment system oversight and settlement finality.

9. Examples of payment system oversight are (a) the Reserve Bank Act 1959 in Australia under which the Reserve Bank of Australia is given the responsibility for determining payments system policy; and (b) the Payment Clearing and Settlement Act 1996 in Canada under which the Bank of Canada is responsible for the oversight of clearing and settlement systems with a view to controlling systemic risk.

10. For settlement finality, most major jurisdictions have already enacted legislation similar to what is being proposed. Examples are Part VII (Sections 154 to 191) of the Companies Act 1989 of the UK, the

Settlement Finality Directive 1998 of the European Union, the Payment Systems and Netting Act 1998 of Australia, the Payment and Settlement Systems (Finality and Netting) Act 2002 of Singapore, and the Payment Clearing and Settlement Act 1996 of Canada. Part III of the recently commenced Securities and Futures Ordinance also carries provisions to ensure settlement finality in the CCASS.

### **Salient features of the proposed legislation**

#### *The Proposed Oversight Regime*

##### *Criteria for designation*

11. Under the proposed legislation, the MA would be empowered to designate any important clearing and settlement system for funds or securities, which meets certain specified criteria, as a “designated system” to be subject to the oversight regime.

12. The oversight regime would be confined to those important clearing and settlement systems that have implications for -

- (a) the stability of the monetary or financial system in Hong Kong;  
or
- (b) the functioning of Hong Kong as an international financial centre.

13. Under these criteria, the proposed oversight regime would effectively cover all the important payment systems that are currently subject to the de facto oversight of the MA such as HKD CHATS, USD

CHATS, Euro CHATS, CMU, Cheque Clearing and the cash settlement leg of CCASS. This would also enable us to cover the CLS System in the future.

### Oversight powers

14. The MA would have powers to impose conditions, to subsequently revoke or vary any conditions and to impose any additional conditions on a designated system.

15. A designated system is required to have in place a set of non-statutory rules ensuring the system's safety (in relation to certainty of settlement, reliability and robustness of operation, proper security control and data integrity) and efficiency (in relation to access by market participants to the system and competition related issues).

16. The MA could require a designated system to have adequate financial resources appropriate for the proper performance of the system's particular functions.

17. The MA would have a general rule making power in relation to the oversight of designated systems to ensure the safety, efficiency and financial soundness of such systems. These rules would be subsidiary legislation subject to vetting of the legislature.

### Revocation of designation

18. The MA may revoke a designation if a designated system is no longer an important clearing and settlement system for the purposes of

the Ordinance, has ceased operations, is being wound-up, or has contravened any condition or requirement of the Ordinance.

19. The MA will have to give the relevant designated system a reasonable opportunity of being heard after notifying it of the MA's intention to revoke the designation.

### *The Proposed Settlement Finality*

#### *Present position*

20. Hong Kong does not have specific legislation on the settlement finality of its clearing and settlement systems except the Securities and Futures Ordinance (Cap. 571) which exempts only recognised clearing houses in respect of exchange-traded securities or futures contracts, from the relevant insolvency rules.

21. It is proposed that provisions similar to sections 45 to 54 of the SFO be provided under the proposed Bill to be applied to transactions cleared through designated systems as appropriate so that settlement finality in such systems can be assured. In such systems, these provisions would provide that the powers of a relevant insolvency office-holder in his capacity as such, and the powers of a court acting under the law of insolvency, are not to be exercised in such a way as to prevent or interfere with the proceedings of a designated system.

22. However, these provisions would not prevent a liquidator from pursuing assets, or a court from afterwards making an order, in respect of the underlying disposition of assets between members of the designated system and/or their customers, provided this does not lead to

any revocation or reversal of the relevant transaction or disposition through the designated system.

23. Further, it is provided that a court is not to recognize or give effect to any foreign court order made under the relevant law of insolvency, or an act of a relevant insolvency office-holder, in so far as making the order or doing that act would be prohibited under the proposed Bill in the case of a Hong Kong court.

24. As mentioned above, the Securities and Futures Commission (SFC) already has the power to designate entities which clear and settle transactions effected on the stock exchange or the futures exchange as “recognised clearing houses”. The Bill will not overlap with Part III of the Securities and Futures Ordinance to avoid any regulatory duplication with the SFC in overseeing the CCASS. It will concern itself with payment systems and systems for the clearing and settlement of securities as referred to in paragraph 3(d) and (f) above.

### Appeals

25. An independent tribunal is proposed to be established to hear any appeal by any person who is aggrieved by a decision of the MA to designate, or to revoke or temporarily revoke designation as a designated system; or to impose, vary, or add a condition in respect of a designation.

### Consultation

26. The MA is conducting briefings for the SFC, HKEx, relevant system operators, insolvency practitioners and the Hong Kong Association of Banks on the proposed legislation. They will be further consulted on the



draft Bill once it is available. Their comments will be incorporated into the Bill as appropriate before the introduction of the Bill to the Legislative Council.

### **Timing**

27. It is intended that the Bill be introduced into the Legislative Council in July 2003 with the hope that it be enacted in time for the inclusion of HKD in the CLS System in 2004.

Hong Kong Monetary Authority  
Financial Services and the Treasury Bureau

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