Alan Marquard
General Counsel

CLS Group

Exchange Tower
One Harbour Exchange Square
London E14 9GE

Tel: +44 (0)20 7971 5409
Fax: +44 (0)20 7971 5729
amarquard@cls-group.com

April 17, 2015

Via email

Resolution Regime Consultation
Financial Services Branch
Financial Services and the Treasury Bureau
24/F, Central Government Offices
2 Tim Mei Avenue, Tamar, Hong Kong

Email: resolution@fstb.gov.hk

Re: Consultation Paper on an Effective Resolution Regime for Financial Institutions in Hong Kong

Ladies and Gentlemen:

CLS Bank International ("**CLS**"), the operator of the CLS settlement system (the "**CLS System**"), appreciates the opportunity to respond to the Consultation Paper on the Effective Resolution Regime for Financial Institutions in Hong Kong (the "**Consultation Paper**"), dated January 21, 2015.

Background

CLS is a special purpose corporation organized under the laws of the United States of America and supervised by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of New York.[1] CLS is also subject to cooperative oversight by 22 central banks whose currencies are settled in the CLS System, including the Hong Kong Monetary Authority (the "**Monetary Authority**"), pursuant to a Protocol for the Cooperative Oversight Arrangement of CLS[2] organized and administered by the Federal Reserve. The CLS System is a

[1] CLS's parent company, CLS UK Intermediate Holdings Ltd., has two representative offices, one located in Hong Kong and the other in Japan.

[2] http://www.federalreserve.gov/paymentsystems/files/cls_protocol.pdf

designated system in Hong Kong for the purposes of the Clearing and Settlement Systems Ordinance (Cap. 584) (the "**CSSO**").

The CLS System is a global settlement system that offers its members and their customers the ability to mitigate settlement risk with regard to their foreign exchange transactions, and has been designated under the CSSO on the basis that its settlement service is material to the monetary and financial stability of Hong Kong as an international financial centre.[3] The CLS System relies on the protection provided by the CSSO to ensure finality of settlement and funding as well as enforceability of its netting and default arrangements. In this manner CLS ensures that it has an acceptable legal basis for its settlement of Hong Kong dollar payment instructions and for the participation of Hong Kong institutions as CLS members. As a financial market infrastructure (an "**FMI**"), the CLS System currently observes the applicable principles of the CPMI[4]-IOSCO Principles for financial market infrastructures (the "**PFMI**"), including Principle 1: Legal Basis ("An FMI should have a well-founded, clear, transparent, and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions").

CLS's Comments

I. Resolution Regime Applicable to FMIs

- **Scope of Regime with Regard to FMIs**

The Consultation Paper proposes that all FMIs overseen by the Monetary Authority under the CSSO be brought within the scope of the resolution regime.[5] CLS is supportive of this approach in light of FMIs' critical role in the financial system and the potential consequences should an FMI experience distress or fail. CLS further supports the general assertion in paragraph 18 of the Consultation Paper, that resolution regimes for FMIs must be appropriately tailored given that the standard objective of an insolvency proceeding, to maximize value for creditors, may be inconsistent with the policy of stability and the goal of the continuation of an FMI's services. In this regard, CLS would also like to highlight that it is critical that an FMI retain its licenses, authorisations, recognitions, legal designations or other protections on which it relies if it is to continue to provide services during resolution. Therefore, for the avoidance of doubt, CLS suggests that the CSSO be amended to clarify that finality and other protections will continue to apply with respect to a designated system, irrespective of whether the settlement institution (or system operator) is itself in resolution.

---

[3] CLS has also been designated under finality legislation in various other jurisdictions and has been designated a systemically important Financial Market Utility by the United States Financial Stability Council under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").

[4] Effective September 1, 2014, the Committee on Payment and Settlement Systems ("**CPSS**") changed its name to the Committee on Payments and Market Infrastructures ("**CPMI**").

[5] Paragraph 17 of the Consultation Paper.

Resolution regimes applicable to FMIs must also take into account that some FMIs, such as the CLS System, are international in scope. For such FMIs, any resolution regime should: (i) only be triggered in cooperation and coordination with the FMI's primary regulators in the jurisdiction of the FMI's operator and under no circumstances be commenced without notifying the FMI and its primary regulators in advance, and (ii) contain clear triggers that are consistent across jurisdictions (and global authorities should coordinate the establishment of such triggers), so that recovery measures will not be inadvertently disrupted. Due to the above-cited complexities, resolution measures for FMIs require unique consideration and a special emphasis on certainty so that relevant protections will not unintentionally terminate, and, in certain cases, require international coordination, in order for an FMI in resolution to maintain the confidence of its participants and thereby provide its critical services without disruption.

- **Question 16: Do you have views on how the list of excluded liabilities in paragraph 108 should be expanded to ensure that the bail-in option is suitable for use with FIs other than banks, and specifically in relation to insurers, FMIs and NBNI FIs?**

CLS believes that any legislation providing for bail-in must clearly provide that bail-in powers will not extend to, or impact upon, an FMI's default arrangements set forth in its rules, such as its access to liquidity providers. Access to liquidity providers in certain situations, pursuant to CLS's rules, is fundamental to the risk design of the CLS System and cannot be called into question. Banks may be reluctant to timely honor their obligations as liquidity providers or to agree to become liquidity providers (or to otherwise play an important role with respect to an FMI's default arrangements) if they have reason to doubt repayment from the FMI.

- **Powers to operate and resolve the FI**

Recognizing the importance of FMIs to the economy at large, CLS supports paragraph 150, which provides that any resolution regime should "also include the power to continue the payment, clearing and settlement functions performed by an FMI in resolution." As an international system designated under the CSSO but organized and operated outside Hong Kong and subject to primary supervision outside Hong Kong, CLS believes that the scope of the Hong Kong resolution regime should however be tailored to extend only as far as necessary to enable Hong Kong authorities to take action in cooperation and coordination with the primary regulator to ensure the continued service of the FMI. CLS therefore suggests that the Hong Kong authorities consider adopting a limited resolution approach for foreign systems designated under the CSSO, which would allow the Hong Kong authorities to take appropriate steps to ensure that designated systems will continue to provide their critical services. In order to accomplish this goal, the Hong Kong authorities' powers should include (i) powers to enforce contractual terms notwithstanding

clauses for termination upon resolution,[6] and (ii) stays to protect the FMI's assets that are used for its systemically important function, wherever held.[7]

- **Loss Sharing Arrangements**

In paragraph 228, the Consultation Paper states that, "following failure of an FMI . . . it would appear to be both necessary and reasonable to recover costs from a wider set of stakeholders than simply other FMIs." For the sake of transparency and fairness, FMIs commonly operate pursuant to rules and participant agreements that underpin the services they provide. The right to allocate losses in the CLS System is governed by its rules, which form part of its contractual agreement with its participants. Therefore, participants subject to loss allocation should be treated as contractual counterparties or, if applicable, creditors, and as such should be treated in the same manner as other similarly ranked creditors. In order to ensure the continuity of an FMI's services in resolution, it is imperative that any resolution regime or authority respect the rules or other contractual relationships between the FMI and its participants in all circumstances (before, during and after a resolution). Participants should otherwise not be subject to losses unless such losses are controllable and pursuant to ex ante arrangements.

II. FMIs' Role in the Resolution of Financial Institutions

- **Protection of financial stability and continuity for critical financial services, including payment, clearing and settlement functions**

CLS fully supports and seeks to accommodate the regulatory goals expressed in paragraph 63 of the Consultation Paper, which provides that "in exercising its powers the resolution authority should…promote and seek to maintain the general stability and effective working of the financial system in Hong Kong, including by securing continued provision of critical financial services, including payment, clearing and settlement functions." In light of the fact that an FMI's failure to allow an entity subject to resolution (including a bridge institution or other successor entity) to participate in an FMI would likely disrupt these critical services, CLS believes that it is imperative for all FMIs to cooperate fully with regulators (including resolution authorities)

---

[6] Some FMIs may use vendors, or even other FMIs such as RTGS systems, that are critical to the performance of their service, and therefore such third party's refusal to provide services would affect the financial community at large. Thus, CLS supports affording resolution authorities the flexibility to ensure the continued performance by third parties under their existing agreements with FMIs, assuming the FMI also continues to perform under such agreements.

[7] The principle of "no creditor worse off" should apply notwithstanding such stays, however, protections from creditor actions for an appropriate time period may be necessary to maintain market confidence while the resolution authorities resolve the FMI in an orderly way to prevent systemic disruption.

to identify and address all issues that may impede continued participation.[8] However, as noted above, payment systems, such as CLS, must observe relevant principles of the PFMI at all times and therefore cannot (and should not) allow continued participation of an entity subject to resolution where continued participation would compromise the continued safe and orderly operations of the FMI.[9] In this context, CLS supports the policy underlying Box A in paragraph 82 of the Consultation Paper, which summarily acknowledges the interface between existing corporate insolvency proceedings and the proposed regime, and the interaction of the proposed regime with existing laws in Hong Kong. It is critically important that a well-founded, clear, transparent, and enforceable legal basis for each material aspect of FMIs' activities continues to exist in Hong Kong with respect to the proposed regime, and CLS is of the view that this would best be accomplished through certain amendments to the CSSO, as discussed further below.

- **Safeguarding of Protected Financial Arrangements**

a) **Proposed Amendments to the CSSO.** A critical means of safeguarding financial arrangements, such as the enforceability of netting, and rules and arrangements with trading, clearing, and settlement systems,[10] is to ensure that the existing underlying statutes upon which the efficacy of such arrangements or rules are predicated are amended to afford appropriate protection in respect of such financial arrangements in a resolution scenario. To this end, and in order to maximize the likelihood that an entity subject to resolution or its successor entity will not be precluded from participating in systems designated under the CSSO, CLS suggests the following amendments to the CSSO:[11]

- The statutory protections set forth in the CSSO should apply with respect to resolution, in addition to insolvency. The statutory protections in the CSSO must apply in the event of resolution, and not solely with respect to insolvency proceedings. In addition, these protections must continue and must not terminate after resolution. This is especially important if resolution authorities are afforded powers in a resolution scenario similar to liquidators' powers in an insolvency scenario (e.g. the power to avoid dispositions), as discussed in paragraph 143 of the Consultation Paper. In order to accomplish this goal,

---

8 Depending upon the specific FMI, its structure and the services it provides, this may also require that the FMI amend its rules, as necessary and appropriate, and facilitate a fast-track application process for successor entities, including bridge institutions.

9 Please refer to Appendix II, Annex 1 to the Financial Stability Board's ("**FSB**") Key Attributes of Effective Resolution Regimes for Financial Institutions (the "**Key Attributes**"), dated October 15, 2014, relating to resolution of FMI participants, which provides that "[j]urisdictions should ensure that laws and regulations applicable to FMIs should not prevent FMIs from maintaining the participation of a firm in resolution *provided that the safe and orderly operation of the FMI is not compromised*." [Emphasis added]

10 Paragraph 192 and Annex IV of the Consultation Paper.

11 CLS suggests that some of these amendments may also be appropriate with respect to Division 3 of Part III of the Securities and Futures Ordinance (Cap. 571) ("**SFO**"), which applies in respect of market contracts cleared through recognized clearing houses.

various amendments to the CSSO would be required, including amendments to the term "law of insolvency" as used in Part 3, Divisions 3 and 4 of the CSSO (governing the scope of finality protections in respect of transfers and settlements within designated systems, and netting protections) to expressly include potential resolution laws.

- The statutory protections set forth in the CSSO should continue upon and after a Hong Kong resolution. In order to maximize the likelihood of a successful resolution and to minimize systemic disruption, CLS suggests that the CSSO should be amended to provide that statutory protections (e.g. finality and netting) for systems designated under the CSSO should continue over the course of the resolution strategy or use of the relevant resolution tool. In addition, and for the sake of consistency, CLS suggests that the CSSO should be amended to provide that protections under the CSSO will not terminate after an insolvency, but will continue at all times (including upon and after insolvency). This approach would align with the Securities and Futures Ordinance (Cap. 571) ("**SFO**") where relevant statutory protections applicable to market contracts cleared through a recognized clearing house do not terminate at a time which corresponds to section 24 of the CSSO.[12] There is no reason for different standards to apply to different types of FMIs; systems designated under the CSSO should be afforded the same protections provided by the SFO.[13]

- Eliminate the "branch issue": Resolution (or Insolvency) of a Hong Kong branch or other office of a foreign financial institution should not have an impact on the statutory protections set forth in the CSSO. CLS fully supports the Consultation Paper's position that Hong Kong resolution authorities should have resolution authority with respect to local branches of foreign financial institutions, as this affords Hong Kong authorities maximum flexibility to facilitate orderly, coordinated cross-broder resolution. In order to buttress this approach, CLS suggests that the CSSO be amended to provide that whether or not a branch or other office in Hong Kong is subject to resolution or insolvency, that fact should not have any impact upon applicable CSSO protections. This is significant because, as

---

12 Section 24 of the CSSO provides as follows:

(1) "This Division shall not apply in relation to any transfer order given by a participant in a designated system which is entered into the designated system after— (a) the expiry of the day on which— (i) a court makes an order for bankruptcy or winding up of the participant; (ii) a resolution for voluntary winding up of the participant is passed; or (iii) a directors' voluntary winding up statement in respect of the participant takes effect; or (b) the receipt by the system operator of notice of the event specified in paragraph (a), whichever first occurs.

(2) Reference in subsection (1) to the expiry of the day on which an event specified in subsection (1)(a) occurs in relation to a participant in a designated system is a reference to— (a) the expiry of that day according to Hong Kong time; or (b) the expiry of the same calendar day according to local time in the place where the designated system is established, whichever is the later."

13 The EU Bank Recovery and Resolution Directive 2014/59/EU of the European Parliament and of the Council of May 15, 2014 (the "**BRRD**") is clear that the regulatory intent with respect to resolution in EU member states is for statutory protections to apply in resolution scenarios (subject to conditions reflected in Article 68 of the BRRD) in order to allow for continued participation in designated systems. (Recital 93 of the BRRD).

noted above, the termination of statutory protections set forth in the CSSO is "triggered" by the start of a Hong Kong insolvency proceeding, and, unless clarified in the CSSO, may potentially be "triggered" by the start of a Hong Kong resolution proceeding, whether or not that insolvency or resolution proceeding relates to the head or home office of a Hong Kong financial institution or a Hong Kong office of a foreign financial institution.

If these issues are not addressed, it is possible that a Hong Kong resolution or insolvency[14] proceeding in respect of a branch of a foreign financial institution may inadvertently frustrate the intent of a foreign regulatory authority to ensure continued participation of that institution in an FMI designated under the CSSO in a time-sensitive situation, with potential systemic consequences.[15]

- Limitations on applicability of stays. In order to ensure that a stay implemented by Hong Kong resolution authorities will not have an adverse, unintended impact on designated FMIs, the CSSO should be amended to provide expressly that (i) a payment into or out of the account of a participant or a designated system to settle a payment obligation in a designated system is protected by the CSSO and may not be subject to a stay; and (ii) the rights and remedies of the system operator of a designated system (in relation to collateral and otherwise) may not be subject to a stay.[16]

b) **Safeguards.** CLS agrees that safeguards should be implemented to protect certain financial arrangements,[17] and acknowledges that this general approach is consistent with the requirements under resolution regimes in other jurisdictions.[18] However, CLS has various concerns regarding Annex 2 of the Consultation Paper. The meaning of the language reflected in column 2 "Protections," relating to the protections of "rules and arrangements within trading, clearing and settlement systems" is unclear. CLS suggests that the scope of this protection be clarified and proposes the addition of the following italicized words: "Resolution may not transfer property, rights or liabilities or modify the operation of or render invalid securities cleared through an FMI, or [*modify or render unenforceable*] the settlement or default rules of an FMI." This change accords with the language used elsewhere in Annex 2. In addition, with respect to column 3 "Remedy," CLS believes that rules and arrangements within systems must be clearly protected by

---

14 As a matter of Hong Kong law, it is possible for an insolvency proceeding to be initiated against a Hong Kong branch of a foreign institution by authorities or by a local court, upon the petition of third-party creditors, even where the head or home office of the financial institution in a foreign jurisdiction is healthy, is subject to recovery, or is under resolution by resolution authorities working to ensure the viability of the institution.

15 Depending upon the specific facts and circumstances, if the protections under the CSSO terminate, the FMI may restrict the ability of the institution to participate in the FMI.

16 This approach is reflected in the Canadian finality legislation (See Sections 8(2) - 8(3) of the Payment and Clearing Settlement Act).

17 Paragraphs 191 – 201 of the Consultation Paper.

18 See, for example, Chapter VII of the BRRD.

the relevant statutory regime in connection with the resolution of the system's participants (as discussed above). The protections of the CSSO must extend to all parties, including resolution authorities. The remedy proposed by the Consultation Paper (i.e., actions performed by resolution authorities can be declared void after the fact) will not afford designated systems and other stakeholders the high level of certainty required by the PFMI.

- **Advance Notice to FMIs regarding a proposed transfer of membership**

CLS notes that, under the proposed Hong Kong resolution framework, the formal commencement of "transfer" resolution proceedings in Hong Kong in relation to a financial institution would be accompanied by issuance of a public notice. In 2014, the FSB introduced Appendix II, Annex 1 to the Key Attributes, which emphasizes the relevance of notice to FMIs, drawing particular attention to the importance of advance notice. The Key Attributes specifically stipulate that "resolution authorities should inform FMIs as soon as possible of the resolution of a participant, and ***if possible in advance of the firm's entry into resolution***" [emphasis added].[19] Receipt of prior notice by FMIs will maximize the likelihood of continued participation in the FMI by the institution or any bridge bank or other successor institution to which the entity's business is transferred as part of a resolution proceeding. CLS fully agrees with the Key Attributes approach, and is of the view that advance notice to FMIs is critical for the following reasons:

(i) FMI's role as provider of information. If the entity in resolution is a participant in an FMI, the FMI will be able to provide the resolution authority with comprehensive up-to-date information regarding that participant, including information about its role in the FMI ecosystem, that will increase the likelihood of a successful resolution.

(ii) Ability to comply with obligations to the FMI. FMIs need sufficient time to ensure that a participant in resolution will be able to comply with its obligations. In the case of CLS, for example, timely funding is critical to ensure timely settlement and to avoid use of default arrangements. Therefore, CLS will need assurance, prior to the start of the next settlement session, that the participant in resolution will be able to comply with its funding obligations. Ensuring that the participant's obligations are met is in the interest of the resolution authority, the FMI, and other participants in the FMI.

(iii) Ability to Timely Undertake Necessary Steps. In order to accommodate the continued participation of a participant in resolution (or its successor) in a compressed timeframe, such as a weekend, FMIs need sufficient time to undertake the many

[19] Please refer to Section 5.1 of Appendix II, Annex 1 to the Key Attributes, relating to resolution of FMI participants, which provides that "Resolution authorities should inform FMIs as soon as possible of the resolution of a participant, and ***if possible in advance of the firm's entry into resolution*** [emphasis added]. Throughout the period that a participant is in resolution, authorities should provide the FMI with information about the participant or any bridge institution to which its functions have been transferred relevant to the continued participation of that firm or bridge institution in the FMI".

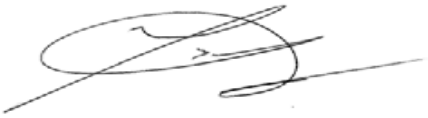
necessary (and often complex) internal steps and processes, which may include operational, liquidity, credit, and legal-related assessments and actions.

(iv) Application of mitigants. FMIs require the time to assess the need to apply appropriate mitigants in a resolution scenario so that the safety of the FMI will not be comprised.

Given the critical importance of notice to FMIs as outlined above, and the fact that it is in the interest of the regulatory authorities to provide as much advance notice as possible to FMIs prior to a proposed transfer of membership, CLS suggests that the Hong Kong resolution regime expressly require that resolution authorities provide advance notice to FMIs whenever possible.

Please do not hesitate to contact us if you have any questions regarding this letter.

Best regards,



Alan Marquard

cc: Dino Kos, Executive Vice President, Head of Global Regulatory Affairs, CLS Bank International
Lauren Alter-Baumann, Managing Director, Legal and Regulatory Strategic Affairs, CLS Bank International
Rachael Hoey, Head of Asia, CLS Group
Andrea Gildea, Director, Assistant General Counsel, CLS Bank International
Andrea Mparadzi, Associate Director, Assistant General Counsel, CLS Bank International