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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 2014.

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, pursuant to a Protocol for the Cooperative Oversight Arrangement of CLS[2] organized and administered by the Federal Reserve. The CLS System is a designated system for the purposes of the Clearing and Settlement Systems Ordinance (Cap. 584) (the "**CSSO**").

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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

The CLS System is a global settlement system that offers its Members and their customers the ability to mitigate settlement risk in the settlement of their foreign exchange transactions and has been designated under the CSSO on the basis that it is a clearing and settlement system, the proper functioning of which 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 complies with the CPSS Core Principles for Systemically Important Payment Systems (the "**Core Principles**"). Upon their implementation in the United States, the CLS System will also comply with the heightened standards set forth in the CPSS-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

- **Application of the Proposed Resolution Regime to FMIs that are designated to be overseen by the Monetary Authority (the "MA") under the CSSO (other than those which are owned and operated by the MA) and those that are recognized as clearing houses under the Securities and Futures Ordinance (Cap. 571) (the "SFO") (Question 4).**

CLS agrees with the Consultation Paper that it is unlikely that an FMI's viability would be threatened, but that if it were, the potential for severe systemic disruption would be very high. CLS therefore recognizes the need for an appropriately tailored resolution regime for FMIs 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 critical services.

CLS suggests that any resolution tools applicable to an international FMI such as CLS should: (i) only be utilized in cooperation and coordination with its 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. Resolution proceedings should only be triggered in circumstances where the FMI cannot operate and the protection of a resolution authority or regime is necessary to implement an orderly wind-down or upon an insolvency or

[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**").

creditor action, where a stay or other legal protections may be warranted to ensure the continuity of the FMI's critical services.[4]

For systems, such as the CLS System, that are designated under the CSSO but are organized and operated outside Hong Kong and subject to primary supervision outside Hong Kong,[5] CLS believes that the scope of the Hong Kong resolution regime should extend only as far as necessary to enable Hong Kong authorities to take action in cooperation and coordination with the primary regulator[6] 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 should have the authority, as necessary and appropriate, to protect any assets of the FMI and/or its affiliates located in Hong Kong, including central bank accounts or other accounts that are necessary for the FMI to provide its services, as well as local offices of the FMI and its affiliates. Accordingly, Hong Kong authorities should have the ability to protect against any enforcement of claims against the FMI and/or its affiliates in Hong Kong (including with respect to their assets) and to preclude the commencement by a third party of any insolvency proceeding against the FMI and/or its affiliates and their assets in Hong Kong. Hong Kong authorities should also have the authority to require an FMI's critical suppliers in Hong Kong, if any, to continue to perform with respect to the FMI, since a failure to provide critical services may have a systemic impact.[7]

- **Continuity for critical financial services, including payment, clearing and settlement functions, and to protect financial stability.**

CLS fully supports and seeks to accommodate the regulatory goals expressed in Section 10 of the Overview, which provides that "[a]ny resolution should seek to secure continuity for critical financial services, including payment, clearing and settlement functions, and to protect

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4 Title II of the Dodd-Frank Act, which creates the Orderly Liquidation Authority receivership for the liquidation of large interconnected financial companies, would only apply to CLS after an exhaustive, multi-step process that includes the evaluation of the merits of liquidation outside of the traditional bankruptcy regime.

5 CLS is not commenting regarding the appropriate approach with respect to a clearing house recognized under the SFO.

6 The Federal Deposit Insurance Corporation and the Bank of England's joint paper on "*Resolving Globally Active, Systemically Important, Financial Institutions*" (10 December 2012) provides, in the G-SIFI context, a positive example of cooperation between regulators.

7 The United Kingdom has recently adopted legislation specifically applicable to payment and settlement systems, which grants UK resolution authorities the ability, in certain circumstances and subject to specific conditions, to require an FMI's critical suppliers to continue to perform with respect to an FMI. (See Part 6 of the Financial Services (Banking Reform) Act 2013, relating to "Special Administration for Operators of Certain Infrastructure Systems.")

financial stability." 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) to identify and address all issues that may impede continued participation.[8] However, as noted above, payment systems such as CLS must comply with the Core Principles (and the PFMI, when implemented) at all times and therefore cannot (and should not) allow continued participation of an entity subject to resolution if such participation would jeopardize the FMI's ability to comply with the Core Principles, thereby potentially introducing systemic risk. In this context, CLS supports Section 14 of the Overview, which acknowledges that certain policy issues will require further development following this consultation, including (i) the interface between existing corporate insolvency proceedings and the proposed regime; and (ii) the interaction of the proposed regime with existing laws in Hong Kong.

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:[9]

- The statutory protections set forth in the CSSO should apply with respect to resolution, in addition to insolvency. It is necessary to ensure that the statutory protections in the CSSO will apply in the event of resolution, and not solely with respect to insolvency proceedings, and that these protections will continue and will not terminate after resolution. In order to accomplish this goal, various amendments to the CSSO would be required, including amendments to the term "law of insolvency" as used in Part 3, Division 3 of the CSSO, to expressly include potential resolution laws.

- The statutory protections set forth in the CSSO should continue upon and after a Hong Kong insolvency (or resolution). The CSSO currently provides that key statutory protections terminate shortly after an insolvency in Hong Kong.[10] For the reasons described below, CLS suggests that the CSSO should be amended to provide that

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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 CLS suggests that some of these amendments may also be appropriate with respect to Division 3 of Part III of the SFO, which applies in respect of market contracts cleared through recognized clearing houses.

10 The CSSO provides that statutory protections will not apply to instructions entered into a designated system after the occurrence of the earlier of the following: (a) the end of the day on which the court makes an insolvency order against the relevant system participant or the directors of the participant pass a voluntary resolution for its winding up or a directors' winding up statement in respect of the participant takes effect, or (b) the system operator receives notice of the insolvency order described above. The end of the day is the later of the end of the Hong Kong calendar day or the end of the calendar day where the system is established.

statutory protections for systems designated under the CSSO will not terminate after an insolvency, but will continue at all times (including upon and after insolvency or resolution).

(i) The CSSO is not consistent with the SFO

CLS notes that the relevant statutory protections set forth in the SFO applicable to market contracts cleared through a recognized clearing house do not terminate at a time which corresponds to section 24 of the CSSO. 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.

(ii) "Trigger" is Outdated.

When the CSSO was adopted in 2004, continued participation in financial market infrastructures (including designated systems) by failed or failing financial institutions was not a concern and the types of resolution proceedings currently under consideration were not contemplated. In light of the critical role played by all FMIs (acknowledged in this Consultation Paper), the enhanced requirements articulated in the PFMI (including Principle 1), and the potential for severe systemic disruption resulting from FMI non-viability (that could result from a lack of finality or other legal protections provided by the CSSO or uncertainty relating thereto), CLS believes that the "trigger" for termination of finality protections in the CSSO is outdated and should be revised as suggested above.[11]

- Eliminate the "branch issue": Insolvency or resolution 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. As noted above, the termination of statutory protections set forth in the CSSO is "triggered" by the start of a Hong Kong insolvency proceeding, whether or not that insolvency proceeding relates to the head or home office of a Hong Kong financial institution or a Hong Kong office of a foreign financial institution. 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

[11] CLS acknowledges that some other jurisdictions, including the European Union, have adopted finality legislation which provides that applicable statutory protections for designated systems likewise terminate shortly after the start of an insolvency (CLS has also proposed amendments to the European Settlement Finality Directive that would address this issue, if implemented). By contrast, however, various other jurisdictions (e.g., Australia, Canada, New Zealand, South Africa and South Korea) have adopted finality legislation which provides that statutory protections for designated systems either continue or may continue after the insolvency of a participant (in certain of these jurisdictions the system must obtain the express authorization of the relevant insolvency official before allowing the entity to continue to participate in the system).

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. Accordingly, (i) in response to Question 9 of the Consultation Paper, CLS agrees that Hong Kong resolution authorities should have resolution authority with respect to local branches of foreign financial institutions, to afford Hong Kong maximum flexibility in order to coordinate its efforts with foreign resolution authorities; and (ii) CLS suggests that the CSSO should be amended to provide that whether or not a branch or other office in Hong Kong is subject to insolvency or resolution should not have any impact upon applicable CSSO protections. If these issues are not addressed, it is possible that a Hong Kong insolvency 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.[12]

- 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 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.[13]

- Advance Notice to FMIs regarding a proposed transfer of membership. It is in the interest of the regulatory authorities to provide as much advance notice to system operators as possible prior to a proposed transfer of membership. Receipt of prior notice by system operators 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. The timely transfer of membership is likely to be extremely challenging and many issues (e.g., operational, liquidity, legal, credit, etc.) must be fully considered, documented, and planned for in advance by the resolution authority, by the institution, the system itself, and other entities (e.g., nostro institutions, third-party customers of the institution, etc.). Accordingly, CLS suggests that the Hong Kong resolution regime expressly require that resolution authorities provide advance notice to FMIs whenever possible.

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12 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.

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

- Resolution of FMIs. For the avoidance of doubt, CLS suggests that the CSSO should be amended to clarify that finality and other protections will continue to apply with respect a designated system, irrespective of whether the settlement institution (or system operator) is itself in resolution.

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

Best regards,

Dino Kos

cc: Alan Marquard, Chief Legal Officer, CLS Group
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