HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

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BY FAX AND BY POST
(2529 5003)

Our Ref.: C/IPC, M25452 6 February 2004

Mr. Tony Miller
Permanent Secretary for Financial Services
and the Treasury (Financial Services),
18/F., Admiralty Centre Tower 1,
18 Harbour Road,
Hong Kong.

Dear Mr. Miller,

Clearing and Settlement Systems Bill

With reference to your letter dated 8 December 2003 enclosing a copy of the Clearing and Settlement Systems Bill, our comments on the Bill are set out in the paragraphs below.

Proposed Effect of the Bill on Insolvency Principles

We understand that the purpose of the Bill in relation to insolvency law ("the Purpose"), is to ensure that transactions and settlements effected through a regulated/designated clearing and settlement system ("Regulated Body") (including both settlements effected by the Regulated Body against and/or collateral security arrangements entered into by an insolvent defaulting counterparty) ("Transfer Order(s)") are valid insofar as the transactions involving the Regulated Body are concerned. The desired result is for the integrity of the Transfer Orders to be preserved and for the settlements not to be subject to challenge both under the general law and/or on the insolvency of a counterparty.

Whilst we agree that the Bill should preserve the integrity of the Transfer Orders, we consider that the rights of an insolvency office holder ("IOH") under the general law to challenge the underlying economic transaction ("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 Regulated Body. It is our understanding that this is also the effect that you wish the Bill to achieve.

Effect on the ability of the Insolvency Practitioner to trace and recover assets

The comments in this letter are confined to the principal practical areas of concern. We have not therefore addressed the provisions of the Bill in relation to extortionate credit transactions or the disclaimer of onerous property.

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Consistency with other Hong Kong legislation

Under the general Hong Kong laws relating to insolvency, the principal ways in which an IOH can challenge transactions of an insolvent Hong Kong entity are as follows:

If the entity is a company

1. void transaction if it is effected after the time of presentation of a winding up petition and before a winding up order (Companies Ordinance (Cap 32) section 182);

2. unfair preference (Companies Ordinance, section 266/266B) if the transaction is effected within 6 months of the presentation of a winding up petition to a non-associate or within 2 years of the presentation of a winding up petition to an associate; and

3. transaction at an undervalue (no statutory provision as such but the IOH can utilise general corporate fiduciary duties to challenge transactions with this effect). The resultant claim, if established, is an unsecured claim against the beneficiary.

If the entity is an individual

4. void transaction if it is effected after the time of presentation of a bankruptcy petition and prior to the making of a bankruptcy order (Bankruptcy Ordinance (Cap 6), section 42);

5. unfair preference (Bankruptcy Ordinance, section 50) if the transaction is effected within 6 months of the presentation of a bankruptcy petition to a non-associate or within 2 years of the presentation of a bankruptcy petition to an associate; and

6. transaction at an undervalue (statutory provision under (Bankruptcy Ordinance, section 49) with a period of challenge of transactions of 5 years pre-presentation of the bankruptcy petition.

If the entity is a company or an individual

7. In both the case of an individual and a company, it is also possible to avoid a transaction on the grounds that it defrauded creditors (Conveyancing and Property Ordinance (Cap 219), section 60).

The provisions of the Securities and Futures Ordinance (Cap 571) ("SFO") alter the above provisions in relation to transactions regulated by the SFO. In particular, the SFO introduces a transaction at an undervalue claim in relation to corporate entities, it removes the existing transaction at an undervalue provisions in relation to individuals, and the existing preference provisions in relation to both corporate entities and individuals, and replaces these provisions with new statutory transaction at an undervalue and preference claims, which are different to the transaction at an undervalue and preference provisions under the general law, in particular in relation to the applicable time limits for challenge.

We note that the Bill proposes to legislate for a further and different insolvency regime in relation to transactions to be regulated by the Bill when it becomes law. Like the SFO, the Bill introduces a transaction at an undervalue claim in relation to corporate entities. Similarly, it removes the existing transaction at an undervalue provisions in relation to individuals and the existing preference provisions in relation to both corporate entities and individuals, and replaces these provisions with new statutory transaction at an undervalue and preference claims, which are different to the provisions under the general law. In relation to the Bill, the differences are both in relation to the applicable time limits for challenge and, significantly, also in the type of claim created. At clauses 26(2) and 27(2) of the Bill, the IOH is entitled to recover from the counterparty the gain made by that counterparty. This provision therefore creates 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.

In summary, in relation to transaction at an undervalue and preference claims, the effect of the Bill, when considered alongside the SFO, is to create a third insolvency regime. We do not consider that it is necessarily appropriate to have different underlying causes of action available to an IOH depending on whether or not the underlying transaction is regulated under the Bill, the SFO or the general law. On its current drafting, the Bill would result in third parties being subject to different treatment on the insolvency of a counterparty, depending on whether or not their transaction(s) were effected by a Regulated Body (e.g. that party could face a direct debt claim from the liquidator of a counterparty company if the transaction were effected through a Regulated Body, whereas if the same economic transaction were effected in another way, this claim would not exist). We suggest that this might not be the desired effect of the proposed legislation.

We have considered how this issue has been dealt with in the United Kingdom (UK), which, as you may be aware, has similar general insolvency laws. UK legislation has achieved the Purpose pursuant to Statutory Instrument 1999 No. 2979 ("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 the IOH in order that the integrity of the Transfer Orders is safeguarded. Such an order would preserve (and not unwind) the Transfer Orders but adjust the underlying transaction by making an order to reverse its economic effect.

We suggest that this might be an alternative and preferable way in which to achieve the Purpose. This approach is already reflected in clause 18 of the Bill.

Drafting issues in relation to void transactions

Under clause 19 (b) of the Bill, grounds 1 and 4 above are removed, i.e. the Transfer Orders are not classed as void unless ratified by an order of the Court, as would otherwise be the case under the general law. We agree that this is an essential provision to preserve the integrity of the clearing system and the Transfer Orders. However, we consider that the drafting of clause 19(b) is too wide (as discussed below) as it validates not only the Transfer Order but also the underlying Transaction (i.e. the disposition of property).

We understand that you do not object to the IOH retaining claims that would otherwise exist against counterparties provided that such claims do not conflict with the Purpose. If this assumption is correct, this would mean that an IOH could claim directly from the counterparty the amount that it has received from the insolvent counterparty, i.e. the IOH could claim that the Transaction was void, but not the Transfer Order. We do not consider that the Bill as drafted has this effect. Whilst clause 25 purports to preserve right of the IOH in relation to the Transactions, clause 25(1) begins "*Except to the extent that it expressly provides, this Part……*". In our view, this qualification renders ineffective this exception as, arguably, the provisions of 19(b) are worded so that they prevent a claim in relation to the underlying Transaction as well as the Transfer Orders.

In view of the fact that, in practice, the various Transfer Orders and the underlying economic Transactions are likely to be very closely connected, we consider that the provisions on the preservation of claims in relation to the Transactions should be amended. We suggest that the words "*Except to the extent that it expressly provides"* should be deleted from clause 25, and further wording be inserted as clause 25(3) to confirm that the provisions of section 42 of the Bankruptcy Ordinance and section 182 of the Companies Ordinance will remain applicable law in relation to the Transaction. We consider it particularly significant that these two provisions are expressly preserved in relation to the Transactions, as the Bill does not replace these provisions with alternative provisions, as is the case in the current draft in relation to transaction at an undervalue and preference claims. It may be appropriate to include a definition of "Transactions" to assist the Court and practitioners in identifying what constitutes a Transfer Order and what constitutes the underlying Transaction.

Further drafting suggestions in relation to antecedent transactions

Clause 20 of the Bill purports to remove the powers of the Court 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 under the grounds 2, 5, 6 and 7 above. This use of the words "*in relation to*" and inclusion of "*or disposition of property*" is, in our view, sufficiently wide to catch the underlying Transaction as well as the Transfer Order and property disposition effected by the Regulated Body pursuant to the Transfer Order itself.

As discussed above, clause 25 of the Bill appears to be intended to make it clear that, except to the extent expressly provided, the Bill shall not limit or restrict the underlying rights of challenge available to the IOH. We consider that the wording of clause 20 makes the operation of clause 25 (even with our proposed revised wording to clause 25 as suggested above) wider than is intended. This is because clause 20 expressly purports to stop the Court from making any order *in relation to* a Transfer Order *or disposition of property.* In practice, due to the connection between Transfer Orders and the underlying Transactions, a Transaction will almost certainly be able to be considered to be "*in relation to*" a Transfer Order and/or a disposition of property**.**

The Bill as drafted would appear to remove the IOH's right to make a claim under ground 7 above (transactions defrauding creditors) without either creating a new and similar statutory ground of claim under the Bill (as is the case for transactions at an undervalue and preferences), or enabling such claims to be pursued in relation to the Transactions. We do not consider that this is necessary in order to achieve the Purpose.

Additional drafting points

Clause 28(1)(a) of the Bill 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.

Clause 29 of the Bill proposes that in order to be released from compliance with the duties of his office to the extent that those duties are affected by action under default arrangements, the IOH must make an application to the Court to be released from compliance with these duties or for his duties to be altered. In order to prevent the delay and expense of such applications, we suggest that the Bill be amended to state that the duties of the IOH will be deemed not to be applicable to the extent that the actions of the IOH otherwise required by such duties would conflict with the Bill.

Clause 30 of the Bill concerns restrictions on the enforcement of execution/judgment or other legal process over assets provided as collateral security or held by a system operator or settlement institution as collateral security. Enforcement against such assets 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 and we consider 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). In particular, we consider this important as it is possible that the asset provided as collateral may have a value that provides surplus realisations over and above the amounts needed to collateralise the obligations for which it was provided. In such circumstances, we suggest 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 collateralised obligation and the surplus paid to the estate of the insolvent counterparty who provided the collateral. It is arguable that this scenario is already covered by clause 30(2) of the Bill in so far as the insolvent participant has "an interest in" the collateral, although this would not necessarily be the case in all circumstances (e.g. "true sale" dispositions of assets provided to effectively collateralise obligations).

Further definitions possibly required

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 the scope of a number of these terms. It might be useful for the terms "Insolvency", "Insolvency Proceeding" and "Insolvency Office Holder" to be defined. We note that there is a definition of "law of insolvency" in clause 13 of the Bill, but consider that it should be amended. The scope of these definitions will depend to some extent on the context in which such terms are used in the Bill. On the basis that a participant (as defined in the Bill) can include a company or an individual incorporated or domiciled in any jurisdiction in the world, clauses which purport to have effect on the insolvency of a counterparty (e.g clause 22 of the Bill) will require insolvency to be defined widely and include not only specific Hong Kong insolvency proceedings but also analogous events in other jurisdictions. A suggested wide definition is below:

"Insolvency" means the presentation of a winding-up or bankruptcy petition, the making of a winding-up or bankruptcy order, the passing of a winding-up resolution, the appointment of a provisional liquidator or interim receiver, the appointment of a person pursuant to an order for the

administration in bankruptcy of the insolvent estate of a deceased person and all analogous events in other jurisdictions.

Arguably, this definition should also include the appointment of a receiver over any assets of the participant, the inability to pay debts as they fall due, an excess of liabilities over assets (including contingent and prospective liabilities, the presentation of a petition for the administration of, the making of an administration order, the proposing of a voluntary arrangement and the approval of a voluntary arrangement, the proposal of a scheme of arrangements in circumstances of insolvency, the initiation of chapter 7 and 11 insolvency proceedings in the United States and again any analogous events in any jurisdiction.

"Insolvency Proceeding" should be defined to include any Insolvency, whether or not a court proceeding forms part of the Insolvency. Insolvency proceedings often do not involve court proceedings, for example in a voluntary liquidation or a receivership appointment by a secured creditor.

"Insolvency office holder" should be defined to include any person appointed or elected as office holder in relation to an "Insolvency Proceeding".

It may be that the terms are deliberately not defined, to leave the interpretation to the Court. However, given the wide range of possible insolvency proceedings and the varying rules applicable, it would be interesting to know the effect that the draftsman is seeking to achieve here. Clause 16 of the Bill refers to "the general law of insolvency" and we consider that there is no such clearly defined law. In our view, the law of insolvency incorporates many concepts from other areas of law, in particular the law relating to the ownership of property and security and other interests.

Jurisdiction / conflict of laws issues

We note that the Bill has been amended from its original draft in relation to the expansion of the definition of insolvency to include analogous insolvency proceedings in other jurisdictions (clause 13 (c)) and the expansion of regulated clearing and/or settlement systems to include such systems outside Hong Kong if they accept trades denominated in Hong Kong Dollars (clause 3(2)(b) of the Bill)(an amendment which in itself appears fine).

However, the Bill now purports to disapply the laws of insolvency (i.e. multi-jurisdictional laws) in relation to the Transfer Orders, i.e. it purports to disapply all insolvency laws (of which there will be many and conflicting laws in the various jurisdictions) in relation to all Transfer Orders by a regulated entity, and does not restrict its application to Transfer Orders by Hong Kong incorporated/domiciled entities and/or Transfer Orders involving assets in Hong Kong and/or even Transfer Orders denominated in Hong Kong Dollars (see clauses 16-18 of the Bill).

Certain clauses of the Bill seem to be drafted in what we would suggest is an appropriate way to deal with conflict of laws/jurisdictional matters (which mirrors the approach taken in the SFO (in particular, section 54 in relation to the law of insolvency in other jurisdictions) and in the 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. We suggest that this drafting should be reflected throughout the Bill.

We trust that the above comments are of assistance to you. If you have any questions in relation to the above, please feel free to contact me on 2287 7084.

Yours sincerely,

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMBERS & SPECIALIST PRACTICES)