

LEGISLATIVE COUNCIL BRIEF

Financial Institutions (Resolution) Ordinance (Cap. 628)

FINANCIAL INSTITUTIONS (RESOLUTION) ORDINANCE (COMMENCEMENT) NOTICE 2017

FINANCIAL INSTITUTIONS (RESOLUTION) (PROTECTED ARRANGEMENTS) REGULATION

INTRODUCTION

Further to the enactment of the Financial Institutions (Resolution) Ordinance (Cap. 628) (“the FIRO”) in June 2016, the Secretary for Financial Services and the Treasury (“SFST”) has made the following pieces of subsidiary legislation –

- (a) the **Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017** (“FIRO Commencement Notice”) at **Annex A**, pursuant to section 1(2) of the FIRO, to appoint 7 July 2017 as the date on which all provisions (except for Part 8 (sections 144 to 148), section 192 and Division 10 of Part 15 (sections 228 to 232)) of the FIRO will commence; and
- (b) the **Financial Institutions (Resolution) (Protected Arrangements) Regulation** (“PAR”) at **Annex B**, pursuant to section 75(1) of the FIRO, to prescribe requirements to be complied with by a resolution authority (“RA”) when exercising certain resolution powers with a view to safeguarding the economic effect of specified financial arrangements (defined together as “protected arrangements” under section 74 of the FIRO).

JUSTIFICATIONS

The FIRO

2. Enacted in June 2016, the FIRO establishes a cross-sector resolution regime for within scope financial institutions (“FIs”)¹ that is designed to meet international standards set by the Financial Stability Board (“FSB”) in respect of resolution regimes, namely the “*Key Attributes of Effective Resolution Regimes for Financial Institutions*” (“Key Attributes”). Ordinary insolvency proceedings are not a suitable mechanism for managing any possible failure of a non-viable systemically important FI in Hong Kong. Instead, resolution is designed to provide a credible alternative aimed at promoting and seeking to maintain the stability and effective working of the financial system of Hong Kong, including securing continuity of critical financial functions, whilst protecting public funds by imposing losses on a non-viable, systemically important FI’s shareholders and creditors. Once the FIRO comes into force, the Monetary Authority (“MA”), the Insurance Authority (“IA”) and the Securities and Futures Commission (“SFC”) will be the RAs. The RAs will be vested with a range of necessary powers to undertake resolution planning to prepare for any possible future application of stabilization options² to within scope FIs, as well as to apply those options as appropriate in the event of non-viability.

The PAR

3. Section 75(1) of the FIRO provides that the SFST may make regulations prescribing requirements to be complied with by an RA in making a regulated Part 5 instrument³ to safeguard the economic effect of

¹ Within scope FIs include all authorized institutions, certain financial market infrastructures, certain licensed corporations, certain authorized insurers, certain settlement institutions and system operators of designated clearing and settlement systems, and recognized clearing houses. The scope of the FIRO also extends to holding companies and affiliated operational entities of within scope FIs.

² These stabilization options are: (i) transfer to a purchaser; (ii) transfer to a bridge institution; (iii) transfer to an asset management vehicle; (iv) bail-in; and (v) transfer to a temporary public ownership company.

³ A Part 5 instrument means any of the following instruments made under Part 5 of the FIRO for the purposes of applying a stabilization option to a within scope entity that has met the relevant conditions for resolution – (i) a securities transfer instrument; (ii) a property transfer instrument; and (iii) a bail-in instrument (see section 2(1) of the FIRO). “Regulated Part 5 instrument” is defined in section 74 of the FIRO as a Part 5

the following six types of financial arrangements that are defined as “protected arrangements” in section 74 of the FIRO –

- (a) clearing and settlement systems arrangements;
- (b) netting arrangements;
- (c) secured arrangements;
- (d) set-off arrangements;
- (e) structured finance arrangements; and
- (f) title transfer arrangements.

4. Examples of “protected arrangements” include arrangements with a recognized clearing house (“RCH”), arrangements for set-off or netting of rights and liabilities with a counterparty under a master agreement, secured financing arrangements with fixed or floating charges, securitization and repurchase transactions. These “protected arrangements” are considered of fundamental importance to the operation of financial markets as financial market participants rely on them to both mitigate credit risk exposure to counterparties (e.g. set-off and netting arrangements) and provide sources of liquidity and financing (e.g. structured finance arrangements). It is therefore crucial that there is legal certainty that these arrangements would be afforded an appropriate degree of protection in resolution, the absence of which could cause a higher cost of funding or reduction of liquidity in the markets.

5. The PAR aims to address the possibility that the application of certain stabilization options may not safeguard the economic effect of “protected arrangements”, as action taken by an RA to effect a stabilization option could “split up” the assets, rights or liabilities constituting such arrangements. This possibility is considered most likely to crystallize: (i) where a partial property transfer (“PPT”) is made by an RA through which some, but not all, of an entity’s assets, rights and liabilities are transferred to a third party;⁴ or (ii) on bail-in where liabilities are written down and / or converted without taking into account linked assets or rights entitled to be set off or netted under arrangements that are documented or otherwise evidenced in writing.

instrument that – (i) results in a partial property transfer (“PPT”) being effected; or (ii) contains a bail-in provision.

⁴ A third party under a PPT could be: (i) a private sector purchaser; (ii) a bridge institution; or (iii) an asset management vehicle.

6. Before the FIRO commences operation, it is considered prudent to have the PAR ready to operate in order to provide legal certainty around the treatment of “protected arrangements” if an RA were to exercise its resolution powers.

Key Proposals

7. The PAR sets out how an RA should treat each type of “protected arrangement” in resolution. It also identifies some limited and clearly specified exclusions⁵ of rights and liabilities from the scope of certain “protected arrangements”. These exclusions are considered necessary to confer an appropriate degree of flexibility on an RA to achieve orderly resolution (e.g. to be able to transfer certain critical liabilities such as deposits quickly and decisively in order to secure continuity of access for depositors). It also establishes the consequences should an RA inadvertently act in a manner inconsistent with the objectives of the PAR. The approach to the PAR is largely modelled on that adopted by the United Kingdom (“UK”) and that required by the European Union’s Bank Recovery and Resolution Directive (“BRRD”).⁶

⁵ It is important to note that even where rights and liabilities are carved out from the PAR, affected pre-resolution shareholders / creditors would still be safeguarded by the “no creditor worse off than in liquidation” (“NCWOL”) compensation mechanism under the FIRO. The NCWOL compensation mechanism provides that pre-resolution shareholders / creditors of an entity in resolution should receive no less favourable a treatment in the resolution of an entity than would have been the case in a winding-up.

⁶ In the UK, these safeguards for certain financial arrangements have been implemented through two pieces of subsidiary legislation, namely The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (see: <http://www.legislation.gov.uk/uksi/2009/322/contents/made>) and The Banking Act 2009 (Restriction of Special Bail-in provision etc.) Order 2014 (see: <http://www.legislation.gov.uk/uksi/2014/3350/contents/made>) which have subsequently been subject to certain amendments through further legislative exercises. The links to the original versions have not yet been updated to reflect these subsequent legislative changes. In the European Union, the BRRD sets the requirements that member states’ resolution regimes must include in this regard in Articles 76 to 80 and the European Commission currently has a Delegated Regulation in development which is to provide further clarity on these Articles (see: <https://ec.europa.eu/transparency/regdoc/rep/3/2017/EN/C-2017-597-F1-EN-MAIN-PART-1.PDF>) based on advice provided to the Commission by the European Banking Authority (see: <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-15+Opinion+on+protected+arrangements.pdf>).

PPT: Clearing and Settlement Systems Arrangements

8. The PAR provides that an RA, in effecting a PPT that transfers assets, rights and liabilities of an entity in resolution that are part of a protected clearing and settlement systems arrangement (i.e. a RCH under the Securities and Futures Ordinance (Cap. 571) (“SFO”) or a designated clearing and settlement system (“DCSS”) under the Payment Systems and Stored Value Facilities Ordinance (Cap. 584) (“PSSVFO”)) is to seek to transfer all, and not just some of the assets, rights and liabilities under the arrangement, as otherwise the PPT may disrupt the operation of the arrangement. The PAR also specifies that the arrangements of an RCH or DCSS that should not be disrupted in a PPT are those arrangements protected by the insolvency override in sections 45(1) and 20(1) of the SFO and PSSVFO respectively. We consider that the approach taken in the PAR is consistent with the practice adopted in other jurisdictions (such as the UK).

PPT: Secured Arrangements

9. The PAR provides that an RA, in effecting a PPT that transfers assets or rights of an entity in resolution against which a liability is secured under a secured arrangement, is to seek to not transfer any constituent part (i.e. assets, rights, liabilities or benefit of security) of a secured arrangement without all other corresponding constituent parts. This extends to secured arrangements where security is by means of a fixed or a floating charge, insofar as the secured arrangements are legitimate (i.e. not made in contravention of any other legal requirement⁷).

PPT: Structured finance arrangements

10. The PAR provides that an RA, in effecting a PPT that transfers assets, rights and liabilities of an entity in resolution that constitute, or form

⁷ For example, a secured arrangement would not be recognized for the purposes of the PAR if it were made in contravention of section 119A(2) of the Banking Ordinance (Cap. 155) which provides that an authorized institution incorporated in Hong Kong must not, except with the approval of the MA, by whatever means create any charge over its assets if either – (a) the aggregate value of all charges existing over its total assets is 5% or more of the value of those total assets; or (b) creating that charge would cause the aggregate value of all charges (including that first-mentioned charge) over its total assets to be more than 5% of the value of those total assets.

part of, a protected structured finance arrangement, is to seek to transfer all, and not just some, of the assets, rights and liabilities under the arrangement. The PAR applies to structured finance arrangements that are securitizations, whether established through a “true sale” or “synthetic” structure. The definition also covers the key roles of an entity in resolution in supporting the performance of a securitization structure if they are directly linked to the underlying assets and payments under the securitization instrument. A deposit is not treated as a protected structured finance arrangement so an RA could transfer the critical financial function of deposit-taking without the need to treat those deposits as part of a structured finance arrangement. This exclusion facilitates an RA’s ability to achieve orderly resolution by allowing for a prompt and decisive transfer of deposits to achieve continuity of access for depositors.

PPT: Set-off, netting and title transfer arrangements

11. The PAR provides that an RA, in effecting a PPT that transfers any of the rights and liabilities of an entity in resolution under a set-off arrangement, a netting arrangement or a title transfer arrangement (that are documented or otherwise evidenced in writing) to which the entity in resolution is a party, is to seek to, subject to certain specified exclusions⁸, transfer all, and not just some, of the rights and liabilities under the arrangement. This approach provides clarity over the treatment of the arrangements along with an appropriate degree of flexibility for an RA to achieve orderly resolution and is intended to be broadly similar to that adopted in the UK.

12. The PAR applies to set-off, netting and title transfer arrangements that are documented or otherwise evidenced in writing (including where held electronically). This is to protect rights and liabilities entitled to be

⁸ These exclusions are rights and liabilities (i) relating to deposits; (ii) relating to assets in the form of receivables owed to the transferor by depositors (other than those owed in relation to a financial contract); (iii) relating to subordinated debts; (iv) relating to transferable securities (unless explicitly identified as the subject matter of a transaction under a set-off arrangement, netting arrangement or title transfer arrangement that is documented or otherwise evidenced in writing); (v) arising under a contract other than in the course of undertaking financial activity; and (vi) relating to a claim for damages, an award of damages or a claim under an indemnity in connection with the undertaking of financial activity. It is considered important to exclude these items from the PAR so as to allow sufficient flexibility for an RA to meet the resolution objectives.

set off or netted under set-off, netting or title transfer arrangements and as such that have a nexus or link *inter se*, as opposed to much broader set-off and netting rights which could arise by operation of law, so as to offer greater clarity for an RA in identifying the relevant arrangements and to provide an appropriate degree of flexibility to split the critical financial functions from a failed FI's balance sheet quickly and decisively in a PPT.

13. The PAR does not protect broad “sweeper” provisions and “walk-away” clauses. The objective is to ensure that (i) broad “sweeper” provisions which extend to any and all assets, rights and liabilities between the entity in resolution and its counterparty do not significantly limit the ability of an RA to effect a PPT (whilst respecting core close-out netting sets under master agreements); and (ii) clauses entitling a non-defaulting party to make no, or only limited, payments (even where the defaulting party is a net creditor) are not afforded protection, given that such clauses are not regarded as valid bilateral netting agreements for the purposes of the Banking Capital Rules (Cap. 155L).

Bail-in: Set-off, netting and title transfer arrangements

14. To respect set-off and netting rights on which counterparties rely to mitigate their exposures, including for regulatory capital calculation purposes, and minimize liquidity needs, pursuant to the PAR, an RA is to seek not to make a bail-in provision in respect of a protected liability (as defined in the PAR) subject to certain exclusions⁹, i.e. an RA is to seek to only bail in the net amount that the entity in resolution and its counterparty are entitled by contract to set off or net under set-off, netting or title transfer

⁹ These exclusions are (i) liabilities arising from any capital instrument issued by the entity in resolution; (ii) liabilities arising from subordinated debt issued by the entity in resolution; (iii) liabilities arising from an unsecured debt instrument that is a transferable security issued by the entity in resolution; (iv) unsecured liabilities arising from any instrument or contract which at the date it was issued, had a maturity period of twelve months or more and is not a financial contract, derivative contract or qualifying master agreement; (v) unsecured liabilities owed to another member of the same group as the entity in resolution which do not arise from a financial contract, derivative contract or qualifying master agreement; (vi) deposits which are not excluded from bail-in pursuant to section 2(b) or 2(c) of Schedule 5 to the FIRO; and (vii) liabilities which relate to a claim for damages, an award of damages or a claim under an indemnity. These exclusions are to facilitate an RA's prompt and decisive application of the bail-in stabilization option to those liabilities most likely to be subject to write-down under this power, with less likelihood of triggering further instability or contagion.

arrangements. The exclusions from the safeguard are specified in the PAR to provide an appropriate degree of flexibility for the RA to bail in those liabilities that considered most likely to represent effective loss-absorbency in resolution. The approach is intended to be consistent with that adopted in the UK.

Consequences

15. The PAR also specifies consequences should an RA inadvertently act inconsistently with the objectives of the PAR in applying a stabilization option. To reduce the risk of such action occurring, the FIRO empowers an RA to undertake *ex ante* resolution planning which may cover, amongst other things, ensuring within scope FIs' Management Information Systems ("MIS") are capable of producing, with adequate speed and accuracy, information necessary to identify the constituent parts of "protected arrangements".

16. Notwithstanding this important *ex ante* work, it is still possible for an RA to inadvertently take an action that is inconsistent with the PAR due to factors beyond the RA's control, e.g. due to deficiencies in an FI's MIS capabilities or definitional legal uncertainty in a transfer instrument. Therefore, we consider it important that the PAR should provide for consequences should an RA inadvertently take action that is inconsistent with the objectives of the PAR. These consequences differ depending upon the type of "protected arrangement" affected. In short, they provide for: (i) an affected party's position to be restored to the position as if an RA had acted consistently with the PAR (e.g. through a supplemental or reverse transfer of assets, rights or liabilities for secured or structured finance arrangements); (ii) counterparties to continue to operate as if the RA had acted consistently with the PAR (e.g. in relation to set-off and netting rights); (iii) for a transfer to be void to the extent that it disrupts the operation of a clearing and settlement systems arrangement; or (iv) the transfer through appropriate means of a "required sum", as defined in section 13(1) of the PAR, to an affected party whose protected liability has been subject to bail-in.

Commencement of the FIRO and the PAR

17. The commencement of the FIRO will confer on the RAs the necessary powers for undertaking resolution planning and to seek to preserve the stability and effective working of the financial system of Hong Kong in the event of a systemically important FI becoming non-viable.

THE SUBSIDIARY LEGISLATION

Financial Institutions (Resolution) Ordinance (Commencement) Notice 2017

18. The FIRO Commencement Notice seeks to bring all provisions (except for Part 8 (sections 144 to 148)¹⁰, section 192¹¹ and Division 10 of Part 15 (sections 228 to 232)¹²) of the FIRO into operation on 7 July 2017.

¹⁰ Part 8 (sections 144 to 148) of the FIRO is related to the clawback of remuneration including the application to the Court of First Instance for a clawback order under section 145. Having consulted the Judiciary Administration (“JA”), it is considered that this part should come into operation after the Chief Justice has made rules, pursuant to section 145(8), regulating the practice and procedure of the Court in connection with applications made under section 145.

¹¹ Section 192 relates to the presentation of a winding up petition of a within scope FI or a holding company of a within scope FI to the Court of First Instance. Having consulted the JA, it is considered that this section should come into operation after the Chief Justice has made rules, pursuant to section 192(3), regulating the practice and procedure of the Court for giving effect to section 192(1).

¹² Divisions 10 (sections 228 to 232) and 11 (sections 233 to 244) of Part 15 of FIRO are designed to cater for two possible scenarios in making the consequential amendments relating to the Insurance Companies (Amendment) Ordinance 2015 (“the ICAO”) and Insurance Ordinance (Cap. 41), depending on the commencement sequence of certain provisions of the ICAO for the purpose of taking over the existing regulatory functions of the Office of the Commissioner of Insurance by the independent Insurance Authority (“Stage 2 Provisions”) and the FIRO. Division 10 should be adopted if the FIRO commences operation before Stage 2 Provisions of the ICAO while division 11 should be adopted if Stage 2 Provisions of the ICAO commence operation before the FIRO. As Stage 2 Provisions of the ICAO will commence operation on 26 June 2017, it would not be necessary to commence division 10.

Financial Institutions (Resolution) (Protected Arrangements) Regulation

19. The main provisions of the PAR are as follows –
- (a) Part 1 provides for the commencement of the PAR and defines the various terms used in it (Sections 1 to 4);
 - (b) Part 2 deals with the protection to be afforded to arrangements when an instrument made under Part 5 of the FIRO results in a PPT being effected and it includes the following –
 - (i) a provision that requires an RA when transferring any of the rights and liabilities of an entity under certain set-off arrangements, netting arrangements or title transfer arrangements to seek to transfer all, and not just some, of the rights and liabilities. It excludes specified rights and liabilities from that requirement (Section 5);
 - (ii) a provision that requires an RA when transferring assets or rights of an entity against which a liability is secured under a secured arrangement to seek to ensure that the liability and the benefit of the security are also transferred (Section 6);
 - (iii) a provision that requires an RA when transferring assets, rights and liabilities of an entity constituting or forming part of a protected structured finance arrangement to seek to transfer all, and not just some, of the assets, rights and liabilities (Section 7);
 - (iv) a provision that requires an RA when transferring assets, rights and liabilities of an entity that are part of a protected clearing and settlement systems arrangement to seek to transfer all, and not just some, of those assets, rights and liabilities to the extent that not to do so would disrupt the operation of the arrangement (Section 8);
 - (v) a provision that provides that the duties of the RA under sections 5, 6 or 7 are to be treated as having been performed

despite the fact that the transfer of an asset, right or liability may not have been effective because of the operation of a non-Hong Kong law that governs the asset, right or liability (Section 9); and

- (vi) provisions that deal with the consequences where an RA effects a transfer inconsistently with what it was required to seek to do or not to do under Part 2 of the PAR (Sections 10 to 12);
- (c) Part 3 deals with the protection to be afforded to set-off arrangements, netting arrangements or title transfer arrangements when an instrument made under Part 5 of the FIRO contains a bail-in provision, and it includes the following –
- (i) definitions of the terms used in Part 3 (Section 13);
 - (ii) a provision that requires an RA to seek to not make a bail-in provision in respect of a protected liability subject to a specified exception (Section 14); and
 - (iii) a provision that enables a person who considers that a liability owed to the person has been affected by the making of a bail-in provision in respect of a protected liability to notify the RA. The RA may take specified steps, if appropriate, to address the consequence caused by the bail-in provision (Section 15);
- (d) the Schedule specifies the definition of financial contracts.

LEGISLATIVE TIMETABLE

20. The Commencement Notice of the FIRO and the PAR will be published in the Gazette on 12 May 2017 and tabled at LegCo at its sitting on 17 May 2017. Subject to the negative vetting by LegCo, the FIRO and PAR will come into operation on 7 July 2017.

IMPLICATIONS OF THE PROPOSALS

21. The FIRO and the PAR are designed to provide for a resolution regime in Hong Kong that is consistent with the international standards set out in the FSB's Key Attributes. The commencement of the FIRO and the PAR will confer necessary powers on the RAs in order to strengthen the resilience of the financial system in Hong Kong to any future shocks or stress events. The two pieces of subsidiary legislation are in conformity with the Basic Law, including the provisions concerning human rights.

PUBLIC CONSULTATION

22. The Financial Services and the Treasury Bureau, Hong Kong Monetary Authority, the IA and the SFC jointly conducted a two-month public consultation (from 22 November 2016 to 21 January 2017) on the PAR. Respondents generally agreed with the approach to the PAR proposed in the consultation paper whilst providing constructive, technical comments to enhance its efficacy. The consultation conclusion, which sets out our comprehensive responses to the comments received, was issued on 6 April 2017.¹³

23. We briefed the LegCo Panel on Financial Affairs on the proposals for the commencement of the FIRO and the PAR at its meeting on 18 April 2017. Members raised no objection to the proposals.

PUBLICITY

24. A press release will be issued upon the gazettal of the subsidiary legislation. A spokesperson will be made available for responding to media enquiries.

¹³ See: http://www.fstb.gov.hk/fsb/ppr/consult/doc/consult_conclu_par_e.pdf.

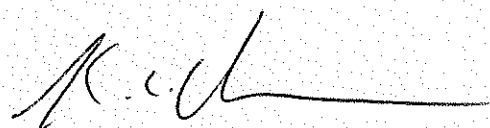
ENQUIRES

25. Enquiries in relation to the LegCo Brief should be directed to Ms Polly Kwok, Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) International and Mainland Affairs at 2810 2150.

**Financial Services and the Treasury Bureau
Hong Kong Monetary Authority
Securities and Futures Commission
Office of the Commissioner of Insurance
10 May 2017**

**Financial Institutions (Resolution) Ordinance
(Commencement) Notice 2017**

Under section 1(2) of the Financial Institutions (Resolution) Ordinance (Cap. 628), I appoint 7 July 2017 as the day on which the Ordinance (except Part 8, section 192 and Division 10 of Part 15) comes into operation.



Secretary for Financial Services and
the Treasury

9th May, 2017

Financial Institutions (Resolution) (Protected Arrangements) Regulation

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Financial Institutions (Resolution) (Protected Arrangements) Regulation

(Made by the Secretary for Financial Services and the Treasury under section 75(1) of the Financial Institutions (Resolution) Ordinance (Cap. 628))

Part 1

Preliminary

1. Commencement

This Regulation comes into operation on the day on which Part 5 of the Financial Institutions (Resolution) Ordinance (Cap. 628) comes into operation.

2. Interpretation

(1) In this Regulation—

financial activity (金融活動) means any activity that relates to deposits, financial contracts, loans, securities or transferable securities;

financial contract (金融合約) means a contract listed in the Schedule or any combination of such contracts;

protected clearing and settlement systems arrangement (受保障結算及交收系統安排)—see section 3;

protected structured finance arrangement (受保障結構式金融安排)—see section 4;

transferable securities (可轉讓證券) means—

- (a) shares in companies, or equivalent securities, or depository receipts in respect of such shares or securities;
- (b) bonds, or other forms of debt instruments, or depository receipts in respect of such bonds or instruments; or
- (c) any other financial instruments—
 - (i) that give a right to acquire or sell any transferable securities mentioned in paragraph (a) or (b); or
 - (ii) that give rise to a cash settlement and under which some or all of the return or amount due (or both the return and the amount due) is determined by reference to any transferable securities mentioned in paragraph (a) or (b), currencies (whether Hong Kong currency or any other currency), interest rates or yields, commodities, indices or other measures dealt in or negotiable on the financial markets.

(2) Words and expressions used in this Regulation and defined in section 74 of the Ordinance for the purposes of Subdivision 7 of Division 1 of Part 5 of the Ordinance have the same meaning as in that Subdivision.

3. Interpretation: protected clearing and settlement systems arrangement

(1) In this Regulation—

protected clearing and settlement systems arrangement (受保障結算及交收系統安排) means a specified arrangement governed by the rules and directions relating to participation in the clearing and settlement of transactions within a designated clearing and settlement system or a recognized clearing house;

specified arrangement (指明安排) means—

- (a) in relation to a designated clearing and settlement system—
- (i) a transfer order;
 - (ii) a disposition of property by or under a transfer order;
 - (iii) the default arrangements of the system;
 - (iv) the operating rules of the system as to the settlement of transfer orders not dealt with under the default arrangements of the system; or
 - (v) a contract for the purpose of realizing collateral security in connection with participation in the system otherwise than under the default arrangements of the system; and
- (b) in relation to a recognized clearing house—
- (i) a market contract;
 - (ii) the rules of the clearing house relating to the settlement of a market contract;
 - (iii) any proceedings or other action taken under the rules mentioned in subparagraph (ii);
 - (iv) a market charge;
 - (v) the provision of market collateral;
 - (vi) the default rules of the clearing house; or
 - (vii) any default proceedings.
- (2) In the definition of *specified arrangement* in subsection (1)—
- collateral security* (附屬抵押品) has the meaning given by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584);

- default arrangements* (違責處理安排) has the meaning given by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584);
- default proceedings* (違責處理程序) has the meaning given by section 18(1) of the Securities and Futures Ordinance (Cap. 571);
- default rules* (違責處理規則) has the meaning given by section 18(1) of the Securities and Futures Ordinance (Cap. 571);
- disposition of property* (財產產權處置) has the meaning given by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584);
- market charge* (市場押記) has the same meaning as in Division 3 of Part III of the Securities and Futures Ordinance (Cap. 571);
- market collateral* (市場抵押品) has the same meaning as in Division 3 of Part III of the Securities and Futures Ordinance (Cap. 571);
- market contract* (市場合約) means a market contract within the meaning of paragraph (a) or (b) of the definition of *market contract* in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);
- operating rules* (運作規則) has the meaning given by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584);
- rules* (規章), in relation to a recognized clearing house, means rules as defined in relation to a recognized clearing house by paragraph (b) of the definition of *rules* in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571);
- settlement* (交收), in relation to a market contract, has the same meaning as in Division 3 of Part III of the Securities and Futures Ordinance (Cap. 571);

transfer order (轉撥指令) has the meaning given by section 2 of the Payment Systems and Stored Value Facilities Ordinance (Cap. 584).

4. Interpretation: protected structured finance arrangement

(1) In this Regulation—

protected structured finance arrangement (受保障結構式金融安排) means a securitization—

- (a) in which the legal and beneficial ownership of the underlying assets have been transferred outright from the balance sheet of the originator; or
 - (b) in which the credit risk of a reference pool of underlying exposures is transferred, wholly or partly, through the use of credit protection afforded to the underlying exposures that remain on the balance sheet of the originator.
- (2) For the purposes of paragraph (a) of the definition of *protected structured finance arrangement* in subsection (1), any role of the originator in the structure is to be treated as a liability that forms part of the protected structured finance arrangement.
- (3) For the purposes of paragraph (b) of the definition of *protected structured finance arrangement* in subsection (1), a security interest is not to be treated as a right that forms part of the protected structured finance arrangement unless it is attached to specific and sufficiently identified or identifiable assets.
- (4) For the purposes of paragraphs (a) and (b) of the definition of *protected structured finance arrangement* in subsection (1), agreements constituting a securitization structure covering mutual relationships between originators, issuers, trustees, servicers, cash managers or swap and credit protection

counterparties are to be treated as forming part of the protected structured finance arrangement if those mutual relationships are directly linked to—

- (a) the underlying assets; and
- (b) the payments to be made from the proceeds generated by those assets to the holders of the instruments issued by the issuer in the securitization.

Part 2

Protections on Partial Property Transfer

5. **Set-off arrangement, netting arrangement and title transfer arrangement**
- (1) A resolution authority, in making a regulated Part 5 instrument that transfers any of the rights and liabilities of an entity (*transferor*) under a set-off arrangement, netting arrangement or title transfer arrangement entered into between the transferor and a particular person (*P*), is to seek to transfer all, and not just some, of those rights and liabilities if—
- (a) the arrangement is documented or otherwise evidenced in writing;
 - (b) either the transferor or *P* is entitled to set off or net the rights or liabilities under the arrangement;
 - (c) the arrangement does not contain a provision permitting a non-defaulting counterparty to make no (or only limited) payments to the defaulting party even if the defaulting party is a net creditor; and
 - (d) the rights or liabilities arise out of the arrangement and are not excluded by subsection (2).
- (2) For the purposes of subsection (1)(d), all of the following rights and liabilities are excluded—
- (a) rights and liabilities relating to a deposit made with the transferor;
 - (b) rights and liabilities relating to assets in the form of receivables owed to the transferor by depositors, other than receivables owed in relation to a financial contract;
 - (c) rights and liabilities relating to subordinated debt;

- (d) rights and liabilities relating to transferable securities unless explicitly identified as the subject matter of a transaction under a set-off arrangement, netting arrangement or title transfer arrangement that is documented or otherwise evidenced in writing;
 - (e) rights and liabilities arising under a contract entered into by, or on behalf of, the transferor otherwise than in the course of undertaking financial activity;
 - (f) rights and liabilities, arising in connection with the undertaking of financial activity, relating to a claim for damages, an award of damages or a claim under an indemnity.
6. **Secured arrangement**
- (1) A resolution authority, in making a regulated Part 5 instrument that transfers assets or rights of an entity (*transferor*) against which a liability is secured under a secured arrangement, is to seek—
- (a) to not transfer those assets or rights unless the liability and the benefit of the security are also transferred under that instrument;
 - (b) to not transfer the benefit of the security unless the liability is also transferred under that instrument; or
 - (c) to not transfer the liability unless the benefit of the security is also transferred under that instrument.
- (2) Subsection (1) applies—
- (a) whether the liability is secured against all, or substantially all, of the assets or rights of the transferor;
 - (b) whether the liability is secured against specified assets or rights; or

- (c) whether the assets or rights against which the liability is secured are not owned by the person who owes the liability.
- (3) Subsection (1) does not apply to an arrangement entered into in contravention of section 119A(2) of the Banking Ordinance (Cap. 155), or of any other restriction imposed by or under any enactment.

7. Protected structured finance arrangement

- (1) A resolution authority, in making a regulated Part 5 instrument that transfers assets, rights and liabilities of an entity (*transferor*) that constitute, or form part of, a protected structured finance arrangement, is to seek to transfer all, and not just some, of those assets, rights and liabilities.
- (2) Subsection (1) does not apply to assets, rights and liabilities relating to a deposit made with the transferor.

8. Protected clearing and settlement systems arrangement

- (1) A resolution authority, in making a regulated Part 5 instrument that transfers assets, rights and liabilities of an entity that are part of a protected clearing and settlement systems arrangement, is to seek to transfer all, and not just some, of those assets, rights and liabilities to the extent that not to do so would disrupt the operation of the arrangement.
- (2) Without limiting the ways in which the operation of a protected clearing and settlement systems arrangement may be disrupted, a disruption of any of the following would disrupt the operation of the arrangement for the purposes of subsection (1)—
 - (a) payment and delivery obligations in respect of transactions cleared and settled through a designated

clearing and settlement system or a recognized clearing house;

- (b) the rules as to settlement finality in respect of a designated clearing and settlement system or a recognized clearing house;
- (c) the rules regarding processes to be observed on the default of a participant in relation to a designated clearing and settlement system or a recognized clearing house.

9. Non-Hong Kong property

- (1) This section applies to a regulated Part 5 instrument that purports to transfer assets, rights or liabilities under a set-off arrangement, netting arrangement, title transfer arrangement, secured arrangement or protected structured finance arrangement.
- (2) The instrument is to be treated as having effectively transferred the assets, rights or liabilities, consistently with what the resolution authority was required to seek to do or to not do by section 5(1), 6(1) or 7(1) (as the case requires) in making the instrument, despite the possibility that any of them—
 - (a) are governed by a non-Hong Kong law; and
 - (b) may not have been effectively transferred by the instrument under the law of the particular non-Hong Kong jurisdiction, despite section 13 of Schedule 4 to the Ordinance.

10. Consequence (set-off arrangement, netting arrangement or title transfer arrangement)

A transfer effected by a regulated Part 5 instrument mentioned in section 5(1) inconsistently with what the resolution authority was

required to seek to do by that section in making the instrument does not affect the exercise of the right of P (referred to in that section) to set off or net rights or liabilities under the set-off arrangement, netting arrangement or title transfer arrangement.

11. Consequence (secured arrangement or protected structured finance arrangement)

- (1) Within the period of 60 days beginning on the day on which a regulated Part 5 instrument is made in respect of an entity, a person may give a written notice to the resolution authority that made the instrument if—
 - (a) immediately before the making of the instrument the person was a party to a contract with the entity or the holder or beneficiary of a security interest in relation to an asset of the entity arising by operation of law; and
 - (b) the person considers that—
 - (i) the instrument has effected a transfer inconsistently with what the resolution authority was required to seek to do or to not do by section 6(1) or 7(1) (as the case requires) in making the instrument; and
 - (ii) the person's assets, rights or liabilities under the contract have, or the security interest has, been affected by the making of the instrument.
- (2) A notice must—
 - (a) identify the regulated Part 5 instrument;
 - (b) give details of the contract or security interest mentioned in subsection (1)(a); and
 - (c) identify the assets, rights, liabilities or security interest of the person that the person considers have been affected by the making of the instrument.

- (3) A person who gives a notice must also, on request, provide any additional information that the resolution authority may reasonably require.
- (4) As soon as reasonably practicable within the applicable period, the resolution authority must determine—
 - (a) whether the regulated Part 5 instrument has effected a transfer inconsistently with what the resolution authority was required to seek to do or to not do by section 6(1) or 7(1) (as the case requires) in making the instrument; and
 - (b) whether the assets, rights, liabilities or security interest identified in the notice have been affected by the making of the instrument.
- (5) If the resolution authority determines that the regulated Part 5 instrument has had the effect mentioned in subsection (4)(a) and (b) it must transfer assets, rights or liabilities to a transferee or the transferor under the instrument, as appropriate, by means of a supplemental property transfer instrument or a reverse property transfer instrument so as to achieve the object mentioned in subsection (6).
- (6) The object is to bring about the outcome that would have been brought about had the resolution authority, in making the regulated Part 5 instrument, not acted inconsistently with what it was required to seek to do or to not do by section 6(1) or 7(1) (as the case requires).
- (7) If the resolution authority determines that the regulated Part 5 instrument has not had the effect mentioned in subsection (4)(a) and (b), it must give reasons for that determination to the person who gave the notice.
- (8) The applicable period is—
 - (a) the period of 60 days beginning on the day on which the notice is received (*initial period*); and

- (b) any period by which the initial period is extended under subsection (9).
- (9) The resolution authority may extend the initial period by a period of up to 60 days if it considers that the matters raised in the notice are of such complexity that it is impracticable to determine whether the regulated Part 5 instrument has had the effect mentioned in subsection (4)(a) and (b) without an extension of time.
- (10) If the resolution authority extends the initial period under subsection (9), it must as soon as reasonably practicable inform the person who gave the notice of the extension and its duration.
- (11) The assets, rights or liabilities that are transferred under subsection (5) may be the same as those whose transfer or non-transfer resulted in the regulated Part 5 instrument having the effect mentioned in subsection (4)(a) and (b) or, if that is not practicable, other assets, rights or liabilities that, in the opinion of the resolution authority, are equivalent to them.
12. **Consequence (protected clearing and settlement systems arrangement)**
- A transfer effected by a regulated Part 5 instrument inconsistently with what the resolution authority was required to seek to do by section 8(1) in making the instrument is void to the extent that it disrupts the operation of a protected clearing and settlement systems arrangement as mentioned in that section.

Part 3

Protections on Bail-in

13. Interpretation

(1) In this Part—

affected entity (受影響實體) means an entity in respect of which a regulated Part 5 instrument containing a bail-in provision is made;

bail-in provision (內部財務重整條文) has the meaning given by section 58(3) of the Ordinance;

protected liability (受保障負債) means a liability that is not an excluded liability as defined by section 58(9) of the Ordinance and that—

- (a) is owed by an affected entity to a particular person (*P*);
- (b) is a liability that either *P* or the affected entity is entitled to set off or net under a set-off arrangement, netting arrangement or title transfer arrangement entered into between *P* and the affected entity;
- (c) if related to a financial contract, has not been converted into a net debt, claim or obligation, whether in accordance with the terms of an arrangement mentioned in paragraph (b) or through the making of a bail-in provision or otherwise;
- (d) if related to a contract of any other kind, has neither been converted, nor treated as if it had been converted, into a net debt, claim or obligation, whether in accordance with the terms of an arrangement mentioned in paragraph (b) or through the making of a bail-in provision or otherwise; and

- (e) is not excluded by subsection (2);
- required sum (所需款項)** means any sum that the resolution authority considers necessary to put a person affected by a bail-in provision made in respect of a protected liability in the position that the person would have been in—
- (a) had the protected liability been converted, or treated as if it had been converted, into a net debt, claim or obligation in accordance with the terms of an arrangement mentioned in paragraph (b) of the definition of *protected liability* in this subsection or through the making of a bail-in provision or otherwise; and
 - (b) had the bail-in provision been made in respect of that net debt, claim or obligation.
- (2) For the purposes of paragraph (e) of the definition of *protected liability* in subsection (1), all of the following liabilities are excluded—
- (a) a liability owed in relation to a capital instrument issued by the affected entity;
 - (b) a liability owed in relation to subordinated debt issued by the affected entity;
 - (c) a liability owed in relation to an unsecured debt instrument that is a transferable security issued by the affected entity;
 - (d) an unsecured liability in relation to any instrument or contract that—
 - (i) at the date on which it was issued or made, had a maturity period of 12 months or more; and
 - (ii) is not a financial contract;

- (e) an unsecured liability owed to a group company of the affected entity that is not owed in relation to a financial contract;
 - (f) a liability in relation to a deposit that is not a liability listed in section 2(b) or (c) of Schedule 5 to the Ordinance;
 - (g) a liability in relation to a claim for damages, an award of damages or a claim under an indemnity.
- (3) For the purposes of the definition of *protected liability* in subsection (1)—
- (a) it does not matter—
 - (i) whether the arrangement that permits P or the affected entity to set off or net the liability also permits P or the affected entity to set off or net rights and liabilities with another person; or
 - (ii) whether the right of P or the affected entity to set off or net is exercisable only on the occurrence of a particular event; and
 - (b) a liability is to be treated as if it is converted into a net debt, claim or obligation if the amount due in relation to the liability is reduced by reference to any sums that the debtor would be able to set off against the liability in the event that the debtor decided to exercise set-off or netting rights.
- 14. Set-off arrangement, netting arrangement and title transfer arrangement**
- (1) A resolution authority is to seek not to exercise a power to make a bail-in provision in respect of a protected liability.
 - (2) However, subsection (1) does not prevent a bail-in provision mentioned in section 58(3)(c) of the Ordinance from being

made in order to convert, or in connection with converting, the protected liability into—

- (a) the net debt, claim or obligation that would be due under the set-off arrangement, netting arrangement or title transfer arrangement at the time the bail-in provision is made; or
- (b) an estimate of that net debt, claim or obligation.

15. Consequence (bail-in provision)

- (1) Within the period of 60 days beginning on the day on which a regulated Part 5 instrument is made in respect of an entity, a person (*P*) may give a written notice to the resolution authority that made the instrument if *P* considers that—
 - (a) the instrument has made a bail-in provision in respect of a protected liability; and
 - (b) as a result, a liability owed to *P* by the entity has been affected.
- (2) A notice must—
 - (a) identify the regulated Part 5 instrument;
 - (b) specify the manner in which it is alleged that a bail-in provision has been made in respect of a protected liability; and
 - (c) identify the liability owed to *P* that *P* considers has been affected.
- (3) *P* must also, on request, provide any additional information that the resolution authority may reasonably require.
- (4) As soon as reasonably practicable within the applicable period, the resolution authority must determine—
 - (a) whether the regulated Part 5 instrument has made a bail-in provision in respect of a protected liability; and

(b) whether, as a result, a liability identified in the notice has been affected.

- (5) If the resolution authority determines that the regulated Part 5 instrument has had the effect mentioned in subsection (4)(a) and (b), it must seek to take a step, or a combination of steps, specified in subsection (7).
- (6) If the resolution authority determines that the regulated Part 5 instrument has not had the effect mentioned in subsection (4)(a) and (b), it must give reasons for that determination to *P*.
- (7) The steps that may be taken are as follows—
 - (a) if the bail-in provision was not made in conjunction with the stabilization option mentioned in section 33(2)(b) of the Ordinance (transfer to a bridge institution)—
 - (i) effecting through the making of a Part 5 instrument, or otherwise procuring, the issuing by the affected entity to *P* of securities that the resolution authority estimates to have a value equal to the required sum;
 - (ii) transferring through the making of a Part 5 instrument, or otherwise procuring the transfer, to *P* of securities issued by the affected entity that the resolution authority estimates to have a value equal to the required sum; or
 - (iii) requiring the affected entity to transfer the required sum to *P*; or
 - (b) if the bail-in provision was made in conjunction with the stabilization option mentioned in section 33(2)(b) of the Ordinance (transfer to a bridge institution)—
 - (i) effecting through the making of a Part 5 instrument, or otherwise procuring, the issuing by the affected entity or the bridge institution to *P* of

- securities that the resolution authority estimates to have a value equal to the required sum;
- (ii) transferring through the making of a Part 5 instrument, or otherwise procuring the transfer, to P of securities issued by the affected entity or the bridge institution that the resolution authority estimates to have a value equal to the required sum; or
 - (iii) requiring the affected entity or the bridge institution to transfer the required sum to P.
- (8) The applicable period is—
- (a) the period of 120 days beginning on the day on which the notice is received (*initial period*); and
 - (b) any period by which the initial period is extended under subsection (9) or (10).
- (9) The resolution authority may extend the initial period by a period of up to 120 days (*first extended period*) if it considers that the matters raised in the notice are of such complexity that it is impracticable to determine whether the regulated Part 5 instrument has had the effect mentioned in subsection (4)(a) and (b) without an extension of time.
- (10) The resolution authority may extend the initial period (as extended by the first extended period) by a period of up to 120 days if it considers that the matters raised in the notice are of such complexity that it is impracticable to determine whether the regulated Part 5 instrument has had the effect mentioned in subsection (4)(a) and (b) without a further extension of time.
- (11) If the resolution authority extends a period under subsection (9) or (10), it must as soon as reasonably practicable inform P of the extension and its duration.

Schedule

[s. 2]

Financial Contracts

1. Securities contracts including—
 - (a) contracts for the purchase, sale or loan of a transferable security or a group or index of transferable securities; and
 - (b) repurchase or reverse purchase transactions on a transferable security or a group or index of transferable securities.
2. Commodities contracts of a financial nature including—
 - (a) contracts for the purchase, sale or loan of a commodity or a group or index of commodities for future delivery; and
 - (b) repurchase or reverse purchase transactions on a commodity or a group or index of commodities.
3. Derivative contracts, that is, financial instruments (other than bonds, loans, shares, notes or structured financial instruments) the value of which is determined by reference to the price or value of, or changes in the price or value of, at least one underlying asset, financial instrument, index, rate or thing of any kind designated in the instrument and includes forwards contracts, futures contracts, options contracts and swap agreements.
4. Contracts for the purchase, sale or delivery of Hong Kong currency or any other currency.

5. Master agreements in so far as they relate to a financial contract listed in items 1, 2, 3 and 4.



Secretary for Financial Services and
the Treasury

9th May, 2017

Explanatory Note

This Regulation is made under section 75(1) of the Financial Institutions (Resolution) Ordinance (Cap. 628) to prescribe requirements to be complied with by a resolution authority when making under Part 5 of that Ordinance a property transfer instrument that results in a partial property transfer being effected or a bail-in instrument that contains a bail-in provision. Its underlying purpose is to safeguard the economic effect of certain financial arrangements that are to be afforded an appropriate degree of protection. Arrangements to be protected are set-off arrangements, netting arrangements, secured arrangements, structured finance arrangements, title transfer arrangements and clearing and settlement systems arrangements. The economic effect of those arrangements would be undermined if assets, rights and liabilities that collectively constitute the arrangements were to become separated from one another. The Regulation specifies the protection to be afforded to each type of arrangement.

2. Part 1 provides for the commencement of the Regulation and defines various terms used in it.
3. Part 2 deals with the protection to be afforded to arrangements when an instrument made under Part 5 of the Ordinance results in a partial property transfer being effected.
4. Section 5 requires a resolution authority when transferring any of the rights and liabilities of an entity under certain set-off arrangements, netting arrangements or title transfer arrangements to seek to transfer all, and not just some, of the rights and liabilities. The section excludes specified rights and liabilities from that requirement.
5. Section 6 requires a resolution authority when transferring assets or rights of an entity against which a liability is secured under a

- secured arrangement to seek to ensure that the liability and the benefit of the security are also transferred.
6. Section 7 requires a resolution authority when transferring assets, rights and liabilities of an entity constituting or forming part of a protected structured finance arrangement to seek to transfer all, and not just some, of the assets, rights and liabilities.
 7. Section 8 relates to protected clearing and settlement systems arrangements. It requires a resolution authority when transferring assets, rights and liabilities of an entity that are part of such an arrangement to seek to transfer all, and not just some, of them to the extent that not to do so would disrupt the operation of the arrangement.
 8. Section 9 provides that the duties of the resolution authority under section 5, 6 or 7 are to be treated as having been performed despite the fact that the transfer of an asset, right or liability may not have been effective because of the operation of a non-Hong Kong law that governs the asset, right or liability.
 9. Sections 10 to 12 deal with the consequences where a resolution authority effects a transfer inconsistently with what it was required to seek to do or not to do under Part 2. Section 10 provides that a person may continue to exercise a right to set off or net rights or liabilities under an affected set-off arrangement, netting arrangement or title transfer arrangement. Section 11 puts a process in place for a person whose assets, rights or liabilities are affected by how an instrument made by a resolution authority has impacted a secured arrangement or a protected structured finance arrangement to bring about the outcome that would have been brought about had the resolution authority acted as it was expected to do in the first place. Section 12 renders void a transfer to the extent that it disrupts the operation of a protected clearing and settlement systems arrangement.

10. Part 3 deals with the protection to be afforded to set-off arrangements, netting arrangements or title transfer arrangements when an instrument made under Part 5 of the Ordinance contains a bail-in provision.
11. Section 13 defines terms used in Part 3.
12. Section 14 requires a resolution authority to seek to not make a bail-in provision in respect of a protected liability subject to a specified exception.
13. Section 15 enables a person who considers that a liability owed to the person has been affected by the making of a bail-in provision in respect of a protected liability to notify the resolution authority. The resolution authority may take specified steps, if appropriate, to address the consequence caused by the bail-in provision.
14. The Schedule sets out the contracts that are financial contracts.