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24 November 2021

Dear Sirs

**Responses to Instructions to Counsel –
Membership, Insolvency, Security, Set-off & Netting and Client Clearing –
Hong Kong Law**

We have been asked to provide advice in respect of the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**" or "**this jurisdiction**") in response to certain specific questions raised by LCH Limited ("**LCH**") in relation to membership, insolvency, security, set-off & netting and client clearing. The relevant questions are set out in full in Section 3 of this advice together with the corresponding responses. Terms not defined in this advice shall have the meaning ascribed to such terms in LCH's Rulebook (as defined below).

1. TERMS OF REFERENCE

1.1 Our advice is given in respect of Clearing Members which are Hong Kong companies (including banks but excluding insurance companies) and all references to a "**Relevant Clearing Member**" in this advice shall be construed accordingly. For these purposes:

- 1.1.1 a reference to a "bank" is a reference to a Hong Kong company which is an authorized institution under the Banking Ordinance;
- 1.1.2 a reference to a "Hong Kong company" is a reference to a company incorporated under the Companies Ordinance or a former Companies Ordinance; and

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- 1.1.3 a reference to an "insurance company" is a reference to a Hong Kong company which is authorised under the Insurance Ordinance to carry on an insurance business in Hong Kong.
- 1.2 We confirm that our advice is applicable to each of the SwapClear Client Clearing Services, the RepoClear Client Clearing Services, the EquityClear Client Clearing Services, the ForexClear Client Clearing Services and the Listed Interest Rates Client Clearing Services.
- 1.3 In this advice:
- 1.3.1 a reference to an "**Affected Entity**" is a reference to any entity which is within the scope of the resolution regime for financial institutions under the FIRO and includes, without limitation, the following (each as defined in section 2 of FIRO):
- (a) a "*within scope financial institution*" (which in turn will fall within the definition of "*banking sector entity*", "*insurance sector entity*" or "*securities and futures sector entity*");
 - (b) (if the relevant conditions in section 28 of the FIRO are satisfied) a "*holding company*" of a within scope financial institution;
 - (c) (if the relevant conditions in section 29 of the FIRO are satisfied) an "*affiliated operational entity*" of a within scope financial institution;
 - (d) (in respect of certain other provisions of the FIRO) a "*holding company*", a "*group company*" or a "subsidiary" of a within scope financial institution; and
 - (e) (if either such entity is subject to a non-Hong Kong resolution action (as defined in section 2 of the FIRO)) a "*non-Hong Kong Financial Institution*" or a "*non-Hong Kong group company*";
- 1.3.2 a reference to the "**Agreements**" is a reference to the Deed of Charge and the Clearing Membership Agreement;
- 1.3.3 a reference to the "**Arrangements**" is a reference to the Client Clearing Arrangements, the Collateral Arrangements and the Default Arrangements;
- 1.3.4 a reference to the "**Banking Ordinance**" is a reference to the Banking Ordinance, Chapter 155 of the Laws of Hong Kong;
- 1.3.5 a reference to "**Charged Property**" is a reference to such term as defined in the Deed of Charge;
- 1.3.6 a reference to the "**Clearing Membership Agreement**" is a reference to the Clearing Membership Agreement (as defined in LCH's Rulebook) which is substantially in the form set out in Appendix 2 to this advice;

- 1.3.7 a reference to the "**Client Clearing Arrangements**" is a reference to the contractual arrangements by which a Relevant Clearing Member is bound to the default management procedures of LCH in respect of Client Contracts, constituted by the Relevant Clearing Member's Clearing Membership Agreement and the General Regulations, including the Client Clearing Annex of the Default Rules of LCH;
- 1.3.8 a reference to a "**Client Contract**" is a reference to a Contract that has been entered into for the purposes of Client Clearing Business;
- 1.3.9 a reference to the "**Commencement Point**" is a reference to:
- (a) in relation to a Compulsory Winding-up, the time the relevant petition is presented to the court (if a winding-up order is made pursuant to the petition);
 - (b) in relation to a Voluntary Winding-up, the time of the passing of the resolution of members for such Voluntary Winding-up; and
 - (c) in relation to a s228A Winding-up, the time of the delivery to the Hong Kong Registrar of Companies of a statement in accordance with section 228A of the CWUMPO;
- 1.3.10 a reference to the "**Companies Ordinance**" is a reference to the Companies Ordinance, Chapter 622 of the Laws of Hong Kong;
- 1.3.11 a reference to the "**Companies Winding Up Ordinance**" is a reference to the Companies (Winding Up and Miscellaneous) Provisions Ordinance, Chapter 32 of the Laws of Hong Kong;
- 1.3.12 a reference to "**Collateral**" is to Securities (as such term is defined in the Deed of Charge) provided by the Relevant Clearing Member to LCH pursuant to the Deed of Charge in accordance with the Procedures of LCH (and, in particular, section 4 (*Collateral*) of the Procedures of LCH) and the term, for the avoidance of doubt, includes the Charged Property (as defined in the Deed of Charge);
- 1.3.13 a reference to the "**Collateral Arrangements**" is a reference to the security arrangements which govern the provision of Collateral by a Relevant Clearing Member to LCH, constituted by the relevant executed Deed of Charge, the General Regulations of LCH (in particular those set out in Section 4 (*Collateral*) of the Procedures of the LCH) and the relevant instruction(s) through LCH's Collateral Management System;
- 1.3.14 a reference to a "**Covered Contract**" is a reference, in relation to the Stay Rules, to a "covered contract" (as defined therein).
- 1.3.15 a reference to a "**Covered Entity**" is a reference, in relation to the Stay Rules, to a "covered entity" (as defined therein).

- 1.3.16 a reference to the "**Deed of Charge**" is a reference to the deed of charge entered into between a Relevant Clearing Member and LCH which is substantially in the form set out in Appendix 1 to this advice and which contains no material modifications to the wording set out in Clause 2 of that annexed form (for the avoidance of doubt, a change to the numbering of the clause or other provision in which the relevant wording appears in a particular deed of charge would not (in either such case) of itself constitute a "material modification" for these purposes);
- 1.3.17 a reference to the "**Default Arrangements**" is a reference to the contractual arrangements by which a Relevant Clearing Member is bound to the default management procedures of LCH, constituted by the Relevant Clearing Member's Clearing Membership Agreement and the General Regulations, including the Default Rules of LCH;
- 1.3.18 a reference to the "**FIRO**" is a reference to the Financial Institutions (Resolution) Ordinance, Chapter 628 of Hong Kong;
- 1.3.19 a reference to "**Insolvency Proceeding**" is a reference to any of the proceedings and procedures referred to in paragraphs 3.2.1(a)(i) to 3.2.1(a)(iv) of this advice;
- 1.3.20 a reference to the "**Insurance Ordinance**" is a reference to the Insurance Ordinance, Chapter 41 of the Laws of Hong Kong;
- 1.3.21 a reference to the "**Payment Systems and Stored Value Facilities Ordinance**" is a reference to the Payment Systems and Stored Value Facilities Ordinance, Chapter 584 of the Laws of Hong Kong;
- 1.3.22 a reference to the "**Parties**" is a reference to LCH and a single Relevant Clearing Member to which this advice applies, and a reference to a "**Party**" is a reference to either of them;
- 1.3.23 a reference to "**Protected Arrangements Regulation**" is a reference to the Financial Institutions (Resolution) (Protected Arrangements) Regulation, Chapter 628A of the Laws of Hong Kong;
- 1.3.24 a reference to the "**Reorganisation Measures**" is a reference to the proceedings referred to in paragraph 3.2.1(a)(v) of this advice;
- 1.3.25 a reference to "**Secured Obligations**" is a reference to such term as defined in the Deed of Charge;
- 1.3.26 a reference to the "**Securities and Futures Ordinance**" is a reference to the Securities and Futures Ordinance, Chapter 571 of the Laws of Hong Kong;
- 1.3.27 a reference to a "**securities transfer instrument**", a "**property transfer instrument**", or a "**bail-in instrument**" issued under the FIRO includes any such instrument issued in respect of a non-Hong Kong financial institution or a non-Hong Kong group company under section 191 of the FIRO;

- 1.3.28 a reference to "**Statutory Insolvency Set-Off**" is a reference to the process referred to in paragraph 3.2.5 of this advice;
 - 1.3.29 a reference to the "**Stay Rules**" is a reference to such term as defined at paragraph 3.2.3(d)(i).
 - 1.3.30 unless the context otherwise requires, a reference to a "paragraph" is a reference to a paragraph in this advice and a reference to a "Section" is a reference to a section in this advice; and
 - 1.3.31 headings are for ease of reference only and shall not affect interpretation of this advice.
- 1.4 For the purposes of preparing our advice we have reviewed only the following documents (the "**Subject Documents**"):
- 1.4.1 the General Regulations, Procedures, Default Rules, Settlement Finality Regulations and the Product Specific Contract Terms and Eligibility Criteria Manual published on LCH's website as at the date of this advice ("**LCH's Rulebook**");
 - 1.4.2 the Clearing Membership Agreement set out in Appendix 2 to this advice; and
 - 1.4.3 the Deed of Charge set out in Appendix 1 to this advice.
- 1.5 We have reviewed the Subject Documents in connection with the instructions to counsel dated 11 June 2021 and 7 July 2021 (the "**Instructions**") and the Service Description (as defined in the Instructions).
- 1.6 Our advice is given in respect of the specific questions raised by you as set out in Section 3. We express no view in this advice as to the validity and enforceability of any provisions of LCH's Rulebook.
- 1.7 Our advice is given in respect of obligations:
- 1.7.1 arising under contracts ("**Contracts**") to which LCH is a party and which have been duly registered by LCH;
 - 1.7.2 which are legal, valid, binding and enforceable; and
 - 1.7.3 which are mutual between the Parties in the sense that each Party is personally and solely liable as regards obligations owing by it and is the sole and beneficial owner of obligations owed to it.
- 1.8 This advice relates solely to matters of Hong Kong law (as in force at the date hereof) and does not consider the impact of any laws (including insolvency laws) other than Hong Kong law, even where, under Hong Kong law, any foreign law falls to be applied. This advice and the views given in it are governed by Hong Kong law and relate only to Hong Kong law as applied by the Hong Kong courts or, where expressly stated, a

duly constituted arbitral tribunal with its seat in Hong Kong as at today's date. We express no view on the laws of any other jurisdiction.

- 1.9 We do not express any view as to any matters of fact.
- 1.10 We do not express any view on the availability of any judicial remedy in respect of any net obligation resulting from any netting or set off.
- 1.11 We do not express any view as to the enforceability of the Default Arrangements in relation to any action which LCH may seek to take outside this jurisdiction.
- 1.12 We do not express any view as to any matter relating to tax law.

2. ASSUMPTIONS

We assume the following:

- 2.1 That the Arrangements and each Contract are legally binding and enforceable against both Parties under their governing law.
- 2.2 That each Party is duly incorporated and has the capacity, power and authority under all applicable laws to enter into the Arrangements and each Contract and to perform its obligations under the Arrangements and each Contract and that each Party has taken all necessary steps to enter into, execute, deliver, be bound by and perform the Arrangements and each Contract, and that such steps have not been revoked or superseded.
- 2.3 That each Party has obtained, complied with the terms of and maintained all authorisations, approvals, licences and consents and has otherwise complied with all applicable laws and regulations required to enable it lawfully to enter into and perform its obligations under the Arrangements and the Contracts and to ensure the legality, validity, enforceability and admissibility in evidence of the Arrangements and each Contract in this jurisdiction.
- 2.4 That the Arrangements are entered into by the Relevant Clearing Member prior to the formal commencement of any Insolvency Proceeding in respect of that Relevant Clearing Member.
- 2.5 That each Party acts in accordance with the powers conferred by the Arrangements; and that (save in relation to any non-performance leading to the taking of action by LCH under the Default Rules) each Party performs its obligations under the Arrangements and each Contract in accordance with their respective terms.
- 2.6 That the contractual arrangements and obligations established pursuant to and by the Arrangements and each Contract are not capable of being avoided for any reason other than as mentioned in paragraph 3.2.4 below.
- 2.7 That there are not and will not be any other agreements, instruments or arrangements between the Parties which modify or supersede the terms of the Arrangements and/or any Subject Document.

- 2.8 That the Agreements have been entered into, and each of the Contracts is carried out, by each of the parties thereto in good faith, for the benefit of each of them respectively, on arms' length commercial terms and for the purpose of carrying on, and by way of, their respective businesses.
- 2.9 That the obligations assumed under the Agreements and the Contracts are "mutual" between the Parties, in the sense that the Parties are each personally and solely liable as regards obligations owing by it to the other Party and solely entitled to the benefit of obligations owed to it by the other Party. Circumstances in which the requisite mutuality will not be established include, without limitation, where a Party is acting as agent for another person, or is a trustee, or in respect of which a Party has a joint interest or in respect of which a Party's rights or obligations or any interest therein have been assigned, charged or transferred (whether in whole or in part) whether unilaterally, by agreement or by operation of law or by order.
- 2.10 That any person (other than the defaulter) which is party to a market contract in respect of which LCH is taking action is not itself insolvent for the purposes of any insolvency law and is not subject to any Insolvency Proceeding.
- 2.11 That the Relevant Clearing Members and LCH have properly executed the Agreements; and that each Agreement is executed by the relevant parties thereto in substantially the same form as the Agreements reviewed by us as described in paragraph 1.4 above; and that LCH's Rulebook (which is incorporated as part of the Clearing Membership Agreement) is in the same form as the rules published on LCH's website as at the date of this advice.
- 2.12 That each Relevant Clearing Member has the capacity, power and authority to create the security constituted by the relevant Agreements and that each Relevant Clearing Member has the capacity, power and authority to enter into and to exercise its rights and to perform its obligations under the relevant Agreements.
- 2.13 That all acts, conditions or things required to be fulfilled, performed or effected in connection with the Agreements under the laws of any jurisdiction other than this jurisdiction have been duly fulfilled, performed and effected.
- 2.14 That, as a matter of English law, the situs of the Securities (as defined in the Deed of Charge) is located in England and Wales.
- 2.15 That, until such time as the security interest created by the Deed of Charge has been released, the Securities (as defined in the Deed of Charge) will be held by LCH in accordance with the terms of the Agreements.
- 2.16 That LCH at all times exercises its rights under the Agreements and does not waive any requirement for it to consent to the withdrawal of any Securities (as defined the Deed of Charge).
- 2.17 That LCH has no notice of any Collateral being subject to any prior equitable interest or right or remedy arising from a breach of fiduciary duty.

- 2.18 That all Collateral provided by a Relevant Clearing Member to LCH is freely transferable and all acts or things required by the laws of this or any other jurisdiction to be done to ensure that Collateral is validly provided by the Relevant Clearing Member to LCH will have been effectively carried out.
- 2.19 That each Party which receives Collateral from the other Party does not treat that Collateral in any manner which could indicate that the other Party retains any proprietary interest in that Collateral.
- 2.20 That the matters set out in Appendix 3 to this advice are correct.

3. **ADVICE**

On the basis of the foregoing terms of reference and assumptions and subject to the reservations and qualifications set out in Section 4, we express the following views. These views are summary conclusions on the specific questions which LCH has raised.

3.1 **MEMBERSHIP**

- 3.1.1 *Are there any statutory limitations on the capacity of, or specific regulatory requirements associated with, any Relevant Clearing Member entering into the Agreements (including for the purpose of granting of security under the Deed of Charge)?*

Capacity and authority of Relevant Clearing Member

- (a) The limitations imposed by the constitutional documents of Relevant Clearing Members and the restrictions limiting the authority of directors of a Relevant Clearing Member to enter into the Agreements on behalf of the Relevant Clearing Member are discussed at paragraph 3.1.3.
- (b) There are no specific statutory limitations or regulatory requirements which would limit the capacity of an appropriately authorised Relevant Clearing Member to enter into the Agreements.

Licensing requirements under the Securities and Futures Ordinance

- (c) Under section 114 of the Securities and Futures Ordinance, a person is prohibited from "carrying on a business" in Hong Kong in a "regulated activity" or holding itself out as doing so unless it is licensed or registered to carry on the regulated activity by the Hong Kong Securities and Futures Commission ("SFC"), unless an exemption applies. There are currently ten types of "regulated activity", the most relevant of which, in this context, are:
- (i) dealing in securities (Type 1), which covers the entering into of an agreement for or with a view to acquiring or disposing of "securities"; and

- (ii) dealing in futures contracts (Type 2), which covers the entering into of an agreement for or with a view to acquiring or disposing of "futures contracts".
- (d) The word "securities" is defined in the Securities and Futures Ordinance to include, among other things:
 - (i) shares, stocks, debentures, loan stocks, funds, bonds or notes; and
 - (ii) rights, options or interests in, or in respect of, such shares, stocks, debentures, loan stocks, funds, bonds or notes.
- (e) The expression "futures contracts" is defined in the Securities and Futures Ordinance to include a contract or an option on a contract made under the rules or conventions of a "futures market" (which is essentially a place where facilities are provided for the trading of futures and options).
- (f) As both expressions "securities" and "futures contracts" are defined very broadly, it is likely that many of the products that are eligible for clearing by LCH fall within one of the expressions.
- (g) There are, however, exemptions that may be available for Relevant Clearing Members. The most relevant, in the context of dealings with LCH, is the "Dealing as Principal with Professional Investors" exemption, which provides that a person is not required to be licensed for entering into an agreement for or with a view to acquiring or disposing "securities" or "futures contracts" (i.e. not required to obtain a Type 1 or a Type 2 licence) if that person deals "as principal" with a "professional investor" as defined in the Securities and Futures Ordinance. LCH will be considered a "professional investor" as it is authorized to provide automated trading services under section 95(2) of the Securities and Futures Ordinance (see paragraph 3.1.2 below).
- (h) Accordingly, on the basis that LCH is authorized to provide automated trading services, then there are no licensing or other regulatory requirements associated solely with a Relevant Clearing Member entering into the Agreements with LCH.

New Regulated Activities

- (i) When the relevant provisions of the Securities and Futures (Amendment) Ordinance 2014 (the "**Amendment Ordinance**") come into effect, there will be two new regulated activities – Type 11 (dealing in OTC derivative products or advising on OTC derivative products) and Type 12 (providing client clearing services for OTC derivative transactions).
 - (i) Type 11 Regulated Activity (dealing in OTC derivative products or advising on OTC derivative products)

- (A) The new Type 11 regulated activity "dealing in OTC derivative products" or "advising on OTC derivative products" broadly includes:
 - (1) entering into or offering to enter into an OTC derivative transaction;
 - (2) inducing or attempting to induce another person to enter into or offer to enter into an OTC derivative transaction; or
 - (3) giving advice on, or issuing reports or analyses on, whether, which, the time at which, or the terms or conditions on which, an OTC derivative transaction should be entered into.
 - (B) The term "OTC derivative transaction" is defined as a transaction in an "OTC derivative product".
- (ii) Expansion of the definition of "automated trading services"
- (A) In addition, the definition of automated trading services will be expanded. When the relevant provisions of the Amendment Ordinance come into force, the provision of automated trading services for trading or clearing OTC derivative products (as opposed to only securities and futures contracts, as is the case currently) will require either authorisation under Part III of the Securities and Futures Ordinance or a licence under Part V of the Securities and Futures Ordinance.
 - (B) As of the date of this advice, we are not aware of when the relevant provisions, insofar as they relate to Type 11 Regulated Activities, of the Amendment Ordinance will come into effect; however, the Securities and Futures (Amendment) Ordinance 2014 Commencement Notice 2016 brought into effect on 1 September 2016 the provisions of the Amendment Ordinance relating to the mandatory clearing and related record-keeping obligations under the OTC derivatives regulatory regime. These include provisions enabling the Securities and Futures Commission to grant an authorisation to providers of automated trading services for clearing of OTC derivative products and a designation as a central counterparty for the purposes of mandatory clearing obligation. In this respect, we note that LCH has been authorized to provide automated trading services under section 95(2) of the Securities and Futures Ordinance (see paragraph 3.1.2 below) and designated as a

"designated CCP" for purposes of the mandatory clearing rules under Part IIIA of the Securities and Futures Ordinance (see paragraph 3.1.2(n) below).

(iii) Type 12 Regulated Activity (providing client clearing services for OTC derivative transactions)

(A) The term "providing client clearing services for OTC derivative transactions" means providing services to another person for the clearing and settlement of OTC derivative transactions through a central counterparty (whether located in Hong Kong or elsewhere), whether or not as a member of the central counterparty.

(B) However, "an act carried out by a central counterparty, whether located in Hong Kong or elsewhere, for the purpose of performing the person's functions as a central counterparty" is specifically carved out from the Type 12 regulated activity. We therefore believe the new regulated activity will not be relevant to LCH's activities.

(iv) Exemptions from Types 11 and 12 Regulated Activities

The main exemption relating to Type 11 and Type 12 regulated activities is that authorized institutions (i.e. licensed banks, restricted licensed banks and deposit-taking companies) and approved money brokers are exempted from the requirement to be licensed, if the relevant acts are carried out in their ordinary course of business. We refer to such entities as "**Type 11/12 Exempted Entities**".

(v) Dealing as Principal with Professional Investor Exemption

(A) As noted above, the most relevant exemption, in the context of dealings with LCH, is the "Dealing as Principal with Professional Investors" exemption for Type 1 and Type 2 regulated activities respectively. However, this exemption does not apply to the Type 11 regulated activity (i.e. it is not available to any entity (not being a Type 11/12 Exempted Entity) in relation to dealing in OTC derivative products).

(B) As a result, a Relevant Clearing Member (which is not a Type 11/12 Exempted Entity) currently relying on the "dealing as principal with a professional investor" exemption from Type 1 and/or Type 2 licensing requirements will not be able to do so for the Type 11 licensing requirement, and will need to obtain a Type 11

licence to continue to deal as principal in OTC derivatives with LCH.

- 3.1.2 ***Would LCH be deemed to be domiciled, resident or carrying on business in the Relevant Jurisdiction by virtue of providing clearing services to a Relevant Clearing Member? If so, would LCH be required to obtain a licence or be registered before providing clearing services to a Relevant Clearing Member or are there any special local arrangements for the recognition of overseas clearing houses in these circumstances?***

Would LCH be deemed to be domiciled, resident or carrying on a business in Hong Kong?

- (a) Under the conflict of laws rules of Hong Kong, the domicile of a company or corporation is in the jurisdiction under whose law it is incorporated – which, in the case of LCH, is England and Wales.
- (b) Under Hong Kong law, a company or corporation is resident in the jurisdiction where its central management and control is exercised. The residence of a corporation may be important in determining, among other things, its liability to Hong Kong taxation. As this is both a question of fact and a matter of Hong Kong tax law, we express no view on this question.
- (c) In contrast, it is possible that LCH would be considered to be "carrying on a business" in Hong Kong for the purposes of the Securities and Futures Ordinance. This is because the expression "carrying on a business" is likely to be interpreted widely by a Hong Kong court, and that little activity is required to be undertaken before an entity, such as LCH, would be considered as "carrying on a business" in Hong Kong. In our view, it is possible that LCH may be considered to be carrying on a business in Hong Kong even though it has no office, branch or other permanent establishment in Hong Kong.

Would LCH be required to obtain a licence or be registered?

- (d) Regardless of whether LCH is considered to be resident or "carrying on a business" in Hong Kong, LCH may be required to obtain authorisation from the SFC under section 95 of the Securities and Futures Ordinance, if LCH is considered to be providing, or offering to provide, automated trading services ("ATS") in Hong Kong.
- (e) The expression "automated trading services" is defined widely in the Securities and Futures Ordinance to cover, among other things, services provided by a person by means of "electronic facilities":
 - (i) where offers to sell or purchase securities or futures contracts are regularly made or accepted in a way that forms or results in a binding transaction, in accordance with established methods; or

- (ii) where transactions effected on, or which are subject to the rules of, a stock market or futures market may be novated, cleared, settled or guaranteed.
- (f) In addition, the provision of ATS for trading or clearing OTC derivative products will require either authorisation under Part III of the Securities and Futures Ordinance or a licence under Part V of the Securities and Futures Ordinance.
- (g) In contrast to the licensing requirements for regulated activities, the authorisation requirements under section 95 apply to a person providing ATS in Hong Kong even if that person is not "carrying on a business in Hong Kong". However, the person must perform some form of permanent or quasi-permanent activity in Hong Kong in order for section 95 to apply.
- (h) ATS are services provided by means of "electronic facilities", which is undefined in the SFO and the SFC has not provided any recent clarification on what would constitute "electronic facilities". In our view, if LCH either places its trading terminals in Hong Kong or establishes computer-to-computer connections from Hong Kong to its system in London¹, that is sufficient to constitute some form of permanent or quasi-permanent activity in Hong Kong for purposes of section 95 of the Securities and Futures Ordinance.
- (i) The SFC has updated its "Guidelines for the Regulation of Automated Trading Services" in September 2016. These guidelines only describe the quality of electronic facilities that the SFC would normally expect from ATS providers. It may be difficult to define "electronic facilities" with clarity and what devices and/or methods they involve, given the recent rapid developments in technology. However, based on these descriptions we believe that the SFC expects more than simply accessing a web page through the internet, such that, for example, the use of some form of special equipment or software may also be required. This is because, for example, we understand that the SFC does not generally intend to regulate automated trading services provided entirely outside Hong Kong that are accessed by persons based in Hong Kong who seek out the service through the internet without the service being actively marketed to them, for example, retail brokerage trading platforms provided by foreign brokerage firms via web-based platforms which do not target Hong Kong clients. In any event, we would expect the SFC may interpret "electronic facilities" broadly where it considers it necessary to do so.

¹ The placement of trading terminals and establishment of computer-to computer connections was described as a typical provision of ATS in the 2003 version of the SFC's "Guidelines for the Regulation of Automated Trading Services".

- (j) Section 95(1) of the Securities and Futures Ordinance provides that no person shall (a) provide automated trading services or (b) offer to provide automated trading services, unless that person is (amongst other things) authorised by the Securities and Futures Commission under Section 95(2) of the Securities and Futures Ordinance.
- (k) We note that LCH Limited is authorized under section 95 of the Securities and Futures Ordinance to provide ATS in respect of SwapClear System and ForexClear System. As such, it is permitted (subject to the conditions of its authorization) to offer access to these two systems as ATS in Hong Kong.

Recognition under the Securities and Futures Ordinance as "recognised clearing house" and "designated CCP"

- (l) There are, broadly, two regimes for the recognition of clearing houses under the Securities and Futures Ordinance:
 - (i) under section 37 of the Securities and Futures Ordinance, a clearing house may apply to the SFC for recognition as a "recognized clearing house" for the purposes of providing clearing and settlement services for transactions in securities, futures contracts or OTC derivatives products; and
 - (ii) under section 101J of the Securities and Futures Ordinance, a "recognized clearing house" or a person authorised to provide ATS may apply to the SFC for recognition as a designated central counterparty ("designated CCP") for the purposes of clearing OTC derivatives transactions.
- (m) The consequences of recognition as a "recognized clearing house" or a "designated CCP" under the Securities and Futures Ordinance include the conferring on the operations of such recognized clearing house or designated CCP, as the case may be, of certain protections against some adverse effects from Hong Kong insolvency law. Such protections are discussed in further detail in paragraphs 3.2.4(v) to 3.2.4(z) below (although as noted therein, the insolvency protections under the Securities and Futures Ordinance for the operations of a "designated CCP" have not yet entered into force).
- (n) At the date of this advice, the Securities and Futures Ordinance does not permit a company incorporated outside Hong Kong, such as LCH, to apply for recognition as a "recognised clearing house". However, we note that LCH has been designated by the SFC as a designated central counterparty for purposes of the mandatory clearing rules under Part IIIA of the Securities and Futures Ordinance.

3.1.3 ***What type of documents should be obtained by LCH to evidence that a Relevant Clearing Member and its officers have the capacity and authority to enter into the Agreements? Is LCH required to verify such evidence?***

Articles of association

- (a) A Hong Kong company is required to have a set of articles of association.
- (b) Under Hong Kong law, the directors of a Hong Kong company are under a duty to observe any limitation in the company's articles of association and not to exercise any power which is not expressed in the articles of association (including, to the extent relevant, the company's objects stated in what was known as its memorandum of association).²
- (c) If the directors purport to exercise, on behalf of the company, any power in contravention of any limitation in the company's articles of association, the directors are almost certainly acting outside the scope of their authority, in which case any contract entered into by the company in contravention of such limitation is voidable at the option of the company, unless the counterparty to the contract may rely on the rule in Turquand's case.
- (d) The rule in Turquand's case provides that a third party dealing with a company in good faith is entitled to assume that all matters of internal management relating to the formal validity of the acts of its directors have been complied with. However, the rule does not apply if the third party has actual or constructive notice of the directors' lack of authority. A third party will be deemed to have constructive notice of the matters which it would have discovered if the third party had made such inquiries which a court considers it ought reasonably to have made.
- (e) Section 117 of the Companies Ordinance provides that in favour of a third party dealing with a company in good faith, the power of the company's directors to bind the company, or to authorize others to bind the company is generally free of any limitation under any relevant document of the company (which will include its articles of association, any resolutions of the company or any agreements between the members of the company).
- (f) Section 117 and the rule in Turquand's case generally cover much of the same ground. However, Section 117 is arguably narrower in scope than Turquand's case as it would only apply where the limitation on the power to bind the company is set out in its relevant documents, but at the same time contains a statutory presumption of good faith on the part of the

² Many Hong Kong companies incorporated under a former Companies Ordinance have an objects clause in their memoranda of association. Under Section 98 of the Companies Ordinance, a condition that was contained in the memoranda of association of such a company is to be regarded as a provision of such company's articles.

person dealing with the company. In addition, while any knowledge of procedural irregularity generally precludes a party from relying on Turquand's case, Section 117 provides that a person dealing with a company is not regarded as acting in bad faith by reason only of the person's knowledge of procedural impropriety³.

- (g) In view of the above, LCH should request a copy of a Relevant Clearing Member's articles of association and check whether entering into the Agreements contravenes any of the limitations in its articles of association (and to the extent its objects are stated in what was known as its memorandum of association, check whether entry into the Agreements falls within one of the stated objects). A copy of a Hong Kong company's articles of association can be obtained from the Hong Kong Registrar of Companies.
- (h) LCH will be able to rely on the statutory protection afforded under Section 117 of the Companies Ordinance. As a matter of prudence however, we believe LCH should continue to perform due diligence in respect of their Relevant Clearing Members, particularly given that LCH is a sophisticated financial institution and can reasonably be expected to seek and receive legal and other professional advice on this issue.
- (i) If, by virtue of the Relevant Clearing Member's articles of association, entering into the Agreements is the subject of a prohibition or restriction (or entering into the Agreements does not fall within one of the stated objects set out in what was known as its memorandum of association), then LCH should request the shareholders of the Relevant Clearing Member to ratify the Agreements by way of a shareholders' resolution.

Board minutes and/or written resolutions

- (j) The articles of association of a Hong Kong company will usually describe how the powers of the company are to be exercised, by setting out the internal procedures of the company. In most cases, a board meeting will usually be required for a company to authorise entering into an agreement. Alternatively, the agreement may be authorised by the directors of the company signing a written resolution.
- (k) Accordingly, LCH should request a Relevant Clearing Member to provide a certified copy of either the minutes of a board meeting or a written resolution, in either case, authorising the entry into and execution of the Agreements. The minutes or the resolutions would normally also specify the person or persons who are authorised to execute the Agreements on behalf of the Relevant Clearing Member.

³ Further analysis has been done by the Hong Kong Department of Justice comparing section 117 to Turquand's case, available here: https://www.doj.gov.hk/en/publications/pdf/cu_review_summer2013e.pdf

- (l) It is also possible that the articles of association may confer authority on the directors to delegate their powers to committees, local boards or a managing director, who in turn may be given powers to appoint and authorise the relevant signatory. Whenever reliance is being made upon a "chain" of authority, care should also be taken to ensure that the necessary power to sub-delegate has been duly conferred and properly exercised. As a general principle, a recipient of a delegated power, unless expressly authorised to do so, may not sub-delegate.

3.1.4 ***Are there any formalities to be complied with upon entry into any of the Agreements and, if so, what is the effect of a failure to comply with these?***

Contracts

- (a) According to section 121 of the Companies Ordinance, a contract that, if made between private persons, would be by law required to be in writing and signed by the parties to it, can be made on behalf of the relevant Hong Kong company in writing and signed by any person acting under the company's authority, express or implied. Accordingly, for any Subject Document that is not required to be executed as a deed (such as the Clearing Membership Agreement), there are no further formalities as long as the person signing on behalf of the company has either the express or implied authority to do so.

Deeds

- (b) However, there are additional execution formalities that must be complied with in respect of deeds (such as the Deed of Charge). A Hong Kong company may execute a deed in one of three ways:
 - (i) by affixing its common seal (which is a metallic seal with its name engraved in legible characters) to the instrument in accordance with its articles of association. The relevant articles will normally provide how the seal shall be used (for example, who shall sign any instrument to which the seal is affixed) and that the seal be used only by the authority of the directors;
 - (ii) by having the instrument signed on the company's behalf by: (i) any two directors of the company or (ii) any of the directors of the company and the secretary of the company (or in the case of a company with only one director, by having the instrument signed on the company's behalf by that director); or
 - (iii) by appointing one or more person(s) as the company's attorney, by a power of attorney, and such attorney(s) will execute the instrument as a deed on behalf of the company.

Security Documents

- (c) Pursuant to Section 335 of the Companies Ordinance, a certified copy of the instrument by which any "charge" falling within Section 334 is created by a Hong Kong company (together with the prescribed particulars of such charge) must be delivered to or received by the Hong Kong Registrar of Companies within one month after the date of its creation, failing which any security on the company's property or undertaking conferred by such charge will be void against the liquidator and any creditor of the company. The term "charge" for these purposes includes a mortgage or grant of security governed by foreign law, regardless of whether the asset that is the subject thereof is located in Hong Kong or outside Hong Kong. A person other than the Hong Kong company which creates the charge may submit to the Hong Kong Registrar of Companies a certified copy of the instrument of charge together with the prescribed particulars in respect of that charge, for registration.
- (d) It is possible that the security interest created by the Deed of Charge will fall within one of the types of registrable charges, specifically a floating charge or a charge on book debts.

(i) Floating charge

- (A) Whether such security is fixed or floating is a question of fact and law. The essential difference between a fixed charge and a floating charge is the degree of control which the chargee, under the terms of the agreement (and how that agreement is observed in practice), has in respect of dealings with the charged assets.
- (B) While the security interest created under the Deed of Charge is expressed to be a "first fixed security", a Hong Kong court may recharacterize the security interest as a floating charge if, in practice, the Relevant Clearing Member (the chargor) is free to deal with the charged assets without the consent of LCH (the chargee).

(ii) Charge on book debts

- (A) The term "book debt" is not defined in the Companies Ordinance, but the generally accepted view is that a book debt is a debt arising out of the trading activities of the company that should properly be entered in the company's books. Whether a debt would be treated this way therefore depends on normal accounting practices, which will usually be determined by reference to expert evidence.
- (B) While the amounts due in respect of certain types of Charged Property may constitute "debts" from a strict

legal perspective, we understand that they would normally be accounted for as holdings in securities (in the case of bonds and other debt securities) or the "fruits" of such securities (in the case of cash distributions due in respect of bonds and other debt securities), rather than as debts. However, the case law in this area is limited and so a degree of uncertainty remains.

- (C) Since a failure to submit a registrable charge for registration would render the charge void against the liquidator and any creditor of the chargor, it will often be desirable, whenever a security interest is taken over assets of the kinds referred to above, to submit the relevant document for registration on a prophylactic basis.
- (D) In addition, under the Deed of Charge, a Relevant Clearing Member may be required to "assign" by way of security in favour of LCH certain debts and other choses in actions owed to the Relevant Clearing Member. Under the rule in *Dearle v Hall*, the priority of an assignment over a debt or other chose in action is governed by the order in which notice is given to the relevant debtor. Accordingly, notice of any such assignment under the Deed of Charge should be given to the relevant debtor(s).

3.1.5 ***Would the courts of the Relevant Jurisdiction uphold the contractual choice of law and jurisdiction set out in Regulation 51?***

In any proceedings properly commenced in a Hong Kong court for enforcement of any agreement governed by a law other than Hong Kong law, the choice of that other law as the law by which that agreement is to be governed would be upheld as a valid choice of law and would be applied by the Hong Kong court if:

- (a) the choice of such law was made in good faith and not with a view to avoiding the provisions or effects of any other applicable law; and
- (b) such law is pleaded and proved to the satisfaction of the Hong Kong court (which satisfaction is within the discretion of the court),

provided that:

- (i) such law will be disregarded if its application will be illegal or contrary to public policy (see paragraph 3.1.7) or mandatory rules in Hong Kong; and
- (ii) matters of procedure including questions of set-off and counter-claim, interest chargeable on judgment debts, priorities, measure of damages, limitation of actions and submission to the jurisdiction of foreign courts

are as a general rule governed by Hong Kong law to the exclusion of the relevant chosen governing law.

3.1.6 ***Will the courts uphold the judgment of English courts or an English arbitration award?***

English judgments

- (a) Since 1997, judgments of the English courts can no longer be directly enforced in Hong Kong under the Judgments (Facilities for Enforcement) Ordinance and the Foreign Judgments (Reciprocal Enforcement) Ordinance.
- (b) However, a judgment obtained in England may still be enforced by suing on the judgment itself under the common law in Hong Kong courts so long as such English judgment:
 - (i) does not fall within those provisions of the Foreign Judgments (Restriction on Recognition and Enforcement) Ordinance (Cap. 46) which prevent an overseas judgment from being recognised or enforced in Hong Kong;
 - (ii) is for a definite sum of money other than a sum payable in respect of taxes or penalties;
 - (iii) is final and conclusive;
 - (iv) was not obtained by fraud or obtained in proceedings which were contrary to natural justice; and
 - (v) is not contrary to public policy in Hong Kong,

and the defendant in the English proceedings was resident, present or (if corporate) carrying on business in England or submitted to the jurisdiction of the English courts.

- (c) The Foreign Judgments (Restriction on Recognition and Enforcement) Ordinance (Cap. 46) provides that, generally speaking, a judgment obtained in an overseas country may not be recognised or enforced in Hong Kong if the bringing of proceedings in the court which gave the judgment was contrary to an agreement under which the dispute in question was to be settled otherwise than by proceedings in the courts of that country, and the judgment debtor did not bring or agree to the bringing of those proceedings in that court and did not counterclaim in the proceedings or otherwise submit to the jurisdiction of that court.

English arbitral award

- (d) The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards is applicable to Hong Kong. Under section 87

of the Arbitration Ordinance (Chapter 609 of the Laws of Hong Kong), a New York Convention arbitration award (including an award by an arbitral tribunal with its seat in England) is enforceable in Hong Kong.

3.1.7 *Are there any "public policy" considerations that the courts may take into account in determining matters related to choice of law and/or the enforcement of foreign judgments?*

- (a) A Hong Kong court may in principle refuse to apply foreign law because the result would violate Hong Kong's mandatory laws or domestic public policy. However, in practice, public policy considerations apply only in exceptional cases – for example, where the contract was brought about by coercion, or constituted a restraint of trade.
- (b) In our view, the choice of English law to govern the Agreements would not be contrary to public policy in Hong Kong.

3.2 **INSOLVENCY, SECURITY, SET-OFF AND NETTING**

3.2.1 *Please identify the different types of Insolvency Proceeding and Reorganisation Measures. Would any of these not be covered by those events entitling LCH to liquidate, transfer or otherwise deal with Contracts as provided for in Rule 3 of the Default Rules? Are any other events or procedures not envisaged in Rule 3 of the Default Rules relevant?*

Insolvency Proceedings

- (a) The only bankruptcy, composition, rehabilitation or other insolvency laws and procedures to which a Relevant Clearing Member would be subject in this jurisdiction are the following:
 - (i) the appointment of one or more provisional liquidators;
 - (ii) a winding-up by the court pursuant to Section 177(1) or (2) of the Companies Winding Up Ordinance (a "**Compulsory Winding-up**");
 - (iii) a winding-up commenced by the passing of a resolution of the members in accordance with Section 228(1)(a) or (b) of the Companies Winding Up Ordinance (a "**Voluntary Winding-up**");
 - (iv) a winding-up commenced in accordance with Section 228A of the Companies Winding Up Ordinance (a "**s228A Winding-up**");
 - (v) a scheme of arrangement pursuant to Part 13 of the Companies Ordinance.

- (b) The events specified in Rule 5 of the Default Rules adequately refer to all Insolvency Proceedings without the need for any additions.

Resolution under FIRO

- (c) Instead of or in addition to an Insolvency Proceeding, a Relevant Clearing Member which is an Affected Entity may be subject to resolution under the FIRO. Resolution involves the application of one or more of the stabilization options set out in section 33(2) of the FIRO and the performance of related functions. The stabilization options are: (a) a transfer to a purchaser; (b) a transfer to a bridge institution; (c) a transfer to an asset management vehicle; (d) bail-in; or (e) a transfer to a TPO company (as defined in the FIRO). The application of a particular stabilization option is achieved through the use of the powers applicable to the relevant stabilization option as set out in Part 5 of the FIRO, in particular by the issue by the Hong Kong resolution authority of one or more of the instruments (any such instrument, a "**Part 5 Instrument**") applicable to the relevant stabilization option and which are provided for in Schedules 3, 4 and 6 to the FIRO. A Part 5 Instrument may be (a) a securities transfer instrument, (b) a property transfer instrument, or (c) a bail-in instrument.
- (d) In addition:
 - (i) an Affected Entity may become subject to a mandatory capital reduction instrument under section 31 of the FIRO; and
 - (ii) in respect of a Relevant Clearing Member which is an Affected Entity because it is a "*non-Hong Kong financial institution*" or a "*non-Hong Kong group company*" (as defined in section 2 of the FIRO)⁴ and which becomes subject to a "*non-Hong Kong resolution action*" (as defined in section 2 of the FIRO), a Hong Kong resolution authority may (i) under section 187(2) of the FIRO issue a recognition instrument in respect of some or all that

⁴ The powers of a resolution authority under sections 187(2) and 191 of the FIRO, together with other relevant powers set out in Part 13 (*Non-Hong Kong Resolution Actions*) of the FIRO, are intended to enable a resolution authority to assist foreign resolution proceedings. Such powers may, broadly, be exercised in respect of a "non-Hong Kong financial institution" and a "non-Hong Kong group company" which is subject to foreign resolution proceedings. A "non-Hong Kong financial institution" is defined in section 2 of the FIRO as a "*financial institution incorporated in a non-Hong Kong jurisdiction*"; and a "non-Hong Kong group company" is defined as "*in relation to a non-Hong Kong financial institution... an entity that is (or, but for the performance of a function by a resolution authority or a non-Hong Kong resolution authority, would be) a member of the same group of companies as the non-Hong Kong financial institution*". Our advice relates only to Clearing Members which are Hong Kong companies (Relevant Clearing Members). It follows that, although a Relevant Clearing Member will not fall within the definition of "non-Hong Kong financial institution", a Relevant Clearing Member may, if it is a member of the same group as a non-Hong Kong Financial Institution, fall within the definition of "non-Hong Kong group company". Accordingly, a Relevant Clearing Entity may be subject to relevant provisions of Part 13 of the FIRO, including the exercise by a resolution authority of the powers under sections 187(2) and 191.

non-Hong Kong resolution action, and/or (ii) under section 191 of the FIRO exercise any other power available under the FIRO in support of the non-Hong Kong resolution action (including the powers described in the paragraph above). The effect of the issue of a recognition instrument is that the non-Hong Kong resolution action (or the part of it) that is recognized has substantially the same legal effect in Hong Kong that it would have produced had it been made, and been authorized to be made, under the laws of Hong Kong.

- (iii) The effect of a Part 5 Instrument, a mandatory capital reduction instrument, a recognition instrument and other powers exercisable by a resolution authority under the FIRO may affect the effectiveness of the Arrangements, are discussed further in paragraph 3.2.3 below.

3.2.2 ***Would the Deed of Charge be effective in the context of Insolvency Proceeding or Reorganisation Measures in respect of a Relevant Clearing Member? Is there anything that would prevent LCH from enforcing its rights under the Deed of Charge? Would LCH be required to take any particular steps or abide by any particular procedures for the purposes of enforcing against Collateral provided to it by a Relevant Clearing Member under the Deed of Charge?***

Effectiveness of the Security Interest created under the Deed of Charge

- (a) The Deed of Charge would generally be effective in the context of an Insolvency Proceeding in respect of a Relevant Clearing Member *provided that* all applicable perfection requirements have been complied with. The perfection requirements applicable to Hong Kong companies are discussed in paragraph 3.1.4.
- (b) However, if the security created under the Deed of Charge is recharacterised as a floating charge (see paragraph 3.1.4 above), LCH's claim to the proceeds of enforcement of the security will rank below certain preferential claims. The categories of "preferential claims" are set out in section 265(1) of the Companies Winding Up Ordinance: in summary, they consist primarily of (i) taxes and other debts owing to the Hong Kong government and (ii) unpaid wages and other amounts owing to employees (subject to a relatively low 'cap').

Enforcement of Security Interest

- (c) Following the occurrence of any default in payment or failure to discharge any Secured Obligation, including in relation to any Insolvency Proceeding with respect to the relevant Relevant Clearing Member, LCH would be entitled under Hong Kong law to enforce the security interest created under the Deed of Charge (without notice or further demand) by exercising any rights and remedies it may have in

respect of the Charged Property under clause 11 of the Deed of Charge, including the right to take possession of and hold, sell, or otherwise dispose of all or any part of the Charged Property.

- (d) However, please note that:
- (i) In exercising its right of sale, LCH is required to act in good faith and to take reasonable care to obtain whatever is the true market value of the secured property at the moment it chooses to sell it (although it may sell promptly and does not have to 'stay its hand' in the hope of achieving a better price at a later date).
 - (ii) LCH may not sell the secured asset to itself, unless the sale is ordered by the court and LCH has obtained the court's leave to bid (because such a transaction would amount to foreclosure without the leave of the court).
 - (iii) LCH may sell to a company in which it is interested *provided that* the company is not a pure nominee, but LCH must prove that the sale was in good faith and that it had taken reasonable steps to obtain the best price reasonably obtainable at that time.
 - (iv) To the extent any Collateral is located in Hong Kong, LCH may not be able to exercise its right of appropriation in respect of such Collateral under clause 13 of the Deed of Charge because such a right may constitute a clog on the equity of redemption or contravene the rule against collateral advantages (or because such appropriation would amount to foreclosure without the leave of the court).
 - (v) If the Relevant Clearing Member becomes subject to resolution under the FIRO, the ability of LCH to enforce the security interest created under the Deed of Charge may be affected as further described in paragraph 3.2.3 below.

3.2.3 ***Would LCH have the right to take the actions provided for in the Default Rules (including exercising rights to deal with Contracts under Rule 6 and rights of set-off under Rule 8 but not at this stage considering those actions specifically provided for in the Client Clearing Annex to the Default Rules) in the event that a Relevant Clearing Member was subject to Insolvency Proceeding or Reorganisation Measures? Is it necessary or recommended that LCH should specify that certain Insolvency Proceeding and/or Reorganisation Measures will constitute an Automatic Early Termination Event in accordance with Rule 3 of the Default Rules? If the answer is affirmative, please identify those specific Insolvency Proceeding and/or Reorganisation Measures to which the answer applies and briefly explain your reasoning.***

Insolvency Proceedings

- (a) Following an Insolvency Proceeding in respect of a Relevant Clearing Member, LCH would generally have the right to take the actions provided for the Default Rules (including exercising rights to deal with Contracts under Rule 6 and rights of set-off under Rule 8). However, upon winding-up, set-off may be implemented under Statutory Insolvency Set-Off, rather than in accordance with the terms of Rule 8. Statutory Insolvency Set-Off is discussed in paragraph 3.2.5.

Resolution under the FIRO

(b) Introduction

- (i) The FIRO contains various provisions which might affect the effectiveness of the Arrangements (including the ability of LCH to take actions under the Default Rules) in relation to a Relevant Clearing Member which is an Affected Entity. In particular:

- (A) under section 31 of the FIRO, a resolution authority may make a capital reduction instrument in respect of any Additional Tier 1 capital instrument or Tier 2 capital instrument (as defined in FIRO) issued by that Affected Entity;

- (B) under Part 5 Division 1 and Schedule 3, a resolution authority may, in respect of an Affected Entity which is subject to resolution, cause (A) the transfer of securities issued by that Affected Entity to another person by means of a securities transfer instrument; (B) the transfer of the property of that Affected Entity to another person by means of a property transfer instrument, or (C) the liabilities of that Affected Entity to be cancelled or modified by means of a bail-in instrument; and

- (C) under Part 13, a resolution authority may, in respect of an Affected Entity that has become subject to a non-Hong Kong resolution action, (a) issue a recognition instrument in respect of some or all that non-Hong Kong resolution action, and (b) exercise any other power available under the FIRO in support of the non-Hong Kong resolution action (including issuing a Part 5 Instrument). The effect of the issue of a recognition instrument is that the non-Hong Kong resolution action so recognized produces substantially the same legal effect in Hong Kong that it would have produced had it been made, and been authorized to be made, under the laws of Hong Kong.

(c) Suspension of obligations

- (i) Under Part 5, Division 3 of the FIRO, the resolution authority of an Affected Entity may, pursuant to a provision in a Part 5 Instrument, suspend, for a period of up to two business days (the "**Suspension Period**"), the obligations of an Affected Entity to make payments or deliveries under a contract to which it is party.
- (ii) Further:
 - (A) section 85 of the FIRO provides that a payment or delivery obligation which falls due during the Suspension Period will be treated as falling due immediately on the expiry of the Suspension Period; and
 - (B) section 83(5) of the FIRO provides that, during the Suspension Period, a creditor of the Affected Entity may not, without the written consent of the resolution authority, commence any action or proceeding to attach any assets of, or obtain the payment of money or delivery of property by, the Affected Entity.
- (iii) Accordingly, the person to whom an Affected Entity owes payment and/or delivery obligations which have been suspended would be unable, during the Suspension Period, to:
 - (A) exercise a contractual termination right for payment or delivery failure by the Affected Entity if that contractual termination right is expressed to be triggered if the Affected Entity fails to make a payment or delivery when due; and/or
 - (B) take any of the actions or proceedings referred to in subparagraph 3.2.3(c)(ii)(B) above as a result of the suspension.
- (iv) Pursuant to section 83(6) of the FIRO, a resolution authority may not impose such a suspension in relation to an "*excluded obligation*" which, pursuant to sections 84(1)(g) and (h) of the FIRO, includes, respectively:
 - (A) "*an obligation of a financial institution in relation to its participation, whether directly or indirectly, in financial market infrastructure*"; and
 - (B) "*an obligation in relation to a security interest that a financial market infrastructure has in relation to any asset of a financial institution that has been pledged or provided as collateral or as cover for margin by a financial institution*".

- (v) A "*financial market infrastructure*" is defined at section 2 of the FIRO as: "*a multilateral system among participating financial institutions used for clearing, settling or recording payments, securities, derivatives or other financial transactions and includes any payment system, central securities depository, securities settlement system, central counterparty and trade repository*".
- (vi) This definition is wide and LCH is likely to fall within it; accordingly:
 - (A) the resolution authority of a Relevant Clearing Member which is an Affected Entity would not be able to suspend, pursuant to a provision in a Part 5 Instrument, the payment and delivery obligations of that Relevant Clearing Member to LCH under or in relation to a Contract; and
 - (B) subject to the discussion in paragraph 3.2.3(d)(d) below in relation to the provisions of the FIRO which may affect the exercise of contractual termination rights, the ability of LCH to take any action under the Default Rules against a Relevant Clearing Member solely as a result of a failure by that Relevant Clearing Member to make a payment or delivery to LCH would be unaffected.
- (vii) However, we note that Rule 5(h) of the Default Rules provides that LCH may treat a failure by a Relevant Clearing Member to pay any sum due and payable under the terms of any agreement (i.e. including an agreement with a third party) as evidence that it is unable, or likely to become unable, to meet its obligations in respect of one or more Contracts for the purposes of Rule 3 of the Default Rules (and accordingly for LCH to designate the Relevant Clearing Member as a Defaulter and take action against the Relevant Clearing Member under the Default Rules).
- (viii) Where a failure by a Relevant Clearing Member to make a payment to a third party arises from such payment being suspended by a resolution authority under Part 5, Division 3 of the FIRO, for the reasons given in paragraph 3.2.3(c)(ii)(A) above, such obligation would not, as a matter of Hong Kong law, be due for the purposes of the relevant agreement for the duration of the Suspension Period and accordingly, as a matter of Hong Kong law, the Relevant Clearing Member would not have failed to pay any sum which was "due and payable". It follows that to the extent that it is a question of Hong Kong law as to whether a Relevant Clearing Member has failed to make a payment when due for the purposes of Rule 5(h) of the Default Rules, then LCH may be unable, for the duration of the Suspension Period, to treat

the non-payment as evidence that the Relevant Clearing Member is unable, or likely to become unable, to meet its obligations in respect of one or more Contracts for the purposes of Rule 3.

- (ix) However, any failure by the Relevant Clearing Member to make a payment or delivery to a third party which falls due after the relevant Suspension Period has expired (including a payment or delivery obligation which, but for the imposition of the suspension, would have fallen due during the Suspension Period) would as a matter of Hong Kong law, constitute a failure by that Relevant Clearing Member to pay a sum which was "due and payable", and accordingly, to the extent that Hong Kong law is relevant, the ability of LCH to exercise its rights under Rule 5(h) of the Default Rules would be unaffected.

(d) Hong Kong Contractual Stay Rules to come into force

- (i) The Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules (the "**Stay Rules**") were gazetted on 25 June 2021. The Stay Rules came into operation on 27 August 2021. The purpose of the Stay Rules is to require financial institutions to include provisions in a range of financial contracts preventing the exercise of termination rights against those financial institutions to ensure that resolution actions taken by a regulator are not inhibited in the event that a financial institution falls into financial distress⁵.
- (ii) The Stay Rules require a Covered Entity (i.e. Hong Kong incorporated authorised institutions, their Hong Kong incorporated holding companies, and their group companies that, in each case, are not themselves an authorised institution) to ensure that any newly entered Covered Contract, or any existing Covered Contract that is renewed or materially amended, contains a written term or condition to the effect that the parties agree in a legally enforceable manner that the parties (other than an "excluded counterparty") will be bound by any suspension of termination rights in relation to the contract that may be imposed by the HKMA under the FIRO.
- (iii) A "financial market infrastructure" is an "excluded counterparty" under the Stay Rules and financial contracts will generally not

⁵ An "initial period" beginning from either: (i) 27 August 2021; or (ii) if the entity is not a Covered Entity on that day, the later day on which it becomes a Covered Entity, has been provided for Covered Entities to achieve compliance with the Stay Rules. This initial period is expected to be 24 months for a contract where there are no counterparties other than an authorized institution or a financial institution that is a global systemically important bank on the initial day. For any other contracts, the initial period is expected to be 30 months.

be subject to the requirements of the Stay Rules if they are entered into with a "financial market infrastructure".

- (iv) The HKMA published a Consultation Conclusion on 31 December 2020 confirming that the Stay Rules adopt the definition of "financial market infrastructure" under the FIRO, the meaning of which is not limited by the location or jurisdiction of incorporation of the entity.
 - (v) As set out in paragraphs 3.2.3(c)(v) and 3.2.3(c)(vi) above, LCH will likely fall within the definition of "financial market infrastructure". Furthermore, the meaning of "financial market infrastructure" is not limited by the location or jurisdiction of incorporation of LCH. Therefore, although a Relevant Clearing Member that is a Covered Entity would be subject to the Stay Rules, we consider that LCH is likely to be an "excluded counterparty" and a Client Contract would not therefore be considered a Covered Contract under the Stay Rules.
- (e) Default event provisions and suspension of termination rights
- (i) Part 5, Division 4 of the FIRO contains certain provisions, the effect of which may be to limit the rights of the counterparty to a "*qualifying contract*" with an Affected Entity to exercise "*default event provisions*" and "*termination rights*" under that contract as a result of the commencement of resolution proceedings under the FIRO in respect of that Affected Entity.
 - (ii) Specifically:
 - (A) Section 89 of the FIRO provides that the taking of a "*crisis prevention measure*", or the occurrence of an event directly linked to the taking of such a measure, does not, of itself, trigger a "*default event provision*" under a qualifying contract provided that the substantive obligations under that contract (including for payment, delivery and provision of collateral) continue to be performed.
- For these purposes:
- (1) a "*qualifying contract*" is defined as a contract to which an Affected Entity (including an entity which is an Affected Entity because it is a group company of a within-scope financial institution) is party and under which the "*obligations... for payment and delivery and for provision of collateral continue to be performed*"; a Contract to which a Relevant Clearing Member is party is

likely to constitute a "*qualifying contract*", provided that the Relevant Clearing Member continues to perform its payment, delivery and collateral provision obligations under that Contract.

- (2) a "*crisis prevention measure*" includes the measures that may be taken by a resolution authority referred to in paragraph 3.2.3(b)(i)(B) above; and
- (3) a "*default event provision*" is defined widely and may include Rules 3 and 5 of the Default Rules.

Accordingly, if a Relevant Clearing Member which is an Affected Entity becomes subject to a "*crisis prevention measure*" under the FIRO, provided that such Relevant Clearing Member continues to fulfil its payment, delivery and collateral provision obligations under the Contracts to which it is party, LCH will not be able to take action under Rule 3 of the Default Rules in respect of that Relevant Clearing Member solely on the basis that the Relevant Clearing Member has become subject to that "*crisis prevention measure*".

- (B) Under section 90 of the FIRO, a resolution authority may, by way of a provision in a Part 5 Instrument, suspend for a period of up to two business days the right of a counterparty to a "*qualifying contract*" to exercise any "*termination rights*" under that contract if such rights have become exercisable. However, section 90(2) of the FIRO provides that such a suspension may not be imposed in respect of a counterparty to a contract which is a "*financial market infrastructure*". As described in paragraph 3.2.3(c)(v), LCH will fall within such definition, and accordingly a resolution authority would not be able to impose a suspension on the termination rights of LCH under the Default Rules.

(f) Protections on partial property transfer

- (i) A Part 5 Instrument which is a property transfer instrument may apply to only part of the assets and liabilities of an Affected Entity (the relevant transfer being referred to as a "**Partial Property Transfer**"). This may be the case because the property transfer instrument concerned expressly applies to only part of the business of the Affected Entity or because it is ineffective in relation to foreign property, which may include contracts, or obligations under contracts, which are governed by the laws of a

non-Hong Kong jurisdiction. A Partial Property Transfer could apply so as to cause the transfer of some but not all, of the of the property, rights and/or liabilities of a Relevant Clearing Member in relation to Contracts and/or the Charged Property associated with such Contracts, with the result that:

- (A) the netting and/or set-off arrangements under the Default Rules of LCH are impaired; and/or
 - (B) the Secured Obligations under the Deed of Charge are dissociated from the Charged Assets, with the result that the ability of LCH to enforce the security under the Deed of Charge is impaired.
- (ii) In this regard, the Protected Arrangements Regulation provides for certain safeguards against the potential effects of a Partial Property Transfer in respect of rights and liabilities that form part of, *inter alia*, a "*protected clearing and settlement systems arrangement*"; a "*set-off arrangement*", "*netting arrangement*", or "*title transfer arrangement*"; and a "*secured arrangement*".

Protected clearing and settlement systems arrangements

- (iii) A protected clearing and settlement systems arrangement is defined in section 3(1) of the Protected Arrangements Regulation as "*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*".
- (iv) The terms "*designated clearing and settlement system*" and "*recognized clearing house*" have the same meanings as under the Payment Systems and Stored Value Facilities Ordinance and the Securities and Futures Ordinance, respectively. As described in paragraph 3.4.1, LCH is currently neither a "*designated clearing and settlement system*" nor a "*recognized clearing house*". Accordingly, liabilities of a Relevant Clearing Member in relation to Contracts and/or the Charged Property associated with such Contracts, will not form part of a "*protected clearing and settlement systems arrangement*" and therefore will not benefit from the protections under the Protected Arrangements Regulation against the effects of a Partial Property Transfer on the grounds of forming part of such arrangements.
- (v) In the consultation conclusions on the Protected Arrangements Regulation published jointly by the Hong Kong Monetary Authority, the Insurance Authority and the Securities and

Futures Commission,⁶ it was concluded that it was not necessary to extend the definition of "*protected clearing and settlement systems arrangement*" under the Protected Arrangements Regulation to include clearing arrangements with a clearing house which is not a "*recognized clearing house*" under the Securities and Futures Ordinance. In part, this was because: "*the broad definitions of set-off arrangement, netting arrangement and secured arrangement in effect extend to a wide range of key relationships between [financial market infrastructures] and their participants and thus provide certainty that these arrangements will benefit from the protections afforded by the [Protected Arrangements Regulation]. The protections, under the Protected Arrangements Regulation, for "set-off arrangements", "netting arrangements" and "secured arrangements" are considered further below.*

Protected "set-off arrangements", "netting arrangements" and "title transfer arrangements"

- (vi) Section 5 of the Protected Arrangements Regulation provides that a resolution authority, in making a property transfer instrument that transfers any rights and liabilities of a person (the "*transferor*") under a "*set-off arrangement*", "*netting arrangement*" or "*title transfer arrangement*" (each as defined in section 74 of the FIRO), must seek to transfer all, and not just some, of those rights and liabilities, subject to the following conditions:
- (A) the arrangement is documented or otherwise evidenced in writing;
 - (B) either of the parties to the arrangement is entitled to set off or net the rights or liabilities under the arrangement;
 - (C) the arrangement does not contain a provision permitting (entitling) 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 under section 5(2) of the Protected Arrangements Regulation.
- (vii) The rights and liabilities excluded under section 5(2) are:

⁶Available at: http://www.fstb.gov.hk/fsb/ppr/consult/doc/consult_conclu_par_e.pdf

- (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, 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; and
 - (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.
- (viii) As described in paragraph 3.2.3(f)(v) above, the definition of a "*set-off arrangement*" and a "*netting arrangement*" under the Protected Arrangements Regulation is broad, and is capable of including arrangements between a financial market infrastructure and its participants. Accordingly, provided that the netting and set-off arrangements under the LCH Default Rules:
- (A) satisfy the conditions described in sub-paragraphs 3.2.3(f)(vi)(A) to (C) above; and
 - (B) none of the rights and liabilities under those arrangements are excluded liabilities as described in paragraph 3.2.3(f)(vii)(vii),

then such arrangements are likely to be capable of benefitting from the protection against the adverse effects of a Partial Property Transfer under section 5 of the Protected Arrangements Regulation.

Protected "secured arrangement"

- (ix) Section 6 of the Protected Arrangements Regulation provides that, a resolution authority, in making a property transfer instrument that transfers assets or rights of an entity (the "*transferor*") against which a liability is secured under a

"*secured arrangement*" (as defined in section 74 of the FIRO) is to seek to:

- (A) not transfer those assets or rights unless the liability and the benefit of the security are also transferred under that instrument;
 - (B) not transfer the benefit of the security unless the liability is also transferred under that instrument; or
 - (C) not transfer the liability unless the benefit of the security is also transferred under that instrument.
- (x) A "secured arrangement" is defined in section 74 of the FIRO as "an arrangement under which a person acquires, by way of security, an actual or contingent interest in the property of another".
- (xi) As described in sub-paragraph (v) above, the definition of "*secured arrangement*" under the Protected Arrangements Regulation is broad, and is capable of including security arrangements entered into between a financial market infrastructure and its participants in connection with the provision of services by that financial market infrastructure. Accordingly, our view is that the security constituted by the Deed of Charge is capable of constituting a secured arrangement for the purposes of the Protected Arrangements Regulation, and accordingly is capable of benefitting from the protection against the adverse effects of a Partial Property Transfer under section 6 of the Protected Arrangements Regulation.

Consequence of protection under Protected Arrangements Regulation

- (xii) Under section 9 of the Protected Arrangements Regulation, a property transfer instrument will be treated as having effectively transferred rights and liabilities in accordance with the requirements of section 5, even where those rights and liabilities are governed by a non-Hong Kong law and may not have been effectively transferred under the law of a particular non-Hong Kong jurisdiction. Accordingly, as the Arrangements are governed by English law, the liabilities of a Relevant Clearing Member in relation to Contracts and/or the Charged Property associated with such Contracts may not be protected from the effects of a Partial Property Transfer under section 5 of the Protected Arrangements Regulation if the property transfer instrument causes a Partial Property Transfer because the property transfer instrument is not effective to transfer the rights and liabilities of the relevant Party under non-Hong Kong law.

- (xiii) Section 10 of the Protected Arrangements Regulation provides that a transfer, under a property transfer instrument, of a protected netting or set-off arrangement which was effected inconsistently with the requirements under section 5 of the Protected Arrangements Regulation does not affect the ability of the counterparty in respect of that protected netting or set-off arrangement to net or set off its rights under such arrangement.
- (g) Protections on bail-in
- (i) A Part 5 Instrument made under section 58 of the FIRO (a bail-in instrument) may include a bail-in provision. Such a bail-in provision may apply to liabilities owed by a Relevant Clearing Member in relation to Contracts and/or the Charged Property associated with such Contracts. A bail-in provision could apply:
- (A) so as to reduce or eliminate any amount owed in respect of such liabilities, with the consequence that the right of LCH to net or set-off, pursuant to the Default Rules, amounts due in respect of those liabilities against liabilities owed by LCH to the Relevant Clearing Member under or in connection with the Contracts, is commensurately reduced or eliminated; and/or
- (B) the amount of the Secured Obligations is reduced, with the result that the right of LCH to enforce the Charged Property in respect of those Secured Obligations is commensurately reduced or eliminated.
- (ii) In this regard:
- (A) under section 58(4) the FIRO, certain categories of "*excluded liability*" may not be the subject of a bail-in provision; The definition of "*excluded liability*" includes:
- (1) "*liabilities arising from participation in the services provided by a recognized clearing house and owed to the clearing house or to its clearing participants*";
- (2) "*any liability, so far as it is secured*"; and
- (B) under section 14 of the Protected Arrangements Regulation, a bail-in provision may not be exercised in respect of a "*protected liability*", which includes, subject to certain conditions, liabilities under a "*set-off arrangement*" and a "*netting arrangement*".

Excluded liabilities owed to a recognized clearing house

- (iii) The categories of "*excluded liability*" under the FIRO in respect of which a bail-in provision may not be exercised are set out at Schedule 5 to the FIRO. Under section 2(s) of Schedule 5, an excluded liability includes: "*liabilities arising from participation in the services provided by a recognized clearing house and owed to the clearing house or to its clearing participants*".
- (iv) As described in paragraph 3.2.3(f)(iv), LCH is currently not a "*recognized clearing house*"; accordingly liabilities owed by a Relevant Clearing Member in relation to Contracts and/or the Charged Property associated with such Contracts will not constitute an "*excluded liability*" under section 2(s) of Schedule 5 to the FIRO.

Excluded secured liabilities

- (v) Under section 2(l) Schedule 5 to the FIRO, an excluded liability includes "*any liability in so far as it is secured*"; and "*secured*", for these purposes, means "*secured against assets or rights of an entity in respect of which a bail-in instrument is made, or otherwise covered by collateral arrangements*".
- (vi) We believe the better view is that the Secured Obligations under the Deed of Charge should constitute an excluded liability under section 59 of the FIRO, and accordingly the Secured Obligations should not be the subject of a bail-in provision in a Part 5 Instrument.

Protected liabilities under netting arrangements and set-off arrangements

- (vii) Section 14 of the Protected Arrangements Regulation provides that a "*resolution authority is to seek not to exercise a power to make a bail-in provision in respect of a protected liability*".
- (viii) In broad terms, a "*protected liability*" is defined in section 13 of the Protected Arrangements Regulation as a liability that:
 - (A) is owed by the person in respect of which the Part 5 Instrument containing the relevant bail-in provision is made (the "*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 (each as defined in section 74 of the FIRO) entered into between P and the affected entity;
 - (C) has not been converted, or treated as if it had been converted, into a net debt, claim or obligation, whether

in accordance with the terms of the relevant set-off arrangement, netting arrangement or title transfer arrangement, through the making of a bail-in provision or otherwise; and

(D) is not "*excluded liability*" under section 58(9) of the FIRO and is not otherwise excluded under section 13(2) of the Protected Arrangements Regulation.

(ix) As described in sub-paragraph 3.2.3(f)(v) above, the definition of a "*set-off arrangement*" and a "*netting arrangement*" under the Protected Arrangements Regulation is broad, and is capable of including arrangements between a financial market infrastructure and its participants. Accordingly, provided that liabilities of a Relevant Clearing Member under a Contract:

(A) have not already been converted into a net debt claim or obligation (whether in accordance with the relevant provisions of the Default Rules or otherwise); and

(B) are not an "*excluded liability*" under section 58(9) of the FIRO and are not otherwise excluded under section 13(2) of the Protected Arrangements Regulation,

such liabilities are likely to be capable of constituting "*protected liabilities*" for the purposes of the Protected Arrangements Regulation, and accordingly may not be the subject of a bail-in provision in a Part 5 Instrument.

(x) However, section 14(2) of the Protected Arrangements Regulation provides that any net sum produced by netting in respect of a protected liability may still itself be liable to reduction or elimination by a bail-in provision in a Part 5 Instrument; accordingly, if, following the exercise by LCH of its netting and/or set-off rights under the Default Rules, an Affected Entity has a liability to make a payment to LCH, such liability may be the subject of a bail-in provision.

(h) Recognition instruments and support measures

(i) As described in paragraph 3.2.1(d)(ii) above, in respect of any non-Hong Kong resolution action to which a Relevant Clearing Member which is a non-Hong Kong financial institution or a non-Hong Kong group company has become subject, a resolution authority may:

(A) pursuant to section 187 of the FIRO, issue a recognition instrument recognising some or all of that non-Hong Kong resolution action (a "**Recognition Instrument**"); and

- (B) pursuant to section 191 of the FIRO, exercise, for the purposes of supporting the relevant non-Hong Kong resolution action, any other power that the resolution authority has under the FIRO.
- (ii) The powers that a resolution authority may exercise under section 191 in support of a non-Hong Kong resolution action are limited to such powers as the resolution authority may exercise under the provisions of the FIRO other than section 191; and the exercise of a power under section 191 is subject to the same protections and limitations as the protections and limitations to which the exercise of that power is subject under the provisions of FIRO other than section 191. Accordingly, if under section 191 a resolution authority were to issue a property transfer instrument or a bail-in instrument in support of a non-Hong Kong resolution action, the protections against a Partial Property Transfer described in paragraphs 3.2.3(f) would apply to that property transfer instrument and the protections on bail-in described in paragraph 3.2.3(g) above would apply to that bail-in instrument.
- (iii) Section 188(2) of the FIRO provides that the effect of the issue of a Recognition Instrument is that *"the non-Hong Kong resolution action (or the part of it) that is recognized...has substantially the same legal effect in Hong Kong that it would have produced had it been made, and been authorized to be made, under the laws of Hong Kong"*.
- (iv) Our view is that the words *"and been authorized to be made"* mean that a Recognition Instrument may give effect to a non-Hong Kong resolution action even if that non-Hong Kong resolution action is an action of a type which a resolution authority would not be authorized to take under the provisions of the FIRO other than those relating to the issue of a Recognition Instrument. Further, the protections under the FIRO and Protected Arrangements Regulation (i) against a partial property transfer (as described in paragraph 3.2.3(f) above) and (ii) on bail-in (as described in paragraph 3.2.3(g) above) do not apply to the exercise by the resolution authority of any power under the FIRO, following the issuance of a Recognition Instrument.
- (v) It follows that it is at least theoretically possible that a Recognition Instrument may give effect to a non-Hong Kong resolution action which might affect the ability of LCH to exercise its rights under the netting and set-off provisions of the Default Rules and/or to enforce the security under the Deed of Charge in a manner that would be prohibited under the provisions of the FIRO other than those relating to the issue of a Recognition Instruction; and in particular that a Recognition

Instrument may give effect to a non-Hong Kong resolution action which causes a partial property transfer or which bails in the liabilities of a non-Hong Kong financial institution on a gross, rather than net, basis.

(vi) However, our view is that it is unlikely that a Recognition Instrument would have either of the effects described in paragraph 3.2.3(h)(v) above, for the following reasons:

(A) Section 2 of the FIRO defines a "*non-Hong Kong resolution action*" as, amongst other things, an action:

"the anticipated results of which are...broadly comparable to results that could have been anticipated from the exercise of a power conferred by Part 5, or by Schedule 3, 4 or 6, on a resolution authority in respect of an entity in Hong Kong".

It follows that an action of a non-Hong Kong resolution authority will constitute a "*non-Hong Kong resolution action*", and thus may be the subject of a Recognition Instrument, only if the anticipated results of that action are comparable to the anticipated results of, amongst other things, a Part 5 Instrument. Given that the protections (i) against partial property transfer and (ii) on bail in (described in paragraphs 3.2.3(f) and 3.2.3(g) above) apply to a Part 5 Instrument, an action by a non-Hong Kong resolution authority which is not subject to comparable protections is unlikely to constitute a "*non-Hong Kong resolution action*" and thus unlikely to be capable of being the subject of a Recognition Instrument.

(B) Section 187(6) of the FIRO provides that a resolution authority may not make a Recognition Instrument if:

- (1) recognition would have an adverse effect on financial stability in Hong Kong;
- (2) recognition would not deliver outcomes that are consistent with the resolution objectives (as set out in section 8(1) of the FIRO); or
- (3) recognition would disadvantage Hong Kong creditors or Hong Kong shareholders (or both) relative to other creditors or shareholders of the entity in respect of which the relevant non-Hong Kong resolution action has been taken.

If a non-Hong Kong resolution action were likely to have, if the subject of a Recognition Instrument, the effects

described in paragraph 3.2.3(h)(v) above, a Hong Kong resolution authority may decline to issue such a Recognition Instrument on the grounds that recognition could either have an adverse effect on financial stability in Hong Kong, or could disadvantage Hong Kong creditors or shareholders.

Further, although the resolution objectives in the FIRO are framed in general terms and do not specifically require netting arrangements, set-off arrangements or title transfer arrangements to be protected in the context of the resolution of a within scope financial institution, a Hong Kong resolution authority may nonetheless take the view that issuing a Recognition Instrument which has the effects described in paragraph 3.2.3(h)(v) above would be inconsistent with the resolution objectives.

- (C) The consultation response in respect of the FIRO prepared jointly by, amongst others, the HKMA, provided that the regime under the FIRO for the recognition of non-Hong Kong resolution actions was intended to be consistent with the approach recommended by the Financial Stability Board (FSB) in its 2014 consultation paper on cross-border recognition of resolution actions. The approach to cross-border recognition recommended by the FSB in the 2014 consultation paper was itself intended as a development of the approach to the resolution of financial institutions recommended by the FSB in its 2011 paper, the "*Key Attributes of Effective Resolution Regimes for Financial Institutions*". One of the key attributes recommended in the 2011 "*Key Attributes*" document is the protection of set-off, netting and collateralisation arrangements. It follows that the recognition of a non-Hong Kong resolution action which would not protect set-off, netting or collateralisation arrangements would be inconsistent with the approach to resolution and recognition of foreign resolution recommended by the FSB in the 2011 "*Key Attributes*" document and the 2014 consultation paper, and a Hong Kong resolution authority may accordingly be unlikely to issue a Recognition Instrument in respect of such non-Hong Kong resolution action.

Automatic Early Termination

- (i) Subject to the discussions in paragraph 3.2.5 in relation to Client Contracts, it is not necessary for LCH to specify that certain Insolvency

Proceeding will constitute an Automatic Early Termination Event in accordance with Rule 3 of the Default Rules.

- 3.2.4 *Is there a "suspect period" prior to Insolvency Proceeding and/or Reorganisation Measures where Contracts with a Relevant Clearing Member could be avoided or challenged and, if so, what are the grounds? What are the risks for LCH in entering into Contracts and in taking Collateral in respect of those Contracts during such a period? Are any special protections or exemptions from the relevant arrangements for avoidance or challenge available under the law of the Relevant Jurisdiction in respect of contracts in financial markets?*

Unfair preference

- (a) Pursuant to section 266 of the Companies Winding Up Ordinance, anything done or suffered to be done by a company within a specified period ending on the date of presentation of a winding-up petition on which that company is wound-up may be set aside as an unfair preference. The relevant specified period is: (i) in the case of an unfair preference given to a person who is connected (as defined in the Companies Winding Up Ordinance) with the company (otherwise than by reason only of being its employee), 2 years and (ii) in any other case of an unfair preference, 6 months.
- (b) The thing done or suffered to be done may be set aside if, at the time it was done or suffered to be done, (i) the company was unable to pay its debts or, in consequence of the thing done or suffered to be done, became unable to pay its debts within the meaning of section 178 of the Companies Winding Up Ordinance and (ii) that thing has the effect of putting any of its creditors or a surety or guarantor of any of its debts or other liabilities in a better position, in the event of that company's insolvent liquidation, than that person would have been in if the thing had not been done. For such purpose, the company goes into insolvent liquidation if it goes into liquidation at a time when its assets are insufficient for the payment of its debts and other liabilities and the expenses of the winding-up.
- (c) The court cannot make an order to set aside an unfair preference unless the company was influenced to give the unfair preference by a desire to put the person to which it was given in such better position. For this purpose, a company which has given an unfair preference to a person connected (as defined in the Companies Winding Up Ordinance) with the company (otherwise than by reason only of being its employee) at the time the unfair preference was given is presumed to have been influenced by a desire to put the person to which it was given in such better position.
- (d) However, if a Contract is entered into on arm's length terms and at then prevailing market rates, and the amount of any additional Collateral in

respect of such Contract is calculated in good faith, taking into account the additional market and credit risks associated with such Contract, then is it unlikely that such Contract or the provision of such additional Collateral will constitute an unfair preference.

Transactions at an undervalue

- (e) Pursuant to section 265D of the Companies Winding Up Ordinance, a transaction entered into by a company with a person within a period of five years ending on the Commencement Point of the winding-up of that company may be set aside if it is a transaction at an undervalue. The transaction is a transaction at an undervalue if (i) it constitutes a gift by the company to that person, or its terms provide for the Company to receive no consideration, or (ii) its terms provide for the company to receive a consideration the value of which, in money or money's worth terms, is significantly less than the value, in money or money's worth, of the consideration provided by that person to the Company.
- (f) However, the transaction may not be set aside as a transaction at an undervalue unless:
 - (A) at the time the transaction was entered into the company was unable to pay its debts; or
 - (B) in consequence of the transaction became unable to pay its debts,in each case within the meaning of section 178 of the Companies Winding Up Ordinance.
- (g) Pursuant to section 266B(3) of the Companies Winding Up Ordinance, a company will be presumed to have been unable to pay its debts, or to have become unable to pay its debts in consequence of the transaction, if the relevant transaction was entered into by the Company with a "connected person" (as defined in the Companies Winding Up Ordinance).
- (h) A court cannot make an order to set aside a transaction at an undervalue if it is satisfied that the Company entered into the transaction in good faith and for the purpose of carrying on its business and that at the time it did so there were reasonable grounds for the belief that the transaction would benefit the Company.

Dispositions to defraud creditors

- (i) Under Section 60 of the Conveyancing and Property Ordinance, any disposition by a company ("disposition" being interpreted widely, so as to include the transferring of property and the undertaking of obligations) made with the intention to defraud creditors may be set aside, where such fraudulent intention is proved by the person thereby prejudiced and seeking to set aside the disposition.

- (j) However, Section 60 does not extend to interests in property that are disposed of for valuable consideration and in good faith (or upon good consideration and in good faith) to any person not having, at the time of the disposition, any notice of the intent to defraud. Accordingly, Section 60 is unlikely to apply to any Contract that is entered into by the Parties on arm's length terms and at then prevailing market rates, or any additional Collateral in respect of such Contract, where the amount of such additional Collateral is calculated in good faith, taking into account the additional market and credit risks associated with such Contract.
- (k) In addition, Section 60 does not affect the operation of the Bankruptcy Ordinance and the Companies Winding Up Ordinance in respect of those provisions for the time being in force under which transactions may be avoided for the protection of creditors upon a company's winding up.

Dispositions of property void

- (l) Under Section 182 of the Companies Winding Up Ordinance, any disposition of a company's property ("disposition" being interpreted widely, so as to include the transferring of property and the undertaking of obligations) made after the commencement of a winding up of that company is void, unless the court otherwise orders. Accordingly, any (i) obligations in respect of any Contract entered into or (ii) Collateral provided by a Relevant Clearing Member after the commencement of the winding-up of that Relevant Clearing Member are unlikely to be valid and enforceable by LCH against that Relevant Clearing Member.

Extortionate credit transaction

- (m) Pursuant to Section 264B of the Companies Winding Up Ordinance, the liquidator of a company may apply to set aside transactions which occurred within three years prior to the commencement of winding up involving the provision of credit to that company.
- (n) A transaction will be extortionate if, having regard to the risk accepted by the party providing the credit, (i) the terms of it are or were such as to require grossly exorbitant payments to be made (whether unconditionally or in certain contingencies) in respect of the provision of credit, or (ii) it otherwise grossly contravenes ordinary principles of fair dealing.
- (o) While certain Contracts may involve the provision of credit to the Relevant Clearing Member, Section 264B is unlikely to apply to those Contracts provided that those Contracts are entered into on arm's length terms and at then prevailing market rates.

Disclaimer of unprofitable contracts

- (p) Section 268 of the Companies Winding Up Ordinance allows the liquidator, in a winding-up of a company, to disclaim unprofitable contracts with the leave of the court. A liquidator may therefore, following the commencement of the winding-up of that company, seek to disclaim any contract entered into by that company, if the liquidator considers that contract to be an unprofitable contract. If any contract is so disclaimed, any damages or injury suffered by the relevant creditor as a result may be claimed by such creditor as a debt in the winding-up of the company.
- (q) However, actual liabilities incurred by a company prior to the date of commencement of such winding up will not be affected by such disclaimer; and section 268 of the Companies Winding Up Ordinance does not entitle a liquidator to:
 - (i) recover any sum paid by the company to such solvent party before the commencement of the winding-up of the company; or
 - (ii) disclaim any contract so as to determine, or release the company from, any liability or obligation of the company in respect of any amount that became due and payable by the company before the commencement of the winding-up of the company.
- (r) In addition, Section 268 of the Companies Winding Up Ordinance does not entitle a liquidator to disclaim a contract if and to the extent that (A) the solvent party has properly exercised an effective right to close-out any liability or obligation (or to close out any contract or transaction giving rise to such liability or obligation) which, but for such close-out, would have been required to be discharged or performed by the company at some future time; and (B) such close-out has become effective (so as to produce an amount due and payable) before the time at which the liquidator seeks to disclaim the relevant contract.
- (s) Moreover, even if a liquidator, with the leave of the court, is able to disclaim a contract which has not been effectively closed-out at the time at which the liquidator seeks to disclaim such contract, the amount representing the damages or injury suffered by the solvent party would be provable in the winding-up of the company, and would therefore be mandatorily included in the Statutory Insolvency Set-Off between the Parties.

Floating charge

- (t) Under sections 267 and 267A of the Companies Winding Up Ordinance, separate avoidance provisions apply to floating charges. If the security created by a Relevant Clearing Member under the Deed of Charge is re-characterised as a floating charge, section 267 of the Companies Winding Up Ordinance provides that such floating charge would be invalid if:

- (i) that floating charge was created in favour of a person who is connected (as defined in the Companies Winding Up Ordinance) with a company, and it was created within a period of two years ending on the date of the Commencement Point of the winding-up of the Company; or
- (ii) that floating charge was created in favour of any person other than a person connected with the Company, and it was created within a period of 12 months ending on the date of the Commencement Point of the winding-up of the Company,

and, in the case of (i) or (ii) above:

- (A) at the time of the creation of that floating charge, the company was unable to pay its debts (within the meaning of section 178 of the Companies Winding Up Ordinance); or
- (B) the company became unable to pay its debts (within the meaning of section 178 of the Companies Winding Up Ordinance) in consequence of the transaction under which the floating charge was created.

except to the extent of any cash paid to the Relevant Clearing Member at the time of or after the creation of, and in consideration for, the charge, together with interest on that amount (not exceeding 12 per cent per annum).

- (u) The effect of section 267 is that a floating charge for "new consideration" is not invalid to the extent of the "new consideration", but may be invalid insofar as it is granted for a pre-existing debt.

Designated CCP

- (v) As described in paragraph 3.1.2(l)(ii) above, the Securities and Futures Ordinance provides that an ATS Provider may apply to the SFC for recognition as a "designated CCP" for the purposes of the mandatory clearing of certain OTC derivatives transactions. As noted in paragraph 3.1.2(n) above, LCH has been designated by the SFC as a "designated CCP" for such purposes.
- (w) The Securities and Futures Ordinance contains a provision, which is not yet in force, that contracts of designated CCPs that are ATS providers may constitute "market contracts" for the purposes of the Securities and Futures Ordinance. The Securities and Futures Ordinance confers on a "market contract" a number of protections in respect of Hong Kong insolvency law; in particular, Section 45 of the Securities and Futures Ordinance provides, amongst other things, that a "market contract" shall not be regarded as to any extent invalid at law on the ground of inconsistency with the law relating to distribution of the assets of a

person on insolvency, bankruptcy or winding up, or on the appointment of a receiver over any of the assets of a person.

- (x) However, in the results of a February 2016 consultation,⁷ the SFC concluded that it would defer for an unspecified period of time the bringing into force of the above-mentioned amendments to the definition of "market contract". The reason given for this decision was the possible risk of "*ambiguities and uncertainties that might arise in terms of how the insolvency override provisions [of the designation of a contract as a "market contract"] apply in respect of overseas CCPs that risk manage on a portfolio basis*".

Recognized clearing house

- (y) For completeness, as previously mentioned, there are provisions under the Securities and Futures Ordinance for a Hong Kong company to apply for recognition as a "recognized clearing house". The Securities and Futures Ordinance confers on the operations of a "recognized clearing house" a number of protections in respect of Hong Kong insolvency law. These protections include the fact that a contract entered into between a "recognized clearing house" and a clearing participant of a "recognized clearing house" will be a "market contract" for the purposes of the Securities and Futures Ordinance, and will therefore have the benefit of the protections conferred on a "market contract" under Section 45 of the Securities and Futures Ordinance as described in the section entitled "*Designated CCP*" above.
- (z) However, as only a Hong Kong company may apply for recognition as a "recognized clearing house", under the law as it presently stands, it is not possible for LCH to apply for recognition as a "recognized clearing house", and thereby obtain the benefits of the insolvency protections under the Securities and Futures Ordinance (including those protections that would accrue to a Contract if it were to constitute a "market contract").

3.2.5 ***Is there relevant netting legislation in the Relevant Jurisdiction that, in the context of Insolvency Proceeding or Reorganisation Measures in respect of a Relevant Clearing Member, might apply as an alternative to the relevant arrangements set out in the Default Rules?***

- (a) Hong Kong has no specific netting statutes, but there is a statutory regime of mandatory insolvency set-off under section 35 of the Bankruptcy Ordinance ("**Statutory Insolvency Set-off**"), which is made applicable to companies by section 264 of the Companies Winding Up Ordinance. Section 35 of the Bankruptcy Ordinance provides that,

⁷ "*Consultation conclusions and further consultation on introducing mandatory clearing and expanding mandatory reporting*", February 2016, available at: <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=16CP1>

where there have been mutual credits, mutual debts or other mutual dealings between the insolvent party and any other person, any amount owing by that insolvent party to that other person shall be set off against any amount owing by that other person to the insolvent party, and only the balance shall be owing by that insolvent party or, as the case may be, that other person.

- (b) Statutory Insolvency Set-off is mandatory and occurs automatically:
 - (i) in relation to a Compulsory Winding-up, at the time of the making of a winding-up order by the court;
 - (ii) in relation to a Voluntary Winding-up, at the time of the passing of the resolution of members for such Voluntary Winding-up; or
 - (iii) in relation to a s228A Winding-up, at the time of the delivery to the Hong Kong Registrar of Companies of a statement in accordance with Section 228A of the Companies Winding Up Ordinance,

(each, a "**SISO Point**").

- (c) All "mutual" obligations between the Parties are mandatorily included in Statutory Insolvency Set-Off: as we have assumed that the obligations assumed under the Agreements and the Contracts are "mutual" between the Parties, the effect of Statutory Insolvency Set-Off would, subject to other reservations and qualifications set out in this advice, be to aggregate and/or set off all Contracts between LCH and the insolvent Relevant Clearing Member together with all other amounts due between the Parties so that only a single net sum is payable, notwithstanding that the Default Rules provide for a net amount to be payable separately in respect of each "kind of account".
- (d) However, any set-off (pursuant to a contractual set-off provision) that took effect prior to the relevant SISO Point will generally not be affected by Statutory Insolvency Set-Off, and Section 35 of the Bankruptcy Ordinance does not entitle a liquidator to require the payment by the solvent party to the insolvent party of the gross amount that had been the subject of such set-off (pursuant to a contractual set-off provision).
- (e) An obligation (a "**Post-Notice Obligation**") incurred by the insolvent party during a specified period before the relevant SISO Point will not be included in the set-off pursuant to Statutory Insolvency Set-Off, if the Post-Notice Obligation (looked at in isolation) gives rise to an amount owing by such insolvent party to the other party.

Client Clearing

- (f) Where a Relevant Clearing Member has entered into a Client Clearing Arrangement with LCH so that certain of the Contracts between the

Parties constitute "Client Contracts", we understand we are to assume that the Relevant Clearing Member has also entered into a Security Deed, pursuant to which the Relevant Clearing Member "charges" in favour of each of its clients the "Client Clearing Entitlement" (which is, broadly, all of the Relevant Clearing Member's rights, title and interest in the net sum resulting from the close-out of all Client Contracts that are attributable to that client) and the "Account Balance" (which is broadly, the collateral balance held with the Clearing House that is attributable to that client).

- (g) In our view, the effect of the Security Deed on the operation of Statutory Insolvency Set-Off would depend on:
 - (i) Whether a "charge" which is expressed to cover the Relevant Clearing Member's rights in the "Client Clearing Entitlement" (which is, broadly, the net sum resulting from the close-out of all Client Contracts that are attributable to that client) would extend to cover all of the Relevant Clearing Member's rights in each of such individual Client Contracts.

If the Client Contracts that are attributable to a client are viewed as a "single agreement", and the operation of the close-out provision of Rule 8 is viewed as a mere accounting between LCH and the Relevant Clearing Member, and does not involve set-off, then it may be argued that a charge on the Relevant Clearing Member's rights in the "Client Clearing Entitlement" would extend to the Relevant Clearing Member's rights in such Client Contracts (on the basis that those rights arise out of the same "single agreement" between the parties). However, there is currently insufficient case law in Hong Kong for us to be confident that the Client Contracts and the operation of Rule 8 would be viewed on this basis. In contrast, if each individual Client Contract is viewed as a separate agreement, and the operation of Rule 8 involves the extinguishment of the parties' obligations under each such individual Client Contract and the creation of a new obligation in respect of the "Client Clearing Entitlement", then a charge on the Relevant Clearing Member's rights to the "Client Clearing Entitlement" would unlikely extend to the Relevant Clearing Member's rights to the individual Client Contracts (as these are rights arising under different agreements). Further, we believe that the principle that a charge over the proceeds of an asset does not (in the absence of clear words) "run backwards" to the asset from which the proceeds are derived⁸ provides further support for the latter view that a charge over rights to the net sum only similarly does not "extend backwards" to the individual Client Contracts.

⁸ See Gullifer (ed.), *Goode on Legal Problems of Credit and Security* (5th ed. 2013) at [1-72].

- (ii) Whether the "charge" created under the Security Deed is fixed or floating.

Even if the "charge" created under the Security Deed does extend to the Relevant Clearing Member's rights in the individual Client Contracts, the issue of whether Client Contracts that are attributable to a particular client are "mutual" with Client Contracts that are attributable to another client or other non-Client Contracts for the purposes of Statutory Insolvency Set-Off would also depend on whether the security created under the Security Deed is fixed or floating.

If the security created under the Security Deed is fixed, and it extends to the Relevant Clearing Member's rights in the individual Client Contracts, we believe the better view is that Client Contracts that are attributable to a particular client are not "mutual" with Client Contracts that are attributable to any other client or with other non-Client Contracts. Accordingly, on the winding-up of the Relevant Clearing Member, there would be Statutory Insolvency Set-Off in respect of obligations owing in respect of all non-Client Contracts between the Relevant Clearing Member and LCH, together with all other "mutual" obligations between the Relevant Clearing Member and LCH (that are otherwise not subject to a fixed charge and have not been assigned in favour of a third party). However, obligations owing in respect of all Client Contracts attributable to a particular client, together with all other obligations of LCH to the Relevant Clearing Member that were the subject of a fixed charge in favour of that particular client (including the value of any cash margin transferred by the Relevant Clearing Member to LCH that was attributable to such Client Contracts) would not be the subject of a Statutory Insolvency Set-off.

In contrast, if the security created under the Security Deed is floating only (because, for example, the chargee does not exercise sufficient control over the charged assets), the better view is that, before crystallisation, the floating charge has no effect on the "mutuality" of the Client Contracts with the non-Client Contracts.

- (h) In view of the uncertainties referred to above, if LCH wishes to have a separate net amount determined in respect of Client Contracts that are attributable to each different client, we recommend that the commencement of each Insolvency Proceeding be made an Automatic Early Termination Event under Rule 3 of the Default Rules.
- (i) If close-out pursuant to Rule 8 takes effect prior to the commencement of an Insolvency Proceeding (whether as a result of Client Contracts being automatically terminated in accordance with Rule 3 or otherwise),

we confirm that there is no rule of Hong Kong law which would render a close-out pursuant to Rule 8 ineffective, or prevent a separate net amount from being determined in respect of Client Contracts that are attributable to each different client.

3.2.6 *Can a claim for a close-out amount be proved for in Insolvency Proceeding without conversion into the local currency?*

For the purpose of proving a claim for a close-out amount in a winding up, the claim must be expressed in Hong Kong dollars and, to the extent that any amounts are not denominated in Hong Kong dollars, they must be converted into Hong Kong dollars at the midpoint between the selling and buying telegraphic transfer rates of exchange quoted by The Hong Kong Association of Banks on the day the winding-up commenced or, where no such rates are quoted, at an exchange rate determined by the court.

3.3 CLIENT CLEARING

3.3.1 *Please opine on the availability and effectiveness of any law, regulation or statutory provision (having the force of law) in the Relevant Jurisdiction which (if so designated by LCH) would be expected to qualify as an Exempting Client Clearing Rule. Please clarify whether the relevant Rule would be expected to apply to Relevant Clearing Members of all entity types or to only certain entity types.*

If, and to the extent that, you consider such an Exempting Client Clearing Rule to be available, please (i) assume for the purposes of answering the following Questions that LCH will rely upon the existence of the relevant Exempting Client Clearing Rule and will not require those Relevant Clearing Members to which that Rule applies to enter into a Security Deed; and (ii) ignore Questions 3.3.8 to 3.3.10.

In cases where you do not consider an Exempting Client Clearing Rule to be available, please: (i) assume for the purposes of answering the following Questions that LCH will require Relevant Clearing Members to enter into a Security Deed; (ii) assume that the Security Deed is legal, valid, binding and enforceable under English law (as its governing law) and complies with all relevant perfection requirements under the law of any jurisdiction(s) other than the Relevant Jurisdiction which you consider to be relevant to that matter; and (iii) provide a response to Questions 3.3.8 to 3.3.10.

- (a) Our view is that no Exempting Client Clearing Rule is available to LCH.
- (b) As discussed in paragraph 3.2.4 above, there are provisions under the Securities and Futures Ordinance:
 - (i) pursuant to which a contract cleared on a "designated CCP" which is a provider of ATS services would constitute a "market contract" for the purposes of the Securities and Futures Ordinance. However, these are not yet in force. Please refer to

the paragraph entitled "*Designated CCP*" in paragraph 3.2.4 above for further discussion on this point; and

- (ii) for a Hong Kong company to apply for recognition as a "recognized clearing house". In this respect, the definition of "market contract" in the Securities and Futures Ordinance includes a contract between a "recognized clearing house" and a clearing member of a "recognized clearing house".
- (c) As discussed in paragraph 3.2.4 above, Section 45 of the Securities and Futures Ordinance provides that a "market contract" will benefit from certain protections from challenge under the insolvency laws of Hong Kong.
- (d) However, as the law presently stands, it is not possible for the "market contract" protections under the Securities and Futures Ordinance to extend to Client Contracts. This is because in, in the case of (a) above, the relevant provisions of the Securities and Futures Ordinance insofar as they relate to a "designated CCP" are not yet in force (and in the case of the provisions of the Securities and Futures Ordinance which would expand the definition of "market contract" to include contracts traded on a provider of ATS services which is a "designated CCP", the entry into force of these provisions has been postponed for an unspecified period of time); and in the case of (b) above, it is not possible for LCH, as a non-Hong Kong company, to apply for recognition as a "recognized clearing house".

3.3.2 ***If LCH were to: (i) declare a Relevant Clearing Member to be in Default in circumstances other than the commencement of Insolvency Proceeding or Reorganisation Measures in respect of that clearing member and (ii) seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could the Relevant Clearing Member or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?***

A Relevant Clearing Member is contractually bound to the Client Clearing Arrangements, by virtue of the Clearing Membership Agreement. In the absence of any Insolvency Proceeding or Reorganisation Measures in respect of a defaulting Relevant Clearing Member, the contractual arrangements supporting the Client Clearing Arrangements should be effective in their own right and without the need for reliance upon any Exempting Client Clearing Rule.

3.3.3 ***If LCH were to: (i) declare a Relevant Clearing Member to be in Default in circumstances other than the commencement of Insolvency Proceeding or Reorganisation Measures in respect of that clearing member; and (ii) seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such client, could the Relevant Clearing***

Member or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?

Please see our response in paragraph 3.3.2 above.

3.3.4 *If (i) following the commencement of Insolvency Proceeding, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could an insolvency officer appointed to the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?*

- (a) We note that porting of Client Contracts may be effected by either (i) a close-out of the relevant Client Contracts between LCH and the Defaulter followed by the replication of such Contracts (by the opening of new Client Contracts on the same terms) between LCH and the Backup Clearing Member ("**Close-out and Replication Porting**"); or (ii) a transfer of the relevant Client Contracts (in the form of open positions and without close-out) from the Defaulter to the Backup Clearing Member ("**Transfer Porting**").

Porting Client Contracts and Account Balance through Transfer Porting

- (b) In a compulsory winding-up of a company in Hong Kong (the "**Insolvent Party**"), any disposition of the Insolvent Party's property ("disposition" being interpreted widely, so as to include the transferring of property and the undertaking of obligations) made after the date the petition for winding-up has been presented to the court is void under Section 182 of the Companies Winding Up Ordinance, unless a court otherwise orders. Section 182 of the Companies Winding Up Ordinance does not apply in a Voluntary Winding-up or a s228A Winding-up.
- (c) In addition, a contractual arrangement may be invalidated under the anti-deprivation principles if: (a) the arrangement removes an asset from an insolvent party that would otherwise be capable of realisation for the benefit of that party's creditors; and (b) the arrangement takes effect as a consequence of the insolvency of that party. The anti-deprivation principles were most recently considered in the UK Supreme Court judgment of *Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited* [2011] UKSC 38. The principles have also been applied in Hong Kong in the Court of Appeal case of *Peregrine Investments Holdings Limited (in liquidation) v Asian Infrastructure Fund Management Company Limited L.D.C.* [2004] 1 HKLRD 598.
- (d) For the above reasons, any porting of the Client Contracts and Account Balance of a Clearing Client conducted through Transfer Porting may be subject to challenge as (a) either the Client Contract or the related

Contract between the Defaulter and LCH will be in-the-money with respect to the Defaulter and (b) the Account Balance will be an asset of the Defaulter (but subject to the security interest under the Security Deed).

Porting Client Contracts and Account Balance through Close-out and Replication Porting

- (e) Any porting of the Client Contracts and Account Balance of a Clearing Client conducted through Close-out and Replication Porting may be subject to challenge on similar grounds.
- (f) However, our view is that, in most cases, the same result as Transfer Porting and/or Close-out and Replication Porting can be achieved through the following three-step process:
 - (i) close-out of the Client Contract or the related Contract between the Defaulter and LCH;
 - (ii) where a net sum is payable by LCH to the Defaulter in respect of the related Contract, enforcement by the Clearing Client of the security interest under the Security Deed; and
 - (iii) the putting in place of contractual arrangements between LCH, the Backup Clearing Member and the Clearing Client (which may be by way of a tri-party agreement or two bilateral agreements (one between the Clearing Client and the Backup Clearing Member and the other between the Backup Clearing Member and LCH)), creating transactions (between the Clearing Client and the Backup Clearing Member and between the Backup Clearing Member and LCH) identical to the Client Contract and the related Contract between the Defaulter and LCH.
- (g) Our reasoning for this is as follows:
 - (i) Client Contracts may be (A) in-the-money for the Defaulter ("**ITM Positions**") or (B) out-of-the-money for the Defaulter ("**OTM Positions**"), at the time of the commencement of Insolvency Proceeding against the Defaulter;
 - (ii) in the case of both ITM Positions and OTM Positions, where the Defaulter has posted sufficient margin to LCH (which may be by way of title transfer or under the Deed of Charge) such that, on close-out of the relevant Contracts between LCH and the Defaulter (the "**Relevant Contracts**"), LCH determines that a net sum is payable to the Defaulter, a net sum of the same amount should be owed by the Defaulter to the Clearing Client in respect of the Client Contracts to which such Relevant Contracts are referable;

- (iii) the security interest under the Security Deed may be enforced, whether by that Clearing Client itself or by LCH on its behalf as security trustee, so as to require LCH to pay directly to the Clearing Client the net sum owed by LCH to the Defaulter in respect of the Relevant Contracts in satisfaction of the obligation of the Defaulter to the Clearing Client in respect of the relevant Client Contracts; and
- (iv) there are no issues under Hong Kong law with LCH, the Backup Clearing Member and the relevant Clearing Client agreeing between them to replicate the Relevant Contracts, Client Contracts and Account Balances referred to above (such 'replication' being of the Relevant Contracts and the Client Contracts immediately before their closing-out).
- (h) However, if, for any reason, LCH determines that a net sum is payable by the Defaulter to LCH in respect of Relevant Contracts (and a net sum of the same amount is payable by the Clearing Client to the Defaulter in respect of the Client Contracts (i.e. ITM Positions to which such Relevant Contracts are referable), it will not be possible to conduct porting in the manner described above as the Security Deed creates security only over any net sum owed by LCH to the Defaulter.
- (i) Please note that the above analysis applies in respect of an Individual Segregated Account client. With respect to Omnibus Segregated Account clients, our view is that porting will be effective to the extent that the above analysis is applicable (i.e. that the net sum owed by LCH to the Defaulter is equal to the net sum owed by the Defaulter to the relevant Clearing Client such that enforcement of the security under the Security Deed results the Clearing Client receiving an amount from LCH equal to the amount which such Clearing Client is required to pay to the Defaulter in respect of the relevant Client Contracts).

3.3.5 *If (i) following the commencement of Insolvency Proceeding, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such client, could an insolvency officer appointed to the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?*

- (a) If, on close-out of the relevant Client Contracts, LCH determines that a net sum is payable by the Defaulter to the relevant Clearing Client in respect of such Client Contracts, it will be possible for the Clearing Client (itself, or by LCH as security trustee) to enforce the security under the Security Deed and require LCH to pay or transfer the Relevant Client Clearing Return and the Relevant Account Property (both as defined under the Security Deed) directly to the relevant Clearing Client. We

understand that the Client Clearing Entitlement forms part of the Relevant Client Clearing Return.

- (b) However, the relevant Clearing Client is not entitled to any payment or transfer from LCH (in respect of the Relevant Client Clearing Return and the Relevant Account Property) under the Security Deed which is in excess of the Liabilities (as defined in the Security Deed) owed by the Defaulter to the relevant Clearing Client. To the extent that the value of the Relevant Client Clearing Return and the Relevant Account Property exceeds the Liabilities owed by the Defaulter to the relevant Clearing Client, such Clearing Client will be required to return such excess value to the Defaulter.
- (c) It should be noted that, unless the Clearing Client (itself, or by LCH as security trustee) enforces the security under the Security Deed, LCH will be required to pay the Relevant Client Clearing Return and the Relevant Account Property to the Defaulter.
- (d) As there is no Exempting Client Clearing Rule in Hong Kong for LCH, each Relevant Clearing Member will be required to enter into a Security Deed. As each Relevant Clearing Member is required to notify LCH of the beneficiaries under such Security Deed, LCH will at all times be aware of the identity of the Clearing Clients of such Relevant Clearing Member.

3.3.6 ***If (i) following the implementation of Reorganisation Measures, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could the representative appointed to reorganise/manage the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?***

A scheme of arrangement pursuant to Part 13 of the Companies Ordinance (referred to in paragraph 3.2.1(a)(v)) is a Reorganisation Measure under the laws of Hong Kong. However, neither a scheme of arrangement nor a proposal for a scheme of arrangement imposes or entitles the relevant company or any other person to seek a moratorium on the enforcement of any security. As a result, the analysis set out in paragraph 3.3.4 above is equally applicable to Insolvency Proceeding and Reorganisation Measures.

3.3.7 ***If (i) following the commencement of Reorganisation Measures, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such client, could the representative appointed to reorganise/manage the***

Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?

In view of what we state in paragraph 3.3.6 above in respect of schemes of arrangement, the analysis set out in paragraph 3.3.5 above is equally applicable to Insolvency Proceeding and Reorganisation Measures.

3.3.8 ***Would the Security Deed provide an effective security interest under the laws of the Relevant Jurisdiction over the Account Balance or Client Clearing Entitlement in favour of the relevant Clearing Client?***

Effectiveness of the Security Interest created under the Security Deed

- (a) The Security Deed would generally be effective in respect of a Relevant Clearing Member *provided that* all applicable perfection requirements have been complied with. The perfection requirements applicable to Hong Kong companies are discussed in paragraph 3.1.4 above.
- (b) However, if the security created under the Security Deed is recharacterised as a floating charge (see our response to paragraph 3.1.4 above), LCH's (or the relevant Clearing Client's) entitlement to the proceeds of enforcement of the security will rank below that of certain preferential creditor claims. The categories of "preferential debts" are set out in section 265(1) of the Companies Winding Up Ordinance: in summary, they consist primarily of (i) taxes and other debts owing to the Hong Kong government and (ii) unpaid wages and other amounts owing to employees (subject to a relatively low 'cap').

Enforcement of Security Interest

- (c) Following the occurrence of an Enforcement Event (as defined in the Security Deed), the relevant Clearing Client (or LCH as security trustee) would be entitled under Hong Kong law to enforce the security interest created under the Security Deed (without notice or further demand) by exercising any rights and remedies it may have in respect of the Charged Assets (as defined in the Security Deed) under clause 7 of the Security Deed, including the right to take possession of and hold, sell, or otherwise dispose of all or any part of the Charged Assets.
- (d) However, please note that:
 - (i) In exercising its right of sale, the relevant Clearing Client (or LCH as security trustee) is required to act in good faith and to take reasonable care to obtain whatever is the true market value of the secured property at the moment it chooses to sell it (although it may sell promptly and does not have to 'stay its hand' in the hope of achieving a better price at a later date).
 - (ii) The relevant Clearing Client (or LCH as security trustee) may not sell the secured asset to itself, unless the sale is ordered by

the court and the relevant Clearing Client (or LCH as security trustee) has obtained the court's leave to bid (because such a transaction would amount to foreclosure without the leave of the court).

- (iii) The relevant Clearing Client (or LCH as security trustee) may sell to a company in which it is interested *provided that* the company is not a pure nominee, but the relevant Clearing Client (or LCH as security trustee) must prove that the sale was in good faith and that it had taken reasonable steps to obtain the best price reasonably obtainable at that time.
- (iv) To the extent any Charged Assets are located in Hong Kong, the relevant Clearing Client (or LCH as security trustee) may not be able to exercise any right of appropriation in respect of such Charged Assets because such a right may constitute a clog on the equity of redemption or contravene the rule against collateral advantages (or because such appropriation would amount to foreclosure without the leave of the court).

3.3.9 *Are there any perfection steps which would need to be taken under the laws of the Relevant Jurisdiction in order for the Security Deed to be effective?*

Please see our response in paragraph 3.1.4 above.

3.3.10 *Is there any risk of a stay on the enforcement of the Security Deed in the event of Insolvency Proceeding or Reorganisation Measures being commenced in respect of a Relevant Clearing Member?*

None.

3.3.11 *Please provide brief details of any other significant legal or regulatory issues which might be expected to arise in connection with the provision by a Relevant Clearing Member of Client Clearing Services and which are not covered by the Questions above.*

There are no other material issues relevant to the issues addressed in this advice which we wish to draw to your attention.

3.4 SETTLEMENT FINALITY

3.4.1 *Would the commencement of Insolvency Proceeding in respect of a Relevant Clearing Member affect finality of settlement of transfers of funds or securities (or both) from the Relevant Clearing Member to LCH? If so, please clarify from which point in time and in which circumstances finality protections in respect of such transfers would be lost.*

- (a) There are two sources of statutory protection of settlement finality under Hong Kong law:

Securities and Futures Ordinance

- (b) Please refer to our discussion in paragraphs 3.2.4 and 3.3.1 above on the settlement finality protections available under the Securities and Futures Ordinance, by virtue of, amongst other things, the protections from Hong Kong insolvency law applicable under the Securities and Futures Ordinance to a "market contract" (which would include a disposition of cash or securities pursuant to a "market contract").
- (c) However, as described in paragraphs 3.2.4 and 3.3.1 above, such protections would apply to LCH only:
 - (i) if it were to become, for the purposes of the Securities and Futures Ordinance, a "recognized clearing house"; or
 - (ii) being an authorized ATS Provider, when the provisions of the Securities and Futures Ordinance which provide that contracts cleared on a "designated CCP" will constitute "market contracts" under the Securities and Futures Ordinance come into force.
- (d) As discussed in paragraphs 3.2.4 and 3.3.1 above, under the law as it currently stands, it is not possible for LCH to apply for recognition as a "recognized clearing house", and the provisions of the Securities and Futures Ordinance whereby contracts cleared on a "designated CCP" will be deemed "market contracts" for the purposes of the Securities and Futures Ordinance, have not yet come into force (and their implementation has been postponed for an indefinite period of time).
- (e) Accordingly, it is currently not possible for LCH to obtain the benefit of the settlement finality protections of the Securities and Futures Ordinance, and therefore such protections cannot be 'lost' in the context of the commencement of an Insolvency Proceeding in respect of a Relevant Clearing Member.

Section 19 of the Payment Systems and Stored Value Facilities Ordinance

- (f) Section 19 of the Payments Systems and Stored Value Facilities Ordinance ("**PSSVFO**") provides that any of the following types of settlement or transfer through, or in connection with, a "designated clearing and settlement system", where the rules of that "designated clearing and settlement system" provide that such settlements or transfers are final and irrevocable, cannot be reversed, repaid or set aside for any reason:
 - (i) a transfer of funds into or out of an account of a participant (of a "designated clearing and settlement system");
 - (ii) a settlement of a payment obligation; and

- (iii) a settlement of an obligation for the transfer of book-entry securities, or the transfer of such securities.
- (g) A clearing and settlement system obtains the benefit of the settlement finality protections of the PSSVFO where the Hong Kong Monetary Authority ("**HKMA**") issues the clearing and settlement system with a "certificate of finality" in accordance with Part 3 of the PSSVFO. The process of designation of a clearing and settlement system under the PSSVFO is initiated by the HKMA itself, and there is no provision in the PSSVFO for a person to make an application to the HKMA for designation as a clearing and settlement system.
- (h) Further, section 4(2) of the PSSVFO provides that a clearing and settlement system may not be 'designated' under the PSSVFO if it is also a 'recognised clearing house' under the Securities and Futures Ordinance. This provision of the PSSVFO has not been expanded to include a clearing and settlement system which is a 'designated CCP' under the Securities and Futures Ordinance, and we are not currently aware of any pending amendments to the PSSVFO to this effect. Nonetheless, because (a) the object of section 4(2) of the PSSVFO appears to be to prevent 'overlap' of settlement finality protections available under the Securities and Futures Ordinance and the PSSVFO, and (b) as described in paragraph 3.2.4 above, if relevant provisions of the Securities and Futures Ordinance are brought into force, a clearing house's status as a 'designated CCP' would confer on it certain settlement finality protection under the Securities and Futures Ordinance, it may be unlikely that the HKMA will designate any 'designated CCP' as a 'designated clearing and settlement system' also.
- (i) As at the date of this advice, the following clearing and settlement systems have been issued with a "certificate of finality" and accordingly each such clearing and settlement system is a "designated clearing and settlement system" for the purposes of the PSSVFO:
 - (i) the Hong Kong Dollar Clearing House Automated Transfer System ("**CHATS**");
 - (ii) Renminbi CHATS;
 - (iii) United States Dollar CHATS;
 - (iv) Euro CHATS;
 - (v) the Central Moneymarkets Unit of the Hong Kong Monetary Authority ("**CMU**"); and
 - (vi) the Continuous Linked Settlement System ("**CLS**").
- (j) CHATS is an automated system for the settlement of inter-bank payments, based in Hong Kong and subject to the supervision of the

HKMA. There are separate CHATS systems for each of the currencies listed above. Further details of the CHATS systems and their membership are available on the HKMA website.⁹

- (k) The CMU is a clearing, settlement and custodial system for debt securities (issued by both public and private institutions) denominated in Hong Kong Dollars and other currencies, set up and regulated by the HKMA. In addition to providing the clearing and settlement of debt securities between Hong Kong market participants, the CMU also has two-way links for the 'through' clearing and settlement of securities with other global clearing systems, including Euroclear and Clearstream. Further information on the CMU and its membership is available on the HKMA website.¹⁰
- (l) CLS is an international system for the settlement of foreign exchange (FX) transactions, including FX spot, FX forward, FX option and FX swap transactions, and OTC Derivative Transactions. Further information on CLS and its membership is available on its website.¹¹
- (m) The effect of section 19 of the PSSVFO is that any transfer or settlement to which it applies may not be set aside for any reason, including pursuant to an order of the court for the rectification or stay of such transfer or settlement. This includes, in connection with an Insolvency Proceeding in respect of a Relevant Clearing Member, a challenge on any of the grounds described in paragraph 3.2.4 above. The PSSVFO and the section 19 protection apply in domestic law proceedings in Hong Kong, as well as in proceedings in Hong Kong in which, pursuant to Hong Kong conflict of laws rules, the laws of another jurisdiction are applied.
- (n) However, although section 19 of the PSSVFO provides statutory finality to any transfer or settlement effected *through* a "designated clearing and settlement system", it does not operate to 'ring-fence' the ultimate end-parties to the commercial transaction to which that settlement or transfer relates. Section 27 of the PSSVFO expressly provides that the settlement finality protections of the PSSVFO:

"shall not operate to limit, restrict or otherwise affect—

- (a) *any right, title, interest, privilege, obligation or liability of a person resulting from the underlying transaction in respect of a transfer order which has been entered into a designated system;*
or

⁹ <http://www.hkma.gov.hk/eng/key-functions/banking-stability/oversight.shtml>

¹⁰ <http://www.hkma.gov.hk/eng/key-functions/international-financial-centre/infrastructure/cmu.shtml>

¹¹ <http://www.cls-group.com/Pages/default.aspx>

- (b) *any investigation, legal proceedings or remedy in respect of any such right, title, interest, privilege, obligation or liability."*
- (o) Accordingly, the overall transaction would remain subject to challenge in connection with an Insolvency Proceeding on the grounds described in paragraph 3.2.4 above. If the overall commercial transaction is successfully challenged on any of these grounds, a Hong Kong court would be unable to make an order for the 'unwinding' of the particular transfer or settlement in respect of the commercial transaction which has been made through the "designated clearing and settlement system". However, for example, a Hong Kong court would not be prevented from making an order, in the context of unfair preference, on such terms as it may think fit in order to restore the position, as between the ultimate end-parties to the commercial transaction, to what it would have been if there had been no unfair preference. It is clear that the Hong Kong court may not make such an order unless the debtor (which gave the unfair preference) was influenced by a desire to produce, **in relation to the other end-party to the commercial transaction**, a preferential effect.
- (p) In effect, the settlement finality protections under the PSSVFO apply only to the operations of a "designated clearing and settlement system" and do not necessarily provide protection from Hong Kong insolvency law to any commercial transaction underlying a payment or transfer of securities made through a "designated clearing and settlement system".
- (q) Accordingly, a commercial transaction involving a payment or transfer of securities between a Relevant Clearing Member and LCH would, in the event of the commencement of an Insolvency Proceeding in respect of that Relevant Clearing Member, remain subject to challenge under Hong Kong insolvency law on the grounds, and within the timeframe, described in paragraph 3.2.4 above.
- 3.4.2 *Are there any circumstances (such as the commencement of Reorganisation Measures) which might give rise to a loss of finality protections before the commencement of Insolvency Proceeding? If so, please clarify from which point in time and in which circumstances finality protections would be lost.*
- (a) Please see the final paragraph to our response to question 3.4.1 above. As the settlement finality protections of the PSSVFO do not provide substantive protection to an underlying transaction from challenge (in the event of the commencement of an Insolvency Proceeding in respect of a party to such transaction), they cannot be 'lost'; the grounds on which and timeframe within which an underlying transaction may be challenged remain as described in paragraph 3.2.4 above.
- (b) In respect of an individual settlement or transfer which benefits from protection under section 19 of the PSSVFO, the only circumstance in which this protection could be lost is if the settlement system to which the transfer or settlement relates ceases to be a "designated clearing and

settlement system" (for example, because the HKMA revokes its designation as such).

4. **RESERVATIONS AND QUALIFICATIONS**

4.1 *Effectiveness of Security*

4.1.1 We express no view as to:

- (a) whether a Relevant Clearing Member has good legal or other title to the assets or rights which are expressed to be subject to a security interest under the Deed of Charge, or as to the existence or value of any such assets or rights;
- (b) the priority of any security interest and whether any security interest constitutes a legal or equitable security interest or a fixed or specific (rather than a floating) charge; or
- (c) whether the Deed of Charge breaches any other agreement or instrument.

4.1.2 Our views are subject to:

- (a) any asset being capable of forming the subject of a security interest and not otherwise being personal to a Relevant Clearing Member;
- (b) the creation of such security interest not requiring any authorisation, consent or fulfilment of any other pre-condition or formality which has not been satisfied, obtained or done; and
- (c) any relevant contract comprised in such security being capable of being set aside as a result of any fraud, misrepresentation or any bribe or corrupt conduct.

4.2 *Enforceability of claims*

In this advice "enforceable" means that an obligation is of a type which the Hong Kong courts may enforce. It does not mean that those obligations will be enforced in all circumstances in accordance with the terms of the Agreements. In particular:

- 4.2.1 the power of a Hong Kong court to order specific performance of an obligation or other equitable remedy is discretionary and accordingly a Hong Kong court might make an award of damages where specific performance of an obligation or other equitable remedy is sought;
- 4.2.2 where any party to a Subject Document is vested with a discretion or may determine a matter in its opinion, that party may be required to exercise its discretion in good faith, reasonably and for a proper purpose, and to form its opinion in good faith and on reasonable grounds;

- 4.2.3 enforcement may be limited by the provisions of the laws of Hong Kong applicable to agreements held to have been frustrated by events happening after their execution;
- 4.2.4 claims may become barred under the Limitation Ordinance (Cap. 347) or may be or become subject to a defence of set-off or counterclaim;
- 4.2.5 in some circumstances a Hong Kong court may, and in certain circumstances it must, terminate or suspend proceedings commenced before it, or decline to restrain proceedings commenced in another court, notwithstanding any provision of a Subject Document that the courts of Hong Kong have jurisdiction in relation thereto;
- 4.2.6 a party to a contract may be able to avoid its obligations under that contract (and may have other remedies) where it has been induced to enter into that contract by a misrepresentation or any bribe or other corrupt conduct, and the Hong Kong courts will generally not enforce an obligation if there has been fraud;
- 4.2.7 whilst a Hong Kong court has power to give judgment in a currency other than Hong Kong dollars, it has the discretion to decline to do so; and
- 4.2.8 any provision of a Subject Document that any calculation, determination or certification by one Party is to be conclusive and binding may not be effective if such calculation, determination or certification is fraudulent or manifestly incorrect, and a Hong Kong court may regard any certification, determination or calculation as no more than prima facie evidence.

4.3 *Application of foreign law*

- 4.3.1 If any obligation is to be performed in a jurisdiction outside Hong Kong, it may not be enforceable in Hong Kong to the extent that performance would be illegal or contrary to public policy under the laws of the other jurisdiction, and a Hong Kong court may take into account the law of the place of performance in relation to the manner of performance and to the steps to be taken in the event of defective performance.
- 4.3.2 It is uncertain whether the parties can agree in advance the governing law of claims connected with a contract but which are not claims on the contract, such as a claim in tort.
- 4.3.3 We express no view as to whether a Relevant Clearing Member has created a valid security interest pursuant to the Deed of Charge over any Collateral which is situated outside Hong Kong.

4.4 *Other insolvency issues*

- 4.4.1 A Hong Kong court may, in some circumstances, stay Insolvency Proceeding where the court is of the view that proceedings in another forum would be more convenient or if concurrent proceedings are being brought elsewhere, but will

take into account whether or not this will prejudice creditors whose claims have a close connection with Hong Kong.

4.4.2 It is possible that:

- (a) the valuation and calculation made to determine the net amount resulting from any netting or set-off;
- (b) any currency conversion rate applied; or
- (c) any other valuation, calculation or determination made or other action or discretionary decision taken under any Subject Document,

could be challenged by a liquidator if they were or it was not done fairly or in a manner consistent with applicable laws.

4.5 *Other Qualifications*

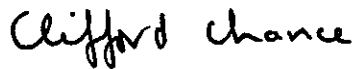
- 4.5.1 The Parties may be able to amend a Subject Document by oral agreement or by conduct despite any provision to the contrary.
- 4.5.2 Any provision of a Subject Document which constitutes, or purports to constitute, a restriction on the exercise of any statutory power by any Party or any other person may be ineffective.
- 4.5.3 If any Subject Document provides that any matter is expressly to be determined by future agreement or negotiation, the relevant provision may be unenforceable or void for uncertainty.
- 4.5.4 Any provision of a Subject Document stating that a failure or delay, on the part of a Party, in exercising any right or remedy under that Subject Document shall not operate as a waiver of such right or remedy may not be effective.
- 4.5.5 The effectiveness of any provision of a Subject Document which allows an invalid provision to be severed in order to save the remainder of that Subject Document will be determined by the Hong Kong courts in their discretion.
- 4.5.6 No view is given as to the enforceability of any obligation assumed or purported to be assumed or any right conferred or purported to be conferred under a Subject Document by or on any person who is not a party thereto.
- 4.5.7 If any Subject Document provides for the deemed receipt of notices, the relevant provision may be ineffective if a party has actual evidence of non-delivery.
- 4.5.8 The views in this advice are subject to the effects of United Nations or Hong Kong sanctions or other similar measures implemented or effective in Hong Kong with respect to a Party which is, or is controlled by or otherwise connected

with, a person resident in, incorporated or constituted under the laws of, or carrying on business in, a country to which any such sanction or other similar measure applies.

- 4.5.9 We refer in this advice to changes to the Securities and Futures Ordinance and to the Stay Rules which have yet to come into force. Except as expressly stated in this advice, this advice does not take into account any proposed changes to any of the Ordinance or Stay Rules.

This advice is given for the exclusive benefit of the addressee. In this advice we do not assume any obligation to notify or inform you of any developments subsequent to its date that might render its content untrue or inaccurate in whole or in part at such time. It may not, without prior written consent, be relied on by any other person. We consent to a copy of this advice being made publically available on the addressee's website and being shown to: (i) actual and prospective clearing members and clearing clients; (ii) relevant regulators; and/or (iii) legal counsel appointed by the addressee or any person listed in (i) above to advise on matters of the laws of other jurisdictions, in each case for information purposes only and solely on the basis that we assume no responsibility to any such parties as a result or otherwise.

Yours faithfully



Clifford Chance

APPENDIX 1
DEED OF CHARGE

A company whether incorporated in England and Wales or an overseas company.

CHARGE BY CLEARING MEMBER

CHARGE SECURING OWN OBLIGATIONS

Date of Execution:
(to be completed by LCH Limited) _____

Date of Delivery:
(to be completed by LCH Limited) _____

Name and Address of Chargor: _____

Clearing Membership Agreement Date: _____

Chargor's Account: _____

THIS DEED made on the date above-stated **BETWEEN THE ABOVE-NAMED CHARGOR** ("the Chargor") and **LCH LIMITED** ("the Clearing House")

WITNESSES as follows :

1. **Interpretation**

- (1) Any reference herein to:
 - (a) any statute or to any provisions of any statute shall be construed as a reference to any statutory modification or re-enactment thereof and to any regulations or orders made thereunder and from time to time in force; and
 - (b) an agreement or instrument shall be to that agreement or instrument as amended from time to time.
- (2) A reference herein to collateral or cash being "provided" includes the act of (i) transferring, (ii) delivering, or (iii) crediting to an account or effecting, directly or indirectly, any of the foregoing.
- (3) The Clause headings shall not affect the construction hereof.

1A. **The Secured Obligations**

- (1) The Chargor shall pay to the Clearing House all monies (including settlement costs, interest and other charges) which now are or at any time hereafter may be or become due or owing by the Chargor to the Clearing House on the account identified above (or, but only if no account is identified, on all accounts of the Chargor with the Clearing House) and discharge all other liabilities of the Chargor (whether actual or contingent, now existing or hereafter incurred) to the Clearing House on the said account (or, if no account is identified, on all accounts of the Chargor with the Clearing House) in each case when due in accordance with the Clearing Membership Agreement and the Clearing House's Rulebook referred to therein (the Clearing Membership Agreement and the Clearing House's Rulebook as from time to time amended, renewed or supplemented being hereinafter referred to as "**the Agreement**") or, if the Agreement does not specify a time for such payment or discharge, promptly following demand by the Clearing House.
- (2) In the event that the Chargor fails to comply with sub-paragraph (1) above, the Chargor shall pay interest accruing from the date of demand on the monies so demanded and on the amount of all other liabilities at the rate provided for in the Agreement or, in the event of no such rate having been agreed, at a rate determined by the Clearing House (the rate so agreed or determined to apply after as well as before any judgment), such interest to be paid upon demand of the Clearing House in accordance with its usual practices and to be compounded

with principal and accrued interest in the event of its not being duly and punctually paid.

- (3) The monies, other liabilities, interest and other charges referred to in sub-paragraph (1) of this Clause, the interest referred to in sub-paragraph (2) of this Clause and all other monies and liabilities payable or to be discharged by the Chargor under or pursuant to any other provision of this Deed are hereinafter collectively referred to as "**the Secured Obligations**".

1B. **Holding of Collateral**

- (1) The Chargor shall, in accordance with the Procedures, transfer collateral to the Clearing House. Where such collateral takes the form of Securities, the Clearing House shall hold such Securities for the Chargor, subject to the terms of (and including the security constituted by) this Deed.
- (2) From time to time, in accordance with the Procedures and in the context of a transfer of one or more contracts and related cover from one member of the Clearing House to the Chargor at the request of a client of that other member or the Chargor, the Clearing House shall designate that certain Securities which it previously held for a third party are instead held by the Clearing House for the Chargor and form part of the collateral provided by the Chargor in satisfaction of its requirements under the Procedures. Upon such designation, the Clearing House shall hold such Securities for the Chargor, subject to the terms of this Deed.
- (3) The Clearing House will identify in its own books that any Securities referred to in sub-paragraphs (1) or (2) above are held by it for the account of and (as between the Chargor and the Clearing House) belong to the Chargor (subject to the terms of this Deed) and shall be recorded in the Securities Account (as defined below) which shall be subject to the security constituted by this Deed. Where the Clearing House holds any such Securities in an account (including an omnibus account) at any Clearance System or with any Custodian Bank with any other Securities, the Clearing House will take all actions within its control to ensure that such Securities are recorded in accounts with the Clearance System or Custodian Bank (as applicable) in which the Clearing House's own assets are not recorded.
- (4) All Distributions in the form of cash received by the Clearing House on any Securities which are held by the Clearing House for the account of the Chargor in accordance with sub-paragraphs (1) or (2) above and any cash provided to the Clearing House in connection with transactions relating to Securities recorded in the Securities Account (excluding, for the avoidance of doubt, any cash provided directly by the Chargor to the Clearing House as collateral on a title transfer basis) shall be received by the Clearing House for its own account and paid into one or more accounts in the Clearing House's name, with a corresponding and equal

credit arising on and being recorded in the Cash Account (as defined below) whereupon such Distributions and other cash so provided to the Clearing House as recorded in the Cash Account shall be held by the Clearing House for the account of the Chargor and shall be subject to the security constituted by this Deed and designated as such in the Clearing House's books and records.

- (5) The Clearing House may hold any Securities pursuant to this Clause 1B (*Holding of Collateral*) in one or more omnibus accounts with a Custodian Bank or Clearance System, as the case may be, together with other Securities which it holds for other third parties which have granted a charge over such assets in favour of the Clearing House in a form substantially the same as this Deed but no other Securities. The Clearing House shall ensure that any such omnibus account with a Clearance System or Custodian Bank is clearly identified as an account relating to Securities held by the Clearing House on behalf of third parties.
- (6) The Clearing House undertakes to the Chargor that it will at all times ensure that, pursuant to the terms governing any account with any Clearance System or Custodian Bank in which any Securities are held for the Chargor, any claim or security interest which that Clearance System or Custodian Bank may have against or over such Securities shall be limited to any unpaid fees owed by the Clearing House to such Clearance System or Custodian Bank in respect of such account.

2. **Charge**

- (1) The Chargor acting in due capacity (as defined in sub-paragraph (3) below) (and to the intent that the security so constituted shall be a security in favour of the Clearing House extending to all beneficial interests in the assets hereby charged and to any proceeds of sale or other realisation thereof or of any part thereof including any redemption monies paid or payable in respect thereof) hereby separately assigns, charges and pledges by way of first fixed security and by way of continuing security to the Clearing House, until discharged by the Clearing House in accordance with this Deed, for the payment to the Clearing House and the discharge of all the Secured Obligations, the Charged Property.
- (2) It shall be implied in respect of sub-paragraph (1) above that the Chargor is charging the Charged Property free from all charges and encumbrances (whether monetary or not) and from all other rights exercisable by third parties (including liabilities imposed and rights conferred by or under any enactment) except for any charge or lien routinely arising in favour of a Custodian Bank or Clearance System and applying to assets held by the Clearing House with that Custodian Bank or Clearance System and any third party's beneficial interest in the Charged Property which ranks behind the rights of the Clearing House in respect of the Charged Property.

(3) In this Deed:

"acting in due capacity" in relation to the Chargor means that each of the dispositions of property hereby effected by the Chargor is made with full title guarantee in accordance with the Law of Property (Miscellaneous Provisions) Act 1994 except as expressly permitted or contemplated under this Deed;

"Cash Account" means any account maintained by the Clearing House on its books for the account of the Chargor in which an amount equal to any cash Distributions or cash provided to the Clearing House in connection with transactions relating to Securities recorded in the Securities Account (excluding, for the avoidance of doubt, any cash provided directly by the Chargor to the Clearing House as collateral on a title transfer basis) are recorded;

"Charged Property" means at any time all present and future rights, title and interest of the Chargor in and to:

- (i) all Securities from time to time recorded in and represented by the Securities Account and held by the Clearing House for the account of the Chargor in accordance with Clause 1B;
- (ii) all Distributions including without limitation Distributions in the form of cash;
- (iii) all cash provided to the Clearing House in connection with transactions relating to Securities recorded in the Securities Account (excluding, for the avoidance of doubt, any cash provided directly by the Chargor to the Clearing House as collateral on a title transfer basis);
- (iv) the Securities Account; and
- (v) the Cash Account;

"Chargor Custodian Bank" means a bank or custodian or any nominee company or trust company which is a subsidiary of such a bank or custodian with which the Chargor maintains any cash account or securities account;

"Clearance System" shall be construed as a reference to any system from time to time used or constituted for the clearing, collective safe custody or central deposit of securities, and any depository for any of the foregoing;

"Clearing Membership Agreement" means in relation to the Chargor the Clearing Membership Agreement between the Chargor and the Clearing House having the date specified on the first page of this Deed, as such agreement may be amended and or replaced from time to time;

"Custodian Bank" means a bank or custodian or any nominee company or trust company which is a subsidiary of such a bank or custodian with which the Clearing House maintains any cash account or securities account;

"Default Notice" has the meaning given to it in the Default Rules;

"Default Rules" has the meaning given to such term in the Clearing Membership Agreement;

"Deed" means this charge made between the Chargor and the Clearing House on the date above-stated, as the same may be amended, supplemented or restated from time to time;

"Distributions" means all rights, benefits and proceeds including, without limitation:

- (a) any dividends or interest, annual payments or other distributions; and
- (b) any proceeds of redemption, substitution, exchange, bonus or preference, under option rights or otherwise,

in each case attaching to or arising from or in respect of any Securities forming part of the Charged Property;

"Procedures" means the one or more documents containing the working practices and administrative requirements of the Clearing House for the purposes of implementing the Clearing House's Rulebook and Default Rules from time to time in force, or procedures for application for and regulation of clearing membership of the Clearing House;

"Receiver" means a receiver, receiver and manager or an administrative receiver as the Clearing House may specify at any time in the relevant appointment made under this Deed, which term will include any appointee made under a joint and/or several appointment by the Clearing House;

"Securities" shall be construed as a reference to bonds, debentures, notes, stock, shares, bills, certificates of deposit and other securities and instruments, including Distributions in the form of Securities (and without limitation, shall include any of the foregoing not constituted, evidenced or represented by a certificate or other document but by any entry in the books or other records of the issuer, a trustee or other fiduciary thereof, or a Clearance System); and

"Securities Account" means any account maintained by the Clearing House on its books for the account of the Chargor in which Securities are recorded.

3. **Release**

- (1) Upon the Clearing House being satisfied that the Secured Obligations have been irrevocably paid or discharged in full, the Clearing House shall, at the request and cost of the Chargor, release or discharge (as appropriate) all the Charged Property from the security created by this Deed provided that, without prejudice to any remedy which the Chargor may have if the Clearing House fails to comply with its obligations under this Clause, such actions shall be without recourse to, and without any representations or warranties by, the Clearing House or any of its nominees
- (2) The Chargor may, in the circumstances specified in sections 1.1.2 and 1.1.3 of the Procedures Section 4 (*Margin and Collateral*), request that part or all of the Charged Property, or the proceeds thereof, be returned or repaid to, or to the order of, the Chargor. Where, pursuant to such a request, the Clearing House returns or repays any of the Charged Property, or the proceeds thereof, pursuant to sections 1.1.2 or 1.1.3 of the Procedures Section 4 (*Margin and Collateral*), such Charged Property shall be released or discharged (as appropriate) from the security interest created over such Charged Property and the proceeds thereof pursuant to Clause 2(1) with effect from the time such Charged Property, or the proceeds thereof, are transferred by the Clearing House to, or to the order of, the Chargor in accordance with the Procedures.

4. **Income**

Prior to a Default (as defined in Clause 11(1) below), the Clearing House consents to the payment or transfer of any and all Distributions received by the Clearing House in respect of any Charged Property to the Chargor (and upon such payment or transfer, the Distributions shall be released from the security constituted by this Deed) provided that, in the Clearing House's reasonable view, the Clearing House would still have sufficient security, following such payment or transfer, to secure the Secured Obligations.

5. **Voting rights, calls and other obligations in respect of the Securities**

- (1) The Chargor must pay all calls and other payments due and payable in respect of any Securities and must comply with all requests (including requests for information by any listing or other authority), obligations and conditions relating to the Securities. In any case of default by the Chargor in this respect the Clearing House may if it thinks fit make any such payments on behalf of the Chargor (but shall be under no obligation to do so) in which event any sums so paid shall be reimbursed by the Chargor on demand by the Clearing House and until reimbursed shall bear interest in accordance with Clause 1A(2) above.
- (2) The Chargor shall not exercise or be entitled to exercise any voting rights, powers and other rights in respect of the Securities which are held by the Clearing House for the account of the Chargor pursuant to this Deed.

6. **Reinstatement**

If any discharge, release or arrangement is made by the Clearing House in whole or in part on the basis of any payment, security or other disposition which is avoided or must be restored in insolvency, liquidation, administration or otherwise, without limitation, then the liability of the Chargor and the security created by this Deed will continue or be reinstated as if the discharge, release or arrangement had not occurred.

7. **Warranties and Undertakings**

The Chargor hereby represents and warrants to the Clearing House and undertakes on an ongoing basis that:

- (i) the Chargor is duly incorporated or organised and validly existing under the laws of its jurisdiction of organisation or incorporation;
- (ii) the Chargor and each of its subsidiaries has the power to own its assets and carry on its business as it is being conducted;
- (iii) subject to any legal or equitable interest which any common depository, Clearance System or Custodian Bank may have in any Securities and to any third party's beneficial interest in the Charged Property which ranks behind the rights of the Clearing House in respect of the Charged Property, the Chargor is and will at all times during the subsistence of the security and security interest hereby constituted, be the sole and lawful owner of, and be entitled to the entire beneficial interest in, the Charged Property free from mortgages or charges (other than as a result of the security created under this Deed, any charge or lien arising in favour of any Clearance System or Custodian Bank and any charge in favour of the Chargor) or other encumbrances and no other person (save as aforesaid) has any rights or interests therein;
- (iv) save as contemplated by Clause 3(2), the Chargor has not sold or agreed to sell or otherwise disposed of or agreed to dispose of, and will not at any time during the subsistence of the security hereby constituted sell or agree to sell or otherwise dispose of or agree to dispose of, the benefit of all or any rights, titles and interest in and to the Charged Property or any part thereof;
- (v) the Chargor has and will at all material times have the necessary power to enable the Chargor to enter into and perform the obligations expressed to be assumed by the Chargor under this Deed;
- (vi) this Deed constitutes legal, valid, binding and enforceable obligations of the Chargor and is a security over, and confers a first security interest in, the Charged Property and every part thereof, effective in accordance with its terms (subject to applicable bankruptcy, resolution, reorganisation, insolvency, moratorium or

similar laws affecting creditors' rights generally and subject, as to enforceability, to equitable principles of general application (regardless of whether enforcement is sought in a proceeding in equity or at law));

- (vii) all necessary authorisations and filings to enable or entitle the Chargor to enter into this Deed have been obtained and are in full force and effect and will remain in such force and effect at all times during the subsistence of the security hereby constituted;
- (viii) the execution of this Deed does not violate any agreement to which the Chargor is a party or breach any obligation to which the Chargor is subject and does not conflict with any law or regulation applicable to it (if such conflict would adversely affect the Clearing House's rights under this Deed) or its constitutional documents;
- (ix) it has been and shall at all times remain expressly agreed between the Chargor and each of the Chargor's clients or other persons who are for the time being (or would be, but for the provisions of this Deed) entitled to the entire beneficial interest in all or any parts of the Charged Property that, in relation to any assets from time to time held by the Chargor or delivered to the Chargor for the account of any such client or other person which at any time form part of the Charged Property, the Chargor may, free of any interest of any such client or other person therein which is adverse to the Clearing House, charge or otherwise constitute security over such assets in favour of the Clearing House on such terms as the Clearing House may from time to time prescribe and, in particular but without limitation, on terms that the Clearing House may enforce and retain such charge or other security in satisfaction of or pending discharge of all or any obligations of the Chargor to the Clearing House;
- (x) in no case is the Chargor or the Chargor's client or other person who is for the time being the lawful owner of or person entitled to the entire beneficial interest in any part of the Charged Property, nor will the Chargor, client or other such person be, in breach of any trust or other fiduciary duty in placing or authorising the placing of any Charged Property (or rights, benefits or proceeds forming part of the Charged Property) under this Deed;
- (xi) no corporate actions, legal proceedings or other procedure or steps have been taken in relation to, or notice given in respect of, a composition, compromise, assignment or arrangement with any creditor of the Chargor or in relation to the suspension of payments or moratorium of any indebtedness, winding-up, dissolution, administration or reorganisation (by way of voluntary arrangement, scheme of arrangement or otherwise) of, or the appointment of an administrator to, the Chargor (other than any which will be dismissed, discharged, stayed or restrained within 15 days of their instigation) and no such step is intended by the Chargor (save for the purposes of any solvent re-organisation or reconstruction which has previously been approved by the Clearing House);

- (xii) the Chargor undertakes to abide by the Procedures as in effect from time to time.

8. **Negative Pledge**

- (1) The Chargor hereby undertakes with the Clearing House that at no time during the subsistence of the security hereby constituted will the Chargor, otherwise than:

- (i) in favour of the Clearing House; or

- (iii) with the prior written consent of the Clearing House and in accordance with and subject to any conditions which the Clearing House may attach to such consent,

create, grant, extend or, except in relation to any charge or lien in favour of any Clearance System or Custodian Bank, permit to subsist any mortgage or other fixed security or any floating charge or other security interest on, over or in the Charged Property or any part thereof. The foregoing prohibition shall apply not only to mortgages, other fixed securities, floating charges and security interests which rank or purport to rank in point of security in priority to the security hereby constituted but also to any mortgages, securities, floating charges or security interests which rank or purport to rank *pari passu* therewith or thereafter.

- (2) Sub-paragraph (1) above does not, during the subsistence of the security hereby constituted, operate to prevent the Chargor from continuing to hold a security interest in the Charged Property previously created in favour of the Chargor, *provided always* that the interest in favour of the Chargor shall rank after the security created by this Deed.

9. **Preservation of Charged Property**

- (1) Until the security hereby constituted shall have been discharged, the Chargor shall ensure, unless required by law or regulation to restrict any transfer (in which case the Chargor shall immediately notify the Clearing House of such restrictions), that all of the Charged Property is and at all times remains free from any restriction on transfer.

- (2) The Chargor shall not, to the extent that the same is within the control of the Chargor, permit or agree to any variation of the rights attaching to or conferred by the Charged Property or any part thereof without the prior consent of the Clearing House in writing.

- (3) The Clearing House shall not have any right of use or re-hypothecation right, in respect of the Charged Property, whether under Regulation 16 of the Financial

Collateral Arrangements (No.2) Regulations 2003, the New York Uniform Commercial Code or any applicable Federal law of the United States or otherwise, *provided that* this provision shall not affect the powers of the Clearing House under Clauses 12 (*Power of Sale*) and 13 (*Right of Appropriation*) or any other rights to enforce the security interest herein created against the Charged Property.

10. **Further Assurance**

- (1) In the case of any part of the Charged Property situated in the United States of America, it is acknowledged and agreed by the Chargor that this Deed shall also constitute a security agreement for the purpose of creating a security interest in the Charged Property under applicable provisions of the Uniform Commercial Code or other applicable laws or regulations of the State of New York. For purposes hereof, "**Charged Property situated in the United States of America**" means: (i) in the case of any securities account and/or securities entitlements or other rights or assets or investment property credited to a securities account as financial assets, a securities account maintained with a securities intermediary whose jurisdiction is New York or any other State of the United States for purposes of the NY UCC; (ii) in the case of any deposit account and/or any amounts credited to a deposit account, a deposit account maintained with a bank whose jurisdiction is New York or any other State of the United States for purposes of the NY UCC; and (iii) in the case of any commodity account or any commodity contract credited to a commodity account such commodity account is maintained with a commodity intermediary whose jurisdiction is New York or any other State of the United States for purposes of the NY UCC . In furtherance of the foregoing and without limiting the generality of Clause 2 (*Charge*) above, in order to secure the payment, performance and observance of the Secured Obligations, the Chargor hereby grants to the Clearing House a continuing security interest in, right of set-off against, and an assignment to the Clearing House of all of the Charged Property situated in the United States of America and all rights thereto, in each case whether now owned or existing or hereafter acquired or arising and which shall include, without limitation, all of the Chargor's interests in any deposit accounts, investment property and securities entitlements (as such terms are defined in the Uniform Commercial Code of the State of New York; the "**NY UCC**"), together with all proceeds (as defined in the NY UCC) and products of all or any of the property described above.
- (2) The Chargor undertakes promptly to execute and do (at the cost and expense of the Chargor) all such deeds, documents, acts and things as may be necessary or desirable in order for the Clearing House to enjoy a fully perfected security interest in the whole of the Charged Property, including without limitation the deposit of the Charged Property with a Clearance System or Custodian Bank (as applicable) and the perfection of pledges or transfers under such laws, of whatever nation or territory, as may govern the pledging or transfer of the Charged Property or part thereof or other mode of perfection of this Deed and the

security interest expressed to be created hereby. Without limiting the foregoing, the Chargor agrees with and covenants to the Clearing House that with respect to all Charged Property situated in the United States of America consisting of investment property, money, instruments, securities, securities entitlements, other financial assets and commodity contracts (as defined in the NY UCC), such Charged Property shall be held, maintained or deposited, as applicable, in a securities account or commodity account (in the case of commodity contracts) (such that, in each case, the Clearing House shall become the entitlement holder thereof, as defined in the NY UCC) or a deposit account (as defined in the NY UCC), in the case of Charged Property that may be credited to a Deposit Account, in the name of the Clearing House, or, if permitted by the Procedures, may be maintained and held in the Chargor's name at a Chargor Custodian Bank (whose jurisdiction is New York or any other State of the United States for purposes of the NY UCC) which shall have executed and delivered to the Clearing House an agreement whereby such Chargor Custodian Bank agrees that it will comply with entitlement orders of the Clearing House without further consent by the Chargor. Notwithstanding anything to the contrary herein, in respect of any Charged Property situated in the United States of America, the Clearing House shall comply with all non-waivable requirements of the NY UCC with respect to how the secured party must deal with collateral under its control or in its possession.

11. **Enforcement of Security**

(1) On and at any time:

- (i) if a Default Notice is served on the Chargor in accordance with Rule 3 of the Default Rules; or
- (ii) if the Chargor requests the Clearing House to exercise any of its powers under this Deed,

(each such event a "**Default**"), the security created by or pursuant to this Deed is immediately enforceable and the Clearing House may, without notice to the Chargor or prior authorisation from any court, in its absolute discretion:

- (a) enforce all or any part of the security created by this Deed (at the times, in the manner and on the terms it thinks fit) and take possession of (provided that the Clearing House will not be liable, by reason of entering into possession of any Charged Property, to account as mortgagee in possession or for any loss on realisation or for any default or omission for which a mortgagee in possession may be liable unless such loss, default or omission is caused by the Clearing House's gross negligence or wilful misconduct) and hold, sell, or otherwise dispose of all or any part of the Charged Property (at the time, in the manner and on the terms it thinks fit); and

- (b) whether or not it has appointed a Receiver, exercise all or any of the powers, authorisations and discretions conferred by the Law of Property Act 1925 (as varied or extended by this Deed) on chargees and by this Deed on any Receiver or otherwise conferred by law on chargees or Receivers.
- (2) The power of sale and other powers conferred by section 101 of the Law of Property Act 1925 on mortgagees, as varied and extended by this Deed, shall arise (and the Secured Obligations shall be deemed due and payable for that purpose) on the date of this Deed and shall be exercisable in accordance with Clause 11(1).

12. **Power of Sale**

- (1) If a Default has occurred, the Clearing House shall have and be entitled without prior notice to the Chargor to exercise the power to sell or otherwise dispose of, for any consideration (whether payable immediately or by instalments) as the Clearing House shall think fit, the whole or any part of the Charged Property and may (without prejudice to any right which it may have under any other provision hereof) treat such part of the Charged Property as consists of money as if it were the proceeds of such a sale or other disposal. The Clearing House shall be entitled to apply the proceeds of such sale or other disposal in paying the costs of such sale or other disposal and (subject to the rights or claims of any person entitled in priority to the Clearing House) in or towards the discharge of the Secured Obligations, the balance (if any) to be paid to the Chargor or other persons entitled thereto. Such power of sale or other disposal shall operate as a variation and extension of the statutory power of sale under section 101 of the Law of Property Act 1925.
- (2) The restriction contained in section 103 of the Law of Property Act 1925 on the exercise of the statutory power of sale shall not apply to any exercise by the Clearing House of its power of sale or other disposal. In favour of a purchaser a certificate in writing by an officer or agent of the Clearing House that either or both of such powers has arisen and is exercisable shall be conclusive evidence of that fact.
- (3) Upon any such default or failure as aforesaid the Clearing House shall also have with respect to any part of the Charged Property situated in the United States of America all of the rights and remedies of a secured party under the NY UCC or any other applicable law of the State of New York and all rights provided herein or in any other applicable security, loan or other agreement, all of which rights and remedies shall to the full extent permitted by law be cumulative.

13. **Right of Appropriation**

- (1) To the extent that any of the Charged Property constitutes "financial collateral" and this Deed and the obligations of the Chargor hereunder constitute a "security financial

collateral arrangement" (in each case as defined in, and for the purposes of, the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003 No. 3226), as amended, (the "**Regulations**") the Clearing House shall have the right (at any time following the occurrence of a Default) to appropriate all or any part of such financial collateral in or towards discharge of the Secured Obligations and may exercise such right to appropriate upon giving written notice to the Chargor. For this purpose, the parties agree that the value of such financial collateral so appropriated shall be determined as follows:

- (a) if the financial collateral is listed or traded on a recognised exchange or by reference to a public index, its value will be taken as the value at which it could have been sold on the exchange or which is given in the public index on the date of appropriation; and
 - (b) in any other case, the value of the financial collateral will be such amount as the Clearing House reasonably determines having taken into account advice obtained by it from an independent investment or accountancy firm of national standing selected by it.
- (2) The parties agree that the method of valuation provided for in this Deed shall constitute a commercially reasonable method of valuation for the purposes of the Regulations.

14. **Immediate Recourse**

The Chargor waives any right it may have of first requiring the Clearing House to proceed against or enforce any other rights or security or claim payment from any person before claiming from the Chargor under this Deed. This waiver applies irrespective of any law or any provision of this Deed to the contrary.

15. **Consolidation of Securities**

Subsection (1) of section 93 of the Law of Property Act 1925 shall not apply to this Deed.

16. **Effectiveness of Security**

- (1) This Deed shall be in addition to and shall be independent of every other security which the Clearing House may at any time hold for any of the Secured Obligations. No prior security held by the Clearing House over the whole or any part of the Charged Property shall merge into the security hereby constituted.
- (2) This Deed shall remain in full force and effect as a continuing security unless and until the Clearing House discharges it.
- (3) Nothing contained in this Deed is intended to, or shall operate so as to, prejudice or affect any bill, note, guarantee, mortgage, pledge, charge or other security of any kind whatsoever which the Clearing House may have for the Secured Obligations of any of them or any right, remedy or privilege of the Clearing House

thereunder.

17. **Avoidance of Payments**

If the Clearing House considers that any payment or discharge of the Secured Obligations is capable of being avoided or reduced by virtue of any bankruptcy, insolvency, liquidation or similar laws then such payment or discharge shall not be considered to have been made for the purposes of determining whether the Secured Obligations have been irrevocably paid or discharged in full.

18. **Power of Attorney**

The Chargor hereby irrevocably appoints the Clearing House to be the Chargor's attorney and in the Chargor's name and on the Chargor's behalf and as the act and deed of the Chargor to sign, seal, execute, deliver, perfect and do all deeds, instruments, mortgages, acts and things as may be, or as the Clearing House may consider to be, requisite for carrying out any obligation imposed on the Chargor under Clause 10 (*Further Assurance*) above, or for enabling the Clearing House to exercise its power of sale or other disposal referred to in Clause 12 (*Power of Sale*) above or for carrying out any such sale or other disposal made under such power into effect, or exercising any of the rights and powers referred to in Clause 9 (*Preservation of Charged Property*) above, including without limitation the appointment of any person as a proxy of the Chargor. The Chargor hereby undertakes to ratify and confirm all things done and documents executed by the Clearing House in the exercise of the power of attorney conferred by this Clause.

19. **Receivers and Administrators**

- (1) At any time after having been requested to do so by the Chargor or after this Deed becomes enforceable in accordance with Clause 11 (*Enforcement of Security*) above the Clearing House may by deed or otherwise (acting through an authorised officer of the Clearing House), without prior notice to the Chargor:
 - (a) appoint one or more persons to be a Receiver of the whole or any part of the Charged Property;
 - (b) appoint one or more Receivers of separate parts of the Charged Property respectively;
 - (c) remove (so far as it is lawfully able) any Receiver so appointed; and
 - (d) appoint another person(s) as an additional or replacement Receiver(s).
- (2) Each person appointed to be a Receiver pursuant to sub-paragraph (1) above will be:
 - (a) entitled to act individually or together with any other person appointed or

substituted as Receiver;

- (b) for all purposes deemed to be the agent of the Chargor which shall be solely responsible for his acts, defaults and liabilities and for the payment of his remuneration and no Receiver shall at any time act as agent for the Clearing House; and
 - (c) entitled to remuneration for his services at a rate to be fixed by the Clearing House from time to time (without being limited to the maximum rate specified by law including the Law of Property Act 1925).
- (3) The powers of appointment of a Receiver shall be in addition to all statutory and other powers of appointment of the Clearing House under the Law of Property Act 1925 (as extended by this Deed) or otherwise and such powers shall remain exercisable from time to time by the Clearing House in respect of any part of the Charged Property.
- (4) Every Receiver shall (subject to any restrictions in the instrument appointing him but notwithstanding any winding-up or dissolution of the Chargor) have and be entitled to exercise, in relation to the Charged Property in respect of which he was appointed, and as varied and extended by the provisions of this Deed (in the name of or on behalf of the Chargor or in his own name and, in each case, at the cost of the Chargor):
- (a) all the powers conferred by the Law of Property Act 1925 on mortgagors and on mortgagees in possession and on receivers appointed under that Act;
 - (b) all the powers of an administrative receiver set out in Schedule 1 to the Insolvency Act 1986 (whether or not the Receiver is an administrative receiver);
 - (c) all the powers and rights of an absolute owner and power to do or omit to do anything which the Chargor itself could do or omit to do;
 - (d) the power to delegate (either generally or specifically) the powers, authorities and discretions conferred on it by this Deed (including the power of attorney) on such terms and conditions as it shall see fit. Such delegation shall not preclude either the subsequent exercise or any subsequent delegation or any revocation of such power, authority or discretion by the Receiver itself; and
 - (e) the power to do all things (including bringing or defending proceedings in the name or on behalf of the Chargor) which seem to the Receiver to be incidental or conducive to:

- (i) any of the functions, powers, authorities or discretions conferred on or vested in him;
 - (ii) the exercise of any rights, powers and remedies of the Clearing House provided by or pursuant to this Deed or by law (including realisation of all or any part of the Charged Property); or
 - (iii) bringing to his hands any assets of the Chargor forming part of, or which when got in would be, Charged Property.
- (5) The receipt of the Clearing House or any Receiver shall be a conclusive discharge to a purchaser and, in making any sale or disposal of any of the Charged Property or making any acquisition, the Clearing House or any Receiver may do so for such consideration, in such manner and on such terms as it thinks fit.
- (6) No purchaser or other person dealing with the Clearing House or any Receiver shall be bound to inquire whether the right of the Clearing House or such Receiver to exercise any of its powers has arisen or become exercisable or be concerned with any propriety or regularity on the part of the Clearing House or such Receiver in such dealings.
- (7) Any liberty or power which may be exercised or any determination which may be made under this Deed by the Clearing House or any Receiver may be exercised or made in its absolute and unfettered discretion without any obligation to give reasons.

20. **No liability**

Neither the Clearing House nor any receiver appointed pursuant to this Deed shall be liable by reason of: (a) taking any action permitted by this Deed; or (b) any neglect or default in connection with the Charged Property; or (c) the taking possession or realisation of all or any part of the Charged Property, except in the case of gross negligence or wilful default upon its part.

21. **Remedies, Time or Indulgence**

- (1) The rights, powers and remedies provided by this Deed are cumulative and are not, nor are they to be construed as, exclusive of any right of set-off or other rights, powers and remedies provided by law.
- (2) The obligations of the Chargor under this Deed shall not be affected by any act, omission or circumstance which, but for this provision, might operate to release or otherwise exonerate the Chargor from its obligations under this Deed or affect

such obligations including (without limitation and whether or not known to the Chargor or the Clearing House):

- (a) any unenforceability, illegality, invalidity or non-provability of any obligation of the Chargor or any other person; or
 - (b) any incapacity or lack of power, authority or legal personality or dissolution or change in the members or status of the Chargor or any other person.
- (3) No failure on the part of the Clearing House to exercise, or delay on its part in exercising, any of the rights, powers and remedies provided by this Deed or by law (collectively "**the Clearing House's Rights**") shall operate as a waiver thereof, nor shall any single or partial waiver of any of the Clearing House's Rights preclude any further or other exercise of that or any other of the Clearing House's Rights.
- (4) The Clearing House may in its discretion grant time or other indulgence or make any other arrangement, variation or release with any person not party hereto (irrespective of whether such person is liable with the Chargor) in respect of the Secured Obligations or in any way affecting or concerning them or any of them or in respect of any security for the Secured Obligations or any of them, without in any such case prejudicing, affecting or impairing the security hereby constituted, or any of the Clearing House's Rights or the exercise of the same, or any indebtedness or other liability of the Chargor to the Clearing House.

22. **Costs, Charges and Expenses**

All costs, charges and expenses of the Clearing House incurred in the exercise of any of the Clearing House's Rights, or in connection with the execution of or otherwise in relation to this Deed or in connection with the perfection or enforcement of all security hereby constituted shall be reimbursed to the Clearing House by the Chargor on demand on a full indemnity basis together with interest from the date of the same having been incurred to the date of payment at the rate referred to in Clause 1A(2) above.

23. **Accounts**

All monies received, recovered or realised by the Clearing House under this Deed (including the proceeds of any conversion of currency) may in the discretion of the Clearing House be credited to any suspense or impersonal account and may be held in such account for so long as the Clearing House shall think fit (with interest accruing thereon at such rate, if any, as the Clearing House may deem fit) pending their application from time to time (as the Clearing House shall be entitled to do in its discretion) in or towards the discharge of any of the Secured Obligations.

24. **Currency**

- (1) For the purpose of or pending the discharge of any of the Secured Obligations the Clearing House may convert any monies received, recovered or realised or subject to application by the Clearing House under this Deed (including the proceeds of any previous conversion under this Clause) from their existing currency of denomination into such other currency of denomination as the Clearing House may think fit, and any such conversion shall be effected at such commercial spot selling rate of exchange then prevailing for such other currency against the existing currency as the Clearing House may in its discretion determine.
- (2) References herein to any currency extend to any funds of that currency and for the avoidance of doubt funds of one currency may be converted into different funds of the same currency.

25. **Notices**

- (1) Any notice or demand (including any Default Notice) requiring to be served on the Chargor by the Clearing House hereunder may be served on any of the officers of the Chargor personally, or by letter addressed to the Chargor or to any of its officers and left at its registered office or any one of its principal places of business, or by posting the same by letter addressed in any such manner as aforesaid to such registered office or any such principal place of business.
- (2) Any notice or demand (including any Default Notice) sent by post in accordance with sub-paragraph (1) of this Clause shall be deemed to have been served on the Chargor at 10 a.m. Greenwich Mean Time on the business day next following the date of posting. In proving such service by post it shall be sufficient to show that the letter containing the notice or demand (including any Default Notice) was properly addressed and posted and such proof of service shall be effective notwithstanding that the letter was in fact not delivered or was returned undelivered.

26. **Provisions Severable**

Each of the provisions contained in this Deed shall be severable and distinct from one another and if at any time any one or more of such provisions is or becomes invalid, illegal or unenforceable, the validity, legality and enforceability of each of the remaining provisions of this Deed shall not in any way be affected, prejudiced or impaired thereby.

27. **Clearing House's Discretions**

Any liberty or power which may be exercised or any determination which may be made hereunder by the Clearing House may (save where stated to the contrary) be exercised or made in the absolute and unfettered discretion of the Clearing House which shall not

be under any obligation to give reasons thereof.

28. **Third Party Rights**

A person who is not a party to this Deed has no right under the Contracts (Rights of Third Parties) Act 1999 to enforce or to enjoy the benefit of any term of this Deed.

29. **Law and Jurisdiction**

This Deed, and any non-contractual obligations arising herefrom, shall be governed by and construed in accordance with English law, and the Chargor hereby irrevocably submits to the non-exclusive jurisdiction of the English courts; provided that with respect to issues arising as a result of the provisions of Clause 10(1) above or the use of this Deed as a security agreement as provided therein, this Deed shall be governed by and construed in accordance with applicable laws of the State of New York.

The Chargor

Executed as a **DEED** by

The Chargor

[CHARGOR NAME]

.....
Signature of Director

.....
Name of Director

.....
Date

.....
Signature of Director/Secretary

.....
Name of Director/Secretary

.....
Date

The Clearing House

LCH Limited

.....
Signature of Authorised Signatory

.....
Name of Authorised Signatory

.....
Title of Authorised Signatory

.....
Date

.....
Signature of Authorised Signatory

.....
Name of Authorised Signatory

.....
Title of Authorised Signatory

.....
Date

Dated _____

and

LCH LIMITED

**CHARGE BY CLEARING MEMBER
SECURING OWN OBLIGATIONS**

APPENDIX 2
CLEARING MEMBERSHIP AGREEMENT

CLEARING MEMBERSHIP AGREEMENT

DATED

LCH.CLEARNET LIMITED

and
("the Firm")

Address of the Firm

THIS AGREEMENT is made on the date stated above

BETWEEN the Firm and LCH.CLEARNET LIMITED ("the Clearing House"), whose registered office is at Aldgate House, 33 Aldgate High Street, London, EC3N 1EA.

WHEREAS:

- A The Clearing House is experienced in carrying on the business of a clearing house and undertakes with each Clearing Member the performance of contracts registered in its name in accordance with the Rulebook;
- B The Clearing House has been appointed by certain Exchanges to provide central counterparty and other services in accordance with the terms and conditions of the Rulebook and certain agreements entered into between the Clearing House and such Exchanges;
- C The Clearing House also provides central counterparty and other services to participants in certain over-the-counter ("OTC") markets in accordance with the terms of this Agreement and the Rulebook;
- D The Firm desires to be admitted as a Clearing Member of the Clearing House to clear certain categories of Contract agreed by The Clearing House with the Firm and, the Clearing House having determined on the basis inter alia of the information supplied to it by the Firm that the Firm satisfies for the time being the relevant Criteria for Admission, the Clearing House agrees to admit the Firm as a Clearing Member subject to the terms and conditions of this Agreement.

NOW IT IS HEREBY AGREED as follows:-

1 Interpretation and Scope of Agreement

1.1. Unless otherwise expressly stated, in this Agreement:

- (a) "Cash Cover" means cover for margin (within the meaning of that term in the "Definitions" section of the Rulebook) provided in the form of a cash deposit with the Clearing House;
- (b) "Clearing Member" means a Person who has been admitted to membership of the Clearing House and whose membership has not terminated;
- (c) "Contract" means a contract or transaction eligible for registration in the Firm's name by the Clearing House in accordance with the Rulebook;
- (d) "Contribution" and "Contribution to the Default Fund" mean the sums of cash deposited by the Firm as cover in respect of the Firm's obligation to indemnify the Clearing House as provided by clause 9 of this Agreement and the Default Rules;
- (e) "Criteria for Admission" means criteria set out in one or more documents published from time to time by the Clearing House, being criteria to be satisfied by an applicant for admission as a Clearing Member in respect of the Designated Contracts which the applicant wishes to clear with the Clearing House;
- (f) "Default Fund" means the fund established under the Default Rules of the Clearing House to which the Clearing Member is required to contribute by virtue of clause 9 of this Agreement;
- (g) [DELETED]

- (h) "Default Notice" means a notice issued by the Clearing House in accordance with the Default Rules in respect of a Clearing Member who is or is likely to become unable to meet its obligations in respect of one or more Contracts;
 - (i) "Default Rules" means that part of the Rulebook having effect in accordance with Part IV of the Financial Services and Market Act 2000 (Recognition Requirements for Investment Exchange and Clearing Houses) Regulations 2001 to provide for action to be taken in respect of a Clearing Member subject to a Default Notice;
 - (j) "Designated Contract" has the meaning given to it in clause 2.1;
 - (k) "Exchange" means an organisation responsible for administering a market with which the Clearing House has an agreement for the provision of central counterparty and other services to Clearing Members;
 - (l) "Exchange Contract" means any contract which an Exchange has adopted and authorised Exchange Members to trade in under its Exchange Rules and in respect of which the Clearing House has agreed to provide central counterparty and other services;
 - (m) "Exchange Member" means any person (by whatever name called) being a member of, or participant in, a Market pursuant to Exchange Rules;
 - (n) "Exchange Rules" means any of the regulations, rules and administrative procedures or contractual arrangements for the time being and from time to time governing the operation of a Market administered by an Exchange and includes, without prejudice to the generality of the foregoing, any regulations made by the directors of an Exchange or by any committee established under the Rules, and, save where the context otherwise requires, includes Exchange Contracts, and the Rulebook;
 - (o) "Rulebook" means the Clearing House's General Regulations, Default Rules, Settlement Finality Regulations and Procedures and such other rules of the Clearing House as published and amended from time to time;
 - (p) "Market" means a futures, options, forward, stock or other market, administered by an Exchange, or an OTC market, in respect of which the Clearing House has agreed with such Exchange or, in respect of an OTC market, with one or more participants in that market, to provide central counterparty and related services on the terms of the Rulebook and in the case of an Exchange, pursuant to the terms of any agreement entered into with the Exchange;
 - (q) "Person" includes any firm, company, corporation, body, association or partnership (whether or not having separate legal personality) or any combination of the foregoing;
 - (r) "Procedures" means that part of the Rulebook by that name;
 - (s) "Registered Contract" means a contract registered in the Firm's name by the Clearing House in accordance with the Rulebook;
- 1.2. (a) References to "the parties" are references to the parties hereto, and "party" shall be construed accordingly;
- (b) References herein to a clause are to a clause hereof and clause headings are for ease of reference only;
- (c) Unless the context otherwise requires, words (including defined terms) denoting the singular shall include the plural and vice versa;

(d) References to writing include typing, printing, lithography, photography, facsimile transmission and other modes of representing or reproducing words in a visible form; and

(e) References herein to statutes, statutory instruments, the Rulebook, or provisions thereof are to those statutes, statutory instruments, Rulebook or provisions thereof as amended, modified or replaced from time to time.

1.3 This Agreement, the terms of any other agreement to which the Clearing House and the Clearing Member are party which relates to the provision of central counterparty and other services by the Clearing House, the terms of, and applicable to, each and every Registered Contract, the Rulebook and all amendments to any of the foregoing shall together constitute a single agreement between the Clearing House and the Clearing Member and both parties acknowledge that all Registered Contracts are entered into in reliance upon the fact that all such items constitute a single agreement between the parties.

1.4 A person who is not a party to this Agreement shall have no rights under or in respect of this Agreement.

2 Clearing Membership

2.1. The Firm is hereby admitted as a Clearing Member on the terms set out in this Agreement. The Firm shall be eligible to clear such categories of Contract (each a "Designated Contract") as the Clearing House shall from time to time notify to the Firm.

2.2. The Firm warrants that the information supplied by the Firm to the Clearing House in connection with the enquiry conducted by the Clearing House to determine whether the Firm satisfies for the time being the Criteria for Admission was and is at the date of this Agreement true and accurate in all material respects.

2.3. The Firm will ensure that it will at all times satisfy the Criteria for Admission. If at any time it has reason to believe that it no longer satisfies or may cease to satisfy any of such criteria the Firm shall immediately notify the Clearing House of the circumstances.

2.4. The Firm shall give written notice forthwith to the Clearing House of the occurrence of any of the following of which it is aware:-

(a) the presentation of a petition or passing of any resolution for the bankruptcy or winding-up of, or for an administration order in respect of, the Firm or of a subsidiary or holding company of the Firm;

(b) the appointment of a receiver, administrative receiver, administrator or trustee of the estate of the Firm;

(c) the making of a composition or arrangement with creditors of the Firm or any order or proposal in connection therewith;

(d) where the Firm is a partnership, an application to dissolve the partnership, the presentation of a petition to wind up the partnership, or any other event which has the effect of dissolving the partnership;

(e) where the Firm is a registered company, the dissolution of the Firm or the striking-off of the Firm's name from the register of companies;

(f) any step analogous to those mentioned in paragraphs (a) to (e) of this clause 2.4 is taken in respect of such persons as are referred to in those respective paragraphs in any jurisdiction;

(g) the granting, withdrawal or refusal of an application for, or the revocation of any licence or authorisation to carry on investment, banking or insurance business in any country;

- (h) the granting, withdrawal or refusal of an application for, or the revocation of, a license or authorisation by the Financial Conduct Authority, the Prudential Regulation Authority or membership of any self-regulating organisation, recognised or overseas investment exchange or clearing house (other than the Clearing House) under the Financial Services and Markets Act 2000 or any other body or authority which exercises a regulatory or supervisory function under the laws of the United Kingdom or any other state;
- (i) the appointment of inspectors by a statutory or other regulatory authority to investigate the affairs of the Firm (other than an inspection of a purely routine and regular nature);
- (j) the imposition of any disciplinary measures or sanctions (or similar measures) on the Firm in relation to its investment or other business by any Exchange, regulatory or supervisory authority;
- (k) the entering of any judgment against the Firm under Section 150 of the Financial Services and Markets Act 2000;
- (l) the conviction of the Firm for any offence under legislation relating to banking or other financial services, building societies, companies, credit unions, consumer credit, friendly societies, insolvency, insurance and industrial and provident societies or for any offence involving fraud or other dishonesty;
- (m) the conviction of the Firm, or any subsidiary or holding company of the Firm for any offence relating to money laundering, or the entering of judgment or the making of any order against the Firm in any civil action or matter relating to money laundering;
- (n) any enforcement proceedings taken or order made in connection with any judgement (other than an arbitration award or judgement in respect of the same) against the Firm; and
- (o) any arrangement entered into by the Firm with any other Clearing Member relating to the provision of central counterparty and associated services by the Clearing House of Contracts or transactions entered into by the Firm after the effective date of termination of this Agreement.

2.5. The Firm shall give written notice forthwith to the Clearing House of any person becoming or ceasing to be a director of or a partner in the Firm or of the occurrence of any of the following in relation to a director of or a partner in the Firm, if aware of the same:-

- (a) the occurrence of any event specified in clause 2.4 (insofar as it is capable of materially affecting him); or
- (b) any disqualification order under the Company Directors Disqualification Act 1986 or equivalent order in overseas jurisdictions.

2.6. The Firm shall give written notice forthwith to the Clearing House of any change in its name, the address of its principal place of business, registered office or UK office.

2.7. The Firm shall give written notice to the Clearing House forthwith upon its becoming aware that any person is to become or cease to be, or has become or ceased to be, a controller of the Firm, and shall in relation to any person becoming a controller of the Firm state:-

- (a) the controller's name, principal business and address;
- (b) the date of the change or proposed change.

In this clause and in clause 2.9 "controller" means a person entitled to exercise or control the exercise of 20 per cent or more of the voting power in the Firm.

- 2.8. The Firm shall give written notice forthwith to the Clearing House of any change in its business which affects the Firm's ability to perform its obligations under this Agreement.
- 2.9. Where the Clearing House receives notification pursuant to any of clauses 2.3 to 2.8, or the Clearing House reasonably suspects that the Firm may no longer satisfy some or all of the Criteria for Admission or the criteria for clearing a Designated Contract, the Clearing House shall be entitled in its absolute discretion to call for information of whatsoever nature in order to determine whether the Firm continues to satisfy the Criteria for Admission or the criteria for clearing a Designated Contract. Without prejudice to the foregoing, the Clearing House may at any time call for information relating to the affairs (including the ownership) of any controller of the Firm or any person who is to become a controller of the Firm. The Firm shall forthwith on demand supply to the Clearing House information called for under this clause and shall ensure that such information is true and accurate in all respects.
- 2.10. The Firm undertakes to abide by the Rulebook and undertakes at all times to comply with other provisions of Exchange Rules so far as they apply to the Firm.
- 2.11. The Firm undertakes that at all times, to the extent the Firm is required under any applicable law to be authorised, licensed or approved in relation to activities undertaken by it, it shall be so authorised, licensed or approved.
- 2.12. The Firm agrees that in respect of any Contract for which central counterparty services are to be provided to the Firm by the Clearing House in accordance with the Rulebook, including, but not limited to, any contract made by the Firm under Exchange Rules on the floor of a Market (or through a Market's automated trading system) or otherwise, whether with a member of that Market or with a client or with any other person, and including any Contract entered into in an OTC market, the Firm shall contract as principal and not as agent.
- 2.13. The Firm shall furnish financial information to the Clearing House in accordance with the requirements of the Rulebook or such other requirements as the Clearing House may from time to time prescribe.
- 2.14. The Firm undertakes that, in its terms of business with its clients (being clients in respect of whom the Firm is subject to any regulations made pursuant to rules and/or legislation applicable to the Firm with respect to the safeguarding or segregation of clients' money):
- (a) where it is subject to Exchange Rules, it will at all times include a stipulation that contracts made under Exchange Rules with or for them shall be subject to Exchange Rules (including the Rulebook); and
 - (b) that money of such clients in the possession of the Clearing House may be dealt with by the Clearing House in accordance with the Rulebook without exception.
- 2.15. Without prejudice to clause 2.14 the Firm undertakes that its dealings with all its clients or counterparties shall be arranged so as to comply with the requirement that the Firm deals with the Clearing House as principal, and that all sums deposited with the Clearing House by way of Cash Cover (including the Firm's Contribution to the Default Fund) shall be deposited unencumbered and by the Firm acting as sole principal and as legal and beneficial owner.
- 2.16. The Firm undertakes not to assign, charge or subject to any other form of security, whether purporting to rank in priority over, pari passu with or subsequent to the rights of the Clearing House, any Cash Cover provided to the Clearing House, including its entitlement to repayment of its Contribution to the Default Fund or any part of it. Any purported charge, assignment or encumbrance (whether by way of security or otherwise) of Cash Cover provided to the Clearing House shall be void. The Firm shall not otherwise encumber (or seek to encumber) any Cash Cover provided to the Clearing House.

3 Remuneration

- 3.1. The Clearing House shall be entitled to charge the Firm such fees, charges, levies and other dues, on such events, and calculated in accordance with such scales and methods, as are for the time prescribed by the Clearing House and, where relevant, for Exchange Contracts, after consultation with the relevant Exchange.

- 3.2. The Clearing House shall give the Firm not less than fourteen days' notice of any increase in such fees, charges, levies or other dues.

4 Facilities Provided by the Clearing House

4.1. Provision of Central Counterparty Services

- (a) Details of all Contracts to be registered by the Clearing House in the name of the Firm and in respect of which central counterparty services are to be provided shall be provided to the Clearing House in accordance with the Rulebook and any other agreement entered into between the Clearing House and the Firm.
- (b) Provided that a Contract meets the criteria for registration of that Contract in the name of the Firm and is a Designated Contract, and subject to the Rulebook, the Clearing House shall enter into a Registered Contract with the Firm in respect thereof. Each such Contract shall be registered in accordance with the Rulebook and the Clearing House shall perform its obligations in respect of all Registered Contracts in accordance with this Agreement and the Rulebook.

4.2. Maintenance of Records

The Clearing House agrees that for a period of ten years after termination of a Registered Contract it shall maintain records thereof. The Clearing House may make a reasonable charge to the Firm for the production of any such records more than three months after registration.

4.3. Information

The Clearing House will provide to the Firm such information at such times as is provided for by the Rulebook.

4.4. Accounts

The Clearing House agrees to establish and maintain one or more accounts for the Firm in accordance with the Rulebook. Accounts will be opened and kept by the Clearing House in such manner as will not prevent the Firm from complying with requirements of any regulations made pursuant to rules and/or legislation applicable to the Firm with respect to the safeguarding or segregation of clients' money and the rules of such regulatory organisation as the Firm may be subject to in respect of their cleared business.

5 Default

In the event of the Firm appearing to the Clearing House to be unable, or to be likely to become unable, to meet any obligation in respect of one or more Registered Contracts, or failing to observe any other financial or contractual obligation under the Rulebook, the Clearing House shall be entitled to take all or any of the steps set out in that regard in the Rulebook, including (but not limited to) the liquidation of all or any of the Registered Contracts.

6 Disclosure of Information

The Firm agrees that the Clearing House shall have authority to disclose any information of whatsoever nature concerning the Firm to such persons as is provided for by the Rulebook.

7 Partnership

If the Firm is a partnership, the liability of each partner in the Firm hereunder and under any Registered Contract shall be joint and several and, notwithstanding an event which would by operation of law give rise to the dissolution of the partnership, or entitle a partner to seek an order to dissolve the partnership, including, but not limited to, the event of the death, bankruptcy, winding-up or dissolution of any such partner, the respective obligations of the Clearing House and all other partners shall remain in full force and effect. If the Firm is a partnership, the Firm undertakes that if any new partner joins the Firm, the Firm shall procure that such new partner becomes jointly and severally liable alongside existing partners in respect of obligations of the Firm to the Clearing House outstanding at the date of such new partner's accession to the Firm.

8 Term

- 8.1. Subject to clause 8.3 either party (provided, in the case of the Firm, that the Clearing House has not issued a Default Notice in respect of the Firm) may terminate this Agreement by giving to the other party notice in writing, such notice to specify the effective date of termination ("the termination date") which shall be a business day not less than three months after the date of the notice, and this Agreement shall, subject to clause 8.2(b), terminate on the termination date. By the close of business on the termination date the Firm shall ensure that all Registered Contracts in the Firm's name have been closed-out or transferred so that there are no open Registered Contracts to which the firm is party at the end of the termination date.
- 8.2. If, under clause 8.1, the Firm has not closed out or transferred all Registered Contracts by the set termination date the Clearing House shall, at its sole discretion, be entitled to:
 - (a) liquidate any such Registered Contracts in accordance with the Rulebook; and
 - (b) require that the Firm remains a member of the Clearing House until such time as there are no Registered Contracts in existence to which the Firm is a party and the effective date of termination of this Agreement shall be postponed until such time.
- 8.3. If the Firm is in breach of or in default under any term of this Agreement or the Rulebook, or if the Clearing House has issued a Default Notice in respect of the Firm, or if the Clearing House reasonably determines that the Firm no longer satisfies the Criteria for Admission as a Clearing Member, the Clearing House may in its absolute discretion terminate this Agreement in writing either summarily or by notice as follows.

Any termination by notice under this clause 8.3 may take effect (subject as follows) on the expiry of 30 days or such longer period as may be specified in the notice. A notice given by the Clearing House under this clause may at the Clearing House's discretion allow the Firm a specified period in which to remedy the breach or default or to satisfy the Criteria for Admission as the case may be, and may specify what is to be done to that end, and may provide that if the same is done to the satisfaction of the Clearing House within that period the termination of this Agreement shall not take effect; and if this Agreement has terminated after the Clearing House has allowed the Firm such a period for remedy or satisfaction, the Clearing House shall then notify the Firm of the fact of termination. The Clearing House may, if the Clearing House has issued a Default Notice in respect of the Firm immediately, and in any other case after the effective date of termination, take such other action as it deems expedient in its absolute discretion to protect itself or any other Clearing Member including, without limitation, the liquidation of Registered Contracts but without prejudice to its own rights in respect of such contracts.

- 8.4. Upon the termination of this Agreement for whatever reason the Firm shall unless otherwise agreed cease to be a Clearing Member.

9 Default Fund

- 9.1. In this clause the term "Excess Loss" bears the meaning ascribed to it in the Rulebook.
- 9.2. The Firm, as primary obligor and not surety, hereby indemnifies the Clearing House in respect of any Excess Loss, and undertakes to deposit cash with the Clearing House as collateral for its obligations in respect of such indemnity, in accordance in each case with the Default Rules.

- 9.3. The Firm shall, in accordance with the Default Rules, continue to be liable to indemnify the Clearing House in respect of any Excess Loss arising upon any default occurring before the effective date of termination of this Agreement. Subject thereto, the indemnity hereby given shall cease to have effect on the effective date of termination of this Agreement, unless a Default Notice is issued by the Clearing House in respect of the Firm, in which case the indemnity hereby given shall cease to have effect after the date three months after the date of issue of such Default Notice.
- 9.4. Save as provided expressly by the Default Rules, the Firm shall not be entitled to exercise any right of subrogation in respect of any sum applied in satisfaction of its obligations to the Clearing House under this clause 9.

10 Force Majeure

Neither party shall be liable for any failure in performance of this Agreement if such failure arises out of causes beyond its control. Such causes may include, but are not limited to, acts of God or the public enemy, acts of civil or military authority, fire, flood, labour dispute (but excluding strikes, lock-outs and labour disputes involving the employees of the party intending to rely on this clause or its sub-contractors), unavailability or restriction of computer or data processing facilities or of energy supplies, communications systems failure, failure of a common depository, clearing system or settlement system, riot or war.

11 The Rulebook

In the event of conflict between the Rulebook and the provisions of this Agreement the Rulebook shall prevail.

12 Notices

- 12.1. Any notice or communication to be made under or in connection with this Agreement shall be made in writing addressed to the party to whom such notice or communication is to be given; save that a notice or communication of an urgent nature shall be given or made orally and as soon as reasonably practicable thereafter confirmed in writing in conformity hereto. A notice may be delivered personally or sent by post to the address of that party stated in this Agreement, or to such other address as may have been notified by that party in accordance herewith.
- 12.2. Where a notice is sent by the Clearing House by post it shall be deemed delivered 24 hours after being deposited in the post first-class postage prepaid in an envelope addressed to the party to whom it is to be given in conformity to clause 12.1, or in the case of international mail, on the fourth business day thereafter. In all other cases notices shall be deemed delivered when actually received.

13 Law

- 13.1. This Agreement shall be governed by and construed in accordance with the laws of England and Wales. The parties irrevocably agree that the courts of England and Wales shall have exclusive jurisdiction to hear and determine any action or dispute which may arise herefrom. The Clearing House and the Firm each irrevocably submits to such jurisdiction and to waive any objection which it might otherwise have to such courts being a convenient and appropriate forum.
- 13.2. The Firm irrevocably waives, with respect to itself and its revenues and assets all immunity on the grounds of sovereignty or other similar grounds from suit, jurisdiction of any court, relief by way of injunction, order for specific performance or for recovery of property, attachment of its assets (whether before or after judgement) and execution or enforcement of any judgement to which it or its revenues or assets might otherwise be entitled in any proceedings in the courts of any jurisdiction and irrevocably agrees that it will not claim any such immunity in any proceedings.

14 Service of Process

Without prejudice to any other mode of service, and subject to its right to change its agent for the purposes of this Clause on 30 days' written notice to the Clearing House, the Firm (other than where it is incorporated in England and Wales or otherwise has an office in England and Wales) appoints, as its agent for service of process relating to any proceedings

before the courts of England and Wales in connection with the Firm the person in London as notified to the Clearing House in writing with the application for admission.

IN WITNESS whereof the parties hereto have caused this Agreement to be signed by their duly authorised representatives the day and year first before written.

(Signature)

(Print Name and Title)

for THE FIRM

(Signature)

(Print Name and Title)

for THE FIRM

(Signature)

(Print Name and Title)

for **LCH.CLEARNET LIMITED**

(Signature)

(Print Name and Title)

for **LCH.CLEARNET LIMITED**

LCH.CLEARNET LIMITED

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APPENDIX 3

1. On 1 July 1997, Hong Kong became the Hong Kong Special Administrative Region (the "**HKSAR**") of the People's Republic of China (the "**PRC**"). On 4 April 1990, the National People's Congress (the "**NPC**") of the PRC adopted the Basic Law of the HKSAR (the "**Basic Law**"). Under Article 8 of the Basic Law, the laws of Hong Kong in force at 30 June 1997, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene the Basic Law, and subject to any amendment by the legislature of the HKSAR. Under Article 160 of the Basic Law, the laws of Hong Kong in force at 30 June 1997 shall be adopted as laws of the HKSAR unless they are declared by the Standing Committee of the NPC (the "**Standing Committee**") to be in contravention of the Basic Law and, if any laws are later discovered to be in contravention of the Basic Law, they shall be amended or cease to have force in accordance with the procedure prescribed by the Basic Law.
2. On 23 February 1997, the Standing Committee adopted a decision (the "**Decision**") on the treatment of laws previously in force in Hong Kong. Under paragraph 1 of the Decision, the Standing Committee decided that "the laws previously in force in Hong Kong, which include, the common law, rules of equity, ordinances, subsidiary legislation and customary law, except for those which contravene the Basic Law, are to be adopted as the laws of the HKSAR". Under paragraph 2 of the Decision, the Standing Committee decided that the ordinances and subsidiary legislation set out in Annex 1 to the Decision "which are in contravention of the Basic Law" are not to be adopted as the laws of the HKSAR. One of the ordinances set out in that Annex is the Application of English Law Ordinance (Cap. 88) (the "**English Law Ordinance**"). The English Law Ordinance applied the common law and rules of equity of England to Hong Kong. We have assumed in giving the opinions in this Opinion Letter that the effect of paragraph 2 of the Decision, insofar as it relates to the English Law Ordinance, is to repeal the English Law Ordinance prospectively and that the common law and rules of equity of England which applied in Hong Kong on 30 June 1997 continue to apply, subject to their subsequent independent development which will rest primarily with the courts of the HKSAR which are empowered by the Basic Law to refer to precedents of other common law jurisdictions when adjudicating cases. In our view and, subject to paragraph 3 below, the judgment of the Court of Appeal of the High Court in *HKSAR v Ma Wai Kwan David and Others* [1997] 2 HKC 315 supports the assumption that the common law and rules of equity of England which applied in Hong Kong on 30 June 1997 continue to apply to the HKSAR.
3. On 30 June 2020, the Law of the People's Republic of China on Safeguarding National Security in the Hong Kong Special Administrative Region ("**NSL**") was implemented in Hong Kong by being added to the list of national laws in Annex III to the Basic Law:
 - (a) Article 62 of the NSL provides that the NSL shall prevail where other laws of the HKSAR are inconsistent with the NSL.
 - (b) Article 65 of the NSL provides that the power of interpretation of the NSL vests in the Standing Committee.

- (c) There has been no decision of a Hong Kong court involving a commercial transaction and the NSL, nor has any case been designated under Article 55 of the NSL (which would not be adjudicated by a court in Hong Kong). There is also no official statement or guidance from the HKSAR Government or the Standing Committee on the provisions of the NSL or their application in commercial transactions. It is therefore difficult to assess the impact (if any) on, or inter-relationship between, the NSL and other Hong Kong law.