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Our reference: PCDB.70-40531117.RCFC

21 February 2013

Dear Sirs

CCP Opinion in relation to SEHK Options Clearing House Limited

You have asked us to give an opinion in respect of the laws of the Hong Kong Special Administrative Region of the People's Republic of China ("**Hong Kong**" or "**this jurisdiction**") as to the effect of certain collateral arrangements in relation to SEHK Options Clearing House Limited (the "**Clearing House**") as between the Clearing House and its clearing members (each a "**Member**").

We understand that your requirement is for the enforceability and validity of such collateral arrangements to be substantiated by a written and reasoned opinion letter.

References herein to "**this opinion**" are to the opinion given in paragraph 3.

1. TERMS OF REFERENCE

- 1.1 Except where otherwise defined herein, terms defined in the Rules of the Clearing House have the same meaning in this opinion letter.
- 1.2 The opinions given in paragraph 3 are in respect of a Member's powers under the Clearing House Documentation as at the date of this opinion. We express no opinion on any provisions of the Clearing House Documentation other than those on which we expressly opine.
- 1.3 The opinions given in paragraph 3.6 are given only in relation to Non-cash Collateral comprising securities credited to a CCMS Collateral Account.

HKG-1-973008-v4

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1.4 Section 264 of the Companies Ordinance provides, among other things, that, in the winding up of an insolvent company, the same rules shall apply with regard to the respective rights of secured and unsecured creditors and to debts provable and to the valuation of annuities and future and contingent liabilities as are in force for the time being under the law of bankruptcy. Accordingly, and because opinions in this opinion letter are given in respect of the Clearing House, which is a Hong Kong Company, in this opinion letter we refer to winding-up, winding-up petitions and winding-up orders, notwithstanding that the relevant provisions of the Bankruptcy Ordinance refer to bankruptcy, bankruptcy petitions and bankruptcy orders, as the case may be.

1.5 Definitions

In this opinion, unless otherwise indicated:

1.5.1 "**Assessment Liability**" means a liability of a Member to pay an amount to the Clearing House (including a contribution to the assets or capital of the Clearing House, or to any default or similar fund maintained by the Clearing House); but excluding:

- (a) any obligations to provide margin or collateral to the Clearing House, where calculated at any time by reference to OCH Contracts open at that time;
- (b) membership fees, fines and charges;
- (c) reimbursement of costs incurred directly or indirectly on behalf of or for the Member or its own clients;
- (d) indemnification for any taxation liabilities;
- (e) payment or delivery obligations under OCH Contracts; or
- (f) any payment of damages awarded by a court or regulator for breach of contract, in respect of any tortious liability or for breach of statutory duty;

1.5.2 "**Bankruptcy Ordinance**" means the Bankruptcy Ordinance, Chapter 6 of Hong Kong;

1.5.3 "**CCMS**" means the Common Collateral Management System, which is a common sub-system of Central Clearing and Settlement System and DCASS and operated by Hong Kong Securities Clearing Company Limited, the Clearing House and HKFE Clearing Corporation Limited to enable Members to manage their collateral paid or delivered to the Clearing House;

1.5.4 "**CCMS Collateral Account**" has the meaning ascribed to that term in the Rules;

1.5.5 "**Clearing House Documentation**" means the Rules and the Procedures;

- 1.5.6 "**Companies Ordinance**" means the Companies Ordinance, Chapter 32 of Hong Kong;
- 1.5.7 "**DCASS**" means the Derivatives Clearing and Settlement System, which is the computerized book-entry clearing and settlement system for options transactions effected on the HKEx and futures transactions effected on the Hong Kong Futures Exchange Limited, and which is operated by the Clearing House and HKFE Clearing Corporation Limited;
- 1.5.8 "**EFBNs**" means Exchange Fund Bills/Notes, which are debt instruments issued by the Hong Kong Special Administrative Region Government for the account of the Exchange Fund;
- 1.5.9 "**Hong Kong Company**" means a company which is incorporated under the Companies Ordinance;
- 1.5.10 "**HKEx**" means The Stock Exchange of Hong Kong Limited;
- 1.5.11 "**Insolvency Proceeding**" means the procedures referred to in paragraph 3.1.1;
- 1.5.12 "**Non-cash Collateral**" means the non-cash collateral provided to the Clearing House as margin under the Clearing House Documentation;
- 1.5.13 "**OCH Contract**" has the meaning ascribed to that term in the Rules;
- 1.5.14 "**Party**" means the Clearing House or the relevant Member;
- 1.5.15 "**Procedures**" means the Operational Clearing Procedures for Options Trading Exchange Participants of SEOCH last updated on 5 November 2012;
- 1.5.16 "**Rules**" means the Options Clearing Rules of SEOCH last updated on 5 November 2012;
- 1.5.17 "**Securities and Futures Ordinance**" means the Securities and Futures Ordinance, Chapter 571 of Hong Kong;
- 1.5.18 "**Statutory Insolvency Set-Off**" has the meaning ascribed to it in paragraph 4.1.3;
- 1.5.19 references to the word "**enforceable**" and cognate terms are used to refer to the ability of a Party to exercise its contractual rights in accordance with their terms and without risk of successful challenge. We do not opine on the availability of any judicial remedy; and
- 1.5.20 references to a "**paragraph**" are (except where the context otherwise requires) to a paragraph of this opinion (as the case may be).

2. ASSUMPTIONS

We assume the following:

- 2.1 Except with regards to the provisions discussed and opined on in this opinion letter, the Clearing House Documentation and the OCH Contracts are legally binding and enforceable against both Parties under their governing laws.
- 2.2 Each Party has the capacity, power and authority under all applicable law(s) to enter into the Clearing House Documentation and the OCH Contracts; to perform its obligations under the Clearing House Documentation and the OCH Contracts; and that each Party has taken all necessary steps to execute and deliver and perform the Clearing House Documentation and the OCH Contracts.
- 2.3 Each Party has obtained, complied with the terms of and maintained all authorisations, approvals, licences and consents required to enable it lawfully to enter into and perform its obligations under the Clearing House Documentation and the OCH Contracts and to ensure the legality, validity, enforceability or admissibility in evidence of the Clearing House Documentation in this jurisdiction.
- 2.4 The Clearing House Documentation has been entered into prior to the commencement of any insolvency procedure under the laws of any jurisdiction in respect of either Party.
- 2.5 Each Party acts in accordance with the powers conferred by the Clearing House Documentation and OCH Contracts; and that each Party performs its obligations under the Clearing House Documentation and each OCH Contract in accordance with their respective terms.
- 2.6 There are no agreements, instruments or arrangements between the Parties which modify or supersede the terms of the Clearing House Documentation.
- 2.7 The Member is at all relevant times solvent and not subject to insolvency proceedings under the laws of any jurisdiction.
- 2.8 No provision of the Clearing House Documentation that is necessary for the giving of our opinions and advice in this opinion letter has been altered in any material respect.
- 2.9 The Clearing House is at all material times recognized by the Securities and Futures Commission as a clearing house pursuant to Section 37 of the Securities and Futures Ordinance.
- 2.10 Each OCH Contract is a contract entered into by the Clearing House, in its capacity as such, for the purpose of enabling a Member to settle its rights and liabilities under a transaction, or for the purpose of providing central counterparty clearing services to that Member.
- 2.11 Each Member, when providing cash and Non-cash Collateral to the Clearing House as margin under the Clearing House Documentation, has full beneficial title to such cash

and Non-cash Collateral at the time of payment or transfer, free and clear of any lien, claim, charge or encumbrance or any other interest of any third person (other than, in the case of Non-cash Collateral, a lien routinely imposed on all securities in a relevant clearance or settlement system).

3. **OPINION**

On the basis of the foregoing terms of reference and assumptions and subject to the qualifications set out in paragraph 4 below, we are of the following opinions.

3.1 **Insolvency Proceedings**

3.1.1 The only bankruptcy, composition, rehabilitation or other insolvency or reorganisation procedures to which the Clearing House could be subject under the laws of this jurisdiction, and which are relevant for the purposes of this opinion, are:

- (a) liquidation (including provisional liquidation); and
- (b) schemes of arrangement.

3.1.2 The legislation applicable to Insolvency Proceedings is:

- (a) the Companies Ordinance; and
- (b) the Bankruptcy Ordinance,

each as modified up to the date hereof, together with any subsidiary legislation.

3.2 **Special provisions of law**

The following special provisions of law apply to OCH Contracts by virtue of the fact that the OCH Contracts are, or relate to, exchange-traded derivative products and are cleared through a central counterparty: Part III of the Securities and Futures Ordinance.

3.3 **Recognition of choice of law**

The choice of law provision of Rule 109 would be recognised under the laws of this jurisdiction, even if a Member is not incorporated, domiciled or established in this jurisdiction.

3.4 **Netting and set-off upon insolvency**

3.4.1 The Clearing House Documentation does not contain any provision expressly entitling a Member to close out and/or set off its positions with, and obligations owed to or by, the Clearing House in the case of the insolvency or other default of the Clearing House.

- 3.4.2 If the Clearing House becomes wound-up in this jurisdiction, debts owing by the Clearing House to a Member shall be mandatorily set off against mutual debts owing by the Member to the Clearing House pursuant to Statutory Insolvency Set-Off, so that the Member would be entitled to claim or be obliged to pay the net sum of the positive and negative mark-to-market values of the included individual OCH Contracts and/or losses or gains referable to the OCH Contracts.

3.5 Cash Collateral

- 3.5.1 Payments made by a Member to the Clearing House as cash margin constitute an absolute transfer of cash, so that, in the event the Clearing House is wound-up, such cash would be treated as the property of the Clearing House available to its creditors generally.
- 3.5.2 However, the amount of cash so provided would constitute a debt owed by the Clearing House to such Member as principal and would, in the event the Clearing House becomes wound-up in this jurisdiction, be subject to Statutory Insolvency Set-Off.

3.6 Non-cash Collateral

- 3.6.1 Although not free from doubt, we believe that any securities provided to the Clearing House as cover for margin held in a CCMS Collateral Account (other than EFBNs) would not be treated as the property of the Clearing House and would be returnable to the Member, even in the event the Clearing House is wound-up, subject to the Member satisfying its obligations to the Clearing House.
- 3.6.2 This is because:
- (a) Paragraph 7.2 (*Securities Collateral*) of the Procedures provides that the Clearing House will accept from a Member any securities designated as acceptable General Collateral or Specific Securities Collateral for the purpose of meeting in part or in whole the margin requirement of the Member, and a Member which intends to lodge such acceptable General Collateral or Specific Securities Collateral must first execute a valid "Deed of Charge", which governs the Clearing House's fixed charge on such securities. The grant of a fixed charge is inconsistent with an absolute or outright transfer of such securities to the Clearing House.
 - (b) There is no general doctrine of Hong Kong law which would have the effect of converting a security interest over property into an absolute transfer of such property so as to extinguish the security giver's proprietary right to recover the secured property on the discharge or extinction of the secured obligation (other than by court order pursuant to a foreclosure). Property rights existing prior to the commencement

- of winding-up proceedings are recognised and respected in such winding-up proceedings and accordingly a Member's proprietary right in the charged assets will remain effective against the Clearing House (in insolvency) and against the liquidator(s) of the Clearing House.
- 3.6.3 However, the above analysis does not apply to EFBNs provided to the Clearing House as cover for margin, because paragraph 7.2 (*Securities Collateral*) of the Procedures states that any EFBN provided by a Member to the Clearing House shall be transferred outright to the Clearing House and will not form the subject matter of the "Deed of Charge".
- 3.6.4 In addition, the analysis in paragraph 3.6.2 above is subject to the following concerns:
- (a) Rule 206 provides that, subject to the Securities and Futures Ordinance, the Clearing House shall be entitled to treat all property received by it from a Member as property delivered to it by a principal and "*no property in the hands of the Clearing House shall be impressed with a trust or other equitable interest in favour of any person*"; and
 - (b) Rule 622 provides that, while the Clearing House will reflect the separation in the manner described in the Procedures of margin held in the various CCMS accounts maintained for the Members, this "*shall not give rise to any trust or other equitable interest of any kind in respect of any ... property standing to the credit of any such separate CCMS accounts*".
- 3.6.5 Rules 206 and 622 suggest that Non-cash Collateral might be regarded as property transferred absolutely to the Clearing House and therefore might not be returnable to the relevant Member in the event the Clearing House is wound-up. This is because it is generally accepted that, as a matter of Hong Kong law, the only manners by which non-tangible property (including immobilized securities) held with a custodian would not fall within the insolvency estate of the custodian would be if:
- (a) the custodian held such non-tangible property on trust for its client(s);
or
 - (b) the custodian held such non-tangible property as chargee or mortgagee pursuant to one or more charges or mortgages in its favour.
- 3.6.6 However, no inconsistency would exist between paragraph 7.2 (*Securities Collateral*) of the Procedures and Rules 206 and 622 if:
- (a) Rule 206 is restricted in its application to property that has been transferred outright to the Clearing House (such as Cash Collateral or a Member's Reserve Fund Contribution and Replenishment

Contribution, but not Non-cash Collateral charged in favour of the Clearing House); and

- (b) Rule 622 is construed as providing that there shall be no other trust or other equitable interest in the Non-cash Collateral in favour of any person, *other than* the bare trust held by the Clearing House (as custodian) in favour of the relevant Member and/or the equity of redemption held by the relevant Member in respect of Non-cash Collateral charged or mortgaged in favour of the Clearing House under the "Deed of Charge".

3.7 Members' Assessment Liabilities

A Member's Assessment Liability is as follows.

- 3.7.1 Pursuant to Rule 403, each Member shall be required to make a Reserve Fund Contribution and Replenishment Contribution to the Reserve Fund.
- 3.7.2 A Member's Reserve Fund Contribution includes an Initial Contribution of:
 - (a) if the Member is a General Clearing Participant: (i) HK\$5,000,000 and (ii) HK\$1,500,000 for every subsequent Clearing Agreement entered into by that General Clearing Participant where the General Clearing Participant already has three valid Clearing Agreements in place, or
 - (b) if the Member is a Direct Clearing Participant, HK\$1,500,000.
- 3.7.3 In addition, pursuant to Rule 406, each Member is required to make a Variable Contribution to the Reserve Fund. The size of each Member's Variable Contribution is determined by the Clearing House in its absolute discretion, having regard "*(without limitation) both to the Reserve Fund size which is needed given aggregate open positions and estimated market volatility, and to any minimum Reserve Fund size needed regardless of those positions and that volatility*".
- 3.7.4 Rule 411 expressly provides that there shall be "*no limit*" on the amount required to be contributed to the Reserve Fund by a Member at any given time: we understand that "*no limit*" means "*no maximum amount*".
- 3.7.5 Rule 413C provides that, in circumstances where all or part of the Reserve Fund Contributions have been applied in respect of the Clearing House's liabilities following the default of a Member, each Member (other than the defaulting Member or any Member which has effectively terminated its membership in the Clearing House) shall on demand by the Clearing House provide Replenishment Contribution to the Reserve Fund: (i) to ensure that the Reserve Fund Contributions are replenished to the same level as before any application were made; and (ii) to provide such additional resources as the Clearing House may require to meet any liabilities that remain outstanding.

- 3.7.6 If a Member fails to make its Reserve Fund Contribution and Replenishment Contribution, such failure will constitute an event of default referred to in Rule 701, and the Clearing House may, pursuant to Rule 703, terminate the Member's membership of the Clearing House.

4. QUALIFICATIONS

The opinions in this opinion letter are subject to the following qualifications:

4.1 Statutory Insolvency Set-off

Section 35 of the Bankruptcy Ordinance

- 4.1.1 The Clearing House is a Hong Kong Company.
- 4.1.2 Section 35 of the Bankruptcy Ordinance, which is made applicable to Hong Kong Companies by Section 264 of the Companies Ordinance, provides that, in a winding-up of a Hong Kong Company (the Insolvent Party), 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.
- 4.1.3 Set-off pursuant to Section 35 of the Bankruptcy Ordinance ("**Statutory Insolvency Set-Off**") is mandatory and occurs automatically on the date of the winding-up order. It is not possible for parties to contract out of Statutory Insolvency Set-Off.

Mutuality

- 4.1.4 "Mutuality", for the purposes of Statutory Insolvency Set-Off, means that the relevant debts must be between the same parties and that they must be held in the same capacity, right or interest. Case law has established that debts would be held by the parties in the same capacity, right or interest if each of the parties is personally and solely liable (as regards debts owing by it) and is solely entitled to the benefit (as regards debts owed to it). Circumstances in which mutuality will not be established include, without limitation, where a party is acting as agent for another person (although mutuality may exist in respect of debts owed by and to the relevant principal) or as trustee for another person.
- 4.1.5 Rule 203 provides that each Party to an OCH Contract shall contract as a principal, and not in any other capacity, and shall accordingly be personally bound by, and entitled under, such OCH Contract.
- 4.1.6 Rule 207 further provides that the benefit of the performance by the Clearing House of its obligations under each OCH Contract is conferred upon the relevant Member as principal and upon no other person whatsoever.

- 4.1.7 Accordingly, as each Party will have entered into OCH Contracts on such basis (i.e. as principal, and not as agent or trustee), any debt owing in respect of a OCH Contract would be considered "mutual" for the purposes of Statutory Insolvency Set-Off.

Executory contracts and contingent debts

- 4.1.8 We are of the view that OCH Contracts between the Clearing House and a Member would typically be classified as either executory contracts or contingent debts.
- 4.1.9 Subject to our discussion in paragraph 4.2.7 below, debts due in respect of both executory contracts and contingent debts may and should be included in Statutory Insolvency Set-Off (but where such a contingent debt is owed *to* the Insolvent Party, only if the relevant contingency is fulfilled during the course of the winding-up).
- 4.1.10 It is not necessary for either Party to take any step to terminate any OCH Contract or even for a Member to file a proof for any amount owed to it under any OCH Contract in order for such OCH Contract to be included in Statutory Insolvency Set-Off.

Effect of Statutory Insolvency Set-Off

- 4.1.11 It follows from the above that, if the Clearing House becomes wound-up in this jurisdiction, Statutory Insolvency Set-Off would operate so that a Member would be entitled to receive or be obliged to pay only the net sum of the positive and negative mark-to-market values of the included individual OCH Contracts and/or other losses or gains referable to the OCH Contracts, subject to other qualifications set out in this opinion letter and subject also to the inclusion in any Statutory Insolvency Set-Off of other mutual debts between the Parties (including any debt owing by the Clearing House to the Member for the amount of cash margin made by a Member to the Clearing House).

4.2 Liquidation

4.2.1 Valuation

Any calculation or valuation made by a Member to determine the net amount resulting from the Statutory Insolvency Set-Off could be challenged by the liquidator of the Clearing House if it was not done fairly or in a manner consistent with applicable law. In our view, on the basis of the English cases of *Australia and New Zealand Banking Group Ltd v Société Générale* [2000] CLC 833 and *Peregrine Fixed Income Limited v Robinson Department Store Public Co Limited* [2000] CLC 1328, if the net amount was calculated on the basis of the mark-to-market values of the individual OCH Contracts and/or the loss which a Party has suffered as a result of the early termination of such OCH Contracts, and such calculation was made fairly and consistently, the net

amount calculated would likely be upheld by a Hong Kong court. However, we are not aware of any case law directly on point.

4.2.2 *Dispositions of property void*

In a winding-up of a Hong Kong Company, 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 commencement of the winding-up of that Insolvent Party is void under Section 182 of the Companies Ordinance, unless the Hong Kong court otherwise orders. Accordingly, we express no opinion as to whether or not an obligation incurred after the commencement of a winding-up of the Clearing House could properly be included in a set-off pursuant to Statutory Insolvency Set-Off. The avoidance of any obligation on this basis would not prejudice the effectiveness of the set-off of other obligations pursuant to Statutory Insolvency Set-Off.

4.2.3 *Obligations incurred after certain times*

In circumstances where a winding-up petition is presented for the winding-up of a Hong Kong Company (the Insolvent Party) and a winding-up order is ultimately made pursuant to that petition, an obligation (a "**Post-Notice Obligation**") incurred between (a) the date on which the other party (the Solvent Party) has notice of the winding-up petition and (b) the date of the winding-up order may not be included in any aggregation or 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 such Solvent Party.

However, this would not affect the aggregation or set-off of the obligations of the Parties in respect of (i) any obligation incurred before such Solvent Party had notice of the winding-up petition and (ii) any Post-Notice Obligation (looked at in isolation) giving rise to an amount owing to such Insolvent Party by such Solvent Party.

4.2.4 *Unfair preference*

Pursuant to Section 50 of the Bankruptcy Ordinance and Section 266B of the Companies Ordinance, anything done or suffered by a Hong Kong Company within a specified period ending on the date of presentation of a winding-up petition on which that Hong Kong Company is wound-up may be set aside as an unfair preference.

The specified period is: (a) in the case of an unfair preference given to a person who is an associate (as defined in the Bankruptcy Ordinance), 2 years and (b) in any other case of an unfair preference, 6 months.

The thing done or suffered will be liable to be set aside if at the time it was done or suffered that Hong Kong Company was insolvent or became insolvent in consequence of the thing done or suffered and that thing has the effect of putting any of that Hong Kong Company's creditors or a surety or guarantor of any of that Hong Kong Company's debts or other liabilities in a better position, in the event of that Hong Kong Company's winding-up, than that person would have been in if the thing had not been done. However, the court cannot make such an order if it is satisfied that the Company which gave the preference was not influenced to give it by a desire to put that person in such better position.

For the purposes of Section 50 of the Bankruptcy Ordinance, a Hong Kong Company is insolvent if it is unable to pay its debts when they fall due or if the value of its assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

4.2.5 *Extortionate credit transactions*

Pursuant to Section 264B of the Companies Ordinance, the liquidator of a Hong Kong Company may apply to set aside a transaction which occurred within three years prior to the commencement of winding up involving the provision of credit to that Hong Kong Company. 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. A court would presume, unless the contrary is proved, that such a transaction is extortionate.

Certain OCH Contracts may involve the provision of credit to the Clearing House and accordingly Section 264B of the Companies Ordinance may apply.

4.2.6 *Disclaimer of unprofitable contracts*

Section 268 of the Companies Ordinance allows the liquidator, in a winding-up of a Hong Kong Company (the Insolvent Party), to disclaim an unprofitable contract with the leave of the court. A liquidator may therefore, following the commencement of the winding-up of that Insolvent Party, seek to disclaim any contract entered into by that Insolvent Party, if the liquidator considers that contract to be an unprofitable contract. If any contract is so disclaimed, any damages or injury suffered by the other Party (the Solvent Party) as a result may be claimed by such Solvent Party as a debt in the winding-up of the Hong Kong Company.

However, any liability or obligation which was incurred by the Insolvent Party prior to the date of commencement of such winding up and which has become payable or due to be performed or discharged on or before such date will not

be affected by such disclaimer; and Section 268 of the Companies Ordinance does not entitle a liquidator to:

- (a) recover any sum paid by the Insolvent Party to the Solvent Party before the commencement of the winding-up of the Insolvent Party; or
- (b) disclaim any contract so as to determine, or release the Insolvent Party from, any liability or obligation of the Insolvent Party in respect of any amount that became due and payable by it before the commencement of its winding-up.

In addition, Section 268 of the Companies Ordinance does not entitle a liquidator of the Insolvent Party to disclaim a contract if and to the extent that Statutory Insolvency Set-Off has been effective to convert into an amount due and payable any liability or obligation which, but for the operation of Statutory Insolvency Set-Off, would have been required to be discharged or performed by the Insolvent Party at some future time.

4.2.7 *Contingent debts*

Section 34 of the Bankruptcy Ordinance provides that contingent debts owing by a Hong Kong Company in winding up (the Insolvent Party) to another person are provable and that an estimate can be made by the liquidator of the value of such contingent debts. However, these provisions do not apply to contingent debts owing to the Insolvent Party. Accordingly, if a debt to the Insolvent Party remains contingent, the fact that nothing is "due" in respect of it, whether by way of an estimate of its value or otherwise, means that it cannot be brought into account in a set-off, unless the contingency is fulfilled during the course of the winding-up proceeding. *Re Daintrey* [1900] 1 QB 546 is authority for the proposition that in such circumstances (the fulfilment of the contingency), the debt would be subject to Statutory Insolvency Set-Off. The position in *Re Daintrey* was followed by the Supreme Court of Hong Kong (as it was then known) in *William Young v Bank of Credit and Commerce (in liquidation)* [1993] HKCU 346.

4.3 **Other Insolvency Issues**

- 4.3.1 The Hong Kong courts may, in some circumstances, stay Insolvency Proceedings where they are of the opinion 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.

However, we consider it is likely that the Hong Kong courts would not stay Insolvency Proceedings in respect of the Clearing House in favour of another forum.

4.3.2 For the purpose of proving a claim in a winding up by the Hong Kong courts, the claim must be expressed in Hong Kong dollars and, to the extent that any amounts are not denominated in Hong Kong dollars, they will 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 order is made or, where no such rates are quoted, at an exchange rate determined by the Hong Kong courts.

4.4 **Disposition to defraud creditors**

Under Section 60 of the Conveyancing and Property Ordinance, any disposition (for example, entering into and performing an OCH Contract) by a Hong Kong Company made with the intention to defraud creditors may be set aside (where such fraudulent intention is proved by the person seeking to set aside the disposition). However, Section 60 does not affect the operation of the Bankruptcy Ordinance and the Companies Ordinance in respect of those provisions for the time being in force under which OCH Contracts may be avoided for the protection of creditors upon the Hong Kong Company's winding-up.

4.5 **Schemes of Arrangement**

It is possible that the Clearing House may be the subject of a scheme of arrangement pursuant to the Companies Ordinance. The courts will not sanction a scheme of arrangement unless reasonable efforts were made to notify those creditors whose rights would be affected by the scheme of the meeting to approve that scheme. Approval at the creditors' meeting of the terms of a scheme of arrangement does not require unanimity of the affected creditors, whether or not present at the meeting. Such a scheme of arrangement could affect both set-off rights of creditors and the amount of claims which the creditors may have against the Clearing House.

4.6 **House and Client Contracts**

4.6.1 It may be argued that debts owing in respect of OCH Contracts which a Member had entered into for its own proprietary account ("**House Contracts**") may not be "mutual" with debts owing in respect OCH Contracts which a Member had entered into the account of any client ("**Client Contracts**"), on the basis that the Member was transacting in a different "capacity" in relation to House Contracts and Client Contracts respectively. If this were the case, then it might result in multiple Statutory Insolvency Set-Offs: one in respect of House Contracts only, and a separate set-off in respect of Client Contracts with each client of the Member.

4.6.2 We do not believe this to be correct because, as mentioned earlier, "mutuality" for the purpose of Statutory Insolvency Set-Off is determined solely by reference to whether each of the Parties is personally and solely liable as regards debts owing by it and is solely entitled to the benefit of debts owed to it. In the case of both House Contracts and Client Contracts, as the Member transacts as principal, and not as agent or trustee, the Member is personally

and solely liable as regards debts owing in respect of both types of OCH Contracts and is solely entitled to the benefit of debts owing in respect of both types of OCH Contracts. However, we cannot discount the possibility that a Hong Kong court may make a distinction between these two types of OCH Contracts on the basis of the commercial intent or long-standing usage, particularly if a refusal to make such distinction would result in significant losses to a broad number of clients of Members and/or the wider investing public.

4.7 **Securities and Futures Ordinance**

- 4.7.1 Section 38 of the Securities and Futures Ordinance provides that it shall be the duty of the Clearing House to ensure:
- (a) so far as reasonably practicable, that there are orderly, fair and expeditious clearing and settlement arrangements for any transactions in securities or futures contracts cleared or settled through its facilities; and
 - (b) that risks associated with its business and operations are managed prudently.
- 4.7.2 Section 39 of the Securities and Futures Ordinance provides that no civil liability, whether arising in contract, tort, defamation, equity or otherwise, shall be incurred by the Clearing House in respect of anything done or omitted to be done in good faith in the discharge or purported discharge of the duties of the Clearing House under Section 38.
- 4.7.3 Section 45 of the Securities and Futures Ordinance provides that none of the following shall 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:
- (a) a market contract;
 - (b) the rules of a recognized clearing house relating to the settlement of a market contract;
 - (c) any proceedings or other action taken under the rules of a recognized clearing house relating to the settlement of a market contract;
 - (d) a market charge;
 - (e) the default rules of a recognized clearing house; or
 - (f) any default proceedings.

- 4.7.4 The Clearing House Documentation does not expressly state the consequences of an Insolvency Proceeding in relation to the Clearing House. (The "default rules" referred to in Section 45 refer to rules providing for the taking of proceedings or other action following a default of a *Member* – not the Clearing House). Accordingly, it is unclear what, if any, step the Clearing House might take in the event of its own insolvency.
- 4.7.5 It is possible that, in the event of its own insolvency, the Clearing House might:
- (a) close out all OCH Contracts between it and a Member and set off the positive mark-to-market values against the negative mark-to-market values of each such OCH Contracts;
 - (b) close out all OCH Contracts between it and a Member but set off the mark-to-market values of only some but not all such OCH Contracts (for example, the Clearing House might exercise set off in respect of OCH Contracts between it and a Member that had been entered into for the Member's proprietary account, but not in respect of OCH Contracts between it and a Member that had been entered into for the Member's clients);
 - (c) close out some, but not all, OCH Contracts between it and a Member; or
 - (d) not close out any OCH Contract between it and a Member or not set off the market-to-market values of any closed-out OCH Contracts.
- 4.7.6 However, any action taken by the Clearing House upon its own insolvency would not be an action taken under the rules of a recognized clearing house or an action prescribed by the rules or default rules of a recognized clearing house. Accordingly, any such action would not benefit from the provisions of Section 45 of the Securities and Futures Ordinance and would be invalidated if it contravened or infringed a mandatory rule of insolvency law, including Statutory Insolvency Set-off pursuant to Section 35 of the Bankruptcy Ordinance.
- 4.7.7 In our view, the possible courses of action described in sub-paragraphs (b) to (d) of paragraph 4.7.5 above would be inconsistent with Statutory Insolvency Set-off because they do not provide for the set-off of *all* "mutual credits, mutual debts or other mutual dealings" between the Parties and they would accordingly be invalidated on the date of the winding-up order. However, the course of action referred to in sub-paragraph (a) of paragraph 4.7.5 above would, if it were implemented on the date of the winding-up order, and subject also to the inclusion of other mutual obligations between the Parties, operate to produce the same net amount that would have been produced if set-off had been implemented under Statutory Insolvency Set-Off. Accordingly, only the

action referred to in sub-paragraph (a) would be effective on the winding-up of the Clearing House.

- 4.7.8 It may be argued that any action taken by the Clearing House would be in good faith in the discharge or purported discharge of the duties of the Clearing House under Section 38 of the Securities and Futures Ordinance, and would accordingly benefit from the immunity under Section 39 of the same ordinance. However, we believe Section 39 does not have the effect of overriding a mandatory rule of insolvency law and, in any event, set-off is a self-help remedy which does not involve the imposition by a Hong Kong court of any civil liability on the Clearing House.

4.8 Non-cash Collateral

- 4.8.1 Paragraph 7.2 (*Securities Collateral*) of the Procedures provides that Non-cash Collateral margin provided by a Member to the Clearing House shall be credited to a CCMS Collateral Account for that Member. However, the Rules and the Procedures are silent as to whether the Clearing House must ensure that such Non-cash Collateral must be operationally segregated from assets that belong beneficially to the Clearing House.
- 4.8.2 Following the Court of First Instance decision in *Re CA Pacific Finance Limited* [1999] 2 HKC 632, the generally accepted view is that it is possible to have equitable proprietary interests in fungible securities that are held on an unallocated basis (i.e. held in the same account as securities that belong beneficially to the custodian), *provided that* the custodian keeps accurate and reliable records of the quantity of the securities that belong to a particular client. Accordingly, if the records maintained by the Clearing House are unclear as to whether the securities held by the Clearing House are held for the Clearing House beneficially or for the Members, the property rights of the Member in the Non-cash Collateral may be lost.
- 4.8.3 Any securities comprised in the Non-cash Collateral may be subject to corporate events which may affect rights to hold or transfer such securities. We express no opinion as to the ability of a Member to recover any Non-cash Collateral which is subject to any such event while in the possession or control of the Clearing House.
- 4.8.4 If any securities comprised in the Non-cash Collateral are situated outside Hong Kong, the Hong Kong courts may take into account the law of the place where such securities are situated. Accordingly, the ability of the Member to recover any Non-cash Collateral may be determined by a system, or systems, of law other than the laws of this jurisdiction.

4.9 Qualifications Relating to special provisions of law

The list of special provisions at paragraph 3.2 is not an exhaustive list of all Hong Kong laws that may apply to OCH Contracts, their interpretation and enforcement

(which, among other things, shall be subject to general principles of Hong Kong contract law and laws particular to individual Members).

4.10 General

4.10.1 We understand that the Securities and Futures Ordinance and the Bankruptcy Ordinance are currently being reviewed and may be amended. However, we are not aware of any timetable having been set for any amendments to the Securities and Futures Ordinance or the Bankruptcy Ordinance to come into force. In addition, a Companies Bill was published in the Hong Kong Gazette on 14 January 2011 and was passed by the Hong Kong Legislative Council on 12 July 2012: the Hong Kong Government has announced that it is expected to come into force in 2014. This opinion letter makes no reference to any proposed changes to any of these Ordinances.

4.10.2 This opinion is 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 sanctions or other similar measures apply.

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

This opinion is given for the sole benefit of the Futures and Options Association and such of its members (excluding associate members) as subscribe to the Futures and Options Association's opinions library (and whose terms of subscription give them access to this opinion). This opinion may not be relied upon by any other person unless we otherwise specifically agree with that person in writing, although we consent to it being shown to such Futures and Options Association members' affiliates (being members of such persons' groups, as defined by the UK Financial Services and Markets Act 2000) and to any competent authority supervising such member firms and their affiliates in connection with their compliance with their obligations under prudential regulation.

Yours faithfully

