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SECURITIES AND EXCHANGE COMMISSION
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Market Regulation Department

SEC-MRD Opinion No. 2
Series of 2008

October 8, 2008

THE HONGKONG AND SHANGHAI BANK CORP.
HSBC Centre
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Bonifacio Global City, Taguig City
Fax: 581-8181

Attention: Atty. Jose German Licup, SVP, Legal & Compliance

SUBJECT: Delivery versus Payment (DVP)

Gentlemen:

This refers to your request for opinion on the issue whether or not the settlement procedures of your bank with qualified institutional buyers (QIBs) with regard to your government securities transactions achieve delivery versus payment (DVP), and hence compliant with SEC Memorandum Circular No. 14, series of 2006, otherwise known as the Rules Governing the Over-the-Counter (OTC) Market.

In particular, you cited Section 20 (B) of the OTC Rules which requires that "the clearing and settlement arrangement in the exchange of assets subject of the trade shall be delivery versus payment (DVP) scheme".

In reply, herein below is our response to your query:

This is not the first time our office is addressing this issue. In *SEC-MRD Opinion No.1 dated 28 July 2008*, we described the different approaches of achieving DVP in securities transactions. We also discussed extensively the different settlement systems in the domestic equities and fixed income markets.

The process of clearing and settling securities trade includes several key steps. *First*, the confirmation of the terms of trade by the market participants. *Second*, the calculation of the obligations of the counterparties resulting from the confirmation process which is known as clearance. *Third*, the final transfer of securities (delivery) in exchange for the final transfer of funds (payment) in order to settle the obligations which is known as settlement.

A DVP system is a securities settlement system that provides a mechanism that ensures that delivery occurs if and only if payment occurs. It is a procedure by which the buyer's payment for securities is due at the time of delivery. The purpose of DVP system is to ensure that counterparties are not exposed to principal risk, that is, the risk that the seller of a security could deliver but not receive payment or that the buyer of a security could make payment but not receive delivery. *[CPSS, Delivery Versus Payment in Securities Settlement Systems (BIS, September 1992)]*

Strictly speaking, DVP does not require simultaneous final transfers of funds and securities. When a central securities depository does not itself provide cash accounts for settlement, it first blocks the underlying securities in the account of the seller or his custodian. It then requests transfer of funds from the buyer to the seller in the settlement bank. The securities are delivered to the buyer or his custodian if and only if the central securities depository receives confirmation of settlement of the cash leg from the settlement bank. *[CPSS, Recommendations For Securities Settlement Systems (BIS, November 2001)]*

In your request, you seek confirmation that the settlement procedures by your bank relative to your GS transactions with QIB clients achieve DVP. Based on your letter and manual of procedures, your bank's settlement procedures can be described in general as follows:

For transactions where the bank sells GS, sell trades concluded between the HSBC's Treasury front-office and QIB representative are recorded in HSBC Treasury Trading System (TREATS) and concurrently reported via the PDEX FI terminal. Payment settlement of the transaction on settlement date can be through any of the following methods: (1) cash payment via debit of the cash settlement amount against the counterparty's deposit account with HSBC funded either by existing balances or by credit of remittance received through Real Time Gross Settlement (RTGS); or (2) check payment via earmarking of the cash settlement amount against existing Effects Not Cleared (ENC) credit facility granted by HSBC to the counterparty.

In both of the above instances, pending settlement of the securities leg of the transaction, the cash settlement amount is **earmarked** and exclusively held for settlement of the transaction, using the hold maintenance function of the HSBC Universal Banking (HUB) Front End system (HFE). It is only when the securities sold are ready for transfer in the Bureau of the Treasury's (BTr) Register of Scripless Securities (RoSS), from the bank's RoSS account to the QIB's RoSS account or that of its third party custodian, pursuant to the confirmation received by HSBC from the BTr RoSS that the transaction has been posted in the RoSS, is the **earmarking lifted** and the funds so earmarked are debited from the account of the counterparty and received by HSBC as payment for the securities.

In the event that the securities settlement fails for any reason: (a) the earmarking against the counterparty's deposit account is **lifted** and the funds so earmarked become available for the counterparty's disposal/use, or (b) the check payment is returned to the counterparty and the earmarking of the ENC line is lifted.

For transactions where the bank buys GS, buy trades concluded between the HSBC's Treasury front-office and QIB representative are recorded in TREATS and concurrently reported via the PDEX FI terminal. Payment settlement by the Bank of the transaction on settlement date can be through any of the following methods: (1) cash payment by the bank via credit of the cash settlement amount into the counterparty's deposit account with HSBC; or (2) remittance of payment via RTGS to the counterparty's bank other than HSBC.

In the case of payment via credit to the counterparty's deposit account with HSBC, pending settlement of the securities leg of the transaction, the cash settlement amount is **earmarked** in favor of the counterparty and exclusively held for settlement of the transaction, using the HFE hold maintenance function. In the case of payment via RTGS, payment is earmarked by temporarily crediting the counterparty's deposit account with HSBC pending settlement of the securities leg of the transaction. Clients who do not have existing deposit accounts with the bank will be required to open an account for settlement purposes prior to trading. This will be documented with a client agreement.

It is only when the securities sold are ready for transfer in the BTr RoSS, from the QIB's or its custodian's RoSS account to the HSBC's RoSS account based on the confirmation received by HSBC from BTr RoSS, is the earmarking lifted and the funds become freely available for the disposition of the counterparty. In the case of RTGS payment, the freely available funds are debited from the counterparty's deposit account with HSBC and then sent to the counterparty's designated bank, other than HSBC, as payment for the securities.

In the unlikely event that the securities settlement fails for any reason: (a) the earmarking against the client's deposit account is lifted and the funds so earmarked are debited, or (b) the RTGS remittance instruction is cancelled, and the funds revert to the bank.

Under the above transactions, whether buy or sell, settlement will be done on a per deal basis and will not involve netting or off-setting of transactions.

These procedures and safeguards ensure that each transfer of securities is effected only when payment occurs or assured within the settlement cycle. As earlier mentioned, DVP does not require simultaneous final transfers of funds and securities. It is essential though that the securities are delivered to the buyer or his custodian if and only if it is confirmed that the cash aspect of the transaction is paid. Thus, in our view, **the settlement arrangements described in your letter and manual of procedures achieve DVP.**

It is understood though that the foregoing opinion is rendered based solely on the facts you disclosed and described in the query and relevant solely to the particular issue raised therein and shall not be used in the nature of a standing rule binding upon the Commission in other cases whether of similar or dissimilar circumstances. *[SEC Memorandum Circular No. 15 (2003)]*

Finally, you are directed that the detailed manual of procedures for GS transactions with QIBs be made part of your records and that the same shall be disclosed to your counterparties and form part of the client agreement.

For your guidance.

Very truly yours,

VICENTE GRACIANO P. FELIZMENIO JR.
Officer in Charge

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