In Focus 2: **Regulatory Changes in Application of the Principle of Finality**

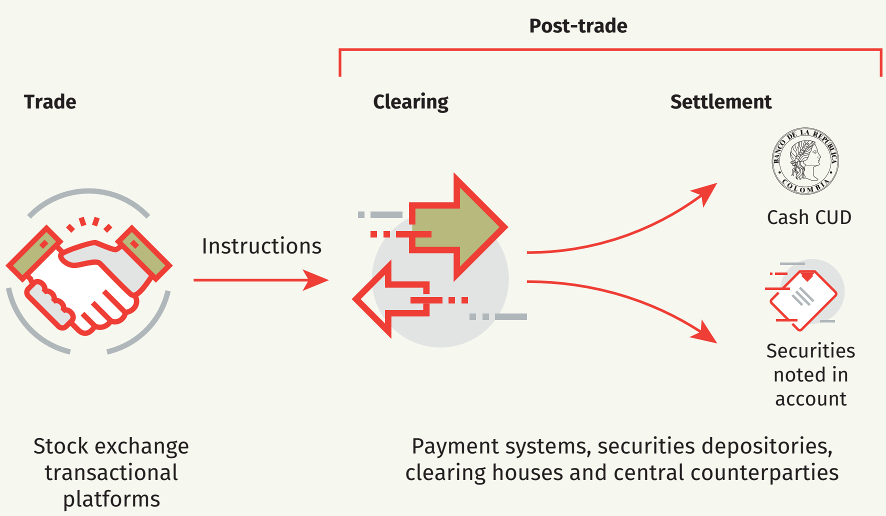
This section offers a formal definition of the principle of finality and details its application in international markets and in the local market. It is a continuation of a publication on the subject released in 2018,[1] and includes the regulatory updates made in Colombia due to modification of the principle.

Finality is framed by the context of the definition of the life cycle of a transaction, which starts with trade or negotiation (instruction or order to buy or sell), continues with clearing (calculation of the obligations of each of the participants) and ends with settlement (receipt or delivery of the traded asset).

Specifically, this cycle begins with the trading or recording of securities on stock exchanges and transactional platforms [2] and then continues in financial market infrastructures (FMIs): clearing and settlement (post-trade) in payment systems, securities depositories, clearing houses and central counterparties (Diagram A).

To ensure post-trade operations are normal and safe, FMIs have several tools to manage risks. The principle of finality is one of them. It defines the moment as of which orders for the transfer of securities and cash may not be revoked.

Diagram A
Cycle of Operations and Financial Market Infrastructures



Source: *Banco de la República.*

1 See "The Concept of Finality and It's Application in an International Example," in the 2018 edition of the Payment Systems Report.

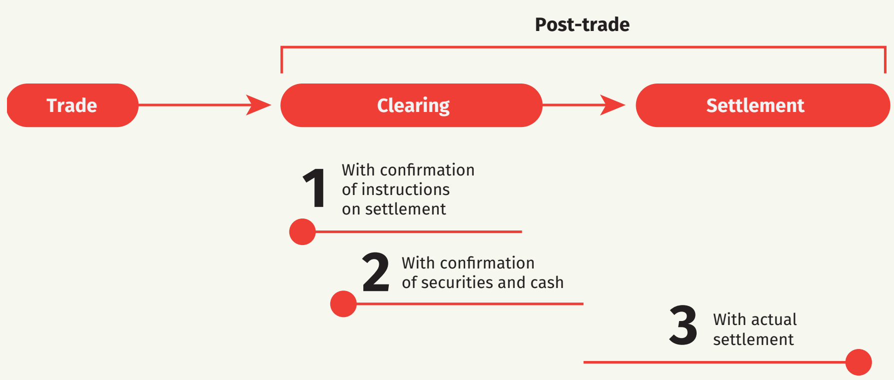
2 This refers to systems authorized by the Office of the Superintendent of Financial Institutions in Colombia that offer their participants securities trading and recording of transactions.

This tool provides protection for orders on the purchase and sale of securities from the moment they are considered firm and binding up to the time they are settled. Should judicial or administrative action be taken against a participant, using this tool does not prejudice or prevent completion of the transactions the participant may have pending in the system.

The finality principle provides a legal basis for protecting trades (i.e., those arising from judicial decisions against a participant) and mitigating systemic risk. Revoking a participant's trades between the start and the end of post-trading could pose significant credit and liquidity risks to participants and the FMI and would have detrimental consequences for the markets served by the infrastructure and, thus, for the economy as a whole.[3]

There are several points in time during the course of a transaction when finality can be set: 1) when settlement instructions on the trade are received and confirmed, 2) when clearing or settlement is initiated (securities and cash adequacy is checked) or 3) when an actual settlement is made (change ownership of assets in the securities depository and transfer of money in the large-value payment system) (Diagram B).

Diagram B
Times When the Principle of Finality is Applied



Source: *Banco de la República.*

In international markets, there is no universal rule on the timing of the application of the finality principle during the post-trade cycle. In general, the timing of finality depends on the functioning of the markets in each jurisdiction, the settlement cycle, the liquidity-saving mechanisms of the systems, and the rules institutions have on intervention and settlement, among other factors.

When reviewing the post-trading process for securities in central securities depositories in some countries, it was found that finality is set when a transaction is settled. This largely responds to the need jurisdictions have for a moment of irrevocability for intraday transactions in the system (without other legal protection). However, if finality is fixed at the time of actual settlement, the benefit of protection will be reduced if the orders are irrevocable only until they are settled completely, leaving pending transactions entered into the system possibly subject to the effects of court decisions.

3 See "Principle 8: Settlement Finality," in CPSS-Iosco (2012). Principles Applicable to Financial Market Infrastructures, April.

For example, if an institution participating in the clearing and settlement system is taken over to be liquidated, it will be subject to the decisions of a settlement agent, which could decide not to meet the institution's pending obligations in the system. This could generate a cascade of defaults in the operations of the other participating institutions and would consequently generate a system risk (as mentioned above).

Therefore, the conclusion is that the moment of finality that offers the most protection against systemic risk is finality upon confirmation of instructions received from the trading systems on the settlement of transactions.

In Colombia, the principle of finality is regulated in the Securities Act (Law 964 of 2005) and in a unitary financial decree (Decree 2555 of 2010). Article 10 of the law states that securities transactions shall be final (firm, irrevocable, enforceable, and liable to third parties) upon acceptance in clearing and settlement systems. Moreover, in an accepted operation, the securities and the respective funds involved may not be subject to judicial or administrative measures that seek to prohibit, suspend or in any way limit the payments to be made in the system.

Therefore, in Colombia, acceptance in clearing and settlement systems is regarded as the moment a transaction comes to be protected under the principle of finality.

The unitary financial decree, in this sense, initially defined[4] a transaction as accepted after having complied with the requirements and risk controls established in the regulations on the clearing and settlement system. It also differentiated the moment of acceptance in gross and net settlement systems. For the former, acceptance was given after verifying the existence of balances and making the respective accounting entries (up to settlement). For net settlement systems, the moment of acceptance occurred after verification of securities and cash (moment of finality prior to settlement).

Accordingly, acceptance after verification of collateral and compliance with transaction limits (prior to settlement) was recognized in the regulations of the Central Counterparty Risk of Colombia (CRCC).

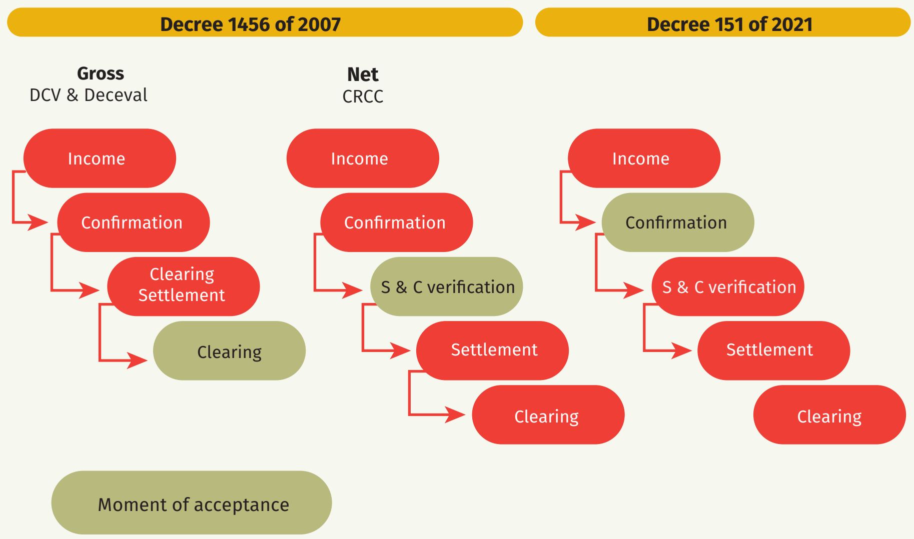
The decree maintained this differentiation between gross and net settlement systems until 2021, when it was eliminated by Decree 151, and the moment of acceptance of transactions was modified from "when they have complied with the requirements and risk controls established in the system's regulations" to "when they have been entered into the system and confirmed by the participants". This change in the moment of acceptance, as also mentioned in the decree, must be incorporated into the regulations and operating manuals of the infrastructures (Diagram C).

It represents recognition of the importance of establishing the moment of acceptance (finality) of transactions at the beginning of the post-trade cycle, minimizing the possibility of settlement risk and reflecting the main objective of the recommendations regarding the purpose of the principles for FMIs: "One of the key risks an FMI faces is settlement risk, which is the risk that settlement will not occur as planned" (see CPSS-Iosco, 2012: op. cit.).

4 Incorporating the provisions of Decree 1456 of 2007.

Therefore, according to the provisions in Decree 151 of 2021, it is now up to the local securities depositories (systems that use clearing and gross settlement) to modify their regulations and to the Office of the Superintendent of Financial Institutions in Colombia to accept them, so as to maintain the spirit of the moment of acceptance indicated in the regulation.

Diagram C
Principle of Finality in Colombia



Source: *Banco de la República.*