AN EFFECTIVE RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

SECOND CONSULTATION PAPER

SUBMISSIONS

The Law Society has reviewed the Second Consultation Paper on an Effective Resolution Regime for Financial Institutions in Hong Kong ("Second Consultation Paper"). The Second Consultation is jointly published by the Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority and was released on 21 January 2015.

The Law Society provides the following responses to the consultation questions, using the same set of definitions and abbreviations in the Second Consultation Paper. The abbreviations appearing in this Submission below are those adopted in the Second Consultation Paper, and are set out in Appendix 1 to this Submission. Where further abbreviations are required, they are identified in the submissions itself.

Question 1

Do you agree with the revised scope of the regime in respect of LCs as set out in paragraph 29?

Law Society's Response:

1. We consider the "subsets" approach to be the most appropriate. Inclusion of any NBNI G-SIFI LC seems clearly correct for the sake of completeness. LCs which are subsidiaries or branches of groups which are identified as being (or containing) G-SIFIs need to be included within the regime to enable a more holistic approach to be adopted in relation to major financial services groups. We agree there is no need to extend the scope to LCs that are part of wider financial services groups other than those that are branches or subsidiaries of groups which are identified as being (or containing) G-SIFIs.

Question 2

Do you have any views on the factors that should be taken into account when assessing the local systemic importance of insurers?

Law Society's Response:

2. We consider that the internationally agreed "Global Systemically Important Insurers: Initial Assessment Methodology" can be adopted to determine whether an insurer (which is not a G-SII or a subsidiary or branch of a G-SII) is systemically significant or critical locally on failure, subject to the following observations: (a) non-traditional insurance products and non-insurance activities are more prevalent in the life insurance markets and may indicate a higher degree of correlated risk (traditional risk is not typically correlated) so that greater consideration of this factor may be needed for insurance companies that carry on life business; and (b) though interconnectedness is clearly a systemically important factor, in determining whether an insurer (or subsidiary or branch) is systemically significant or locally critical on failure, substitutability of an insurer (typically a non-life insurer) in relevant jurisdictions should be given greater importance - it is therefore suggested that the weighting of substitutability be given a higher weighting than 5%, with a corresponding reduction in the weighting of interconnectedness.

Question 3

With a view to ensuring that all FIs which could be critical or systemic on failure are within scope of the regime, and recognising that the risks posed by any given types of FI may change over time, do you agree that providing the FS with a power to designate additional FIs as being within scope is appropriate?

Law Society's Response:

3. We agree with the principle that as the market evolves other types of FI or parts of FI groups may need to be brought within the regime. Having said that, we consider that such changed circumstances are unlikely to arise overnight and, to the extent that any FI types are identified as potentially critical or systemic on failure and need to be covered by the regime, we consider that the authorities should ensure that any such proposed designation is put to the market for consultation as early as possible to ensure a measured and consistent approach is maintained, and so avoiding any potential for what may be seen as arbitrary or precipitous action, given the implications and potential consequences.

Question 4

Do you agree that in cases where one or more FIs within scope of the regime are part of mixed activity groups, the presumption should be that resolution will be undertaken at the level of a locally incorporated FSHC? And that resolution at the level of a locally incorporated MAHC would be undertaken only in exceptional circumstances where orderly resolution cannot otherwise be achieved?

Law Society's Response:

4. We agree with the presumption. It would be potentially highly de-stabilising for any financial sector problems to be automatically allowed to "bleed" into non-financial sectors of a group. This is however very much an issue that needs to be addressed in relation to individual groups at the time of preparing resolution strategies to ensure that the issue is given due emphasis in relation to how the group is structured overall in terms of its resolution planning. As for a locally incorporated MAHC, it is important to gain more clarity as to what would be regarded as "exceptional circumstances" in this type of context. It is a welcome result that the restructuring of groups will not be required as a matter of course and will be able to be debated by FI as and when the issue arises with regulators.

Question 5

Do you agree with the proposed definition of, and approach to, setting the regime's scope in respect of, AOEs?

Law Society's Response:

5. Operational continuity is a crucial element of any successful resolution of an in-scope FI.

6. The authorities propose to define an *affiliated operational entity* (**AOE**) as ***a locally incorporated entity that is, or but for the exercise of a resolution power would be, in the same group as an FI (or FIs) and which provides a service (or a series of services) to that FI (or FIs) which is (or are collectively material) to the continuity of essential services and functions provided by the FI (or FIs).*** [Our proposed modifications are underlined] We consider that the definition needs to be tied directly to the criticality of the services and functions of the FI (or FIs) and require the services, etc. to be material to the provision of those services and functions. We appreciate that in times of trouble the lines can become blurred, but it is important to ensure that the overall principle is locked into the regime (especially given the discussions in CP2 regarding appeals mechanisms).

7. We agree that it should be possible to use resolution powers available under the regime in relation to an AOE (or AOEs), but only where: (i) one or more FIs in the same group are to be resolved; and (ii) using powers in relation to the AOE(s) is justified to secure operational continuity and achieve the orderly resolution of the affiliated FI (or FIs).

8. We note that an additional layer of continuity provisions is contemplated in the resolution regime under paragraphs 153-157 of CP2, being the ability of the resolution authorities to require continued provision of essential services and functions by the relevant AOE and to source such services and functions from third parties. We would expect these powers to be the first port of call for the resolution authorities, with the deployment of resolution powers directly against an AOE as only to be used where it is clear that the mere direction of continuity will not suffice.

9. We note that further consideration will be given to the potential interaction between restructuring and insolvency arrangements and the resolution regime. That is clearly necessary, and will require on the face of it the blocking of insolvency action in respect of AOEs to the extent that it could either prevent or delay resolution action to preserve the continuity of essential functions or services. That would on the face of it require advance notice to be given to the resolution authorities in the event of intended insolvency action concerning an FI group member. Given the nature of FI groups, that could prove to be challenging to administer. Such provisions would also give rise to considerations concerning compensation.

Question 6

Do you have views on how AOEs might be more precisely defined, without restricting the resolution authority's ability to achieve orderly resolution of an affiliated FI?

Law Society's Response:

10. Please note our response to Question 5.

Question 7

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to recognized exchange companies that are considered systemically important to the effective functioning of the Hong Kong financial market?

Law Society's Response:

11. We agree that it would be appropriate to extend the scope of the proposed

resolution regime to recognized exchange companies that are considered systemically important to the effective functioning of the Hong Kong financial market. We note that the current recognized exchange companies and recognized clearing houses are all owned and operated by Hong Kong Exchanges and Clearing Limited (which owns the London Metal Exchange as well). In view of the current market structure, we consider that the relevant resolution regimes and proposals regarding holding companies and affiliated operational entities should also be applicable to recognized exchange companies as well.

Question 8

Do you agree with the factors to be taken into consideration in designation of systemically important recognized exchange companies set out above? Do you have suggestions as to what other factors should also be taken into consideration?

Law Society's Response:

12. We agree with the factors to be taken into consideration in designation of systemically important recognized exchange companies set out in paragraph 58 of CP2.

13. In relation to the last factor proposed in paragraph 58 (i.e., any other factors that the SFC deems appropriate), as circumstances may change over time, to the extent that the SFC identifies any additional factors for determining whether a recognized exchange company is, or is likely become, systemically important, we would expect that the SFC would inform the market for the sake of clarity, and if necessary, conduct public consultations as soon as possible to ensure a measured and consistent approach is maintained, and to avoid any potential for what may be seen as arbitrary or precipitous action, given the implications and potential consequences.

Question 9

Do you have any views on whether it is necessary to introduce an additional resolution objective in respect of the protection of client assets considering the policy intention behind the drafting of resolution objective (ii) in paragraph 63?

Law Society's Response:

14. According to the preamble to the Key Attributes, an effective resolution regime should, inter alia, protect, where applicable and, in coordination with the relevant insurance schemes and arrangements, such depositors, insurance policy holders and investors as are covered by such schemes and arrangements,

and ensure the rapid return of segregated client assets.

15. We consider that the introduction of an additional resolution objective in respect of protection of client assets is necessary for the avoidance of any doubt, given that this is one of the essential features of a resolution regime as suggested in the Key Attributes. It is also in line with the Key Attributes for the local regime to cover those client assets which are subject to protection under the applicable laws or regulations in Hong Kong.

Question 10

Do you agree that an LRA should be designated for each cross-sector financial group containing "in scope" FIs by the FS once the legislation establishing the regime has passed?

Law Society's Response:

16. Yes.

Question 11

Do you agree that the designation of the LRA should be based upon the resolution authorities' assessment of the relative systemic importance of the individual 'in scope' FIs within a cross-sector financial group and that the resolution authority of the FI assessed to pose the greatest systemic risk be designated as the LRA for that group?

Law Society's Response:

17. Yes.

Question 12

Do you agree that the role of the LRA should be one of coordination and, when required, ultimate decision-maker?

Law Society's Response:

18. Yes.

Question 13

Do you agree that the proposals for providing temporary DPS cover should reduce the incentives for transferred depositors to withdraw excess balances immediately on completion of a business transfer in resolution?

Law Society's Response:

19. Yes.

Question 14

Do you have any views on the steps and processes, outlined in paragraphs 104 to 106, with a view to making the bail-in process operational?

Law Society's Response:

20. The Bank of England's approach to executing a bail-in, as outlined in its October 2014 paper, should provide a workable framework for the resolution regime in Hong Kong. Careful thoughts should be given to the steps and processes required for each of the stages of a bail-in to ensure efficiency as well as legal certainty, from the run up to a resolution through the preliminary valuation/detailed valuation stage to the announcement of final bail-in terms and the post bail-in restructuring stage. With regard to legal certainty, the legislation establishing the regime should provide the resolution authority with the power to create instruments capable of giving legal effect to the steps taken during a bail-in. We would also welcome clarification on how a bail-in of a branch of an overseas-incorporated FI would work.

21. The legislation for the regime should also provide for: (i) a mechanism for the transfer of the instruments (with their legal title) identified as within scope of the bail-in, to be held on trust; (ii) a process for former bondholders/other creditors to make their claim for shares following the announcement of the final terms of the bail-in, and for the resolution authority or resolution manager (if any is appointed) to assess and manage such claims; (iii) a process and timeline for the distribution of the "certificates of entitlement" and the eventual shares; and (iv) requirements for a business reorganisation plan, to be prepared either by the resolution manager or the failing FI's management. Considering the extended time that the distribution of shares is likely to take, effective management of this process would be key.

22. Since the conversion into and distribution of shares may trigger the general offer obligation under the Takeovers Code and/or the shareholders' approval requirement under the Listing Rules (in the case of a listed failing FI) and/or

"change in control" approval requirements under the sectorial legislation, time for obtaining waiver or approval should be factored into the timeline of the process. Please also see our response to Question 49.

Question 15

Do you have views on the scope of the bail-in power within the resolution regime and specifically on (i) the list of liabilities identified in paragraph 108 which would always be excluded from bail-in and (ii) the grounds for excluding further liabilities from any bail-in on a case-by-case basis as identified in paragraph 110?

Law Society's Response:

23. The list of excluded liabilities is largely in line with the UK Banking Act 2013 and the BRRD, and should ensure that the resolution objectives can be met. However clarification from the authorities on certain issues would be welcome, including that:

    (i) these liabilities will be excluded regardless of whether they are governed by Hong Kong law or the law of a foreign jurisdiction (in line with the BRRD requirement);

    (ii) "deposits protected by the DPS" exclude any deposits which exceed the coverage level under the DPS;

    (iii) derivatives positions cleared through a CCP are covered by the exclusion under paragraphs 108 (iii) and 108 (viii); and

    (iv) paragraph 108 (viii) covers liabilities under market contracts.

24. We also query:

    (i) under the UK Banking Act 2013, "protected deposit" is defined to include not only a deposit which is covered by the local Financial Services Compensation Scheme, but also a deposit covered by a scheme which operates outside the UK and which is comparable to the Financial Services Compensation Scheme. Should the liabilities excluded from bail-in under the Hong Kong regime be extended to cover deposits with the failing bank that are protected by overseas schemes which are similar to the DPS?

    (ii) how will partially secured liabilities be treated?

    (iii) why are client assets included in the list of excluded liabilities, considering that the holding of assets on trust would not generate a

creditor/debtor relationship hence client assets cannot be bailed-in in any event? This risks causing confusion.

25. Terms such as "employees", "pension benefits", "payments, clearing and securities settlement systems" and "client assets" also need to be defined, although the reference to the SFO definition of "client assets" in paragraph 108 of CP2 is noted.

26. Regarding the indication from the authorities that the list of excluded liabilities will be further refined, we would welcome the opportunity to comment on any proposed modification during the next stage of public consultation. In relation to amendments to the list of excluded liabilities after the legislation for the regime has come into effect, it is suggested that an approach similar to that of the UK Banking Act 2013 should be adopted i.e. certain liabilities will always be excluded from bail-in (i.e. shall never be removed from the list), such as the ones listed in paragraph 108(i) – (iii) of CP2, in order to provide a high degree of reassurance to retail depositors and secured creditors.

27. We agree in general with the proposed grounds for excluding further liabilities on a case-by-case basis.

Question 16

Do you have views on how the list of excluded liabilities in paragraph 108 should be expanded to ensure that the bail-in option is suitable for use with FIs other than banks, and specifically in relation to insurers, FMIs and NBNI FIs?

Law Society's Response:

28. Regarding non-bank FIs such as insurers, FMIs and NBNI FIs, the question remains whether the bail-in option is suitable for their resolution, due to the different types of business activities that non-bank FIs engage in (as compared to banks), as well as the nature of non-bank FIs' assets and liabilities. It is noted that in the 2014 FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, the guidance on choice of resolution powers for insurers (under Annex II) does not include the use of bail-in. Further, in the main text of the Key Attributes, the guidance on the resolution of insurers is that resolution authorities should also have powers to: (i) undertake a portfolio transfer; and (ii) discontinue the writing of new business while continuing to administer existing contractual policy obligations for inforce business. On the other hand, the FSB has recognised in the Key Attributes that bail-in is one of the powers that authorities might rely on in the resolution of an FMI.

29. If the authorities consider bail-in as a suitable resolution tool for non-bank FIs, they should, in determining the types of liabilities to be excluded from bail-in, ensure that the sector specificities of non-bank FIs (for example, the financing

conditions of the insurance business model and the timeframes warranted for insurance contracts and derivative contracts). The ultimate question to ask would be where should different stakeholders be positioned in the creditor hierarchy in the event of a bail-in, so that those who require the most protection from financial loss (for example, individual insurance policyholders, certain participants of FMIs, and retail clients of licensed corporations and their assets) would be afforded the protection that they require.

Question 17

Do you have views on the proposed approach to bail-in of liabilities arising from derivatives as outlined in paragraph 111?

Law Society's Response:

30. We agree with keeping derivatives generally within scope of any bail-in, while recognising that certain derivatives would readily be excluded from bail-in by virtue of falling within one of the categories under paragraph 108 of CP2. We would welcome confirmation from the authorities that only net liability of an FI to a counterparty should be potentially bailed-in. The authorities should consider whether to introduce provisions similar to those under the BRRD, which provide that where derivative transactions are subject to a netting agreement, the resolution authority (or an independent valuer) shall determine as part of the valuation the liability arising from those transactions on a net basis, in accordance with: (i) appropriate methodologies for determining the value of classes of derivatives; (ii) principles for establishing the relevant point in time at which the value of a derivative position should be established; and (iii) appropriate methodologies for comparing the destruction in value that would arise from the close out and bail-in of derivatives with the amount of losses that would be borne by derivatives in a bail-in.

31. Further, as already noted in CP2, the resolution authority would need to be given the power to terminate and close out derivative transactions which are to be subject to a bail-in. There should however be limits to this power i.e. done within certain time of a resolution to promote certainty.

32. Specifically in relation to insurers, it is noted that in its Policy Measures for global systemically important insurers published in 2013, the International Association of Insurance Supervisors has suggested that authorities would need to determine whether a mainly traditional insurance group with a large derivatives portfolio may experience a disorderly run-off due to legally binding close-out netting of those derivatives.

Question 18

Do you agree that an additional condition is required for TPO? Is the additional condition, proposed in paragraph 115, appropriate?

Law Society's Response:

33. We agree that an additional condition is required for TPO.

34. According to paragraph 6.5 of Key Attributes, it is suggested that a TPO option may be available **as a last resort and for the overarching purpose of maintaining financial stability**. In particular, as acknowledged in paragraph 241 of CP1, the government and the resolution authority would become responsible for continuing the activities of a large and complex FI which is failing. Hence, the risk to public funds associated with TPO may not be overlooked.

35. In view of the standards set in the Key Attributes, we consider that, in addition to the "last resort" condition, the resolution authority should also set a higher threshold for the second financial stability condition when assessing whether TPO could be initiated.

Question 19

Do you agree with the scope, timing and conditions proposed for temporary stays on early termination rights in financial contracts?

Law Society's Response:

36. We agree with the scope proposed for temporary stays on early termination rights in financial contracts.

37. In relation to the proposed timing and duration of the temporary stay, we agree that the temporary stay shall come into effect upon the issuance of the public notice on commencement of resolution proceedings. We also agree that the stay should be limited in time. In this regard, in order to avoid any doubt as to on which business day "midnight" falls, we suggest that the stay will last "until, at the latest, midnight in Hong Kong at the end of the business day following that publication".

38. We consider that the "reasons in connection with the use of resolution powers" as referred to in condition (ii) proposed in paragraph 121 of CP2 may be further elaborated by providing examples, such as "including, for example, a change in control of the relevant FI or its business arising from such proceeds" as suggested in Annex 5 of the Key Attributes. Other than that, we agree with the

conditions as proposed in paragraph 121 of CP2.

Question 20

Do you have views on whether a temporary stay on early termination rights should apply solely to financial contracts or whether broader provision should be made?

Law Society's Response:

39. Given the possibility that other contracts relating to matters important to operational continuity may reference "event of default" type events, we consider that a broader provision should be made.

40. In this regard, in view of the statements from the Key Attributes (paragraph 4.3 and Annex 5) that (i) a stay may be discretionary (imposed by resolution authority on a case-by-case basis) or automatic in operation; and (ii) counterparties to the FI in resolution should have clarity as to the beginning and the end of the stay, we suggest that a temporary stay on early termination rights should apply to financial contracts automatically in operation for the sake of clarity, whereas the resolution authority be given a discretionary power to suspend the termination rights of other contracts on a case-by-case basis. In that case, the regime should provide for how such discretionary power should be exercised.

Question 21

Do you have views on whether there are other issues which need to be considered in relation to staying early termination rights in resolution?

Law Society's Response:

41. Whilst it is expected that the resolution authority will need a short window between taking an FI into resolution and determining and communicating the form its resolution will take, in the event that such process takes more than 2 business days, then the counterparties may exercise the right to close out and cause difficulty to orderly resolution.

42. As a contingency measure, it is suggested that the resolution authority be given a discretionary power to extend the duration of the temporary stay for a limited time (for example, another 2 business days) for a limited number of times, but it should be made clear that any such extension would only be permitted in exceptional cases.

Question 22

Do you have views on how best to implement a temporary stay of early termination rights such that it is effective in supporting resolution of FMIs in particular?

Law Society's Response:

43. We agree that the resolution authority should be given power to stay the exercise of early termination rights on resolution of FMIs.

44. In view of the role of FMI entities in Hong Kong and the fact that each of them is currently operating as a monopoly (or nearly so), it is likely to be impracticable to achieve satisfactory resolution on any basis other than one which facilitates the relevant FMI to resume full functionality. This will in most situations require immediate injection of significant additional capital and/or risk acceptance. Unlike banks and other intermediaries, given the impact of an FMI failure on Hong Kong's financial markets, the government (or a quasi-government entity such as HKMA) is likely to be best placed to provide this on a timely basis, and at the same time, to restore the necessary confidence in the continued functioning of the relevant FMI. This is supported by historical precedent in Hong Kong. Given the differences between the FMIs and the FIs in this regard, we consider that the power to be given to the resolution authority on stay of early termination rights in supporting resolution of FMIs in Hong Kong should be broader than that for FIs in terms of the scope, timing and duration. In the event of a prompt restoration of full functionality, the possibility of pre-restoration defaults by the relevant FMI arising by virtue of the triggering of resolution or exercise of resolution powers being permanently waived should also be considered.

Question 23

Do you have views on the proposals for the temporary suspension of insurance policyholders' surrender rights, including the proposed duration of the suspension?

Law Society's Response:

45. There is no fundamental objection to granting the resolution authority power to suspend policy holders' rights to surrender their policies in the event of insurer resolution. However, the need for a power to suspend is less clear. On surrender, a policy holder will exercise his contractual rights to surrender the policy and recover the surrender value of the policy but if an insurer is in resolution, no payments will be made to policy holders within the (approximate) two day suspension period in any event, thereby allowing other policy holders who surrender their policies two days later to do so without prejudice. In addition, though suspension will provide time for the market to understand the issues

surrounding the resolution and help policy holders make informed decisions on whether or not to surrender, the delay in surrender will not materially reduce the operational and financial pressure faced by the insurer in resolution and may in fact exacerbate the problem by encouraging more policy holders to surrender at the same time once the suspension is lifted. This differs from the situation applying on a suspension in dealing in securities, which also allows the market to become aware of the relevant issues and for shareholders to obtain relevant information, as dealings are essentially instantaneous and suspension will allow shareholders to be treated fairly and equally before they decide whether or not to sell their shares and for others to buy them.

46. The period of suspension of insurance policy holders' surrender rights seems reasonable and consistent.

Question 24

Do you have views on the proposals for a temporary stay on reinsurers of an insurer or of another reinsurer in resolution to terminate or not reinstate coverage relating to periods after the commencement of resolution?

Law Society's Response:

47. It is noted that the proposed stay on reinsurers to terminate their reinsurance contracts early only applies to termination for reasons of entry into resolution or in connection with the use of resolution powers and for the same limited (approximate) two-day period. Unless the contract expressly provides that the contract may be terminated on insurer resolution and the reinsurer states that to be the reason for termination, it may be difficult to establish that a reinsurance contract which contains broad powers for early termination is in fact being terminated for a reason connected to the resolution. Further it is noted that such stay on the powers of termination may effectively provide the insurer with two days' free reinsurance; if this is the case, the reinsurer should be entitled to recover the cost of that reinsurance for that period to the same extent as a transferee third party or bridge institution will recover reinsurance premiums.

48. Though the period of stay may provide sufficient time for new reinsurance cover to be obtained, compelling a reinsurer to reinstate when it has no contractual obligation to do so appears to be usurping the rights of the reinsurer to determine how it wishes to carry on business. This is materially more aggressive than merely suspending a right to terminate early and requires further justification. Further, no indication is given as to how the terms, including the premium, of that reinsurance will be determined and how the reinsurer will be paid for that reinsurance cover.

Question 25

Do you agree with the proposals set out above to provide the resolution authority with powers to require an FI to make changes to improve its resolvability?

Law Society's Response:

49. The proposals set out in paragraphs 131 to 135 are acceptable in principle. In terms of the applicable time frames for the FIs to respond, where a FI belongs to a larger group of FIs which are subject to another home regulator, the applicable time frames should be further extended given the time required to discuss and agree with the home regulator. We would also expect that there will be further consultation on the draft legislative provisions to ensure that those principles and intents are appropriately reflected in the actual drafting.

Question 26

Do you agree with the proposal that the resolution authority should be notified of an intention to petition for an in-scope FI's winding-up and be afforded a maximum 14 day notice period to determine whether or not to initiate resolution before that winding-up petition can be presented to the court?

Law Society's Response:

50. Yes. We consider that it is one of the most crucial features to have a notice requirement at this stage to allow sufficient time for the resolution authority to step in if it sees fit to do so.

51. However, we have reservations on the authorities' concerns as to how it would ease the concern of triggering default and cross-default provisions in financial contracts. A statutory demand or even the non-viability of the FI itself may trigger the relevant provisions in the financial contracts. It is also anticipated that future default and cross-default provisions would be amended to cover the act of sending a notice to the resolution authority.

Question 27

Do you have views on which of the approaches outlined in paragraph 141 above might best deliver continuity of services from a residual FI and which are essential to secure continuity of the business transferred to an acquirer?

Law Society's Response:

52. We consider approach (a) in paragraph 141 would be more straight-forward and

would leave less uncertainty (such as those stated in paragraph 142) and, therefore for the sake of continuity of the business transferred, would be preferred.

Question 28

Do you agree that the regime should empower the resolution authority to impose a temporary moratorium on payments to unsecured creditors and to restrict the enforcement of security interests in line with proposals set out above? Do you have views as to the exclusions to which this power should be subject?

Law Society's Response:

53. Yes. We consider that the resolution authority shall be empowered to impose such a temporary moratorium on payments to unsecured creditor and to restrict the enforcement of security interest to ensure the resolution will be carried out properly. Without such power, we consider that there is a possibility that the creditors will race for the exits and cause instability to the market.

54. We agree with the proposed exclusion set out in paragraph 147 to ensure continuity of services and financial stability.

Question 29

Do you agree that the regime should empower the resolution authority to appoint a resolution manager in line with the proposals set out above?

Law Society's Response:

55. We agree that the regime should empower the resolution authority to appoint a resolution manager. We echo the comments in paragraph 151 that the resolution manager should have the responsibility to promote the resolution objectives in the course of carrying out the functions and duties of the regime.

Question 30
Do you agree that the regime should provide the resolution authority with the necessary powers to secure the continuity of essential services as set out in paragraph 156?

Law Society's Response:

56. Please note our response to Question 5.

Question 31

Do you agree that resolution should result in the automatic removal of all the directors, the CEO and Deputy Chief Executive Officer ("DCEO") (where relevant) of an FI in resolution and that the resolution authority should have powers to remove other senior management at its discretion?

Law Society's Response:

57. No. Experience of intervention in other banks such as Hang Lung Bank and Bank of Credit and Commerce (Hong Kong) Limited ("BCCHK") shows that existing management often has a key role to play in the continued operation of the FI and the resolution authority is likely to find its task of resolution of the FI significantly hampered by the removal of those people who are likely to have the most hands-on knowledge of the FI. It is suggested the resolution authority should have power to remove any director or officer at its discretion but that there should be no automatic removal of directors or officers.

Question 32

Do you agree that the resolution authority should be able to apply to the court to seek remuneration claw-back from those parties identified in paragraph 165 whose actions or omissions have caused or materially contributed to an FI entering resolution?

Law Society's Response:

58. Yes. This seems an obvious power to give to the resolution authority.

Question 33

Do you have views on whether remuneration claw-back should apply to both fixed and variable remuneration (both vested and unvested) or only to variable remuneration (both vested and unvested)?

Law Society's Response:

59. Whilst one would expect that remuneration claw-back should primarily focus on variable remuneration, whether vested or unvested, it seems artificial to limit remuneration claw- back only to variable remuneration. If this is done, it simply encourages compensation packages to stress the fixed remuneration element, thus removing a potential means of incentivizing management to the benefit of shareholders, if such incentives prove successful.

Question 34

In light of the practices adopted in other jurisdictions, do you have views on how far back in time a remuneration claw-back power should reach?

Law Society's Response:

60. Fairness to officers and management of the FI would suggest there should be some temporal limitation on the ability to exercise remuneration claw-back power. Six years, being the standard limitation period, would be the outside limit. As a rule of thumb, we would suggest remuneration claw-back should be limited to two or at most three years backward review.

Question 35

Do you agree that the indicative criteria to assess the independence and expertise of an NCWOL valuer, as set out in Box F, are appropriate and that a degree of judgment will be inherent in assessing whether these, or any other, factors are relevant in individual cases?

Law Society's Response:

61. We agree to the indicative criteria set out in Box F for the appointment of NCWOL valuer. An additional criteria is proposed, namely, the NCWOL valuer should not be or have been an officer of the FI (including as auditor). Also agreed that there will be a degree of judgment to assess those criteria for the reason that we recognize each appointment would be case and situation specific.

Question 36

Do you agree that the resolution authority should appoint the NCWOL valuer, guided by the indicative criteria set out in Box F?

Law Society's Response:

62. We agree that the resolution authority should be guided by the indicative criteria set out in Box F when appointing the NCWOL valuer but we would add that the appointment process should be open and transparent.

Question 37

Do you agree with the proposed grounds for removal of a NCWOL valuer, as set out in paragraph 174?

Law Society's Response:

63. Yes, save for the following:-

(i) The onus for establishing a ground for removal of the NCWOL valuer should be on the applicant as is the case with the removal of a liquidator;
(ii) The onus of proof should be a high one, again as is the case with the removal of a liquidator;
(iii) Ground (iii) in paragraph 174 should be "actual" bias.

64. The suggestions above are to avoid frivolous applications for the removal of the NCWOL valuer.

Question 37 (cont'd)

Do you agree that the proposed mechanism for seeking removal on those grounds is appropriate?

Law Society's Response:

65. Yes. Presumably, an appeal of the resolution authority's decision on an application for removal lies to the court by way of judicial review.

66. As a general suggestion with regard to the quasi-judicial review of the quality of the NCWOL valuer, thought ought to be given to providing a mechanism, as an alternative to removal, where a party aggrieved of any decision of the NCWOL valuer can apply to the resolution authority to have that decision reviewed. In liquidation cases, many applications for removal of the liquidator relate to some act of the liquidator which aggrieves a party - the CWUMPO provides for an alternative mechanism for the court to review the liquidator's decision.

Question 38

Do you agree that the treatment of the outgoing valuer's work up to the point of removal is a matter for any incoming valuer, who should clearly explain that treatment in his/her final valuation?

Law Society's Response:

67. Yes.

Question 39

Do you agree that the three overarching valuation principles identified in paragraphs 176 (i) to (iii) should be applied each time an NCWOL valuation is undertaken?

Law Society's Response:

68. Yes, subject to what is said below in respect of the three valuation principles and the suggested addition of a fourth valuation principle (discussed in part 2 of Question 39 below).

(i) Valuation Reference Date – the intention of the NCWOL valuation is to determine what creditors and shareholders of a non-viable FI would have received had the FI instead been entirely liquidated. This will then be compared with the treatment of shareholders and creditors under a proposed resolution. In order for this valuation comparable to achieve its objective, the date of the hypothetical liquidation should be the same date as that used for evaluing the treatment of creditors and shareholders under the proposed resolution.

Two dates are discussed in paragraph 176(i): the first is the date that the FI would have entered liquidation had it not been placed into resolution (the "**Liquidation Date"**); and the second is the date of the resolution authority's publication of notice that resolution proceedings would be used (the **"Notice Date"**).

Neither date achieves the objectives of the NCWOL valuation comparison.

The Liquidation Date is indeterminate. In the liquidation of a company, the assets of the company are distributed to creditors (and, if a surplus, shareholders) as at the date of the winding up order. In a resolution, there will be no winding up petition so identifying the date when a winding up order might be made is simply conjecture.

The resolution Notice Date is also not ideal as there may be a considerable period of time between publishing the notice and the resolution authority's promulgation of a proposed resolution. If the Notice Date is used for the hypothetical liquidation, this would not match the date used in valuing the treatment of creditors and shareholders under the resolution.

It is proposed that, instead of fixing a date for the NCWOL valuation, it be

provided that the valuation be conducted by the NCWOL valuer as at such date as the resumption authority directs having regard to the objective of providing a NCWOL valuation which can form a comparable to the treatment of creditors and shareholders under the resolution.

(ii) Creditor Hierarchy – It is agreed that evaluation should adhere to the creditor hierarchy that applies in a winding-up. The classes of creditor in paragraph 176(ii) is not, however, complete. It is assumed that this is an intentional use of shorthand.

Question 39 (cont'd)

Do you have views on other valuation principles that should underpin an NCWOL valuation?

69. It is suggested that there be a fourth valuation principle, namely, that the NCWOL valuation methodology is the same as that which underpins a liquidation valuation analysis. The valuation would, therefore, presuppose a hypothetical liquidation that: (a) estimates the realisable liquidation value of the FI's assets and (b) estimates a distribution to creditors (and shareholders) resulting from the liquidation, net of estimated costs of the hypothetical liquidation. Estimated realisable asset values reflect the gross amount that can be realised from the hypothetical liquidation sale, given reasonable market exposure to find a purchaser, with the liquidator being compelled to sell on an "as – is", "where is" basis, as of a specific date.

Question 40

Do you agree that the right to receive NCWOL compensation (if due) should be restricted to those creditors and shareholders who held liabilities of a failed FI as at the point resolution proceedings formally commenced and who suffer an economic loss as a direct result of the resolution authority's actions?

Law Society's Response:

70. Yes. It appears that the affected party will only be the creditors and contributories (shareholders) of the failed FI.

71. When distributing payment, the shareholders will only be entitled to the assets of the failed FI after deducting those payment mentioned in Section 250, Companies (Winding up and Miscellaneous Provisions) Ordinance Cap 32.

Question 41

Do you have views on how a mechanism might be provided for to expedite the payment of NCWOL compensation due where at least part of any valid NCWOL claims can reliably be identified?

Law Society's Response:

72. This is an extremely difficult question. Experience in the liquidation of BCCHK shows why. As part of interim relief to depositors, the Financial Secretary announced at the time when he presented a petition to wind up BCCHK the payment by BCCHK of 25% of deposits to depositors up to a maximum of HK$500,000 per depositor.

73. The payment of this interim relief constituted a major task in terms of time and manpower for the Special Managers and arguably detracted from more commercially pressing needs such as the closure of branches and the possibility of an overall sale of part or all of BCCHK.

74. Additionally, BCCHK's records did not necessarily reveal the full picture of amounts due to or from depositors. For example, many individuals or entities had deposits but these were security for advances to a related entity. A common example was an individual had made a deposit which was held as security for an advance to a company controlled by that individual.

75. The records of BCCHK often did not disclose that a particular deposit was being held as security for an advance and so there were cases where a payment was made by way of interim relief to a depositor when the whole of the deposit would otherwise have been capable of being appropriated in reduction of the liability of a third party.

76. The likelihood of valid NCWOL claims being reliably identified early in the resolution is slim. That being so, we consider it is a low priority to establish a mechanism to provide for expedited payment of NCWOL compensation.

77. Having said that, it is noted that prior to making payment, the valuer must conduct a valuation (similar to the adjudication process conducted by a liquidator). After gathering the assets the liquidator will make dividend payment. It is presumed the NCWOL compensation payment process will be similar to the liquidation process and it may be as follows:

    (i) The creditors will submit a claim (a proof of debt form in a typical liquidation matter)
    (ii) The valuer will perform valuation
    (iii) Payment

78. The only way to expedite the payment of NCWOL compensation is to ask the valuer to make the appropriate calculation within an acceptable time span.

79. It is suggested that the valuer should make calculation within three (3) months to six (6) months upon receipt of the claim submitted by the relevant claimants.

80. After making calculation it will be the jurisdiction of the resolution authority to make payment and possibly within another agreed time span.

81. It is interesting to note that the Official Receiver made a performance pledge that she will make dividend payment within 9 months from the date when the distribution is possible.

Question 42

Do you agree that the RCT should be established under the regime to hear appeals of: (i) the shareholders and creditors of an FI in resolution; and/or (ii) the resolution authority against a NCWOL valuation?

Law Society's Response:

82. There clearly needs to be some form of appeal mechanism from a decision on NCWOL compensation.

83. We agree that RCT should be established to hear appeal of (i) the shareholders and creditors of an FI in resolution; and (ii) the resolution authority against a NCWOL valuation.

84. We like to see how the RCT would be structured e.g. who would be appointed to the RCT and the rules governing its operation.

Question 43

Do you agree with the proposed composition of, and process for appointment to, the RCT?

Law Society's Response:

85. Yes.

Question 44

Do you have any views on the powers that should be available to the RCT in addition to those identified in paragraph 186?

Law Society's Response:

86. Provided the RCT has similar powers to the BRT and the SFAT, that should be sufficient. It is hard to see why the RCT should receive powers above and beyond those vested in other tribunals such as the BRT and the SFAT.

Question 45

Do you agree that applicants should have the right to appeal against a determination of the RCT on a point of law, as set out in paragraph 187?

Law Society's Response:

87. Yes.

Question 46

Do you have any further comments on the way in which it is proposed that the various types of protected financial arrangement would be safeguarded and remedies for inadvertent breaches executed?

Law Society's Response:

88. To a large extent, the devil is in the detail. It is important that primacy is given to private contractual rights between the FI and counterparties. We believe CP2 has embraced comprehensively the proposals as to which type of protected financial arrangements will be safeguarded and potential remedies for inadvertent breaches. We do not have any further comments.

Question 47

How could a similar safeguard be provided for to support use of the bail-in option?

Law Society's Response:

89. We do not see there should be any material difference in treatment between the safeguards to be used in the bail-in option.

90. However, a mechanism may be put in place under which creditors who feel that their liabilities should not have been written down or converted, or those who feel that the bail-in has been conducted in a way which fails to respect the hierarchy of claims in liquidation, could notify the resolution authority so that adjustments may be made as necessary. This however would need to be reconciled with the contractual clauses proposed by the authorities in CP2 which would purportedly bind debt holders to the terms of a bail-in.

Question 48

Do you have any views on the factors the authorities should take into account in developing effective protections from civil liability for: (i) the resolution authority and its staff and agents; and (ii) the directors, officers and employees of an FI in resolution in a cross-border context?

Law Society's Response:

91. We agree with the principles set out in paragraphs 202-208 of CP2. In particular, we agree there should be a good faith requirement for an exemption from civil liability for the directors, officers and employees of an FI.

Question 49

Do you agree with the proposal to provide the relevant authorities the power to defer or exempt compliance with the following requirements, as discussed above: (i) the disclosure requirements under Part XIVA and Part XV of the SFO, the Listing Rules and the Takeovers Code; (ii) the shareholders' approval requirements under the Listing Rules; and (iii) the general offer obligation under the Takeovers Code?

Law Society's Response:

92. We agree that compliance with the above requirements should be deferred or exempted in certain circumstances. However we would seek clarification on the following:

(i) in the event of a listed FI or a shareholder applying for a deferral pursuant to the proposal under paragraph 214 of CP2, what will be the criteria for assessing the "reasonable likelihood" that the listed FI (or an affiliate) will become subject to resolution, and the "reasonable likelihood" that disclosure would cause non-viability/impede orderly resolution? And who will be making such assessments?

(ii) what would be the interaction between the proposals and: (1) section 307F of the SFO which gives the SFC the power to make rules to

prescribe circumstances in which a listed entity is not required to disclose inside information under Part XIVA; and (2) section 309 of the SFO, which gives the SFC the power to publish guidelines for the exemption from compliance with the Part XV disclosure obligations, and to grant/withdraw such exemptions?

(iii) what is the rationale for the automatic deferral in relation to disclosure obligations under the Listing Rules and Takeovers Code?

(iv) how would compliance with Part XV for others be treated e.g. for banks with a discloseable interest under a security arrangement with a controlling shareholder of an affected FI – should this also be exempted from disclosure?

93. We would also welcome the opportunity to comment on any draft new legislation/rules and draft amendments to existing legislation/rules in due course.

Question 50

Are the costs identified in Box G those that might, most commonly, be met through resolution funding arrangements established under the regime? Do you agree that these should be set out only in a non-exhaustive list to allow for the structuring of resolutions appropriate to individual FIs?

Law Society's Response:

94. The list of resolution costs set out in Box G should in most cases be met through the resolution funding arrangements and it is appropriate that such list should not be an exhaustive list. However, the relevant issues of funding and spending (e.g. what costs can be spent, how such should be funded and who can make the relevant determination) should be subject to appropriate safeguards (which should, on the other hand, be balanced against any time frame concerns) that need to be clearly set out in the future legislation.

Question 51

Do you agree that it would be appropriate to set overarching principles which would guide the resolution authority in setting levies to recover costs incurred in any individual resolution? Do you have views on what those principles should be?

Law Society's Response:

95. Yes, it is appropriate and indeed necessary to set out the overarching principles

that would not only guide but also bind the resolution authority in setting levies. Notwithstanding the comments made in paragraph 228, it should not be ruled that in an appropriate case, it may still be feasible to impose specific sector levy; therefore, the overarching principles should include the need for the resolution authority to consider whether it is appropriate to impose specific sector levy in any particular case, taking in account all the relevant factors (including how much of the failed FI has impacted on the other sectors (and which sectors) financially and whether imposing such sector specific levy will cause undue hardship on that sector). Further, an impact analysis should be undertaken, with the relevant basis and details to be disclosable to the relevant stakeholders including the payers of the relevant levies. Such analysis may include the relative financial impact of a levy on the relevant subject payers against how much of the spent costs can be recouped from a successful resolution. In case of a cross border FI, the financial impact of local levy should be weighted against the financial support or funding that may be available or recouped from an overseas source and the viability of a successful resolution of its local operations.

Question 52

Do you agree that it would be appropriate to set specific "cross-border conditions" which must be met before the local resolution regime may be used to support foreign resolution measures?

Law Society's Response:

96. Yes.

Question 53

Are the conditions identified in paragraph 239 above appropriate? Do you consider that in addition to being satisfied that foreign resolution measures are consistent with the objectives set for resolution locally, a further requirement should be set with regard to considering the fiscal implications?

Law Society's Response:

97. We note the suggestion that the "cross-border conditions" for inclusion in the local regime could be that:

    (i) a foreign resolution authority is initiating resolution in relation to a cross-border group with operations in Hong Kong which are themselves within scope of the local regime;

(ii) it is assessed, by the resolution authority in Hong Kong, that the approach which the foreign resolution authority proposes to adopt will deliver outcomes that are consistent with the objectives for resolution and will not disadvantage local creditors relative to foreign creditors.

98. We consider the conditions to be appropriate given the outlining of the resolution objectives. It would not be appropriate to be overly prescriptive in this area (and in our view no need to refer directly here to fiscal implications for the reasons set out in CP2), given the need for flexibility of response for the Hong Kong resolution authorities, particularly in the light of Hong Kong's necessarily outward looking approach to the actions of other jurisdictions as a result of Hong Kong's market structure, and the inevitable sensitivities that this creates.

99. Notwithstanding the above, the only credible and sustainable resolution regime in Hong Kong and internationally will demand implementation of internationally consistent regimes where it can be relied upon that resolution authorities cross-border will apply similar standards and actions to potential crises. Until that is demonstrably the case, the Hong Kong authorities need to ensure equivalence with international development, but we agree that automatic support and recognition by Hong Kong for foreign-led resolution action would not serve the Hong Kong market best.

Question 54

Do you have any views on how to accommodate the scenarios outlined in Box H above? ***[Repeated below for quick reference]***

Box H: Scenarios identified by FSB for cross-border resolution

1. "a foreign bank undergoing resolution in its home jurisdiction operates a foreign branch. Home resolution measures need to have effect throughout the whole legal entity, including the branches in host jurisdictions. In this scenario, the protection of the domestic creditors and local financial stability will generally be primary considerations for the host authorities;

2. a foreign financial institution undergoing resolution in its home jurisdiction controls a subsidiary in another jurisdiction. In order for home resolution measures to be effective, host jurisdictions may, in particular, need to provide a process to allow the transfer of shares in the subsidiary to another institution or to require local subsidiaries to continue to provide essential services to the parent company or other group entities. Particular concerns of host authorities may relate to local financial stability given the potential spill-over between entities of the same group, and prudential matters (for example, 'fit and proper' test for the acquirer of the subsidiary); and

3. assets, liabilities or contracts of a foreign firm in resolution are located or booked in, or subject to the law of, another jurisdiction in which the firm is not established. In order for home resolution measures to be effective, the relevant jurisdiction would need to allow the implementation of the resolution measures adopted by a foreign authority."

Law Society's Response:

100. The scenarios are necessarily generic, but showcase some of the significant difficulties created in the context of cross-border resolution.

101. In each of the scenarios, there would need to be a recognition of the overwhelming importance of information sharing between the foreign authority and the Hong Kong authorities to ensure sufficient transparency to enable assessment of the potential impact of the foreign action on the Hong Kong market. Scenario 1 would be the most sensitive in many respects from the Hong Kong perspective, and indeed the most usual given the make-up of the Hong Kong market. Great reliance would need to be placed on the robustness of the exercise of Hong Kong resolution powers in line with the resolution objectives. This scenario inevitably puts considerable pressure on the host regulators and brings the trust issue among resolution authorities into sharp focus.

102. Scenario 2 provides more control to the Hong Kong authorities, however the change of control issue is important: where any potential transferee entity is an FI regulated in Hong Kong it is likely to be more straightforward to fast-track a change, but it should not in our view be an automatic process. If automatic, that could simply defer prudential issues rather than solve them.

103. Scenario 3 is likely to prove to be a more political situation, given the likely lack of systemic impact for Hong Kong, where it is a host jurisdiction.

104. There is no one-size-fits-all answer to this question.

The Law Society of Hong Kong
28 April 2015
2272425

APPENDIX 1

ABBREVIATIONS ADOPTED IN THIS SUBMISSION[1]

AI	Authorized institution
AMV	Asset management vehicle
AOE	Affiliated operational entity
BAU	Business as usual
BCBS	Basel Committee on Banking Supervision
BO	Banking Ordinance (Cap. 155)
BoE	Bank of England
BRRD	Bank Recovery and Resolution Directive (of the European Union)
BRT	Banking Review Tribunal
CCP	Central counterparty
CEO	Chief Executive Officer
CO	Companies Ordinance (Cap. 622)
COAG	Institution-specific cross-border cooperation agreement
CP1, CP2, CP3	First stage, second stage and third stage consultation papers
CSSO	Clearing and Settlement Systems Ordinance (Cap. 584)
CWUMPO	Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DPS	Deposit Protection Scheme (of Hong Kong)
D-SIFI	Domestic systemically important financial institution
DTC	Deposit-taking company
EU	European Union
FIs	Financial institutions (including financial market infrastructures unless the context otherwise requires)
FMIs	Financial market infrastructures
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSHC	Financial services holding company

[1] See p.5 to 6 of the Consultation Paper

FSTB	Financial Services and the Treasury Bureau
G-SIB	Global systemically important bank
G-SIFI	Global systemically important financial institution
G-SII	Global systemically important insurer
HC	Holding company
HKMA	Hong Kong Monetary Authority
IA	Insurance Authority
IAIG	Internationally active insurance group
IAIS	International Association of Insurance Supervisors
IAT	Insurance Appeals Tribunal
ICF	Investor Compensation Fund
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
KAAM	(Draft) Key Attributes Assessment Methodology
LB	Licensed bank
LC	Licensed corporation
LegCo	Legislative Council
LIFSHC	Locally incorporated financial services holding company
LIHC	Locally incorporated holding company
LoLR	Lender of last resort
LRA	Lead resolution authority
MA	Monetary Authority
MAHC	Mixed activity holding company
MOU	Memorandum of understanding
MPE	Multiple point of entry (resolution strategy)
NBNI FI	Non-bank non-insurer financial institution
NBNI G-SIFI	Non-bank non-insurance G-SIFI
NCWOL	No creditor worse off than in liquidation
OLF	Orderly Liquidation Fund
OTC derivatives	Over-the-counter derivatives
PPF	Policyholders' Protection Fund
RCT	Resolution Compensation Tribunal
RI	Registered institution

RLB	Restricted licence bank
SFAT	Securities and Futures Appeals Tribunal
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)
SIFI	Systemically important financial institution
SPE	Single point of entry (resolution strategy)
SPM	Supervisory Policy Manual
SRR	Special Resolution Regime of the United Kingdom
TLAC	Total loss absorbing capacity
TPO	Temporary public ownership
UK	United Kingdom
US	United States of America