Practitioners Affairs

PA0005/03/70931

15 September 2003

Mrs. Mary Tang
Bills Committee
Legislative Council Building
8 Jackson Road, Central, Hong Kong

Dear Mrs. Tang,

Re: Bills Committee on Deposit Protection Scheme Bill

I refer to your letter dated 22 July 2003 and attach Law Society's submissions on 30 June and 17 July 2003 respectively sent to HKMA for consideration by the Bills Committee.

The Law Society will not be sending any representatives to attend the meeting on 17 September 2003.

Yours sincerely,

Joyce Wong
Director of Practitioners Affairs
e-mail: dpa@hklawsoc.org.hk

Encl.

THE
LAW SOCIETY OF HONG KONG
香 港 律 師 會

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SHI/HC/sp/DPSB
B9/62C
2846 0503

From the President

17 July 2003

Mr Raymond Li
Executive Director (Banking Devel
Hong Kong Monetary Authority
Banking Development Department
30th Floor
3 Garden Road
Hong Kong

Dear Mr Li,

Re : Deposit Protection Scheme Bill

Thank you for your letter dated 6 June 2003.

Compensation limit

Under the proposed deposit protection scheme, each depositor of the failed bank is entitled to compensation up to a limit of $100,000. It is common practice among solicitors that money held on behalf of different clients may be pooled for deposit into one client account, subject to proper recording of all dealings in respect of each individual client in the solicitors' books.

In the case where a client account holds money on behalf of more than one client, it is our understanding that under the provisions of the Bill, each client will be entitled to compensation from the Fund and the total amount of compensation to which each client is so entitled in respect of his share of deposit in the pooled deposit in the client account shall not exceed $100,000. In determining whether the limit of $100,000 has been exceeded, the balance of all the other accounts maintained by the individual client with the failed bank (including his share in other client accounts) will be aggregated with his share of deposit in the pooled deposit in the client account.

Please confirm if the above understanding of the application of the Bill is correct.

Client account

Clause 27(5) of the Bill provides that if *"the depositor holds the deposit in a client account, the client, but not the depositor, is entitled, in respect of the deposit..."*. The provision appears to cover the situation where the client is the only person entitled to the deposit in a client account. However, there may be situations under the Solicitors' Accounts Rules (Cap 159. sub.leg.) where there may be other persons who are not clients of the solicitor but are entitled to the deposit in the client account.

For instance, money held by a solicitor in connection with his practice as stakeholder is, by definition under the Solicitors' Accounts Rules, client money and may therefore be paid into a client account. There may be office money resulting from an un-split receipt in the client account (rule 4(d) of the Solicitors' Accounts Rules). Such kinds of money in the client account do not belong to the client.

Our preliminary view is that instead of grouping it as deposit in a client account (which carries a defined meaning in the Solicitors' Accounts Rules) in clause 27(5) in the Bill, it may be more appropriate to express the deposit as deposit held on account of a client to exclude cases where the money does not belong to the client.

Yours sincerely,

Ip Shing Hing
President

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THE LAW SOCIETY OF HONG KONG 香港律師會

Deposit Protection Scheme Bill

1. We support the introduction of the Bill. We think it will be helpful to have a deposit protection scheme.

2. As far as the working of the Bill is concerned, we think it will be quite complicated in terms of implementation.

3. In order to determine who are entitled to claim for compensation, it will be necessary to find out who are the underlying principals and beneficiaries. In some circumstances, it may be straightforward but in many other circumstances, this can be very complicated. The Bill does seem to contain some provisions that may be useful in overcoming some of these problems.

4. The Bill deals with different persons having claims over the same deposit (an example of this will be deposits in a general clients' account). Solicitors and other persons in regulated industries (e.g. brokers) will presumably be keeping good and proper records in accordance with applicable requirements and such records can be produced to the Board pursuant to a request made under Section 30(1)(b)(i). In respect of other persons who may be holding deposits, but who do not operate in a regulated industry, it will be a lot harder to implement the provisions. This is, however, a point beyond the Bill itself and we also note that the Bill does contain a presumption broadly to the effect that where different persons have claims over the same deposit, subject to production of evidence to the contrary, such persons are deemed to have an equal share in the deposit itself.

5. Complexities may also arise on account of "layering" - for example, a lawyer holding funds on a client's account may know that the client is actually also an agent. As far as that is concerned, it would appear that "the client" and not the depositor (i.e. the lawyer) will be taken to be entitled in respect of the deposit and hence, compensation from the fund. If this is correct, then it is not necessary to go all the way to determine who are the principals. The same applies to a trust other than a bare trust. In such a case, the trustee/depositor will be entitled to claim for compensation as trustee of the trust. It would be helpful to state clearly in the Bill in the situation of “layering” referred to above whether the HK$100,000 cap is imposed on the agent as the solicitor’s client or the individual principals for whom the agent represents.

6. Under clause 30(1)(b)(i), the Board is given power to require a depositor of a failed bank to produce documents in support of the depositor’s entitlement to compensation. The Bill should state clearly that such power may be used only in the

administration of claims so that if no claim is made, the Board cannot, of its own volition, compel the production of documents by the depositors.

7. Under clause 27(5), where the protected deposit is held in a client account, the entitlement to claim compensation is vested, not in the depositor, but in the client. If only the clients can lodge clients, law firms may not be able to seek compensation from the fund for untraceable clients.

8. The Bill distinguishes between situations where the deposit is held by the depositor in his own right (in the case of a law firm, it means the funds of the law firm) and where the deposit is held by the depositor in the capacity of a bare trustee, an agent, in a client's account or in trust (other than a bare trust). What constitutes a protected deposit "in a client account" is not defined. Does it therefore cover both designated clients' accounts and general clients' accounts? The problem with applying that concept to designated clients' accounts is that funds held in escrow may not belong to the "client" and where they are stakeholders' money, it cannot be said that the depositor (i.e. the law firm) holds the deposit in a client's account for that person.

9. Clause 36 gives the Board extensive rights of subrogation to the effect that, broadly, if compensation is paid to a depositor, until the Board has obtained full recovery of the compensation amount, the depositor has no right to claim in the winding up of the failed bank. It is necessary to ensure that this will not result in prejudicing a law firm that has both office account and client account with the same bank. There is some concern whether the drafting is sufficiently clear that amounts payable to clients will not be treated as amounts payable to a law firm. The result should be that the amount of dividends payable to the firm on its own account will not be reduced or be affected on account of compensation paid out of the fund to the clients.

10. One other minor point: we note that the definition of "bare trustee" is somewhat narrow. If the bare trustee receives remuneration from the trust fund, he will not be regarded as a bare trustee. This is because the reference to payment of duty, taxes, costs and other outgoings probably does not extend to the remuneration of the bare trustee. We are not sure whether this is the intended result.

The Law Society of Hong Kong
Company & Financial Law Committee
30 June 2003
69195

Your Ref.: PA/0005/03/69184
SHI/HC/sp/DPSB
Our Ref.: B9/62C

12 August 2003

By Fax (2845 0387) and By Post

Mr Ip Shing Hing
President
The Law Society of Hong Kong
3/F, Wing On House
71 Des Voeux Road
Central
Hong Kong

Dear Mr Ip,

Deposit Protection Scheme Bill

Thank you for the Society's letters of 30 June 2003 and 17 July 2003. Our responses to the Society's comments are set out in the attachment.

We understand that the LegCo Secretariat has invited the Society to provide its comments on the Deposit Protection Scheme Bill. I would be most grateful if you could let us have a copy of your submission in due course.

Yours sincerely,

Raymond Li
Executive Director (Banking Development)

Encl.

c.c. SFST (Attn: Mr Edmond Lau)
Ms Joyce Wong (The Law Society of Hong Kong)

RESPONSE TO THE QUERIES AND COMMENTS OF THE LAW SOCIETY OF HONG KONG

Compensation limit

The Society's query

In the case where a client account holds money on behalf of more than one client, it is our understanding that under the provisions of the Bill, each client will be entitled to compensation from the Fund and the total amount of compensation to which each client is so entitled in respect of his share of deposit in the pooled deposit in the client account shall not exceed $100,000. In determining whether the limit of $100,000 has been exceeded, the balance of all the other accounts maintained by the individual client with the failed bank (including his share in other client accounts) will be aggregated with his share of deposit in the pooled deposit in the client account. Please confirm if the above understanding of the application of the Bill is correct (as per the President's letter of 17 July 2003).

The HKMA's response

The understanding of the Society is correct.

Layering of accounts

The Society's comment

Complexities may arise on account of "layering" – for example, a lawyer holding funds on a client's account may know that the client is actually also an agent. As far as that is concerned, it would appear that "the client" and not the depositor (i.e. the lawyer) will be taken to be entitled in respect of the deposit and hence, compensation from the fund. If this is correct, then it is not necessary to go all the way to determine who are the principals....It would be helpful to state clearly in the Bill in the situation of "layering" referred to above whether the HK$100,000 cap is imposed on the agent as the solicitor's client or the individual principals for whom the agent represents (as per the Society's submission of 30 June 2003).

The HKMA's response

The Society's interpretation is correct. In the example cited by the Society, it is the client/agent, rather than the ultimate principals, who would be entitled to compensation under the DPS (clause 27(5) refers). In order to keep the scheme simple, we do not recommend that the coverage of the DPS be extended to the ultimate principals.

Clause 25(1) of the Bill provides that a person's aggregate entitlement to compensation from the DPS Fund under clause 26 (depositors in their own right) and clause 27 (bare trusts, agencies and client accounts) should not exceed $100,000.

Having consulted the Department of Justice, we believe that it is already clear that the coverage limit is imposed on the client/agent.

Board's power to obtain information

The Society's comment

Under clause 30(1)(b)(i), the Board is given power to require a depositor of a failed bank to produce documents in support of the depositor's entitlement to compensation. The Bill should state clearly that such power may be used only in the administration of claims so that if no claim is made, the Board cannot, of its own volition, compel the production of documents by the depositors (as per the Society's submission of 30 June 2003).

The HKMA's response

The proposed scheme does not operate on the basis of claims. In accordance with clause 30(5), it is the Board who determines a person's entitlement to compensation. To facilitate the determination, the Board may request a depositor to provide documents in support of the depositor and other relevant persons' entitlement to compensation. The depositor can refuse to produce such documents, but if he does so, the Board would be entitled to determine the relevant persons' entitlement on the basis of the information available to him.

Entitlement to compensation

The Society's comment

Under clause 27(5), where the protected deposit is held in a client account, the entitlement to claim compensation is vested, not in the depositor, but in the client. If only the clients can lodge claims, law firms may not be able to seek compensation from the fund for untraceable clients (as per the Society's submission of 30 June 2003).

The HKMA's response

As noted above, the proposed scheme does not operate on the basis of claims. A person's entitlement to compensation is governed by the DPS legislation. It is the Board who decides each person's entitlement to compensation in accordance with the legislation. Where the protected deposit is held in a client account, the Board will request the intermediary (i.e. the depositor) to provide documents in support of the clients' entitlement. Such documents would include the client agreements, copies of the identity documents of the clients and the clients' respective share in the deposit etc. If the intermediary already has such documents at its disposal and the documents can prove the clients' entitlement to the Board's satisfaction, the Board would pay the compensation to the intermediary. On the other hand, if the relevant documents are not available, the Board would be entitled to determine entitlement on the basis of the information available to it.

Client accounts

The Society's comment

What constitutes a protected deposit "in a client account" is not defined. Does it therefore cover both designated clients' accounts and general clients' accounts? The problem with applying that concept to designated clients' accounts is that funds held in escrow may not belong to the "client" and where they are stakeholders' money, it cannot be said that the depositor (i.e. the law firm) holds the deposit in a client's account for that person (as per the Society's submission of 30 June 2003).

The HKMA's response

As currently provided in the Bill, the term "client account" would cover both "designated client account" and "general client account". As we understand the nature of the two kinds of client account, the former refers to a client account for keeping the money of a particular client or transaction and the latter refers to a client account for keeping clients' money generally.

As we understand the Society's concern, the duty of a law firm holding funds in a client account as stakeholder is to hold the funds until one or more of the specified events happens and then pay the funds to one or other of the parties. Before the occurrence of such event(s), the funds so held are not vested in the client of the firm. Accordingly, it cannot be said that the law firm holds the relevant deposit in the client account for its client. A typical example is the proceeds from a pre-sale of real property. The proceeds are held by the law firm acting for the developer, who acts as the stakeholder. The developer is not entitled to the funds until certain conditions are met (e.g. the construction has reached a certain stage and the relevant surveyor's certificate has been obtained, etc.). We understand that a law firm may keep the money it holds as stakeholder in a designated client account or a general client account.

Since the funds held by a law firm as stakeholder have yet to be vested in the client, we agree with the Society that it is inappropriate to treat those funds as the client's money. It appears that the law firm holds those funds on active trust on terms agreed among the law firm as stakeholder, its client and the counterparty.[1] ***[We would be grateful if the Society could confirm this.]***. If that is the case, it is proposed that funds held by stakeholders should be treated in the same way as funds held on active trust under the DPS. It follows that the law firm, rather than the client, would be entitled to compensation in respect of the money held as stakeholder. We will introduce appropriate committee stage amendments to give effect to the above proposal.

The Society's comment

There may be other persons who are not clients of the solicitor but are entitled to the deposit in the client account. For instance, money held by a solicitor in connection with his practice as stakeholder is, by definition under the Solicitors' Accounts Rules,

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1 *Alimand Computer Systems Ltd v Radcliffes & Co*, The Times 6 November 1991.

client money and may therefore be paid into a client account. There may be office money resulting from an un-split receipt in the client account (rule 4(d) of the Solicitors' Accounts Rules). Such kinds of money in the client account do not belong to the client. Our preliminary view is that instead of grouping it as deposit in a client account (which carries a defined meaning in the Solicitors' Accounts Rules) in clause 27(5) in the Bill, it may be more appropriate to express the deposit as deposit held on account of a client to exclude cases where the money does not belong to the client (as per the President's letter of 17 July 2003).

The HKMA's response

This comment is related to the previous one. As noted above, appropriate committee stage amendments will be introduced to deal with the situation where funds in a client account do not belong to the client (i.e. stakeholder's money). As regards the situation where an un-split cheque is paid into a client account, the policy intention is that the law firm should be entitled to compensation in respect of the part of the money attributable to the law firm, while the client will be entitled to compensation in respect of the part attributable to him. It appears to us that clause 26(1) and clause 27(5), when read in conjunction with clause 24, would be capable of covering such a situation (i.e. the part of the funds attributable to the law firm will be dealt with under clause 26(1), whereas the part attributable to the client will be dealt with under clause 27(5)). Having said that, we will consult the Law Draftsman whether any amendment is necessary to make our intention clearer.

Clause 36 - Subrogation

The Society's comment

Clause 36 gives the Board extensive rights of subrogation to the effect that, broadly, if compensation is paid to a depositor, until the Board has obtained full recovery of the compensation amount, the depositor has no right to claim in the winding up of the failed bank. It is necessary to ensure that this will not result in prejudicing a law firm that has both office account and client account with the same bank. There is some concern whether the drafting is sufficiently clear that amounts payable to clients will not be treated as amounts payable to a law firm. The result should be that the amount of dividends payable to the firm on its own account will not be reduced or be affected on account of compensation paid out of the fund to the clients (as per the Society's submission of 30 June 2003).

The HKMA's response

The HKMA agrees that, as currently drafted, clause 36(1) might in certain circumstances affect the interests of a law firm that has maintained both an office account and a client account with the failed bank. We will consider whether appropriate amendments to the Bill are required to address the Society's concern.

Definition of bare trustee

The Society's comment

The definition of "bare trustee" is somewhat narrow. If the bare trustee receives remuneration from the trust fund, he will not be regarded as a bare trustee. This is because the reference to payment of duty, taxes, costs and other outgoings probably does not extend to the remuneration of the bare trustee. We are not sure whether this is the intended result (as per the Society's submission of 30 June 2003).

The HKMA's response

This is not the intended result. The proposed definition of "*bare trustee*" is adapted from the UK Banking Act 1987 and is similar to the same definition found in sections 323(8) and 346(5) of the Securities and Futures Ordinance. The Department of Justice and our inhouse counsel believe that the phrase "*costs or other outgoings*" is wide enough to cover remuneration of the bare trustee authorised under the relevant trust instrument. In view of this, we do not propose to amend the existing definition.