

## Bills Committee on Deposit Protection Scheme Bill

**Summary of concerns  
(as at 17 October 2003)**

| <u>Subject/Clause</u>                             | <u>Organization</u> | <u>Concern/View</u>   | <u>Administration's response and follow-up action</u>   |
|---|---------------------|---|---|
| Membership of the Deposit Protection Scheme (DPS) | The DTC Association | The business of deposit taking companies (DTCs) and restricted licence banks (RLBs) will be adversely affected if they are excluded from DPS. DTCs and RLBs should be given the option to participate in the Scheme as otherwise they may need to set up a private scheme providing similar or improved levels of protection. | <p>Under the current three-tier system of authorization, RLBs and DTCs are not permitted to take small deposits<sup>1</sup>, which the DPS is designed to protect. In practice, therefore, most of these institutions provide services mainly to corporate customers or more affluent individuals. Since the coverage limit of the proposed DPS in Hong Kong would be set at a relatively low level (i.e. HK\$100,000), the Administration does not expect that the business of RLBs and DTCs will be significantly affected if they are excluded from the DPS. In any case, the authorization criteria for a banking licence have been relaxed since May 2002. A RLB or DTC which wishes to become protected under the DPS may seek to be upgraded to the status of a licensed bank.</p> <p>It is important to note that participation in a DPS must be mandatory in order to avoid the problem of adverse selection whereby only riskier institutions choose to join the scheme. Therefore, even if RLBs and DTCs were to be allowed to join the DPS, their participation would have to be mandatory. It would clearly be undesirable and unfair to have a scheme in which participation is mandatory for banks but voluntary for RLBs and DTCs. The proposed arrangements under the Bill are consistent with the practices of other established schemes in overseas countries.</p> |

<sup>1</sup> RLBs may take call, notice or time deposits from the public in amounts of HK\$500,000 or above. DTCs are restricted to taking deposits of HK\$100,000 or above with an original term to maturity, or call or notice period, of at least 3 months.

| <u>Subject/Clause</u> | <u>Organization</u>      | <u>Concern/View</u>   | <u>Administration's response and follow-up action</u>  |
|-----------------------|--------------------------|---|--|
| Membership of<br>DPS  | Consumer<br>Council (CC) | Measures should be put in place to ensure that depositors can distinguish between member and non-member institutions and provisions should be introduced to prohibit false or deceptive representations concerning membership status. | <p>The HKMA has already taken on the board the Consumer Council's suggestion. Clause 47 of the DPS Bill provides that no person shall, with intent to deceive, make any false, misleading or deceptive statement or representation as to whether or not a person is a Scheme member, or whether or not a deposit or any other financial product is a protected deposit. Clause 49(1)(e) further empowers the DPS Board to make rules requiring a Scheme member to make known to the public under specified circumstances whether or not it is a member of the Scheme or whether or not a deposit, or any other financial product offered by the Scheme member, is a protected deposit. With these arrangements in place, the Administration believes that depositors will be able to distinguish between member and non-member institutions.</p> <p>In addition, the DPS Board may also publish a full list of the Scheme members on its website and in its Annual Report. The Administration is prepared to make this proposal to the DPS Board when it is established.</p> |

| <u>Subject/Clause</u>                 | <u>Organization</u>               | <u>Concern/View</u>  | <u>Administration's response and follow-up action</u>   |
|---------------------------------------|-----------------------------------|--|---|
| Composition of the DPS Board          | CC                                | <p>To ensure that depositors' interest are adequately represented and protected in the event that the Hong Kong Monetary Authority (HKMA) is appointed as the agent for the day-to-day administration of the Scheme, consideration should be given to appointing to the DPS Board persons who have the appropriate qualifications to represent consumers' interests. In this connection, clause 4(1)(c)(ii) should be amended as follows -</p> <p><i>“not fewer than four and not more than seven other members, who have knowledge of, experience in consumer protection or are competent to otherwise represent consumer, as distinct from industry, interests.”</i></p> | <p>The Government's policy is that the DPS Board should be broadly based and representative of public interest, in particular the depositors' interest. In this light, it may not be desirable to specify in the legislation that all the non-executive members of the Board should have consumer protection background. To do so would undermine the Government's ability to ensure that the Board is served by the best available candidates and has a good mix of expertise and experience (e.g. members with accounting and insolvency law background) required to enable the Board to discharge its functions effectively.</p> |
| Definition of “bare trustee” Clause 2 | The Law Society of Hong Kong (LS) | <p>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.</p>   | <p>The proposed definition 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 Administration believes that the phrase “costs or other outgoings” is wide enough to cover remuneration of the bare trustee authorised under the relevant instrument. In view of this, the Administration does not propose to amend the existing definition.</p>  |

| <b><u>Subject/Clause</u></b>          | <b><u>Organization</u></b>                  | <b><u>Concern/View</u></b>  | <b><u>Administration's response and follow-up action</u></b>  |
|---------------------------------------|---|---|---|
| Definition of "depositor"<br>Clause 2 | The Hong Kong Society of Accountants (HKSA) | References to "depositor" seem to be somewhat loose and ambiguous in places.  | As defined in clause 2, the term "depositor" means a person entitled to repayment of a deposit, whether made by him or not. This definition is the same as the one used in the Banking Ordinance and the Companies Ordinance. The Administration has explained to the HKSA how this would work in practice. The Administration notes again that the Society is content with the clarification.  |
| Exemption<br>Clause 12                | Hong Kong Bar Association (BA)              | <p>Suggests amending clause 12(4)(c) as follows -</p> <p>"the scope and the level of protection available to those deposits under that scheme are not more limited or lower than that which would be available to those deposits under the Scheme if the bank were not exempted."</p> <p>In order to ensure that exempted banks properly honour the obligation under clause 12(5)(a)(ii) to report any change of circumstances to the Board, consideration should be given to imposing a sanction for breach of the clause.</p> | <p>The Administration will consider amending clause 12(4)(c) along the lines suggested by the Association.</p> <p>The sanction for breach of the obligation under clause 12(5)(a)(ii) is revocation of the exemption. Given that the DPS Board will actively monitor the scope of coverage of the exempted schemes and charge an annual fee for doing so, the Administration believes that the continuation of exemption, would not, as the Bar Association has suggested, depends entirely on the exempted banks' observance of their duty to report the changes to the Board.</p> |



| <u>Subject/Clause</u>                    | <u>Organization</u> | <u>Concern/View</u>  | <u>Administration's response and follow-up action</u>  |
|--|---------------------|--|--|
| Entitlement to compensation<br>Clause 27 | LS                  | <p>Clause 27(5) provides that if the depositor holds the deposit in a client account, the client, but not the depositor, is entitled to compensation from the Fund. 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 also be office money resulting from an un-split receipt in the client account (rule 4(d) of the Solicitors' Accounts Rules).</p> <p>There is a need to explain the meaning of a protected deposit "in a client account" and whether this should cover both designated clients' accounts and general clients' accounts. 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, consideration may be given to expressing the deposit as deposit held on account of a client to exclude cases where the money does not belong to the client.</p> | <p>As currently provided in the Bill, the term "client account" would cover both "designated client account" and "general client account". Since the funds held by a law firm as stakeholder have yet to be vested in the client, the Administration agrees with the Society that it is inappropriate to treat those funds as the client's money. 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. The Administration will introduce appropriate committee stage amendments to give effect to the above proposal.</p> <p>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. The Administration believes that clause 26(1) and clause 27(5), when read in conjunction with clause 24 of the Bill, would be capable of covering such a situation.</p> |

| <b><u>Subject/Clause</u></b>                       | <b><u>Organization</u></b> | <b><u>Concern/View</u></b>  | <b><u>Administration's response and follow-up action</u></b>   |
|--|----------------------------|---|--|
| Clause 27  | BA                         | <p>Since the expressions “agent” and “agency” are not defined in the legislation, it is unclear whether and, if so, to what extent an “agency” within the meaning of sections 27(3) and 27(4) overlaps with a trust. As a depositor who holds the deposit as an agent would also hold the deposit as a trustee, there may not be a need for a separate provision dealing with an agent's entitlement to compensation when sections 27(1) and (2) or section 28 relating to trustees would apply.</p> <p>A definition of “client account” under clause 27(5) will be useful.</p> | <p>According to the Department of Justice, the holding of a deposit by an agent could be anatomised into holding in one's own right (clause 26), as a bare trustee for the principal (clause 27(1)&amp;(2)) or as a trustee (clause 28). The Administration therefore agrees with the Association that clauses 27(3) and 27(4) may not be necessary. Corresponding amendments will also be made to other parts of the Bill.</p> <p>The Administration is considering introducing a definition of client account in the Bill.</p> |
| DPS Board's duties and powers<br>Clauses 30 and 49 | HKSA                       | Need for a cross-reference between clause 30(1)(b) on the requirement for depositors to produce documents in support of entitlement for compensation and clause 49 on the rule-making power specifying the documents which should be produced.  | The Administration will consider the suggestion of the Society in consultation with the Law Draftsman.   |

| <u>Subject/Clause</u>                            | <u>Organization</u> | <u>Concern/View</u>   | <u>Administration's response and follow-up action</u>   |
|--|---------------------|---|---|
| Board's power to obtain information<br>Clause 30 | LS                  | 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. | The Administration has clarified that 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. |



| <u>Subject/Clause</u>                         | <u>Organization</u> | <u>Concern/View</u>   | <u>Administration's response and follow-up action</u>   |
|---|---------------------|---|---|
| Limits to amount of compensation<br>Clause 33 | LS                  | <p>In the event where a client account holds money on behalf of more than one client, whether <u>each</u> client will be entitled to compensation from the Fund and the total amount of compensation to which <u>each</u> client is so entitled in respect of his share of deposit in the pooled deposit in the client account shall not exceed \$100,000. To also confirm whether 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 in determining whether the limit of \$100,000 has been exceeded.</p> <p>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. 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.</p> | <p>The Administration has confirmed that the Society’s understanding is correct.</p> <p>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). Having consulted the Department of Justice, the Administration believes that it is already clear that the coverage limit is imposed on the client/ agent.</p> |

| <b><u>Subject/Clause</u></b> | <b><u>Organization</u></b> | <b><u>Concern/View</u></b>   | <b><u>Administration's response and follow-up action</u></b>   |
|------------------------------|----------------------------|--|--|
| Interim payment<br>Clause 34 | BA                         | It is unclear whether all the conditions set out in subsections (a), (b) and (c) need to be satisfied before the Board can make an interim payment since “and” or “or” between subsection (b) and subsection (c) is missing. It is impossible to satisfy subsection (c), in view of section 33, which provides that the amount of compensation payable to a depositor of a failed Scheme member shall not exceed the amount in respect of which the depositor would, on the winding up of the failed Scheme member, be entitled to priority under section 265(1)(db) of the Companies Ordinance. | The Administration agrees that paragraph (c) is unnecessary and the word “or” should be added between paragraphs (a) and (b).  |
| Subrogation<br>Clause 36     | HKSA                       | The subrogation provision under clause 36(1)(b) may create uncertainty over the rights of depositors to receive compensation.  | The Society is concerned whether clause 36(1)(b) would affect a depositor's right to prove his claim in the liquidation of the failed bank. The Administration has explained that the purpose of this clause is to make it clear that the rights and remedies of the DPS Board acquired from the depositor will rank in priority to any residual rights and remedies of the depositor in respect of his deposits. This arrangement aims to reduce the cost of the scheme. To give effect to this proposal, clause 36(1)(b) imposes a restriction on the right of the depositor to receive payment from the liquidator until the Board has been reimbursed in full. According to the Department of Justice, the clause will not affect the depositor's right to prove in a winding up. The Administration notes that the Society is content with the explanation. |

| <b><u>Subject/Clause</u></b> | <b><u>Organization</u></b> | <b><u>Concern/View</u></b>   | <b><u>Administration's response and follow-up action</u></b>  |
|------------------------------|----------------------------|--|---|
| Subrogation<br>Clause 36     | LS                         | It is necessary to ensure that the subrogation provision under clause 36 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.                  | The Administration 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. The Administration will consider whether appropriate amendments to the Bill are required to address the Society's concern. |
|                              | BA                         | Clause 36(1)(a) will have the effect that the Board has priority over the depositor. This is a different from that in respect of the United Exchange Compensation Fund as formerly governed by Part X of the Securities Ordinance which provides that the Securities and Futures Commission is entitled under section 118 to be subrogated to a client's right in the proportion which the compensation payment bears to the client's claim. Under the latter approach, the Board and the depositor would have an equal right to prove in the liquidation. | The intention of the Administration is that the rights and remedies of the Board taken over from the depositor to whom it has paid compensation should rank in priority to any residual claims of the depositor. This arrangement is necessary to minimise the cost of the DPS.   |

| <b><u>Subject/Clause</u></b>                           | <b><u>Organization</u></b> | <b><u>Concern/View</u></b>  | <b><u>Administration's response and follow-up action</u></b>   |
|--|----------------------------|---|--|
| Subrogation<br>Clause 36                               | BA                         | The phrase “or any person who is subrogated under clause 36(1)(b), whether or not before the Board’s subrogation, to the rights and remedies or the depositor in relation to those rights” is superfluous since as a matter of common law, any person who is subrogated to the rights and remedies of the depositor in relation the deposits will be subject to prior equities. | It is possible that a depositor would be entitled to compensation under the DPS and the Investor Compensation Scheme (ICS) administered by the SFC. It has been agreed between the HKMA and the SFC that the DPS Board should have priority over the ICS in the liquidation when both schemes have paid compensation to the depositor. This provision is necessary to reflect this agreement. The Administration has explained to the Association the need for this provision. The Association is content with the explanation.  |
| Reimbursement from provisional liquidator<br>Clause 37 | HKSA                       | The circumstances under which a provisional liquidator may make payments to the DPS Board out of the assets of a failed member bank are unclear.  | The Administration has explained to the Society that clause 37 only enables, but does not oblige, the provisional liquidator (PL) of a failed Scheme member to make payment to the DPS Board. The intention is to allow the possibility of shortening the time required for the Board to receive payment from the liquidation, thereby helping to reduce the financing cost of the scheme. To protect the interests of the PL, it is expected that the DPS Board would provide an indemnity to the PL in respect of the payment. In addition, any such payment will be subject to the sanction of the court, which will take into account the interests of all relevant parties in determining whether the payment should be approved. It is relevant to note that in 1992 the PL of the Bank of Credit and Commerce Hong Kong Ltd made an interim payment to all depositors against an indemnity provided by the Government after obtaining the court’s approval of such an arrangement. The Administration notes that the Society is content with the clarification. |

| <b><u>Subject/Clause</u></b>  | <b><u>Organization</u></b> | <b><u>Concern/View</u></b>  | <b><u>Administration's response and follow-up action</u></b>   |
|---|----------------------------|---|--|
| Review of decisions or assessments by Tribunal Clause 39  | BA                         | Clause 39(10) should expressly provide for the right to legal representation at hearings before the Tribunal for review of a decision or assessment of the Board or a decision of HKMA.   | The right to legal representation is already provided in paragraph 5(6) of Schedule 3.   |
| Definition of "protected deposit" Schedule 1 Para1(a)(i)  | BA                         | The expression "agreed to by the depositor at the most recent time it was negotiated" appears to be too vague. An alternative is "a deposit which had an original term to maturity of more than 5 years", which is a phrase based on section 60(6)(b) of Banking Act 1987 (UK).   | The Administration prefers the proposed wording, which is consistent with the existing wording in the Companies Ordinance. It avoids any possible uncertainty in the situation where a depositor renews an existing term deposit before maturity (i.e. the original term to maturity). In this situation, it is the existing term to maturity rather than the original term to maturity which is relevant in determining whether or not the term deposit is protected by the scheme. |
| Consequential and other amendments Schedule 5 Para 1(d)(iii) on preferential payments under Companies Ordinance | BA                         | <p>Suggests revising the definition of "excluded person" under para (b)(ii) as follows -</p> <p>"the date on which <u>the</u> petition for the winding up of the company being wound up <u>was</u> presented"</p> <p>Suggests revising the definition of "related company" under para (c) as follows -</p> <p>"a subsidiary of the holding company <u>of the company</u>"</p> | <p>The Administration will consider amending paragraph (b)(ii) along the lines suggested by the Association.</p> <p>The Administration believes that the existing wording is clear and is more concise than the version suggested by the Association.</p>  |