Bills Committee on the Financial Institutions (Resolution) Bill

Response to matters raised by the Assistant Legal Adviser

This paper sets out the Government's response to matters in relation to the Financial Institutions (Resolution) Bill (the Bill) as raised by the Assistant Legal Adviser (ALA) of the Legislative Council Secretariat in the letter dated 4 January 2016 .

Basic Law issues

Article 110 of the Basic Law (BL) provides that the Government of the Hong Kong Special Administrative Region shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law. It appears that the proposed regime under the Bill would allow extensive intervention in the operation, appointment of senior executives and structure of the within scope financial institutions (FIs) by the relevant resolution authorities (before or after the taking place of resolution of such FIs). Please clarify whether the proposed regime as a whole would be consistent with the free operation of financial business in Hong Kong which is enshrined in Article 110 of the Basic Law and whether there are sufficient grounds to justify the extensive restrictions on the free operation of financial business imposed by the proposed regime.

2. Article 110 of the Basic Law (BL110) provides as follows:

"*The monetary and financial systems of the Hong Kong Special Administrative Region shall be prescribed by law*.

The Government of the Hong Kong Special Administrative Region shall, on its own, formulate monetary and financial policies, safeguard the free operation of financial business and financial markets, and regulate and supervise them in accordance with law."

First, the Government notes that whilst BL110 safeguards the free operation of financial business and financial markets, it also acknowledges that the operation can be regulated and supervised "in accordance with law". The Bill serves to regulate financial business operations in the sense of providing a mechanism for dealing with a financial business when it fails and thereby seeking to safeguard the

financial sector and financial markets.

3. The restrictions imposed by the Bill are reasonable measures. In considering the justifications of the restrictions on the free operation of financial business and financial markets imposed by the proposed regime under the Bill in regulating and supervising them, the Government has taken the prudent approach to consider if the restrictions are rationally connected to the aims of the restrictions and if the restrictions are proportionate to the aims.

4. We understand that the ALA's areas of concern are: (i) the "preparatory powers" under Part 3 of the Bill enabling the removal of impediments to resolution (clause 14) and, in the short period preceding resolution, the giving of directions to (clause 22), and removal from position of, directors and certain senior management of a within scope FI or related group company (clause 24); and (ii) the range of stabilization options and resolution powers available to the resolution authority once a within scope FI has met the three conjunctive conditions under clause 25 and resolution has been initiated.

5. Consistent with the resolution objectives under clause 8, the preparatory powers are designed to enable a resolution authority to take actions it deems will assist in achieving the aim of orderly resolution of within scope FIs. The preparatory powers are clearly connected to that aim given that the conditions on their use are tied to the resolution authority's ability to remove impediments to orderly resolution and to meet the resolution objectives (see clauses 14(1), 22(2) and 24(4)).

6. We are of the view that the above powers are proportionate. In respect of the powers to remove impediments under clause 14, affected FIs are afforded opportunity to make representations (clause 15(1)(c)) against any direction given by the resolution authority as well as ultimately being able to seek review of the direction at the Resolvability Review Tribunal (clause 17).

7. In respect of the direction and removal powers under clauses 22 and 24 respectively, these may only be exercised in the short period before resolution where the resolution authority is satisfied that Conditions 1 and 3 have been met (clause 21) but has yet to make a final determination on Condition 2. The powers are designed to prevent malicious / unsupportive action being taken by the directors of an FI or related group company that could serve to frustrate the resolution authority achieving the legitimate aim of meeting the resolution

objectives.

8. Once resolution has been initiated, for which a high threshold is established by the three conjunctive conditions under clause 25, a resolution authority should be equipped with a broad range of tools which it may deploy in order to best meet the resolution objectives taking into account the nature of the failure and prevailing circumstances at the time. While extensive powers are necessarily conferred on a resolution authority, in line with the powers set out in the Financial Stability Board (FSB)'s "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes),[1] to achieve the effective application of one or more stabilization options to a failed FI, a number of important safeguards are also provided for under the regime in order to ensure powers are applied proportionately. These safeguards include: (i) the explicit protection of certain financial arrangements (clause 75); (ii) the requirement to impose losses in resolution consistent with the insolvency creditor hierarchy (e.g. clause 58(6)(b)); and (iii) the "no creditor worse off than in liquidation" (NCWOL) safeguard.

9. Given the above, it is our view that the overall aim of the "restrictions" cited by the ALA is legitimate (i.e. to facilitate the achievement of orderly resolution and to meet the resolution objectives). The Government believes that there are sufficient grounds to justify the "intervention powers" provided for under the Bill and that the proposed regime is consistent with BL110.

10. Apart from BL 110, Article 109 of the Basic Law (BL109) is relevant. BL109 provides as follows:

"*The Government of the Hong Kong Special Administrative Region shall provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre*."

11. In safeguarding the free operation of financial business and financial markets under BL 110, the Government should provide an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an international financial centre (IFC).

[1] For reference, see: http://www.fsb.org/wp-content/uploads/r_141015.pdf

12. Given that Hong Kong is a member jurisdiction of the FSB and an IFC, we are seeking to implement the latest international standards in the Key Attributes. With a relatively small and open economy and as an IFC playing host to 29 of the 30 global systemically important banks (G-SIBs) and 8 of the 9 global systemically important insurers (G-SIIs), Hong Kong faces increased risks from any failure of an FI with significant international operations if an effective resolution framework is not in place. An effective resolution regime will complement the other prudential regulatory mechanisms adopted by Hong Kong to strengthen the resilience of its financial system.

13. In order to comply with the Key Attributes, there is no viable alternative but to enact local legislation to establish a resolution regime in Hong Kong. Therefore, we believe that the Bill, which is designed to implement international standards, provides an appropriate economic and legal environment for the maintenance of the status of Hong Kong as an IFC and that the safeguard of free operation of financial business and financial markets should be viewed in such light.

Under Article 105 of the Basic Law, the right of individuals and legal persons to the acquisition, use, disposal and inheritance of property and their right to compensation for lawful deprivation of their property shall be protected in accordance with law. It is noted that certain resolution measures and instruments proposed in the Bill would have the effect of derogating or even depriving of private properties in or relating to the within scope FIs (e.g. clawback of remuneration of certain senior executives of the FIs concerned, bail-in instruments, temporary public ownership, mandatory reduction of capital instruments, transfer instruments and suspension of payment obligations of a FI to its creditor, etc.). In the light of the protection of private property under Article 105 of the Basic Law, please clarify whether there are sufficient grounds to justify the proposed measures and instruments respectively in view of their impacts on the private property right of the shareholders, creditors and senior executives of the within scope FIs.

14. BL105 provides as follows:

(i) *"The Hong Kong Special Administrative Region shall, in accordance with law, protect the right of individuals and legal persons to the acquisition, use, disposal and inheritance of property and their right to compensation for lawful deprivation of their property.*

(ii) *Such compensation shall correspond to the real value of the property concerned at the time and shall be freely convertible and paid without undue delay.*

The ownership of enterprises and the investments from outside the Region shall be protected by law".

15. BL105 does not prohibit lawful deprivation of property per se and protects the right to compensation for lawful deprivation of property. Hence, the second paragraph of BL105 further provides that such compensation shall correspond to the real value of the property concerned at the time.

16. Regarding the "real value" compensation as referred to in BL105, it has been held[2] that there is no difference in substance between the real value test in BL105 and the principle of equivalence set out in Hong Kong's decided cases[3]. According to the principle of equivalence, the claimant is entitled to be compensated fairly and fully for his/her loss.

17. In the Bill, clause 33(3) provides for payment of "real value consideration" to the person whose property is transferred when resolution is initiated. This clause states that consideration that is fair and reasonable in the circumstances is due to the transferor in respect of any transfer under a Part 5 instrument (e.g. to the FI in a property transfer, or to the FI's shareholders in a share transfer).

18. In addition to the payment of fair and reasonable consideration on any transfer, those whose property rights are affected by resolution may also be eligible for NCWOL compensation. Clause 102 provides that pre-resolution creditors and pre-resolution shareholders, as a result of the resolution of the FI, who have received, are receiving or are likely to receive less favourable treatment than would have been the case had the entity been wound up immediately before its resolution was initiated are eligible for payment of NCWOL compensation.

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[2] See Penny's Bay Investment Company Limited v Director of Lands, LDMR 23/1999 and LDMR 1/2005 (25 May 2007) at paragraph 43.

[3] For the principle of equivalence, see *Director of Lands v Shun Fung Ironworks Ltd.* [1995] 2 AC 111, per lord Nicholls at 125.

19. We consider that NCWOL compensation would provide fair compensation (based on valuation assumptions and principles set out in Schedule 7 to the Bill and in the regulations to be made by the Secretary for Financial Services and the Treasury under clause 105) to the above-mentioned parties who suffer loss as a result of the resolution, instead of the FI entering into liquidation.

20. There is also an appeal mechanism to the Resolution Compensation Tribunal available to those aggrieved by any decision made by the independent valuer who undertakes the NCWOL compensation calculation.

21. The Government has also taken the prudent approach[4] to ensure that any lawful interference with property rights, even if it does not amount to deprivation, would need to be proportionate, i.e. a fair balance would be struck between the extent of the interference and the legitimate aim served by the interference so that any interference should be no more than is necessary to accomplish the aim.

22. It is the Government's intention that any application of stabilization options and exercise of resolution powers under the Bill will be pursued by the resolution authorities proportionately in the circumstances in a way that will best deliver the resolution objectives. In deciding how to resolve a failing institution in order to secure the continuity of the critical financial services, the Bill provides that a resolution authority must have regard to the objectives (clause 8) and must act in a way most appropriate for meeting those objectives. Thus in deciding on assets to be transferred or liabilities to be bailed-in etc., the authorities will be focussed on doing so to the extent they consider reasonably required to maintain financial stability (including continuity of services) and protect deposits, insurance policies and client assets to no less an extent than they would be protected on a winding-up. In

[4] The Court of Appeal has discussed whether the principle of proportionality applied in the light of the phrase of "in accordance with law" in the context of property right protection under BL105 in the case of *Hysan Development Co Ltd* v *Town Planning Board* CACV 232 and 233/2012. While it was held that the principle of proportionality was not inherent in the term "in accordance with the law" in BL105, the Court of Appeal did not reject the argument that the proportionality principle might be applicable at a systemic level in considering the constitutionality of the law itself. Accordingly, the Government is advised to take a prudent approach and to consider the proportionality principle in relation to property right protection. The case is currently subject to appeal.

other words, the actions of the resolution authorities will meet the proportionality test (where the resolution authorities pursue a legitimate aim and exercise their powers under the Bill in a way proportional to the achievement of that aim). It is not our intention to unjustifiably interfere with the property rights of individuals and legal persons under BL105.

23. In view of the significant public interest that the Bill will serve (i.e. enabling orderly resolution of FIs to mitigate the risks otherwise posed by their failure to the stability and effective working of the entire financial system of Hong Kong, including to the continued performance of critical financial functions (see the Long Title and clause 4 of the Bill)), we consider that any interference with property rights by enactment of the Bill would satisfy the proportionality requirement that may be implicit in BL105.

24. Lastly, we note that the question refers to, amongst others, (i) clawback of remuneration of certain senior executives of the FIs concerned; (ii) mandatory reduction of capital; and (iii) suspension of payment obligations as examples of deprivation of property. We would like to clarify that BL105 is unlikely to be infringed in the exercise of these powers under the Bill.

25. Clawback: The remuneration that is subject to clawback is traceable to the senior executives' misconduct in causing or contributing to the failure of an FI (clause 143) and is in the nature of a penalty rather than deprivation of property. Besides, given that the recovery of a sum of money paid to a senior executive would not render their employment contract completely worthless, it would not amount to deprivation. Applying the fair balance test, as the restriction of contractual rights would pursue the legitimate aim of penalizing misconduct, the senior executive would unlikely suffer a disproportionate burden.

26. Mandatory reduction of capital instrument: Any "deprivation" of property caused by the making of a capital reduction instrument will actually reflect and be in accordance with the terms of write down or conversion as previously agreed between the issuer and the holder of the relevant subordinated debt capital instruments (and set out in terms and conditions of the relevant instrument). See clause 31(9) of the Bill.

27. Suspension of payment obligations / Stay on early termination rights: Given that any suspension of payment obligations or stay on exercise of early termination rights by counterparties of the failing FI

would not render the relevant contracts void, it does not amount to deprivation. Applying the fair balance test, as the restriction of contractual rights would be strictly limited in time (two business days) (clauses 83(4) and 90(4) respectively) and pursues the legitimate aim of ensuring the stability of the financial market and the continued provision of critical financial services, the counterparties would unlikely suffer a disproportionate burden.

Mandatory Provident Fund (MPF) Scheme issues

It is noted that certain banks and insurance companies in Hong Kong (i.e. systematically important banks and insurers) are also approved trustees of registered MPF Schemes. Please clarify the following matters:-

(a) The reasons why the Bill does not provide for (i) the arrangements or transfer of the registered MPF Schemes managed by the FIs which move into resolution and (ii) the protection of accrued benefits in such Schemes in the relevant resolution process; and the reasons why there are no corresponding or consequential amendments to the Mandatory Provident Fund Schemes Ordinance (Cap. 485).

28. In respect of (a)(i) above, under the Bill the resolution authority can transfer assets held on trust by an FI in resolution (sections 4(7) and (8) of Schedule 4 refers). Accordingly, if the FI in resolution is itself an MPF trustee and the resolution strategy is to use a transfer stabilization option, then the MPF assets it holds as trustee can be transferred to a purchaser, or bridge institution if required. Furthermore, liabilities arising because of holding client assets cannot be subject to bail-in (section 2(m) of Schedule 5) – so if the resolution strategy is a bail-in to recapitalise an FI in resolution but leaving its businesses intact – then the recapitalised FI could continue to act as an MPF trustee.

29. Where the MPF assets are not held by the FI in resolution directly but are held by a subsidiary – the Bill enables the resolution authority to transfer the shares in the subsidiary as assets of the FI in resolution (clauses 39(2) and 42(2)).

30. In the course of the resolution planning and resolvability assessments which will be conducted in respect of FIs within the scope of the regime, consideration will be given to any business of the FI as an MPF trustee and the options available for dealing with and securing

continuity of this business in an orderly manner should the FI enter resolution. This pre-planning should ensure the smooth and safe transfer of MPF Scheme trust assets in the event of resolution of an FI.

31. Considering further the scope of the resolution regime in the context of activities of FIs as approved trustees of registered MPF Schemes, it is our understanding that (i) all MPF trustees are subsidiaries or associated companies of banking or insurance groups; and (ii) MPF assets are held either by those trustees or their appointed custodian banks (which are themselves authorized institutions (AIs) under the Banking Ordinance (Cap.155)). All AIs are within scope of the resolution regime and as such any MPF trustee subsidiary/associated company of a within scope AI or any AI's activities as a custodian bank for MPF trustees could be captured within the group resolution strategy for that AI. In respect of authorized insurers, only those that are, or are a subsidiary or branch of, a global systemically important insurer are proposed to be within scope of the resolution regime and so not all authorized insurers are "automatically" within the scope of the local regime. Where MPF trustees are subsidiaries/associated companies of insurers that are not within the scope of the resolution regime, and there are systemic grounds for doing so, those insurers could be brought within the scope of the regime through the exercise of the FS's power to designate an FI as a within scope FI under clause 6 of the Bill. Furthermore, were the FS to assess that the failure of an MPF trustee of itself could pose a threat to the stability and effective working of the financial system of Hong Kong, the MPF trustee could also be brought within scope of the regime through the exercise of such designation power under clause 6 of the Bill.

32. In respect of (a)(ii), the second resolution objective to which the resolution authority must have regard is to seek to protect client assets (clause 8(1)(c)) and, as noted in the response to (a)(i), whilst the resolution authority can transfer the MPF assets held on trust by the FI in resolution to a purchaser/or bridge institution it cannot, in doing so, affect the beneficial interest of a client in those client assets (section 4(8) of Schedule 4 to the Bill). So in effect the MPF assets can be transferred to another trustee or custodian but this would not affect the beneficiaries' interests in the assets so transferred. If bail-in, rather than transfer, is the preferred resolution strategy, then client assets are protected from bail-in as they are not assets beneficially owned by the FI in resolution.

33. On the above basis, it is considered not necessary to include

additional consequential amendments to the Mandatory Provident Fund Schemes Ordinance (Cap.485).

(b) As the registered MPF Schemes are not within the protective schemes under Schedule 1 to the Bill, it appears that the accrued benefits in those Schemes would not be excluded from the resolution actions under the Bill. Would those registered MPF Schemes and the accrued benefits administrated by the FIs concerned be made subject to the stabilization options or resolution instruments proposed in the Bill?

34. The resolution objective under clause 8(1)(b) of the Bill requires a resolution authority to seek to protect deposits or insurance policies of an FI in resolution to no less an extent than they would be protected under one of the Schemes set out in Schedule 1 to the Bill in a winding up of the FI. The schemes set out under Schedule 1 are those existing schemes that afford a degree of protection to depositors and policyholders in the event that the bank holding their deposit or the insurer that has issued their policy enters into winding up proceedings. Since these Schemes are designed to provide protection in the case of a winding-up, it is appropriate that the resolution authority should be required to afford relevant parties at least the same degree of protection in resolution.

35. The resolution objective to protect "client assets", under clause 8(1)(c), obliges a resolution authority to protect client assets to no less an extent than they would be protected on a winding up. Client assets are defined to include securities and other property held by an FI in the course of carrying on a business as a trustee or custodian of securities or other property for another person whether on trust or by contract (clause 3 "client assets" definition section (c)). Accordingly, where an FI in resolution is an MPF trustee, holding MPF assets on trust for others, those assets are to be protected under the Bill to no less an extent than on a winding-up of the FI.

(c) Will the MPF Authority play a role in the resolution of a within scope FI which is also an approved MPF Schemes trustee under Cap. 485? Why the Bill does not provide for the functions and roles of the MPF Authority in the resolution of such FIs? Will the MPF Authority be consulted by the relevant resolution authorities in the resolution actions?

36. Assistance may be sought by a resolution authority from the Mandatory Provident Fund Authority (MPFA) in support of the resolution of a within scope FI which is also an approved MPF Schemes

trustee under Cap. 485. Such support might take the form of expediting the approval of an acquirer to whom MPF assets are sought to be transferred through the use of a property transfer instrument, in cases where the acquirer is not already approved by the MPFA to act as a trustee for registered MPF Schemes. In cases where the resolution strategy envisions a transfer of assets, it is expected that the resolution authority will engage the MPFA during the resolution planning process. However, it is not the Government's intent for the MPFA to have a formal function or role in undertaking orderly resolution of FIs under the Bill, as the central remit of resolution lies with the resolution authorities appointed under the Bill.

Protection of employees' interests in resolution of FIs

It is noted that there are no provisions in the Bill which are specifically made for protecting the interests of the pre-resolution employees of FIs which move into resolution. In this connection, please clarify the following matters:

(a) Since the FIs that move into resolution under Part 4 of the Bill will not be subject to a winding-up petition, payments from the Protection of Wages on Insolvency Fund under section 16 of the Protection of Wages on Insolvency Ordinance (Cap. 380) will not be available to the pre-resolution employees of such FIs. Please explain why there is no provision in the Bill to ensure that the treatment of pre-resolution employees of such FIs would not be worse off than those in the winding-up scenario under Cap. 380.

37. We are of the view that resolution should result in a better outcome for most, if not all, of the employees of a failed FI. That said, the precise outcome for employees, who are still in employment at the point of resolution being initiated, will depend on the resolution strategy ultimately carried out on a case-by-case basis.

38. Following the exercise of certain stabilization options, namely (i) a compulsory transfer of ownership of an FI in resolution (i.e. transfer of the shares in the FI) to a financially sound acquirer or (ii) a bail-in of certain liabilities of the FI; then all employees of the failed FI should experience little, if any, disruption to their immediate employment in that they will continue to be employed by the same legal entity (albeit that the ownership of shares in the FI may have changed hands).

39. Where resolution is effected through a partial property transfer (because it is only necessary to transfer certain of the failed FI's assets, rights and liabilities to a financially sound acquirer/bridge institution/asset management vehicle (AMV) in order to secure the continuity of critical financial functions), then the resolution authority would need to transfer to the acquirer the employment contracts of those employees who are needed to support the performance of the critical functions which have been transferred. For those employees whose contracts of employment are transferred, section 7(4) of Schedule 4 to the Bill provides that the property transfer instrument effecting that partial transfer can include provision about continuity of employment. Further, section 7(1)(b) of Schedule 4 enables a property transfer instrument to provide for a transferee to be treated for any purposes connected with the transfer as the same person as the transferor.

40. In the case of a partial transfer, other employees not involved in the performance of the critical financial functions (and hence whose contracts of employments are not transferred to the acquirer) will remain employed by the residual FI which would now house those parts of the FI in resolution that are not systemically important and that a commercial purchaser would not find it attractive to buy. For those employees remaining with the residual FI, there would be no impact on their employment status or contract as the employing entity remains unchanged and as such there is no need for the employees to seek assistance from the Protection of Wages on Insolvency Fund at all. In case the residual FI subsequently enters into liquidation or is wound up by creditors, all existing statutory and contractual protections will remain applicable to employees including specifically the protections under the Protection of Wages on Insolvency Fund and the priority afforded in liquidation under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32). In addition, to the extent that they are pre-resolution creditors of the FI in resolution, employees would be eligible for NCWOL compensation should their treatment in resolution, as creditors, be assessed to be worse than it would have been if the FI had otherwise been wound up. This safeguard ensures that no pre-resolution creditors, including employees, would receive a worse outcome in resolution than they would have received had the FI otherwise been wound up.

(b) What measures (legislative or administrative) will be taken by the Administration and the relevant resolution authorities to protect the interests of the pre-resolution employees of such FIs?

41. We are considering the matter and will respond in due course.

(c) Will the requirements in the Employment Ordinance (Cap. 57) be binding on the resolution authorities, the section 10 entities and the bridge institutions/asset management vehicles/temporary public ownership companies in respect of the pre-resolution employees of the FIs?

42. In respect of the resolution authorities and section 10 entities, there is no concept in the Bill of employees of a failed FI being transferred to either as a result of the application of a stabilization option.

43. The resolution authority can however use a property transfer instrument to transfer contracts of employment to an acquirer (which is usually a company in the private sector but might be a bridge institution (bridge), an AMV or a temporary public ownership (TPO) company) of part of the business of a failing FI. The property transfer instrument, when used to transfer employment contracts, can include provisions regarding continuity of employment.

44. In the unlikely event that an employee objects to his/her contract of employment being transferred by a property transfer instrument, the employee cannot be compelled to work for the acquirer and hence the resolution authority can either make the property transfer instrument conditional upon employees' attendance and work following the issuance of the instrument, or alternatively use a reverse property transfer instrument to retransfer the contract of the objecting employee back to the residual FI. As noted above, to the extent it is practicable to engage with employees and employee representatives ahead of the issuance of any property transfer instrument (whilst recognising that there may be a need for confidentiality in respect of planned resolution action), this will be done to minimise the need to use conditional or reverse property transfer instruments.

45. A bridge, AMV or TPO company would be a separate legal entity incorporated under the Companies Ordinance (Cap. 622) (see clauses 43(a), 51(a) and 69(a) of the Bill) and as such would be subject to the requirements of any Ordinance that is generally binding on such companies, including the Employment Ordinance (Cap. 57). There is no specific provision in the Bill that would seek to restrict the provisions of the Employment Ordinance (Cap. 57) from applying to a bridge, AMV or TPO company in respect of any of their employees, including

"pre-resolution employees" transferred from a failed FI.

(d) Will the resolution authorities, the section 10 entities and the bridge institutions/asset management vehicles/temporary public ownership companies, subject to the relevant provisions in the Bill, be bound by the terms of the relevant pre-resolution employment/service agreements of the FIs in resolution?

46. In the case of bail-in or a transfer of ownership (i.e. a transfer of the shares) of a failed FI, employees would continue to be employed on the same terms given that they remain employed by the same legal entity and, as noted in the response to (b) above, wages (and employee benefits calculated by reference to wages) are excluded from the application of bail-in. In the case of a partial property transfer, again as noted above in the response to (b), section 7(4) of Schedule 4 empowers the resolution authority to include provision about continuity of employment in a property transfer instrument. It is anticipated that this provision, coupled with that in section 7(1)(a) of Schedule 4, could follow the approach adopted in bank merger ordinances and provide for a transferee (i.e. a bridge, AMV, or commercial purchaser) to be treated as the same person as the transferor (i.e. the failed FI) for the purposes of protecting employees' interests (e.g. the qualifying period of employment for the purpose of determining long service payments/severance payments).

Part 1 (Preliminary)

Please clarify if the definition of "assets" under clause 2(1) would include goodwill, copyright and registered patent of the entities concerned.

47. The definition of "assets" under section 2 is purposefully intended to be broad and our view is that it covers goodwill, copyright and registered patents.

Under clause 2(1), "chief executive officer" (CEO) means a person who is responsible (alone or jointly with others) under the immediate authority of the directors for the management of the whole of the business of the entity (emphasis added). Please clarify if this definition of CEO can cover the scenario that part of the business of an entity is not under the management of a CEO but is directly managed by the board of directors (or by another person appointed by the board) and

thus the relevant CEO does not actually manage the whole of the business of the entity.

48. We would not have thought that the scenario outlined above would be very common and indeed under the Banking Ordinance (Cap.155), which requires every authorized institution (AI) to appoint a chief executive and not less than one alternative chief executive, the Monetary Authority would generally expect that person to be responsible for the management of the entire business of the relevant AI (or, in the case of overseas incorporated AIs, of all the business of the institution in Hong Kong).

49. That said, we acknowledge that it is not inconceivable that certain control functions might work directly to the Board. To capture such eventualities, the Government would have no objection to amending the definition of "chief executive officer" along the following lines (addition underlined): "chief executive officer (行政總裁), in relation to an entity, means (except in Part 9) a person (by whatever name called) who is responsible (alone or jointly with others) under the immediate authority of the directors for the general strategy of the entity and the general management of the business of the entity and includes, if the entity is established or incorporated in a non-Hong Kong jurisdiction, the person who is responsible (alone or jointly with others) for the general management of the business of the entity in Hong Kong".

Please confirm if the notices to be published by the Financial Secretary (FS) under clause 6(5) (i.e. notices for specifying the control functions of an entity) are subsidiary legislation subject to amendment by the Legislative Council (LegCo) under section 34 of the Interpretation and General Clauses Ordinance (Cap. 1).

50. The notice which specifies the control functions of an entity to be published by the FS under clause 6(5) of the Bill is subsidiary legislation. It will be subject to negative vetting by the Legislative Council under section 34 of Cap. 1.

Please consider if Financial Secretary (FS) should be empowered by the Bill to give directions to the resolution authorities, section 10 entities and the appointing persons (appointed under clause 95) that he thinks fit with respect to the exercise of their respective functions under the resolution regime either generally or in any particular case so that FS can oversee the overall resolution process after its initiation and ensure that public interest is always safeguarded in such process.

51. In developing the regime proposed to be established by the Bill, the Government has paid close attention to the international standards in this area, namely the FSB's Key Attributes. Key Attribute 2.5 states that "[t]he resolution authority should have operational independence consistent with its statutory responsibilities, transparent processes, sound governance and adequate resources and be subject to rigorous evaluation and accountability mechanisms to assess the effectiveness of any resolution measures". The Bill has therefore been prepared on the basis that a resolution authority should have the necessary operational independence in order to be able to act promptly and decisively to implement resolution actions at a time of crisis. The Bill also provides accountability through requirements for the resolution authority to consult the FS before initiating resolution and also through reporting requirements to the FS and the FS will cause a copy of the report to be laid on the table of the Legislative Council.

52. Furthermore, as part of its recommendation that the Government should continue efforts to develop a comprehensive resolution regime in line with international practice, the International Monetary Fund, in its 2014 assessment of Hong Kong under its Financial Stability Assessment Program (FSAP), specifically emphasised that any resolution authority should be sufficiently operationally independent from the Government, and not bound by decision-making procedures which could impede the prompt and decisive exercise of resolution powers.

53. Section 10 entities will act in accordance with instructions from the resolution authority given that their role is to assist the resolution authority in the performance of its functions (clause 10). As the resolution authority should have operational independence and section 10 entities should act in accordance with the resolution authority's instructions, it would not seem appropriate for section 10 entities to be subject to direction by FS. Since the role of the appointing person is to ensure that neither the resolution authority nor the Government exercise undue influence over the choice of an independent valuer (otherwise the FS or the resolution authority could more easily make the appointment), it would not seem appropriate for FS to issue directions to the appointing person.

Part 3 (Powers related to Resolution)

Please give examples or illustrations on what would be regarded by the resolution authorities under clause 12 as impediments to the orderly resolution of the within scope FIs in the banking, the insurance and the securities and futures sectors.

54. It is not possible to provide an exhaustive list of potential impediments to an FI's orderly resolution as much will depend upon the organizational structures and business practices of individual FIs, but we set out below examples of scenarios which might be relevant in this context:

(i) Group structure: a local financial group might be made up of several entities which are highly interconnected but legally separate. Given the interconnections, it may not be feasible to seek to resolve each of the entities individually. In such a case the incorporation of a new local holding company, over such entities, might enable orderly resolution of the group. That said, it is not a requirement of the regime that all within scope FIs will automatically be required to establish locally incorporated holding companies and any such decision would be made on a case-by-case basis;

(ii) Securing operational continuity: crucial services may be provided to a within scope FI from disparate entities within its corporate group located in various jurisdictions. This may make it difficult to attain a sufficient degree of certainty that these services will continue to be provided to the FI in resolution. This might be addressed by requiring activities supporting the provision of critical financial services to be concentrated into certain legal entities within a group with separate management and funding structures so that they might be made "bankruptcy remote" and protected more readily in resolution, or by enhancing contractual arrangements so that they will withstand the resolution of the FI and are in effect "resolution remote";

(iii) Financial dependencies: a within scope FI might rely on an overseas group member for the provision of significant intra-group liquidity. The resolution authority may require the FI to reduce such reliance on other parts of the group (e.g. by limiting the scale of intra-group exposures) if the resolution strategy for the group envisages the separation of the relevant

parts of the group;

(iv) Booking models: an FI might book trades with another group entity, possibly overseas, in order to transfer the associated risk. Such arrangements may need to be rationalised to enhance certainty of resolution, e.g. where the preferred resolution strategy envisions the separation of the FI and the booking entity;

(v) Local presence: a local branch operation may be systemically important but concerns may arise in respect of the ability/willingness of a home authority to resolve that branch as part of a coordinated group resolution strategy. In such cases, in order to have greater control, the resolution authority may determine that local subsidiarisation of the branch's operations is warranted. (It is, however, not an automatic requirement of the proposed regime that branch operations must be "subsidiarised" and any such decision would be made on a case-by-case basis.)

55. Clause 194(1) of the Bill empowers a resolution authority to issue a Code of Practice (CoP) about the performance of its functions under the Bill. Clause 194(2)(a) specifies that the CoP may provide guidance on, amongst other things, the approach to, and procedures for, resolution planning and resolvability assessment (including the removal of impediments to orderly resolution). We consider that, given the wide range of potential scenarios that could arise, further details and examples are more appropriate for inclusion in a CoP rather than in the Bill itself.

Under clause 14, a resolution authority may serve a written notice on a holding company of a within scope FI to direct it to take measures to remove or mitigate the effect of impediments to the orderly resolution of the within scope FI. In case the holding company is incorporated and situated in a non-Hong Kong jurisdiction, how can the relevant resolution authority implement or enforce the notice issued under clause 14?

56. The Government recognises the potential issues in exercising powers under the Bill in respect of, for example, holding companies and affiliated operational entities (AOEs) where these are incorporated in a jurisdiction other than Hong Kong. It is, however, worth noting that precedent exists in other Ordinances for regulators to have powers over holding companies without reference to their place of incorporation.

For example, section 63(2A)(a) of the Banking Ordinance (Cap. 155) empowers the Monetary Authority to require, amongst others, a holding company of an authorized institution "to submit… information… as he may reasonably require for the exercise of his functions under [the Banking Ordinance]…".

57. In the context of resolution, the standards set by the Key Attributes are designed to enhance certainty in cross-border resolution through alignment of jurisdictions' resolution frameworks. Therefore, to the extent that the jurisdiction in which a holding company is incorporated has implemented the standards set by the Key Attributes in respect of the "recognition" of resolution actions exercised by a foreign resolution authority, including that in Hong Kong, then the exercise of the powers under clause 14 in respect of an overseas incorporated holding company could, subject to any relevant conditions, be given effect in that jurisdiction.

58. Furthermore, where the overseas incorporation of the holding company in question was determined to represent a barrier to a local FI's resolvability because the jurisdiction of incorporation would not or could not enforce any such direction under clause 14, then a resolution authority in Hong Kong would be empowered to require the FI itself to take steps to address that barrier, e.g. by reducing any operational dependencies upon that holding company or establishing a locally incorporated intermediate holding company. It is important to note that such measures would not be automatic as a result of the regime, but would be case-specific dependent on the extent to which the impediment posed a threat to orderly resolution and on any alternative actions that had been proposed by the FI.

<u>Please clarify if the relevant resolution authority has discretion, on reasonable grounds, to extend the period specified in the notice served under clause 14(2) (whether on its own motion or on the application of the FI concerned). For the avoidance of doubt, please consider if such discretion (if any) should be expressly provided in the Bill.</u>

59. The Bill does not expressly provide that a resolution authority has discretion to extend the period specified in the notice served under clause 14(2). The Government does not consider it necessary to include such an express provision in the Bill because section 46 of Cap. 1 provides that:

"*[w]here any Ordinance confers power upon any person to make, grant,*

issue or approve any proclamation, order, notice, declaration, instrument, notification, licence, permit, exemption, register or list, such power shall include power-

(i) to amend or suspend such proclamation, order, notice, declaration, instrument, notification, licence, permit, exemption, register or list;

(ii) to substitute another proclamation, order, notice, declaration, instrument, notification, licence, permit, exemption, register or list for one already made, granted, issued or approved;

(iii) to withdraw approval of any proclamation, order, notice, declaration, instrument, notification, licence, permit, exemption, register or list so approved; and

(iv) declare the date of the coming into operation, and the period of operation, of any such proclamation, order, notice, declaration, instrument, notification, licence, permit, exemption, register or list".

60. Therefore, if a relevant resolution authority considers it reasonable to extend the period specified in the notice served under clause 14(2), it can amend the relevant notice or substitute the relevant notice with another notice specifying an extended period in which measures directed by a resolution authority must be taken.

Under clause 16(3)(b), an officer of a within scope FI or holding company commits an offence (i.e. not complying with the notice of a resolution authority) if he was knowingly concerned in any way (whether by act or omission) in the commission of the offence under that section by the FI or holding company. Please clarify what elements would need to be proved for an offence under clause 16(3)(b). Would a senior executive of the FI be criminally liable under clause 16(3)(b) merely by knowing the facts about the commission of the offence by the FI under clause 16(1) and occupying certain senior position in the FI even if he did not assist or take part in the act (or omission) of committing such an offence by the FI?

61. In order to establish an offence under clause 16(3)(b), the prosecution needs to prove beyond reasonable doubt the following elements:

(i) the within scope FI or holding company to which the officer belongs committed an offence under clause 16(1); and

(ii) the officer was knowingly concerned in any way (whether by act or omission) in the commission of the offence by the FI or holding company.

62. The term "knowingly concerned" is not defined in the Bill and this term has also been used in a number of Ordinances (without definition). It has been held that:

(i) the accused must have had actual knowledge of the facts on which the relevant contravention of law depends (though it is irrelevant whether he knew those facts constituted a contravention) (i.e. "knowingly"); and

(ii) the accused must have had actual involvement in the contravention (i.e. "concerned").[5] It seems that the actual involvement must be with the accused's knowledge that doing so would contribute to the factual circumstances constituting the offence, though such knowledge might be inferred if the accused had deliberately shut his eyes to the obvious or refrained from inquiry because he suspected the truth but did not want his suspicions confirmed (although suspicion alone would not seem to be enough).[6]

63. In the example raised in the question above, if the senior executive (assuming for the purpose of this response that he is an "officer" as defined in clause 2(1) of the Bill) had actual knowledge of the facts (i.e. he knew that the within scope FI or holding company had been served with a notice under clause 14(2) that is confirmed under section 15(2) or (4) and that the FI had no reasonable excuse not to comply with the notice within the period specified in it) and acted in a

[5] Regarding actual knowledge and involvement, see *Securities and Investments Board v Pantell SA and others (No 2)* [1993] 1 All ER 134 at 148 (a decision of the English Court of Appeal) and *R. v Taaffe* [1983] 1 WLR 627 at 630 (a decision of the English Court of Appeal affirmed by the English House of Lords in [1984] 2 WLR 326). Regarding knowledge of the facts, see *Securities and Investments Board v Scandex Capital Management A/S and another* [1998] 1 All ER 514 at 521 (a decision of the English Court of Appeal).

[6] See *R. v Corrigan* [2014] NICA 85 at paragraph 37 (a decision of the Court of Appeal in Northern Ireland).

way that he knew would contribute to the factual circumstances constituting the offence by the within scope FI or holding company (e.g. he instructed his subordinates not to comply with the notice), that would be an example in which he could be "knowingly concerned" in the commission of the offence under clause 16(3)(b).

64. Apart from positive action, criminal liability under clause 16(3)(b) could also arise by way of an omission to act because the words in parenthesis "whether by act or omission" appearing in clause 16(3)(b) serve to categorise how an accused may be "concerned" (which verb is qualified by "knowingly"). For an omission, rather than having knowingly acted, it must be proved beyond reasonable doubt that the accused had knowingly omitted to act in a way that he knew would further the facts leading to the commission of the offence by the within scope FI or holding company. For example, if the senior executive (again having actual knowledge of the facts) omitted or failed to give a necessary approval to implement changes to comply with the notice issued by the resolution authority, that would be an example in which he could be "knowingly concerned" in the commission of the offence under clause 16(3)(b) of the Bill.

65. The offence in clause 16(3)(b) is intentionally directed at an "officer" of the FI (or of the holding company) which, given the definition of "officer" in clause 2, should only capture persons who are in a position to do something (because of their relative seniority) about a prospective contravention by the FI or holding company.

Please clarify whether the rules prescribing the "loss-absorbing capacity requirements" for within scope FIs to be made under clause 19 are subsidiary legislation subject to amendment by LegCo under section 34 of Cap. 1.

66. The rules prescribing the loss-absorbing capacity requirements for within scope FIs to be made by a resolution authority under clause 19 are subsidiary legislation and will be subject to negative vetting by the Legislative Council under section 34 of Cap. 1.

Please clarify whether a resolution authority has power under clauses 23 and 24 to revoke the appointment of an authorized representative of a non-Hong Kong FI appointed under section 786 of the Companies Ordinance (Cap. 622). If so, please consider if such power should be expressly provided in Part 3 of the Bill or Part 16 of Cap. 622.

67. The policy intent behind the power in clause 24 of the Bill, (which is only operable in the short period leading up to the initiation of resolution) is to enable the resolution authority to remove from their posts those persons who are empowered to take actions that might bind the FI (and thus could potentially frustrate the objective of the resolution authority in achieving orderly resolution). It is therefore not the Government's intention that such power could be used to revoke a person's appointment as an authorized representative under section 786 of the Companies Ordinance (Cap. 622) per se, but it could remove them from their position to the extent that such person is also a director, CEO or DCEO of the FI or its holding company.

Please clarify whether the revocation of appointment as a director, CEO or deputy CEO of a within scope FI under clause 24 would be made known to the public by the relevant resolution authority. If so, how?

68. We have carefully considered how the removal of a director under clause 24 of the Bill should be publicised, especially given the potential signalling effects of the removal at a time when the FI is under severe stress. Given that the power of revocation can only be exercised when the resolution authority is satisfied that the FI has ceased, or is likely to cease, to be viable, and that failure of the FI poses risks to the stability of the financial system (i.e. Condition 1 and Condition 3 under clause 25 are met) a resolution authority would be extremely concerned about fuelling any panic or stress surrounding the FI by making an immediate announcement itself which essentially confirms that resolution might be imminent and thereby triggers behaviour (such as abrupt withdrawal of funding) that might jeopardise subsequent orderly resolution or make it more difficult to achieve. On balance, it is therefore considered that notification to the public should be made through the usual mechanisms under the prevailing company and securities law requirements.

Part 4 (Moving to Resolution)

Please elaborate what would be regarded by a resolution authority as non-viability of a within scope FI under conditions 1, 2 and 3 in clause 25 of the Bill. Should the criteria for non-viability of within scope FIs be expressly provided in the Bill?

69. Clause 5 of the Bill defines, for the purposes of condition 1 in clause 25, when an FI ceases to be viable linking the decision in the case

of a regulated FI to a breach of the FI's authorization or licensing criteria that warrants removal of its authorization or licence. It is however not automatically the case that any contravention of an authorization / licensing criterion will be regarded as non-viability. Much will depend upon the surrounding circumstances. For instance in the case of a failure to maintain a minimum solvency ratio, consideration would be given to whether the trajectory of the capital ratio is sharply descending or whether the breach is of a more technical nature (e.g. perhaps due to a previously undetected computational error.).

70. Since an element of judgement must inevitably play a part in an assessment of non-viability, we consider that it is not feasible to set out precisely each and every criterion by reference to which, or each and every situation in which, a resolution authority would make a non-viability determination. However, appropriate guidance and examples are intended to be included in the CoP expected to be issued under the Bill (clause 194(2)(a)(ii)) to provide more clarity to the industry. Consultation would be conducted before the CoP is issued.

71. Decisions on non-viability for the purpose of triggering resolution are subject to judicial review should it transpire that a resolution authority has acted in an unreasonable manner.

<u>How would a resolution authority exercise its powers or enforce its decisions made under clauses 28(1) and 29(1) if the relevant holding company or affiliated operational entity of a within scope FI is incorporated in a foreign jurisdiction and its major operation or assets are situated outside Hong Kong?</u>

72. As explained above in paragraphs 56-58, the Government recognises the potential issues in exercising powers under the Bill in respect of, for example, holding companies and AOEs where these are incorporated in a jurisdiction other than Hong Kong. We also note precedents exist in other Ordinances for requirements directed at holding companies (irrespective of their jurisdiction of incorporation). For example, section 63(2A)(a) of the Banking Ordinance (Cap. 155) empowers the Monetary Authority to require, amongst others, a holding company of an authorized institution "to submit… information… as he may reasonably require for the exercise of his functions under [the Banking Ordinance]…".

73. In the context of resolution, the standards set by the Key

Attributes are designed to enhance certainty in cross-border resolution through alignment of jurisdictions' resolution frameworks. Therefore, to the extent that the relevant jurisdiction (in which a holding company or AOE is incorporated) has implemented the standards set by the Key Attributes in respect of the "recognition" of resolution actions exercised by a foreign resolution authority, including that in Hong Kong, then the exercise of the powers under clauses 28(1) and/or 29(1) in respect of an overseas incorporated holding company or AOE could, subject to any relevant conditions, be given effect in that jurisdiction.

74. The resolution planning and resolvability assessment process will be used to identify any potential impediments to orderly resolution stemming from any inability to exercise powers in relation to entities incorporated outside Hong Kong and to determine whether measures need to be taken to remove them (please see also response above regarding clause 14 notices served on holding companies).

Please clarify the reasons why there are no appeal mechanisms for the decisions on (a) initiation of resolution of a FI and (b) making of a capital reduction instrument in respect of an authorized institution (i.e. a bank) under Part 4 of the Bill.

75. Initiation of resolution: recognizing that it is imperative that a resolution authority be able to implement resolution actions swiftly and decisively in respect of a failed FI in order to secure continuity of critical financial functions and maintain confidence and certainty in the market, the Key Attributes (Key Attribute 5.5) provide that "[t]he legislation establishing resolution regimes should not provide for judicial actions that could constrain the implementation of, or result in a reversal of, measures taken by resolution authorities acting within their legal powers and in good faith. Instead it should provide for redress by awarding compensation, if justified".

76. In light of above, although the Bill does not provide a specific avenue of appeal against a decision to initiate resolution, the resolution authority's exercise of powers is subject to checks and balances and appropriate governance arrangements. Before the initiation of resolution, the resolution authority must issue a "letter of mindedness" to the FI giving the FI an opportunity to make representations (clause 30). The resolution authority must also consult the FS (clause 27) (and must seek the FS' approval in the "last resort" case of TPO (clause 68)) and must periodically report to the FS who will cause a copy of any such report to be laid on the table of the Legislative Council (clauses 40,

46, 55, 65 and 72). The Bill also provides for the NCWOL compensation mechanism as a safeguard to ensure that pre-resolution shareholders and creditors of the FI in resolution have a right to compensation to the extent that their outcome in resolution is worse than would have been the case had the FI otherwise been wound up. Ultimately, judicial review remains available in respect of decisions made on the exercise of resolution powers.

77. Although the Key Attributes expressly require that the legislation establishing the regime should not provide for judicial action, they do not attempt to disapply rights to judicial review which exist outside of the legislation establishing the regime. We consider that the availability of an avenue of appeal through judicial review strikes an appropriate balance between the need to secure speed and certainty of resolution action and the provision of an avenue of redress for those affected by resolution.

78. Capital reduction instrument: the resolution authority's power to make a capital reduction instrument ensures that the holders of Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments issued by an AI absorb losses in accordance with the existing terms and conditions of those instruments. Under the Banking (Capital) Rules (Cap.155L) AT1 & T2 capital instruments must include a provision in their terms and conditions to the effect that the instrument will be written off or converted into ordinary shares upon the occurrence of a trigger event. That trigger event is the earlier of (A) the Monetary Authority notifying the institution in writing that the Monetary Authority is of the opinion that a write-off or conversion is necessary, without which the institution would become non-viable, or (B) the Monetary Authority notifying the institution in writing that a decision has been made by the government body, a government officer or other relevant regulatory body with the authority to make such a decision, that a public sector injection of capital or equivalent support is necessary, without which the institution would become non-viable.

79. As the AT1 and T2 instruments are issued on the basis that they will absorb loss at the "point of non-viability" as determined by the Monetary Authority, their write-off/conversion under the Bill does no more than implement an existing contracted term once the conditions for resolution (including non-viability) are considered met by the resolution authority (in the case of AIs this will be the Monetary Authority), (but before a stabilization option is applied). It covers the situation where the contractual provisions for write-off or conversion of AT1 capital

instruments or T2 capital instruments have not already been triggered under the provisions of the Banking (Capital) Rules (Cap. 155L) before the resolution authority decides that an AI fulfils the conditions for resolution under the resolution regime.

80. This approach reflects Key Attribute 3.5(iii), which provides that the resolution authority should have power to: "upon entry into resolution, convert or write-down any contingent convertible or contractual bail-in instruments whose terms had not been triggered prior to entry into resolution"... and treat any instruments resulting from the conversion alongside other existing equity or debt instruments in the bail-in of the firm.

81. As a capital reduction instrument would only enable the Monetary Authority to write off or convert AT1 and T2 capital instruments in accordance with their existing contractual provisions at the point of non-viability, the position of the holders of the relevant capital instruments should not be materially affected by the capital reduction instrument and therefore a dedicated appeal mechanism is not considered necessary. Again redress through judicial review would remain available should the holder of an AT1 or T2 capital instrument consider that the resolution authority has acted unreasonably in issuing a capital reduction instrument.

Part 5 (Stabilization Options)

What is/are the reason(s) for excluding all Part 5 instruments as subsidiary legislation (under clause 199(c) of the Bill)?

82. Clause 199(c) of the Bill expressly states that a Part 5 instrument is not subsidiary legislation in order to remove the risk or uncertainty that the instrument be treated, or at least be questioned or challenged as subsidiary legislation.

83. "Subsidiary legislation" is defined in section 3 of Cap. 1 to mean "any proclamation, rule, regulation, order, resolution, notice, rule of court, bylaw or other instrument made under or by virtue of any Ordinance and having legislative effect".

84. The term "legislative effect" is not defined in any Ordinance but is used in the definition of "subsidiary legislation" in Cap. 1. In determining whether an instrument has legislative effect, the

Department of Justice advised that the following criteria can be discerned from local and other common law jurisprudence:

(i) whether the instrument extends or amends existing legislation, or alters the common law;

(ii) whether the instrument has general application to the public or a class as opposed to individuals;

(iii) whether the instrument formulates a general rule of conduct, usually of prospective application, as opposed to applying those rules to particular cases;

(iv) whether the measure is legally binding, as opposed to providing guidance only;

(v) whether the instrument is subject to parliamentary control; and

(vi) whether the legislative intent is to treat the instrument as subsidiary legislation.

85. Applying the criteria to this case, we consider that a Part 5 instrument is not subsidiary legislation as:

(i) a Part 5 instrument will not amend or extend the powers of resolution authorities under the Bill but rather only bring into effect the consequences as already provided for in the Bill (which will have been enacted when it is passed by the Legislative Council.);[7]

(ii) a Part 5 instrument will not have general application to the public or a class as it will only have application to the FI in resolution and those parties that might be relevant to the specific stabilization option, e.g. the transferee in a transfer of shares or property;

(iii) the making of a Part 5 instrument by a resolution authority

[7] For example, the power to transfer assets, rights and liabilities of an FI in resolution to a commercial purchaser or bridge institution is provided for in the Bill. However, precisely which securities, assets, rights and liabilities are to be transferred in a given case at a given time cannot be known in advance and so this detail would be set out in the instrument in order to give effect to the transfer powers provided for under the Bill.

under the Bill is a case-specific administrative act and will not formulate any general rule or code of conduct;

(iv) whilst a transfer effected by a Part 5 instrument will be binding on the parties concerned, this is due to the legal effect of the Bill which is brought into operation by the making of the instrument by a resolution authority pursuant to the provisions in the Bill;

(v) the intention of the Government is that a Part 5 instrument should not be subject to any parliamentary control; and

(vi) the legislative intention will be set out expressly in the Ordinance (see clause 199 of the Bill).

86. However, each criterion above may not necessarily be conclusive on its own. Nor are the above criteria exhaustive. The Department of Justice considers that in the absence of explicit legislative provision stating unequivocally that a Part 5 instrument is not subsidiary legislation, the risk or uncertainty that the instrument be treated, or at least be questioned or challenged as subsidiary legislation could not be precluded.

87. The express provision is consistent with the approach taken by the Government since October 1999, i.e. where there may be doubt as to the nature of an instrument to be made pursuant to an Ordinance, an express provision would be included in the primary legislation indicating whether the instrument is or is not subsidiary legislation, in order to clarify the position.

88. A resolution authority must be able to act promptly and decisively to resolve a failing, systemically important FI in order to be able to effectively avoid or mitigate the risks posed to the stability and effective working of the financial system in Hong Kong, including to the continuity of critical financial functions. This is in line with the Key Attributes.[8]

89. If a Part 5 instrument were treated as subsidiary legislation, it

[8] The Key Attributes state in their preamble that an effective regime should provide for "speed and transparency and as much predictability as possible through legal and procedural clarity", and Key Attribute 5.4 and 2.5 require that a resolution authority "should have the capacity to exercise the resolution powers with the necessary speed and flexibility" and have "operational independence consistent with its statutory responsibilities", respectively.

would take effect subject to the scrutiny of the Legislative Council and the time required for that process to be completed would lead to uncertainty in the financial markets, likely prompting the withdrawal of funding lines and deposits, heavy selling of securities (debt and equity) issued by the FI concerned, attempts to close out contracts, demands for increased margin etc., all of which could create the panic and disorder which resolution is designed to avoid or minimise. This would in turn likely render the resolution regime unworkable in practice and result in a negative assessment of the resolution framework in Hong Kong against the standards set by the Key Attributes.

Under clause 37(1), a section 10 entity may assist a resolution authority in the making of a valuation of a FI in resolution and the appointment of such entity must satisfy the criteria set out in clause 37(2). Would the valuation of a FI by a section 10 entity be invalidated if it is subsequently discovered that a defect in the appointment of such entity has arisen due to the fact that the criteria of appointment specified in clause 37(2) were not met?

90. In the case where it is subsequently discovered that there is a defect in the appointment of a section 10 entity under clause 37(1) because the criteria for appointment specified in clause 37(2) have not been met, the acts of the section 10 entity, including any valuation done by the entity, would be invalidated. However, the invalidation of a valuation done by a section 10 entity does not automatically invalidate a valuation made under section 35(1) by the resolution authority, with the assistance of the section 10 entity. It might be the case that the valuation made under section 35(1) could still be valid if, for example, the assistance provided by the section 10 entity did not materially affect (or could not be reasonably be perceived to have affected) the overall valuation conducted by the resolution authority (although this would very much depend upon the tasks assigned to the section 10 entity in the context of the valuation.). We see little alternative but for the resolution authority to gauge the extent to which any valuation has been affected by any conflict identified in a given case and then make a considered decision on whether the valuation should be varied or invalidated as a whole.

Would the resolution authority (or the section 10 entity) be liable to the possible loss or damages suffered by the pre-resolution shareholders or pre-resolution creditors, if any, arising from the defect in the appointment of the entity mentioned in the previous paragraph?

91. Pursuant to clause 197(1) of the Bill, a person acting on behalf of a resolution authority (or as a section 10 entity) would not be liable for loss or damages arising as a result of acts done by the person in good faith in performing or purportedly performing, or assisting a person in the performance or purported performance of, a function under this Ordinance. This would include the appointment of a section 10 entity, provided the appointment was made in good faith. Nevertheless, to the extent possible, the resolution authority will consider appropriate remedial action (as mentioned in our response to the previous question).

Under clauses 43 and 51, a bridge institution or an asset management vehicle is wholly or partially owned by the Government (emphasis added). Do these clauses mean that the private sector entities may partially own the bridge institution or an asset management vehicle together with the Government? If so, why is that? And how could the Government ensure that the private sector owners' decisions or actions taken for the bridge institution or an asset management vehicle would be consistent with the resolution objectives set out in clause 8?

92. The definition under clauses 43 and 51 of a bridge and an AMV as companies that are wholly or partially owned by the Government is to accommodate changes in ownership which may occur over the life of the bridge or AMV. The intention is that any bridge or AMV would initially be wholly owned by the Government. As a bridge onward transfers the business transferred to it to the private sector (or as an AMV disposes its assets), it is possible that ownership may be gradually transferred to the private sector such that these companies could be partially owned by the Government during the transition period. In order to ensure that the resolution authority remains in full control of decisions and actions taken with respect to the bridge or AMV before the transaction is fully completed, it is intended that the relevant company articles of association would provide for voting rights to be suspended for any non-Government shareholders in a partially owned bridge or AMV in the interim.

Under clause 79(3), the relevant resolution authority may direct a FI under resolution to continue to provide, on reasonable commercial terms to another entity services that are essential to the continued performance of critical financial functions in Hong Kong. Please clarify which party (the Government, the relevant resolution authority or otherwise) would pay for the above-mentioned essential services provided by such FI on reasonable commercial terms.

93. The recipient entity would pay for those essential services required to be provided by a residual FI under clause 79(3). It is expected that the recipient would be a bridge institution or commercial purchaser which requires the services. It is extremely unlikely that the Government or the resolution authority would be directly receiving services from a residual FI.

Under clause 83(5), a creditor of a within scope FI may not, without the written consent of the resolution authority concerned, commence or continue any action to attach any assets of, or obtain the payment of money or delivery of any other property by, such Fl. Please clarify if such restriction would be applicable to a scenario that a "writ of execution" (e.g. a writ of fieri facias, a writ of delivery, a writ of possession or a writ of sequestration) against the FI's assets has already issued and sealed by the relevant court under Order 46 of the Rules of the High Court (Cap. 4A) or the Rules of the District Court (Cap. 336H) but the actual delivery or possession of the assets concerned has not yet taken place. If this is the case, please consider if it is necessary to expressly provide for such scenario under clause 83.

94. We are considering the matter and will respond in due course.

Part 6 (Compensation)

Please clarify whether the notice of appointment of an appointing person published by FS under clause 95 is subsidiary legislation.

95. No. An appointment of an appointing person is an administrative act and does not have legislative effect.

Under clause 104(3), an independent valuer appointed under Part 6 may, at any time before a decision under that section takes effect, correct a clerical mistake in the decision or an error in it arising from any accidental slip or omission. Please clarify if a miscalculation of the amount of compensation in question could be viewed as a clerical mistake or an error arising from accidental slip or omission which the independent valuer may correct or change unilaterally under the clause.

96. We are considering the matter and will respond in due course.

Part 7 (Tribunals)

Under clause 113(6), when publishing the reasons for its determination in any proceeding before the Resolvability Review Tribunal, the Tribunal should not disclose any commercially sensitive information relating to an applicant in the relevant proceeding. Please clarify what would be regarded as "commercially sensitive information" in the proceeding under Part 7. For the avoidance of doubt, please consider if it would be helpful to provide the relevant criteria in the Bill in respect of "commercially sensitive information" relating to the applicants in the proceeding under Part 7.

97. "Commercially sensitive information" in relation to an FI would generally be considered as information the release of which could prejudice the FI's commercial position. Examples include information relating to an FI's: (i) derivatives positions and counterparties; (ii) business volume and pricing; (iii) funding sources; (iv) location and type of customers. Given the diversity of possible types of commercially sensitive information, it would be difficult to set out an exhaustive list of specific criteria in the Bill (other than general reference to the release of the information being prejudicial to the FI's commercial position), and we consider it preferable to confer discretion on the Resolvability Review Tribunal in this regard based on the circumstances of the given case.

Part 8 (Clawback of Remuneration)

If an officer of a within scope FI is ordered by the court to repay all or a specified part of the remuneration received from the FI under clause 144, please clarify whether the salaries tax paid by the officer for such remuneration can be deducted from the amount of repayment. If not, why not?

98. The clawback provisions in the Bill envisage a court-based process where clawback will be applied pursuant to an order of the Court (clause 143 of the Bill). Under the clawback provisions, the Court must, amongst other things, take into account the financial circumstances of an officer before determining the extent of any clawback. The Court is not specifically obliged by the Bill to take into account the tax paid by an officer in respect of the remuneration, but it would be at the Court's discretion to decide whether such paid tax should be taken into account in determining the clawback amount in an

order made under clause 144.

Part 10 (Information Gathering, Inspection and Investigation Powers)

Under clause 158(4)(a), an authorized person may at any reasonable time enter the business premises of a controlled entity to do the acts set out in the clause. Please clarify if it would be an offence if a controlled entity refuses an authorized person to enter its business premises but is able to provide the authorized person with the relevant documents, records and information under clause 158(4)(b) and (c). Please also clarify why entering the business premises of a controlled entity by an authorized person (without a court's warrant) is necessary for the purposes of clause 158.

99. Clause 158 sets out powers of inspection and clause 159 creates an offence in respect of, inter alia, clause 158(5) which in turn refers to clause 158(4)(b) and (c) (i.e. inspection of records and documents located at the business premises of the controlled entity by an authorized person, and making inquiries of a controlled entity concerning those records or documents, after entering the business premises) but not 158(4)(a) (i.e. entering the business premises). In other words, clause 159 does not create an offence for a controlled entity's refusal to permit an authorized person to enter its business premises. This is similar to what is provided under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).[9]

100. Whilst the resolution authorities are given a separate information gathering power (without the need to enter any premises) under clause 156 to obtain information, records and documents from a controlled entity or third party entity that the resolution authorities reasonably require in connection with the performance of their functions under the Bill, the use of this power relies upon the resolution authority having prior knowledge of the specific type of information or document which it seeks. This may not always be the case.

[9] See sections 9 and 10.

101. Accordingly, the resolution authority considers there are other records or documents at the business premises of an FI which it is not able to specifically identify but which it considers will assist the resolution authority in performing its functions, then clause 158 allows the resolution authority to conduct an on-site inspection (via an authorized person). The use of such on-site inspection is not unusual in regulatory ordinances (e.g. section 55 of the Banking Ordinance (Cap.155)).

102. In the event that a resolution authority exercises the inspection power under clause 158 and the authorized person is refused entry into the business premises, the authorized person or the resolution authority could seek a Magistrate's warrant under clause 164 of the Bill.

Please explain why the defence of "reasonable excuse" is not provided for the offence under clause 168 (destruction of documents, etc.).

103. Commission of an offence under clause 168 requires mens rea of an "intent to conceal" from the authorized person or an investigator certain facts or matters. In other words, the prosecution needs to prove both actus reus and mens rea of the accused beyond reasonable doubt. It is not appropriate to provide a statutory defence of "reasonable excuse" to the accused under this clause because there should not be any reasonable excuse for a deliberate intention to conceal the relevant information from the authorized person or investigator.

Part 13 (Non-Hong Kong Resolution Actions)

What is/are the reason(s) for excluding the instruments for recognition of non-Hong Kong resolution actions as subsidiary legislation (under clause 199(e) of the Bill)?

104. Clause 199(e) of the Bill provides that a recognition instrument is not subsidiary legislation because:

(i) a recognition instrument has legal but not legislative effect; and

(ii) the administrative act of making a recognition instrument should not be subject to parliamentary control for good reasons.

105. The justifications applicable to a Part 5 instrument equally

apply to a recognition instrument. Please refer to paragraphs 82-89.

Why do conditions 1, 2 and 3 under clause 25 not apply to the making of a recognition instrument under Part 13?

106. Consistent with the FSB's principles for cross-border effectiveness of resolution actions,[10] the making of a recognition instrument under Part 13 of the Bill is designed to recognise all or part of a "foreign resolution action" (i.e. action taken by a non-Hong Kong resolution authority to resolve an overseas incorporated FI with operations in Hong Kong), such that the foreign resolution action (or part of it) could produce substantially the same legal effect in Hong Kong as it would have produced had it been made, or been authorized to be made, under the laws of Hong Kong. Importantly, recognition is not dependent on, and does not trigger, the exercise of stabilization options and accompanying resolution powers by the local resolution authorities under the Hong Kong resolution regime. As such, Conditions 1, 2 and 3 under clause 25 are not relevant in, and do not apply to, the making of a recognition instrument. Whilst the conditions under clause 25 do not apply to the making of a recognition instrument, other conditions are applied to the resolution authority in respect of the making of a recognition instrument. Specifically:

(i) clause 185(6) provides that "recognition" must not be granted if the resolution authority is of the opinion that recognition would: (a) have an adverse effect on financial stability in Hong Kong; (b) not deliver outcomes that are consistent with the resolution objectives; or (c) disadvantage Hong Kong creditors or shareholders (or both) relative to their counterparts overseas;

(ii) clause 185(7) provides that a resolution authority may also take into account any fiscal implications for Hong Kong in deciding whether to "recognise" a foreign resolution action;

(iii) clause 187 provides that a resolution authority may only "recognise" a foreign resolution action if it is of the opinion that any Hong Kong shareholders or creditors would be eligible to claim compensation under an arrangement that is broadly consistent with the eligibility to claim compensation under clause

[10] Principles for Cross-border effectiveness of resolution actions, November 2015, FSB: http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf

102 of the local regime;

(iv) clause 185(5) provides that the FS must be consulted before the making of a recognition instrument.

107. This is in contrast to the taking of "support measures" with respect to a non-Hong Kong resolution action where, upon the three conditions under clause 25 having been met by the relevant within scope FI, a resolution authority may initiate resolution and then use any power it has under the Bill for the purpose of supporting all or part of the non-Hong Kong resolution action (if of the opinion that doing so would be consistent with the resolution objectives (clause 189)).

Under clause 186, the non-Hong Kong resolution action produces substantially the same legal effect in Hong Kong that it would have produced had it been made under the laws of Hong Kong. Please clarify the meaning of "the laws of Hong Kong" in the clause. Does it only refer to the provisions in the Bill or does it also refer to other legislation (or common law principles) of Hong Kong?

108. The reference to "the laws of Hong Kong" in clause 186 is made in a general sense, i.e. it may include other legislation (or common law principles) of Hong Kong as applicable. In practice, given the nature of recognition instruments and the activity contemplated by this clause it is envisaged that "the laws of Hong Kong" in this context should largely fall within the provisions in the Bill.

Would resolution authorities in Hong Kong need to assist in the non-Hong Kong resolution action after a recognition instrument is made? In this regard, are the resolution authorities entitled under clause 189 to exercise all the powers under the Bill (on behalf of the non-Hong Kong resolution authority) against a non-Hong Kong FI as if it were a within scope FI in Hong Kong? And if so, how would the Hong Kong resolution authorities safeguard the interest of Hong Kong creditors and shareholders? Please also clarify which party will bear the costs and expenses incurred by the Hong Kong resolution authorities in the non-Hong Kong resolution action(s).

109. As explained above in paragraphs 106-107, the making of a recognition instrument is not dependent upon the three conditions for initiating "local" resolution under clause 25 of the Bill having been met and does not trigger the exercise of stabilization options (and accompanying resolution powers) by the local resolution authority. In

the case of recognition, the expectation is that the role of the local resolution authority would be limited to assessing whether the making of a recognition instrument was in the interests of Hong Kong and, possibly, assisting an overseas resolution authority in relation to any challenge before the courts of Hong Kong in respect of actions recognized by a recognition instrument (where the local resolution authority might be called upon to explain the process and considerations leading to the making by it of the relevant recognition instrument.) "Recognition" (clause 185) and "Support" (clause 189) measures are intended to complement each other and in some cases both may be required to achieve the desired outcome. However, "support" measures may only be deployed in respect of within-scope FIs to support foreign resolution actions, provided that the conditions under clause 25 have been met by the relevant within scope FI. In short, in the case of "recognition" a resolution authority would not be empowered to exercise any of the powers under the Bill against the non-Hong Kong FI (save for the making of a recognition instrument under clause 185).

110. Although a resolution authority in Hong Kong would not be exercising powers under the Bill in a recognition case (except those under clause 185) there are a range of safeguards established under clauses 185(6), 185(7) and 187 to protect the interests of Hong Kong shareholders or creditors in a "recognition" case. Any internal costs and expenses associated with the making of a "recognition instrument" are expected to be absorbed by the resolution authority in Hong Kong.

For the compensation arrangements under clause 187, please clarify whether before the relevant decisions on compensation to Hong Kong creditors or shareholders are made by the non-Hong Kong resolution authority, any valuation and assessment of the non-Hong Kong FI would be conducted as in the case of a within scope Hong Kong FI.

111. The resolution authority has full discretion to recognise a non-Hong Kong resolution action. One factor to be taken into account would be whether there is an arrangement with the non-Hong Kong resolution authority that is broadly consistent with the eligibility for NCWOL compensation under the Bill (clause 187). The local resolution authority would need a degree of certainty to be provided from the relevant foreign resolution authority that a valuation would be performed following the initiation of resolution in order that the ability to seek compensation would be established. Without such certainty,

the local resolution authority may determine that it is not able to make a recognition instrument, (and this, in turn, might potentially jeopardize the efficacy of a group resolution plan). It is anticipated that the mechanics of how NCWOL compensation frameworks are to work practically in cross-border cases will be developed through the Crisis Management Groups which have been established to develop resolution strategies and plans for the resolution of global systemically important financial institutions (G-SIFIs).

Schedule 3 (Securities Transfer Instruments)

When the appointment of a director, CEO or deputy CEO of a prescribed entity is revoked by a securities transfer instrument under section 7 of Schedule 3, would the validity of the commercial agreements entered into by such director, CEO or deputy CEO (on behalf of the prescribed entity) be affected by the relevant revocation?

112. A revocation of the appointment of a director, CEO or deputy CEO of a "prescribed entity" by a securities transfer instrument under section 7 of Schedule 3 would not, of itself, affect the validity of the commercial agreements entered into by such persons before the issue of the securities transfer instrument.

Schedules 8 and 9 (Resolvability Review Tribunal and Resolution Compensation Tribunal)

Please clarify the reason(s) why there are no provisions in Schedules 8 and 9 (a) to require the chairpersons and ordinary members of the Resolvability Review Tribunal and the Resolution Compensation Tribunal to declare and register their interests which relate to the functions or purviews of the Tribunals upon their appointments and at reasonable intervals thereafter and (b) to provide for prevention of any conflict of interests in the hearings or proceedings conducted by the chairpersons and ordinary members of the Tribunals.

113. The Government has considered a number of Ordinances[11] and

[11] See, for instance, Banking Ordinance (Cap. 155), Securities and Futures Ordinance (Cap. 571), Payment Systems and Stored Value Facilities Ordinance (Cap. 584), Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615) and Insurance Companies (Amendment) Ordinance, No. 12 of 2015.

has not been able to identify provisions specifically requiring the chairpersons and ordinary members (or persons in similar positions) of the tribunals established by those Ordinances to declare and register their interests which relate to the functions or purviews of the tribunals upon their appointments and at reasonable intervals thereafter.

114. Should any conflict of interest issue arise, or be likely to arise, upon appointment or at any time thereafter (e.g. in a hearing or proceeding), the chairperson and ordinary members will be expected to raise the issues with the person appointing them. Such voluntary disclosure practice would appear to be adequate in the case of existing statutory tribunals. Judicial officers are familiar with declaring conflicts or possible conflicts of interest and recusing themselves of their own volition or inviting submissions from parties on whether they should do so. Experience with empanelling lay members has been that such members are generally familiar with the need to disclose conflicts or the appearance of conflicts of interest to those appointing them. Take the example of the Securities and Futures Appeals Tribunal, individual members are requested, as a matter of administrative practice, to declare that they have no conflict of interest before they are appointed as ordinary members for each individual case. Such administrative practices have been in place and have been running smoothly.

115. The Government has considered if it is necessary to include an explicit provision in the Bill to prevent any conflict of interests in the hearings or proceedings conducted by the chairperson and ordinary members of the Resolvability Review Tribunal and Resolution Compensation Tribunal. It is noted that sections 2(5) and 3(6) of Schedule 8 and sections 2(5) and 3(6) of Schedule 9 to the Bill provide that the Chief Executive may (and, in the case regarding the appointment of a person as the chairperson, after consultation with the Chief Justice) revoke the appointment of a person as the chairperson or a panel member (as the case may be) if satisfied that such person is unable or unfit to perform the duties and exercise the powers of the chairperson or ordinary member (as the case may be) because of physical or mental illness or any other reason. We believe that these provisions should be broad enough to cover scenarios where the chairperson or ordinary member has become unable or unfit to perform his duties on various grounds such as conflict of interest, incapacity, bankruptcy, neglect of duty and misconduct.

Financial Services and the Treasury Bureau (Financial Services Branch)
Hong Kong Monetary Authority
Securities and Futures Commission
Office of the Commissioner of Insurance
1 February 2016