Bills Committee on Financial Institutions (Resolution) Bill

Response to Matters Raised by Members at the Meeting on 3 May 2016

This paper sets out the Government's response to the matters raised by Members in relation to the Financial Institutions (Resolution) Bill (the Bill) at the Bills Committee (BC) meeting on 3 May 2016.

Clauses 142 to 145 – Clawback of Remuneration

Clauses 142 and 143 provide that a resolution authority may, at any time after it has initiated the resolution of a within scope financial institution, apply to the Court for a clawback order against an officer or former officer of that institution. The controlled period for a clawback is three years immediately preceding the date on which the resolution of FI was initiated, or a further three years extended by the Court. Members have expressed grave concern about the duration of the controlled period. There are also enquiries about the operation of the controlled period with the relevant provisions in the Limitation Ordinance (Cap. 347), the operation of the clawback provisions with the relevant provisions in the Employment Ordinance (Cap. 57), and the factors the Court would take into account in making the clawback order. The Administration is requested to:

(a) Explain the rationale for setting the initial controlled period at three years, and the considerations of not providing a longer period (e.g. five years);

2. Our policy consideration behind the proposals relating to clawback had been set out in paragraphs 2-17 of the Government's response to issues raised at the meeting on 5 January 2016 (LC Paper No. CB(1)443/15-16(02)). To recap, the Financial Stability Board (FSB)'s Key Attributes of Effective Resolution Regimes for Financial Institutions (KA) are not specific in their requirements (including the controlled period) as regards clawback, except for stating that the resolution authorities should make available power to "recover monies from responsible persons, including claw-back of variable remuneration".

3. The Government has taken into account overseas practices when developing Part 8 of the Bill, and sought to adopt a "middle ground". The "controlled period" in the regime in the United Kingdom (UK) is seven years from the date on which the variable remuneration (i.e. bonus) is awarded, but it

must be noted that such power is part of a broader remuneration framework that is not specific to resolution and it is the financial institution (FI) which seeks clawback rather than the regulator or the resolution authority. On the other hand, the "controlled period" in the regimes in both the United States (US) and Singapore is two years (extendable in the case of fraud by two years in Singapore and indefinitely in the US), and in each case the power is linked to resolution and exercised by a resolution authority through a Court-based process. On balance, having considered these different models, our proposal is to have a three-year clawback period (extendable by a further three years in cases of dishonesty); including both fixed and variable remuneration; covering directors and shadow directors, certain senior management (including the chief executive officer, deputy chief executive officer and any persons principally responsible for the management of part of the business or performance of a control function) and persons with the potential to have a material impact on an FI's risk profile (defined as "officers" in clause 142 of the Bill); and using a court based system (a statutory remedy sought by a resolution authority in the public interest from the court which can impartially assess the role of a given officer in the failure of an FI) .

(b) clarify the time limit, if any, for a resolution authority to apply for a clawback order, including whether the resolution authority would be subject to the Limitation Ordinance in exercising its power in this regard;

4. According to Clause 143(1) of the Bill, a resolution authority may "at any time after it has initiated the resolution of a within scope FI" apply to the Court for a clawback order. No time limit is imposed.

5. Having consulted the Department of Justice (DoJ), we consider that the Limitation Ordinance (Cap. 347) (LO) would not apply to an application for a clawback order by a resolution authority under clause 143(1) unless it is so expressly provided in the LO.

(c) clarify whether in making a clawback order, the Court is only required to be satisfied that the acts or omission of acts of the officer concerned were made intentionally, recklessly or negligently, and had materially contributed to the ceasing of the FI or its non-viability under clause 143(2), or the Court is also required to consider the negligence and fault (including concealed fault) of the officer concerned under the Common Law;

6. Clause 143(2) of the Bill expressly stipulates that "[t]he Court may

make a clawback order against an officer if it is satisfied that — (a) the officer, in performing his or her functions, acted or omitted to act in a way that caused, or materially contributed, to the financial institution ceasing, or being likely to cease, to be viable; and (b) the act was done, or the omission was made, intentionally, recklessly or negligently."

7. Under clause 143(2), the Court may make a clawback order as long as the two conditions set out in Clause 143(2) are fulfilled. If "negligence and fault (including concealed fault) of the officer concerned" is present in a particular case, it would be a matter for the Court to consider whether that is relevant to the two conditions set out in (a) and (b) in paragraph 6 and whether that should be taken into account when making the clawback order in the circumstances of the case.

(e) explain whether the clawback provisions would be in conflict with the provisions in the Employment Ordinance, especially if a clawback order would override the provisions relating to the officer's entitlement to fixed remuneration (e.g. wages); and

8. The Employment Ordinance (Cap. 57) (EO) provides for the time of paying wages to employees (sections 23 and 24) and the time for paying any sum on termination of an employment contract (section 25). An "employer" who wilfully and without reasonable excuse contravenes section 23, 24 or 25 commits an offence (section 63C).

9. Clause 144(1) of the Bill provides:

"A clawback order is an order that provides for either or both of the following –

(a) that the officer repays or returns all or a specified part of the fixed or variable remuneration ***received by*** *the officer from the financial institution during the controlled period;*

(b) that the officer ***ceases to be entitled to receive*** *all or a specified part of any fixed or variable remuneration that the financial institution had agreed during the controlled period to give, but had not yet given, to the officer."*
(emphasis added)

10. It appears that a clawback order under clause 144(1)(a) would not affect the obligations of an FI, as an employer, to pay wages or any sum payable

to an officer under section 23, 24 or 25 of the EO. Rather, a clawback order under clause 144(1)(a) would only have the effect to mandate an officer to pay to a resolution authority the wages received during the controlled period as specified in the clawback order.

11. However, it seems that a clawback order under clause 144(1)(b) might be in conflict with section 23, 24 or 25 of the EO. It is not clear whether a clawback order under clause 144(1)(b) could override the FI's obligations to pay wages and any sum payable to an officer under these provisions in the EO.

12. To put it beyond doubt, we will move a Committee Stage Amendment (CSA) to expressly provide in clause 144 that an order made under clause 144(1) would, in case of conflict, override any obligations of the FI concerned under the EO.

(f) consider some members' suggestion of empowering the resolution authority to retain the remuneration or part of the remuneration of the officer or former officer of the FI concerned, including the retention period, the kinds of remuneration to be retained, the matters the resolution authority should consider for the retention, etc.

13. We have carefully considered Members' suggestion of empowering the resolution authority to retain the remuneration of the officers. Our considerations are set out in ensuing paragraphs.

14. First, we are not aware that there are any examples in overseas jurisdictions in which resolution authorities are specifically empowered with similar powers. Neither is this a KA requirement. We are concerned that building in powers beyond what we understand the resolution-related clawback powers in other jurisdictions provide, and what is stipulated by the KAs, might disincentivise financial talents to work in Hong Kong and prompt international financial institutions to re-domicile elsewhere, thereby threatening Hong Kong's position as an international financial centre. We note the comments from some Members that the foregoing threat is more perceived than real. Nevertheless, for Hong Kong as a major international financial centre to adopt on its own such rules not present in other major jurisdictions, this is highly risky for Hong Kong, especially in the long run.

15. Secondly, upon the initiation of resolution, decisions and actions will need to be made and conducted swiftly and decisively. The primary priority for the resolution authority will be to stabilize the failing FI, thereby mitigating

the risks of its failure to the stability and effective working of the financial system, including to the continued performance of critical financial functions. Identifying and analyzing the "evidence" concerning which senior officer(s) are culpable for the failure is likely to distract from this fundamental objective. And the retention of remuneration by the resolution authority based on premature *prima facie* evidence would not only distract the resolution authority from carrying out its primary functions, but would also stigmatise the officer(s) concerned (if he/she is later found out to be innocent) and would be presuming guilt before trial.

16. Finally, the quantum of the remuneration subject to retention would be relatively small, if not negligible, when compared to the financial implications likely incurred in a resolution action. Given most fixed remuneration is awarded on a monthly basis as a usual market practice, the amount concerned would likely be 30 days' worth of pay of an officer, and would not contribute meaningfully to the costs incurred in a resolution action. As for variable remuneration, under the Hong Kong Monetary Authority (HKMA)'s prevailing Supervisory Policy Manual module "Guideline on a Sound Remuneration System" (as detailed in paragraphs 13-22 of the Government's response to matters raised by Members at the meetings on 18 and 19 April 2016 (LC Paper No. CB(1)860/15-16(04))) authorized institutions (AIs) should devise remuneration packages that are consistent with those guidelines, which include provisions in respect of the deferral and "claw-back" of unvested variable remuneration and which implement the Financial Stability Board's Principles for Sound Compensation Practices and their corresponding Implementation Standards. Compliance with the terms of the SPM module is monitored as part of the HKMA's risk-based supervisory review process. Additionally, as detailed in paragraphs 8 – 11 of the Government's response to matters raised by Members at the meetings on 18 and 19 April 2016 (LC Paper No. CB(1)860/15-16(04)), the Banking Capital Rules (Cap. 155L) require AIs to restrict distributions of earnings, including discretionary bonus payments, where its capital ratio has fallen below a "buffer level" which limits the ability of a distressed AI to make such payments.

17. However, noting the concerns raised by Members on this matter, the financial regulators would commit to developing, under their existing supervisory powers, a mechanism to provide greater certainty that officers of an FI will not receive inappropriate awards of remuneration, including variable remuneration, where the institution concerned is moving towards or has entered into resolution. An example would be the statutory guidelines that can be issued under section 7 or the directions available under section 52 of the

Banking Ordinance (Cap. 155) (BO) as to the manner in which an AI carries on its business once the specified conditions are met. This will also have the benefit of allowing more time to carefully consider the implications of such a power. Naturally, we will have to structure these arrangements carefully, maintaining a balance between the objectives Members wish to achieve here, which we support, and inadvertently disincentising persons from taking senior roles at institutions in Hong Kong and indeed FIs from doing business in Hong Kong. Seeking to achieve this through the use of existing supervisory tools, rather than the resolution framework, is consistent with our general approach that the regulation of AIs' remuneration frameworks is an ongoing supervisory matter.

Clause 143(3)(b) stipulates that the Court "must" take into account the financial circumstances of the officer in determining the extent to which the officer's remuneration would be covered by the clawback order. Members are concerned that the officer may conceal his/her financial circumstances through transferring his/her remuneration to a third party/outside Hong Kong. There is also concern as how the resolution authority would recover the remuneration subject to the clawback order under clause 145. The Administration is requested to:

(a) review the relevant provisions to address members' concerns;
(b) provide details on the financial circumstances that the Court would take into account under clause 143(3)(b); and
(c) consider some members' views to delete clause 143(3)(b) and 143(4) from the Bill, and the views of the legal adviser to the Bills Committee to replace the word "must" by "may" in clause 143(3) so that the Court would have discretion on whether to consider the financial circumstances of the officer.

18. We duly noted Members' views and have reviewed the relevant clauses in consultation with DoJ. We found that the term "financial circumstances" has been used in relation to a person in other statutes (such as section 28(3) of the Ferry Services Ordinance (Cap. 104) and Section 4 of the Practising Certificate (Special Conditions) Rules (Cap. 159Y)) under which the person's financial circumstances should be considered. These statutes do not specifically define the term or set out the factors that should be taken into account in considering the "financial circumstances".

19. Therefore, we consider that our present formulation is consistent with the existing practice. The term "financial circumstances" in clause 143(3)(b)

would be given its ordinary meaning by the Court which would have the discretion to determine the factors to be taken into account when considering the "financial circumstances" of a person, i.e. an officer in the context of the clawback provisions. As such, no amendment to the clauses is considered necessary.

Clause 144(2) provides that the making of a clawback order against an officer does not affect any criminal or civil liability incurred by the officer in relation to the FI under resolution. The Administration is requested to explain the purpose for including the provisions in the Bill, and clarify the possible impact of the clawback order on the criminal or civil liability incurred by the officer.

20. Clause 144(2) makes it clear that a clawback order imposed against an officer would not affect his liability (such as civil damages or criminal sentence) under other civil or criminal actions brought against him if, for instance, his intentional, reckless or negligent act (upon which the Court has considered and made a clawback order against him) constitutes the cause of action in such other actions. For further reference, provisions similar to clause 144(2) can be found in other statutes such as section 32M(3) of the EO.

21. In fact, the policy intention of a clawback order is to minimize the incentives for the senior management to engage in high-risk activities and business that put that FI at greater risk of failure which in turn would lead to higher possibility of resolution actions. It is not our intention that such an order would displace any criminal penalties or civil liabilities.

Clauses 171 – Official secrecy

Clause 171 imposes secrecy requirements to any person who holds or has held an office, appointment, employment or other role under the Bill. Certain disclosure gateways are provided in clause 171(3). The Administration is requested to consider a member's suggestion to exempt parties, such as representatives of the resolution authority and Government officials (e.g. the Financial Secretary (FS) and Secretary for Financial Services and Treasury), from the secrecy requirements so that they may make public statements or answer enquiries regarding possible resolution of a distressed FI. The exemption may be necessary to prevent panic arising from rumors about the distressed FIs.

22. We are of the view that the existing disclosure gateways could support disclosure in these circumstances. In the first instance, a resolution authority

may disclose information that has come into its knowledge in the course of performing functions under the Bill through the gateway established under clause 171(3)(a) which provides for disclosure "as necessary for performing any function" under the Bill. This could include where such a disclosure was intended to calm the public and maintain financial stability. Secondly, a disclosure could be made by the Financial Secretary (FS) where the information is disclosed to the FS by a resolution authority, pursuant to clause 171(3)(f), if the resolution authority is of the opinion that such disclosure will enable or assist the FS to perform his functions (which could be argued to include, inter alia, responsibility for the maintenance of the stability and integrity of the financial system of Hong Kong given that FS is the Controller of the Exchange Fund under the Exchange Fund Ordinance (Cap. 66) (EFO) and the resolution authority has consented to FS's onward disclosure of that information (pursuant to clause 171(7) of the Bill). The resolution authority will, in considering whether to give the consent, take into account financial stability as a public interest concern so that the FS may make public statements to support the resolution objectives under the Bill.

23. In a crisis situation, including resolution, we consider it crucial to have a focal point of communication to support consistency in messaging to the public. Once a public statement is made by a resolution authority (pursuant to clause 171(3)(a) or by the FS (pursuant to clauses 171(3)(f) and 171(7)), the information will be in the public domain. While other Government officials (e.g. SFST) could repeat the same message, any Government communications with the public should be made in a coordinated and controlled manner to mitigate the risk of confusion and misinformation in a crisis context.

<u>In the light of comments by the legal adviser to the Bills Committee, the Administration is requested to consider the need to set out clearly in clause 171(2) that the members, employees or agents of, or the consultants or advisors to, a section 10 entity or an independent valuer are also covered by the secrecy requirements.</u>

24. We recognize the point made by the legal adviser to the Committee and agree to pursue a CSA to enhance the certainty of the confidentiality provisions by making explicit that the members, employees or agents of, or the consultants or advisors to, a section 10 entity or an independent valuer are also covered by the confidentiality requirements under clause 171(1).

Drafting issue

In the light of a member's comment, the Administration has agreed to review the Chinese rendition "幕後董事" for the term "shadow director" in clause 142 of the Bill making reference to the Chinese rendition adopted in the Companies Ordinance (Cap. 622).

25. The term "幕後董事" is defined in the Chinese text of section 2(1) of the Companies Ordinance (Cap. 622) for the purposes of that Ordinance. It is our intention that the same definition applies for the purposes of Part 8 of the Bill.

26. Under the established drafting practice, this is achieved by defining the same term in the interpretation clause (i.e. clause 142) with reference to that definition in section 2(1) of the Companies Ordinance ("has the meaning given by section 2(1) of the Companies Ordinance"), and as such the term "幕後董事" ("shadow director") is bound to be used as the defined term for the purpose.

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