CONSULTATION PAPER ON AN EFFECTIVE RESOLUTION REGIME FOR FINANCIAL INSTITUTIONS IN HONG KONG

SUBMISSIONS

Introduction

1. The Financial Services and the Treasury Bureau, the Hong Kong Monetary Authority, the Securities and Futures Commission and the Insurance Authority in January 2014 jointly issued a Consultation Paper on setting up "An Effective Resolution Regime for Financial Institutions in Hong Kong" ("the Consultation Paper").

2. This Consultation Paper outlines a number of reform initiatives aimed to enhance the resilience and stability of the financial system, in particular with respect to those systemically important financial institutions or "too-big-to-fail" institutes in a major or global financial crisis, and also to provide alternatives when financial institute fails due to severe systemic disruption or costly public bail-out. The Law Society understands that the release of the Consultation Paper represents the first stage of the consultation, to be followed by further consultation on the proposed legislation. The Law Society reckons that the Administration intends to introduce a bill into the Legislative Council in 2015.

3. The Consultation Paper has been reviewed by the Law Society's Working Party on Resolution Regime, which comprises of members from the Investment Products and Financial Services Committee, the Civil Litigation Committee, the Insolvency Law Committee and the Insurance Law Committee of the Law Society.

4. The Law Society's general comments on the Consultation Paper, and their specific responses to the 34 consultation questions listed in the Annex to the Consultation Paper, are set out below, using the same set of definitions and abbreviations in the Consultation Paper. For ease of reference, the abbreviations adopted are repeated in Appendix 1 to this Submission. Where further abbreviations are required, these are identified in the submissions itself.

General Comment on the Consultation Paper

5. The Law Society acknowledges that the proposed regime are aimed for the benefits the Hong Kong economy and maintenance of Hong Kong's status as one of the leading financial centers. For that reason, the Law Society in principle is in support of establishing the proposed regime, subject to the views expressed in this Submission and also the review and the discussion of the details of the draft legislation to be released in subsequent consultation.

6. Without prejudice to the above, the Law Society at this stage wishes to point out that one important aspect it would keenly be looking into in the draft legislation would be whether the draft legislation could provide adequate and appropriate safeguards to ensure and also to facilitate a fair, balanced and cohesive exercise of the powers by the resolution authorities. The protection or preservation of the interests of different parties which may potentially be affected by the regime, including the right to compensation and appeal, should be reviewed closely in the draft legislation.

7. Of equal importance is that the proposed legislation should prescribe clearly the criteria and triggers for exercising the various powers by the resolution authorities. The challenge is to maintain the right degree of flexibility to allow the regime to work and to achieve its objectives effectively. The balancing exercise should promote confidence in the parties who may be affected by the regime as they may perceive or relate ill-defined flexibility to arbitrariness or worse, opportunity for manipulation.

8. The Law Society anticipates that in subsequent consultation, in-depth explanation and consideration would be given to practical issues likely to be encountered in such resolution regime. At the moment, the underlying thesis of the Consultation Paper seemingly suggests that in a global financial crisis, under the proposal the resolution authority can within a short period of time make decisions on the transfer of assets and liabilities. How these could be achieved in practice remains to be clarified. The very fact the FI has failed raises its own questions. Other solvent FIs understandably should be wary of taking on potential liabilities they know nothing of.

9. The Working Party could relate to the experience of its member who was involved in the Government's nationalization of Overseas Trust Bank ("OTB") in 1985 and also the closure of Bank of Credit and Commerce Hong Kong Ltd ("BCCHK") in 1991. It is considered that these cases clearly demonstrate the need for a sound regulatory system in these situations. Among other things, it took the Administration a long period of time to sort out the indebtedness and the selling of the bank at issue. The case of Bank of America, which bought the Countrywide Financial Group and which as a result became caught up in a major civil suit involving allegations of fraud, is a telling example.

Responses to the Consultation Questions

Question 1

Do you agree that a common framework for resolution through a single regime (albeit with some sector-specific provisions) offers advantages over establishing different regimes for FIs operating in different sectors of the financial system? If not, please explain the advantages of separate regimes and how it can be ensured that these operate together effectively in the resolution of cross-sectoral groups.

Law Society's Response:

10. The Law Society understands the proposed approach is to set up a single resolution regime with sector-specific provisions targeting all systemically significant FIs in Hong Kong to enhance the resilience and stability of the financial system. The purpose of the proposed regime is to ensure the orderly resolution of a non-viable FI which provides critical finance services and/or poses systemic risk to the financial markets in Hong Kong. Relevant FIs include a broad range of industry participants including, FMIs, LCs and insurers. Cognizant on the cross-sectoral differences, the Law Society believes a single resolution regime can be designed to serve the various types of FIs in general, provided that necessary sector-specific provisions are in place to address the different operational needs. In the context of group companies, a single resolution regime is preferred from both an administrative and a compliance perspective.

11. At the same time, as a large number of the systemically significant financial institutions are operated globally with branches in different FSB jurisdictions, it is important that the various resolution authorities implement their respective resolution regimes in a coordinated and cooperative manner. The Law Society notes that the single regime approach has been adopted in a number of other FSB jurisdictions, including Singapore, the UK and the US. A single resolution regime is, relatively speaking, more conducive to cross-border cooperation.

Question 2

Do you agree that it is appropriate for all LBs to be within the scope of the regime (given it would only be used where a non-viable LB also posed a threat to financial stability)? If not, what other approaches to the setting of the scope of the regime, which ensure that all relevant LBs are covered, should be considered?

Law Society's Response:

12. Hong Kong has a relatively small and open economy with an aggregate of 158[1] LBs. While the size of these LBs varies significantly, given the unique business nature of LBs and the importance of market confidence for the banking industry, the failure of even a small LB may result in potential "domino effect" and gives rise to liquidity and capital pressure for other LBs.

13. It is therefore appropriate to include all LBs within the scope of resolution regime. The Law Society is of the view that excluding individual LBs purely based on the size of their business is inappropriate. For any given non-viable LB, the liquidation approach should be adopted if, after reasonable assessment, the failure of such LB is not likely to pose a severe threat to the continuity of critical financial services and financial stability in Hong Kong market.

Question 3

Do you agree that it is appropriate for all RLBs and DTCs to be within the scope of the regime (given it would only be used where a non-viable RLB or DTC posed a threat to financial stability)? If not, what other approaches, which would ensure that all relevant RLBs and DTCs are covered, should be considered?

Law Society's Response:

14. Due to the nature of the financial services they provide, the Law Society agrees that it is less likely that non-viable RLBs and DTCs will pose systemic risk to financial stability. However, as a significant number of RLBs and DTCs in Hong Kong are owned by or otherwise associated with LBs, the successful implementation of the resolution regime targeting LBs may require extension of the regime to a related RLB and/or DTC in the same group.

15. Similar to the proposed approach for LBs, the Law Society believes it is appropriate to include all RLBs and DTCs within the scope of the regime as a starting point, subject to the assessment on the impact of the actual failure of any given RLB and DTC by the resolution authority.

Question 4

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to FMIs which are designated to be overseen by the MA under the CSSO (other than those which are owned and operated by the MA) and those that are recognized as clearing houses under the SFO?

Law Society's Response:

[1] As at 12 March 2014.

16. FMIs play an essential and increasingly important role in the financial services industry and the disorderly insolvency of FMIs may cause disruption of market operation and potentially lead to severe systemic failure. Maintenance of an FMI's critical services forms an indispensable part of the resolution regime and, having regard to the regulatory framework for FMIs in Hong Kong, the Law Society agrees that it would be appropriate to extend the scope of the resolution regime to the FMIs which are designated to be overseen by the MA under the CSSO (other than those owned and operated by the MA) and the recognized exchange companies and clearing houses under the SFO.

Question 5

Do you agree that it is appropriate to set the scope of the regime to extend to some LCs?

Law Society's Response:

17. The Law Society agrees that the failure of certain LCs (such as securities and investment firms) of large scale may lead to disruption and even systemic risks in the continuity of financial services and it is therefore appropriate to extend the scope of the resolution regime to such LCs.

Question 6

If so, and in order to capture those LCs which could be critical or systemic, should the scope be set with reference to the regulated activities undertaken by LCs? Are the regulated activities identified in paragraph 144 those that are most relevant? Is there a case for further narrowing the scope through the use of a minimum size threshold?

Law Society's Response:

18. The Law Society believes the regulated activities set out in paragraph 144 of the Consultation Paper are the more relevant regulated activities for the purposes of determining the scope of the resolution regime, which include

    (i) dealing in securities or futures contracts,
    (ii) asset management and
    (iii) dealing in OTC derivatives or acting as a clearing agent for OTC derivatives.

    At the same time, the Law Society is in favour of the use of a minimum size threshold because it is highly unlikely that LC with small operational scale or trading volume will become systemically significant or critical or pose genuine risk to the financial stability. The Law Society notes that the FSB and the

IOSCO have jointly launched a consultation on assessment methodologies for identifying NBNI G-SIFIs in January 2014 and understands that the consultation conclusions (which are still pending) will be taken into consideration in formulating the minimum size threshold of LCs that are subject to the Hong Kong resolution regime.

Question 7

Do you agree that the scope should extend to LCs which are branches or subsidiaries of G-SIFIs? Do you see a need for the scope to extend to LCs which are part of wider financial services groups, other than G-SIFIs, whether those operate only locally or cross-border?

Law Society's Response:

19. An LC should be subject to the resolution regime if, after applying the relevant assessment, it is regarded as systemically significant or critical to the financial industry in Hong Kong. Failing such assessment, an LC should be included in the scope of the resolution regime purely for the purpose of supporting an orderly resolution of a G-SIFI if the LC is a branch or subsidiary of such G-SIFIs. The Law Society is of the view that there is no need to further extend the scope of resolution regime to other LCs which are not systemically significant or critical but merely form part of a wider non G-SIFI financial services group.

Question 8

Do you agree that it would be appropriate to extend the scope of the proposed resolution regime to the local operations of insurers designated as G-SIIs and/or IAIGs as well as those insurers which it is assessed could be critical or systemically important locally were they to fail?

Law Society's Response:

20. The underlying principle should be that measures designed to capture G-SIIs and IAIGs should be by reference to the critical or systemic importance of their operations in Hong Kong only; equally if the operations of the insurer in Hong Kong are critical or systemically important in Hong Kong, then the proposed resolution regime should apply to that insurer and its Hong Kong operations. However, it should be noted that except in the case of limited branch authorization, Hong Kong law already provides for the protection of the capital of almost all insurers; e.g. general insurers are required to maintain assets in Hong Kong in respect of their Hong Kong liabilities of an amount equal to a significant part of those liabilities, while life insurers are required to maintain separate insurance funds in respect of their Hong Kong long term business. As Hong Kong has a local asset, ring-fenced regime for general insurers and a

segregated life fund regime for life insurers, and provided that those structures can be maintained against the resolution regimes in the relevant home jurisdiction or other jurisdiction in which the insurer has operations and assets, it would seem that any proposed resolution regime in respect of the operations of those insurers in Hong Kong should be limited to the systemic importance of those operations in Hong Kong only.

21. It should also be noted that, by imposing the proposed resolution regime on the local operations of G-SII and IAIG insurers, that regime might be significantly burdensome and damaging to the competitiveness of those insurers in the Hong Kong market. This would be detrimental both to the insurer concerned and also the insuring public in Hong Kong. Similarly, any insurer critical or systemically important locally to which the proposed resolution regime is applied might also be adversely affected. It might instead be more appropriate to impose limits on the scale of operations of such an insurer so that it could not become such a critical or systemically important insurer in Hong Kong, while at the same time allowing it to compete in Hong Kong and elsewhere on a regulatory level playing field.

22. The application by the relevant resolution authorities of the proposed resolution regime in the home jurisdiction of any G-SII or IAIG insurer with operations in Hong Kong or in any other jurisdiction where that insurer has operations and the relationship that those resolution authorities have with their counterparts in Hong Kong would also be important, as a competition for control of the insurer and its assets might defeat that purpose of the proposed resolution regime.

23. The Law Society further submits that given that a G-SII or IAIG or an insurer which is critical or systemically important locally may carry a large proportion of risk of a certain type in Hong Kong, and given that the occurrence of that risk may be the cause of the insurer's difficulties resulting in the application of the resolution regime, consideration should be given to whether the Administration should establish (or require the relevant insurer to establish) a fund, reinsurance cover or capital markets structure to pay in the event of the relevant risk occurring and the relevant insurer failing and the Policyholders Protection Fund, Motor Insurer's Bureau funds, Employees' Compensation Insurance Residual Scheme funds and/or Employees' Compensation Assistance Fund as appropriate being inadequate to meet the relevant liabilities.

Question 9

Do you agree that branches of foreign FIs should be within the scope of the local resolution regime such that the powers made available might be used to: (i) facilitate resolution being undertaken by a home authority; or (ii) support local resolution?

Law Society's Response:

24. Foreign FIs for these purposes principally mean banks and, to a lesser extent, insurance companies, given the preponderance of offshore institutions operating in the Hong Kong market – the Consultation Paper refers to the fact that of the 29 global systemically important banks, 26 operate in Hong Kong as licensed banks, typically through a branch structure (sometimes with an affiliated Hong Kong-incorporated bank). Removing Hong Kong branches of foreign institutions from the equation would mean that the proposed regime would essentially be reduced to a domestic regime for all practical purposes, which would be clearly contrary to the evolution of these types of provision internationally, and likely to be impractical for Hong Kong to sustain as an international financial centre.

25. Accordingly, the Law Society agrees that branches need to be covered to (i) facilitate resolution being undertaken by a home authority, or (ii) support local resolution; subject to the points made in the response to Question 10 below concerning international cooperation and cohesion.

Question 10

Do you see any particular issues that need to be taken into consideration in ensuring that the regime can be deployed effectively in relation to branches of foreign FIs where necessary?

Law Society's Response:

26. The principal issue concerns the concept of global cooperation in respect of potentially conflicting international regimes under stressful conditions.

27. Firstly, where an overseas institution which operates a Hong Kong branch gets into financial difficulties in its home jurisdiction, there will need to be sufficient trust in the home resolution regime regarding the triggers for resolution. Hong Kong would support the home resolution authority insofar as the Hong Kong markets would not suffer, i.e. the Hong Kong creditors. Clearly, given that the Hong Kong resolution powers would be deployed, even where the Hong Kong conditions have not necessarily been met, there would need to be a reasonably certain test to be passed for Hong Kong to cooperate, so as to avoid any potential knock-on effects in the Hong Kong market which would only be created by that cooperation, not the status of the Hong Kong operations.

28. Secondly, if the Hong Kong resolution authority deploys the resolution powers as a result of the inherent position of the Hong Kong branch, regardless of the standing of the parent company, then the position with the home regulators would need to be carefully managed to avoid conflict.

29. What is envisaged where local resolution powers are triggered in a jurisdiction

of the offshore bank different from its home or Hong Kong, e.g. the Singapore branch of a UK entity? If the threat is perceived as sufficiently serious for the Hong Kong market, would the Hong Kong authorities treat that event as meeting local conditions for Hong Kong resolution? Presumably, in that case, there would need to be urgent discussions with the home regulator before activation.

30. In all cases, discussion with relevant authorities would be important, and that discussion should be held not necessarily only with the home resolution authority. That is particularly the case where there have been close links between multiple European regulators for example at the time of creation of global recovery and resolution plans. A carefully delineated set of communication lines would be necessary to avoid disputes across borders.

31. In this regard, the Law Society notes, by way of a general remark, that it is very important that international groups' structures and operations in Hong Kong should be considered in a pragmatic manner in the light of their global recovery and resolution arrangements in order to ensure consistency.

Question 11

Do you agree that extending the scope of the proposed resolution regime to cover locally-incorporated holding companies is appropriate such that the powers available might be used where, and to the extent, appropriate to support resolution of one or more FIs?

Law Society's Response:

32. There are merits to extend the scope of the proposed resolution regime to holding company in circumstances where the financial viability of the regulated entities relies support on such company for continuity for most (if not all) of its activities. That said, how this will be implemented in practice is a key issue, especially for holding company which has other non-bank business, or whose main line of business is non-financial. It is of paramount importance to include "safeguards" to minimize the effect of the exercise of its powers on the rest of the group. It seems that special conditions must be satisfied before such power could be exercised. Given the usual complicated structures for financial or a mixed group company, further delineation of what constitutes a group company is also recommended.

Question 12

Do you have any initial views on whether it is appropriate to extend the scope of the regime to affiliated operational entities to help ensure that they can continue to provide critical services to any FIs which are being resolved?

Law Society's Response:

33. The Consultation Paper mentions only a few jurisdictions under the resolution regime which are extending its coverage to operational companies of the FIs. Before deliberating on this topic, the Law Society believes that it is important to know which such jurisdictions are and under what circumstances would such an extension power be given to the resolution regime, as well as the rationale for those jurisdictions that do not have it. In fact, these operational companies are non-regulated, non-licensed, non-authorized, and considerations need to be balanced against overarching of regulatory powers vis-à-vis creditors and shareholder's rights. If the intention is to extend such power, it should (at the very least) only do so for the relevant ones in a limited set of circumstances subject to "appropriateness" and "reasonableness" considerations.

34. Another aspect worth looking at is the usual multi-faceted functions of such operational companies spanning across multiple jurisdictions. The Hong Kong's position with the home or other regulators needs to be carefully looked at, otherwise, conflict will be an inevitable corollary. Given the uncertainties, the Law Society suggests a further and more detailed public consultation in this regard or that this aspect is to be revisited in greater details in the subsequent consultation.

Question 13

Do you agree that the conditions proposed for initiating resolution are appropriate in that they will support the use of the regime in relevant circumstances?

Law Society's Response:

35. In general, the Law Society considers the two main conditions proposed for initiating resolution are appropriate. However, the Administration are invited to consider whether additional (and broader) resolution conditions should be incorporated, for example the "public interest test" set forth under the European Union Recovery and Resolution Directive ("EU RRD") (which requires a resolution action to be in the public interest i.e. if it achieves and is proportionate to the resolution objectives), and normal insolvency proceedings would not meet those objectives to the same extent. A similar "public interest" condition appears under the UK's Special Resolution Regime ("SRR").

Question 14

In particular, do you agree that it is appropriate that the first condition recognizes that non-viability could arise on financial and non-financial grounds (noting that resolution could occur only if the second financial stability condition is also met)?

Law Society's Response:

36. The Law Society agrees in principle that the first condition for initiating resolution should recognize that non-viability could arise on financial and non-financial grounds. However, the Law Society submits that for an FI to be considered non-viable due to non-financial reasons, the circumstances surrounding the failure must be sufficiently extreme. Following the example given in the Consultation Paper (see paragraph 169), the Law Society considers that a breach of regulatory requirement by an FI should have such a detrimental effect on market integrity that no other regulatory sanctions – other than revoking its licence or authorization, thus fulfilling the "non-viability" condition – could be justifiably imposed on the FI. Any breach that does not meet this high threshold should only be met with regulatory responses that do not involve the FI concerned being potentially placed in resolution. Further, the Law Society submits that in addition to guidance on the factors that the resolution authorities would consider in assessing the non-viability condition, there should also be guidance on the type of breaches that would lead to the supervisory authorities removing the FI's permission to conduct regulated activities or business, and as a result rendering the FI non-viable.

37. As emphasized throughout the Consultation Paper, the resolution process should allow the authorities to act quickly and decisively. This however may not be possible in a situation where a supervisory authority proposes to revoke an FI's permission to conduct regulated activities or business as part of a disciplinary process, since that process would necessarily involve dealings between the supervisory authority and the FI over a potentially significant period of time. Any disciplinary decision is also subject to appeal. To illustrate this with an example: the SFC proposes to revoke a licensed corporation's licence due to a severe breach of an SFO provision, which in turn would lead to the licensed corporation becoming non-viable. The licensed corporation then lodges an appeal of the SFC's proposed disciplinary action in the Securities and Futures Appeals Tribunal ("SFAT"). Assuming the second financial stability condition is also met, issues would arise in this scenario since:

    (i) to suspend the resolution process pending the conclusion of the appeal hearings and the SFAT's determination would render a quick resolution impossible; but

    (ii) to continue with the resolution without any final and conclusive determination on the SFC's disciplinary decision would be an infringement on due process, and would also be problematic if the SFAT is to eventually overturn the SFC's decision.

    The Administration are invited to consider how the supervisory function would fit into the resolution process in general.

Question 15

Are the objectives which it is proposed should be set for resolution suitable to guide the delivery of the desired outcomes?

Law Society's Response:

38. The Law Society agrees broadly that the three proposed objectives should be adopted to guide resolution actions. However, it is noted that under the EU RRD, the resolution objectives of maintaining financial stability, protecting investors and containing the costs of resolution are described as being of "equal significance", while under the UK's SRR, the resolution objectives are to be "balanced as appropriate" without being placed in any particular hierarchy. Similarly, under the FSB's Key Attributes, no priority has been accorded to any of the resolution objectives listed in the Preamble. Given the importance that the Consultation Paper places on containing resolution costs and protecting public funds, the Administration are invited to consider whether it would be more appropriate to mandate that the three proposed resolution objectives should be given equal significance in devising and executing any resolution action.

39. The Law Society also urges the Administration to provide further guidance on the types of financial services that might be regarded as "critical" in the context of the first resolution objective, while bearing in mind that a degree of flexibility should be allowed in relation to this element, and that a prescriptive approach would not be appropriate.

Question 16

Do you agree that, in line with their existing statutory responsibilities and supervisory intervention powers, the MA, SFC and IA should be appointed to act as resolution authorities for the FIs under their respective purviews?

Law Society's Response:

40. The Law Society agrees with the respective pros and cons of the sector-specific model and the integrated model as highlighted on page 80 of the Consultation Paper. One particular concern regarding the sector-specific model would be the resourcing issue i.e. does each of the MA, SFC, and IA currently have employees who have the requisite level of expertise on resolution matters? If not, would it be necessary for each of the authorities to establish and maintain its own team of resolution experts, and if so, would that be financially feasible and practical?

41. Although it is understood that the arrangements for a lead resolution authority ("LRA") would be discussed in the second stage consultation, the Law Society submits that the functions of a LRA as mentioned in the Consultation Paper would clearly pose challenges to the operation of, and may be interpreted as arguments against the adoption of, the sectoral model. In particular, seeking consensus across the relevant sectoral resolution authorities regarding whether the conditions for resolution have been met and which resolution option to pursue may prove to be difficult and time-consuming.

42. The Law Society also urges the Administration to provide more clarity on the basis for the LRA's appointment i.e. whether:

(i) a LRA would be appointed on an ad hoc, case-by-case basis;
(ii) each authority would be assigned to specific FIs/category of FIs in relation to which it would act as the LRA;
(iii) a designated agency would act as the LRA in all resolution scenarios; or
(iv) some other basis for appointing the LRA.

In any event, there must be complete transparency and open communications between the sectoral resolution authorities and the LRA in any resolution planning or action, in the event that the sectoral model is adopted.

43. The Law Society would make the following further comments in relation to information sharing. In case the sectoral model is adopted, appropriate and effective mechanisms for information sharing among the three resolution authorities, and between the relevant resolution authorities and the LRA (if applicable) must be put in place. There must also be sufficiently robust safeguards for protecting the confidentiality of any information being shared. This and the aforementioned potential supervisory conflict should be fully addressed, or else, the integrated model would have to be considered in the alternative.

Question 17

Do you have any views on how a resolution option allowing compulsory transfer of all or part of a failing FI's business could most effectively be structured and used?

Law Society's Response:

44. The UK experience can serve a useful reference point for the second consultation. The Banking Act 2009 (UK) can provide an appropriate model for a private sector purchase in the case of banks. The subsequent attempt to extend the special resolution regime in the Banking Act 2009 (UK) to group companies, investment firms and UK clearing houses, with the relevant modifications and the decision of the UK regulator to adopt a "wait and see" approach in the case of insurance companies (whilst engaging in continuous

discussions with the relevant stakeholders domestically and internationally such as the International Association of Insurance Supervisors) should also be noted for our Hong Kong discussion.

Question 18

Do you have any views on how a resolution option allowing compulsory transfer of part of a failing FI's business to a bridge institution could most effectively be structured and used?

Law Society's Response:

45. The Banking Act 2009 (UK) and Title II of the Dodd Frank can serve as suitable models for bridge bank structures.

Question 19

Do you have any views on the factors which should be taken into account in drawing up proposals for the provision of a bail-in option for the resolution regime in Hong Kong?

Law Society's Response:

46. The funding for the banking sector in Hong Kong is different from that of the US and Europe. In Hong Kong, most banks are largely funded by deposits, with less reliance on the wholesale funding. The bail-in regime is more appropriate for markets where banks are more reliant on senior debt issuance for funding. There is therefore a question of whether the bail-in regime is appropriate and effective for Hong Kong.

47. Should a bail-in regime be introduced, consideration should be given to the following:

    (i) whether certain uninsured deposits can be included as part of the bail-in requirements (reference can be made to the EU's draft BRRD which provides that uninsured non-preferred deposits (i.e. not personal or SME deposits) with a maturity of over one year are included as eligible liabilities for Minimum Required Eligible Liabilities for bail-in);

    (ii) how bail-in powers will exactly sit alongside the bail-in of convertible bonds or other contingent capital instruments issued,

    (iii) the means for determining non-viability,

    (iv) at what point the relevant FI would be deemed to be in resolution,

(v) the effect on and interaction with the close-out netting under the major industry documents such as ISDA documentation,

(vi) how to safeguard derivatives positions which are cleared through a CCP (where any default should be dealt with in accordance with the default waterfall and loss allocation rules of the relevant CCP).

Question 20

Do you agree that there is a case for including a TPO option in the proposed regime?

Law Society's Response:

48. Yes.

Question 21

Do you have any views on when it would be appropriate to make temporary use of an AMV in order to manage the residual parts of an FI in resolution?

Law Society's Response:

49. Whilst there are merits in using AMV to manage the residual parts of an FI in resolution, such option should only be used in restricted circumstances such as those mentioned in the Consultation Paper and where there are demonstrable benefits of using AMV in any particular case and enough safeguards are given to the protection of interest of the relevant stakeholders such as the creditors and shareholders of the failed FI. More specific criteria and details should be provided in the second consultation for further discussion.

Question 22

Do you have any views on how best to provide for a stay of early termination rights where these might otherwise be exercisable on the grounds of an FI entering resolution as a result of the use of certain resolution options?

Law Society's Response:

50. The Law Society suggests the introduction of some form of moratorium of enforcement or closing out of contracts which overrides the contractual provisions. This would be akin to the moratorium on enforcement of claims which arises when one files for Chapter 11 in US bankruptcy proceedings.

Similar suggestion was envisaged in the corporate rescue bills [2] the Administration introduced in 2000 and 2001 where it was proposed to inter alia introduce a protocol akin to judicial management in Singapore or administration in England. Under these bills, if a company went into corporate supervision, creditors' claims were to be stayed for a period of time while the corporate supervisor came up with a rescue plan.

51. The Law Society does not recall the corporate rescue bills raising any Basic Law issues nor does the Law Society see any such issues, because proprietary rights of individuals are not disturbed. Instead a party is merely delaying for a specified period (subject to redress because the Court is normally given an overriding power to end the moratorium in special circumstances) the enforcement of specific property rights.

Question 23

Do you have any views on how best to provide the supervisory or resolution authorities with powers to require that FIs remove substantial barriers to resolution?

Law Society's Response:

52. Subject to further clarification on the Administration' view on the best way to empower supervisory or resolution authorities to require an FI to remove barriers to resolution, the Law Society submits that any such powers must be exercised in a manner which:

    (i) allows direct, open and regular dialogues between the relevant FI and the authorities; and

    (ii) respects business freedom and the role that FIs have to play in maintaining market efficiency.

    This is particularly important for instilling confidence in FIs and the wider economy that the authority will take into account the views of the FIs – which are often in the best position to determine the optimal way to remain viable due to their knowledge of the day-to-day operation of their business, as well as their expertise in the particular market sector – in deciding what barriers need to be removed, and the actions that an FI is required to take to accomplish that.

53. Further to the suggestion in the Consultation Paper that an FI should be allowed to propose to the authorities alternative ways of enhancing its resolvability, it is submitted that there should be a formal appeals mechanism for resolving any disagreement between the FI and the supervisory or resolution authority on the best way to remove substantial barriers to resolution

[2] the Companies (Amendment) Bill 2000 and the Companies (Corporate Rescue) Bill 2001

without compromising the future viability of the FI concerned.

54. In relation to global financial services groups, it is of vital importance that the resolution authorities in Hong Kong remain in open and ongoing dialogues with the relevant group's home regulator, as well as any other regulators which have oversight of the group, regarding any identified resolution barriers, as well as the action(s) which are required of the group to remove such barriers in its Hong Kong entities. In this regard, the Hong Kong authorities should take into account the impact that any business restructuring or ringfencing to be undertaken by the group's Hong Kong entities may have on the financial stability in the overseas jurisdictions in which it also operates. It is further submitted that the Hong Kong authorities should consider any resolution planning action that the group may be required to take in overseas markets, in order to avoid potentially duplicative or incompatible approaches, and to minimize regulatory burden and uncertainty.

Question 24

Is the proposed approach to ensuring that third parties cannot act to pre-empt the resolution of a non-viable FI (including by means of a petition to initiate a winding-up) appropriate?

Law Society's Response:

55. The proposed approach is appropriate in order to allow the resolution regime to work and achieve its objectives effectively. That said, it is important that the legislation prescribes clearly the parameters of the powers of the resolution authorities on this aspect, including the time period (which should not be unduly long) during which third parties are not allowed to exercise their rights and remedies to which they are otherwise entitled, and what recourse is available if they feel aggrieved by a decision or delay in decision by a resolution authority.

56. The Law Society notes that at the moment the Administration is introducing a Contracts (Rights of Third Party) Bill 2013. Consideration will need to be given on any implications that Bill may have on the implementation of the resolution regime.

Question 25

Do you have any views on how provision might be made to ensure that the residual part of an FI could be called on to temporarily support a transfer of business to another FI or bridge institution (in the manner described in paragraph 266)?

Law Society's Response:

57. In order for this proposal to make sense, the provisions should clearly define their intended purpose and the meaning of "residual" and "temporarily". The provisions must safeguard against abuse. The key is how to classify various assets and functions of an AI as "residual" and only needed "temporarily" to support a transfer of business of a non-viable FI, as opposed to assets and functions that are to be acquired by the acquiring entity. Other questions include: Would the acquiring entity be required to pay a reasonable fee or compensation for the use of those assets and functions? What happens to those residual assets and functions afterwards, would they retain a commercial value for realization at liquidation or would their value be significantly reduced by the process? Given the different variety and complexity of businesses amongst various types of financial institutions, the starting point is to determine a set of principles that work for all of them.

Question 26

Do you attach any priority to pursuing reforms designed to ensure that the claims of protected parties (particularly those of depositors and investors) can be transferred out of liquidation proceedings, alongside those reforms being pursued to establish an effective resolution regime?

Law Society's Response:

58. The Law Society agrees to attach priority to pursuing reforms which would ensure that the claims of protected parties can be quickly and efficiently transferred out of liquidation proceedings. However, the Law Society waits to see what protection would be offered to the non-protected creditors and shareholders of a failed FI. If the claims of the protected parties are transferred out of the liquidation proceedings, it should not mean that the position of the creditors and shareholders would be put into a less advantageous position than that in the current liquidation framework (or, if it is, there be an effective compensation mechanism to make good the difference). There should be a balance with respect to the interest of the various stakeholders.

59. In addition, there must be clarity and transparency in which contracts with a FI will be such as to constitute that counterparty a protected creditor so that parties dealing with FIs can assess, at the time of contracting, how they would fair under a future resolution plan. Whether a party will be a protected creditor or one having to seek a compensatory payment will have a bearing on risk management and pricing.

Question 27

Do you agree that a compensation mechanism is a necessary safeguard to ensure that shareholders and creditors are no worse off under resolution than they would have been in liquidation? Do you have any views on the factors which should be taken into account in designing such a compensation mechanism?

Law Society's Response:

60. The Law Society agrees that a compensation scheme should be put in place to safeguard the interest of the shareholders and creditors when a FI fails so that they would be in no worse of a position than they would have been in liquidation. The compensation scheme should take into account:

    (i) How will the compensation be funded? Clearly, there must be a levy imposed on the collective FIs but what safeguards will prevent (or will there not be safeguards?) this cost being ultimately passed on to the consumer?

    (ii) Compensation should track priorities existing in a liquidation so compensation is paid first to unsecured creditors and, subject to point (iii) below, only becomes available to shareholders if the hypothetical liquidation scenario determines that the FI would have been solvent.

    (iii) Compensation should extend to interest a creditor would have been entitled to in a solvent liquidation before being available for shareholders.

    (iv) "No creditor worse off than in a liquidation" is an *ex post facto* assessment and raises issues as to what valuation methodology or processes will apply and who will carry it out (ideally an expert valuation agent independent of the resolution authority). There should be a fair process, probably judicial, through which value can be scrutinized for the purposes of compensation but not such as to allow the resolution authority's implementation of the resolution plan to be undermined or second-guessed.

    (v) Consideration will need to be given as to whether the Hong Kong compensation fund will be available for payments in respect of creditors of Hong Kong branches of overseas banks which are, themselves, subject to a resolution plan or regime in their home jurisdiction.

Question 28

Do you consider that any adjustments are needed to the existing framework for protecting client assets for the purposes of resolution?

Law Society's Response:

61. No. The existing framework is laid down having regard to the different nature of businesses of authorized institutions (under the Banking Ordinance, Cap 155), licensed corporations (under the Securities and Futures Ordinance, Cap 571) and insurers (under the Insurance Companies Ordinance, Cap 41). The framework for each of the three industries serves the purposes of that industry. It is not feasible to align the framework for all types of financial institutions. For example, it is a long standing and fundamental principle that a deposit placed by a depositor with a bank is a debt owed by the bank to the depositor. The bank is a debtor and not a trustee. It is not appropriate to impose the trust concept with respect to client money as in the case of licensed corporations.

Question 29

What types of "financial arrangements" do you consider as important to protect in resolution? Why is it important that those arrangements by protected?

Law Society's Response:

62. In principle, those financial arrangements that are critical to securing continuity of the non-viable AI's critical financial services, preserving financial stability and reducing use of public funds (namely, the key objectives of the regime) are important to protect in resolution. What those financial arrangements are in practice may differ from one non-viable AI to another. Hence, the legislation will have to identify them by laying down a clear set of principles or criteria. It would also be useful to give a non-exhaustive list of some typical financial arrangements as examples.

Question 30

Do you agree that, in order to ensure resolution can be effected as swiftly as needed, there should be protection from civil liability for: (a) officers, employees and agents of the resolution authority, and (b) directors and officers of FIs acting in compliance with the instructions of the resolution authority, limited to cases where these parties are acting in good faith?

Law Society's Response:

63. Yes. This is akin to the immunity of the Bank of England which was explored, before it collapsed, in the case brought by the liquidators of BCCIO.

64. The Law Society agrees but subject to the proviso that the officer, employee, agent as well as directors and other officers who are tasked with carrying out

the instructions of the resolution authority should possess a reasonable level of competency and expertise in handling the instructions. Any absolution must be limited to liability incurred in respect of the implementation of the resolution plan – not failings in office pre-resolution (regardless of whether those failings did or did not contribute to the need for resolution).

Question 31

What provisions should be made under the regime to fund resolution, with a view to ensuring that any call on public funds is no more than temporary?

Law Society's Response:

65. A general levy for failure of any FI, whether or not a SIFI or TBTF, would be unfair on solvent institutions who manage their risks and business appropriately. Necessary protection should be limited to the establishment of a specific fund financed by the relevant institutions and their customers, such as the Policyholders Protection Fund presently being established for the protection of policy holders in the event of failure of an insurer, including a G-SII or IAIG or an insurer which is critical or systemically important locally. Consideration should be given to avoiding any levy other than through and for a specific fund regime.

66. Insofar as such a specific fund is insufficient to satisfy the liabilities of a SIFI or TBTF, the relevant customers should rank as general creditors of the institution concerned. Consideration should be given as to whether any additional funding required for the institution concerned should be levied on the shareholders of the institution and other strategic investors in the institution.

Question 32

Do you agree that it is important that the resolution regime in Hong Kong supports, and is seen to support, cooperative and coordinated approaches to the resolution of cross-border groups given Hong Kong's status as a major financial centre playing host to a significant number of global financial services groups?

Law Society's Response:

67. Yes. Please see the response to Question 10 above.

Question 33

Do you agree that the model outlined in paragraphs 331 to 333 to support and give

effect to resolution actions being carried out by a foreign home resolution authority would be effective in supporting coordinated approaches to resolution where it is in the interests of Hong Kong to do so?

Law Society's Response:

68. As noted in this response generally, the crucial issue in relation to the cross-border resolution aspects is the extent to which global cooperation agreements or other arrangements entered into by Hong Kong with other jurisdictions, insofar as relevant in a particular situation, are in practice adhered to.

69. The Consultation Paper, and the broader underpinning international materials, hold the inherent danger of sparking protectionist behaviour at times of stress. Accordingly, there needs to be a careful mapping of the stances and regimes of other relevant jurisdictions to ensure that these issues are catered for as swiftly and surely as possible – there will be no benefit to Hong Kong, and indeed adverse consequences, where Hong Kong's relevant resolution authorities feel the need to take essentially unilateral action to protect Hong Kong creditors, given the obvious carve-out articulated in the Hong Kong consultation paper. That would degenerate into tit-for-tat action on the part of the other regulators and generate huge levels of mistrust which could take decades to rebuild.

70. Hence, the issues are very much at the political rather than legal end of the spectrum in many respects.

71. One specific question raised in paragraph 333 of the Consultation Paper relates to whether Hong Kong should take into account the potential impact of the exercise of its resolution powers in the context of the financial stability of any other jurisdiction. The answer is that, from a global political perspective, clearly yes in relation to the home jurisdiction to promote sustainable cooperation both at the time of the crisis at hand and also any future issues where the tables may have turned. Having said that, the Hong Kong public's and politicians' expectations would needless to say look closer to home, creating significant tension that no amount of legislative drafting would necessarily remove.

72. As regards potential impact on other jurisdictions other than the home jurisdiction, the answer is less clear-cut, but remains, from a global cooperation perspective, that the other jurisdiction's position should be taken into account. Again, presumably that would be to the extent that the Hong Kong markets are not adversely affected; again, the political realities would inevitably come into play.

Question 34

Do you consider that the powers proposed regarding information sharing strike an

appropriate balance in terms of facilitating information sharing for resolution in both in a domestic and cross-border context whilst also ensuring that all reasonable steps are taken to preserve confidentiality?

Law Society's Response:

73. The suggested powers are an inevitable corollary of the proposed resolution regime, particularly given the international context.

74. In terms of cross-border information sharing, the key will be the degree of trust that can be held by the relevant Hong Kong authority in the overseas authority. It is important that for specific jurisdictions specific authorities are identified, recognizing the point made in the Consultation Paper as regards the different structural methods employed in implementing regimes. There should not be a "blank cheque" for information disclosure out of Hong Kong to supervisory authorities, central banks, ministries of finance and public bodies administering resolution funds and protection schemes without it being clear the limits of the scope of such bodies and relevant departments, etc. within them. It seems correct that the degree of reciprocity on the part of the other jurisdiction is an important factor to be weighted in these considerations.

The Law Society of Hong Kong
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APPENDIX 1

ABBREVIATIONS ADOPTED IN THIS SUBMISSION[3]

AI	Authorized institution
AMV	Asset management vehicle
BIS	Bank for International Settlements
BO	Banking Ordinance (Cap. 155)
BoE	Bank of England
CCP	Central counterparty
CMG	Crisis management group
CO	Companies Ordinance (Cap. 32)
COAG	Institution-specific cross-border cooperation agreement
CPSS	Committee on Payment and Settlement Systems (of the Bank for International Settlements)
CSSO	Clearing and Settlement Systems Ordinance (Cap. 584)
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
DPB	Hong Kong Deposit Protection Board
DPS	Deposit Protection Scheme
DPSO	Deposit Protection Scheme Ordinance (Cap. 581)
D-SIFI	Domestic systemically important financial institution
DTC	Deposit-taking company
EU	European Union
EU RRD	Recovery and Resolution Directive of the European Union
FDI	Act Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FIs	Financial institutions (including financial market infrastructures unless the context otherwise requires)
FINMA	Financial Market Supervisory Authority (Switzerland)
FMIs	Financial market infrastructures
FS	Financial Secretary
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board

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

FSTB	Financial Services and the Treasury Bureau
G20	Group of Twenty
GLAC	Gone concern loss absorbing capacity
G-SIB	Global systemically important bank
G-SIFI	Global systemically important financial institution
G-SII	Global systemically important insurer
HKEx	Hong Kong Exchanges and Clearing Limited
HKMA	Hong Kong Monetary Authority
IA	Insurance Authority
IAIG	Internationally active insurance group
IAIS	International Association of Insurance Supervisors
ICF	Investor Compensation Fund
ICO	Insurance Companies Ordinance (Cap. 41)
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LB	Licensed bank
LC	Licensed corporation
LegCo	Legislative Council
LRA	Lead resolution authority
MA	Monetary Authority
MAD	Market Abuse Directive (of the European Union)
MAS	Monetary Authority of Singapore
MOU	Memorandum of understanding
MPE	Multiple point of entry (resolution strategy)
NBNI G-SIFI	Non-bank non-insurance G-SIFI
NCWOL	No creditor worse off than in liquidation
OTC derivatives	Over-the-counter derivatives
PPF	Policyholders' Protection Fund
RI	Registered institution
RLB	Restricted licence bank
ROSC	Report on the Observance of Standards and Codes
SFC	Securities and Futures Commission
SFO	Securities and Futures Ordinance (Cap. 571)

SIFI	Systemically important financial institution
SPE	Single point of entry (resolution strategy)
SRR	Special Resolution Regime (UK)
TBTF	Too big to fail
TPO	Temporary public ownership
UK	United Kingdom
US	United States of America