31 May 2016

Financial Institutions (Resolution) Bill

The Hong Kong Institute of CPAs' Restructuring and Insolvency Faculty ("RIF") commented on the two rounds of consultations on the proposed resolution regime conducted in 2014 and 2015, respectively, by the Financial Services and the Treasury Bureau. Some of the issues that we raised in those consultation exercises have been addressed in the Financial Institutions (Resolution) Bill, while others remain. The RIF's comments on the Bill are outlined below.

1. Definitions

(i) We note from definitions the extremely wide definition of "financial institution" as "an entity that is primarily engaged in the provision of financial services or the conduct of financial activities…". Under clause 6, the Financial Secretary ("FS") may by notice published in the Gazette designate a financial institution ("FI") as a within-scope FI. We note from paragraph 6 of the Legislative Council Brief that it is intended "to provide for this designation power to extend to both regulated and unregulated FIs". Under clause 6(3), the FS is required to consult with the resolution authority ("RA") proposed to be designated as the RA of a newly-designated FI and each other RA. However, there is no requirement for consultation with the FIs concerned. Thus it would seem that a whole class of FIs could, in principle, be brought within the scope of the resolution regime without the kind of consultation that was conducted in the case of the banking, securities and insurance sectors. This does not seem appropriate and therefore we would suggest that a commitment be given by the government that, if it is proposed to bring new types of entity within the scope of the legislation, this will not be done without public consultation. As we stated in our response to the second consultation on the proposed resolution regime, there needs to be a proper, transparent and orderly process for designating FIs not initially covered by the resolution regime as being within its scope, which should include sufficient advance notification to/ consultation with stakeholders.

(ii) The definition of "officer" is also very broad and different from the definition in the Companies Ordinance (Cap. 622). No rationale is given for this. It includes, for example, a person who is principally responsible, alone or jointly with others, for the performance of one or more of the control functions of an entity, i.e., any of the following functions, that is likely to enable the person responsible for its performance to exercise a significant influence on the business of the entity - risk management, financial control, compliance, internal audit, or, under clause 6(5), any other function so specified by the FS in the Gazette. As, under various circumstances, officers may also be liable for offences committed by an FI, we suggest that more specific guidance needs to be provided as to the persons who may fall within the scope of the definition of "officer".

(iii) Paragraph 11 of the Legislative Council Brief indicates that a "TPO company", which is included in the definitions under the Bill, in fact refers to

temporary public ownership. We would suggest that this be made more explicit as the term "TPO company" is not self-explanatory.

2. Appointment of entities to assist an RA (clause 10)

In our response to the second consultation paper on the proposed resolution regime, we supported the proposal that an RA should be empowered to appoint a resolution manager. We suggested that further consideration be given to the qualifications required of the resolution manager and that the basic skills needed were similar those required for managing a corporate rescue procedure, i.e., those of a "provisional supervisor" under the government's proposed framework for corporate rescue or "provisional supervision". Under these proposals, members of relevant regulated professions in Hong Kong, namely CPAs and solicitors holding practising certificates, would be among those eligible to take up appointments. (Depending on the specific situation, others with appropriate qualifications and/ or experience, such as those with turnaround management skills, might also be suitable for the role.) On top of any basic criteria, knowledge of restructuring/ business recovery would be desirable and, in individual cases, specific industry knowledge and experience may also be called for. In relation to knowledge of insolvency and restructuring, we also referred to the Institute's specialist qualification and designation in insolvency, which are well-regarded qualifications in the Hong Kong restructuring and insolvency market.

3. Power to direct removal of impediments (clause 14)

As we noted in our response to the second consultation, the powers of an RA to require an FI to make changes to improve its resolvability are potentially very intrusive. We doubt, therefore, whether a right for an FI to make representations to the RA after receipt of a direction under clause 14(2) is sufficient. It may be more appropriate for the FI to be able to make representations/appeal to a higher authority such as the FS or, preferably, the Resolvability Review Tribunal ("RRT"). In fact, clause 111(a) indicates that the RRT does have jurisdiction over decisions of RAs or lead RAs ("LRAs") to serve a notice under clause 14(2). However, there seems to be no clear reference to this in clause 14, giving an FI a right of appeal to the RRT. It would also seem, on the face of it, that shareholders of an FI should also be kept informed where the FI is for example being directed to restructure, although care would need to be taken to avoid the spread of rumours regarding the stability of the FI.

4. Removal of directors (clauses 23-24)

In our response to the second consultation, we opposed the proposal that all the directors, chief executive officer ("CEO") and deputy chief executive officer CEO ("DCEO") of an FI should automatically be removed from office by process of law in the event of a resolution. The relevant parties will be part of the "institutional memory" of the FI and, if they are automatically removed, it may be difficult for a manager appointed by the RA in their place to obtain their assistance and support. It is also quite possible that the need for resolution has not be brought about through the actions or inaction of the directors, CEO and DCEO, but may, instead, be due to extraneous factors, in which case, again, it may be preferable to retain their services during the process of resolution or part of it. This being the case, we

support the general position reflected in the Bill, i.e., that an RA be required to give notice to a person who is a director, the CEO or DCEO in order to revoke that person's appointment. However, given the severity of this action, and that it may be exercised when an FI has not reached the point of non-viability, we consider that a person so affected should have a statutory right of objection or appeal against a notice of revocation of appointment issued by an RA.

Clause 24(7) stipulates that anything done by a person purporting to act as a director, CEO or DCEO of an FI after the person's appointment has been revoked "is void from the beginning". Under such circumstances, the impact on an innocent third party who may have entered into a transaction with the FI represented by such a person needs to be made clear.

It is also not clear at what point the RA can give a notice of a revocation of appointment to a relevant person. Logically, it should be only after a letter of mindedness that the RA is intending to initiate resolution of the FI has been issued by the RA (clause 30), because under clause 30(2)(e) the directors may make representations to the RA in relation to anything stated in the letter. However, this chronology of events is not specified and, if it is intended that a notice of revocation of appointment may be issued only after a letter of mindedness, then there would be no need to specify in clause 23 that an RA must be satisfied that conditions 1 and 3 are met in the case of an FI before the powers of an RA to remove the directors, etc. can be exercised. This is because, before a letter of mindedness can be issued under clause 30(2)(b), the RA must already be satisfied that all three conditions, 1,2 and 3, are met. If, on the other hand, it is intended that the directors may be removed before a letter of mindedness is issued, then the right of the directors to make representations under clause 30(2)(e) in respect of the letter could be of little practical value in such cases.

5. Letter of mindedness (clause 30)

Given the seriousness of decision to resolve an FI, it may not be sufficient to allow the directors of the FI, or other relevant entity, to make representations to the RA, i.e., the same agency that has already satisfied itself that the conditions for initiating resolution have been met. It may be more appropriate for the FI to be able to make representations to the FS or to have a right of appeal to the RRT. See also the comments under "removal of directors" above.

6. Part 5, Division 1 – Stabilization options

Valuation (clauses 35-37)

Clause 35 requires an RA to carry out a valuation in relation to a within-scope FI before applying a stabilization option or making a capital reduction instrument. It is unclear how an RA could itself be expected to have sufficient expertise to conduct a valuation. Clause 37 allows an RA to appoint a "section 10 entity" to assist in conducting a valuation. The definition of "section 10 entity" does not make it clear what type of entity this may be. However, under clause 37(2)(a) it must have the expertise, experience and resources necessary for the purpose. Under clause 37(2)(b), it must not have an interest in common or conflict with, amongst others, a person who is a creditor of the FI concerned, which could influence or be

reasonably perceived to influence the section 10 entity's judgment in assisting with the valuation.

We note that, in the consultation conclusions from the public consultation exercise, the government acknowledged that the pool of valuers in Hong Kong may be small. The above restrictions are likely to further limit the choice of valuers, given that the entity that is the subject of the valuation may be a bank with numerous creditors and depositors.

We would suggest that more thought be given to the prohibition on the appointment of a person that may have a perceived common interest or conflict only by virtue of, say, an indirect connection with creditor/depositor of the FI concerned (which may arise due to, e.g., other valuation engagements). If joint appointments of valuers were to be permitted, this could also be an advantage, because if a (perceived) conflict were to arise with one valuer, the joint appointee would be able to take up the particular matter in relation to which the (perceived) conflict had arisen or, if necessary, the valuation as a whole.

Transfers of assets

Under clauses 39, 42 and 50, an RA may transfer assets, rights or liabilities of an FI being resolved to a purchaser, bridge institution or asset management company, respectively. We would suggest that decisions as to which assets, rights or liabilities should be transferred should be appealable to the RRT.

7. Power to direct residual FIs/ effect of a direction (clauses 79-80)

Under clause 79(3), an RA may, by giving a written notice, direct an FI "to continue to provide, on reasonable commercial terms, to another entity to which any assets, rights, or liabilities of the [FI] have been transferred in the application of a stabilization option, services that are essential to the continued performance of critical financial functions in Hong Kong". Under clause 80(1), a notice may be served by an RA under clause 79(3) on a within-scope FI, "whether or not winding up proceedings have been commenced in relation to it" and under clause 80(2), the serving on a notice on an FI "does not prevent the commencement or continuation of winding up proceedings in relation to it".

However, it is not clear how this would operate in practice where winding up proceedings were under way in relation to a residual FI. For example, who would pay for the continuation of essential services to the entity to which assets, etc. had been transferred? How could it be ensured that there would be sufficient suitable personnel in place to provide those services? Who would be liable for any failure in those essential services if they were provided? A liquidator would not want to assume liability for the provision of such services unless, possibly, he or she were fully indemnified.

8. Part 6, Division 2 - Independent valuer

(i) With regard to clause 95, we do not see the need to provide for the

appointment of an appointing person whose role is to appoint an independent valuer. If such a person were to be appointed, what eligibility criteria would apply to that person and what criteria should the appointing person apply, in any given circumstances, when appointing an independent valuer, other than the very general criteria contained in Schedule 2? We would guess that the aim of the arrangement is ensure an objective and fair impartial process for appointing a valuer, but if the criteria for appointing the appointing person were not themselves transparent, there would seem to be no particular benefit to adding another layer of administration and additional costs, rather than having a valuer directly appointed by, for example, the FS. It is also not clear from the Bill whether it is envisaged that an appointing person would be appointed for one resolution or for a particular period of time.

We would envisage that valuers may have to be appointed expeditiously. It would make sense for a panel of suitably qualified valuers to be established in advance. In terms of expertise and experience, we would suggest that a valuer should be required to have on board at least one or more experienced insolvency practitioners. In this regard, we would refer again to the Institute's specialist qualification and designation in insolvency, which represent a respected accreditation in the market.

(ii) We would make here the same observations as we make in relation to clauses 35-37 above, about reconsidering the need to disqualify persons who might have a perceived common interest or conflict by virtue of only of an indirect connection with a creditor/depositor of the FI in resolution; and also about allowing for joint appointments.

(iii) With regard to the situation under clause 99, where a new valuer is appointed to replace an existing valuer, consideration may need to be given to the potential liabilities of the former valuer who may have been required, under clause 99(2), to provide documents, records and accounts to the successor valuer, particularly where the new valuer makes use of material supplied by the former valuer.

9. Part 6, Division 3 - Valuation

(i) Under clause 103, the independent valuer has to assess, in effect, whether, following a resolution, the treatment of pre-resolution creditors or shareholders is worse than they would have received had the winding up of the FI commenced immediately before its resolution was initiated. This is the so-called "no creditor worse off than in a liquidation ('NCWOL')" principle. One problem with this, in our view, is that there appears to be no specific time or event under the Bill that demarcates the start of the resolution. Under clause 30(2), a resolution cannot be initiated until the RA has sent a letter of mindedness to the FI. Under clause 30(2)(f), the RA must state a reasonable period within which representations may be made by the FI in relation to anything in the letter. However, there does not seem to be any specific provision in the bill indicating after that time when a resolution is deemed to

have commenced.

(ii) A second point of concern is that under clause 190, a petitioner must give notice in writing to an RA or LRA of an intention to present a petition for the winding by the court of a within-scope FI and wait for up to seven days following receipt of the notice before taking further action. Only if the seven days have ended without the (L)RA initiating resolution of the FI or, within that period, the (L)RA has indicated that it does not intend to initiate resolution, may the petitioner proceed to present the petition. If an FI is resolved and the date of the comparison of a creditor's relative position in a winding up and in the resolution is only several days after the creditor has notified the (L)RA of the intention to petition, there is a risk that creditor's position may have changed significantly in those few days and the creditor has not been able to protect his or her position in the meanwhile. This seems to be unfair. Therefore, we would suggest that the date for assessing the value of a creditor's relative position should be the date that the notice of the intention to present a petition is given to the (L)RA. An exception to this would be where a debt has been incurred after this time and then the relevant date should be the date that the debt was incurred.

(iii) We note from its response to deputations on policy issues, that the government intends to produce regulations regarding the assumptions and processes applicable to an NCWOL valuation. We welcome the acknowledgment of the importance of providing sufficient guidance on this issue, and we would hope to be consulted on the draft regulations.

10. Part 7 - Tribunals

The proposed RRT and the Resolution Compensation Tribunal must be chaired by a former Justice of Appeal of the Court of Appeal; or a former judge, a former recorder or a former deputy judge of the Court; or a person who is eligible for appointment as a judge of the High Court. The bill also provides for the possibility of appeals from the tribunal to the Court of Appeal. This highlights the need to ensure the adequacy of the resources of the judiciary. These tribunals will need to act expeditiously and, if there are appeals, they will also have to be dealt with swiftly. Given this and the potential competition for resources between the tribunal system and the judiciary, proper forward planning will be essential to secure and maintain the necessary resources.

11. Part 13 - Non-Hong Kong resolution actions

(i) This is an important part of the proposed regime, yet few details are provided about how and under what specific circumstances and conditions Hong Kong will recognise overseas resolution actions and ensure that the NCWOL principle is adhered to.

For example, under clause 185(5), an RA may not make a recognition instrument without first consulting the FS. It would be helpful to know what role the FS will play in making a decision to recognise an overseas resolution action and what factors will be taken into account.

(ii) We note that, under clause 185((2), the RA may make a recognition instrument "irrespective of whether the non-Hong Kong [FI] or non-Hong Kong group company to which the instrument relates is a within scope [FI]". Under clause 186(3), clause 25 does not apply to the making of a recognition instrument, i.e., the Hong Kong RA does not need to satisfy itself that the three conditions necessary to initiate a resolution in Hong Kong apply to the FI. In addition, clause 187 on the compensation arrangements seems somewhat vague: It is required merely that a Hong Kong creditor or shareholder be eligible to claim compensation under an arrangement with the relevant non-Hong Kong RA "that is broadly consistent with the eligibility provided by [clause] 102." This concerns the matter of eligibility only and does not address the question of the procedure or ease of making claims. In addition, how could a creditor or shareholder be expected to know what his or her legal entitlement would be in a liquidation procedure in the home jurisdiction of the FI concerned?

(iii) It is worth noting also that, under clause 189, the Hong Kong RA can exercise any power under the bill in support of the non-Hong Kong RA, if it is of the opinion that this would be consistent with the resolution objectives. As indicated above, this is despite that fact that the Hong Kong RA would not need to be satisfied that the three conditions necessary to initiate a resolution in Hong Kong applied to the FI.

(iv) In response to the earlier consultations, we noted that there is no intention to require that FIs within the scope of the regime be restructured into locally incorporated financial services holding companies, except where the absence of such a structure may represent a material barrier to orderly resolution. In relation to the extension of the local resolution regime to branches of overseas FIs operating in Hong Kong, the second consultation paper stated that the "primary objective of this approach is to facilitate orderly, coordinated cross-border resolution", although the RA will also be able to resolve a branch independently under certain circumstances. In our response, we repeated a point made in our submission on the first consultation paper, that it should be made clear how it is to be determined and ensured that local creditors will not be disadvantaged relative to foreign creditors, where a Hong Kong branch is a part a resolution process initiated by the FI's home RA. This is particularly important given that, for historical policy reasons, Hong Kong has generally favoured the establishment of branches of foreign FIs over locally incorporated subsidiaries. In our response to the first consultation paper, we noted that when the Bank of Credit and Commerce ("BCC") collapsed internationally, a winding up procedure was conducted in Hong Kong and creditors received a dividend exceeding one hundred percent from the liquidation of the local subsidiary, BCC (Hong Kong). Creditors of some group companies in other jurisdictions, on the other hand, received little or nothing from the liquidation of those entities. In the case of Hong Kong branches of overseas banks, the authorities here would inevitably have less control over events.

Given all of the above, it is very important that the public be fully apprised of how the proposed recognition regime will operate in practice in Hong Kong.

(v) There appears to be something of an inconsistency between clause 185(9) which states that, subject to clause 191, "the making of a recognition instrument has no effect on the taking of any step for the winding up of an entity affected by the non-Hong Kong resolution action" and clause 191 itself, which states, in relation to a within scope FI or holding company: "Despite any provision in any other Ordinance, winding up proceedings may not be commenced in relation to the [FI] or holding company except with the consent in writing of the [RA]".

12. Other matters

As indicated above, proposals have been under discussion for some time to implement a statutory corporate rescue regime in Hong Kong. In fact, bills addressing this subject have previously been introduced into the legislature although, ultimately, they were deferred or allowed to lapse. We understand that the government intends to introduce another bill on this subject in the future. Detailed consideration will need to be given, therefore, as to how the resolution and corporate rescue regimes will align with one another, or least not give rise to any major conflicts or discrepancies.