

## HONG KONG CONTRACTUAL STAY RULES FOR BANKS TO COME INTO FORCE

### Financial Institutions (Resolution) (Contractual Recognition of Suspension of Termination Rights – Banking Sector) Rules (the Stay Rules) will come into operation on 27 August 2021

Hong Kong joins jurisdictions such as the United States, the United Kingdom and the European Union in preparing to put in place rules requiring financial institutions to include provisions in a range of financial contracts preventing the exercise of termination rights against those financial institutions if they fall into financial distress. The purpose of the Stay Rules is to ensure that resolution actions taken by a regulator of a distressed financial institution are not inhibited. Below, we take a closer look at the Stay Rules and their impact on capital markets, finance, and derivatives documentation governed by non-Hong Kong law.

### Background

To meet the *Key Attributes of Effective Resolution Regimes for Financial Institutions* set by the Financial Stability Board (FSB), Hong Kong enacted the Financial Institutions (Resolution) Ordinance (Cap. 628) (FIRO) in 2017. See our client briefing "*Too Big to Fail? Details of Hong Kong's New Resolution Regime*" [here](#).

FIRO established a cross-sectoral resolution regime for within scope financial institutions – which includes all authorized institutions (AIs). The Hong Kong Monetary Authority (HKMA) is the primary resolution authority for AIs under FIRO and is provided with a range of resolution powers, including stabilization options (see "*Stabilization Options*" below) to resolve a non-viable AI which poses risks to the stability and effective functioning of the financial system in Hong Kong.

### Key issues

- The Stay Rules require Hong Kong incorporated AIs and certain of their group companies to include a contractual term in their covered contracts for parties to be bound by a temporary suspension of termination rights that may be imposed by the HKMA under FIRO.
- Covered contracts are non-Hong Kong law governed financial contracts containing a termination right exercisable by a counterparty (other than an Excluded Counterparty).
- Covered entities should begin to consider establishing relevant processes, identifying covered contracts and preparing contractual stay language.
- The implementation period is 24 months for certain covered contracts and 30 months for the rest, with the HKMA having power to extend the implementation period where necessary.

### ***Stabilization Options***

A full menu of stabilization options (that can be used in any combination) is available to the HKMA under FIRO, including: (i) transfer of the failing AI or some or all of its business to a commercial purchaser; (ii) transfer of some or all of its business to a bridge institution; (iii) transfer to an asset management vehicle; (iv) statutory bail-in - writing down shareholders and certain unsecured creditors; and (v) taking a failing AI into temporary public ownership, as a last resort, with the approval of the Financial Secretary. See Part 5, Division 1 - Stabilization Options of FIRO.

In a resolution of a non-viable AI where one or more stabilization options are used by the HKMA, it is important that the contractual counterparties to the AI cannot terminate and close out their positions solely as a result of the AI's entry into resolution. Disorderly termination of contracts on a mass scale could frustrate resolution actions taken with respect to a non-viable AI, thus causing significant contagion effects to the financial markets and posing wider risks to the stability and effective working of the financial system. Should a termination right of a counterparty to a qualifying contract nevertheless become exercisable, section 90(2) of FIRO allows a resolution authority to temporarily suspend, for up to two business days, the termination right of a counterparty to a qualifying contract, by way a Part 5 instrument. Under FIRO, a Part 5 instrument means a securities transfer instrument, a property transfer instrument or a bail-in instrument.

However, in circumstances where contracts are governed by non-Hong Kong law, it is not always entirely clear whether such non-Hong Kong law would give effect to a suspension of termination rights imposed by the HKMA under section 90(2) of FIRO, unless the law of that jurisdiction expressly recognises the HKMA's resolution actions.

Even if the law of a foreign jurisdiction were to give effect to the suspension imposed under FIRO, there are no assurances that this would happen in a timely manner and so the HKMA's resolution actions could be hindered.

To address the issue of ensuring cross-border effectiveness of suspension of termination rights imposed under local rules or laws with respect to contracts governed by laws of other jurisdictions, the FSB has set out certain principles in its "*Principles for Cross-border Effectiveness of Resolution Actions*" (FSB Principles). The FSB Principles support contractual approaches to giving effect to cross-border resolution actions, which complement and support statutory frameworks.

## **The Stay Rules**

Consistent with the FSB Principles, the HKMA is implementing the Stay Rules to require covered entities to ensure that any covered contracts made, or evidenced in writing contain a term or condition to the effect that the parties (other than a financial market infrastructure, the HKMA, the HKSAR Government and governments and central banks of non-Hong Kong jurisdictions (Excluded Counterparties)) agree in a legally enforceable manner that they will be bound by any suspension of termination rights in relation to the contract that may be imposed by the HKMA under section 90(2) of FIRO.

The Stay Rules apply to newly entered covered contracts or existing covered contracts that are renewed or materially amended.

***Draft Code of Practice chapter ST-1 "Resolution Planning – Contractual Recognition of Suspension of Termination Rights"***

The HKMA has opened for industry consultation, until 9 September 2021, the chapter relating to the Stay Rules for its Code of Conduct.

The chapter contains guidance on how the HKMA intends to exercise certain discretionary powers under, and on the operation of certain provisions in, the Stay Rules. There are further details on (a) the obligations of a Related Company (as defined below); (b) covered contracts entered into before the implementation of the Stay Rules; (c) the systems of controls and record keeping required of covered entities; (d) the legal opinions which covered entities might have to produce to the HKMA under the Stay Rules; and (e) what constitutes a financial contract.

***Who will the Stay Rules apply to?***

The Stay Rules are applicable to any "covered entity", being:

- (a) an AI incorporated in Hong Kong;
- (b) an entity that is a holding company incorporated in Hong Kong of an AI incorporated in Hong Kong, but is not itself an AI (HK Holding Company); or
- (c) a group company of an AI incorporated in Hong Kong, that is not itself an AI incorporated in Hong Kong or an HK holding company (Related Company).

***What are covered contracts?***

Under the Stay Rules, a "covered contract" in respect of a covered entity that is an AI incorporated in Hong Kong or an HK Holding Company, is a financial contract which (a) is entered into by the covered entity; (b) is governed by non-Hong Kong law; and (c) contains a termination right exercisable by a counterparty (other than an Excluded Counterparty).

An additional criterion for a covered contract in relation a Related Company is that the contract contains obligation(s) of such entity that are guaranteed or otherwise supported by an AI incorporated in Hong Kong, or an HK Holding Company, that is a member of the same group of companies as that Related Company.

Under the Stay Rules, a "financial contract" is any of the contracts listed below or any combination of these contracts:

- (a) a securities contract;
- (b) a commodities contract;
- (c) a derivatives contract;
- (d) a currency contract;
- (e) a contract of a similar nature to a contract in (a), (b), (c), or (d); or
- (f) a master or other agreement in so far as it relates to a contract in (a), (b), (c), (d), or (e),

but does not include a contract or combination of contracts for short-term inter-bank borrowing with an original maturity of 3 months or less.

***"Out of scope" financial contracts***

In the draft Code of Conduct chapter ST-1, the HKMA highlights that a covered entity may have entered into financial contracts that are not contracts subject to the Stay Rules but that nevertheless, to support resolvability, the covered entity should have a clear understanding of any risk of early termination of these "out of scope" financial contracts in resolution. This understanding is important in order for the covered entity to identify whether any "out of scope" financial contract may become a covered contract in the future (as envisaged by the Stay Rules), any significant risk of early termination in relation to such contracts in resolution, and the implications for resolvability and the application of stabilization options to an AI incorporated in Hong Kong or a HK holding company.

The HKMA asks that a covered entity should therefore be able to identify these financial contracts and assess the risk of early termination in resolution in a timely manner.

***What is a "Termination Right"?***

Under the Stay Rules, "termination right" has the same meaning as under section 86 of FIRO, which is (a) a right to terminate the contract; (b) a right to accelerate, close out, set off or net obligations, or any similar right that suspends, modifies or extinguishes an obligation of a party to the contract; or (c) a right to prevent an obligation from arising under the contract.

This ensures consistency between termination rights under the Stay Rules and the termination right that could be suspended by the HKMA under section 90(2) of FIRO.

***When do AIs have to start including contractual stay provisions?***

The Stay Rules provide for an initial implementation period for covered entities to comply with the requirement of ensuring that a suspension of termination rights provision is contained in covered contracts.

With respect to covered contracts, the counterparties to which are solely (a) an AI; or (b) a FI (which is not an AI) that is a global systemically important bank on the implementation day, the implementation period will be 24 months, and for any other covered contracts, the implementation period will be 30 months.

To facilitate implementation and provide for flexibility as needed, the Stay Rules give the HKMA powers to extend the implementation period for a covered entity to comply with, and to exempt a covered entity from complying with, the requirement to ensure that a suspension of termination rights provision is contained in one or more covered contracts if the HKMA is satisfied that it is prudent to do so.

***What are the compliance and enforcement requirements of the Stay Rules?***

The Stay Rules require a covered entity to have adequate systems of control in place to ensure compliance, including the ability to keep sufficient records to demonstrate compliance.

The Stay Rules also give the HKMA discretionary power to require a covered entity to provide a legal opinion that a suspension of termination rights provision contained in a covered contract is legally enforceable.

A covered entity also needs to notify the HKMA as soon as practicable if it has failed to comply with the Stay Rules and the HKMA is empowered to require such covered entity to propose and implement a plan to rectify the failure.

## **Stay Rules Considerations**

### ***Capital Markets***

A range of capital markets documentation is expected to fall within the ambit of the Stay Rules. When AIs enter into non-English law-governed bond documents post 27 August 2021, such as subscription agreements, underwriting agreements, placement agreements and dealer manager agreements, they will need to consider carefully if such contracts contain a termination right exercisable by a counterparty and if so, include relevant contractual stay provisions as required under the Stay Rules. For example, in a typical English-law governed subscription agreement for a syndicated trade with an agreement among managers clause in the ICMA form for Asia, such a termination right may arise if the non-defaulting managers have the ability to terminate in circumstances where a manager defaults on its underwriting obligations.

For issuers which are AIs, the range of capital markets documentation that may fall within the ambit of the Stay Rules are wider still and will need to be considered on a case by case basis.

### ***Banking and Finance***

For the Stay Rules to apply, the relevant contract must contain a termination right exercisable by a counterparty, other than an Excluded Counterparty. For banking documentation drafted based on APLMA templates, obligors do not typically have extensive rights against the finance parties. The Stay Rules should be analysed, accordingly, in light of the rights and obligations of the finance parties (unless a covered entity is an obligor) in syndicated loan agreements and intercreditor agreements, in particular.

In view of the way the term "financial contracts" is defined, it is likely that unsecured corporate lending for general corporate or working capital purposes will not fall within the Stay Rules. Structured or "specialist" type financings such as those involving acquisition of shares or bonds, or other securities, or margin financings (the term used in the Stay Rules for these is securities contracts) and commodities financing (the term used in the Stay Rules for these is commodities contracts) would appear to fall within the Stay Rules. For those transactions which appear to fall within the Stay Rules, one will need to consider further whether the rights which a counterparty has against a covered entity constitute a Termination Right (as defined). These could in the context of banking documentation where the covered entity is a finance party, capture, among other things, rights of set off, netting rights and rights against a defaulting finance party.

The definition of "finance contracts" also has a catch all category described as "master or other agreements" in so far as they relate to the other contracts specified listed in that same definition. This would mean that financing transactions or arrangements (including intercreditor agreements) relating to those other specific contracts, for example derivatives contracts or foreign exchange contracts, will also need to be analysed for Stay Rules purposes.

### ***Derivatives***

The Stay Rules will apply to "financial contracts"; these encompass a broad range of derivatives and financial markets related contracts, including:

- (a) "derivatives contracts", being financial instruments whose value is determined by reference to the price or value of an underlying asset, financial instrument, index, rate or thing of any kind. This will cover most contracts relating to derivatives transactions including, without limitation, forwards, futures, options and swaps;
- (b) "securities contracts" and "commodities contracts", which will include (i) contracts for the purchase, sale or loan of securities or commodities or a group or index of securities or commodities and (ii) repos and reverse repos relating to securities or commodities or a group or index of securities or commodities;
- (c) contracts for the purchase sale or delivery of Hong Kong currency and any other currency; and
- (d) master or other agreements relating to the above types of contract.

It is worth noting that a "financial market infrastructure" (as defined in FIRO) is an Excluded Counterparty under the Stay Rules. It therefore follows that, for example, centrally cleared derivatives transactions will generally not be subject to the Stay Rules if they are entered into with a "financial market infrastructure" (as defined in FIRO).

### **Conclusion**

With the Stay Rules becoming effective on 27 August 2021, AIs should immediately consider how to implement systematically the requirements under the Stay Rules. This might require a detailed examination of the AI's compliance systems to ensure that the requisite covered contracts are identified and the relevant contractual stay language prepared.

## CONTACTS

### Global Financial Markets – Debt Capital Markets



**Connie Heng**  
Regional Managing  
Partner, Asia Pacific  
**T** +852 2826 2457  
**E** connie.heng  
@cliffordchance.com



**Matt Fairclough**  
Partner  
**T** + 44 207006 1717  
**E** matt.fairclough  
@cliffordchance.com



**Angela Chan**  
Partner  
**T** + 852 2825 8891  
**E** angela.chan  
@cliffordchance.com



**David Tsai**  
Partner  
**T** + +852 2826 2466  
**E** david.tsai  
@cliffordchance.com



**Mark Chan**  
Partner  
**T** + 852 2826 3424  
**E** mark.chan  
@cliffordchance.com

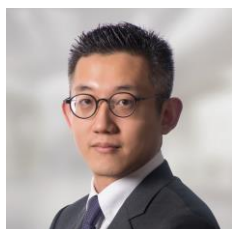


**Malini Budhwani**  
Professional Support  
Lawyer (PSL)  
**T** + 852 2826 2483  
**E** malini.budhwani  
@cliffordchance.com

### Global Financial Markets – Loans, Derivatives and Structured Finance



**Francis Edwards**  
Partner  
**T** + 852 2826 3453  
**E** francis.edwards  
@cliffordchance.com



**Terry Yang**  
Partner  
**T** + 852 2825 8863  
**E** terry.yang  
@cliffordchance.com



**Dauwood Malik**  
Managing Partner,  
Hong Kong  
**T** +852 2826 3485  
**E** dauwood.malik  
@cliffordchance.com



**Maggie Lo**  
Partner

**T** + 852 2826 3568  
**E** maggie.lo  
@cliffordchance.com



**Vicky Ma**  
Partner

**T** + 852 2825 8995  
**E** vicky.ma  
@cliffordchance.com

**Global Financial Markets – Funds & Investment Management/ Financial Services Regulatory**



**Mark Shipman**  
Partner

**T** + 852 2825 8992  
**E** mark.shipman  
@cliffordchance.com



**Rocky Mui**  
Partner

**T** + 852 2826 3481  
**E** rocky.mui  
@cliffordchance.com

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One Connaught Place, Hong Kong

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