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Regulation of bankers' pay: balancing risk and reward

Has the storm over regulation of bankers' pay abated, or are we just in the eye of the storm? Pádraig Walsh offers a view.

Not so long ago, risk weighted remuneration for bankers seemed remote theory. Then, this thorny issue became politicised. By the end of 2010, a new era will have dawned and remuneration will be at the heart of regulatory reviews and assessments. The time for debate is almost over. Regulators are issuing consultation papers and proposals to put meat on the bones of outline objectives put forward by the G20. The question now is - will the new world be all that is hoped for?

In each of the key financial centres in the world, regulators have published detailed draft proposals to bring pay and remuneration in the financial services sector under their remit and review. In England, the final recommendations of the Walker report contain controversial proposals that will form the basis of draft rules to be proposed by the Financial Services Authority next year. If implemented in their current form, it would

put the City as the leader in the charge to bring remuneration under stricter control. Timing is key. The FSA will bring its proposals forward in the second quarter of 2010, just as electioneering heats up for the next general election. If polls are to be believed, and there is a change of government to be led by the Conservatives, then the FSA may not be the regulator for the banking sector under the next regime. Nonetheless, given the hot potato that is bankers' pay, there is every chance that this complex and contentious issue will become embroiled in political manoeuvring, and this may make a workable solution less likely.

The Hong Kong Monetary Authority has also published its draft Policy. Though more moderate than the Walker report, the proposals will nonetheless require a new regulatory and compliance structure for

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Regulation of bankers' pay: balancing risk and reward continued

banks to meet the proposed requirements. In Hong Kong, the regulatory approach is very much "wait and see". The recent recession did not cut as deep in Hong Kong as elsewhere. The remit of the Walker review was to review corporate governance in UK banks in the light of the experience of critical loss and failure throughout the banking system. In Hong Kong, no Hong Kong banks went under. Apart from regulatory issues arising from the retail distribution and sale of Lehman Brothers-backed "mini-bonds", no serious regulatory scandal has hit the headlines. Consequently,

the objectives of Hong Kong regulators are to adopt sensible improvements, and to keep pace with international norms to avoid unwanted regulatory arbitrage. Hong Kong, then, is following international trends rather than leading them. Even still, there are voices that express the view that no action is needed. If it ain't broke, don't fix it, being the core value of a laissez faire system.

So what, then, can we expect the new regime to hold? The table below gives a sense of the direction in which regulators are heading.

	Walker Report	HKMA Guidelines
Disclosure - amount	Mandatory disclosure required of the number of earners over GBP1m within various bands of income from that level up, but no disclosure of names.	Similar principles, but not mandatory and no prescriptive threshold from which disclosure must be made.
Disclosure - business line	Mandatory disclosure required of business line in which the high end earner works.	Similar principles, but not mandatory.
Disclosure - fixed and variable	Mandatory disclosure required of breakdown of allocation between salary, pension and variable remuneration.	Similar principles, but not mandatory.
Long-term remuneration	Half of total remuneration must be paid under a long-term incentive scheme. At least half of minimum of long-term remuneration must vest after five years, and the remainder in three to five years.	Similar principles, but not prescriptive. Proportion of variable income to increase according to seniority and risk sensitivity.
Short-term remuneration	Short-term must be paid over three years, with no more than one-third in year one.	No provisions.
Share incentives	Encouraged, but to vest in line with risk horizons applicable to total compensation.	Same.
Clawbacks	Encouraged.	Same.
Termination payments	Discouraged.	Same.
Enhanced benefits	Discouraged, and subject to disclosure.	No provisions, though guaranteed minimum bonuses are discouraged.

Regardless of the precise shape of the regulatory review of remuneration in the banking sector, the underlying thrust and purpose of these changes are aligned. Remuneration has moved from a

management decision focused solely on attracting and incentivising talent. Now, remuneration decisions must be made within a properly constituted Remuneration Committee and must include a risk based

assessment as a fundamental tenet of its decision-making process. This approach is intended to avoid the risks inherent in a remuneration system which creates incentives towards inappropriate and excessive risk-taking, and recognises that, absent a risk-based assessment, a poorly conceived remuneration policy could threaten the safety and soundness of that bank and potentially the stability of the banking system itself.

In Hong Kong, although the HKMA has not proposed prescriptive changes, it is clear that it will use its regulatory reviews with banks to coax and cajole them into compliance, and if that does not work, will direct change. Banks are required to undertake an immediate review of their remuneration structures, and to report to the HKMA in their normal self-assessment processes. If a bank fails to carry out necessary measures to strengthen remuneration systems, the HKMA may require that additional capital be allocated to cover risks that it believes have not been addressed, or may impose quantitative limits on remuneration. Ultimately, of course, failure to comply with HKMA directions can result in the usual range of regulatory sanction, including loss of its banking licence.

These proposals are an example of regulators learning the lessons of the past to shape change. There is no doubt that banks were undertaking a review of their remuneration policies, and that some of the proposed changes would have occurred in any event. Many banks have already taken steps to introduce longer time horizons for vesting of remuneration awards. However, in such a competitive sector, the temptation remains for rising banks to acquire key talent in the short term using guaranteed minimum bonuses and other short-term incentives. With regulatory oversight, the prospect of a level playing field appears realistic.

What trends can we expect to see in the coming year?

- Banks are expected to be compliant within 2010. This means that restructuring of remuneration arrangements must be undertaken. Banks know that they have regulatory backing. Affected employees know they

have an existing contract. The scope for dispute, and litigation, is significant. Let the negotiations begin.

- We expect to see an increase in base fixed pay levels. This may seem counter-intuitive. However, key talent know that their package is being changed from the prior industry norm so that expected earnings in year one will now arrive in year three or later (even if they leave) and that vesting will be conditional on performance. High end earners will seek more upfront in fixed salary. The tension with meeting the regulatory requirement that a substantial part of total remuneration must comprise variable or deferred remuneration may result paradoxically in an increase in total remuneration.
- The trends on remuneration in the banking sector will expand into other parts of the financial services sector. The Walker Report is targeted primarily at large UK banks that are listed, and some recommendations were made in light of an ongoing review by the Financial Reporting Council of the Combined Code on Corporate Governance for listed companies in the UK. Also, the FSA rules can be expected to apply to banks and other financial institutions. In Hong Kong, we might see similar proposals being brought forward.

Presently, the proposals for change are in the form of draft Guidelines in Hong Kong. The HKMA has indicated that it will issue more specific provisions in the form of a supervisor policy module. This was due by the end of last year, but has not yet been published. This may indicate that the HKMA has received feedback from the industry that it is considering. There is no doubt that this is a sensitive issue. On the one hand, it is politically charged. The disconnect between Wall Street and Main Street reduced from a canyon to a valley in the recent recession, but there is a sense that the chasm is widening again. Governments will want to be seen to be sensitive and responsive to public concerns. Conversely, remuneration traditionally has been the bulwark of the free market. Nonetheless, change is on the horizon, and there is no doubt that change is going to come. ■



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Shanghai directives on the application of the Labour Contract Law

Shanghai has taken the lead on addressing some points of uncertainty on the Labour Contract Law in China. This article considers the key points.

The implementation of the Labour Contract Law was of particular interest to many foreign companies active in China. Shanghai, as its most international city, has seen more labour contract disputes than many other cities since the law came into force.

The Shanghai High People's Court issued Directives on the application of the Labour Contract Law in July 2009 which will apply to the trial of labour contract disputes before the courts in Shanghai. This is extremely important for companies in Shanghai, but is also of interest generally to all businesses in China, as many other locations may take their lead from these Directives.

The Directives recognise that it is most common that the contract will be amended during the course of performance. It provides that the labour contract can be amended during the period of the contract and any form of writing can evidence those amendments. For instance, documentation such as pay slips can be sufficient for the purpose of amending the contract.

It was once believed that the employer is obliged to sign an open-term contract with the employee after two fixed-term contracts under the provision in the Labour Contract Law which provides that if the employee has already completed two fixed-term contracts, the employee has a right to sign an open-term contract. The Directives make it clear that after two fixed-term contracts, the employer is not obliged to automatically conclude an open-term unless the employee requests so.

The Directives restate that the employer is only liable for compensation if he terminates the contract in violation of law or in breach of contract. In the event that the employer does not give a 30-day notice for termination of the contract, the employer is only liable for one month's salary but not liable for any other compensation, provided that the

grounds for the termination are valid subject to the law and the contract.

The courts will give force to such clauses as much as they possibly can. Where the contract contains a non-compete clause but does not set out provisions on compensation to the employee, parties can negotiate to reach an agreement on the standards of compensation. If a consensus cannot be reached, the employer must give 20 - 50 per cent of the employee's previous standard income as compensation and the non-compete period must not be longer than two years.

The status of representative offices of foreign companies in employment disputes poses a tricky issue in China. The Directives clarify that representative offices which are properly registered in Shanghai and have employed Chinese nationals through agents such as FESCO, can be sued directly by the employee before the labour dispute tribunal. By contrast, if the representative office employs Chinese nationals directly instead of using agents, any disputes (such as payment of remuneration) will not be regarded as labour disputes. The employee can sue the representative office before the courts as civil disputes.

The above are the main points of interest in the Directives. The Directives were issued by the Shanghai High People's Court. They will therefore only be binding on the courts in Shanghai. The Labour Contract Law and the Supreme People's Court implementing rules remain the primary and prevailing sources of law in this area. ■



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Restrictive covenants, privilege, and restricting former employees

"In the absence of an enforceable covenant... the courts do not interfere with the new activities of former employees."

The Court of Final Appeal has considered the applicability of the conflict of interest principle commonly applied in the context of the solicitor-client relationship for restraining the activities of a former employee in the case of **PCCW-HKT Telephone Limited and PCCW Services Limited v David Matthew McDonald Aitken and Hong Kong CSL Limited (FACV 27/2008)**.

Mr Aitken started working for PCCW as the General Manager of Regulatory Compliance. Soon after he joined, the Telecommunications Authority proposed to abandon the policy of requiring mobile network operators (MNOs) to pay fixed network operators (FNOs) fixed-mobile interconnection charges (FMIC) regardless of where such calls originate. Mr Aitken was privy to documents and meetings revealing PCCW's proposed strategy on the issue. Later, Mr Aitken gave the required three months' notice to terminate his employment before rejoining CSL, one of the largest MNOs in Hong Kong. A post-termination restriction restraining Mr Aitken from working for any of PCCW's competitors for a period of three months was waived by PCCW.

Mr Aitken joined CSL as the Head of Regulatory and Corporate Affairs and took part in the work relating to the FMIC issue. Clearly, CSL as a MNO and PCCW as a FNO had directly competing business interests in this issue. PCCW therefore sought a court order preventing Mr Aitken from working in relation to FMIC matters. PCCW argued that, by acquiring legally privileged information on a matter, an employee should be restrained from working on the same matter for the opposite side, just as a solicitor is refrained from accepting instructions from one side where he has obtained confidential information from the opposite side.

The Court of Final Appeal reaffirmed the lower courts' decision and no restrictive order was granted. Three key issues affected their decision:

- 1) Mr Aitken did not act as an in-house lawyer in respect of the FMIC issue whilst at PCCW, so no issue of privilege arose.
- 2) In any event, since Mr Aitken consented to a non-disclosure order, issues concerning disclosure of privileged information did not arise.
- 3) Although Mr Aitken was privy to confidential information, the rule that prevents solicitors moving to another firm and working on the opposite side of the same matter did not apply to normal employment situations. The public interest in protecting the free movement of employees was overridden in the special case of solicitors moving between firms because a solicitor is expected to have a number of clients and does not have to act for a particular client where he has previously acted on the other side. The employee, however, only has one client: his employer.

The law is therefore clear that, in the absence of an enforceable covenant restraining an employee's employment with a competitor, the courts do not interfere with the new activities of former employees. ■



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UK defined benefit pension schemes: reducing the PPF levy

We explore a recent change in approach by the PPF where guarantees to reduce the levy can now be given by Hong Kong domiciled companies.

In 2005, the UK introduced the Pension Protection Fund (PPF) which is funded by a levy on pension schemes. The PPF provides compensation for members of defined benefit occupational pension schemes where the employer sponsoring the scheme has become insolvent and the scheme is underfunded.

The PPF levy on defined benefit pension schemes is split into two parts:

- 20 per cent of the levy is based simply on the size of the liabilities in the scheme
- 80 per cent is risk based, which takes into account the level of underfunding in the scheme and the probability of the sponsoring employer becoming insolvent.

Since the introduction of the levy, it has been possible to reduce its effect by providing "contingent assets" to the trustees of the scheme. These are assets which would only become available to the scheme in the event of insolvency. One type of contingent asset is a guarantee from another group company, and Hong Kong domiciled companies can now guarantee the pension obligations of a UK subsidiary and reduce the PPF levy.

The effect of a guarantee will vary according to how much of the pension liabilities are guaranteed, but broadly it is to substitute the guarantor's probability of insolvency for that of the sponsoring employer (assuming that it is better). This would reduce the risk based levy. The probability of insolvency is determined by Dunn & Bradstreet.

The guarantor can decide how much of the pension liabilities it wants to guarantee. The main choices are:

- (a) a fixed amount
- (b) an amount bringing the scheme funding up to a specified percentage
- (c) the full "section 75 debt". This is the amount required to be put into the

scheme if the scheme was to buy out all the pension benefits in the scheme with annuities from an insurance company.

A guarantor can also limit the guarantee to the lower of a fixed amount and the amounts in (b) and (c).

The guarantee could be called upon if the sponsoring employer misses a payment or has an insolvency event. An insolvency event would trigger payment of the "section 75 debt" by the sponsoring employer.

The guarantee should be in the form on the PPF's website (www.pensionprotectionfund.org.uk). Changes from the standard form are possible, but they cannot have a materially detrimental effect on the rights of the trustees of the scheme (who are the beneficiaries of the guarantee).

A copy of the guarantee has to be submitted to the PPF in hard copy. A certificate must be given using the Pensions Regulator's online system. The certificate confirms a number of points, including a confirmation that the agreement is legally valid and enforceable against the guarantor and that this is supported by a legal opinion. For a Hong Kong company giving the guarantee, this means that English law and Hong Kong law opinions would be required.

The levy is calculated on an annual basis. The deadline for entering into the guarantee and providing the certificate is **5.00pm on 31 March 2010**. If this is not met then the guarantee will not be taken into account for the levy year 2010/2011. ■



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Risks in managing collective redundancies: cutting to the bone

Do you know how to avoid employee claims when implementing a redundancy programme in Hong Kong? Pádraig Walsh gives some practical tips.

We all know the recession is not over, until it's over. The decision of who to select for redundancy, and how to implement that decision, is fraught with difficulty and risk, both legal and operational. Here are the 10 tips to help see you through the process.

1. Know what redundancy means

Under Hong Kong law, redundancy arises when an employment termination is caused because the business for which the employee was employed ceases entirely or diminishes, in general or in the specific location where the employee worked.

2. Know the basis of an employee claim

Once employees have served two years of continuous employment with the employer, there is a presumption that the termination of his employment is unreasonable, unless an employer can prove that the reason for the termination comes within prescribed exceptions. Redundancy is one of those prescribed exceptions.

3. Adopt fair selection procedures

An employer must ensure that he does not breach the requirements of discrimination laws in Hong Kong. Presently, the discrimination laws cover discrimination on the basis of gender, family status, disability and race. The employer will need to be in a position to demonstrate that employees were selected on proper and consistent grounds. Examples will include length of service, and prior job performance.

4. Know the contractual base line

Each employee selected for redundancy will have specific rights on employment termination provided in their employment contracts. The employer will need to check period of notice, contractual benefits, accrued annual leave entitlements and other possible termination payments. If an employee's remuneration is commission based or includes non-discretionary variable income, then special calculations will be required for contractual payments on

employment termination.

5. Know the statutory base line

An employee who has served two years of continuous employment with the employer will be entitled to receive a statutory severance payment from the employer that is calculated according to his period of service.

6. Map out the process

The redundancy process will involve informing the selected employees, handling the notice period, managing the employee departures, making the termination payments, and managing the reallocation of the remaining employees. Map out this entire time sequence into a project plan with critical milestones to completion of the process.

7. Document the process

Set out clearly in writing the contractual and statutory entitlements of each employee, and the continuing obligations of employees. Provide this to the employee during the meeting when he is informed of his employment termination. Keep a written record of employee meetings when giving the termination notice and handle employee queries after the initial meeting in writing. When providing an employee with his termination payment, obtain an acknowledgement of receipt and, if possible, a waiver and release of claims.

8. Give a clear and consistent message

It is very easy, and all too human, to respond to emotion with emotion. However, complications could arise both operationally and legally if employees who will be made redundant (and employees who remain) are

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given unclear or inconsistent messages. It may call into doubt that fair selection procedures were used, or give concern that different termination payment packages were made for different employees.

9. Prepare for the worst

It is well known that the imminence of an employee departure increases the risk of employee misconduct or data theft. Consider introducing a reasonable protocol to govern employee behaviour during a notice period - but be careful, as too strict a protocol could give rise to a claim for constructive dismissal. If budget permits, consider paying out the notice period. This reduces the risk of employee theft and maintains stability among the remaining employees.

10. Pay on time

Ensure that all payments due to be made on termination are paid promptly. The statutory requirement is that payment be made as soon as practicable but no later than seven days from the termination date. Best practice is to pay on the last working day.

If there is an 11th tip, it is to be compassionate. Lay-offs and job losses are traumatic experiences for employees. Often those who have been selected will find difficulty in securing alternative employment,

and their main source of income will be lost. There is a loss of dignity and self respect that goes with job loss. Many employers respond to these issues by providing post-termination support in locating alternative employment. It may be possible to mitigate some of the human impact by considering alternatives, such as an option for the employee to leave on voluntary terms. There is no legal requirement in Hong Kong to offer voluntary redundancy, or to engage in a consultation exercise, but it may help to keep harmony in the remaining workforce if these options were explored.

Redundancy is a necessary business decision. A business operates to make profit, and people - human resources - are one of the elements of that process. Every business must consider its method of operation carefully. A failure to make a tough decision now could result in the business itself closing entirely. However, a poorly managed redundancy programme can lead to the same result. A significant risk of employee claims arises in redundancy situations and, in addition, a poorly managed redundancy process can be a bitter pill to swallow for departing and remaining employees. So, if it is necessary to cut to the bone, make note to stem the flow to the beating heart. ■

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