Corporate Governance Review
By
The Standing Committee on
Company Law Reform

A Consultation Paper
on Proposals made
in Phase II of the Review

June 2003

CONTENTS

Chapter 4 SHAREHOLDERS

Membership of the Standing Committee on Company Law Reform

The Standing Committee on Company Law Reform was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance and other related ordinances.

The members of the Committee for the period from February 2002 to April 2003 were :-

Chairman	:	The Hon Mr Justice Rogers, V-P, JP	
Members	:	Mr Roger T Best, JP	
		Mr Henry Fan Hung-ling, SBS, JP	
		Ms Betty Ho May-foon	(up to 31.7.2002)
		Mrs Angelina Lee Wong Pui-ling, JP	(up to 31.1.2003)
		Mr Ian Perkin	(up to 31.10.2002)
		Mr Winston Poon Chung-fai, SC	
		Mr Alvin Wong Tak-wai	
		Mr Randolph G Sullivan	
		Mr Peter Wong Shiu-hoi	
		Mr Richard Thornhill	
		Mr Michael W Scales	
		Mr William Tam Sai-ming	
		Professor Stephen CHEUNG Yan-leung	(from 1.2.2003)
		Mr John POON Cho-ming	(from 1.2.2003)
		Mr David P R Stannard	(from 1.2.2003)
Ex-Officio Members	:	Mr Ashley Alder Executive Director (Corporate Finance) The Securities & Futures Commission	
		Mr Lawrence Fok, Chief Executive The Stock Exchange of Hong Kong Limited	(up to 31.12.2002)
		Miss Karen Lee Head of Listing Regulation & Risk Management The Stock Exchange of Hong Kong Limited	(from 1.1.2003)
		Mr Charles Barr Department of Justice	

Mr E T O'Connell
The Official Receiver

Mr Gordon W E Jones, JP
The Registrar of Companies

Mr David T R Carse, SBS, JP
Deputy Chief Executive
The Hong Kong Monetary Authority

Miss Susie HO Shuk-yee, JP
Deputy Secretary for Financial Services and the Treasury

Secretary	:	Mr J S Bush	(up to 30.1.2003)
		Mr Edward Lau	(from 31.1.2003)

Corporate Governance Review
Directors Sub-Committee

Terms of Reference

1. In the light of -

- the predominance of controlling shareholder groups and the rights and interests of controlling shareholders;
- the lack of shareholder activism as a natural force for improving corporate governance;
- the domiciling of a significant proportion of listed companies outside Hong Kong,

to review the current statute law, administrative rules and regulations and codes of practice relevant to the directors and boards of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby further improving corporate governance standards.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

(a) The structure of the board including the establishment, where appropriate, of audit, executive, nomination and remuneration committees;

(b) The roles and functions of the Chairman and Chief Executive Officers;

(c) The roles and functions of the executive directors;

(d) The roles and functions of the non-executive directors;

(e) The composition of the board with particular reference to achieving an appropriate balance between executive and non-executive directors;

(f) The appropriate procedures for the appointment, re-election and resignation of directors, including the establishment of a nomination committee (where appropriate);

(g) The appropriate procedures for undertaking the business of the board;

(h) The development of a statutory statement of principles on directors' duties;

(i) The development of coherent proposals on how to deal with directors' conflicts of interest including –

- the question of self-dealing; and
- the establishment of a register of directors' interests

(j) The development of appropriate training programmes and qualifications for directors;

(k) The development of appropriate principles and procedures regarding setting and approval of the levels and composition of directors' remuneration, including contracts and compensation, the establishment of a remuneration committee (where appropriate), disclosure and shareholder involvement;

(l) The roles and functions of Audit Committees;

(m) The necessary regulatory framework and best practice to ensure that directors and boards are encouraged to comply with their statutory and non-statutory obligations.

3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.

4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

Corporate Governance Review
Shareholders Sub-Committee

Terms of Reference

1. In the light of -

- the predominance of controlling shareholder groups and the rights and interests of controlling shareholders;
- the existence of corporate groups;
- the lack of shareholder activism as a natural force for improving corporate governance;
- the domiciling of a significant proportion of listed companies outside Hong Kong,

to review the current statute law, administrative rules and regulations and codes of practice relevant to the shareholders of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby further improving shareholder democracy and communications.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

(a) The definition, timing, notice, agenda (including resolutions) of, and conduct and voting (including the rights of proxies) at, company general meetings, having regard to the use of audio-visual communication and electronic voting;

(b) The possible development of institutional investors as a force for promoting shareholder democracy and good corporate governance;

(c) The development of a proxy system, having regard to the rights of persons other than registered shareholders, particularly given the need to ensure genuine shareholder democracy in the context of the Central Clearing and Settlement System (CCASS);

(d) Restraints on controlling shareholders' voting having regard to the following considerations -

- transactions in which controlling shareholders have an interest different from that of other shareholders should be subject to approval by shareholders, with the controlling shareholder abstaining from voting;

- adequate exceptions should be made available to accommodate immaterial transactions and bona fide transactions in the ordinary course of business on arm's length terms;

- compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law;

- private companies may include exemptions in their articles;

(e) Improved accessibility to corporate records by shareholders;

(f) The variation of class rights;

(g) The suitability of judicial control, multiplicity of provisions and class votes;

(h) The circumstances in which it would be appropriate for minority shareholders to take action against the company or its directors and officers;

(i) The types of action which can be taken by minority shareholders against the company or its directors and officers.

3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.

4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

Corporate Governance Review
Corporate Reporting Sub-Committee

Terms of Reference

1. In the light of the role of disclosure as one of the key elements in corporate governance to review -

- the existing level and nature of information, both financial and non-financial, which all companies incorporated or registered in Hong Kong need to disclose to their shareholders; and
- the existing processes by which this information is prepared, vetted and approved.

with the objective of enhancing the standard of corporate disclosure, transparency and accountability.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

(a) Reforming and strengthening the statutory disclosure requirements in Part IV of and the Tenth and Eleventh Schedules to the Companies Ordinance, taking account of –

- Possible further modification and extension of the simplified disclosure requirements in Part IV of and the Eleventh Schedule to the Companies Ordinance;
- The possibility of mandatory publication and filing of financial statements by private companies.

(b) Reforming and strengthening the non-statutory disclosure requirements in respect of listed companies promulgated in the Listing Rules issued by the Stock Exchange of Hong Kong;

(c) Improving compliance with the accounting standards as promulgated by the Hong Kong Society of Accountants, with particular reference to sanctions;

(d) The use of information technology to report and distribute, among other things, the annual reports and accounts of companies to enhance timeliness of provision of corporate information;

(e) Strengthening the internal controls in companies with particular reference to internal audit functions;

(f) The roles and functions of Audit Committees;

(g) The responsibilities, liabilities and independence of external auditors;

(h) The necessary regulatory framework to ensure efficient and effective monitoring of compliance with reporting requirements.

3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.

4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

SUMMARY OF PROPOSALS

1. Chapter 1 - Introduction

1.1 Chapter 1 is a brief introduction containing a progress report on the proposals made in Phase I of the SCCLR's Corporate Governance Review, and outlining the procedures for submitting comments in the context of the present consultation exercise.

2. Chapter 2 – Consultancy Studies

2.1 Chapter 2 is a summary of the findings of the four consultancy studies commissioned by the Government under the Corporate Governance Review on :-

- A comparative survey and analysis of the development of corporate governance standards in other jurisdictions.
- A survey of the attitudes of international institutional investors towards corporate governance standards in Hong Kong.
- The roles and functions of audit, nomination and remuneration committees.
- An economic analysis correlating the performance of listed companies with their shareholders' profile.

2.2 These studies have provided useful input to the SCCLR in formulating the proposals in this Consultation Paper. The four studies will be separately published. However, the views expressed in the studies should not be taken as representing the views of the SCCLR.

3. Chapter 3 – Directors

3.1 *Section 7 - Directors' Duties*

3.1.1 The SCCLR recommends the adoption of non-statutory guidelines stating the following principles of law in relation to directors' duties in Hong Kong : -

Principle 1 : Duty to observe the company's memorandum and articles of association and resolutions
Principle 2 : Duty to act in good faith for the benefit of the company as a whole
Principle 3 : Duty to use powers for a proper purpose for the benefit of members as a whole
Principle 4 : Duty not to delegate powers except with proper authorization and duty to exercise independent judgment
Principle 5 : Duty to exercise care, skill and diligence
Principle 6 : Duty to avoid conflicts between personal interests and interests of the company.

Principle 7 :	Duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law.
Principle 8 :	Duty not to gain personal profit from use of position as a director
Principle 9 :	Duty not to make personal use of company's property or information
Principle 10 :	Duty not to accept personal benefit from third parties conferred because of position as a director
Principle 11 :	Liabilities for fraudulent trading

3.2 *Section 8 - Voting by Directors in relation to Directors' self-dealing*

[*There is a fair amount of overlapping between sections 8, 9 and 17 as they deal with different aspects of conflicts of interest on the part of those who have influence over the conduct of companies. Consequently, the proposals in this section should be read together with those in the other two sections.]*

3.2.1 The SCCLR reconfirms its previous proposals to improve the general legal position on self-dealing by directors as follows :-

- The Companies Ordinance should set out the general prohibition against directors voting on transactions in which they are interested in accordance with paragraph 13.3 of Part C of the HKEx's Consultation Paper.

- The Companies Ordinance should set out the exceptions to the general voting prohibition as currently provided in Note 1 of Appendix 3 to the Listing Rules, and the additional exception proposed in paragraph 13.3 of Part C of HKEx's Consultation Paper on immaterial interest, i.e. one that does not give rise to an actual conflict.

- The Companies Ordinance should be amended in accordance with the current Listing Rules (Rules 14.24 and 14.25 of the Main Board Rules and Rules 20.23 and 20.24 of the GEM Rules) so that contracts, transactions and arrangements in which directors (or connected persons) have an interest should be disclosed to shareholders and be subject to their approval if the value or consideration thereof is equal to or exceeds certain de minimis thresholds. The SCCLR seeks the views of the public on the level of the de minimis thresholds.

- The Companies Ordinance should be amended to set out the civil consequences of a breach of the general rule : (i) the transaction or arrangement will be voidable at the instance of the company or any shareholder subject to rights of bona fide third parties for value, the impossibility of restitution and ratification (where permissible) within a reasonable time by disinterested shareholders; and (ii) without prejudice to any other liability that may be imposed by law, the director or connected person will be liable to account to the company for any gain, or to indemnify the company for any damage resulting from the contract, transaction or arrangement.

- The ambit of section 162 of the Companies Ordinance should be widened to cover "transactions", "arrangements and "connected persons".

- The proposals under this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

3.3 *Section 9 - Shareholders' approval for connected transactions of significance involving Directors*

3.3.1 The SCCLR reconfirms its previous proposals on shareholders' approval for significant transactions involving directors as follows :-

- The Companies Ordinance should be amended based on Section 320 of the United Kingdom Companies Act 1985 to provide that connected transactions should be subject to disclosure and shareholders' approval if the total consideration or value is greater than or equal to certain de minimis thresholds. The SCCLR seeks the views of the public on these de minimis thresholds.

- "Connected persons" should include the following :-

  (a) director's or controlling shareholders' children or step-children;
  (b) spouse;
  (c) trustee of any trusts in which the director or controlling shareholder, his spouse, children or step children are beneficiaries under the trust;
  (d) any corporation associated with the director or controlling shareholder. The question of what should be regarded as a corporation associated with the director or controlling shareholder and what should be regarded as a controlling shareholder are discussed further in paragraphs 10.01 to 10.20 and paragraph 17.09 (below).

- The Companies Ordinance should be amended in accordance with the current Listing Rules (Rule 14.26 of the Main Board Rules and Rule 20.42 of the GEM Rules) to make it a requirement that any connected person (including connected persons in relation to controlling shareholders) having an interest in a transaction shall abstain from voting at the general meeting whereby the transaction is considered for the purpose of approving it.

- Where several companies are interposed between the subsidiary and the ultimate listed holding company, the provision should be applied so that only the approval of the shareholders of the ultimate holding company is necessary, unless the subsidiary itself is a listed company, in which case, the approval of the shareholders of the subsidiary should also be required.

- The law should be amended to set out the consequences of a breach of the general rule :-

  - The transaction or arrangement should be voidable at the instance of the company or any shareholder subject to rights of bona fide third parties for value, the impossibility of restitution or ratification (where permissible) within a reasonable time by disinterested shareholders;

  - The director or connected person should be liable to account to the company for any profits and to indemnify the company against any loss or damage resulting from the breach of the provision;

  - The liability of the director or connected person must be without prejudice to any other liability that may be imposed by law.

  - Criminal penalties may be imposed on officers involved in the breach of this provision if the company is wound up within one year after the transaction.

- The proposals under this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

3.4 *Section 10 - Transactions between Directors or Connected Parties with an Associated Company*

3.4.1 The test of control through the right to exercise dominant influence will become part of the legislation when the definition of "subsidiary" is changed in the context of the Companies (Amendment) Bill 2003 which will be introduced into the Legislative Council shortly. Consequently, the SCCLR is inclined, in relation to the definition of "associated company", to adopt the test of control through the exercise of dominant influence to determine whether the company is associated with another company for the purposes of connected party transactions. It wishes, however, to seek the views of the public on such a concept and whether it should be introduced into either the Companies Ordinance or the Listing Rules to help define the scope of the disclosure and shareholders' approval requirements for connected party transactions.

3.4.2 Subject to the public's view on whether the test of control through the exercise of dominant influence should be adopted, the SCCLR reconfirms the following proposals :-

- The Listing Rules relating to connected party transactions should be extended to an "associated company". The issue of whether an "associated company" for these purposes should be defined by using the "dominant influence" concept under section 258 of the United Kingdom Companies Act 1985 is a matter on which the SCCLR wishes to consult further.

- The Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors or connected persons and an associated company.

- The proposed provision under the Companies Ordinance should be widened to cover arrangements between the associated company and directors or connected persons.

- The proposals under this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

3.5 *Section 11 - The Roles and Functions of the Chairman and Chief Executive Officer*

3.5.1 The SCCLR does not recommend mandatory separation of the roles and functions of the Chairman and Chief Executive Officer. However, the SCCLR considers that it should be considered best practice to separate these functions with appropriate amendments being made to the Listing Rules and Code of Best Practice.

3.6 *Section 12 - Board Procedures*

3.6.1 The SCCLR proposes that the following provisions should be included in the Code of Best Practice :-

- Full board meetings should be held no less frequently than every three months. The board should disclose in its annual report the number of board meetings held in a year and the details of attendance of each individual director.

- The agenda and board papers for consideration at the board meeting should be sent to all directors in a timely manner and at least three days before the meeting.

- There should be broader guidelines on what type of materials should be supplied to directors and how they may access this information :-

  - The management should have an obligation to supply the board with full and adequate information in a timely manner. The board should have separate and independent access to the company's senior management for such information.

  - The information provided should include relevant background or explanatory information, copies of all disclosure documents, budgets, variance between projections and actual results, forecasts and monthly internal financial statements.

- There should be a formalised procedure for individual directors to obtain professional advice required to perform their duties at the expense of the company.

- The company secretary should work closely with the chairman in advising directors of their duties and responsibilities under applicable rules and regulations; how these duties and responsibilities should be discharged; and to ensure that board procedures are followed. All directors should also have access to such advice and services of the company secretary.

- There should be a formal schedule of matters for the board's decision and the procedures to be followed when decisions must be made between board meetings.

- There should be guidelines on the relationship between the company's board of directors and the company's management.

- The chairman of the board should be primarily responsible for setting the agenda of the board meeting even though the work of drawing up the agenda may be delegated to the company secretary.

- Where the board appoints a committee, the authority, the terms of reference and the committee's duty to report back to the board on its action should be spelled out.

3.6.2 The required qualifications for the company secretary should be determined by HKEx after taking the market situation into account.

3.7 *Section 13 - Audit, Nomination and Remuneration Committees*

3.7.1 Whilst noting that there are practical difficulties in establishing truly effective board committees, the SCCLR agrees that their establishment is now a recognized benchmark of the standard of corporate governance. In view of this, the SCCLR makes the following proposals :-

- The Listing Rules should be amended to make it mandatory that all listed companies should establish an audit committee.

- The Code of Best Practice should be amended to make the establishment of nomination and remuneration committees in listed companies a recommended best practice.

- At least one independent non-executive director (INED) on a listed company's audit committee should have some "financial expertise". A retired partner of the firm auditing the company's accounts should be prohibited absolutely from being the chairman or member of an audit committee.

3.8 *Section 14 - The Structure of the Board and the Role of Non-executive Directors*

3.8.1 The SCCLR recognizes the important role played by non-executive directors (NEDs) as "outsiders" in company boards and recommends that :-

- The boards of listed companies should have a minimum of three INEDs and the long term objective should be for one-third of the board to comprise INEDs.

- Where nomination committees exist, they should take a more systematic approach to identifying suitable NEDs.

- Sources of NEDs should be broadened to bring in directors with a wider range of abilities, skills and experience.

- The Code of Best Practice should provide that the adequacy of NED's remuneration should be reviewed and the system for deciding their remuneration should be disclosed in their companies' annual reports. The disclosure of all directors' remuneration is considered in section 16.

- The Code of Best Practice should provide that the directors of listed companies should disclose the number of other directorships which they hold, other than in wholly-owned subsidiaries, in their companies' annual reports.

- The Code of Best Practice should outline the role, functions and standards expected of NEDs.

3.8.2 However, the SCCLR considers that there should be no statutory distinction between executive directors and NEDs, and that the "monitoring" role of NEDs should not be achieved through either a two-tier board or having INEDs elected by minority shareholders.

3.9 *Section 15 - Directors' Qualifications and Training*

3.9.1 The SCCLR recommends that the Code of Best Practice should contain a requirement that a listed company has to disclose the arrangements made to train its directors, and in particular new NEDs, on both an initial and continuous basis, with particular reference to knowledge of company law, the Listing Rules and the Code of Best Practice. Listed companies should also be required to disclose in their annual reports their compliance, or reasons for non-compliance, with this requirement. However, the SCCLR does not recommend mandating directors' training and qualifications.

3.10 *Section 16 - Directors' Remuneration*

3.10.1 The SCCLR notes the increasing public concern about the remuneration of directors of listed companies and makes the following proposals :-

- The Companies Ordinance and Listing Rules should be amended to require listed companies to disclose individual director's remuneration packages by name in their annual financial statements including full details of all elements included such as basic salary, fees, housing and other allowances, benefits in kind, pension contributions, bonuses, compensation for loss of office and long term incentive schemes including share options.

- The Companies Ordinance should be amended to require an unlisted public company or a private company, if directed to do so by holders of not less than 5% of the nominal issued share capital of the company, to disclose full details of all elements of individual director's remuneration package by name in the company's annual financial statement.

- The Listing Rules should be amended to require disclosure, in both the annual financial statements and by way of a separate statement in the annual report, of the values of share options granted and values realized by each director of a listed company, when such options are exercised, calculated according to International Accounting Standards.

- The views of the public are sought on whether the disclosures in the first and third bullet points should also apply to the directors of unlisted public companies if they are required to disclose their remuneration packages under the proposal in the second bullet point.

3.10.2 However, the SCCLR was unable to reach a consensus on the need to make specific disclosures on key aspects of a company's remuneration policy. The SCCLR would like to seek the views of the public in this respect.

3.10.3 The SCCLR would also like to seek the views of the public on whether requirements along the lines of the United Kingdom's Directors' Remuneration Regulations 2002 which require shareholders' approval of remuneration reports, including details of directors' remuneration packages, should be introduced at the present time in Hong Kong.

4. Chapter 4 - Shareholders

4.1 *Section 17 - Self-dealing by Controlling Shareholders*

4.1.1 The SCCLR reconfirms its previous proposals that the following changes should be incorporated into the law :-

- Connected transactions must be disclosed and subject to a disinterested shareholders' vote.

- The definition of a connected person in relation to controlling shareholder.

- The rule should be subject to certain exceptions such as transactions entered into by liquidators during the course of compulsory winding-up or on a general reduction of capital; the limited exemptions allowed under the Listing Rules (Rule 14.24 and 14.25 of the Main Board Listing Rules and Rule 20.23, 20.24, 20.35 and 20.43 of the GEM Listing Rules) and other de minimis exceptions, along the lines of those adopted in respect of director-related transactions. The SCCLR would like to consult further on the appropriate levels for the de minimis thresholds.

  The SCCLR noted that under the Listing Rules (Main Board Rule 14.23 and GEM Rule 20.31), the Stock Exchange has the discretion to waive the requirements relating to connected transactions. However, the SCCLR is aware of the difficulty of any attempt to include such a kind of waiver discretion into the law and would like to seek the public's views on this.

- Voting on connected transactions must be on a poll.

- The court's power to determine whether or not a transaction constitutes a waste of corporate assets should be preserved.

- Failure to comply with the rule should render the transaction voidable at the instance of the company or of any shareholder provided that bona fide third party rights are not affected or restitution is not lost.

- The liability of an interested shareholder to compensate the company should arise where the transaction is a waste of corporate assets and the interested shareholder has benefited from the transaction. The burden of proof would be on the interested shareholder to show that the transaction was not a waste of corporate assets or a transaction in bad faith from which he had benefited if there was no disclosure and approval of the disinterested shareholders or if the company went into liquidation within one year of the transaction.

- The proposals in this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

4.1.2 The SCCLR would like to know the public's view on how "controlling shareholders" should be defined for the purposes of connected transactions.

4.2 *Section 18 - Substantial Transactions*

4.2.1 The SCCLR is basically of the view that section 155A of the Companies Ordinance should only be optional for private companies and that the provisions of this section should be aligned with the corresponding Listing Rules for listed companies. However, the SCCLR is undecided on how exactly these are to be carried out. In view of this, the SCCLR wishes to consult the public on the following :-

- the relevant tests and thresholds for requiring shareholders' approval and whether those in the Listing Rules should be followed;
- whether section 155A should apply to all companies or just to listed companies;
- whether section 155A should be transplanted to Table A;
- whether section 155A should remain in the main body of the Companies Ordinance but subject to any contrary provisions in the company's articles of association;
- whether the relevant thresholds and tests should be set in subsidiary legislation while the main provision remains in the main legislation;
- whether section 155A should be made mandatory for listed companies including oversea companies so that any contravention would result in legal sanctions.

4.3 *Section 19 - Variation of Class rights*

4.3.1 The SCCLR considers that this area may be an area which is better suited for further case law development. It does not therefore recommend any legislative changes to define what constitutes a variation of class rights.

4.4 *Section 20 - The Suitability of Judicial Control, Multiplicity of Provisions and Class Votes*

4.4.1 The SCCLR was unable to reach a consensus on issues relating to these matters. It wishes to further consult the public on the following :-

- On class composition –
  - whether the current practice of the courts in determining fairness as between controlling shareholders and minority shareholders is adequate;

  - if not, whether the definition of class should be defined so as to allow minority shareholders to have a greater say in a proposed scheme of arrangement, for instance, by having separate class meetings for minority shareholders on the basis of their interest rather than legal rights;

- On the multiplicity of provisions –
  - whether section 58 should be amended to ensure greater consistency with section 166 so that, where a reduction of capital might result in the different treatment of shareholders of equal standing or not rateably as between classes of shareholders, the procedure should be the same as that under section 166;

- whether the provisions in sections 58, 166 and 168 should be rationalized, especially where the law allows for compulsory acquisition, to prevent compulsory acquisition being achieved other than under section 168.

- On the suitability of judicial control –
  - whether judicial control is suitable in the context of Hong Kong and how the current system may, in practice, be improved.

4.5 *Section 21 - Company General Meetings*

4.5.1 To enhance the effectiveness and transparency of company general meetings, the SCCLR makes the following proposals :-

- General meeting located at more than one venue
  - A Hong Kong company should be permitted to hold a general meeting at more than one location. The meeting should take place at the venue specified by the notice of the meeting which would be regarded as the principal venue, but subsidiary or satellite venues should be allowed.

  - To permit effective communication between venues, both visual and audio real time communications should be permitted by legislation.

- AGM required by Statute
  For companies with more than one shareholder, the AGM should continue to be required unless there is unanimous shareholders' consent to dispense with it, however, single shareholder companies should not be required to hold AGMs.

- Timing of AGM
  The timing of the AGM should be changed to within a certain period after the end of each financial year of the company. For private companies with a share capital and companies limited by guarantee, the period should be nine months and for other public companies, the period should be six months.

- Minimum Period of Notice
  The existing minimum periods of notice for the AGMs and the EGMs should be maintained. Any variation for EGMs of listed companies can be included in the Listing Rules.

- Service of Notice
  Notices should be given personally or sent by post to shareholders unless the shareholders agree to adopt electronic means of communication including the use of personal identification numbers. This requirement should be included in the main body of the Companies Ordinance and Table A.

- Contents of Notice
  There should be a requirement of minimum information to be given in the meeting notices regarding the proposed resolutions. Such a requirement can be put in the Listing Rules for listed companies and in the Companies Ordinance for unlisted companies.

- Agenda of AGM
  The existing law on agenda of AGM should be maintained, but the part of subsection 141(2) of the Companies Ordinance which requires the auditor's report to be read before the company in general meeting should be repealed as the report has already been certified by the auditor and circulated to the shareholders well in advance of the general meeting.

- Members' Resolution
  - Shareholders' resolutions and related information should be circulated at the expense of the company if they were received by the company one month after the notification of the intention to hold the AGM or two weeks before the anticipated date of dispatch of the AGM notice (whichever is the later) provided that the shareholders requesting the circulation meets the threshold requirements and the document for circulation consists of not more than 1000 words. The duty of the company to circulate members' resolutions should not be extended to EGMs called by directors.

  - The SCCLR wishes to seek the views of the public on the following two related issues:-

    - ✧ a proposed deposit system as an alternative approach to dealing with members' resolutions whereunder the requisitioning member is only required to place a certain deposit with the company in order to have his resolution circulated. The deposit will be refunded if the proposal receives a minimum percentage of votes in support.

    - ✧ whether there should be any limit on the number of nominations by shareholders for election of directors at general meetings;

    - ✧ what should be the criteria for nomination; and

    - ✧ what should be the percentage of shareholding requirement for such nomination.

- Written Resolution
  The requirement for unanimous approval in order to pass a written resolution should be maintained.

- Functions and Duties of Chairman of a Meeting
  A general formulation of the functions and duties of the chairman of a meeting should be placed in the Listing Rules and not in the Companies Ordinance.

- Voting on a Show of Hands
  No consensus was reached by the SCCLR as to whether voting by a show of hands should be discontinued and whether the chairman's discretion to call a poll should remain intact. The SCCLR would like to seek the views of the public before deciding how to proceed.

- Absentee and Electronic Voting
  - Absentee voting should be permitted. Absentee voting by post should be done before and not after the meeting as signatures have to be verified. Postal votes should reach the company during the same period as for lodging of proxy forms.

  - Electronic voting should be permitted and there should be rules and guidance for such voting procedures (e.g. authentication, security and the precedence as between votes received electronically and by post). The Companies Ordinance should be amended to enable rather than to compel electronic voting while the Listing Rules should encourage such voting.

- One proxy for each shareholding
  Without prejudice to the general principle of company law that a company is not concerned with trusts over its shares, multiple proxies should be permitted.

- Proxies to vote on a show of hands
  Proxies should be allowed to vote on a show of hands and to speak at the meeting. However, it is noted that, in the case of the chairman being appointed as the proxy for more than one shareholder, his vote, on a show of hands, would still be counted as one vote only.

- Proxy Solicitation
  The SCCLR would like to seek the views of the public on whether proxy solicitation should be regulated.

- Delivery of Proxy by Electronic Means
  Specific provisions should be made for the delivery of proxies by electronic means and there should be guidance on how an electronic proxy is to be signed.

- A Proxy to vote on Poll according to their Terms
  There should be a requirement for any person put forward by the company board as a proxy to vote by using the proxies on any poll according to their terms.

- Disclosure of Proxy Voting Information
  There should be a requirement for the chairman of the meeting to disclose to the meeting before the voting the number of proxies held by the company and the voting instructions (if any) thereunder. If the proxy was

a general proxy with no voting instructions, the way the chairman intended to use that proxy to vote should also be disclosed.

- Inspection of Proxy Document
  Any shareholder should be able to inspect votes but the inspection should be made after the meeting so as not to disrupt the proceedings.

5. Chapter 5 - Corporate Reporting

5.1 *Section 22 - The Responsibilities, Liabilities and Independence of External Auditors*

5.1.1 To enhance and strengthen the functioning and quality of external auditors, the SCCLR makes the following proposals :-

- Auditors' Function and Standards
  - In view of the review of the Practice Review Programme currently being undertaken by the HKSA aimed at introducing a system based on "risk-assessment", the SCCLR makes no specific proposal at this stage with regard to auditor's functions and standards. However, it urges the government to closely monitor developments in this area.

  - The issue of whether there should be independent regulation of the auditing profession should be considered by the government in the context of the current review of the HKSA's regulatory regime.

- Auditors' Remuneration
  - Section 131(8) of the Companies Ordinance should be amended to remove the requirement for the shareholders to fix the auditors' remuneration or determine the manner of how it is to be fixed.

- Auditors' Access to Information
  The present requirement under section 141(5) of the Companies Ordinance on directors and officers of the company to provide such information and explanation as the auditors think necessary and the corresponding criminal sanction should be extended by :-

  - bringing employees within its scope;
  - widening the duty of directors and the directors or auditors of a subsidiary undertaking of a company so as to require them to volunteer information where the normal standards of directors' or auditors' care and skill recognize that such information is required. However, the criminal sanction should be applied only to breaches where the director or auditor knows that the information is material to the audit.

- Outgoing Auditors
  Subject to the HKSA's further research and views on the subject, outgoing auditors should be required to volunteer material information to their successors.

- Auditors' Independence
  The Government and HKSA should undertake work to :-

  – identify the types of non-audit services which are incompatible with the principles underlying auditor independence;

  – enhance the disclosure of the nature and value of all services provided by auditors to audit clients, defining what falls into the categories of audit, audit-related and non-audit.

- Rotation of Audit Firms
  – There should not be mandatory rotation of audit firms in Hong Kong.

- Rotation of Audit Partners
  – There should be mandatory rotation of both the lead and concurring audit partners every five years.

  – The SCCLR would like to seek the views of the public on whether partner rotation should be extended to below the lead and concurring audit partner level and, if so, what should be the appropriate period.

- Auditors' Duties
  The 'Caparo' rule should remain in place with any further development of negligence law being left to the normal process of case law.

- Auditors' Liability
  No decision was reached on auditors' liability, the desirability of proportionate liability and whether they should be distinguished from other parties given the regulatory role of auditors even though it was agreed that the issue should be looked at in a wider context covering not just auditors. The SCCLR would like to seek the views of the public on these issues. Subsequently, the SCCLR will consider and make proposals regarding directors' liability and proportionate liability.

6. Chapter 6 - Corporate Regulation

6.1 The SCCLR would like to seek the views of the public on whether, in principle, statutory backing should be given to the Listing Rules together with tougher statutory sanctions including civil fines against non-compliance.

6.2 The SCCLR would like to seek the views of the public on -

- whether the regulation of unlisted companies needs to be improved; and if so
- how should this be addressed in terms of institutional change.

CHAPTER 1

INTRODUCTION

1. Progress on proposals made in Phase 1 of the Review

Background

1.01 The Consultation Paper on Phase I of the Corporate Governance Review made a total of 21 proposals regarding directors, shareholders and corporate reporting. As a result of the consultation exercise and further consideration within the Administration, the present position on these proposals is outlined in the following paragraphs.

Proposals included in the Companies (Amendment) Bill 2003

1.02 Four proposals concern shareholder protection and remedies namely: creating a statutory derivative action; extending the unfair prejudice remedy; providing a statutory method for shareholders to obtain company records; and giving the court various general powers. The first concerned the power, on application by an affected person or a relevant authority, to grant an injunction against any contravention of the Companies Ordinance or any breach of fiduciary duties; and the second gave the court a clear general power to grant orders as to costs for shareholders for the purposes of taking action in respect of corporate injury as well as for unfair prejudice actions. It is proposed to submit this Bill to the Legislative Council in June 2003.

Proposal under consideration

1.03 This proposal covers issues regarding the nomination and election of directors. Draft drafting instructions are being considered with a view to including them in a future Companies Amendment Bill.

Proposals requiring further consultation

1.04 Two proposals on regulatory reforms require further consultation. With regard to giving the Securities and Futures Commission (SFC) a power to conduct derivative actions for minority shareholders against a listed company, the Financial Services and The Treasury Bureau (FSTB) and SFC have recently published a joint consultation paper. With regard to setting up a body to investigate financial statements, similar to the Financial Reporting Review Panel in the United Kingdom, the FSTB in consultation with the listed sector and accountancy profession will finalize and take forward the proposal in the fourth quarter of 2003.

Proposals which overlap with proposals in Hong Kong Exchanges and Clearing Limited's Consultation Paper

1.05 Four proposals, which largely concern connected transactions and dominant shareholders, overlap with similar proposals in Hong Kong Exchanges and Clearing Limited's (HKEx) Consultation Paper. These concern voting by directors in relation to directors' self-dealing; shareholder approval for connected transactions of significance involving directors; transactions between directors or connected parties with an associated company; and self-dealing by controlling shareholders. After further consideration, the SCCLR's proposals on the most appropriate way of proceeding are outlined in Chapters 3 and 4 of this Consultation Paper.

Proposals subsumed by the Government/Hong Kong Society of Accountants Joint Working Group

1.06 Three proposals on financial reporting have been subsumed by the Government/HKSA Joint Working Group (JWG) which was established in early 2002 to review the accounting and auditing provisions of the Companies Ordinance. These are : giving auditors the power to report on inconsistencies between the audited financial statements and other financial information contained in the directors' report and other sections of the financial report; the provision of an accounting reference date; and the provision of a statutory procedure to revise financial statements after they have been laid before the company in general meeting or delivered to the Registrar of Companies. It is hoped that the JWG will complete its work in 2004.

Proposals to be followed-up by the Hong Kong Society of Accountants

1.07 Two proposals on financial reporting have already been followed up by the HKSA. The first concerns the opening up of the accounting and auditing standards process, through the Financial Accounting Standards Committee (FASC) and the Auditing Standards Committee (AuSC), to involve more lay members. The second concerns the strengthening of the HKSA's Practice Review Programme (PRP) which monitors the standard of audit practices in Hong Kong. Further details are given in Chapter 5 Section 22.

Proposal to be followed up by the Stock Exchange of Hong Kong Limited

1.08 One proposal on listed companies' Management Discussion & Analysis (MD&A) is being followed by the Stock Exchange of Hong Kong Limited ("SEHK"). This concerns revising the Listing Rules on MD&A so that they include more qualitative and forward looking disclosure in certain specified areas.

Miscellaneous Proposals

1.09 The position regarding the remaining four proposals is as follows :-

- The proposal that private companies file financial statements was rejected by the majority of consultees. The reasons given were sound and this proposal has therefore not been pursued.

- The discussion regarding the role of the independent directors requires no statutory amendments. However, the SCCLR's proposals regarding non-executive directors are outlined in Chapter 4 Section 14.

- The proposal that an individual member can enforce all the rights in a company's memorandum and articles of association as personal rights has been included in the Companies (Amendment) Bill 2002 which it is hoped will be enacted by mid-2003.

- The proposal that there should be a non-statutory code of directors' duties is covered in Chapter 3 Section 7 which outlines the provisions of such a code for further consultation.

2. Consultation

2.01 The views of the public are sought on the proposals outlined in Chapters 3, 4, 5 and 6 of the Consultation Paper. Submissions should be made in writing using either hard copy or e-mail not later than 30 September 2003 to :-

Mr Edward Lau
Secretary, Standing Committee on Company Law Reform
Companies Registry
Queensway Government Offices (High Block), 15th Floor
66, Queensway
Hong Kong

Tel. No.: 2867-2820
Fax No.: 2869-1007
E-mail: edwardlau@cr.gov.hk

CHAPTER 2

CONSULTANCY STUDIES ON CORPORATE GOVERNANCE

3. A comparative survey and analysis of the development of corporate governance standards in other jurisdictions

Background

3.01 The survey was conducted by Professor Judy Tsui and Professor Ferdinand Gul of the City University of Hong Kong. The objective was to examine and understand the corporate governance regimes, including the legal, regulatory and institutional frameworks of Hong Kong, the United Kingdom, the USA, Australia, Malaysia, Taiwan and Singapore and compare the strengths and weaknesses of these regimes to the regime in Hong Kong including corporate disclosure requirements.

Methodology

3.02 The researchers conducted a comprehensive literature review supplemented by interviews with selected key regulators and personnel from government departments and prominent corporate governance experts from private sector institutes.

3.03 The researchers also conducted a comparative analysis of the legal and regulatory requirements in various jurisdictions. Three broad aspects of corporate governance : board characteristics, disclosure of corporate governance policies and practices required by regulators, and the definition of independence with reference to independent non-executive directors (INEDs) were reviewed.

Findings

3.04 In relation to board composition, the emphasis is on ensuring that no individual group can dominate decision making on the board, although the number of non-executive directors (NEDs) on the board varies. The recommendations on INEDs are more specific than those for NEDs: either a specific number of INEDs is required or a portion of the board is required to be independent. There is no specific requirement for directors' education and training in any jurisdiction surveyed except for Malaysia.

3.05 Chief Executive Officer (CEO) duality (one person filing the roles of both CEO and chairman) is a common practice in the USA but discouraged (though not prohibited) in other jurisdictions (United Kingdom, Australia, Malaysia and Singapore). Most jurisdictions explicitly state that all directors should have equal access to relevant information of a company.

3.06 On disclosure, most jurisdictions (with the exception of the USA and Taiwan) require a statement on the corporate governance practices in place during the reporting period to be disclosed in the annual report and give details as to whether or not the company has complied with the corporate governance requirements (where applicable). They must also disclose the reasons for failure to comply with such requirements.

3.07 Extensive disclosure requirements relating to the board are common. As a minimum, names and qualifications of directors, their status as NEDs or INEDs, and other biographical information should be disclosed.

3.08 On the definition of independence, the researchers concluded that the definition is not exactly the same across jurisdictions but it is similar, with difference in wording or in details. Most jurisdictions adopted the definition of “a related party” as set out in International Accounting Standards.

3.09 The academic literature review does not provide conclusive evidence on the positive relationship between corporate governance and firm performance. Nonetheless, there is an increasing trend in the business and legal literature to emphasize the point that good corporate governance should lead to better performance. The literature also showed that financial disclosures, an element contributing to good corporate governance, are not without costs, and these costs should be considered when considering changes in financial disclosure policies in Hong Kong.

3.10 Most respondents at the interviews believed that Hong Kong should take the lead to legislate and regulate the basic elements of corporate governance such as connected party transactions. A balanced approach should be adopted, namely, clearly specifying corporate governance best practices but allowing companies to deviate from such best practices with appropriate disclosures and explanations. They generally disagreed that corporate governance measures should be included in legislation. Training of directors was regarded as crucial. Respondents were however skeptical about the existence of ‘truly independent’ INEDs in Hong Kong. Interviewees suggested that companies can outsource the search function to professional recruitment agencies.

Recommendations

3.11 The consultants recommended a two pronged approach to improve corporate governance –

(a) A set of fundamental rules needs to be mandated as minimum requirements preferably through the Listing Rules. This would include the number of INEDs, the proportion of INEDs on the board, a more comprehensive definition of independence and better quality disclosures such as related party transactions. These rules would be mandatory for all listed companies;

(b) A comprehensive code of best practice should be established whereby listed companies are encouraged to comply with the code or explain their non-compliance. The code can include matters relating to CEO duality, board composition, disclosures of corporate governance practices, and possibly the formation of a corporate governance committee.

3.12 The implementation of (a) and (b) above is essentially a balanced approach. The consultants also believed that Hong Kong needs to pay more attention to increase the powers of the Securities and Futures Commission to investigate breaches of related laws and regulations. This would not only deter offenders but also complement the balanced approach to corporate governance.

4. A survey on the attitudes of international institutional investors towards corporate governance standards in Hong Kong

Background

4.01 The survey was conducted by Professor Judy Tsui and Professor Ferdinand Gul of the City University of Hong Kong.

Methodology

4.02 The researchers conducted a comprehensive literature review on institutional investment to identify the corporate information needs of institutional investors. This review provided the basis for designing the questionnaires for data collection via personal interviews and web-based questionnaires. A list of information needs (or company specific factors) of institutional investors are set out at Annex I.

4.03 Eleven institutional investors and two investment bankers were interviewed. The respondents' ranking of the company specific factors are set out at Annex II.

Findings

4.04 Most respondents ranked quality management as the most important factor in their investment decisions and integrity was regarded as an important ingredient for quality. If the quality of management is high, the corporate governance mechanisms set up by the company will correspondingly be effective. Many respondents also believed that past and future financial performance, cash flows and quality of disclosure of financial statements are very important factors that affected their investment decisions. Not many of the interviewees systematically took account of corporate governance as a significant factor in their investment decisions. They recognized that it is important but did not take it explicitly in any evaluation criteria.

4.05 Most respondents believed that the most important mechanism for good corporate governance is the quality of INEDs. Many were however very skeptical about the existence of 'truly independent' INEDs because of Hong Kong's 'closely knit' business community characterized by a large number of family owned companies and interlocking INEDs who sit on each other's company's boards.

4.06 Many respondents pointed out that family ownership in Hong Kong is an impediment to good corporate governance. Since the board is dominated by the controlling family, INEDs may have difficulty in functioning effectively even if they wanted to do so. In many companies, INEDs may not be related to the controlling family but they have been appointed by the Chairman or Chief Executive Officer and so could be under their influence.

4.07 All interviewees believed that corporate governance would lead to better company performance in the long run and they would pay a premium for companies with better corporate governance. Nonetheless, they were still willing to invest in companies whose corporate governance standards are perceived as not comparable to international standards on the condition that they were sufficiently compensated with higher returns.

4.08 Most respondents expressed the view that they do not take an active role in monitoring their investee companies. Some interviewees found that it is more effective for them to sell off their investments if they object to management policies. By and large, the institutional investors interviewed believed that institutional shareholder activism is almost non-existent.

4.09 On enforcement, some respondents felt that the SFC should have wider investigatory powers in respect of companies which do not comply with the Listing Rules. Others felt that corporate governance cannot be legislated for nor regulated.

4.10 All respondents supported corporate governance reform.

4.11 The findings of the personal interviews and web-based questionnaires were generally consistent with each other. The ranking of company specific factors of the questionnaire survey are set out in Annex III.

5. The roles and functions of audit, nomination and remuneration committees

Background

5.01 The study was conducted by Professor Judy Tsui and Professor Ferdinand Gul of the City University of Hong Kong.

Methodology

5.02 The researchers conducted a comprehensive review of academic literature and broad practice surveys on the roles and functions of audit, nomination and remuneration committees in Hong Kong and a number of overseas jurisdictions.

5.03 The key regulators and representatives from government departments and corporate governance experts in different countries were interviewed to seek their views on the key factors that contribute to effective board committees in their respective countries.

5.04 The opinions of the CEOs or Chairmen of Hong Kong listed companies toward the effectiveness of the three board committees were also collected through a questionnaire. Empirical analyses were conducted on the relationship between board and audit committee characteristics and firm performance.

Findings

5.05 From the literature review, the number and quality of INEDs and their experience and expertise such as financial literacy were identified as crucial elements for the effectiveness of audit and remuneration committees. The frequency of meetings is also a good indicator of the extent to which management relies on these committees and determines their effectiveness. Up till now, literature on the effectiveness of nomination committees has been scarce.

5.06 According to the interview findings, the most vital element in implementing effective audit, remuneration and nomination committees is the quality of INEDs. However, interviewees were in general skeptical about the having genuinely independent INEDs. Good quality INEDs are hard to find in Hong Kong unless more incentives are provided in terms of compensation. Another alternative is to outsource the searching function to professional recruitment agencies that recruit globally. Interviewees were supportive of corporate governance reform in Hong Kong. However, they favoured a disclosure-based approach over a regulatory-based regime. They considered that an effective way to upgrade the quality of INEDs is to 'professionalize' them through continuing education and training.

5.07 The questionnaire survey also concluded that the independence of the INEDs is the most important factor contributing to good corporate governance. Respondents agreed that the establishment of audit committees (but not remuneration and nomination committees) should be made compulsory and audit committee meetings should be attended by the external auditor of the company. These committees should be chaired by INEDs and there should be at least three members in each of the committees.

5.08 The empirical analyses indicated that the existence of audit committees was positively associated with better performance. For companies with audit committees, it was found that more INEDs as committee members were associated with better performance.

Recommendations

Audit Committees

5.09 The Consultants recommended that :-

(a) All listed companies should establish an audit committee with at least three NEDs, with the chairman and the majority of its members being independent;

(b) All the NEDs and INEDs on the committee should have some financial expertise either acquired through accounting or financial management qualifications or experience;

(c) The role of the audit committee is to assist the board of directors to monitor and oversee the financial reporting process, the external audit and internal controls including the audit function and risk management;

(d) The terms of reference for this committee should be disclosed so that all members understand their role and responsibilities in the committee;

(e) The annual report should disclose the composition of the audit committee, the number of audit committee meetings and how it has discharged its responsibilities;

(f) The establishment of the audit committee with detailed requirements on the constitution should be incorporated in the Listing Rules of the Main and GEM Boards. The other recommendations should be incorporated in the Code of Best Practice.

Remuneration Committees

5.10 The Consultants recommended that :-

(a) The remuneration committee should be established and consist wholly of NEDs with the chairman and the majority members being INEDs;

(b) The remuneration committee should be responsible for recommending to the board the compensation policy and all aspects of compensation for key executives, including all the executive directors and the CEO. The compensation for NEDs and INEDs should be a matter for the board. Disclosure of the individual members' remuneration including all aspects of their remuneration packages should be made in the annual report;

(c) The terms of reference of the remuneration committee together with the composition, number of meetings and work done should be disclosed in the annual report;

(d) Ideally, there should be at least one member who is knowledgeable in executive compensation. Otherwise, external professional advice should be sought;

(e) The principle that no executives, NEDs or INEDs should have a role to play in determining his/her compensation should be strictly adhered to;.

(f) The composition, role and remuneration policy of NEDs should be disclosed and include :-

- an analysis of individual directors' remuneration including basic salaries, housing allowances, other allowances and benefits in kind;
- an analysis of directors' remuneration between 'performance-based' and 'non-performance-based' compensation;
- directors' share options including their individual benefits derived from the aggregate value realized on the exercised options during the year and the closing market price of shares at the balance sheet date.

(g) The establishment of the remuneration committee with detailed requirements on the constitution should be incorporated in the Listing

Rules of the Main and GEM Boards. The other recommendations should be incorporated in the Code of Best Practice.

Nomination Committees

5.11 The Consultants recommended that :-

(a) A nomination committee should be established with the chairman and a majority of its members being INEDs. This constitution is particularly important for Hong Kong because over 60% of listed companies are family owned or dominated by controlling shareholders and the quality of INEDs is the most critical element in corporate governance;

(b) The nomination committee should be responsible for making recommendations to the board on all new appointments including executives, NEDs and INEDs. It is also crucial that the CEO and Chairman should have some control/influence over the recommendations of executive directors to the board or its committees. However, the nomination of INEDs and NEDs should be the sole responsibility of this committee. One of the functions of this committee is to consider the best qualified candidate in terms of skills and characteristics required for the membership of the board. Performance evaluation of individual directors should be undertaken by this committee on an on-going basis;

(c) There should be a charter stipulating the role and functions of this committee;

(d) Disclosures in the annual report should include: membership, terms of reference and responsibilities of members, procedures for recruiting and evaluating directors including executives, NEDs and INEDs;

(e) The establishment of the nomination committee with detailed requirements on the constitution should be incorporated in the Listing Rules of the Main and GEM Boards. The other recommendations should be incorporated in the Code of Best Practice.

Corporate Governance Committees

5.12 If nomination and/or remuneration committees are not established, the Consultants recommended that a corporate governance committee should be established as an intermediate step to formally establishing these committees. This is perhaps more appropriate for smaller companies where there may not be enough directors to formally constitute all the recommended committees.

5.13 The corporate governance committee may be chaired by the chairman of the board, if that person is not also the CEO. The duties of the committee should include :-

(a) General responsibility for developing corporate governance policies;
(b) Proposing changes as necessary to conform with governance guidelines;
(c) Explaining the rationale behind the company's practices if they do not follow corporate governance guidelines; and
(d) Providing a forum for concerns of individual directors when the matters

may not be appropriate for a full board meeting, such as individual performance of other directors, or the company's approach to governance.

5.14 The appointment of a corporate governance committee with the above duties, together with the duties of the remuneration and nomination committees would likely be a feasible undertaking for all but the smallest of listed companies. The researchers also considered this as a logical step towards the long-term goal of establishing the other nomination and remuneration committees as the company grows in size.

6. An economic analysis co-relating the performance of listed companies with their shareholders' profile

Background

6.01 This Study was conducted by Professor Larry HP Lang and Dr. Raymond W So of the Chinese University of Hong Kong.

Methodology

6.02 The Study was based on an analysis of the ownership structure and economic performance of 754 companies that were listed on the Stock Exchange of Hong Kong as at 31 August 2001. The ownership of companies were categorized into four major groups as follows :-

(a) Family-controlled companies where members of a family own more than 10% of the issued share capital of the company;
(b) Widely-held companies where no shareholder owns more than 10% of the issued share capital of the company;
(c) State-owned enterprises where the control vests with the central, provincial or city governments as the case may be; and
(d) 'Miscellaneous' which is the 'catch-all' category into which a company will fall if it is not defined as any of the above.

6.03 Two widely-used measures were used to compute the economic performance of these companies, namely return on assets and return on equity. The researchers also provided the market assessment of company valuation through the ratio of market value of assets to book value of assets.

Findings

6.04 Details of the findings can be found in the Study Report. Anyone interested may refer to the Report for further information.

Annex I

Information Needs of Institutional Investors

- Financial performance
- Future cash flows
- Dividend yield
- Stock liquidity
- Share price volatility
- Market risk
- Leverage
- Company size
- Company age
- Years listed in stock exchanges
- Cross-listing
- Book-to-market ratio
- Transaction costs
- Quality and disclosure of financial statements
- Availability of information
- Corporate strategy
- Quality of management
- Audit quality
- Conservatism
- Social or human resources information disclosure
- Level of corporate governance

Annex II

Ranking given by interviewees on company specific factors which are relevant for their investment decisions

Most important
Quality of management
Past financial performance
Future financial performance
Future cash flow
Corporate strategy
Content of financial statement (including notes)
Information availability

Important
Dividend yield
Trading liquidity
Share price volatility
Market risk
Leverage

Somewhat important
Company size
Ration of market price per share/ book value per share
Audit quality (whether audited by the Big-Four CPA Firms)
Transaction costs
Corporate governance

Not important
Company age
Years listed in stock exchanges
Cross listing
Conservatism
Corporate social responsibilities disclosures, e.g., environmental issues

Annex III

Ranking by respondents from web-based questionnaire on company specific factors which are relevant for their investment decisions

Most Important

- Legal and regulatory environments
- Content of financial statements (including notes)
- Quality of management
- Trading liquidity
- Corporate strategy
- Timeliness of annual reports
- Audit quality (whether audited by Big 4 CPA firms)
- Corruption

Important

- Future financial performance
- Share price volatility
- Past financial performance
- Level of communication between institutional investors and investee companies
- Future cash flow
- Independence of INDs
- Family ownership and influence
- Auditor’s report
- A statement of responsibilities issued by directors in relation to the financial statements and the content of the annual report
- Past cash flow

Somewhat important

- Directors’ share ownership
- Market risk i.e. beta
- Existence of audit committees
- Directors’ performance evaluation
- Ratio of market price per share / book value per share
- Leverage
- Transaction costs

Not important

- Dividend yield
- Corporate social responsibility disclosures, e.g. environmental issues

CHAPTER 3

DIRECTORS

7. Directors' Duties

Background

7.01 In Phase I of the Corporate Governance Review, the SCCLR recommended the publication of draft guidelines in non-statutory language, stating the principles of law in Hong Kong in relation to directors' duties.

7.02 The views of the respondents to the consultation exercise on this issue were equally balanced as to whether these guidelines should take a statutory or non-statutory form. Consequently, the SCCLR suggests the issue be revisited after observing the practical application of the statutory approach in those jurisdictions where such an approach has been adopted such as the United Kingdom. In the meantime, the SCCLR proposes the adoption of the guidelines below on a non-statutory basis.

Proposal

7.03 ***Draft Guidelines on Directors' Duties***

(I) Introduction

In general the responsibilities and liabilities of directors derive from various sources, including the constitution of the company, statute and case law. If a person does not comply with his duties as a director he may be liable to civil or criminal proceedings and may be disqualified from acting as a director. Case law sets out and elaborates on most of these significant principles.

However, case law tends to be complex and inaccessible. The objective of these guidelines is to outline the general principles for a director in the performance of his functions and exercise of his powers.

All directors should read these guidelines which are also readily accessible on the websites of the Companies Registry, the Hong Kong Stock Exchange, the Securities and Futures Commission, the Official Receiver's Office and the Hong Kong Monetary Authority. Hard copies are also available at the Companies Registry.

Companies should orientate new directors and give a copy of these guidelines to new directors. Directors are also encouraged to refer to more detailed reviews of the role and duties of directors in law. For example, the Hong Kong Institute of Directors has issued the Guidelines for Directors (1995) and the Guidelines for independent Non-Executive Directors (2000). Directors might also refer to codes of best practice to improve the manner in which their companies are managed.

It is important to note that the statements in these guidelines are principles only and are *not* intended to be exhaustive statements of the law. Furthermore, statute or case law could require certain forms of conduct under specified circumstances. If directors are at all in doubt about the nature of their responsibilities and obligations, they should seek legal advice.

(II) The general principles of directors' duties

Principle 1: Duty to observe the company's memorandum and articles of association and resolutions

A director of a company must act in accordance with the company's memorandum and articles of association (the "constitution".) He must also comply with resolutions that are made in accordance with the company's constitution.

Principle 2: Duty to act in good faith for the benefit of the company as a whole

A director of a company must act in good faith in the best interests of the company[1]. This means that a director owes a duty to act in the interests of all its shareholders, present and future. In carrying out this duty, a director must (as far as practicable) have regard to the need to achieve outcomes that are fair as between its members.

Principle 3: Duty to use powers for a proper purpose for the benefit of members as a whole

A director of a company must exercise his powers for a "proper purpose". This means that he must not exercise his powers for purposes that are different from purposes for which they were conferred. The primary and substantial purpose of the exercise of a director's powers must be for the benefit of the company. If the primary motive is found to be for some other reasons (e.g. to benefit one or more directors and to gain control of the company), then the effects of his exercise of his power may be set aside[2]. This duty can be breached even if he has acted in good faith[3].

Principle 4: Duty not to delegate powers except with proper authorization and duty to exercise independent judgement

Except where authorised to do so by the company's constitution or any resolution, a director of a company must not delegate any of his powers[4].

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[1] Lee Tak Samuel v. Chou Wen Hsein et al [1984] HKC 409

[2] SCIC Ltd. et al v. Tomei International (Holdings Ltd.) et al (unreported, 21 November 1995, HCA No. A11427 of 1995), "Hong Kong Company Law, Cases, Materials and Comments" (Phillip Smart, Katherine Lynch and Anna Tam (Butterworths) (1997)

[3] See also Hogg v. Crampborn [1967] 1 Ch 254; Bishopsgate Investment Management Ltd. Maxwell [1993] BCC 120 at 140 CA

[4] R v. Lo Hon Yui Henry [1985] 1 HKC 183; Wong Kin Man v. Official Receiver & Liquidator of

He must not fail to exercise his independent judgement in relation to any exercise of his powers.

Principle 5: Duty to exercise care, skill and diligence

A director of a company must exercise the care, skill and diligence that would be exercised by a reasonable person with the knowledge, skill and experience reasonably expected of a director in his position. In determining whether he has fulfilled this duty, the court will also consider whether he has exercised the care, skill and diligence that would be exercised by a reasonable person with any additional knowledge, skill and experience which he has.

Principle 6: Duty to avoid conflicts between personal interests and interests of the company

As a general rule, a director of a company must not allow personal interests, or the interests of any connected person, to conflict with the interests of the company.

Principle 7: Duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law

A director of a company has certain duties where he has a material interest in any transaction to which the company is, or may be, a party. Until he has complied with these duties, he cannot, in the performance of his functions as a director, authorise, procure or permit the company to enter into a transaction. Furthermore, he cannot enter into a transaction with the company, unless he has complied with the requirements of the law.

The law requires a director to disclose the nature of his interest and refrain from voting in respect of such transactions[5]. Under certain circumstances the law[6] or constitution may prescribe procedures to secure the approval of directors or members in respect of proposed transactions. A director must disclose the relevant interest to the extent required. Where applicable, he must secure the requisite approval of other directors or members.

A director may also need to comply with these or other procedures if an "connected person" (which might include a company) has an interest in the transaction.

Principle 8: Duty not to gain personal profit from use of position as a director

A director of a company cannot use his position as a director to gain (directly or indirectly) an advantage for himself, or someone else, or which causes detriment to the company.

Goldmann Commodities (HK) Limited [1983] 2 HKC 38 (Hong Kong Court of Appeal)

5 Subject to the adoption of the proposals in paragraph 8.06 below

6 This again, is subject to the adoption of the proposals in paragraph 8.06 below

Principle 9: Duty not to make personal use of company's property or information

A director of a company must not use the company's property or information, or any opportunity that presents itself to the company, of which he becomes aware as a director of the company. This is except where the use or benefit has been disclosed to the company in general meeting and the company has consented to it.

Principle 10: Duty not to accept personal benefit from third parties conferred because of position as a director

A director or former director of a company must not accept any benefit from a third party, which is conferred because of the powers he has as director or by way of reward for any exercise of his powers as a director. This is unless the company itself confers the benefit, or the company has consented to it by ordinary resolution, or where the benefit is necessarily incidental to the proper performance of any of his functions as director.

Principle 11: Liabilities for fraudulent trading

A director of a company should also take note of section 275 of the Companies Ordinance (Cap. 32) relating to "fraudulent trading". Fraudulent trading takes place when a company carries on its business with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose. During insolvency proceedings the court can impose personal liabilities on a director who is found to be knowingly involved in fraudulent trading.

Explanation

7.04 The Introduction makes clear that, unlike the United Kingdom proposals, the guidelines do *not* provide an exhaustive statement of the law[7]. However, similar to the United Kingdom proposals, the intended purpose of the guidelines is to make the principles of common law and equity more accessible. What the guidelines are unable to do, as proposed in the United Kingdom provisions, is to clarify those issues of law that are unclear[8]. The guidelines are intended for all directors or potential directors of all companies, irrespective of whether they are private or public, listed or unlisted.

7.05 Principle 1 (Duty to act in good faith for the benefit of the company) sets out the duty to act in good faith for the benefit of its company as a whole or the "duty of loyalty" to the company. In reaching decisions, directors may be confronted with the duty to act in the interests of the company as a whole. Corporate governance debates often discuss the issue as to whether directors owe a duty to consider the interests of other stakeholders. The present drafting, however, as with the United Kingdom provisions, does not recognise such a duty.

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[7] The UK's Company Law Review Steering Group's draft statement of directors duties are found on the website under http://www.dti.gov.uk/cld/final_report/index.htm.

[8] "Modern Company Law For a Competitive Economy Final Report", Page 41, 3.7, second bullet

7.06 Principle 5 (Care, Skill, Diligence) states the standards of care, skill and diligence at common law. Today the standard combines both a subjective element[9] as well as an objective element.

7.07 The director must thus *also* meet the standard of a reasonably diligent person with the knowledge, skill and experience of a director in his position[10]. Although there do not appear to be reported cases on this point in Hong Kong, this standard appears to be generally accepted in Hong Kong[11].

7.08 Principle 7 (Transactions involving conflict of interest) is broader than the United Kingdom proposals. The drafting accommodates the fact that the law or listing rules or constitution may require directors to secure the approval of shareholders for such transactions. This drafting also takes into account the proposals in Phase I of the Corporate Governance Review as discussed in paragraph 8.06 below. As such, if the proposals in paragraph 8.06 are enacted into legislation, the draft guidelines would also highlight the obligations of a director where "connected persons" (i.e. persons connected with the director) have an interest in the transaction.

7.09 Principle 9 (Personal use of company's information, property and opportunities) differs from the United Kingdom proposals in order to reflect the current state of law in Hong Kong. This duty is one aspect of the duty to avoid conflicts of interests. Generally, as fiduciaries, directors may not usurp the corporation's opportunities or profit from their position, unless expressly allowed. Directors in breach of this rule must account for any personal profit that they make as a result of their position, or of any information, or corporate opportunities that come to them by reason of their office: *Carrian Investments Ltd. v. Wong Chong Po et all*[12]. In *Man Luen Corporation v. Sun King Electronic Printed Circuit Board Factory Ltd.*[13], a director who wished to keep profits for which he was accountable had to make full disclosure of the nature and extent of his profit and obtain the express approval *of the general meeting*. The United Kingdom proposals contemplate that, if allowed by the constitution, genuinely independent directors may waive the company's rights to these opportunities[14]. Unlike the United Kingdom proposals, the draft guidelines can only reflect the current state of law and allow such transactions to be approved by general meeting.

7.10 Principle 11: Directors' liabilities in the event of fraudulent trading highlights the potential liability for fraudulent trading under section 275 of the Companies

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[9] Hong Kong Company Law, Cases, Materials and Comments, Phillip Smart, Katherine Lynch, Anna Tam, Butterworths (1997), page 243

[10] Norman v. Theodore Goddard [1991] BCLC 1028; Hong Kong Company Law, Cases, Materials and Comments, Phillip Smart, Katherine Lynch, Anna Tam, Butterworths (1997), page 243

[11] Hong Kong Company Law, Cases, Materials and Comments, Phillip Smart, Katherine Lynch, Anna Tam, Butterworths (1997), page 236

[12] [1986] HKLR 945; Sears J, at page 950, held that the limitation period under the Limitation Ordinance did not apply in the case of an action brought by a beneficiary to recover trust property. In this case the defendants had used confidential information and speculated in the company's shares and were held to be in breach of trust.

[13] [1981] HKC 407

[14] "Modern Company Law For a Competitive Economy Developing the Framework", page 47, paragraph 3.24

Ordinance[15].

Promulgation

7.11 Subject to endorsement in the context of this consultation exercise, the draft guidelines outlined in paragraph 7.03 (above) will be finalized and issued, on a trial basis, by the Companies Registry. They will be made widely available in hard copy at the offices as well as the web-sites of the Financial Services and the Treasury Bureau, Companies Registry, the Securities and Futures Commission, Hong Kong Stock Exchange, the Official Receiver's Office and the Hong Kong Monetary Authority. Directors of companies will be required to sign an acknowledgement that they have obtained a copy of and read the guidelines when submitting a company's annual return.

7.12 It is envisaged that the guidelines will need to be revised from time to time to reflect any changes in the principles of the law on directors' duties. One possible such change is the introduction of the concept of "insolvent trading" in the Companies (Corporate Rescue) Bill 2001. If enacted, this will affect the normal duty of loyalty of a director to the company as this is displaced in a situation where the director knows or ought to have recognized that the company has no reasonable prospects of avoiding insolvent liquidation. Consequently, a director would be responsible for insolvent trading.

8. Voting by Directors in relation to Directors' self-dealing

[*There is a fair amount of overlapping between sections 8, 9 and 17 as they deal with different aspects of conflicts of interest on the part of those who have influence over the conduct of companies. Consequently, the proposals in this section should be read together with those in the other two sections.]*

Background

8.01 The general law on self-dealing by directors does not prohibit an interested director voting on a matter in which he has a material interest if the company's constitution so permits. This position is also reflected in Regulation 86 of Table A in the Companies Ordinance.

8.02 The SCCLR considered that the position could be improved if directors were prohibited from voting on transactions in which they were interested. In view of this, the SCCLR made a number of proposals in section 7 of the Consultation Paper on Phase I of the Corporate Governance Review as follows :-

(a) The law should set out the general position, subject to certain exceptions, that an interested director should not vote at a board meeting on a matter in which he has an interest;

(b) An ad hoc disclosure requirement should be imposed on interested directors, in addition to the general advance notice requirement under section 162 of the Companies Ordinance;

[15] For case law on higher standard of proof, see Aktielskabet Dansk Skibsfinansiering v. Wheelock Marden & Co. Ltd. [1989] 2 HKC 273; Court of Appeal [2000] 1 HKC 511

(c) Contracts, transactions or arrangements in which the directors (or connected persons) have an interest should be disclosed to shareholders, and if significant, for their approval;
(d) The law should be amended to clarify the civil consequences of a breach of the general rule;
(e) The ambit of section 162 of the Companies Ordinance should be widened to cover "transactions", "arrangements" and "connected persons".

8.03 The results of the Phase I Consultation indicated that most of the respondents were in favour of the proposals made but objected to the application of the proposals to private companies. Some of them were also of the view that the mandatory ad hoc disclosure requirement was impractical and unnecessary.

8.04 The issue has also been addressed in paragraph 13.3 of Part C of Hong Kong Exchange and Clearing Limited's (HKEx) Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues. This paper made the following recommendations :-

> "We will amend the Rules to require a director to abstain from voting on any matter in which he or any of his associates (as defined in the Rules) has any interest which is different from other shareholders and not to be counted towards the quorum of the relevant board meeting. There will be an exception to the general prohibition if the relevant interest is immaterial. The existing exceptions to the general voting prohibition as currently provided in the Rules will continue to apply."

The HKEx's proposals are broadly in line with the SCCLR's proposal. The majority of the respondents to the HKEx's consultation agreed with this proposal. The HKEx will make appropriate amendments to the Listing Rules accordingly.

8.05 The SCCLR has further reviewed the issue taking into account respondents' views in the Phase I Consultation exercise, the current Listing Rules, the proposals in HKEx's Consultation Paper and the results of that consultation exercise.

Proposals

8.06 The SCCLR proposes that the law should be amended as follows :-

(a) The Companies Ordinance should set out the general prohibition against directors voting on transactions in which they are interested, in accordance with paragraph 13.3 of Part C of HKEx's Consultation Paper;

(b) The Companies Ordinance should set out the exceptions to the general voting prohibition as currently provided in Note 1 of Appendix 3 to the Listing Rules, and the additional exception proposed in paragraph 13.3 of Part C of HKEx's Consultation Paper on immaterial interest, i.e. one that does not give rise to an actual conflict. Note 1 of Appendix 3 to the Listing Rules provides exceptions from the requirement that a director shall not vote on anything in which he has a material interest in respect of the following matters :-

(i) the giving of any security or indemnity either:-

(A) to the director in respect of money lent or obligations incurred or undertaken by him at the request of or for the benefit of the issuer or any of its subsidiaries; or

(B) to a third party in respect of a debt or obligation of the issuer or any of its subsidiaries for which the director has himself assumed responsibility in whole or in part and whether alone or jointly under a guarantee or indemnity or by the giving of security;

(ii) any proposal concerning an offer of shares or debentures or other securities of or by the issuer or any other company which the issuer may promote or be interested in for subscription or purchase where the director is or is to be interested only as a participant in the underwriting or sub-underwriting of the offer;

(iii) any proposal concerning any other company in which the director is interested only, whether directly or indirectly, as an officer or executive or shareholder or in which the director is beneficially interested in shares of that company, provided that he, together with any of his associates, is not beneficially interested in five per cent or more of the issued shares of any class of such company (or of any third company through which his interest is derived) or of the voting rights;

(iv) any proposal or arrangement concerning the benefit of employees of the issuer or its subsidiaries including :-

(A) the adoption, modification or operation of any employees' share scheme or any share incentive or share option scheme under which he may benefit and does not provide in respect of any director as such any privilege or advantage not generally accorded to the class of persons to which such scheme or incentive relates; or

(B) the adoption, modification or operation of a pension fund or retirement, death or disability benefits scheme which relates both to directors and employees of the issuer or any of its subsidiaries and does not provide in respect of any director as such any privilege or advantage not generally accorded to the class of persons to which such scheme or fund relates; and

(v) any contract or arrangement in which the director is interested in the same manner as other holders of shares or debentures or other securities of the issuer by virtue only of his interest in shares or debentures or other securities of the issuer.

(c) The Companies Ordinance should be amended in accordance with the current Listing Rules (Rules 14.24 and 14.25 of the Main Board Rules and Rules 20.23 and 20.24 of the GEM Rules) so that contracts, transactions and arrangements in which directors (or connected persons) have an interest should be disclosed to shareholders and be subject to their approval if the value or consideration thereof is equal to or exceeds certain de minimis thresholds. However, the SCCLR was unable to come to a consensus on what the de minimis thresholds should be and wishes therefore to consult further on this issue. For further details, please refer to paragraphs 9.05 to 9.09 (below);

(d) The Companies Ordinance should be amended as previously proposed in paragraphs 7.09(e) and 7.09(f) of the Phase I Consultation Paper as follows :-

- This would provide for the civil consequences of a breach of the general rule if the directors, or, as the case may be, the shareholders' approval is not obtained. Under such circumstances, the transaction or arrangement will be voidable at the instance of the company or any shareholder. For commercial certainty, the company's or shareholder's right to avoid the transaction or arrangement will, however, be lost if:-

    - ➢ restitution is no longer possible;
    - ➢ if rights acquired by a third party in good faith and for value would be affected by the avoidance;
    - ➢ the arrangement is affirmed (where ratifiable) within a reasonable time by disinterested shareholders.

  The director or connected person will be liable to account to the company for any gain that he has made, and to indemnify the company for any loss or damage resulting from the arrangement or transaction. The section should be "without prejudice to any liability imposed otherwise than by that subsection";

- Section 162 of the Companies Ordinance should be expanded to deal with :-

    - ➢ "transactions" and "arrangements", as opposed to just "contracts" or "proposed contracts"; and
    - ➢ "connected persons" including relatives and associates of the director.

(e) All the proposals in this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

9. Shareholders' approval for connected transactions of significance involving Directors

Background

9.01 Other than in relation to payments to directors in connection with the loss of office, the Companies Ordinance does not require shareholders' approval for transactions involving directors or persons connected with them. This is in contrast with the position in other common law jurisdictions like the United Kingdom, Singapore and Australia, as well as the USA[16].

9.02 The SCCLR considered that the law in this respect should be brought into line with those of other common law jurisdictions. Section 8 of the Consultation Paper on Phase I of the Corporate Governance Review proposed that a statutory provision similar to Section 320 of the UK Companies Act should be adopted so that the approval of shareholders should be obtained in relation to any relevant transaction covering not only non-cash assets but the acquisition or disposition of all assets and other arrangements potentially benefiting the director or connected person. In this respect, the SCCLR sought the views of the public on :-

- the appropriate test for determining the requisite value;
- the triggering percentage for shareholders' approval requirement;
- the need for a de minimis figure and the amount thereof.

9.03 In addition, the SCCLR made also a number of related proposals on :-

(a) the definition of "connected person";
(b) that an interested controlling shareholder (and connected persons) should abstain from voting in the relevant transaction;
(c) that only the approval of the shareholders of the ultimate holding company is necessary;
(d) the consequences of breach of the requirement;
(e) the scope of the requirement should be extended to cover directors and connected persons of unlisted public companies as well as private companies.

9.04 Even though these proposals were confined to transactions involving directors, the principles applicable to directors (and connected persons) apply equally to controlling shareholders (and connected persons), notwithstanding that they were dealt with separately in the Phase I Consultation Paper as well as in this Paper.

9.05 The majority of the respondents to the SCCLR's Phase I Consultation exercise agreed with the adoption of a statutory provision along the lines of section 320 of the UK Companies Act 1985. They favoured the idea of adopting a de minimis figure but had mixed views on the level and percentage of the threshold

[16] For further details, please see paragraphs 8.01 to 8.21 of SCCLR's Consultation Paper on proposals made in Phase I of the Corporate Governance Review.

requirement for shareholders' approval. Very few of the respondents expressed views on whether the test should be by reference to the net asset or gross asset value of the company.

9.06 The current Listing Rules of the SEHK already contain a number of provisions dealing with connected transactions. Paragraph 28.2 of Part B of HKEx's Consultation Paper made the following proposals :-

> "We will amend the Rules so that the basis for the de minimis thresholds for connected transactions will refer to the total assets instead of the net tangible assets of issuers. Consequently, we will also adjust the relevant percentage level of the de minimis thresholds. The revised Rules will provide the following de minimis thresholds :
>
> (a) a connected transaction will normally be exempt from all the relevant reporting, announcement and shareholders' approval requirements if it is on normal commercial terms where the total consideration or value is less than the higher of :-
> (i) HK$1,000,000 or
> (ii) 0.01% of the total assets of the issuer and
>
> (b) a connected transaction will normally be subject to the reporting and announcement requirements if it is on normal commercial terms where the total consideration or value is less than the higher of :-
> (i) HK$10,000,000 or
> (ii) 1% of the total assets of the issuer."

9.07 A number of respondents to HKEx's consultation supported the retention of the net assets test rather than the adoption of a "total assets" test so as to avoid the uncertainty of the inclusion of intangible assets or other inappropriate accounting methods. Some respondents, however, were prepared to accept that a "total assets" test might be acceptable under certain circumstances to take into account the differing financial structures of companies. As such, HKEx considered that the net assets test would continue to be the norm, with an allowance for companies to choose a total assets test for "valid reasons"[17].

9.08 The SCCLR has further reviewed the issues taking into account the respondents' views in the Phase I Consultation exercise, the current Listing Rules, the proposals in HKEx's Consultation Paper and the results of HKEx's Consultation exercise.

Proposals

9.09 The SCCLR reconfirms the previous proposal in paragraph 8.22 of the Phase I Consultation Paper and proposes the adoption of a statutory provision modelled on Section 320 of the United Kingdom Companies Act 1985 to provide that connected transactions should be subject to disclosure and shareholders' approval if the total consideration or value is greater than or equal to certain de

[17] Consultation Conclusions on the Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues (January 2003), paragraphs 57 to 63

minimis thresholds. However, the SCCLR was unable to reach a consensus on what the de minimis thresholds should be and wishes to consult further on this issue with particular reference to the proposals in paragraph 28.2 of Part B of HKEx's Consultation Paper as outlined in paragraph 9.06 above. (Please see also paragraphs 8.06(c)(above) and 17.11 (below))

9.10 Subject to paragraph 10.21 (below), the SCCLR proposes that "connected persons" should include the following :-

- director's or controlling shareholders' children or step-children;
- spouse;
- trustee of any trusts in which the director or controlling shareholder, his spouse, children or step children are beneficiaries under the trust;
- any corporation associated with the director or controlling shareholder. The question of what should be regarded as a corporation associated with the director or controlling shareholder and what should be regarded as a controlling shareholder are discussed further in paragraphs 10.01 to 10.20 and paragraph 17.09 (below).

9.11 The SCCLR proposes also the following :-

(a) The Companies Ordinance should be amended in accordance with the current Listing Rules (Rule 14.26 of the Main Board Rules and Rule 20.42 of the GEM Rules) to make it a requirement that any connected person (including connected persons in relation to controlling shareholders) having an interest in a transaction shall abstain from voting at the general meeting where the transaction is considered for the purpose of approving it. For the purpose of this requirement, "interest" should, however, exclude the interest of a shareholder which is the same as the interest of other shareholders;

(b) Where several companies are interposed between the subsidiary party to the transaction and the ultimate listed holding company, the provision should be applied so that only the approval of the shareholders of the ultimate holding company is necessary, unless the subsidiary itself is a listed company, in which case, the approval of the shareholders of the subsidiary should also be required;

(c) The law should be amended to set out the consequences of a breach of the general requirement as previously proposed in paragraph 8.29 of the Phase I Consultation Paper as follows :-

    - The transaction should be voidable at the instance of the company or any shareholder, subject to rights of bona fide third parties for value, and the impossibility of restitution or ratification (where permissible) within a reasonable time;

- The director or connected person should be liable to account to the company for any profits and to indemnify the company against any loss or damage resulting from the breach of the provision;

- The liability of the director or connected person must be without prejudice to any other liability that may be imposed by law. As such, any criminal sanctions applicable to the director or connected person would continue to apply;

- In addition, should the company also be wound up within one year after the entry of the transaction is entered into, criminal penalties may be imposed on the officers involved in the breach of this provision. In addition, the burden would fall on the director or connected person to show that the transaction or arrangement is not a misappropriation of the company's assets.

(d) All the proposals in this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

10. Transactions between Directors or Connected Parties with an Associated Company

Background

10.01 At present, Chapter 14 of the Listing Rules regulates "connected transactions". However, the SCCLR found that the Listing Rules did not address arrangements and transactions entered into between a director of a listed company (or connected person) and an "associated company" of the listed company.

10.02 The SCCLR proposed in section 9 of the Consultation Paper on Phase I of the Corporate Governance Review that the problem could be addressed as follows :-

(a) The Listing Rules relating to connected party transactions should be extended to an "associated company", i.e. one in which the listed company controls the exercise of 20% or more of the voting rights of the equity share capital;

(b) The Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors (or connected persons) and an associated company;

(c) The proposed provision under the Companies Ordinance relating to shareholders' approval for connected transactions should also apply to arrangements between a director (or connected person) of a company or of its holding company, and an associated company of the company.

10.03 Most of the respondents to the SCCLR's Phase I Consultation supported in principle the proposals made but raised doubts on the appropriateness of using the control of the exercise of 20% or more of the voting rights of the equity share capital of a company to determine whether or not a company was 'associated'. Their main concern was that, as a company having only 20% voting power control over an associated company might not have actual control over the associated company, it might not be in a position to prevent the associated company from proceeding with a connected party transaction even if the company had disapproved it. They also did not favour the application of the proposals to private companies.

10.04 The issue has also been addressed in paragraph 26.9 of Part B of HKEx's Consultation Paper. This Paper made the following recommendations :-

> "We will amend the Rules so that transactions between connected persons of an issuer and an associated company of the issuer will be regulated as connected transactions if :-
>
> (a) the issuer and/or its subsidiaries hold not less than 20% of the voting power in such associated company; and
> (b) the issuer and/or its subsidiaries together with connected person(s) of the issuer (excluding connected person(s) at the subsidiary level have control over such associated company. Control here shall have the same meaning as stated in paragraph 30.5 of Part B of this Consultation Paper."

Paragraph 30.5 states that :-

> "Under SSAP 32, emphasis is placed not on the legal form but the substance of the relationship. Whether an entity is a subsidiary is determined by whether an enterprise has "control" over it. "Control" here means the power to govern the finance and operating policies of an entity "so as to obtain benefits from its activities."
>
> Control is presumed to exist if more than 50% of voting power is held. However, even if it owns 50% or less of the voting rights, control also exists where :-
>
> (a) by virtue of an agreement with other investors, it has the power over more than 50% of voting rights;
> (b) it has the power to appoint or remove a majority of the board (or the equivalent governing body);
> (c) it has the power to cast a majority of votes at board meetings (or meetings of the equivalent governing body); or
> (d) it has the power to govern the finance and operating policies of the enterprise under statute or pursuant to an agreement."

10.05 HKEx's proposal is broadly in line with the SCCLR's proposal except that HKEx takes into account the practicality issues arising from the governing of associated companies and proposed therefore to apply a criteria of "control" when regulating a transaction between a connected person and an associated company of an issuer.

10.06 However, as the use of a criterion of 20% voting power to determine whether or not a company was 'associated' did not receive the public's support, HKEx has decided therefore to drop the proposal.

10.07 The SCCLR has further reviewed the proposal taking into account respondents' views in the Phase I Consultation exercise, the current Listing Rules, the proposals in HKEx's Consultation Paper and the results of HKEx's consultation exercise. However, although the SCCLR reaffirmed the general rule that the Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors (or connected persons) and an associated company, it was unable to come to a consensus on the scoping criteria, i.e. the point at which a company or a director should be regarded as in control of another company for the purpose of connected party transactions.

Position in the United Kingdom

10.08 In the United Kingdom, the question of control of companies has been raised in the context of consolidated accounts and the implementation of the Seventh European Community (EC) Directive[18]. In this respect, the emphasis has shifted from the company to the broader concept of an undertaking and a key definition for the purpose of the parent/subsidiary relationship should be based on factual control through a right to exercise dominant influence.

10.09 The Seventh Directive provides for mandatory implementation by member states of tests based on legal control (Articles 1(1)(a), (b) and (d)) while tests based on factual control (Articles 1(1)(c) and (2)) are optional. The United Kingdom has, however, adopted, through legislative amendments[19], the implementation of tests based on legal control and factual control.

10.10 The Companies Act 1985 now contains two definitions of a holding company/subsidiary company, and employs two sets of tests to identify the companies or undertaking involved in the relationship.

10.11 For all purposes other than accounting, the definition is somewhat narrower and the tests are based only on legal control. The companies belonging to a group are designated as a "holding company" and "subsidiaries", and the group is taken as comprising only bodies corporate.

10.12 For accounting purposes (primarily for the preparation of group accounts), the definition takes a broader view and the tests are based not only on legal control but also on factual control. The companies or undertakings belonging to the group are designated as a "parent undertaking or a parent company (if it is a company) and "subsidiary undertakings". An undertaking is defined for this purpose as a body corporate, partnership, or an unincorporated association carrying on a trade or business with or without a view to profit, but only the

[18] EEC Council Directive 83/349 of June 13, 1983 O.J. L193/1
[19] United Kingdom Companies Act 1989 S.21

parent company (i.e. a corporate body) is required to prepare and lay consolidated accounts.

Tests based on legal and factual control

10.13 For the non-accounting and accounting purposes of the Companies Act 1985, one company is the holding company or parent undertaking of another company or undertaking if it controls it in any one of four ways (sections 285, 736 and 736A) as follows :-

- holds a majority of its voting rights.
- is a member of it and has the right to appoint or remove a majority of its board of directors.
- is a member of it and controls alone (under an agreement with other members) a majority of its voting rights.
- where a company is a parent undertaking or holding company of another company, it is treated as a parent undertaking or holding company in relation to all subsidiaries of that other company.

10.14 For accounting purposes, section 258 of the Companies Act 1985 inserted two additional tests as follows :-

- the parent undertaking has the right to exercise a dominant influence over the subsidiary undertaking by virtue either of provisions contained in the latter's memorandum or articles; or of a control contract (as defined in Companies Act 1985 Schedule 10A paragraph 4(2) i.e. a written contract conferring a right to exercise dominant influence over another undertaking which (a) is of a kind authorized by the memorandum or articles of the undertaking in relation to which the right is exercised and (b) is permitted by the law under which the undertaking is established.) (section 258(2)(c)).

- an undertaking will also be deemed to be a parent if it has a "participating interest" and it either exercises a dominant influence or it and the subsidiary are managed on a unified basis (section 258(4)).

10.15 "Right to exercise a dominant influence", as used in section 258(2)(c) of Companies Act 1985, is further explained in paragraph 4 of Schedule 10A to the Act as "a right to give directions with respect to the operating and financial policies of another undertaking which its directors are obliged to comply with whether or not they are for the benefit of that other undertaking".

10.16 "Participating interest" as used in section 258(4) is defined in section 260(1) as an interest in the shares of another undertaking held on a long term basis for the purpose of securing a contribution to its activities by exercise of control or influence resulting from its interest. Generally speaking, a holding of 20% or more of shares will give rise to the presumption of there being a "participating interest" unless the contrary is shown (section 260(2)).

10.17 Neither the term "dominant influence" nor the term "managed on a unified basis" in section 258(4) is defined in the Act. In particular, the statutory provision regarding the interpretation of the phrase "the right to exercise a dominant influence" referred to above does not apply here. Whether "dominant influence" has been exercised would very much depend on the facts of each case and can only be identified by its effect in practice.

Chapter 11 of the United Kingdom Listing Rules

10.18 Chapter 11 of the United Kingdom Financial Services Authority Listing Rules provides certain safeguards against directors or substantial shareholders (or associates of either) taking advantage of their position. Paragraph 11.4 imposes a disclosure and shareholders' approval requirement (subject to certain exceptions) on the company with regard to any transaction proposed to be entered into between the company with a related party.

10.19 A "transaction with a related party" is defined in paragraph 11.1 to cover transactions between the company or any of its subsidiary undertakings and a related party or any person who or any entity which exercises significant influence over the company.

10.20 A "subsidiary undertaking" is defined "as in Section 258 of the Companies Act 1985" and therefore incorporated into the Listing Rules the concept of "dominant influence" and the presumption of "participating interest".

Proposals

10.21 The test of control through the right to exercise dominant influence will become part of the legislation when the definition of "subsidiary" in the context of the Companies (Amendment) Bill 2003 which will be introduced into the Legislative Council shortly. Consequently, the SCCLR is inclined, in relation to the definition of "associated company", to adopt the test of control through the exercise of dominant influence to determine whether the company is associated with another company for the purposes of connected party transactions. It wishes, however, to seek the views of the public on such a concept and whether it should be introduced into either the Companies Ordinance or the Listing Rules to help define the scope of the disclosure and shareholders' approval requirements for connected party transactions.

10.22 Subject to paragraph 10.21, the SCCLR confirms the adoption of the previous proposals in paragraph 9.08 of the Phase I Consultation Paper as follows :-

(a) The Listing Rules relating to connected party transactions should be extended to an "associated company" and not limited to "subsidiaries". Instead of treating one in which the listed company controls the exercise of 20% or more of the voting rights of the equity share capital as an "associated company" for these purposes, the SCCLR now proposes to define an "associated company" as one in which the listed company has the right to exercise a dominant influence or that the listed company has a participating interest and it either exercises a dominant influence or it and the associated company are managed on a unified basis, following the concept under section 258 of the Companies Act 1985;

(b) The Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors or connected persons and an associated company;

(c) The proposed provision under the Companies Ordinance (section 9 above) would in addition equally apply to arrangements between :-

- the associated company of the company; and
- directors of the company or directors of its holding company or other persons connected with the director.

(d) All the proposals in this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

11. The Roles and Functions of the Chairman and Chief Executive Officer

Background

11.01 The SCCLR considered the question of the separation of the roles and functions of the Chairman and Chief Executive Officer. It noted that, in all the jurisdictions studied, there was no mandatory requirement that the roles should be separated. However, various corporate governance codes in the United Kingdom, Singapore, the United States, Malaysia and Australia all recommend that it should be best practice to separate the roles. Furthermore, where the roles are combined, it is normally required that this should be publicly disclosed.

11.02 In Hong Kong, however, the reality is that it would probably be difficult in the short to medium term, to achieve such a separation of roles in the generality of listed companies for the following reasons :-

(a) It may be difficult to find sufficient qualified persons to perform the role expected of a Chairman or who are willing to accept what may be regarded as higher responsibilities;

(b) More importantly, many listed companies have substantial shareholders who will tend to favour the appointment of a Chief Executive and Chairman in a combined role. Even if these companies were to formally adopt the practice of separating these roles in form, this would not address concerns that this would be cosmetic and, in many cases, not practical. Consequently, issues regarding the degree of independence the Chairman has from the substantial shareholder who is (most likely) the Chief Executive, or is in a position to influence the Chief Executive, would not be resolved.

Proposals

11.03 In view of the above considerations, the SCCLR did not find it possible to recommend that the separation of the roles and functions of the Chairman and

Chief Executive Officer should be a mandatory requirement. Furthermore, as this issue is one which is relevant only to listed companies, it should be covered by appropriate provisions in the Listing Rules and Code of Best Practice rather than the Companies Ordinance.

11.04 At a minimum, the SCCLR proposes that it should be considered best practice to separate the roles and functions of the Chairman and Chief Executive. This would help to reduce, while not necessarily guarantee, that the conflicts that could arise from combining the roles can be addressed. Under the Listing Rules in Hong Kong, sub-paragraph 9(2) of the Listing Agreement of the Main Board, directors are also required to disclose, in their annual reports, family relationships among directors and service managers. This could be extended to specifically deal with the relationship, if any, between a Chairman and a Chief Executive Officer.

11.05 Since the SCCLR considered the separation of roles and functions, the issue has been addressed in paragraphs 11.1 to 11.5 of Hong Kong Exchanges and Clearing Limited's (HKEx) Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues. The Consultation Paper made two recommendations in this respect as follows :-

(a) The Code of Best Practice would be amended to recommend separation of the roles of Chairman and Chief Executive as a good practice. However, in view of the practical issues in relation to the separation of these two roles, it was not proposed to make this a mandatory requirement;

(b) The Listing Rules would be amended to require issuers to disclose in their Annual Reports whether or not these two roles are segregated.

11.06 In the light of the favourable response to these two recommendations, HKEx will be making appropriate amendments to the Listing Rules and Code of Best Practice.

12. Board Procedures

Background

12.01 Board procedures concern the 'process' of decision making by the parties charged with directing and managing the business of a company. As such, they are very relevant for the purposes of making these decision makers accountable. Processes or systems of governance i.e. the ways in which boards work within the legal structure and the quality of people who make it work, are difficult to capture in legal terms and, generally speaking, cannot be sensibly incorporated into the law. However, guidance as to best practice and disclosures of these practices will, however, give investors better tools by which to assess the practices of the companies in which they invest.

12.02 In Hong Kong, the Code of Best Practice ("the Hong Kong Code") under the Listing Rules is "….. not intended to be rules which are rigidly adhered to. All issuers are encouraged to devise their own codes of practice in the interests not only of their independent non-executive directors, but of the board of directors as a whole". The Code contains certain guidelines on the procedures of a company. Listed companies must explain whether or not they are complying and give reasons for any incidence of non-compliance.

12.03 Board procedures are set out in the Hong Kong Code at Appendix 14A of the Listing Rules. These are as follows :-

The following are the procedures set out in Appendix 14A of the Main Board Listing Rules ("**Hong Kong Code**"): -

1. Full board meetings shall be held no less frequently than every six months. "Full" board meetings means meetings at which directors are physically present and not "paper" meetings or meetings by circulation.

2. Except in emergencies an agenda and accompanying board papers should be sent in full to all directors at least 2 days before the intended date of a board meeting (or such other period as the board agrees).

3. Except in emergencies adequate notice should be given of a board meeting to give all directors an opportunity to attend.

4. All directors, executive and non-executive, are entitled to have access to board papers and materials. Where queries are raised by non-executive directors, steps must be taken to respond as promptly and fully as possible.

5. Full minutes shall be kept by a duly appointed secretary of the meeting and such minutes shall be open for inspection at any time in office hours on reasonable notice by any director.

6. The directors' fees and any other reimbursement or emolument payable to an independent non-executive director shall be disclosed in full in the annual report and accounts of the issuer.

7. Non-executive directors should be appointed for a specific term and that term should be disclosed in the annual report and accounts of the issuer.

8. If, in respect of any matter discussed at a board meeting, the independent non-executive directors hold views contrary to those of the executive directors, the minutes should clearly reflect this.

9. Arrangements shall be made in appropriate circumstances to enable the independent non-executive directors of the board, at their request, to seek separate professional advice at the expense of the issuer.

10. Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer and should not accept the appointment if he cannot.

11. If a matter to be considered by the board involves a conflict of interest for a substantial shareholder or a director, a full board meeting should be held and the matter should not be dealt with by circulation or by committee.

12. If an independent non-executive director resigns or is removed from office, the Exchange should be notified of the reasons why.

13. Every director on the board is required to keep abreast of his responsibilities as a director of a listed issuer. Newly appointed board members should receive an appropriate briefing on the issuer's affairs and be provided by the issuer's company secretary with relevant corporate governance materials currently published by the Exchange on an ongoing basis.

14. The board should establish an audit committee with written terms of reference which deal clearly with its authority and duties. Amongst the committee's principal duties should be the review and supervision of the issuer'' financial reporting process and internal controls. For further guidance on establishing an audit committee listed issuers may refer to "A Guide For The Formation Of An Audit Committee" published by the Hong Kong Society of Accountants in December 1997. Listed issuers may adopt the terms of reference set out in that guide, except that the committee may have a minimum of two members, or they may adopt any other comparable terms of reference for the implementation of audit committees. The committee should be appointed from amongst the non-executive directors and a majority of the non-executive directors should be independent.

12.04 The SCCLR surveyed best practice in a number of major common law jurisdictions. As a result of this survey, a number of differences were noted as outlined in the following paragraphs.

Regularity of Board Meetings

12.05 Paragraph 1 of the Hong Kong Code states that companies should hold full board meetings no less than every six months. Most jurisdictions e.g. the United Kingdom, Singapore and Malaysia, require that the board should meet "regularly" with due notice of issues to be discussed and a record of its conclusions in discharging its duties and responsibilities. The Codes in these jurisdictions also suggest that the board should disclose in its annual report the number of board meetings held a year and the details of attendance of each individual director in respect of meetings held.

Proposals

12.06 The SCCLR proposes that the Hong Kong Code should provide that :-

(a) full board meetings shall be held no less frequently than every three months;

(b) the board should disclose in its annual report the number of board meetings held in a year and the details of attendance of each individual director.

Circulation of Information

12.07 Paragraph 2 of the Hong Kong Code suggests that, except in emergencies, an agenda and accompanying board papers should be sent in full to all directors at least two days before the intended date of a board meeting (or such other period as the board agrees). The principle adopted in other jurisdictions, such as Singapore, is that, in order to fulfil their responsibilities, board members should have complete, adequate and timely information be it for the purposes of board meetings and on an ongoing basis (Singapore Code of Corporate Governance, Board Matters, paragraph 6).

12.08 None of the Codes in the other jurisdictions surveyed specify the minimum number of days by which the board should receive the agenda and board papers for the purposes of meetings. Instead, the Codes suggest "due" notice of the issues to be discussed or that information should be provided in a "timely manner".

Proposal

12.09 The SCCLR proposes that the Hong Kong Code should provide that the agenda and board papers for the purposes of a board meeting should be sent in full to all directors in a timely manner and at least three days before the meeting.

Access to Information

12.10 Paragraph 4 of the Hong Kong Code provides that all directors, executive and non-executive, are entitled to have access to board papers and "materials". Where queries are raised by non-executive directors, steps must be taken to respond as promptly and fully as possible. Paragraph 5 also states that full minutes shall be kept by a duly appointed secretary at the meeting and such minutes shall be open for inspection at any time in office hours on reasonable notice by any director.

12.11 Other Codes also set out the importance of access to information for purposes more broadly and clearly so that it is understood that this information should be accessible for purposes other than a board meeting. The United Kingdom Combined Code, the Singapore Code of Corporate Governance and the Malaysian Code of Corporate Governance all contemplate that directors should have access to all information within a company whether as a board or in their individual capacities, in furtherance of their duties or on an ongoing basis.

Proposals

12.12 The SCCLR proposes that broader guidelines, than currently exist, might be useful as to what types of "materials" ought to be supplied to directors or that directors should look for and how they might access this information by reference to the obligations of the Board. In this respect, the Hong Kong Code should be amended to provide that :-

(a) Management has an obligation to supply the board with complete, adequate information in a timely manner. Reliance purely on what is volunteered by management is unlikely to be enough in all circumstances and further enquiries may be required if the particular director is to fulfil his or her duties properly. Hence, the board should have separate and independent access to the company's senior management;

(b) Information provided should include background or explanatory information relating to matters to be brought before the board, copies of disclosure documents, budgets, forecasts and monthly internal financial statements. In respect of budgets, any material variance between the projections and actual results must also be disclosed and explained.

Access to Professional Advice by Executive and Non-executive Directors

12.13 Paragraph 9 of the Hong Kong Code provides that "Arrangements shall be made in appropriate circumstances to enable the independent non-executive directors of the board at their request, to seek separate professional advice at the expense of the issuer". In the United Kingdom, the Cadbury Report (paragraph 4.18) recommended that directors should be able to obtain such advice as is necessary in performing their duties through a formalized procedure. This should, for example, be contained in a board resolution, in the articles of associations, or in the letter of appointment. The Singapore and Malaysian Codes also both provide that the board should have a procedure for directors, either individually or as a group, in furtherance of their duties, to take independent professional advice, if necessary, at the company's expense. In Australia, it is recommended that the company should have established procedures by which the board or individual directors can seek independent professional advice, at the company's expense, in carrying out their duties.

12.14 The current wording of paragraph 9 of the Hong Kong Code might be read to mean that (i) the request of all non-executive directors is necessary; and (ii) arrangements will be made on an ad-hoc basis in "appropriate circumstances". In contrast, the other jurisdictions suggest having an established system or procedure from the outset to enable directors to carry out their duties effectively and efficiently. The codes in other jurisdictions suggest that this avenue is also open to individual non-executive directors subject to approval of an appropriate committee, for the purpose of carrying out their duties.

Proposal

12.15 The SCCLR proposes that the Hong Kong Code should provide for a formalized procedure for individual directors, at their reasonable request, to obtain professional advice that is necessary to perform their duties at the expense of the company.

Access to the Company Secretary

12.16 The Cadbury Report (paragraph 4.25) takes the following view of the role of the company secretary :-

"The company secretary has a key role to play in ensuring that board procedures are both followed and regularly reviewed. The chairman and board will look to the company secretary for guidance on what their responsibilities are under the rules and regulations to which they are subject and how those responsibilities should be discharged. All directors should have access to the advice and services of the company secretary and should recognize that the chairman is entitled to the strong support of the company secretary in ensuring the effective functioning of the board."

12.17 The Combined Code and the Singaporean and Malaysian Codes all accept this practice and suggest the following best practices in relation to company secretaries: -

- Directors to have separate and independent access to the company secretary.

- The role of the company secretary should include responsibility for ensuring that board procedures are followed and that applicable rules and regulations are complied with.

- Removal of the secretary should be considered by the board as a whole.

12.18 There are suggestions that there is currently little interaction between directors and the company secretary in Hong Kong. However, there seems to be general support for the company secretary to perform the role of facilitating and implementing policy decisions of the board, and providing board support and, in some cases, acting as a channel of effective communication between executive directors and non-executive directors. It is suggested that that properly qualified company secretaries could assist in raising the standards of corporate governance practices.

Proposals

12.19 The SCCLR proposes that the company secretary should work closely with the chairman in advising directors of their duties and responsibilities under applicable rules and regulations; how these duties and responsibilities should be discharged; and for ensuring that board procedures are followed. All directors should have access to the advice and services of the company secretary. The required qualifications for the company secretary would be determined by the Stock Exchange of Hong Kong after taking the market situation into account.

A Formal Schedule of Matters for the Board's Decision

12.20 The board should have a formal schedule of matters reserved to it for decision to ensure that the direction and control of the company is firmly in its hands and act as a safeguard against misjudgments and possible illegal practices. The Cadbury Report (paragraph 4.23) proposed that there should be a schedule of matters that are given to directors on their appointments and kept up to date. Such a schedule might include matters such as investments in capital projects, authority levels, treasury policies and risk management policies. Boards might also agree on the procedures to be followed when, exceptionally, decisions are required between board meetings.

Proposal

12.21 The SCCLR notes that some of these matters are already provided for in the law e.g. section 155A of the Companies Ordinance, the Listing Rules and companies' Articles of Association. However, it is suggested that such a procedure would be of assistance both to the directors or, where appropriate, the company secretary to advise the board. This would, in particular, relate to matters that might be of particular importance given the circumstances of the company, or the type of industry concerned, that should be brought to the board's attention. In view of this, the SCCLR proposes that the Hong Kong Code should provide for such a procedure.

Relationship of Board to Management

12.22 In Hong Kong, the exact nature of the relationship of the board to management is likely to be undefined, especially given the probability that a large number of members of the board are likely to be executive directors. Nevertheless, in theory, many of the board's responsibilities can be delegated to management. In principle, the board is thought to function more effectively if it is able to do so independent of management. Thus, the Codes of Best Practice in many jurisdictions prescribe that there should be an adequate degree of independence of process and practice in place in order to allow directors to meet and actively exchange views. Without this ability, the board cannot adequately assess the company's directors and the performance of its management. In certain jurisdictions, it is proposed that the board and chief executive should develop position descriptions for the board and Chief Executive, involving defining the limits to the management's responsibilities. Furthermore, the board should approve, or develop with the Chief Executive, the corporate objectives which the Chief Executive is responsible for meeting.

Proposal

12.23 The SCCLR proposes that the Hong Kong Code should provide for such guidelines.

Setting the Agenda

12.24 The Cadbury Report (paragraphs 4.7 and 4.8) recommends that the chairman of the board should have the primary responsibility for organizing the information necessary for the board to deal with the agenda and for providing this information to directors on a timely basis. If the Chairman is also the Chief Executive, the board should also have in place a procedure to ensure that its agenda items are placed on the agenda and for providing this information to directors.

Proposal

12.25 The SCCLR proposes that the Hong Kong Code should be amended to provide that the chairman of the board should be primarily responsible for organizing the subjects to be included in the agenda. However, the chairman might delegate the work of drawing-up the agenda to the company secretary.

Board Committees

12.26 A company may establish board committees to examine various issues and make recommendations to the board. These committees can serve to implement and support the functions of a board in overseeing the company's management. Furthermore, non-executive directors can play a particularly important role on committees formed to discuss issues where executive directors might face conflicts of interest e.g. the audit of financial statements, the remuneration of senior executives and the selection of board members.

Proposal

12.27 The SCCLR proposes that, where the board appoints a committee, the board should spell out the committee's authority and terms of reference and the committee must report back to the board on its action at board meetings. The Hong Kong Code should be amended to contain the necessary provisions.

Review of the Hong Kong Code

12.28 As HKEx is currently reviewing the Hong Kong Code, these proposals have been forwarded to HKEx with the request that they be incorporated in the revised Code. However, as the review of best practice is a continuous process, any comments on the above proposals and suggestions for additional items for inclusion in the Hong Kong Code would be welcomed.

13. Audit, Nomination and Remuneration Committees

Background

13.01 The increased use of board committees on audit, nomination and remuneration over the past decade has played an important role in raising standards of corporate governance. Although the board must, by definition, retain ultimate responsibility, the existence of these committees helps to ensure that important board responsibilities are given proper focus and attention. However, in the final analysis, the mere existence of these committees will not lead to any improvement of corporate governance standards unless they are made up of truly independent non-executive directors (INEDs) who are prepared to contribute fully and robustly to the workings of these committees.

13.02 The SCCLR commissioned the City University of Hong Kong to undertake a consultancy on this roles and functions of Audit, Nomination and Remuneration Committees. The consultants employed four methods for their study as follows:-

(a) A comprehensive review e.g. academic literature and board practice surveys on the roles and functions of audit, nomination and remuneration committees in the United Kingdom, the USA, Australia, Canada, Malaysia, Taiwan, Singapore and Hong Kong;

(b) Interviews of the key regulators and representatives from government departments and prominent corporate governance experts from private sector institutes in the United Kingdom, the USA, Australia, Canada and Malaysia to ascertain their views on the key factors which contribute to effective board committees in their countries;

(c) A questionnaire to collect the opinion of the Chairmen or Chief Executive officers (CEOs) of Hong Kong listed companies on the effectiveness of the three board committees;

(d) Relevant corporate governance information including information on audit committees from the annual reports of Hong Kong listed companies in 1999 and empirical analyses on the relationship between board and audit committee characteristics and corporate performance.

13.03 As the Consultancy Report will be published separately only the main points are covered in this Consultation Paper. However, both the Interview Findings and Questionnaire Results revealed that, in the opinion of those polled, the quality and independence of INEDs were the most important factors contributing to good corporate governance in general and the effectiveness of audit, nomination and remuneration committees in particular.

13.04 The empirical analyses conducted by the Consultants also had the following findings:-

(a) The Annual Reports of 566 Hong Kong listed companies in 1999 showed that-

- A total of 342 listed companies or over half (60%) of the listed companies in 1999 disclosed that they have an audit committee;

- Out of those companies with audit committee, disclosure of the number of audit committee meetings was rare (7% disclosing that they had two meetings a year);

- The majority of audit committees had at least two INEDs;

- Only 2% of Hong Kong companies reported remuneration committees and 1% reported nomination committees for 1999.

(b) An analysis of the Hang Seng 100 companies in 1998 and 1999 showed that -

- There was an increasing trend of disclosure on the roles and functions of audit committees in 1999;

- There was a marked increase in the number of companies with audit committee (from 28 in 1998 to 76 in 1999);

- There was no disclosure of remuneration committees for 1998 and two disclosures in 1999;

- There was one disclosure of nomination committee in 1998 and two disclosures in 1999.

13.05 On the basis of the Consultants' analysis using 1998 and 1999 data collected from Hang Seng 100 annual reports, it is encouraging to note that Hong Kong listed companies have taken steps to improve their corporate governance practice. For example, there was a dramatic increase in the number of audit committees established in 1999 and more companies disclosed the work done by the audit committees during the year 1999.

13.06 Findings from the regression analyses of 408 companies for 1999 showed that the existence of audit committees was positively associated (at a marginally significant level) with better performance. In addition, in the case of companies with audit committees, it was found that the presence of more INEDs as committee members was associated with better performance. Further, studies by Professors Gul and Tsui of the City University of Hong Kong showed that those companies with audit committees were associated with lower audit fees suggesting that the existence of audit committee reduced control risks. For companies with audit committees, the results showed that companies with larger audit committee membership were associated with higher audit fees due to increased audit scope. This finding is consistent with the view that audit committees with more independent and diligent members would be more concerned with discharging their monitoring role and more supportive of the external audit function.

13.07 On the basis of the literature review, interview findings, questionnaire results and empirical analyses, the Consultants made a number of recommendations as outlined in the following paragraphs.

Audit Committees

13.08 The Consultants recommended that:-

(a) All listed companies should establish an audit committee with at least three non-executive directors (NEDs), with the chairman and the majority of its members being independent;

(b) All the NEDs and INEDs on the committee should have some financial expertise acquired either through accounting or financial management qualifications or experience;

(c) The role of the audit committee is to assist the board of directors to monitor and oversee the financial reporting process, the external audit and internal controls including the audit function and risk management;

(d) A charter stipulating the terms of reference of this committee should be disclosed in order that all members understand their role and responsibilities in the committee;

(e) The annual report should disclose the composition of the audit committee, the number of audit committee meetings and how it has discharged its responsibilities.

13.09 In terms of implementation, the Consultants recommended that a balanced approach be adopted. The requirement to establish an audit committee with at least three NEDs as members, the chairman being an INED and the majority of members being independent should be incorporated in the Listing Requirements of the Main Board and the GEM Board. Other detailed recommendations should be incorporated in the Hong Kong Code.

Remuneration Committees

13.10 The Consultants recommended that:-

(a) A remuneration committee should be established and consist wholly of NEDs with the chairman and the majority being INEDs;

(b) The remuneration committee should be responsible for recommending to the board the compensation policy as well as all aspects of compensation for key executives including all the executive directors and the CEO. The compensation for NEDs and INEDs should be a matter for the board. Disclosure of the individual members' remuneration including all aspects of their remuneration packages should be made in the annual report;

(c) The terms of reference of the remuneration committee together with composition, number of meetings and work done should be disclosed in the annual report;

(d) Ideally, there should be at least one member who is knowledgeable in executive compensation. Otherwise, external professional advice should be sought;

(e) The principle that no executives or NEDs or INEDs should have a role to play in determining his/her own compensation should be strictly adhered to;

(f) The composition, role and remuneration policy of NEDs should be disclosed and include :-

- an analysis of individual directors' remuneration including basic salaries, housing allowances, other allowances and benefits in kind;

- an analysis of directors' remuneration between 'performance-based' and 'non-performance-based' compensation;

- directors' share options including their individual benefits derived from the aggregate value realized on the exercised options during the year and the closing market price of shares at the balance sheet date.

13.11 In terms of implementation, the Consultants recommended that a balanced approach be adopted. The requirement to establish a remuneration committee/corporate governance committee with detailed requirements on the constitution of the committee should be incorporated in the Listing Requirements of the Main Board and GEM Board. Details of other recommendations should be incorporated in the Code of Best Practice.

Nomination Committees

13.12 The Consultants recommended that:-

(a) A nomination committee should be established with the chairman and a majority of its members being INEDs. This constitution is particularly important for Hong Kong because over 60% of listed companies are family owned or dominated by controlling shareholders and the quality of INEDs is the most critical element in corporate governance;

(b) The nomination committee should be responsible for making recommendations to the board on all new appointments including executives, NEDs and INEDs. It is also crucial that the CEO and Chairman should have some control/influence over the recommendation of executive directors to the board or its committees. However, the nomination of INEDs and NEDs should be the sole responsibility of this committee. One of the functions of this committee is to consider the best qualified candidates in terms of the skills and characteristics required for the membership of the board. Performance evaluation of individual directors should be undertaken by this committee on an on-going basis;

(c) There should be a charter stipulating the role and functions of this committee;

(d) Disclosures in the annual report should include: membership, terms of reference and responsibilities of members, procedures for recruiting and evaluating directors including executives, NEDs and INEDs.

13.13 In terms of implementation, the Consultants recommended that a balanced approach should be adopted. The requirement to establish a nomination committee/corporate governance committee with detailed requirements on the constitution of the committee should be incorporated in the Listing Requirements of the Main Board and GEM Board. Details of other recommendations should be incorporated in the Code of Best Practice.

Corporate Governance Committees

13.14 If nomination and/or remuneration committees are not established, the Consultants recommended that a corporate governance committee should be established as an intermediate step to formally establishing these committees. This is perhaps more appropriate for smaller companies where there may not be enough directors to formally constitute all the recommended committees. The appointment of a corporate governance committee with the duties as outlined below, plus the duties of the remuneration and nomination committees would likely be a feasible undertaking for all but the smallest of listed companies. It is also a logical step to the long-term goal of establishing separate nomination and remuneration committees as the company grows in size.

13.15 The corporate governance committee may be chaired by the chairman of the board, if that person is not also the CEO. The duties of the committee should include :-

(a) General responsibility for developing corporate governance policies;

(b) Proposing changes as necessary to conform with governance guidelines;

(c) Explaining the rationale behind the company’s practices if they do not follow corporate governance guidelines; and

(d) A forum for discussing the concerns of individual directors when the matters may not be appropriate for discussion at a full board meeting, such as the individual performance of other directors, or the company's approach to governance.

Audit Committees in Other Jurisdictions

United Kingdom

13.16 The Combined Code (paragraph D.3.1) states that the board should establish an audit committee. The Cadbury Report stated that the audit committee should consist of at least three directors, all non-executives, with written terms of reference dealing clearly with its authority and duties. Paragraph D.3.1 has enhanced the Cadbury Report by recommending that a majority of the audit committee be INEDs. According to paragraph D.3.2 'the duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the (external) auditors. Where the (external) auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money'.

13.17 In 1997, the Institute of Chartered Accountants of England and Wales (ICAEW) published 'Audit Committees: A Framework for Assessment' which helped to fill the gap in existing guidance often written on the assumption that the board wished to set up an audit committee and had a basic understanding of what it involves. A Framework for Assessment dealt with the assessment of audit committee performance and presented examples of good practice. In essence, the framework suggested that audit committees ask themselves a series of key questions and provided suggestions for resolving them. The publication draws on existing codes of best practice such as Cadbury and Greenbury, and provides guidance on how an audit committee could actually implement the recommendations. It could be looked upon as a 'how to' guide for audit committees.

13.18 Most recently, the Report 'Audit Committees: Combined Code Guidance' by Sir Robert Smith ('the Smith Report'), which was published in January 2003, gives guidance to assist company boards in making suitable arrangements for their audit committees, and to assist directors serving on audit committees to carry out their roles. It is proposed that the guidance shall apply in respect of accounting periods starting on or after 1 July 2003.

13.19 The Smith Report proposes, inter alia, that the Combined Code should be expanded and strengthened as follows:-

"**Combined Code: proposed section on audit committees**

1. We consider that the Code itself needs to be expanded and strengthened in this area. We propose the following:

D.3 <u>Audit Committee and Auditors</u>

Principle The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

D.3.1 The board should establish an audit committee of at least three members, who should all be independent non-executive directors. At least one member of the audit committee should have significant, recent and relevant financial experience.

D.3.2 The main role and responsibilities should be set out in written terms of reference and should include:

(a) to monitor the integrity of the financial statements of the company, reviewing significant financial reporting issues and judgements contained in them;

(b) to review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems;

(c) to monitor and review the effectiveness of the company's internal audit function;

(d) to make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;

(e) to monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements;

(f) to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm.

D.3.3 The audit committee should be provided with sufficient resources to undertake its duties.

D.3.4 The directors' report should contain a separate section that describes the role and responsibilities of the committee and the actions taken by the committee to discharge those responsibilities.

D.3.5 The chairman of the audit committee should be present at the AGM to answer questions, through the chairman of the board.

2. We also propose a small change to Code provision D.2.2, in order to bring it into

line with paragraph 5.10 of the guidance:

D.2.2 Companies which do not have an internal audit function should consider the need for one annually."

United States of America

13.20 The Securities and Exchange Commission (SEC) approved amendments to the listing standards of both the New York Stock Exchange (NYSE) and the North American Securities Dealers (NASDAQ) on audit committees and independent directors following the recommendations of 'The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees' (1999). Both the NYSE (Rule 303.01) and NASDAQ (Rule 4350(d)) now require every listed company to have a qualified audit committee that consists of at least three members and consist of independent directors only. Other requirements by the NYSE and NASDAQ on audit committees include the following :-

- The audit committee must have a formal written charter, outlining the committee's responsibilities and role;

- Each member of the committee shall be financially literate, defined as an ability to ask and evaluate questions, supplemented by a basic financial literacy that could be provided through in-house training;

- At least one member will have financial or accounting expertise, defined as having past employment in finance/accounting, a professional certificate in accounting, or relevant experience/background.

13.21 Most recently, the Sarbanes-Oxley Act (2002) contains a number of provisions directed at audit committees, of which several are to be implemented through NYSE and NASDAQ rulemaking. Interestingly, however, the Act does not seem to mandate that issuers must have an audit committee. The definition of an audit committee contemplates situations where there is no board committee acting as an audit committee, in which case, the definition of an audit committee includes the whole board of directors. However, the implications of the application of audit committee mandates to the whole board are unclear.

13.22 On 1 August 2002, the NYSE announced its final corporate governance rules, which include a number of provisions with respect to audit committees. Notably (as proposed), listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from NYSE rules, rather than having to comply with the specific NYSE requirements. The SEC is directed to adopt a rule effective no later than 270 days after enactment directing the national securities exchanges and national securities associations to prohibit the listing of any security of any issuer unless such issuer's audit committee meets certain requirements as to composition and operation. In this respect, the audit committee must :-

- be composed entirely of independent directors who do not accept any consulting, advisory, or compensatory fees, other than directors' fees, from the issuer and who are not affiliated with the issuer or any of its subsidiaries (although the Act gives the SEC exemptive authority with respect to these relationships);

- be directly responsible for the appointment, compensation and oversight of registered public accounting firms (including resolution of disagreements between management and the auditor regarding financial reporting for the purpose of issuing an audit report), and such firms must report directly to the audit committee;

- have the authority to engage, and determine the fees of, independent counsel and other advisors as they determine necessary; and

- establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Australia

13.23 A Working Group formed by the Australian Institute of Company Directors, the Australian Society of Certified Practising Accountants, the Business Council of Australia, the Law Council of Australia, the Institute of Chartered Accountants in Australia and the Securities Institute of Australia under the chairmanship of Henry Bosch published 'Corporate Practices and Conduct' (1995) (commonly called the Bosch Report). The Report states that :-

> " An audit committee should be set up in all companies with boards of four or more members. The committee should have a majority of non-executive members, preferably independent, a non-executive chairman, and have clear, written terms of reference. It should have access to the CEO/chairman, internal and external auditors, and all directors. As a delegated representative of the full board, the audit committee is responsible for issues of audit quality and effectiveness, coordination of the internal and external audit process, and should be the line of communication between the external auditor and management."

13.24 The Australian Stock Exchange (ASX) also provides an indicative list of matters that it considers relevant to corporate governance as guidance to companies, although it is not intended to be a guide to best practice itself. In September 2001, the ASX introduced Listing Rule 4.10 which requires listed companies to include a separate statement detailing the corporate governance practices in place. In order to help the companies to prepare this declaration, the ASX also published Guidance Note 9 of the Listing Rules on the Disclosure of Corporate Governance Practices, giving the indicative list of 'corporate matters' that should be reported.

13.25 The indicative list of corporate governance matters pertaining to audit committees that an entity may take into account when making the statement in its annual report under Listing Rule 4.10.3 is as follows :-

- "The main procedures the entity has in place for the nomination of external auditors, and for reviewing the adequacy of existing external audit arrangements (particularly the scope and quality of the audit)."

- "If a procedure involves an audit committee, set out, or summarise, the committee's main responsibilities and rights, and the names of committee members. If a member of the committee is not a member of the entity's governing body (e.g., director of the entity), state that person's position."

Although there is no statutory requirement for audit committees in Australian listed companies, evidence suggests that the largest companies (defined by sales) have voluntarily set up audit committees.

13.26 The Corporate Law Economic Reform Programme (CLERP), which was launched by the Australian Government in 1997 (which became the Corporate Law Economic Reform Program Act in 1999), aims to improve Australian business and company regulation as well as corporate governance in order to promote business, economic development and employment. Although CLERP did not recommend making the establishment of audit committees mandatory for Australian companies, it recognized the importance of audit committees in the corporate governance of the companies, and proposed that 'it may be desirable for the indicative list of corporate governance matters in the ASX listing rules to be appropriately enhanced to facilitate the disclosure by listed companies of their policies on audit committees.' The Australian Government believes that a non-prescriptive approach to audit committees is appropriate, and it is preferable for Australian corporate governance practices, including the setting up of audit committees, to develop in response to competitive economic, commercial and international pressures, rather than in response to prescriptive rules mandated by the Government.

Singapore

13.27 In Singapore, the audit committee is the only board committee mandated by the Singaporean Companies Act. Section 201B of the Act requires every listed company to establish an audit committee. It should comprise at least three members of which the majority of members, including the chairman, cannot be executive directors of the company or any related company (including foreign companies) or relatives of an executive director. The Audit Committee is expected to function independently of the executive directors and officers and to serve as a communication channel between the board and the external auditors on matters related to external audit. For the purposes of the appointment of audit committees, a NED is defined as 'a director who is not an employee of, and does not hold any other office of profit in, the company or in any subsidiary or associated company of the company in conjunction with his office of director and his membership of an audit committee' (Section 201B(10)).

13.28 Section 201B(5) prescribes the functions of an audit committee as follows:

- To review with the auditor, the audit plan, his evaluation of the system of internal accounting controls, and his audit report; the assistance given by the company's officers to the auditor; the scope and results of the internal audit procedures; and the balance sheet and profit and loss account, including the consolidated balance sheet and profit and loss account where relevant, before submission to the board of directors of the company or the holding company;

- To nominate a person or persons as auditor; and

- Such other functions as may be agreed to by the audit committee and the board of directors.

Remuneration Committees in Other Jurisdictions

United Kingdom

13.29 There are no legal or regulatory requirements for remuneration committees to be established in listed companies in the United Kingdom. However, every listed company must disclose how it applies corporate governance principles, and whether or not the company complies with the recommendations of the Combined Code. The Combined Code recommends that a company's annual report contains a statement of remuneration policy and the details of each director's remuneration packages including share options schemes and pension entitlements. It emphasizes the need for remuneration committees to be responsible to shareholders by warning against excessive remuneration.

13.30 The Combined Code's detailed recommendations on remuneration are summarized as follows :-

- A remuneration committee should be used for making recommendations to the board on matters of executive director remuneration;

- A remuneration committee should comprise solely of INEDs;

- A remuneration committee should consult with the Chairman/CEO on executive remuneration, and seek professional advice inside and outside the company where appropriate;

- The board, or a specially delegated sub-committee should set the remuneration of NEDs;

- Remuneration should be linked to company performance in order to align shareholder and board interests;

- No director is to be involved in deciding his or her own remuneration.

13.31 There remains, however, an interesting question as to whether United Kingdom companies have voluntarily complied with the Combined Code. A recent survey commissioned by the European Commission found that only 9% of United Kingdom listed companies had fully complied with all the recommendations of the Combined Code (Financial Times, 8 April 2002). This is clearly an area that warrants further study to determine why listed companies are not complying with certain parts of the Code.

United States of America

13.32 Companies in the USA are not required by law, the SEC rules or the Listing Rules of NYSE and NASDAQ to establish remuneration committees. The NYSE Listing Rules (Rule 203.01(D)) only recommend that listed companies include the identification of directors in the audit committee and other major committees of the main board in their annual reports. However, if companies registered under the Security Exchange Act of 1934 have established remuneration committees, the SEC regulation requires additional disclosures. Specifically, the company must disclose any committee member who is, at any time during the preceding fiscal year, an officer or director of the company or any of its subsidiaries (or formerly an officer of the company or its subsidiaries) or who had certain transactional relationships with the company (Regulation S-K Item 402(j)). In addition, the remuneration committee is required to issue a report that discusses the remuneration policy applicable to the company's executive officers, the basis for determining the CEO's compensation, and how the remuneration of executives and the CEO are related to company performance in the annual proxy statement (Regulation S-K Item 402(k)). On the other hand, the regulation does not contain any requirements on the composition of the remuneration committee.

Australia

13.33 The ASX Listing Rules require a listed company to provide a statement of the main corporate governance practices in place during the reporting period to allow investors to make their own assessments and conclusions about a company's corporate governance. The Bosch Report (1995) suggested that it is good practice to set up a remuneration committee to allow independent judgment to be exercised with respect to remuneration matters. Such a committee would be especially important if there was a large or powerful executive presence on the board. The committee should be led by an independent non-executive chairman, and consist of at least a majority of INEDs.

13.34 Guidance Note 9 of the ASX Listing Rules provides an indicative list of 'corporate matters' that should be reported in the statement regarding corporate governance in its annual report (Rule 4.10.3). These include the procedures for establishing and reviewing the compensation arrangements for the CEO, other senior executives and NEDs of the board. The statement should also summarize the committee's main responsibilities and rights, and the names of committee members.

Singapore

13.35 The Singapore Code of Corporate Governance (2001) recommends that every listed company should establish a remuneration committee comprising a majority of independent directors and chaired by an independent director in order to minimize the risk of any potential conflict of interest. At least one member of the remuneration committee should be knowledgeable in the field of executive compensation. Otherwise, the committee should obtain expert advice inside and/or outside the company on remuneration matters. The objectives of establishing remuneration committees are to facilitate appropriateness, transparency, accountability on the issue of executive remuneration and link up the performance of individual executive director and senior manager with the corporate performance in the remuneration setting process. The main function of remuneration committees is to recommend to the board a framework for remunerating the board and key executives, and to determine the specific compensation packages for each executive and independent director. The committee covers all aspects of compensation, including director fees, bonuses, options, allowances, salaries, benefits-in-kind, etc.

Nomination Committees in Other Jurisdictions

United Kingdom

13.36 There are no legal or regulatory requirements for nomination committees to be established in companies in the United Kingdom. However, the Combined Code recommends the establishment of a nomination committee as best practice. The Combined Code (paragraph A.5) states that there should be a formal and transparent procedure for the appointment of new directors to the board, and the best practice guide states that a nomination committee should be established to make recommendations to the board on all new board appointments. If the board is small, the provision implies that such a committee is not necessary. A majority of the members of this committee should be NEDs and the chairman should be either the chairman of the board on a NED.

13.37 Most recently, the Higgs Report recommends that all listed companies should have a nomination committee which should lead the process for board appointments and make recommendations to the board (suggested Combined Code provision A.4.1). In addition, the nomination committee should consist of a majority of INEDs. It may include the chairman of the board, but should be chaired by an INED (suggested Combined Code provision A.4.1).

United States of America

13.38 Companies in the USA are not required by law, the SEC rules or the Listing Rules of NYSE and NASDAQ to appoint nomination committees. The American Law Institute's (1994) 'Principles of Corporate Governance: Analysis and Recommendations' principle 3A.04, however, recommends that each publicly held corporation establish a nomination committee composed exclusively of outside independent directors. This committee has the task of recommending candidates for all directorships to the board. In addition, two recent developments in the USA to allow the nomination committee to fulfill its role and functions more effectively are 'out-sourced recruitment' and director education. These are discussed in section 14 on non-executive directors and section 15 on directors' training.

Australia

13.39 There are no legal or regulatory requirements for nomination committees in Australia. However, the ASX Listing Rules require a listed company to provide a statement of the main corporate governance practices in place during the reporting period, allowing investors to make their own assessments and conclusions about a company's corporate governance. The Bosch Report (1995) states that it is good practice to set up a nomination committee for the nomination of candidates to the board and for assessing performance of the CEO, the board, and individual directors. The committee should be led by an independent non-executive chairman, and consist of at least a majority of INEDs.

13.40 Guidance Note 9 of the ASX Listing Rules gives the indicative list of 'corporate matters' that should be reported. Those relating to nomination committees when making the statement in its annual report (Rule 4.10.3) are as follows :-

- The main procedures for:
  - devising criteria for membership of the board;
  - reviewing its membership; and
  - nominating representatives.

- If a procedure involves a nomination committee, to set out or summarise the committee's main responsibilities, the names of committee members and their positions in relation to the entity (e.g., director of the entity).

Singapore

13.41 There are no legal or regulatory requirements to establish nomination committees in listed companies in Singapore. However, listed companies are required to provide a statement of corporate governance that either acknowledges compliance with the Singapore Code of Corporate Governance (2001), or explains instances of non-compliance. The Code recommends a nomination committee of at least three directors, with a majority including the chairperson being independent, for companies listed on the Singapore Stock Exchange. The objective of establishing nomination committees is to make the process of board appointments transparent and to assess the effectiveness of the board.

13.42 The nomination committee should have written terms of reference that describe the duties and responsibilities of its members, and its membership should be disclosed annually. It is charged with making recommendations to the board on all board appointments, including independent directors, re-nomination of directors and performance evaluation of independent directors with particular attention to independence and performance of his/her duties as an independent director of the company.

Proposals

13.43 The SCCLR notes that the establishment of audit, nomination and remuneration committees is, in practice, mainly relevant only to listed companies. However, there is nothing to prevent 'intermediate companies' such as unlisted public and large private companies from establishing such committees if they believe that the nature and scope of their business operations requires this. Furthermore, with the exception of Singapore, all other major jurisdictions have dealt with the establishment of such committees through either the Listing Rules and/or Codes of Best Practice.

13.44 The SCCLR also notes that the establishment of these committees is now a recognized benchmark of the standard of corporate governance. As such, and given Hong Kong's status as a major international financial and business centre, it is necessary for Hong Kong to follow suit as failure to do so could result in adverse international perceptions of Hong Kong's commitment to corporate governance reform. However, it also recognizes that, in Hong Kong's circumstances, there are practical difficulties in establishing truly effective board committees. They are as follows:-

- The lack of sufficient numbers of qualified and 'independent' non-executive directors to sit on these committees. (The major issue of non-executive directors is addressed in section 14);

- Given the very high percentage of family controlled listed companies, the practical impact of such committees could be limited since, in many cases, the members would probably act in accordance with the wishes of the majority shareholders. This would be particularly true in the case of nomination committees where any nomination made by the committee could be defeated by the majority shareholders;

- Whereas audit committees are now a well-established concept for listed companies, as they have been a requirement of the Hong Kong Code since 1994, the same could not be said of nomination and remuneration committees.

13.45 The SCCLR considers the Consultants' recommendation that the majority of the INEDs on an Audit Committee have some form of 'financial expertise' (irrespective of how this is to be defined) to be not a practical proposition, at least at present. However, it agrees that, for such committees to be able to function effectively, at least one such member should have 'financial expertize'.

13.46 In view of the above considerations, the SCCLR proposes that :-

(a) The Listing Rules should be amended to make it mandatory that all listed companies must establish an audit committee;

(b) The Hong Kong Code should be amended to make the establishment of nomination and remuneration committees in listed companies a recommended best practice;

(c) At least one INED on a listed company's audit committee should be required to have some 'financial expertise'. A retired partner of the firm auditing the company's accounts should be prohibited absolutely from acting as the chairman or member of an audit committee.

13.47 In parallel with the SCCLR's consideration of audit, nomination and remuneration committees, these issues have also been addressed in paragraphs 7.1 to 9.8 of Hong Kong Exchanges and Clearing Limited's (HKEx) Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance Issues. The Consultation Paper made a number of recommendations in this respect as follows :-

(a) The Main Board Rules will be amended to follow the GEM Rules so that establishing an audit committee will become a compulsory requirement;

(b) The Main Board Rules will be amended to require an audit committee to comprise at least three non-executive directors with a majority of INEDs;

(c) The Main Board Rules will be amended to require an audit committee to have at least one INED with appropriate financial qualifications or experience in financial matters;

(d) The Hong Kong Code will be amended to recommend that issuers establish a remuneration committee comprising a majority of INEDs;

(e) The Hong Kong Code will be amended to recommend that issuers establish a nomination committee comprising a majority of INEDs.

13.48 In the light of the favourable response to these and other recommendations, HKEx will be making appropriate amendments to the Listing Rules and Code of Best Practice. However, the SCCLR recognizes that the role and functions of audit, nomination and remuneration committees are evolving concepts and, in this respect, would be interested in receiving consultees' comments.

14. The Structure of the Board and the Role of Non-executive Directors

Background

The Role of Non-executive Directors

14.01 The existence of NEDs on company boards predates by many years the growth of concern and interest with 'corporate governance' in the course of the 1990's. In theory, a NED was a person who was brought onto a company board because of his or her expertise in a particular field and/or business acumen as this would assist in enhancing the company's performance and shareholder value. Furthermore, by virtue of the fact that they were 'outsiders', they could comment objectively, if not critically, on the company's management and operations thereby also helping to improve its overall performance.

14.02 The Cadbury Report (1992) in the United Kingdom emphasized the unitary nature of the board. The key test of a board's effectiveness was the positive inter-action of the executive directors (EDs) and NEDs. The section in the Cadbury Report on board effectiveness stated that :-

"4.4 Whilst it is the board as a whole which is the final authority, executive and non-executive directors are likely to contribute in different ways to its work. Non-executive directors have two particularly important contributions to make to the governance process as a consequence of their independence from executive responsibility. Neither is in conflict with the unitary nature of the board.

4.5 The first is in reviewing the performance of the board and of the executive. Non-executive directors should address this aspect of their responsibilities carefully and should ensure that the chairman is aware of their views. If the chairman is also the chief executive, board members should look to a senior non-executive director, who might be the deputy chairman, as the person to whom they should address any concerns about the combined office of chairman/chief executive and its consequences for the effectiveness of the board. A number of companies have recognized that role and some have done so formally in their Articles.

4.6 The second is in taking the lead where potential conflicts of interest arise. An important aspect of effective corporate governance is the recognition that the specific interests of the executive management and the wider interests of the company may at times diverge, for example over takeovers, boardroom succession, or directors' pay. Independent non-executive directors, whose interests are less directly affected, are well-placed to help to resolve such situations."

14.03 The Hampel Report (1998), which reviewed, inter-alia, the implementation of the Cadbury Report considered that this report had raised the profile of the NED which had been very beneficial. However, an unintended side-effect had been to over emphasize the 'monitoring role'. The Cadbury Committee, in fact, recognized this danger :-

" The emphasis in this report on the control function of non-executive directors is a consequence of our remit and should not in any way detract from the primary and positive contribution which they are expected to make, as equal board members, to the leadership of the company. "

14.04 The Hampel Report went on to state that :-

"3.8 Non-executive directors are normally appointed to the board primarily for their contribution to the development of the company's strategy. This is clearly right. We have found general acceptance that non-executive directors should have both a strategic and a monitoring function. In addition, and particularly in smaller companies, non-executive directors may contribute valuable expertise not otherwise available to management; or they may act as mentors to relatively inexperienced executives. What matters in every case is that the non-executive directors should command the respect of the executives and should be able to work with them in a cohesive team to further the company's interests."

14.05 Most recently, the Higgs Report (2003) considered that, while there might be a tension between the 'monitoring' and 'strategic' components of the NEDs' role, there was no essential contradiction. The section on the 'role of the non-executive director' stated that :-

"6.1 The role of the non-executive director is frequently described as having two principal components: monitoring executive activity and contributing to the development of strategy. Both Cadbury and Hampel identified a tension between these two elements.

6.2 Research commissioned for the Review drew a somewhat different conclusion. Based on 40 in-depth interviews with directors, the research found that, while there might be a tension, there was no essential contradiction between the monitoring and strategic aspects of the role of the non-executive director. Polarized conceptions of the role, the research noted, bear little relation to the actual conditions for non-executive effectiveness. An overemphasis on monitoring and control risks non-executive directors seeing themselves, and being seen, as an alien policing influence detached from the rest of the board. An overemphasis on strategy risks non-executive directors becoming too close to executive management, undermining shareholder confidence in the effectiveness of board governance.

6.3 The research concludes that it is important to establish a spirit of partnership and mutual respect on the unitary board. This requires the non-executive director to build recognition by executives of their contribution in order to promote openness and trust. Only then can non-executive directors contribute effectively. The key to non-executive director effectiveness lies as much in behaviours and relationships as in structures and processes."

14.06 In conclusion, the Higgs Report proposed that the Combined Code in the United Kingdom should contain a description of the role of the NED as follows :-

" **Strategy**: Non-executive directors should constructively challenge and contribute to the development of strategy.

Performance: Non-executive directors should scrutinize the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

Risk: Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.

People: Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning."

Directors' Duties and Functions : Legal Position

14.07 A review of the legal position in major common-law jurisdictions such as Australia, Canada, Hong Kong Malaysia, Singapore, the United Kingdom and the United States, indicates that, generally speaking, neither statute nor case law makes a distinction in terms of the duty of care in relation to EDs and NEDs. The exact degree or standard of care, skill and diligence that is applicable may vary from jurisdiction to jurisdiction. However, the general consensus of commentators is that, in view of modern commercial expectations, the law is likely to demand much higher standards of care, skill and diligence from a director than traditional case law demands.

14.08 In order to determine whether a director has met the requisite standard of care, skill and diligence expected of him, the courts have generally had regard to various factors including the functions that are to be performed by the director concerned. For this purpose, “functions” are to be taken to mean the powers that are to be exercised by the director, and the responsibilities that are used to define the director’s corporate tasks, and not the standard by which the director’s performance is to be judged. The determination of whether the director has met the relevant standards largely depends on the particular circumstances – including the directors’ functions or responsibilities – in each case.

14.09 In the United Kingdom, the test now appears to relate to the standard expected from a person undertaking those duties as a ‘director’ and not merely that of a ‘reasonable person’ which is the traditional negligence standard laid down in *‘Re: City Equitable Fire Insurance Co. Ltd [1925] Ch 407.* In *D’Jan of London Ltd [1993] BCC 646*, the test was held to include an objective test by reference to the standard in the English Insolvency Act 1986. Thus, in determining whether or not a director should be disqualified from acting as a director, the courts must be satisfied that the director should meet the standard of care with -

- the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as carried out by that director in relation to the company; and

- the general knowledge, skill and experience that the director has.

14.10 More recent English case law also supports the proposition that the standard of care expected of NEDs is much higher than the standard set under previous case law e.g. *Continental Assurance Co. of London plc [1996] BCC 888* and *Re Wimbledon Village Restaurant [1994] BCC 753*. A similar trend to tighten standards is also evident in Australia. In *Daniels v. Anderson [1995] 6 ACSR 607*, the Court of Appeal indicated that it considered the standard of skill, care and diligent to be the same regardless of whether the director is an ED or an NED. However, it accepted that the exact degree of care and skill expected of the director would vary depending on the size and business of the company, and whether the directors concerned were senior managers or non-executives.

14.11 However, despite this overall tightening of standards, the English law also appears to recognize that the practical duties of a director in one company will differ from those of a director in a different company, and that the responsibilities of individual directors within the same company may also vary. Thus, in determining whether the duty of care, skill or diligence has been met, the courts are still likely to have regard to the responsibilities of the director as an ED or NED. This view was re-iterated in the Hampel Report which stated :-

> “3.3 There is a view that non-executive directors should face less onerous duties than executive directors, since they will inevitably be less well informed about the company’s business. However, we support the retention of common duties in the interests of the unity and cohesion of

the board. Where the English courts are called upon to decide whether a director has fulfilled his or her duty, they have recently tended to take into account such factors as the position of the director concerned (e.g. whether he or she is a full time executive director or a non-executive director) and the type of company. We consider this to be a helpful recognition of the practical situation."

14.12 The SCCLR consulted previously on this issue in the context of the Consultation Paper on Phase I of the Corporate Governance Review (Section 11) when the overwhelming majority of respondents who commented agreed that there should be no statutory distinction between EDs and NEDs. However, the SCCLR wishes to reconfirm this decision in the light of subsequent events in the U.S.A. and continued calls that there should be a statutory distinction between EDs and NEDs.

"Independence"

14.13 Both the Cadbury and Hampel Reports emphasized the importance of "independence" as a quality of NEDs. The Cadbury Report stated that :-

"4.12 An essential quality which non-executive directors should bring to the board's deliberations is that of independence of judgement. We recommend that the majority of non-executives on a board should be independent of the company. This means that, apart from their directors' fees and shareholdings, they should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. It is for the board to decide in particular cases whether this definition is met. Information about the relevant interests of directors should be disclosed in the Directors' Report."

14.14 The Hampel Report agreed with the definition of "independence" in Cadbury and did not consider that it would be more practicable to lay down more precise criteria for independence. However, the Hampel Report went on to state that :-

"We agree with Cadbury that it should be for the board to take a view on whether an individual director is independent in the above sense. The corollary is that boards should disclose in the annual report which of the directors are considered to be independent and be prepared to justify their view if challenged. We recognize, however, that non-executive directors who are not in this sense 'independent' may nonetheless make a useful contribution to the board."

14.15 Most recently, the Higgs Report considered the issue of "independence" in terms, which are worth re-stating, as follows :-

"9.1 A major contribution of the non-executive director is to bring wider experience and a fresh perspective to the boardroom. Although they need to establish close relationships with the executives and be well-informed, all non-executive directors need to be independent of mind and willing and able to challenge, question and speak up. All non-executive directors, and indeed executive directors, need to be independent in this sense.

9.2 At least a proportion of non-executive directors also need to be independent in a stricter sense. There is natural potential for conflict between the interests of executive management and shareholders in the case of director remuneration, or audit (where decisions on the financial results can have a direct impact on remuneration), or indeed in a range of other instances.

9.3 Although there is a legal duty on all directors to act in the best interests of the company, it has long been recognized that in itself this is insufficient to give full assurance that these potential conflicts will not impair objective board decision-making.

9.4 Requiring a greater degree of independence on boards has been a central theme in the recent US corporate governance reform measures. The Sarbanes-Oxley Act requires all members of the audit committee to be independent. Under the new NASDAQ listing rules and the new NYSE listing rules, a majority of the board must be independent. The Bouton Report on corporate governance in France also recommended that half the board should be independent.

9.5 I agree with the conclusions of these reports that a board is strengthened significantly by having a strong group of non-executive directors with no other connection with the company. These individuals bring a dispassionate objectivity that directors with a closer relationship to the company cannot provide. In the light of the need to manage conflict of interests, the increasing role of the board committees, and the positive benefits of independence, **I recommend that the code should provide that at least half of the members of the board, excluding the chairman, should be independent non-executive directors.**"

14.16 In view of this, the Higgs Report recommends that the Combined Code in the United Kingdom should be amended to -

(a) provide that all directors have to take decisions objectively in the interests of the company;

(b) include a definition of independence as follows :-

"A.3.4. A non-executive director is considered independent when the board determines that the director is independent in character and judgement, and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement.

Such relationships or circumstances would include where the director:

- is a former employee of the company or group until five years after employment, or any other material connection, has ended;

- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;

- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;

- has close family ties with any of the company's advisers, directors or senior employees;

- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

- represents a significant shareholder; or

- has served on the board for more than ten years.

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination."

Two-Tier Board Structure

14.17 One way of strengthening the 'monitoring' role of the NEDs, it has been argued, is the adoption of a two-tier board structure as, for example, in Germany. Under this structure, a 'management board' of EDs is monitored, appointed and dismissed by a 'supervisory board'. The members of the supervisory board have some of the characteristics of NEDs and include employee as well as shareholder and management representatives although this is not a necessary feature of a two-tier system. An advantage of a two-tier system is that it can create a clear separation of management and monitoring functions. It also excludes EDs from NED appointments and enables NEDs to remove EDs from office.

14.18 However, a similar outcome may be achievable while retaining the unitary board. In the United States, many large corporations, while formally retaining such a board, now have boards consisting of a clear majority of independent directors. Day to day management is conducted by a separate management led by the Chief Executive or often the Chairman. In the United Kingdom, the practice of delegating day to day management and major operational questions to a management board while reserving major strategic and monitoring functions to the board proper is becoming increasingly common. Similar practices can also be observed to be taking place in Hong Kong amongst some listed companies.

14.19 However, while the formal two-tier structure may strengthen monitoring by formally separating supervisory and management roles, it has significant disadvantages. Members of the supervisory board may have a poorer understanding of the business and more limited access to information than members of the management board. Furthermore, they cannot fully perform the strategic and relationship roles which are the fundamental rationale for having NEDs in the first place (*pace* Cadbury and Hampel). In this respect, the obligation to supervise cannot sensibly be separated from the obligation to manage without diluting accountability to an extent that is unacceptable. While the fact that NEDs currently perform a strategic function may arguably reduce the effectiveness of monitoring to some extent, this may be more than compensated for by the value of the independent viewpoint that they bring to strategy formation. This is widely recognized as a strength of the unitary board system.

Appointment of Independent Non-executive Directors by Minority Shareholders

14.20 Another alternative to the 'two-tier' board structure as a means of monitoring corporate performance is to have INEDs appointed by the minority shareholders as only thus, as it is argued by some, can their 'independence' be guaranteed. While this may appear superficially attractive, at least from the perspective of shareholder activists, there are very fundamental objections, both conceptual and practical as outlined below.

14.21 First, such a move would undermine the essential unity of the board which is so essential for driving as well as monitoring corporate performance. It would create a 'them' and 'us' culture where creative and pro-active dialogue and constructive criticism would tend to be replaced by totally unnecessary and negative institutionalized confrontation. Furthermore, in such a situation, the EDs would find working with the INEDs virtually impossible, particularly if the INEDs had a sectional agenda to pursue. Consequently, key corporate governance mechanisms such as the Audit and Remuneration Committees could not function. In the words of the United Kingdom's Company Law Reform Steering Group (CLRSG), 'there is ….. a legitimate case for allowing the executive team to have a say in approval of colleagues with whom they are expected to work' (paragraph 3.140 of Consultation Paper No. 5). While it is recognized that family controlled companies may create a difficult operating environment for INEDs, there also exist family controlled companies in Hong Kong which recognize the value of the contribution made by INEDs. What is important is the company's corporate culture and the existence of a 'mature' board which tolerates and responds to dissenting views.

14.22 Secondly, directors are expected to work in the interests of the company as a whole irrespective of whether they are EDs, NEDs or INEDs. If INEDs were to represent only the minority shareholders, they would inevitably have to give preference to a particular sectional interest over that of the company as a whole. In other words, there can be no guarantee that INEDs elected by minority shareholders will act altruistically in the interests of the company as a whole. There is just as great a danger of such INEDs acting in just as self-interested a manner as the majority shareholder(s) are frequently accused of.

14.23 Thirdly, there can be no guarantee that there will be complete uniformity in the views of minority shareholders on any given issue. In the event that there is disagreement, how is an INED to decide which line to take?

14.24 Fourthly, it is well-established best practice that the memberships of a company's audit and remuneration committees should consist solely or at least a majority of INEDs. If the INEDs were appointed by a minority, it would be totally inequitable for them to dominate key corporate governance mechanisms such as these committees which oversee the good governance of a company for the benefit of all its members.

14.25 Fifthly, minority shareholder interests can be protected by requiring the INEDs to take special care of these interests and formally stating that, if minority shareholders have any concerns, they can take them to the INEDs. The Australian case of *Duke Group Ltd v. Palmer [1998] ALCL* illustrates that there will be occasions where the INEDs are called upon to protect the interests of minority shareholders.

14.26 Sixthly, 'independence' does not mean necessarily being 'independently elected'. It is more accurately characterized as possessing 'independence of mind and judgment'. While these qualities can and frequently do exist in a NED, quite irrespective of the closeness of his relationship to the company's management, perception is critically important. In view of this, there have to be objective criteria for determining 'independence' e.g. in the Listing Rules.

14.27 Seventhly, it is highly unlikely that many, if any, directors would wish to stand for election by this route as it would involve -

(a) submitting to election by a small group which, by definition, was not representative of the company's shareholders as a whole and the directorship would therefore not have as much status as that of a 'full' director;

(b) 'institutionalized confrontation' which is, rightly or wrongly, alien to Hong Kong's corporate culture in the board room, at least at present.

Practical Issues

Numbers of Non-executive Directors

14.28 At present, there are about 800 companies listed on the Main Board with boards comprising, say, 10 to 12 members. Consequently, the recommendation in the Hong Kong Exchanges and Clearing (HKEx)'s Consultation Paper that a third of the members should be INEDs, if it had proceeded, would require approximately a minimum of 3,000 INEDs. In the Hong Kong Society of Accountants' Best Corporate Governance Disclosure Awards 2002, a total of 120 company reports were entered into the competition of which, inter-alia, a number of Hang Seng and a number of Non-Hang Seng Index Companies were short-listed for further consideration by the panel of judges. The companies, together with the mix of EDs, NEDs and INEDs, included the following -

Company	EDs	NEDs	INEDs
• CLP Holdings Ltd	4	9	4
• HSBC Holdings plc	8	2	11
• Li and Fung Ltd	8	3	4
• Swire Pacific Ltd	6	3	3
• First Pacific Company Ltd	4	4	2
• Hong Kong Exchanges & Clearing Ltd	1	-	14
• Hsing Chong Construction Group Ltd	6	1	4
• Kerry Properties Ltd	5	1	3
• Tai Fook Securities Group Ltd	7	6	2

It is clear from this table that many, but not all, of the companies have two or more INEDs on their boards. Furthermore, on the assumption that these companies are indicative of best corporate governance practice in Hong Kong, the position is likely to be worse in other listed companies particularly the third and fourth liners given that the minimum number of INEDs required under the Listing Rules is only two. Consequently, now that HKEx has dropped the previous proposal to increase the number of INEDs on listed company boards, it seems likely that they will continue to be in the minority on the majority of listed company boards.

14.29 The SCCLR considers that there would be major practical difficulties in stipulating that INEDs should make up a specified percentage of a board's membership. Furthermore, as quality is more important than quantity, a rigid insistence on having a specified number of INEDs would not necessarily enhance corporate governance. However, given that either all or the majority of the members of audit, nomination and remuneration committees are required to be INEDs as a matter of best practice, it would be difficult to manage effectively with only two INEDs. Furthermore, if there are only two INEDs and one of them cannot attend a board meeting, it would be extremely difficult for the remaining member to maintain an "independent" line. Consequently, in order to ensure that at least two INEDs are available at any moment, it would be necessary to have a minimum of three INEDs on the board. Subsequently, the number of INEDs would be increased until they comprised, say, one-third of the board.

Appointment of Non-executive Directors

14.30 The Higgs Report has highlighted the 'high level of informality' surrounding the process of appointing NEDs in the United Kingdom, the main methods being personal contacts or friendships, and a similar state of affairs is know to prevail in Hong Kong. The Report considered that "all listed companies should have a nomination committee which should lead the process for board appointments and make recommendations to the board" (paragraph 10.9). Furthermore, the nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but should be chaired by an independent non-executive director (paragraph 10.9).

14.31 However, in the United Kingdom, almost all the FSTE 100 companies have a nomination committee whereas, in Hong Kong, very few HSI companies have a nomination committee. Consequently, until nomination committees become a more widespread feature of Hong Kong companies, consequent to the proposed amendments to the Hong Kong Code, it would not be realistic to expect nomination committees to play a major role in the selection of NEDs. However, where they exist, they should be required to play a leading role in the selection of NEDs and, where they do not exist, the board should consider adopting more formal recruitment processes to 'tap' good potential sources of NEDs.

Sources of Non-executive Directors

14.32 As regards sources of potential NEDs/INEDs, there are no easy solutions. If the principle for the appointment of NEDs is their contribution to the development of the company's strategy, it would be helpful if they had some business background or knowledge but this is not essential. What is essential, however, is that they demonstrate an active interest in the company's business and are prepared to engage in constructive, robust debate regarding the formulation of the company's overall strategy. Furthermore, given the closely-knit nature of the upper echelons of Hong Kong's business community, many good potential NED candidates may not be sufficiently 'independent' therefore preventing them from becoming INEDs. Possible sources of NEDs/INEDs are therefore not and, in view of the potential numbers involved, cannot be limited to businessmen. Furthermore, given the nature of the work of audit committees, it is essential that at least one member of the committee has 'financial competency' no matter how this is defined. The Higgs Report also recommended that lawyers, accountants, consultants, directors of private companies and 'individuals in charitable or public sector bodies who have developed strong commercial and market understanding' could be considered as good potential sources of NEDs (paragraphs 10.29 to 10.31).

14.33 The consultancy report on audit, nomination and remuneration committees undertaken by the City University of Hong Kong also suggested that companies look overseas for potential NEDs. However, except in the case of exceptionally large listed companies with a global outreach, this may not be a realistic solution for many companies, notwithstanding the existence of facilities such as teleconferencing. To be an effective NED, the individual has to engage with other members of the board and have a first hand knowledge of the company's operations on the ground. This means inter-acting with other board members and the company outside the confines of the board room, and this cannot be achieved if the NED is non-resident in Hong Kong. However, the Higgs Report noted that 'all companies operating in international markets could ….. benefit from having at least one international non-executive director with relevant skills and experience on their board' (paragraph 10.28).

14.34 A recent trend in the way EDs, NEDs and INEDs are recruited is through the use of executive recruitment agencies. In this respect, a major executive search firm based in the U.S.A. with offices around the world reported a threefold increase in the number of searches for EDs, NEDs and INEDs in 2001 as compared to 1995. Two advantages of using executive recruitment agencies to assist a nomination committee in recruiting members to the board have been identified. First, these recruitment firms can increase the pool of director candidates through their global database and search process. Secondly, they could also have a higher level of independence than members of a nomination committee in identifying more qualified INEDs. This is particularly relevant for developing capital markets where the pool of local INEDs is limited. Consequently, an 'out-sourced recruitment' strategy could be an efficient way of recruiting highly qualified and experienced INEDs with a global perspective.

Part-Time Directors

14.35 One of the fundamental problems with NEDs/INEDs is that they can be, at best, no more than part-time directors. Consequently, there is a very clear limit to what can be reasonably expected of them and what they can achieve quite irrespective of the individuals' own personal qualities and experience. This limit to expectations is particularly important to bear in mind when considering how much can be reasonably expected of board committees such as the audit, nomination and remuneration committees whose memberships should consist exclusively of INEDs or a majority of INEDs. In the cases of the nine companies reviewed in paragraph 14.28 (above), the membership of the audit committee comprised, typically, two to four INEDs who met two to four times a year. Given this, the nature of the audit committees' work has to be essentially reactive, and it is totally unrealistic to expect them to adopt a consistently proactive, intrusive approach unless the membership comprises full-time or near to full-time NEDs which would make them little different from EDs. If this happened, the NEDs would therefore cease to be intelligent, informed 'outsiders', at a distance from the company which is the whole point of having NEDs in the first place.

14.36 In the aftermath of the string of corporate scandals in the United States e.g. Enron, World Com etc., the expectations of what, for example, audit committees and NEDs can or should achieve need to receive a salutary dose of reality. Audit committees are not 'bloodhounds' but 'watch-dogs' and much of their effectiveness is dependent as much on the quality of the company's financial director, external auditors and internal auditing systems as the quality of the NEDs. Both the Cadbury and Hampel Reports laid down sensible guidelines for the remit and functioning of audit committees on the basis that they consist primarily of part-time directors and should normally meet at least twice a year. However, given the need that the NEDs are 'part-timers', it is essential that they are fully engaged with the company's affairs during the few meetings a year which they attend. In turn, this lead to the question of the adequacy (or otherwise) of remuneration and the number of other directorships which they may hold.

Remuneration

14.37 The adequacy of NEDs/INEDs' remuneration is of some importance because, unless they are appropriately remunerated, it will be difficult, if not impossible, to appoint persons of appropriate calibre and ensure that, once they are appointed, they are totally focused on the company's affairs during meetings of the board and various committees. The Higgs Report (paragraph 12.24) stated that –

> " Remuneration for directors needs to be sufficient to attract and retain high calibre candidates but no more than is necessary for this purpose. **The level of remuneration appropriate for any particular non-executive director role should reflect the likely workload, the scale and complexity of the business and the responsibility involved.** In practice, it may be helpful in assessing remuneration for non-executive directors to use as a benchmark the daily remuneration of a senior representative of the company's professional advisers. The risk of high levels of remuneration (or a large shareholding) prejudicing independence of thought is real and should be avoided. Where a non-executive director has extra responsibilities (such as membership or chairmanship of board committees), the total remuneration should reflect these. I recommend that **non-executive directors' fees should be more clearly built up from an annual fee, meeting attendance fees (to include board committee meetings) and an additional fee for the chairmanship of committees (typically a multiple of the attendance fee) or role as senior independent director.** The level of remuneration for non-executive directors should be a matter for the chairman and the executive directors of the board."

14.38 The proposals outlined above provide a sensible and clearly understandable basis for remunerating NEDs although this is clearly a matter for the company concerned. In addition, there may be merit in the current practice of some companies giving their NEDs the opportunity to take part of their remuneration in the form of shares in lieu of cash as this would help to align the interests of the director with the long term interests of the shareholders. However, the Higgs Report considers that NEDs should not hold share options over the shares of their company as this runs the risk of an undesirable focus on share prices rather than underlying company performance.

14.39 In the final analysis, the way in which a company remunerates its NEDs is a matter for the company to decide. However, unless they are paid an appropriate amount commensurate with their responsibilities and duties, it is unlikely that it will be possible to attract persons of quality to maintain a high standard of corporate governance in the company.

Other Directorships

14.40 Equally, it will be difficult for a NED to be totally focused on a company affairs if he is also a director on many other company boards. In Hong Kong, it is not uncommon for directors to have over 50 other directorships and, in extreme cases, several 100 other directorships. Many of these multiple directorships can be explained by the existence of wholly-owned subsidiaries so the apparent dilution of the director's time and talents may be more apparent than real. Furthermore, as an individual's ability to function effectively and efficiently as a director will vary from person to person, it may be possible for a particular individual to function perfectly adequately as a NED in a number of companies. In view of these considerations, it would be difficult to stipulate a limit which, by its nature, would have to be purely arbitrary, on the number of directorships which an individual can hold. The Higgs Report reaches the same conclusion.

14.41 Despite this, it is highly unlikely, all things being equal, that an individual could function adequately, let alone exceptionally, as a NED if he was also a NED in, say, more than six totally unrelated listed companies bearing in mind that the board usually meets six times a year and the NEDs will also be required to attend many of the board committees. Furthermore, if NEDs are to be focused during their part-time involvement with a company, the fewer other distractions they have, the better. In view of this, it is proposed that the directors of listed companies disclose in the company's annual report any other directorships they hold in companies which are not wholly-owned subsidiaries of companies of which the director was already a director. This requirement would apply equally to EDs as well as to NEDs given that it would be a matter of considerable concern if a full-time ED were to take on, say, more than one non-executive directorship in another company. Consequential amendments should be made to the Hong Kong Code.

Liability of Non-executive Directors

14.42 Many people may be deterred from joining company boards as they do not know what is expected of them. Furthermore, post-Enron, many good potential NEDs may be discouraged from serving on boards because of their potential liabilities in the event of a major corporate collapse or scandal. Once again, there are no easy solutions to this problem but two possible approaches are as follows :-

- The Hong Kong Code is revised to set out clearly the role and functions of a NED and the standard against which he will be measured (paragraphs 14.01 to 14.12);

- Extensive publicity is given to the proposed provision in section 165 of the Companies Ordinance (to be introduced by the Companies (Amendment) Bill 2002) which makes it explicit that a company may purchase and maintain for any officer of the company -

  — insurance against any liability to the company, a related company or any other party in respect of any negligence, default, breach of duty or breach of trust (save for fraud) of which he may be guilty in relation to the company or a related company; and

  — insurance against any liability incurred by him in defending any proceedings, whether civil or criminal, taken against him for any negligence, default, breach of duty or breach of trust (including fraud) of which he may be guilty in relation to the company or a related company.

Conclusion

14.43 While NEDs have a very important role to play on company boards, this role should not be over-stated and the expectations of what they can achieve in practice must be tailored to the realities of their positions as part-time directors who can devote only limited time to a company's affairs. Essentially, they should bring outside expertise and experience to assist and nurture a company's development. Given their status as 'outsiders', they are in a position to objectively monitor and make constructive criticism or proposal as appropriate and, where necessary, act as catalysts for taking remedial action. However, it would be both unrealistic and unreasonable to expect them to have the same detailed knowledge of and involvement in the company's affairs as the EDs. Furthermore, they are largely dependent on the information given to them by the EDs and the internal systems put in place by the EDs to do their work. In the final analysis NEDs are there to advise, to add value and, if necessary, to criticize and take remedial action: they are not there to do the EDs' work for them.

Proposals

14.44 The SCCLR proposes that :-

(a) The boards of listed companies should have a minimum of three INEDs and the long term objective should be for one-third of the board to comprise INEDs (paragraph 14.29);

(b) Where they exist, Nomination Committees should take a more systematic approach to identifying suitable NEDs (paragraph 14.31);

(c) Sources of NEDs, having regard to the need to increase the numbers of INEDs, should be broadened to bring in directors with a wider range of abilities, skills and experience (paragraphs 14.32 to 14.34);

(d) The adequacy of NEDs' remuneration should be reviewed and companies disclose the system for deciding their remuneration in their annual reports. Consequential amendments should be made to the Hong Kong Code (paragraphs 14.37 to 14.39). The disclosure of all directors' remunerations is considered in section 16 (below);

(e) The directors of listed companies should disclose the number of other directorships which they hold, other than in wholly-owned subsidiaries, in their companies' annual reports. Consequential amendments should be made to the Hong Kong Code (paragraphs 14.40 and 14.41);

(f) The role, functions and standards expected of NEDs should be outlined in the Hong Kong Code (paragraph 14.42).

14.45 However, the SCCLR considers that there should be no statutory distinction between executive directors and NEDs, and that the "monitoring" role of NEDs should not be achieved through either a two-tier board or having INEDs elected by minority shareholders.

15. Directors' Qualifications and Training

Background

15.01 It is axiomatic that, to a very large extent, the quality of corporate governance in any company is dependent on the quality of its directors, both executive and non-executive. As a direct consequence, the issue of directors' qualifications and training has assumed a degree of considerable importance, particularly in the case of non-executive directors who, unlike the executive directors, will not have any 'hands-on' knowledge of the company's operations but will be expected to pay a significant role in developing the company's strategy and helping to prevent corporate abuse.

15.02 The Research Study conducted by MORI for the Review of the role and effectiveness of non-executive directors undertaken for the Higg's Report (2003) had, inter-alia, the following findings :-

- Most non-executive directors (81%) received some sort of briefing or instruction when they started their role. For many, this occurred either before they were appointed or was informed. Less than a quarter received a formal introduction after appointments;

- Two thirds of non-executive directors have never received any training for this role (62%). Of those who have received training, four in five found it fairly or very useful (81%).

Although such a survey has not been commissioned in Hong Kong to date, it is expected that, all things being equal, the situation would be similar if not worse to that in the United Kingdom.

15.03 At present, the Hong Kong Institute of Directors ("HKIOD") is the principal professional body in Hong Kong concerned with providing directors with education and training. The HKIOD's training programme comprises two major components as follows :-

- Prescribed Seminar Programmes;
- Regular Continuing Professional Development (CPD) Programmes.

15.04 The HKIOD's prescribed seminar programmes are planned to deliver contents that are strategic and visionary rather than operational. The seminars, which are conducted by authorized tutors, combine both lectures and interactive discussion sessions in classes and self-study of handout notes and prescribed reference publications. The essential elements of core competencies include the 'New Director', 'The Role of Chairman', 'The Role of the Listed Board', and 'The Role of INED & Audit Committee'.

15.05 Under the HKIOD's credits programme, which has been in existence for over 10 years, completion of eight seminars, which must include the mandatory session on 'The Role of the Company Director', leads to the qualification of the 'HKIOD Diploma in Company Director'. The total professional hours required for the Diploma include 28 hours in class and seven hours in self-study. Seminar programmes organized in recent years include 'The Role of Company Director', 'The Role of the Board', 'The Role of the Managing Director' and 'The Role of Non-Executive Director'.

15.06 An alternative to the Credits Programme is attendance at a packaged programme with registration for the entire programme offered for a schedule fixed duration. Fast track programmes are designed for attendees who wish to complete a programme and obtain the Diploma within a defined period of time. Completion of 75% of the seminars, including the mandatory session on 'The Role of the Company Director' and a case presentation, qualifies for a Diploma. The total professional hours required for the Diploma include 27 hours in class and eight hours in self-study and a case analysis. The pilot course for this fast track programme was the 'Diploma in SME Directorship' which was launched in March 2002. The seminars covered by this Diploma include 'The Role of Company Director', 'Problems of Family Businesses & Using External Advisors', 'How to Pitch for Investments' and 'Boardroom Strategies & Practices'.

15.07 Another fast track programme is the 'Diploma in Listed Company Directorship' which is organized by the HKIOD, HKEx and the Hong Kong Securities Institute (HKSI). The curriculum is specifically orientated towards the directors of listed companies. The seminars covered by this Diploma include 'The Role of Company Director', 'Directing in the New Millennium', 'Accountability, Listing Rules and Compliance, Disclosure and Investor Relations' and 'Board Culture, Committees & Decision-Making for Directors'.

15.08 A further conceptual extension of the Diploma courses is a programme leading to an 'Advanced Diploma'. The curriculum for this Diploma will provide greater in-depth study of the cases and situation faced by directors. The first of these courses is planned for implementation in the second to third quarters of 2003.

15.09 The HKIOD also provides a Certificate Programme which, like the Fast Track Programmes, is offered to attendees in a package format over a fixed duration. Attendees must complete the entire course to qualify for a certificate. Certificate Programmes include: 'The New Director', 'Going Public', 'The Role of Chairman', 'The Role of Managing Director', 'The Role of Independent non-Executive Director and Audit Committee' and 'Introduction to Not-for-profit Governance'.

15.10 As well as the Prescribed Seminal Programmes, the HKIOD provides a wide spectrum of regular CPE programmes which provide directors with an opportunity to keep up-to-date with changes in company and securities law, corporate governance and commercial developments generally. The CPD programme structure includes presented seminars, theme workshops, professional talks and speaker meetings.

Other Jurisdictions

15.11 Although the HKIOD was the first Institute of Directors established in Asia, the institutes in other Asian jurisdictions such as Singapore and Malaysia are not far behind in developing directors' training and education. Furthermore, although the Mainland does not have such an Institute, the Chinese Securities Regulatory Commission (CSRC) and the China Academy of Social Services have launched frequent and, in some instances compulsory, training programmes linked with stringent rules from the CSRC. Developments in other jurisdictions are outlined in the following paragraphs.

United Kingdom

15.12 In the United Kingdom, the Combined Code recommends: 'Principle 1: Every listed company should be headed by an effective board which should lead and control the company.' A section of this principle states: 'Every director should receive appropriate training on the first occasion that he or she is appointed to the board of a listed company, and subsequently as necessary.' (Section A.1.6) All listed companies are required to report on how it applies the principles in the Combined Code. The Institute of Directors (IoD) offers a comprehensive set of education and training programmes, including the well-established and well-subscribed *Essential Directors' Programme* and the *IoD Company Direction Programme*, which leads to a Certificate upon completion (15 days) and a Diploma upon passing an examination (3 hours). A variety of seminars and workshops are regularly organized under the group headings of *The Effective Board, Strategy & Leadership, Directors' Skills, Finance, PLC Board*. Other services include conferences, events, board consultancy and executive coaching, etc and a popularly attended Annual Convention. A Chartered Director status was launched in 1999. To achieve this status, a candidate has to satisfy stringent requirements of examination, among other things, professional review, subscribing to the IoD Code of Professional Conduct and maintaining CPD hours.

15.13 More recently, the Higgs Report has recommended that –

- A comprehensive induction programme should be provided to new non-executive directors (paragraph 11.1) and is the responsibility of the chairman supported by the company secretary (paragraph 11.4);

- The chairman should address the developmental needs of the board as a whole with a view to enhancing its effectiveness. Resources should be provided for developing and refreshing the knowledge and skills of directors (paragraph 11.14).

United States of America

15.14 In the U.S.A., there are currently no legal requirements for director education, with several notable exceptions. In order to serve on the audit committee of a company listed on the NYSE, American Stock Exchange (ASE) or NASDAQ, a director must either be financially literate or become so within a reasonable period of time. The requirement, when applied to directors who are not financially literate, logically necessitates the education of the director to become financially literate. The NYSE states that the definition of financial literacy is up to the board in its business judgment. However, the ASE and NASDAQ define financial literacy as follows: 'Each member of the audit committee must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement, or become able to do so within a reasonable period of time after joining the committee.'

15.15 More recently, the Sarbanes-Oxley Act (2002) requires 'issuers' to disclose whether a 'financial expert' sits on the board's audit committee. The Act directs the SEC to propose no later than 90 days after enactment and adopt no later than 180 days after enactment rules requiring issuers to disclose in periodic reports whether or not their audit committee has at least one member who is a 'financial expert'. The term is to be defined by the SEC taking into consideration whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer, or similar position:

- an understanding of generally accepted accounting principles and financial statements;
- experience in the preparation or auditing of financial statements of generally comparable issuers; and the application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience with internal accounting controls; and
- an understanding of audit committee functions.

15.16 The National Association of Corporate Directors (NACD) and several other organizations believe that the requirements for director education should be strengthened. NACD believes that public companies should be required to disclose to the stock exchanges/NASDAQ whether or not they have had director education. Furthermore, the NACD has suggested that the exchanges/NASDAQ should make such education a mandatory requirement. The NACD, which was founded in 1977, is based in Washington DC, has 3,000 members, 8,000 customers and 12 local chapters throughout the USA. Its major education and training programmes include the fundamental programme of *Director Professionalism*, a number of other structured courses and an Annual Corporate Governance Conference.

Australia

15.17 Currently, Australia has no statutory or regulatory requirements which mandate director education and training. The Australian Securities and Investments Commission (ASIC) has indicated that it would like to see the ASX Listing Requirements stipulate that companies must indicate their policy towards director education and training and that director education and training is desirable. The Australian Institute of Company Directors (AICD) is in close dialogue with these two bodies and is preparing development of a Best Practice Guide to be released by the AICD with ASIC and ASX support. The AICD is engaged in extensive education and training for directors with a structured programme of 15 core education courses. Its *New Director Program* and *Company Directors Course* leading to Certificates and Diplomas are well subscribed and supported courses. The *Company Directors Course* is offered in tutorial, residential and correspondence modes, ranging from 30 to 37 hours in class and 60 hours in study. Various courses of specific foci and updates are offered throughout the year.

Singapore

15.18 Although neither the Singapore Government nor the Singapore Stock Exchange require compulsory training for directors, a Code of Corporate Governance has been accepted by the Ministry of Finance for adoption from 1 January 2003. Amongst other requirements, the Code requires a publicly listed company's audit committee to have 'at least two members ….. having accounting or related financial management expertise or experience …..' and for the company's Remuneration Committee, the Code specifies that it should 'have at least one member who is knowledgeable in the field of executive compensation, failing which the committee should have access to expert advice inside and/or outside the company.' In addition to its usual training courses, the Singapore Institute of Directors (SID) commenced training programmes in 2002 aimed at assisting its members to implement the recommendations of the Code. The SID organizes on a regular basis its *Company Directors Course* in four modules.

Malaysia

15.19 The Malaysian Code on Corporate Governance, which was released in March 2000, contains recommendations on directors' training under Best Practice in Corporate Governance. These require listed companies to provide orientation and education programme for new directors and specify this as an integral element in the process of appointing new directors. In July 2001, the Kuala Lumpur Stock Exchange (KLSE)'s new Listing Requirements (LR) came into force. The LR focused on corporate governance, transparency, efficiency, investor protection and confidence as well as adopted the recommendation on Best Practices in the Code in respect of training and education for directors. Paragraph 15.09 of the LR states that it is mandatory for every director of a listed company to undergo continuous training as prescribed by the KLSE. Practice Note 5.2001 of the LR prescribes programmes for directors, i.e. Mandatory Accreditation Programme (MAP) and Continuing Education Programme (CEP), setting out time frames and requirements for attendance. Paragraph 16.16 of the LR sets down the penalties for non-compliance.

15.20 Malaysia is the first jurisdiction in the world to make directors' training mandatory. The MAP commenced in April 2001, with a duration of 1.5 days (about 10 hours) for each course and a regular time-table. MAP modules cover such subjects as a director's fiduciary role, a director's statutory duties, the listing requirements, the regulatory framework, the fund-raising framework, the concept of corporate governance and the Code, the audit committee, general meetings, shareholders' rights, investor relations, the regulation of securities market, risk management and control, etc. Most of the courses are public programmes involving seminars, except for some in-house programmes conducted for listed companies upon request. The CEP will commence in the near future, with a requirement for directors to attend the CEP on an annual basis after completion of the MAP. Topics will include regulatory developments, corporate governance, internal control, risk management, ethics etc. There will be a minimum number of accreditation points from activities such as participation in seminars, workshops, conferences, being a speaker on relevant topics, attending post-graduate courses, writing books/articles, etc.

China

15.21 In the absence of an Institute of Directors, the China Securities Regulatory Commission (CSRC) assumes the role of educating and training directors from listed companies and enforces a stringent programme. The China Academy for Social Sciences (CASS) works in close conjunction with the CSRC. The CSRC organizes quarterly one-week seminars for the directors of listed companies, leading to a two-hour examination at the end of each seminar. The contents of these seminars include the roles and responsibilities of directors, rules and legislation in China, principles and situation analyses. In addition, the CSRC administers a qualifying examination for the Chairmen of boards of H-shares companies. The one-hour open-book examination consists of a mandatory Part I with 30 questions on listing rules in China with a Part II section on Hong Kong rules for individuals involved in publicly listed companies in Hong Kong. Given the requirement to have three INEDs on each listed board, with the prospect of increasing this number to one-third, the CSRC has, over the past year, introduced a training seminar for INEDs, which is organized on a monthly basis. The curriculum of the 4.5-day training course includes basic principles of corporate governance, the strategic role of the board, INEDs' rights, responsibilities and legal duties, INEDs' role in connected transactions, the audit committee, financial reporting and disclosure, remuneration committee and remuneration of directors and senior management, corporate governance cases in China and other jurisdictions and a three-hour examination.

15.22 It would therefore appear from the above that Malaysia is the only jurisdiction which has mandatory training and education for the directors of listed companies, although many other jurisdictions have well established training and education programmes for directors. The question is, therefore, whether Hong Kong should make initial director training and CPD programmes either —

- a mandatory requirement under the Listing Rules; or
- recommended best practice in the Hong Kong Code.

Proposals

15.23 The SCCLR does not believe that it would be either practical or desirable to make directors' training and qualifications mandatory at this stage for the following reasons :-

(a) Only one jurisdiction in the world has so far made directors' training mandatory and, at this stage, it is not possible to evaluate whether or not it has had any beneficial effect;

(b) It would be extremely difficult, if not impossible, to require current directors to undergo training, unless they were willing to do so.

Consequently, it would be necessary to 'grandfather' a very significant number of company directors which would tend to negate the impact of the mandatory requirement;

(c) In discharging their fiduciary duties, directors commonly rely on professionals such as lawyers, accountants, bankers and internal advisers. They have a responsibility to obtain professional advice from the company secretary or some other person charged with the obligation of ensuring compliance with the Companies Ordinance and the Listing Rules;

(d) Many of the problems faced by NEDs are due to their lack of information rather than their lack of knowledge. Furthermore, much malpractice and fraud related to issues such as excessive directors' remuneration and related or associated partly transactions has little, if anything, to do with lack of knowledge, qualifications and education;

(e) Mandatory qualifications and training could discourage good potential NEDs from becoming NEDs.

15.24 However, the SCCLR recognizes that, in practice, there are non-executive directors who do not know what responsibilities they have to the company. As a matter of principle, all directors should be required to have an appropriate knowledge of company law, the Listing Rules and the Hong Kong Code. In view of this, the Hong Kong Code should contain a requirement that a listed company has to disclose what arrangements are made to train its directors, particularly new NEDs, on both an initial and continuous basis, with particular reference to knowledge of company law, the Listing Rules and Hong Kong Code. Listed companies would be required to disclose in their annual reports either their compliance or reasons for non-compliance with this requirement in the Code.

15.25 Notwithstanding the above, the SCCLR recognizes that there are some arguments for making directors' training mandatory. These include the possibility that, unless the requirement is made mandatory, it is unlikely that much, if anything, will be done. Furthermore, the HKIOD's voluntary training programmes have, so far, reached only about 10% of listed companies. Despite this, the SCCLR's view is that, at least initially, the better course of action would be to make directors' training, particularly for NEDs, recommended best practice for new directors and for companies to disclose in their annual reports what arrangements are in place for directors training. A mandatory requirement would not necessarily ensure a better calibre of director and might also have the effect of deterring potentially good NEDs, most of whom are very busy people. However, the SCCLR would be interested in hearing other opinions.

16. Directors' Remuneration

Background

16.01 In recent years, there has been increasing public concern over the remuneration of the directors of listed companies. There has been considerable market pressure for improved corporate governance practices in relation to the level and disclosure of directors' and executives' remuneration.

16.02 Directors face a direct conflict of interest when setting their own remuneration in terms of their duty to the company, their accountability to shareholders and their own self-interest. This had caused not inconsiderable controversy over directors' pay in recent years. It is in shareholders' interests to see this issue dealt with satisfactorily if the integrity and reputation of business is not to be undermined.

Position in Hong Kong

16.03 Section 161 of the Companies Ordinance requires a company to disclose the aggregate amount of directors' emoluments in the annual accounts. Emoluments for this purpose include any emoluments paid to or receivable by any person in respect of his services as director of the company or any subsidiary or otherwise in connection with the management of the affairs of the company or any subsidiary.

16.04 If the company fails to disclose such information, the auditors are required to do so.[20] Despite the fact that shareholders could glean some information from the annual accounts, there is little they could do about it beyond complaining at an annual general meeting that the total amount was excessive.

16.05 In the case of companies listed on the Main Board, the minimum financial information relating to directors that has to be disclosed in their annual reports includes the aggregate of directors' fees, basic salaries, discretionary bonuses, contributions to pension schemes and an analysis showing directors' emoluments by bands.[21] In the case of companies listed on GEM, the relevant information must be analysed by individual directors (without any obligation to disclose their names).[22]

16.06 HKEx's Consultation Paper made a number of proposals regarding directors' remuneration. One proposal was to remove the current requirement of disclosure of directors' remuneration by bands and require listed issuers to disclose the following information relating to directors' remuneration and compensation packages in their annual reports:-

- Directors' remuneration and compensation packages by individual director showing the name of each director;
- Remuneration policy and long-term incentive schemes;
- Basis on which fees and other benefits for independent non-executive directors are determined; and
- Information on share options held by directors.

16.07 HKEx published its Consultation Conclusions on the proposed amendments in January 2003, one of which recommends changes to the Main Board listing rules

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[20] Section 161(8), Companies Ordinance.
[21] Paragraph 24, Appendix 16, Main Board listing rules
[22] Rules 18.28 and 18.29, GEM listing rules

requiring listed issuers to disclose the amount of remuneration and compensation for directors on an individual but "no name" basis. Since the existing GEM listing rules already have this disclosure requirement, no amendments are proposed. The proposal for disclosure of directors' remuneration on an individual, named basis will be included in the Code of Best Practice as a recommended good practice. It is also proposed to amend the Main Board Listing Rules and GEM Listing Rules to require issuers to give a general description of a company's remuneration policy and long-term incentive schemes and the basis on which independent non-executive directors' remuneration is determined.

Other Jurisdictions

United Kingdom

16.08 The notes to companies' annual accounts require disclosure of the aggregate amount of directors' emoluments, the aggregate gain made on exercise of share options and the aggregate amount for pensions and payments for loss of office.[23] Disclosure of directors' emoluments must include details of payments under long term incentive plans. Companies are also required in certain circumstances to give specific information about the highest paid director.

16.09 The listing rules, a breach of which may lead to the imposition of a penalty under the Financial Services and Markets Act 2000[24], require a listed company to include in its annual report and accounts a report containing, inter alia, its policy on executive directors' remuneration and the amount of each element in the remuneration package of each director by name.[25]

16.10 For financial periods ending on or after 31 December 2002 onwards, "quoted companies" as defined in the Directors' Remuneration Report Regulations 2002 (i.e. United Kingdom companies whose equity share capital are listed on the London Stock Exchange, the New York or Nasdaq exchanges or in a member state of the European Economic Area) are required to set out a large part of the information concerning directors' remuneration in the directors' remuneration report, which has to be approved by members at the annual general meeting. Matters to be included in the remuneration report include details of the remuneration committee; a forward looking statement of the company's policy on directors' remuneration, details of directors' service contracts; the amount of each director's emoluments and compensation; details of share option, pension rights and sums paid to third parties in respect of a director's services. The Regulations also require disclosures of the values of options granted and values realized by executives when options are exercised. They also require the disclosure of a performance line graph comparing, in respect of the company's last five fiscal years, the yearly percentage change in the company's cumulative total shareholder return with the cumulative total return of a broad equity market index chosen by the company.[26]

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23 Section 232 and Schedule 6 of the United Kingdom Companies Act 1985
24 Section 91 of the United Kingdom Financial Services and Markets Act 2000
25 Rule 12.43A of the United Kingdom Listing Rules
26 Paragraph 4, Director's Remuneration Report Regulations 2002

Australia

16.11 The requirements in relation to the disclosure of directors' remuneration are found in section 300A of the Corporations Act 2001. This section applies only to listed companies and requires that that the directors' report include :-

- Details of the company's policy on directors and senior executives' emoluments;
- A discussion of the relationship between such policy and the company's performance; and
- Details of the nature and amount of the emoluments of each director and the five named officers of the company receiving the highest emoluments. In addition, details of options granted to any such officers and directors must also be disclosed.

16.12 For unlisted companies, section 202B of the Corporations Act requires that disclosure of directors' remuneration must be made if directed to do so by not less 100 members or by members who hold at least 5% of the issued share capital of such companies.

16.13 All companies required to report and prepare financial statements under the Corporations Act 2001 must comply with the standard laid down by the Australian Accounting Standards Board (AASB). AASB 1017 requires that disclosure must be made in the financial report in relation to directors' remuneration on :-

- The aggregate of the income paid or payable to all directors, whether directly or indirectly, by the company or any related party; and
- The number of directors of the company whose total income paid or payable fall within each successive A$10,000 band of income.

16.14 The disclosure requirements for directors' and executives' remuneration under the Corporations Act 2001 are comparatively less stringent than those in other major capital markets including the United States and the United Kingdom. In view of this, the AASB has issued an Exposure Draft on Director, Executive and Related Party Disclosures; ED106[27], proposing to increase significantly the disclosure in relation to directors' and executives' remuneration, including options and bring these more in line with international requirements.

16.15 The Exposure Draft proposes detailed disclosures by companies in relation to their directors and executives including :-

- Components of their remuneration;

[27] ED106 was issued by AASB on 31 May 2002 with a comment period ending 30 September 2002. Before the end of the comment period, the Financial Reporting Council announced in July 2002 its policy of adopting the International Accounting Standards Board in Australia by 1 January 2005. This was followed on 7 November 2002 by the AASB issuing ED108 : Request for Comments on IASB ED2 share-based Payment" with a proposed effective date of 1 January 2004.

- Details of the company's remuneration policy and the relationship of such policy to the performance of the company;
- The terms and conditions of any performance related benefits, allocated or granted; and
- Details of every service contract between directors and executives and any company in the group.

The Exposure Draft includes also the requirement to value options issued to directors or executives as compensation and to include this value in the amount of remuneration disclosed.

16.16 The AASB decided in December 2002 that a standard based on these proposals should be issued by January 2004, the expected effective date of the standard to be issued on share-based payment[28].

United States of America

16.17 The US focus is mainly on executives' compensation, with some requirements for directors' compensation. In relation to executives' remuneration, SEC Regulation S-K subpart 229.402(a) requires detailed disclosures for each of :-

- The chief executive officer (CEO);
- The four most highly compensated executive officers (US$100,000 is the minimum compensation level requiring disclosure), other than the CEO, serving at year end; and
- Up to two additional individuals not serving at year end for whom disclosure would have been provided had they been serving at year end.

16.18 The US requires disclosure, by individual executives, of interests in and awards under long-term incentive schemes. Terms of the awards and the company's policy on the granting of options or awards must also be disclosed. Further, the US requires disclosure of details of benefits accruing under defined benefit plans, e.g. pension plans, for each named executive. Detailed disclosure is also required of the compensation committee's policies on executive compensation.

16.19 The US requires disclosures about the values of options granted and values realized by executives when options are exercised. It also requires a separate report on the re-pricing of options, and disclosure of a performance line graph comparing, in respect of the company's last five fiscal years, the yearly percentage change in the company's cumulative total shareholder return (taking into account accumulated dividends and share price) with the cumulative total return of a broad equity market index.

Singapore

16.20 A company incorporated under the Singapore Companies Act 1994 is required to prepare and cause to be audited a statement showing the total amount of the emoluments and other benefits paid to the directors (including salary) if directed to do so by not less than 10% of the total number of members or the holders in

[28] See note 7

aggregate of not less than 5% in nominal value of the company's issued share capital.[29]

16.21 Listed companies are required, under the Singapore Listing Manual, to give a complete description of their corporate governance practices with specific reference to each of the guidelines set out in the Code of Corporate Governance in their annual reports.[30] Under the Code, a listed company should provide clear disclosure of its remuneration policy, level and mix of remuneration and the procedure for setting remuneration in its financial statements. It should also include within, or annexed to, its financial statements, a report on the remuneration of directors. As a minimum, the report should disclose the names of the relevant individuals whose remuneration falls within certain bands. Within each band, there needs to be a breakdown (in percentage terms) of each director's remuneration earned through base salary, variable or performance-related income or bonuses, benefits in kind and long-term incentives.

Proposals

16.22 In view of the increasing public concern over the remuneration of directors of listed companies, the questions the SCCLR seeks to address are as follows :-

(a) Should companies be required to disclose individual directors' remuneration packages in their annual financial statements?
(b) If not, should companies be required to disclose such information when directed to do so by members holding a certain percentage of issued shares?
(c) Should full details of all elements of each named director's remuneration package such as basic salary, benefits in kind, bonuses and long term incentive schemes including share options be disclosed in companies' annual financial statements?
(d) Should gains made by individual directors on exercise of share options be also disclosed?
(e) What form of regulation should be used for the reforms proposed?

16.23 In order that there is an acceptable level of transparency in respect of the disclosure of directors' remuneration packages so as to enhance accountability to shareholders, having regard to the practice in other comparable jurisdictions, the SCCLR proposes that :-

(a) The Companies Ordinance and the Listing Rules should be amended to require listed companies to disclose individual directors' remuneration packages by name in their annual financial statements;

(b) The Companies Ordinance should be amended to require an unlisted public company or a private company to disclose full details of all elements of individual directors' remuneration packages by name in its annual financial statements if directed to do so by holders of not less than 5% of the nominal issued share capital of the company;

[29] Section 164A, Singapore Companies Act 1994
[30] Rule 710, Singapore Listing Manual

(c) The Listing Rules should be amended to require disclosure in a listed company's annual financial statements of full details of all elements of each named director's remuneration package such as basic salary, fees, housing and other allowances, benefits in kind, pension contributions, bonuses, compensation for loss of office and long term incentive schemes including share options; and

(d) The Listing Rules should be amended to require disclosure, in both the annual financial statements and by way of a separate statement in the annual report, of the values of share options granted and values realised by each director of a listed company when such options are exercised, calculated according to international accounting standards.

(e) The views of the public are sought on whether the disclosures in (c) and (d) should also apply to the directors of unlisted public companies if they are required to disclose their remuneration packages under the proposal in (b) above .

16.24 The SCCLR was, however, unable to reach a consensus on whether a company should be required to make specific disclosures in respect of the key aspects of remuneration policy such as the main parameters and rationale for any share option or other long term incentive scheme; and if so, the form of regulation to be used. The SCCLR would like to seek the views of the public in this respect.

16.25 The SCCLR would also like to seek the views of the public on whether requirements along the lines of the United Kingdom's Directors' Remuneration Regulations 2002 which require shareholders' approval of remuneration reports, including details of directors' remuneration packages, should be introduced at the present time in Hong Kong.

CHAPTER 4

SHAREHOLDERS

17. Self-dealing by controlling shareholders

Background

17.01 A director of a company is in a fiduciary position and so is subject to the rule against any conflict of interest and duty. However, it has often been stated that a shareholder of a company is not, when voting as a shareholder, subject to any rule against conflict of interest and duty because a shareholder of a company is not a fiduciary for the company[31].

17.02 This focus on the freedom of a shareholder of a company to benefit from membership of the company has increasingly been overshadowed recently by concerns for the position of minorities in companies. In jurisdictions such as Australia and the United States, there are legal provisions which require disinterested shareholders voting in relation to transactions in which controlling shareholders have an interest[32]. While the United Kingdom and Singapore have not incorporated this requirement into the law, the requirement nevertheless applies in relation to listed companies and their subsidiary undertakings under their respective Listing Rules[33].

17.03 In Hong Kong, chapter 14 of the Listing Rules prescribes how connected transactions are to be handled. For significant 'connected transactions', shareholders are deemed to be "interested persons" and are not permitted to vote[34].

17.04 For the sake of commercial certainty and in order to ensure procedural fairness, the SCCLR made a number of proposals in this respect in section 13 of the Consultation Paper on Phase I of the Corporate Governance Review as follows :-

(a) Shareholders should be bound by their approval of a self-dealing transaction in which the director or substantial shareholder or other connected person has an interest, subject to certain exceptions involving dishonesty, bad faith and misappropriation of company assets. (paragraph 13.18(a));

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31 Peter's American Delicacy Co. Ltd. v Heath [1939] 61 CLR 457; North West Transportation Co. Ltd. v Beatty [1887] 12 App Cases 589

32 Paragraphs 13.14 and 13.15, Consultation Paper on Proposals made in Phase I of the SCCLR's Corporate Governance Review.

33 Paragraph 13.17 of the SCCLR's Phase I Consultation Paper

34 Rule 14.26, Chapter 14, Main Board listing rules of the SEHK/ Rule 20.15 of the GEM listing rules of the SEHK. This includes directors, substantial shareholders (defined under rule 1.01 of the Main Board listing rules and rule 1.01 of the GEM listing rules as persons entitled to exercise 10% or more of the voting rights at general meeting) and connected persons (defined under rule 14.03(2) of the Main Board listing rules/rule 20.10 of the GEM listing rules of the SEHK)

(b) Connected transactions must be disclosed and subject to disinterested shareholders' vote, with interested shareholders abstaining from voting. (paragraph 13.18(b));

(c) The rule in (b) would be subject to certain exceptions such as the limited exemptions allowed under the listing rules 14.24 and 14.25 and the de minimis exceptions as in the case of director related transactions. (paragraph 13.18(c));

(d) Voting should take place on a poll. (paragraph 13.18(d));

(e) The court's power to determine whether or not a transaction constitute a waste of corporate assets should be preserved. (paragraph 13.18(e));

(f) Failure to comply with the rule should render the transaction voidable at the instance of the company or any shareholder provided that bona fide third party rights are not affected or restitution is not lost. (paragraph 13.18(f));

(g) The liability of an interested shareholder to compensate the company should arise where the transaction is a waste of corporate assets and the interested shareholder has benefited from the transaction. The burden of proof would be on the interested shareholder to show that the transaction was not a waste of corporate assets or a transaction in bad faith from which he had benefited if there was no disclosure and approval of the disinterested shareholders or if the company went into liquidation within one year of the transaction. (paragraph 13.18(g)).

17.05 The majority of the respondents to the Phase I Consultation supported the proposals although they objected to them being applied to private companies. However, a few of the respondents expressed concern over the issue of voting by way of a poll and the related expenses and practical inconvenience. Some respondents suggested that there should be provisions to cater for the situation of where there were insufficient disinterested shareholders to approve the transactions.

17.06 Subsequent to the Phase I Consultation, the issue has also been considered and addressed by the HKEx's Consultation Paper where some of proposals overlapped with those of the SCCLR's. Paragraph 1.4 of Part B of HKEx's Consultation Paper proposes to amend the Listing Rules to require voting by way of poll for connected transactions and all resolutions requiring independent shareholders' approval (i.e. where controlling shareholders are required to abstain from voting). Paragraph 28.2 of Part B of HKEx's Consultation Paper (please see paragraph 9.05 (above) also proposes to amend the de minimis thresholds now existing under Listing Rule 14.24 of the Main Board Rules and 20.23 of the GEM Rules to the higher of HK$1,000,000 or 0.01% of the total assets of the issuer before the requirements for disclosure and shareholders' approval are triggered.

17.07 In the light of the favourable response to the proposal and other proposals related to the issue, HKEx will make appropriate amendments to the Listing Rules.

17.08 The SCCLR has further reviewed the issue taking into account respondents' views in the Phase I consultation exercise, the current Listing Rules, the proposals in HKEx's Consultation Paper and the results of that consultation exercise.

Views sought from the public

17.09 As in the Phase I Consultation Paper, the SCCLR has not decided on how "controlling shareholders" should be defined for the purpose of "connected transactions" in this paper. Consequently, the SCCLR would like to seek the views of the public on

(a) whether "controlling shareholders" should be defined as –

- a person who is entitled to exercise or control the exercise of 10 percent or more of the voting power at any general meeting of the company (i.e. a substantial shareholder under the Listing Rules)[35];

- any person who is or group of persons who are together entitled to exercise or control the exercise of 30 percent or more of the voting power at general meetings of the company or who is or are in a position to control the composition of a majority of the board of directors of the company (i.e. a controlling shareholder under the Listing Rules);

- a person having subsidiary control through controlling the composition of the board of directors or controlling more than half of the voting power of the company or holding more than half of the issued share capital of the company (i.e. a subsidiary under section 2 of the Companies Ordinance);

- a person having the right to exercise dominant influence or the actual exercise of dominant influence over the voting power of the company (please refer to section 10 (above) for a detailed discussion on the concept of dominant influence).

(b) whether, in defining "controlling shareholders", connected persons should be taken into account.

Proposals

17.10 With regard to the previous proposals in paragraph 13.18(a) of the Phase I Consultation Paper that shareholders should normally be bound by their approval of a self-dealing transaction subject to exceptions relating to transactions involving dishonesty, bad faith and misappropriation of company assets, the SCCLR has taken into account the existing Listing Rules' requirements that there

[35] It is possible that in the future, the 10 percent test for substantial shareholder will drop to 5 percent in line with the threshold for disclosure under Part XV of the Securities and Futures Ordinance, Cap. 571

should be separate shareholders' approval for changes in the material terms of the transactions and that an announcement should be published as soon as practicable if they fail to fulfil certain conditions of the agreements or to proceed with the transactions. In view of this, the SCCLR is satisfied with the adequacy of the existing requirement and has decided not to pursue the proposal any further.

17.11 Subject to paragraph 17.09 above, the SCCLR reconfirms its previous proposals in paragraphs 13.18(b) and (c) of the Phase I Consultation Paper that the following changes should be incorporated into the law -

- Connected transactions must be disclosed and subject to a disinterested shareholders' vote;
- The definition of a connected person in relation to controlling shareholder (please also see paragraph 9.10 (above));
- The rule should be subject to certain exceptions such as transactions entered into by liquidators during the course of compulsory winding-up or on a general reduction of capital; the limited exemptions allowed under the Listing Rules (Rule 14.24 and 14.25 of the Main Board Listing Rules and Rule 20.23, 20.24, 20.35 and 20.43 of the GEM Listing Rules) and other de minimis exceptions, along the lines of those adopted in respect of director-related transactions. However as regards the de minimis thresholds, the SCCLR was unable to come to a consensus. It wishes therefore to consult further on this. For details please refer to paragraphs 8.06(c) and 9.05 to 9.09 (above).

17.12 The SCCLR noted that under the Listing Rules (Rule 14.23 of the Main Board Listing Rules and Rule 20.31 of the GEM Listing Rules), the Stock Exchange has the discretion to waive the requirements relating to connected transactions. However, the SCCLR is aware of the difficulty of any attempt to include such a kind of waiver discretion into the law and would like to seek the public's views on this.

17.13 The SCCLR reconfirms its previous proposal in paragraph 13.18(d) of the Phase I Consultation Paper that voting on connected transactions must take place on a poll.

17.14 The SCCLR reconfirms its previous proposals in paragraphs 13.18(e), (f) and (g) of the Phase I Consultation Paper (please see paragraphs 17.04(e), (f) and (g) (above)), save that for the proposal under paragraph 13.18(f), the transaction should also be voidable at the instance of any shareholder. As to the proposal under paragraph 13.18(g), the phrase 'waste of corporate assets' is basically a US concept. If such a concept is introduced in Hong Kong, a definition would probably be required.

17.15 All the proposals in this section should apply to all listed and unlisted public companies in Hong Kong including companies registered under Part XI of the Companies Ordinance. Although the proposals do not apply to private companies, the common law regarding conflicts of interest still applies to such companies.

18. Substantial Transactions

Background

18.01 In the Report which was issued in February 2000, the Standing Committee recommended the repeal of section 155A of the Companies Ordinance, which requires prior shareholder approval for disposal of fixed assets exceeding a certain level, in view of its limited application[36]. Instead, it proposed that similar provisions (with modifications) should be in the model articles of association in Table A.

18.02 In the course of Phase II of Corporate Governance Review, the SCCLR reconsidered this proposal. While members agreed that the existing scope of section 155A was anomalous and should be amended, there were diverging views as to whether the amended provision should be located either in the main body of the Companies Ordinance or as a default provision in Table A.

Limitations of Section 155A

18.03 The limitations of section 155A as noted by the SCCLR include the following :-

- The provisions apply to listed companies or to a company which is part of a group which includes a listed company;
- The provisions are limited to fixed assets and disposals of a percentage of such assets;
- There is no proviso which exempts transactions between parents and wholly-owned subsidiaries and between wholly owned subsidiaries of the same holding company;
- The threshold triggering the requirement for shareholders' approval is determined by reference to the company's assets and not by reference to the assets of the group as a whole.

Inconsistencies with the Listing Rules

18.04 Furthermore, the provisions in section 155A are also inconsistent with the Listing Rules in the following respects :-

(a) Section 155A deals with listed companies or a company belonging to a group which includes a listed company. The Listing Rules are wider in that they deal with all listed companies including oversea companies with shares listed in Hong Kong, or their subsidiaries;

(b) In the Listing Rules, there are several alternative tests to determine whether a proposal constitutes a "major transaction" thus requiring shareholders' approval. The Listing Rules refer to a "major transaction" to include, for example, any acquisition or realisation of assets (not limited to fixed assets) by a listed issuer or any of its subsidiaries where

[36] The Report of the SCCLR on the Recommendations of a Consultancy Report of the Review of the HK Companies Ordinance (February 2000), page 152, recommendation 103

the value of the assets being acquired or realized represents 50% or more of the assets or consolidated assets of the acquiring or realizing group[37]. Further, HKEx has recently decided that the Listing Rules will incorporate a category of disposals, with "percentage ratios" of 75% or more, where shareholders' approval will also be necessary[38]. Section 155A, on the other hand, only deals with disposals of fixed assets constituting 33% of the value of the company's fixed assets as shown in the latest balance sheet;

(c) Unlike the requirements in the Listing Rules, under section 155A, shareholders' approval only needs to be obtained from shareholders of the company carrying out the disposal. Unless the listed company itself is carrying out the transaction in question, no approval is required to be obtained from the shareholders of the listed company;

(d) Unlike the requirements in the Listing Rules, under section 155A, the threshold for triggering the requirement is determined by reference to the company's fixed assets and not by reference to the assets of the group as a whole.

Other Jurisdictions

18.05 A review of the position in other significant jurisdictions reveals that there are generally some requirements to either obtain shareholder approval or disclose before allowing certain transactions (not being connected transactions), with reference sometimes to a specified threshold. In most jurisdictions, the specification of the quantitative thresholds tends to be found in the listing rules, not in the law. In Singapore, the law has no quantitative threshold, but appears to aim only at requiring shareholders' approval for the disposal of the whole of the company's undertaking.

18.06 The comparative table below illustrates the differences.

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37 The threshold applies where:

(i) the value of the assets being acquired or realised represents 50% or more of the assets of consolidated assets, as the case may be, of the acquiring or realising group; or

(ii) the net profit (after deducting all charges except taxation and excluding extraordinary items) attributable to the assets being acquired or realised as disclosed in the latest published audited accounts represents 50% or more of such net profit of the acquiring or realising group; or

(iii) the aggregate value of the consideration given or received represents 50% or more of the assets of consolidated assets, as the case may be, of the acquiring or realising group; or

(iv) the value of the equity capital issued as consideration by the acquiring issuer represents 50% or more of the value of the equity capital previously in issue (Main Board Listing Rules of the Stock Exchange Of Hong Kong; rule 14.09)

38 "Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues" (January 2002), page 58, paragraph 16; and "Consultation Conclusions on Proposed Amendments to Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Relating to Corporate Governance Issues" (January 2003) page 58, paragraphs 189 to 191

	Obligation	Type of Assets and Scope	Threshold	Consequences
Hong Kong	Statutory provision for shareholders' approval.	Fixed assets. Listed companies and companies which have a listed company within its group (but not including oversea companies registered under Part XI).	33% of company's fixed assets only on a "single company" basis	(i) It is an offence for directors who contravene statutory provision. (ii) Court has power to restrain a transaction in contravention of the provision. (iii) Contract remains valid.
	Also Listing Rules require shareholders approval	Assets of group not limited to fixed assets Listed companies (including oversea companies listed on the Exchange)	the value of the assets being acquired or realized represents 50% or more of the assets or consolidated assets of the acquiring or realizing group	
United Kingdom	No statutory provision for shareholders' approval.			
	Listing Rules require shareholders approval.	Assets not limited to fixed assets. Listed companies and subsidiary undertakings.	Percentage ratio exceeds 25%, classified as "Class 1 transactions"[39]	Financial Services Authority (FSA) can impose fine or reprimand directors under the Financial Market Services Act 2001.
Australia	No statutory provision for shareholders'			

[39] UKLA Listing Rules, Chapter 10, clause 10.37, found at http://www.fsa.gov.uk/pubs/ukla/lr_chapters4/

	approval			
	Listing rules[40] require information to be provided to ASX for change in nature or scale of activities, and shareholders' approval for disposals of main undertaking.	Disposals of main undertaking. Listed companies.	No quantitative threshold.	Australian Stock Exchange (ASX) enforces listing rules.
Singapore	Listing rules require shareholders approval[41].	Assets not limited to fixed assets Listed companies or subsidiaries	Percentage ratio exceeds 20%, this constitutes a "major transaction".	
	Statutory provision for shareholders' approval.	Disposals of substantially the whole of the company's undertaking or property. All companies.	No quantitative threshold. "Substantially the whole of the company's undertaking or property."	(i) Does not affect contracts with third parties for valuable consideration without notice of contravention. (ii) Court has power to restrain such a transaction.

Views of the SCCLR

18.07 The SCCLR considers that the provisions under section 155A and the corresponding Listing Rules should be aligned, at least in the context of listed companies. This will both facilitate compliance and ensure a level playing field with listed oversea companies not at present covered by section 155A.

18.08 The SCCLR has considered whether the provisions in the Listing Rules should be incorporated into the law so that the consequences would mirror consequences of a breach of law. The general view is that this question is part of the broader

[40] Rules 11.1 and 11.2 of the ASX Listing Rules, found at http://www.asx.com.au/about/l3/listingrules_aa3.shtm

[41] Listing Manual of the Singapore Stock Exchange, Chapter 10, rule 1013, found at http://info.sgx.com/weblist.nsf/vwAppendix1?OpenView

question of statutory backing to the Listing Rules, and should not therefore be considered in isolation. In the long term, this question may be resolved if the Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure[42] is implemented so that the Listing Rules are given statutory backing[43] with the SFC having powers to fine directors[44].

18.09 The SCCLR believes that section 155A is not intended to deal with improprieties[45]. Unlike provisions dealing with connected transactions, members are of the view that these provisions are, more likely than not, aimed at setting out the division of powers between shareholders and management where disposals of substantial assets of the company are concerned. Such provisions (with a threshold currently only at 33% of fixed assets) cannot, however, effectively deal with a fundamental change in business direction, since in practice it will be difficult, with such a threshold, to specify when a fundamental change takes place[46].

18.10 The SCCLR also considers that section 155A should not apply to private companies.

Views sought from the public

18.11 The SCCLR would like to seek the views of the public on the following questions: -

(a) What should be the relevant test(s) and thresholds for requiring shareholders' approval and should these be in line with those in the Listing Rules?

(b) On the assumption that section 155A is aimed at establishing the division of powers between shareholders and management rather than at preventing improprieties, should section 155A apply to all companies and not be limited to listed companies? If so: -

(i) Should section 155A be transferred from the body of the Companies Ordinance and be incorporated into Table A as originally proposed? This would mean that the default provisions in Table A would apply unless specifically excluded by the company. Unlisted public companies and private companies would thus have the option to take steps to avoid the provision.

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[42] The Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure, March, 2003

[43] Ibid, page 15, subparagraph 53(e)

[44] Ibid, page 16, subparagraph 53(l)

[45] The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance (February 2000) (the "SCCLR " Report), page 152, paragraph 9.34

[46] On the other hand proposals to amend the Listing Rules are aimed at dealing with the situation where the disposal may have a significant impact on the remaining business of the issuer and its prospects "Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues" (January 2002), page 58, paragraph 16. In Singapore the law requires that shareholders approval is in relation to disposals of "substantially the whole of the company's undertaking". The requirement is aimed at securing prior shareholders' approval for clearly fundamental changes.

Listed companies would, in any event, be bound by the Listing Rules;

(ii) Should the Companies Ordinance be amended so that section 155A is extended to all companies including oversea companies but, at the same time, companies have the ability to exclude section 155A through their articles of association? This option means (as above) that unlisted public companies and private companies would have the option to take steps to avoid the provision. Listed companies would, in any event, be bound by the Listing Rules.

(iii) If the provisions are adopted in the main body of the law as in (ii) (above), should the relevant threshold and/or tests be placed in secondary legislation rather than the main body of the law? This would provide flexibility for changing circumstances including changes to the Listing Rules.

(c) On the assumption that section 155A will remain in the main body of the law, should it be made mandatory for listed companies including oversea companies so that any breach, unlike an infringement of the Listing Rules, would attract legal consequences[47]. If this approach is adopted, the Listing Rules should at least mirror if not have a wider application than the Companies Ordinance.

19. Variation of Class Rights

Background

19.01 In the Report which was issued in February 2000[48], the Standing Committee recommended a further study of possible issues relating to the variation of class rights[49]. Subsequently, the SCCLR has reviewed the law to see if the shareholders of a class need greater protection.

The issues

19.02 Where the rights of a class of shareholders are concerned, the power to alter the articles by special resolution is normally qualified under circumstances set out either by law or the company's constitution. A special class approval may be necessary for a variation of the rights of any class of shareholders.

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47 Also as noted earlier, section 155A will be limited to companies incorporated in Hong Kong only. This may mean different (possibly lighter) consequences for breaches by directors of companies incorporated outside Hong Kong but with securities listed on the Stock Exchange of Hong Kong.

48 The Standing Law Committee on Company Law Reform on the Consultancy Report of the Review of the Hong Kong Companies Ordinance; Pages 154 to 157; recommendations 105-106

49 This area is more relevant in relation to private and unlisted public companies than for public listed companies. For listed companies, disproportionate voting rights for classes of shares are generally discouraged. Since 1987, the share capital of a new applicant for listing should not usually include shares of which the voting power does not bear a reasonable relationship to the equity interest when fully paid: Rule 8.11 of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong

19.03 In Hong Kong, the definition of what constitutes "a variation of class rights" requiring class approval is determined by reference to case law, generally following the English position. In *Greenhalgh v. Arderne Cinemas Ltd*.[50] the court drew a distinction between the variation of the legal rights of a class and the enjoyment of class rights. The test is whether, after the articles have been amended, holders of the shares in question have the same rights that they had before. If the rights remain the same, then there is no variation of rights, notwithstanding that the enjoyment of these rights (i.e. the "economic interests") may have changed[51]. The test is the same in Hong Kong. It is clear that there is not a great deal of procedural protection for changes to "economic interests" as opposed to "legal rights". This position applies in the United Kingdom where no change has been proposed[52].

What are "class rights"?

19.04 There are two significant interpretations of what constitute "class rights". The first interpretation is that only rights which are exclusive to the class and distinct from rights in relation to another class are class rights[53].

19.05 The second interpretation considers that other rights (not necessarily distinct from rights of another class or exclusive to the class) are nevertheless class rights if expressly described to be so in the constitution or terms of issue as class rights, or if they relate to dividends, return of capital, voting rights or procedures for the variation of class rights. The argument in favour of this approach is that a change to the rights which shareholders might consider as fundamental to their investments e.g. financial returns and voting rights, deserves more protection than peripheral rights derived from the articles, e.g. a right to transfer shares.

19.06 There is, however, little clear judicial support for the second approach. It is not clear that all investors place the same degree of importance on having such rights. In particular, an investor can agree to forgo what might normally be considered a fundamental right, for example, by accepting shares with non-voting rights, and accept other economic or alternative benefits instead.

19.07 Certain writers[54] suggest, nevertheless, that it would be prudent for companies to assume that proposals relating to dividends, capital or voting rights attaching to a class of shares would vary class rights. In practice, in the event of uncertainty it

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[50] [1946] 1 All ER 512 (Court of Appeal, England)

[51] For example X holds 5 shares out of 100, and each of his shares carries 5 votes. Each of the remaining 95 shares carries one vote. If the proposed resolution were to reduce X's voting power to one vote, then there will be variation of class rights. If, on the other hand, the voting rights attached to the 95 shares were to be increased to 5 votes each, then X's class rights would not be affected. See the Report of the Standing Committee on Company Law Reform dated February 2000, page 155, paragraph 9.48

[52] The English Company Law Steering Committee Report page 139, paragraph 4.151; page 160, paragraph 7.29 "… do not recommend that the law should restrict the freedom of companies to have classes of shares with different voting rights. The acceptability of such structures for quoted companies should be a matter for the relevant regulatory authorities."

[53] Thus, for example, if the capital structure is divided into (i) ordinary shares which carry 2 votes and (ii) ordinary shares which carry 1 vote, only the voting rights constitute class rights. Other common rights, such as rights to dividends or capital rights, are not.

[54] e.g. Ellis Ferran, Company Law and Corporate Finance, on page 340

is likely that management would be advised to follow the special procedure. The SCCLR considers this position to be generally satisfactory.

What constitutes a "variation of class rights"?

19.08 Apart from the case law, articles of association or statute could define what constitutes a "variation of class rights". For example, in Australia[55] and Singapore[56], the statute law provides that the issue of preference shares ranking *pari passu* with existing preference shares will be deemed a variation of class rights, unless the terms of issue or the articles have authorised a further issue at the time of the initial issue. In Hong Kong, on the other hand, Article 5 in Table A of the Companies Ordinance provides that the rights conferred on any class of shares are *not* varied by the creation of issue of further shares ranking *pari passu* with that class, unless the terms of issue provide otherwise.

19.09 In Hong Kong, case law, not legislation, deals with what constitutes a "variation of class rights". Clear examples of a variation include a reduction in the rate of preferential dividend or a decrease in the number of votes attached to a share. It seems clear from *Re Industrial Equity (Pacific) Ltd*[57]. and *UDL Argos Engineering & Heavy Industries Co. Ltd. v Li Oi Lin and others*[58] that there is a distinction between the *rights* of the shareholders and the *interests* of the shareholders. The test as to whether a class has been properly constituted is fulfilled by reference to shareholders who had the same rights[59].

19.10 However, there are also less clear-cut cases as illustrated by the following examples: -

(a) The issue of ordinary shares do not vary the class rights of either existing ordinary shares or existing preference shares[60];
(b) A bonus issue of shares does not vary the entitlement of preference shareholders to participate in a winding up rateably with ordinary shareholders even though the practical effect was that the bonus issue affected the individual shareholders' share of the surplus on liquidation[61];
(c) The issue of preference shares ranking *pari passu* with existing preference shares[62] is not a variation of class rights;
(d) In a case where the articles prescribed special procedures when a class of rights were to be "affected, modified, varied, dealt with or abrogated in any manner", the court held that rights of existing preference shares would not be "affected" by the issue of further preference rights ranking *pari passu* with them[63].

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[55] Section 246C of the Corporations Act 2001
[56] Subsection 74(5) of the Companies Act of Singapore.
[57] [1991] 2 HKLR 614
[58] [2001] 3 HKLRD 634 (CFA) FACV 11 of 2001, Lord Millett NPS
[59] In Re Industrial Equity (Pacific) Limited, Nazareth J. [1991] 2 HKLR 614
[60] Re Schweppes Ltd [1914] 1 Ch 322 CA
[61] Dimbula Valley (Ceylon) Tea Co Ltd. v. Laurie [1961] 1 Ch 353
[62] Underwood v. London Music Hall Ltd [1901] 2 Ch 309
[63] White v. Bristol Aeroplane Co. Ltd [1953] 1 Ch 65, English Court of Appeal; Re: John Smith's Tadcaster Brewery Ltd [1953] Ch 308, English Court of Appeal

Arguments for and against the restrictive "rights" approach

19.11 Certain academic writers[64] support the restrictive "rights" approach. This is on the basis that there is little that a company does that would not affect the value of the shares whereas a less restrictive approach would mean that the holders of any class of shares could veto a wide range of company activities. Other writers consider that the courts are capable of looking at the realities and of weighing "interests", as shown in the context of schemes of arrangement[65]. Farrar and Gower, for instance, respectively consider that the distinction between variation of formal rights and the enjoyment of these rights, to be "artificial"[66] and "extraordinarily narrow"[67].

Unfair prejudice provisions where economic interests are concerned

19.12 Section 63A of the Companies Ordinance permits the holders (in aggregate) of not less than 10% in nominal value of the issued shares of a class to apply to the court to have a variation cancelled. The court may disallow the variation if it is satisfied that the variation would unfairly prejudice the shareholders of the class represented by the applicant[68]. However, although the use of this section is not clear, the view has been advanced that the provision is useful as it draws the attention of the board to the need to ensure that variations are fair[69].

19.13 Many writers contemplate that the "unfair prejudice" provisions (equivalent to section 168A of the Companies Ordinance) are more likely to be used[70] than provisions similar to section 63A. While the extent to which the unfair prejudice provisions can be relied upon in this context is not clear[71], the unfair prejudice provisions might provide a supplementary remedy where economic interests are affected. The English Company Law Steering Committee Report for example has considered this issue but has made no recommendations to change the unfair prejudice provisions[72].

Crafting special provisions in the constitution of the company

19.14 The law does not preclude shareholders from specifically identifying those matters that are deemed to be a variation or abrogation of rights attached to the class. If so specified, a proposal for further issues would trigger the requirement for a special procedure[73]. In view of this, the SCCLR has concluded that it is

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64 e.g. Pennington

65 in the United Kingdom, see Re Hellenic & General Trust Ltd. This position does not apply in Hong Kong [1976] 1 WLR 123; "The Rights of Shareholders", Peter G Zuereb, (BSP Professional Books) (1989) page 160; See also discussion below, on judicial control in Hong Kong

66 Farrar's Company Law, (Butterworths, 1998) page 232; Gower's Principles of Modern Company Law (6th Edition), page 725

67 Gower's Principles of Modern Company Law (Sweet & Maxwell, 6th Edition), page 724

68 Subsection 64(3) of the CO. There do not appear to be cases on this point in Hong Kong: Tomasic & Tyler Hong Kong Company Law – Legislation and Commentary (Butterworths Asia Updated April 2001); Example of application made under similar provisions in the English case of Re: Sound City (Films) Ltd. [1947] Ch 169

69 Gower's Principles of Modern Company Law (Sweet & Maxwell, 6th Edition), page 724

70 Gower's Principles of Modern Company Law (Sweet & Maxwell, 6th Edition), page 724; Farrar's Company Law, (Butterworths, 1998) page 235

71 "The Rights of Shareholders", Peter G Zuereb, (BSP Professional Books) (1989) page 157

72 The English Company Law Steering Committee Report (March 2000)

73 Farrar's Company Law (Butterworths, 1998) page 233

possible, with clear wording, for the shareholders of a class to protect their rights by ensuring that the articles or terms of issue address this matter[74].

Proposal

19.15 The SCCLR agrees that the distinction between formal legal rights and economic rights may appear artificial. It notes, however, that it is possible for an investor to entrench specific provisions to protect his own particular set of circumstances[75]. Furthermore, the SCCLR considers that the circumstances of possible variation are so wide ranging that it would be preferable not to address them by legislation. In addition, it should be possible to challenge any alleged unfairness using existing provisions of the Companies Ordinance. In view of this, the SCCLR considers that this area may be an area which is better suited for further case law development and does not recommend legislative changes to define what constitutes a variation of class rights.

20. The Suitability of Judicial Control, Multiplicity of Provisions and Class Votes

Background

20.01 In the Report which was issued by the SCCLR in February 2000, the Standing Committee recommended further studies on sections 58, 166 and 168 of the Companies Ordinance[76] regarding the two main forms of restructuring that are subject to shareholders' approval and judicial approval, namely, a scheme of arrangement and reduction of share capital. In this consultation exercise the focus will be on the following issues[77]:-

(a) Is the law which determines what constitutes a class for voting on a scheme of arrangement satisfactory[78]?
(b) Does the ability to choose from different provisions to achieve broadly similar effects mean different standards of protection for the investor? Should they be rationalized to achieve greater consistency[79]?
(c) Is judicial approval a suitable means to protect minority shareholders or a class of investors in the context of companies with controlling shareholders[80]?

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[74] Re Northern Engineering Industries plc. [1994] 2 BCLC 704 (English Court of Appeal)

[75] See also, the English Law Society's response to consultation under the UK's Steering Group "Modern Company Law for a Competitive Economy: Developing the Framework" (March 2000) for this view. It considered that the company and an investor contemplating taking up a new class of shares should have the freedom to negotiate what will or will not constitute a variation of class rights.

[76] The Report of the SCCLR on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the HK Companies Ordinance (February 2000)("The SCCLR Report") page 163, recommendation 107

[77] There are other questions regarding these provisions, for example, whether the section 166 scheme procedure could be simplified for the applicant or proposer. However the Committee's review in this Paper is limited to questions regarding the investor or class of investors and that issues such as those should be addressed separately from this Paper.

[78] see paragraphs 20.08-20.17 below

[79] The SCCLR Report, page 162, paragraphs 9.76 to 9.78; see paragraphs 20.24, 20.27 and 20.28 below

[80] The SCCLR Report, page 162, paragraph 9.75; see paragraph 20.32 below

Overview

20.02 The two main forms of restructuring that are subject to shareholders' as well as judicial approval are schemes of arrangement and reduction of share capital. Section 166 of the Companies Ordinance provides for schemes of arrangement. In the absence of statutory provision, proposals for reconstructions and other schemes may be achieved only through novation and assignment. This would entail the impracticality of securing the approval of ***all*** shareholders and creditors, so as to bind all dissenting parties. Section 166 therefore allows for such schemes subject to supermajority voting and judicial approval. Class approval is also necessary in the event there is a variation of the rights of any class of shareholders.

20.03 Section 58 provides a statutory scheme for companies to reduce their share capital, again with court approval and shareholder approval. Traditionally, section 58 was more concerned with creditor, rather than shareholder, protection. In practice, a reduction of capital may take place as part of a reconstruction exercise, or to redistribute corporate wealth among shareholders, or to write off losses[81]. The objects of court sanction today are, first, to protect persons dealing with the company so that the funds available for satisfying their claims are not diminished except by ordinary business risks, secondly, to ensure that the reduction is equitable as between the various classes of shareholders and, thirdly, to protect the interests of the public[82]. Unless the articles provide otherwise, the court has the power to approve a reduction without the approval of any class of shareholders.

20.04 Section 168 allows a transferee company to compulsorily acquire the shares of dissenting minorities in an amalgamation or merger. Where the transferee company has acceptances amounting to 9/10ths in value of the shares for which an offer is received, the dissentient minority can be required to sell to the transferee company.

Areas of overlap or possible overlap between sections 166, 58 and 168

20.05 Schemes of arrangement may also be implemented through a reduction of capital. Under section 58, once the requisite majority approval has been achieved, it is for those opposing the reduction to show that it is unfair to a section of shareholders[83]. However, for court approval under section 166, the applicant must show that the scheme is fair among classes of shareholders. The case of *Re Robert Stephen Holdings Limited*[84] indicates that, where one part of a class of equity shareholders is treated differently from another, the usual practice is to proceed by a scheme of arrangement under which the interests of the minority are better protected. Nevertheless, there are cases (discussed below) where the court has approved a reduction of capital without the approval of a class of

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[81] The SCCLR Report, page 158, paragraph 9.58

[82] Trevor v. Whitworth (1887) 12 App. Cas 409 at 423; British and American Finance Corporation Ltd. v. Couper [1894] AC 399 at 411

[83] Scottish Insurance Corp Ltd. v. Wilsons & Clyde Coal Co Ltd. [1949] AC 462; Re Holders Investment Trust Ltd. [1971] 2 All ER 289; Carruth v. Imperial Chemical Industries [1937] AC 707

[84] [1968] 1 WLR 522

shareholders.

20.06 A scheme of arrangement can also achieve the same result as a compulsory acquisition under section 168. In a proceeding under section 168, the matter may never go to court at all (unless a challenge is made). In contrast, under section 166 court approval is necessary. However, a majority acceptance of 90% is needed for section 168. For section 166, the required percentage to approve the proposal comprises parties representing three-fourths in value of the creditors or class of creditors, or members or class of members. In practice, under a section 166 scheme, court approval is not generally withheld once the requisite majority shareholder or creditor approval has been obtained. Consequently, court approval under section 166 might conceivably provide a better route for achieving the same result as section 168.

20.07 The law does not limit the powers of the court to approve a reduction of capital to achieve the same results as a compulsory acquisition. This means that minority shareholders might be expelled using the reduction of capital procedure instead[85]. For listed companies, since the amendment to the Code for Share Repurchases and Takeovers ("the Takeovers Code") in February 2002, different procedures would apply.

Class Composition

Section 166 Schemes of Arrangement

20.08 For schemes of arrangement to take place, among other matters: -

(a) The scheme must be approved by special resolutions of classes of shareholders voting by person or proxy in separate meetings of the interested classes of shareholders, and sanctioned by the court. The section contemplates proposals affecting the rights of creditors or members or different classes of either of them;

(b) Common law requires the majority of shareholders *of each class* to act in *good faith.* The court must determine that the scheme is fair and reasonable and that the majority interests do not override the interests of the minority[86].

Where schemes of arrangement also need a reduction of capital the court also considers the principles applicable to approve a reduction of capital. (See paragraph 20.18 (below)).

Class voting

20.09 The general principle is that separate meetings of classes of creditors and shareholders must be properly constituted in order to secure their approval to a scheme. What constitutes a "class" takes on significance from the perspective

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[85] Nicron Resources Ltd. v. Catto & Ors (1992) 8 ASCR 219; 10 ACLC 1, 186

[86] Re Wedgewood Coal and Iron Co (1877) 6 Ch D 627, 637 (High Court, England); Re Alabama New Orleans Texas and Pacific Junction Railway Company [1891] 1 Ch 213

of shareholder protection. If a certain group of rights or interests constitute a "class", and separate meetings are required in relation to such a group, the chances of the proposal being passed to the detriment of this class of rights or interests would be reduced.

20.10 The responsibility for determining what constitutes a class lies with the company. On an application to convene meetings, the court will not provide guidance as to whether or not the classes have been properly constituted[87]. If the company fails to properly convene the class of meetings, however, it is open to any shareholder to object and the courts to dismiss the petition to sanction the scheme.

20.11 The test for determining whether shareholders form a single class is "… *such as will prevent the section being so worked as to result in confiscation and injustice, and that it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest…"*[88].The court does not, therefore, merely look to see if the group of shareholders has the same type of shares. Rather, the court looks to see whether the rights of particular groups of shareholders under the proposed scheme are the same.

20.12 In the past, English cases treated "rights" and "interests" of shareholders as alternative tests for the determination of the constitution of classes. It was possible, therefore, to constitute a class by assessing the effect of a scheme on the *interests* of the shareholders, rather than just the effect on their formal legal rights. Thus, in *Re Hellenic and General Trust Ltd.,* it was held that, in an attempted use of the scheme to effect a takeover, a shareholder was a subsidiary of the bidder, had a different interest from the other shareholders and was therefore in a different class[89]. The "interest" test was however rejected by the court in a later case of *Re BTR plc [1999] 2 BCLC 675 (CA)* where the court confirmed that the relevant test is that of differing "rights" rather than differing "interests".

20.13 In Hong Kong, it seems clear from *Re Industrial Equity (Pacific) Ltd.*[90] and *UDL Argos Engineering & Heavy Industries Co. Ltd. v Li Oi Lin and others*[91] that there is a distinction between the *rights* of the shareholders and the *interests* of the shareholders. The test as to whether a class has been properly constituted is fulfilled by reference to shareholders who had the same rights[92]. In *UDL Argos Engineering & Heavy Industries Co. Ltd. v Li Oi Lin and others*[93]*,* the Court of Final Appeal confirmed that the proper test is based on similarity or dissimilarity of legal rights and not on similarity or dissimilarity of interests not derived from such legal rights. It was held further that the court might discount or disregard altogether the votes of those who, though entitled to vote at a meeting as a member of the class concerned, had such personal or special interests in

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[87] Re Hellenic & General Trust Limited [1976] 1 WLR 123
[88] Sovereign Life Assurance Co. v. Dunn (1892) 2 QB 573 at 583, per Bowen LJ
[89] Re: Hellenic and General Trust Limited [1975] 3 All ER 382
[90] [1991] 2 HKLR 614
[91] [2001] 3 HKLRD 634 (CFA) FACV 11 of 2001
[92] In Re Industrial Equity (Pacific) Limited, Nazareth J. [1991] 2 HKLR 614
[93] [2001] 3 HKLRD 634 (CFA) FACV 11 of 2001

supporting the proposals that their views could not be regarded as fairly representative of the class in action. Thus, even after the court has determined the "rights test" had *prima facie* been fulfilled, it would be able to go on to consider if the result of the meeting fairly reflected the view of the class in question.

Fairness of the scheme and functions of the court

20.14 In determining whether a compromise or arrangement should be sanctioned the court must: -

(a) ensure that resolutions are passed in accordance with statutory requirements;
(b) satisfy itself that the scheme is fair.

The onus is on the applicant to show that the proposal is fair[94]. To determine if the scheme is fair, the proposal must be "… such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest as such a member might approve of it."[95] If the court is not satisfied as to the *bona fides* of the resolution, it may decline to approve the scheme. The section is not intended to allow the majority to expropriate the minority but is designed to allow a compromise under which all parties can benefit. A scheme that makes some persons give up everything without receiving anything in return would be regarded as unreasonable[96].

20.15 In comparison with section 58, the court's role is said to be "… very similar to that in the case of reductions of capital …" , though it may be that in section 166 cases there is less of a tendency to rely on the rule that creditors and members are better judges of what is to their commercial advantage than the court can be[97]. Even so, in practice, the courts have been slow to differ from the decisions of the majority of shareholders or creditors because the members and creditors are considered better judges of what is in the best commercial interests of the company than the court[98]. Even in the United Kingdom, the consensus is that courts prefer to identify procedural flaws when refusing to sanction a scheme, rather than exercise their independent "business" judgment[99].

20.16 In Hong Kong, there is a similarly strong inference that the scheme is fair if the requisite majority approval(s) has or have been obtained, provided that approving members have sufficient information and are not prejudiced by conflicting interests. In the context of creditors, Le Pichon J. in *China Light & Power Co. Limited and CLP Holdings Limited*[100] took on board criticisms[101] that the

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94 Re China Light & Power and CLP Holdings [1998] 1 HKC 170, per Le Pichon J.
95 Re Dorman Long & Co. [1934] Ch 635, 655-666. Also Re Alabama New Orleans Texas and Pacific Junction Railway Company [1891] 1 Ch 213, 239 per Lindley J (Court of Appeal, England); Re Anglo-Continental Supply Co Ltd. [1922] 2 Ch 723, 736; Re National Bank [1966] 1 WLR 819 – the latter applied in Re Sharp Brave Co. Ltd. (in Liq) [1999] 4 HKC 79, Le Pichon J.
96 Re Alabama New Orleans Texas and Pacific Junction Railway Company [1891] 1 Ch 213, 247 (Court of Appeal, England); Re NFU Development Trust Ltd. [1973] 1 All ER 135, 140 (High Court England)
97 Gower's Principles of Modern Company Law (Sweet & Maxwell, 6th Ed 1997), page 765
98 Re English, Scottish and Australian Chartered Bank [1893] 3 Ch 385, 409 (Court of Appeal)
99 Gower's Principles of Modern Company Law (Sweet & Maxwell, 6th Ed), page 765
100 [1998] 1 HKC 170

traditional approach that (in that case) creditors are better placed to decide the commercial advantage to them is "… based on the fundamentally false assumption that a vote of a meeting necessarily represents the informed opinion of the majority of the members of the class concerned, unprejudiced by any conflicting interests". On the facts of the case, however, it was found there were no such conflicting interests so that the question did not arise.

Views of the SCCLR

20.17 The SCCLR found the law regarding the definition of a "class" clear. The test of whether a class is properly constituted is by reference to formal legal rights rather than "interests", leaving the court the liberty to refuse approving a scheme if it finds that the proposal is unfair. From the point of view of minority shareholders, their primary concern is that the court rarely refuses to confirm a scheme on grounds of unfairness. The issue may be especially pertinent in the context of the Hong Kong corporate environment where there is often a controlling shareholder[102].

Multiplicity of Provisions

Reduction of capital under section 58

20.18 To effect a reduction of capital under section 58, first, the articles must allow for a reduction, secondly, there must be a special resolution, and thirdly, court approval. Case law sets out the criteria for approving a reduction of capital[103]. In Hong Kong, the courts have considered the following principles before granting approval[104], the shareholders must be treated equitably[105], a circular must properly explain the proposal, the interests of creditors must be safeguarded[106], and the reduction must be for a discernible purpose[107]. The court may also consider the public interest[108]. The court will not, however, consider whether the reduction is wise or desirable from a business point of view[109].

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101 Criticisms by Professor Gower, discussed in [1998] 1 HKC 170

102 Betty M. Ho, Public Companies and Their Equity Securities, Public Companies and their Equity Securities, (Kluwer Law International 1998), page 467

103 n.b. The SCCLR Report, page 185, recommendation 117, that the court approval for reduction of capital will not be required under certain conditions. i.e. for the redesignation of par value to a lower amount provided that the company only has one class of shares, and the reduction is distributed equally to all shares, and the reduction is credited to a share premium account. This recommendation has already been included in the Companies (Amendment) Bill 2002.

104 Re South China Strategic Ltd. [1997] HKLRD 131, [1996] 4 HKC 182, Rogers J, applying Thorn EMI plc; Re [1989] BCLC 612, Harman J. Re Lippo China Resource [1998] 1 HKC 161 at 164F-164B, Le Pichon J. applying Re Ratners Group Plc. [1988] 4 BCC and Thorn EMI plc; Re [1989] BCLC 612

105 Poole v. National Bank of China Ltd. [1907] AC 229 (House of Lords)

106 Ex p Westburn Sugar Refineries Ltd. [1951] AC 526 (House of Lords)

107 Re Lippo China Resource [1998] 1 HKC 161 at 184I-185B, Le Pichon J. This is "… something which is demonstrated by evidence to the court and is something sufficiently solid and near in expectations to be a real prospect". In this case the reduction was to make available a reserve for the writing off or setting off of goodwill during a consolidation which was the accounting policy of the group.

108 Ex p Westburn Sugar Refineries Ltd. [1951] AC 526 (House of Lords)

109 Poole v. National Bank of China Ltd. [1907] AC 229 (House of Lords)

No requirement for class votes under section 58

20.19 Unless the company's constitution requires[110], the court has the power to confirm a reduction of capital without requiring separate meetings for a class vote[111].

Equality of treatment of shareholders

20.20 In principle, the court must be satisfied that a proposed reduction affects all members of equal standing in a similar manner. It must also be satisfied that the proposed reduction is fair and equitable as between different classes of shareholders[112]. The courts will, in practice, generally approve a reduction of capital where the reduction treats the classes of shareholders in accordance with their rights[113], either as they formerly were or as varied in accordance with section 63A of the Companies Ordinance. The onus of proof is on those opposing the reduction to show that the reduction is unfair.

20.21 Where members are treated differently from their equals, those affected must have consented to their different treatment: *Re Jupiter House Investments (Cambridge) Ltd.*[114]. The courts may refuse to sanction reductions of capital which would work unfairly against any shareholders who do not consent to it, or which is not fair between shareholders of the same class[115]. Where a reduction treats shareholders with similar rights differently, it is said that the courts will narrowly scrutinize the proposal[116].

20.22 In practice, however, the question of fairness between shareholders or classes of shareholders on a reduction of capital is difficult[117]. There is some old case law to the effect that the court may still confirm a reduction, which it considers fair, even if the reduction is not spread equally or rateably across all the shares in the company. For example: -

(a) In *British and American Trustee and Finance Corp Ltd. and Reduced v. Cooper*[118], the House of Lords held that a company could reduce some shares but not others. The decision gave effect to a proposal to split a company into two businesses and to transfer the American business to American shareholders on the payment of a certain sum with a cancellation of their shares in the existing company;

(b) This decision was followed in *Re Credit Assurance and Guarantee*

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110 Re Northern Engineering Industries plc. [1994] 2 BCLC 704, Court of Appeal

111 House of Fraser plc. v. ACGE Investments Ltd. [1987] AC 387, House of Lords

112 Poole v. National Bank of China [1907] AC 229

113 House of Fraser plc. V. AGCE Investments Ltd. [1987] AC 387 House of Lords

114 [1985] 1 WLR 975

115 Poole v. National Bank of China ltd. [1907] AC 229; British and American Trustee and Finance Corp Ltd. and Reduced v. Cooper [1894] AC 399 at 406, ex p Westburn Sugar Refineries Ltd. [1951] AC 625; Re Silkstone Collieries Ltd. [1954] Ch 169 Court of Appeal; Re Holders Investment Trust [1971] WLR 583

116 Poole v. National Bank of China Limited [1907] AC 229 English House of Lords; Halsbury's Laws of Hong Kong, page 205, paragraph [95.0276]

117 Hong Kong Company Law, Tomasic & Tyler, (Butterworths) Volume 1, Issue 7, page 957, paragraph [2730]

118 [1894] AC 399

Corporation Limited[119]. Shares of one or more shareholders may be extinguished without affecting the rights of other shares of the same or other classes, so long as the court considers that there is nothing unfair or inequitable about the scheme[120];

(c) In *Prudential Assurance Co. Ltd. v. Chatterly-Whitfield Collieries Ltd.*[121], a company proposed to reduce its capital by repaying and extinguishing its preference shares. The House of Lords confirmed the reduction over the objections of preference shareholders, since it was a normal incident of preference shares that they are subject to redemption.

20.23 Case law indicates that, where one part of a class of equity shareholders is treated differently from the other, the usual practice is to proceed by way of a scheme of arrangement under section 166 where the interests of the minority are better protected[122]. This means that the approval of the class of shareholders must be first obtained (above) and the applicant must bear the onus of showing that the reduction is fair.

Overlap between sections 58 and 166

20.24 The differences between how the court exercises its discretion under sections 58 and 166 do not appear to be of great significance. If a reduction of capital is part of a scheme of arrangement, it is still necessary to comply with the requirements of the Companies Ordinance regarding the reduction of capital. Section 58 does not, however, preclude the court from confirming a reduction of capital even where shareholders are not treated rateably. Under the circumstances, it is probably easier for an applicant for a scheme to proceed under section 58 than under section 166, since no class approval is necessary. In addition, under section 58, the onus is generally on the disagreeing party to the reduction of capital to show that it is unfair while under section 166, it is on the applicant proposing the scheme of arrangement to show the fairness of the scheme.

Compulsory buy-out after successful takeover under section 168

20.25 The purpose of section 168 is to facilitate takeovers, amalgamations or mergers of companies. In takeovers, it is often the aim to acquire 100% control of the company. Where the transferee company has acceptances amounting to 9/10ths in value of the shares for which an offer has been received, a dissentient minority can be forced to sell to the transferee company[123].

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[119] [1902] 2 Ch 601; Both cases may be considered exceptional cases: See Betty M. Ho, Public Companies and their Equity Securities (Kluwer International Law 1998), page 481

[120] Halsbury's Laws of Hong Kong, page 205, paragraph [95.0276]; citing among other cases, British American Trustee and Finance Corpn v. Couper [1894] AC 399 at 406, 415, 417 House of Lords; Bannatyne v. Direct Spanish Telegraph Co (1886) 34 CHD 287, Court of Appeal; Re Direct Spanish Telegraph Co (1886) 34 CHD 307; Re Thomas La Rue & Co Ltd. and Reduced [1911] 2 Ch 341; n.b. these appear to be older cases.

[121] [1949] AC 512 House of Lords

[122] Re Robert Stephen Holdings Ltd [1968] 1 All ER 195

[123] Chancery Division [1976] 1 WLR 123; [1975] 3 All ER 382.

Unfairness

20.26 Under section 168, the matter may never come to court at all. However, a dissentient minority shareholder can apply to the court to have the acquisition stopped[124]. The court may then consider whether the acquisition is fair. If it can be shown that the proposed acquisition is not made *bona fide*, the court may decline to allow it to proceed. The onus is cast on the dissenting minority to demonstrate the unfairness of the scheme[125]. However, where the offeror is shown to be an insider, the burden would be reversed, so that the offeror must show that the offer was fair[126].

Overlap between sections 168 and 166

20.27 The fact that a scheme of arrangement produces a similar result to a compulsory acquisition further to a merger or amalgamation is not necessarily fatal to the application[127]. In *Re National Bank Ltd*[128], the argument was raised that a scheme of arrangement ought to be treated as a compulsory acquisition case requiring a 90 per cent majority acceptance. The court held that the strict language of the compulsory acquisitions provision would not preclude the court from allowing a proposal under the scheme provisions, even where the scheme resulted in a compulsory acquisition[129]. The sections were found to involve different considerations and different approaches. However, it was also of the view that the petitioner must fulfil a high standard of proof to justify securing an approval under a proposed arrangement rather than under the compulsory acquisition scheme.

20.28 In *Re Hellenic & General Trust Ltd.*[130], parties attempted to use the court approval process so that a smaller majority would effectively achieve a takeover. In this case, the court refused to allow the compulsory acquisition provisions to be circumvented using the scheme provisions. This was on the basis that the resolution under the scheme provisions could be passed only with the assistance of the votes of a wholly-owned subsidiary[131].

20.29 Similarly, in *Re Bugle Press Ltd.*[132], two majority shareholders formed a new company, which then proposed a scheme of arrangement simply to enable the majority shareholders to secure the requisite majority under the scheme of arrangement provisions. The court held that the majority had not shown good reason in the interests of the company for approving the scheme and that the section had been used for an improper purpose. The courts will not therefore allow the section 166 procedure (requiring a smaller majority approval) if it is used to overcome the requirements under section 168 to the detriment of minority interests.

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124 Paragraph 4, Ninth Schedule, Companies Ordinance (Cap. 32)
125 Re: Grierson, Oldham & Adams Ltd. [1968] Ch 17, 31 per Plowman J (High Court, England)
126 Re Chez Nico (Restaurants) Ltd. [1992] BCLC 192
127 Re Hellenic & General Trust Ltd; Chancery Division [1976] 1 WLR 123; [1975] 3 All ER 382
128 [1966] 1 WLR 819
129 Ibid Plowman J at page 829; In Singapore, the "Committee on Law Reform" is seeking public views as whether and why the thresholds might be altered.
130 [1976] 1 WLR 123; [1975] 3 All ER 382
131 Re: Hellenic & General Trust Ltd. [1976] 1 WLR 123; [1975] 3 All ER 382
132 [1961] Ch 270

Overlap between sections 168 and 58

20.30 Similarly, the court has the power to allow a proceeding to take place by way of a reduction of capital that would achieve the same effect as a compulsory acquisition. In the Australian case of *Nicron Resources Ltd. v. Catto*[133], the court held that it was not necessary to compel the majority to proceed under the compulsory acquisition provisions under which the proposal would not have succeeded (due to a large number of untraceable shareholders). The court, nevertheless, considered that it was necessary to refer to what the position would have been had they proceeded under compulsory acquisition provisions. In addition, the court required that the proposal must fulfil underlying principles of fairness and information for the acquisition of shares[134].

20.31 It should be noted that, since 2000, new laws have been passed in Australia which requires that, for such reductions of capital, the reduction must be "fair and reasonable to the company's shareholders as a whole". In addition, if there is a cancellation of shares, not only must there be a special resolution of shareholders who will receive consideration for shares acquired, but there must be a special resolution of all shareholders save for those whose shares are to be cancelled[135].

Section 168 and the Takeovers Code

20.32 In the past, the relevant rule in the Hong Kong Code on Takeovers and Mergers and Share Repurchases ("Takeovers Code") applied to general offers relating to privatisations requiring votes of disinterested shareholders in a two-tier test[136]. Following a consultation[137], for public companies <u>all</u> takeovers effected whether by way of a scheme of arrangement or capital reorganisation[138] must have the approval of 75% of disinterested shareholders present and voting and no more than 10% of the disinterested shareholders voting against[139].

20.33 The tests in the Takeovers Code may be contrasted with the provisions in section 168 of the Companies Ordinance. The Code requires the active disapproval by at least 10% of the disinterested shareholders, whereas section 168 requires acceptances by 90% of shares for which the offer relates (not including shares of the offeror).

20.34 In some cases of reduction of capital, the court has found it difficult to be persuaded that a vote was fair unless the majority shareholders who stood to

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[133] (1992) 8 ACSR 219: The proposal was a capital reduction in which all the shares were to be cancelled except for those of the majority shareholders, in return for cash.

[134] Note: In Australian, the corporate regulator has a role in compulsory acquisitions and schemes by statute which enables it to monitor proposals for expropriation from the viewpoint of investor protection. In reductions of capital, traditionally, while not specifically articulated, it has also played a significant role.

[135] Part 2J.1 of the Corporations Act 2000; section 256B

[136] Rule 2.10 Code on Takeovers and Mergers; 90% approval of disinterested shareholders present and voting, and not less than 2.5% voting against

[137] Consultation Paper on the Review of the Codes of Takeovers and Mergers and Share Repurchases, April 2001

[138] Rule 2.10 Code on Takeovers and Mergers

[139] effective since February 2002

benefit from the proposal refrained from voting[140]. The requirement in the case of schemes for constituting class meetings may, in some cases, have the effect of requiring the approval of disinterested shareholders, but this is by no means a certainty. Apart from the Takeovers Code, there is no clear rule that interested parties and their associates must not vote in approving these transactions.

Suitability of judicial control

20.35 In its earlier report, the SCCLR accepted that there are advantages to the judicial approval system. However, it also considered that there are structural weaknesses, evidenced by the reluctance of the court to find proposals unfair. The Standing Committee considered that this may be because many proposals are either unopposed or opposed without the benefit of an expert opinion, so that the court is deprived of hearing opposing views[141]. The SCCLR considered the possible use of amicus curae to assist the court in these cases but considered that this solution, in the context of Hong Kong, would involve costs.

Views sought from the public

20.36 As the SCCLR was unable to reach a consensus on the questions stated in paragraph 20.01 (above), it would like therefore to seek the views of the public on the following questions :-

(a) On class composition -

- whether the current practice of the courts in determining fairness as between controlling shareholders and minority shareholders is adequate;
- if not, whether the definition of class should be defined so as to allow minority shareholders to have a greater say in the proposed scheme of arrangement, for instance, by having separate class meetings for minority shareholders on the basis of their interest rather than legal rights;

(b) On the multiplicity of provisions -

- whether section 58 should be amended to ensure greater consistency with section 166 so that, where a reduction of capital might result in the different treatment of shareholders of equal standing or treatment not rateably as between classes of shareholders, the procedure should be the same as that under section 166;
- whether the provisions in sections 58, 166 and 168 should be rationalized, especially where the law allows for compulsory acquisition, to prevent compulsory acquisition being achieved other than under section 168;

(c) On the suitability of judicial control -

- whether judicial control is suitable in the context of Hong Kong and

140 Ibid, page 186, per Bryson J.
141 The SCCLR Report, pages 160 to 162, paragraphs 9.70 to 9.75

on how the current system may, in practice, be improved.

21. Company General Meetings

Introduction

21.01 This section discusses the law on company general meetings in Hong Kong under the following areas: -

(a) definition;
(b) timing ;
(c) notice;
(d) agenda (including resolution); and
(e) conduct and voting (including the rights of proxies).

21.02 The SCCLR has reviewed the relevant laws and reforms studies[142] in relation to company general meetings in Hong Kong and three other jurisdictions, namely, the United Kingdom, Australia and Singapore (collectively "the subject jurisdictions"), having regard to the use of audio-visual communication and electronic voting in company general meeting.

General Meeting located at more than one Venue

21.03 Should a company be permitted to hold a general meeting at more than one location with two way real time communication between the participants?

21.04 There is no statutory definition of a "meeting". At common law, a meeting has been defined as "the coming together of at least two persons for any lawful purpose"[143]. A question arises as to whether as a matter of law a meeting must be held at the same place. It was held in *Byng v London Life Association Ltd* [1989] 1 All ER 560 that a general meeting could take place in more than one room with adequate audio-visual links to enable everyone attending to see and hear what is going on in all the rooms being used.

21.05 In Australia, legislation has been amended to provide for meetings at two or more places. Section 249S of the Corporations Act 2001 ("ACA") provides that a company may hold a meeting of its members at two or more venues using any

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[142] In the United Kingdom, the Company Law Review Steering Group ("the CLRSG") issued the following relevant consultation papers and reports from 1999 to 2001: *Modern Company Law for a Competitive Economy: Company General Meetings and Shareholder Communication* (URN 99/1144) (London: DTI, 1999) ("the UK Consultation Paper"), *Modern Company Law for a Competitive Economy: Developing the Framework* (URN 00/656) (London: DTI, 2000) ("the UK Report No.5"), *Company Law Review: Completing the Structure* (URN 00/1335) (London: DTI, 2000) ("the UK Report No.8"), *Modern Company Law for a Competitive Economy: Final Report* (URN 01/942) (London: DTI, 2001) ("the UK Final Report"). In Australia, the Corporations and Markets Advisory Committee ("the CAMAC") published its Final Report on Shareholder Participation in the Modern Listed Public Company ("the Australian Final Report") in June 2000. In Singapore, the Committee on Corporate Governance, published a consultation paper on corporate governance in November 2000 and a final report on 21 March 2001 recommending a Code of Corporate Governance to be adopted by the Singapore listed companies.

[143] *Sharp v Dawes* (1876) 2 QBC 29

technology that gives the members as a whole a reasonable opportunity to participate. This contemplates the use of video-conferencing and electronic communications and requires opportunity to participate.

21.06 In the United Kingdom, the CLRSG recommends that a company should be permitted to hold a general meeting at more than one location, with two way real time communication between the participants, and that the law should if necessary make this clear. The CLRSG further recommends that detailed rules for dispersed meetings (e.g. on the type of communications, the arrangements for verifying attendance) need to be responsive to changing technology and should therefore be best left to non-statutory rules[144]. The CLRSG proposes to include provision for dispersed meetings in the new version of Table A for both private and public companies[145].

Proposals

21.07 In view of the above, the SCCLR proposes that :-

(a) A Hong Kong company should be permitted to hold a general meeting at more than one location. The meeting should take place at the venue as specified by the notice of the meeting which would be regarded as the principal venue, but subsidiary or satellite venues should be allowed.
(b) To permit effective communication between venues, both visual and audio real time communications should be permitted by legislation.

AGMs required by Statute

21.08 Should private companies be allowed not to hold AGMs unless they opt to do so or its members demand one?

21.09 In Hong Kong, every company is required in each year to hold a general meeting as its AGM in addition to any other meeting in that year (section 111 of the Companies Ordinance ("CO")). However, a company may dispense with the holding of an AGM if everything that is required or intended to be done at the meeting is done by resolutions in writing in accordance with section 116B of the CO. Copies of documents (including any accounts or records) which, under the CO are required to be laid before AGM must be provided to each member of the company prior to their signing of the resolution.

21.10 In the United Kingdom, there is similar requirement for holding an AGM each year (section 366(1) of the Companies Act 1985 ("CA")). However, a private company may elect (by elective resolution in accordance with section 379A of the CA) to dispense with the holding of AGM pursuant to section 366A of the CA. The CLRSG recommends that public companies should be enabled to dispense with holding of AGMs provided that the members unanimously so decide. It also recommends a power for the Secretary of State by secondary legislation to permit public companies to dispense with the AGM provided that they comply with certain recognized rules meeting the essential public policy requirement

[144] The UK Report No.8, paragraph 5.21
[145] The UK Report No.8, paragraph 5.22

would be met by the AGM[146]. For newly formed private companies, the CLRSG recommends that, unless they opt to do so or members demand one, they will be free of any obligation to hold an AGM[147].

21.11 In Australia, after the First Corporate Law Simplification Act 1995 came into effect on 9 December 1995, proprietary companies (similar to private companies) are no longer required to hold AGMs. There is however no provision allowing public companies to dispense with holding of AGMs.

Proposal

21.12 In view of the above, the SCCLR proposes that for companies with more than one shareholder, the AGM should continue to be required unless there is unanimous shareholders' consent to dispense with it, however, single shareholder companies should not be required to hold AGMs.

Timing of AGM

21.13 Should the timing of the AGM be changed from once for each year to within a time period after the end of each financial year? If so, what should the time period be for private and public companies?

21.14 In Hong Kong, the United Kingdom and Singapore, it is required that not more than 15 months shall elapse between the date of one annual general meeting of the company and the next (section 111(1) of the CO, section 366 of the CA, section 175 of the Singapore Companies Act (Cap.50) ("SCA")). In Australia, all public companies must hold an AGM at least once in each calendar year and within five months after the end of the financial year (section 250N of the ACA).

21.15 In the United Kingdom, the CLRSG recommends that the requirement to hold an annual general meeting 'in each year' should be replaced by a requirement that one should be held within a certain period after the end of each financial year, namely, 10 months for private companies and 180 days for public companies. The requirement that the AGM must be held at least once in every calendar year will disappear in favour of the linkage to the financial year[148].

Proposal

21.16 In view of the above, the SCCLR proposes that the timing of the AGM should be changed to within a certain period after the end of each financial year of the company. For private companies with a share capital and companies limited by guarantee, the period should be nine months and for other public companies, the period should be six months.

Minimum Period of Notice

21.17 Should the minimum notice period for (i) the AGM, (ii) an EGM for passing special resolution; and (iii) an EGM not for passing special resolution be changed? If so, how?

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146 The UK Final Report, Vol. 1 paragraph 7.6
147 The UK Final Report, Vol. 1 paragraph 7.6
148 The UK Final Report, Vol. 1, paragraph 7.8

21.18 In Hong Kong, the minimum notice requirements under section 114(1) and section 116(1) of the CO for general meetings of companies are as follows: -

(a) in the case of an AGM, 21 days' notice in writing;
(b) in the case of a meeting which is neither an AGM nor a meeting for the passing of a special resolution, 14 days in writing in the case of a company other than an unlimited company and 7 days' notice in writing in the case of an unlimited company; and
(c) in the case of a general meeting for passing of a special resolution, 21 days' notice is required.

21.19 In the United Kingdom, the law relating to minimum period of notice is the same as that of Hong Kong (sections 369(1) and (2) and section 378(2) of the CA). The CLRSG recommends that for all general meetings (including AGMs) and for all limited companies, the minimum notice period should be 14 days[149]. For listed companies, the Combined Code provision for a minimum period of 20 working days should remain.

21.20 In Australia, at least 21 days notice must be given for a meeting of a company's members (section 249H(1) of the ACA). In the case of listed company, a minimum period of 28 days notice is required to be given notwithstanding anything in the company's constitution (section 249HA of the ACA).

21.21 In Singapore, not less than 14 days notice is required for all meetings of a company (including AGMs) other than a meeting for the passing of a special resolution (section 177(2) of the SCA). In the case of a general meeting for passing of a special resolution, 21 days' notice is required (section 184(1) of the SCA).

Proposal

21.22 In view of the above, the SCCLR recommends that the existing minimum period of notices for the AGMs and the EGMs should be maintained. Any variation for EGMs of listed companies can be included in the Listing Rules.

Service of Notice

21.23 Should specific provisions for service of notice by means of electronic communications and/or by posting on the web sites be made?

21.24 Notice should be served in the manner as provided in a company's constitution (section 114(1) of the CO). In Hong Kong, Regulation 132 of Table A only provides that a notice may be given personally or by post. Though members may agree to alter the company's articles to provide other means of service of notice, there is no express provision, unlike in the United Kingdom or Australia, that notice can be delivered by fax or using electronic communications.

21.25 In the United Kingdom, after the Companies Act 1985 (Electronic Communication) Order 2000 came into operation on 22 December 2000, a

[149] The UK Final Report Vol. 1 paragraph 7.10

company may send notice using electronic communications to such address as may for the time being notified by that person to the company for that purpose (section 369(4A) of the CA) or by publishing the notice on a web site in accordance with section 369(4B) of the CA notwithstanding any provision to the contrary in its articles (section 369(4E) of the CA).

21.26 In Australia, section 249J(3) of the ACA expressly provides that a notice of a meeting may be served on a member by sending it to the fax number or electronic address nominated by the member or by any other means that the company's constitution (if any) permits.

Proposal

21.27 In view of the above, the SCCLR does not recommend service of notice by posting on web sites. It proposes that notices should be given personally or sent by post to shareholders unless the shareholders agree to adopt electronic means of communication including the use of personal identification numbers. This requirement should be included in the main body of the Companies Ordinance and Table A.

Contents of Notice

21.28 Should certain minimum amount of information (e.g. the text of the resolution, a brief explanation of the reasons behind any proposed resolution, including relevant biographical details of a director proposed for election or re-election, material interests of directors or major shareholders, etc.) be required to be disclosed in the notice?

21.29 At common law, the information contained in or with the notice must be sufficient to allow a member to determine whether or not to attend the meeting[150]. If a material fact is not disclosed in the notice calling the meeting, any resolutions passed will be invalidated at the instance of a member who did not attend[151].

21.30 In Hong Kong, the SCCLR has previously recommended that dispersed notice provisions be consolidated under one general criterion, i.e. the notice must provide a full explanation (including conflict of interests) of any proposed transaction to enable the shareholders to form a judgment[152].

21.31 In Australia, the CAMAC recommends that there should be no legislative prescription of the information to be contained in a notice of meeting of a listed company as it takes the view that that the current common law principles are sufficiently clear[153].

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[150] *Chung Cheung She etc. Al v. The Sze Yap SS Company Ltd.* [1931] HKLR 77 (Court of Appeal, HK); *Kaye v. Croydon Tramways Co.* [1989] Ch 358.

[151] *Tiessen v. Henderson* [1899] 1 Ch 461 (High Court, UK); *Ballie v. Orient Telephone etc. Co. Ltd.* [1915] 1 Ch 503 (Court of Appeal, UK).

[152] The Report of the SCCLR on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance published in Feb 2000 ("SCCLR Report"), Recommendation 80, p.96.

[153] The Australian Final Report, Recommendation No.3, p.17

21.32 In the United Kingdom, the CLRSG also recommends that there should be no new statutory requirements relating to the contents of a meeting notice, but the Standards Board should be able to prescribe rules for the content of meeting notices[154].

Proposal

21.33 In view of the above, the SCCLR proposes that there should be a requirement of minimum information to be given in the meeting notices regarding the proposed resolutions. Such a requirement can be put in the Listing Rules for listed companies and in the Companies Ordinance for unlisted companies.

Agenda of AGM

21.34 Should a minimum agenda of the AGM be prescribed?

21.35 In Hong Kong, company legislation does not prescribe any agenda for an AGM except the requirement for laying financial statements, directors' and auditors' reports under sections 122, 129C and 129D of the CO. However, Regulation 54 of Table A provides that the general business of an AGM includes the declaration of dividends, consideration of the accounts, balance sheets and the reports of directors and auditors, the election of directors in the place of those retiring and the appointment of, and the fixing of the remuneration of auditors.

21.36 In Australia, section 250R of the ACA provides that the business of an AGM may include any of the following, even if not referred to in the notice of meeting: (a) the consideration of the annual financial report, directors' report and auditors' report; (b) the election of directors; (c) the appointment of the auditors; and (d) the fixing of the auditor's remuneration.

21.37 In the United Kingdom, there is neither legislation nor any regulation in Table A prescribing any agenda for an AGM except the requirement for laying financial statements, directors' and auditors' reports under section 241 of the CA. The CLRSG does not recommend that the law should require any specified matters to be dealt with at the AGM, other than laying of the reports and accounts and the consequential appointment or reappointment of the auditors, where they are subject to annual appointment[155]. The CLRSG recommends, however, that the Standards Committee should be empowered to issue (non-statutory) rules on this subject[156]. Further, the CLRSG proposes to drop the statutory requirement that auditors' remuneration should be fixed by shareholders in general meeting under section 390A of the CA[157].

Proposal

21.38 In view of the above, the SCCLR proposes that the existing law on agenda of AGM should be maintained, but the part of section 141(2) of the Companies Ordinance which requires the auditor's report to be read before the company in

[154] The UK Final Report, Vol.1 paragraph 7.10
[155] The UK Final Report Vol.1 paragraph 7.9
[156] The UK Report No.8 paragraph 5.27
[157] The UK Final Report Vo.1, paragraph 7.9

general meeting should be repealed as the report has already been certified by the auditor and circulated to the shareholders well in advance of the general meeting.

Members' Resolution

21.39 Should shareholders' resolutions be circulated by the company without any charge on the requisitionists if they are received in time by the company to circulate them out together with the notice of meeting?

21.40 In the subject jurisdictions, all company law has provisions allowing a certain proportion of shareholders to require the company to circulate their proposed resolutions or statements to be considered at the company's next AGM. This enables the requisitionists to bring the matter to the attention of other shareholders and seek their support before they decide whether or not to attend the meeting or how to complete their proxies.

21.41 In Hong Kong, it is the duty of a company, on the requisition in writing of a member or members representing not less than 5% of the total voting rights[158], or 100 shareholders holding shares on which there is an average paid-up capital of not less than HK$2000 (unless the company otherwise resolves) at the expense of the requisitionists –

(a) to give to members of the company entitled to receive notice of the next annual general meeting notice of any resolution which may properly be moved and is intended to be moved at that meeting;
(b) to circulate to members entitled to have notice of any general meeting sent to them any statement of not more than 1 000 words with respect to the matter referred to in any proposed resolution or the business to be dealt with at that meeting (section 115A of the CO).

21.42 In the United Kingdom, Australia and Singapore, there are provisions similar to section 115A of the CO (section 376 of the CA, section 249N of the ACA and section 183 of the SCA).

21.43 In Hong Kong, the United Kingdom and Singapore, it is the requisitionists who bear the costs of circulating the notices of shareholders' resolutions or statements (section 115A(1) of the CO, section 376(1) of the CA and section 183(1) of the SCA). However, in Australia, it is the company which is responsible for the cost thereof if the company receives the notice in time to send it out to members with the notice of meeting (sections 249O(3) & (4) of the ACA).

21.44 In the United Kingdom, the CLRSG recommends that members' resolutions received in time should be circulated with the meeting notice to be sent out free of charge (i.e. at the company's expense)[159].

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[158] The SCCLR has previously recommended that the threshold for shareholders' proposals be reduced from 5% of voting rights or 100 shareholders to 2.5% of voting rights or 50 shareholders. The Recommendation has been included in the Companies (Amendment) Bill 2002.

[159] The UK Final Report Vol.1 paragraph 7.12.

21.45 In Hong Kong, during the Bills Committee Stage of the Companies (Amendment) Bill 2002, a submission was received suggesting a deposit system as an alternative approach to dealing with members' resolutions. Instead of the requirement to meet a certain threshold for circulating members' resolutions, all that the requisitioning member has to do is to place a certain deposit (to be fixed by law) with the company, and the company is then obliged to circulate the requisitioning member's resolution. If the proposal eventually receives a minimum percentage of shares voted in support (to be fixed again by law), the deposit will be refunded to the requisitionist on the basis that the proposal has sufficient merit. This is irrespective of whether the proposal is carried or defeated. The deposit will be taken by the company and used to meet the expenses on circulating the proposal if the proposal receives no or less than the minimum percentage of support.

Proposal

21.46 In view of the above, the SCCLR proposes that shareholders' resolutions and related information should be circulated at the expense of the company if they were received by the company one month after the notification of the intention to hold the AGM or two weeks before the anticipated date of dispatch of the AGM notice (whichever is the later) provided that the shareholders requesting the circulation meets the threshold requirements and the document for circulation consists of not more than 1000 words. The SCCLR does not, however, propose that the duty of the company to circulate members' resolutions should be extended to EGMs called by directors as it would be difficult for the shareholders to know the date of such EGMs.

21.47 As an alternative, the SCCLR would also welcome views on the proposal regarding a deposit outlined in paragraph 21.45 above.

21.48 The SCCLR has also considered a related issue regarding the right of shareholders to nominate directors for election at general meetings. The proposal in paragraph 10.29(e) of the Consultation Paper on Phase I of the Corporate Governance Review stated that the right of the shareholders to elect directors should be clearly set out in the legislation so that it could not be excluded by the articles of association of the company. This proposal was endorsed by consultees and appropriate legislative amendments will be drafted. However, the SCCLR has not reached a firm decision on -

- whether there should be any limit on the number of such nominations;
- what should be the criteria for nomination;
- what should be the percentage of shareholding requirement for such nominations.

The SCCLR would like to seek the views of the public on the above questions.

Written Resolution

21.49 Should the requirement for unanimous approval of a written resolution be replaced by a requirement that special resolutions be approved by a majority of three quarters of those entitled to vote and ordinary resolutions by a simple majority of those entitled to vote?

21.50 In Hong Kong, section 116B of the CO provides that anything which may be done by a company by resolution in general meeting may be done, without a meeting and without any pervious notice, by a resolution signed by or on behalf of all members who at the date of the resolution would be entitled to attend and vote at the meeting[160].

21.51 The United Kingdom and Australia have the equivalent provisions (section 381A of the CA, section 249A(2) of the ACA) but both of them apply to private companies only. In Singapore, there is no provision in the SCA allowing a company to dispense with a meeting by written resolution. Instead, companies in Singapore may rely on the common law doctrine of unanimous consent rules to dispense with formal meeting and notice for decision making (*Jimat Bin Awang v Lai Wee Ngen* [1995] 3 SLR)[161].

21.52 In the United Kingdom, the SLRSG recommends that the requirement for unanimous approval of a written resolution should be replaced by a requirement that special resolutions be approved by a majority of three quarters of those entitled to vote and ordinary resolutions by a simple majority of those entitled to vote[162]. The CLRSG explains that this would prevent a minority shareholder delaying decision-making.

Proposal

21.53 The SCCLR considers it dangerous to replace the requirement of unanimous approval of a written resolution by a percentage of votes and proposes that unanimous approval should be maintained.

Functions and Duties of Chairman of a Meeting

21.54 Should there be a general formulation or codification of the functions and duties of chairman of a shareholders' meeting?

21.55 The chairman of a shareholders' meeting has a very broad discretion on how to perform the role. The legislation in all the subject jurisdictions contains similar provisions as to the general powers and obligations of the chairman, for example :-

(a) to determine objections to a person's right to vote (Reg. 68 Table A of the CO, Reg. 58 Table A of the CA, section 250G (RR)[163] of the ACA and Reg. 58 Table A of the SCA);
(b) to declare the results of a vote on a show of hands (Reg. 60 Table A of the CO, Reg. 47 Table A of the CA, section 250J(2) (RR) of the ACA and Reg. 51 Table A of the SCA);

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160 Section 116B(1) of the CO. This section was substituted pursuant to section 14 of the Companies (Amendment) Ordinance 2000 (46 of 2000), commencing 1 July 2000.
161 where the Singapore Court of Appeal upheld the principle that no general meeting need to be held if all the members assent to a certain course of action.
162 The UK Consultation Paper, paragraph 4.3
163 i.e. Replaceable Rule. For the meaning of Replaceable Rule, please refer to note (48)

(c) to demand a poll[164] (section 114D(1)(a) of the CO, Reg. 46 Table A of the CA, section 250L(1)(c) of the ACA);
(d) to determine when and how to conduct a poll (Reg. 63 Table A of the CO, Reg. 51 Table A of the CA, section 250M(1) (RR) of the ACA and Reg. 52 Table A of the SCA); and
(e) to adjourn the meeting (Reg. 59 Table A of the CO, Reg. 45 Table A of the CA, section 249U(4) (RR) of the ACA and Reg. 50 Table A of the SCA).

21.56 At common law, the duty of the chairman is to ensure that the meeting is properly run[165] and that order is maintained[166]. He has the authority to decide all incidental questions arising at the meeting concerning its proceedings which require decisions at the time[167].

21.57 In the United Kingdom, the CLRSG has considered whether it would be helpful to codify the law on the duty of the chairman by including basic principles and rules in the Act[168]. However, in its Final Report, it does not make any recommendation for any codification of the functions and duties of the chairman of a meeting.

21.58 In Australia, the CAMAC has also discussed whether there should be a general formulation of the functions and duties of the chair of a meeting[169]. The CAMAC believes that its necessarily broad language would make it unsuitable for legislation or could create considerable difficulties or uncertainties in its interpretation[170] and therefore recommends that there should be no statutory formulation of the functions and duties of the chair of a meeting of a listed public company[171].

Proposal

21.59 In view of the above, the SCCLR proposes that there should be a general formulation of the functions and duties of the chairman of a meeting to be placed in the Listing Rules and not in the Companies Ordinance.

Voting on a Show of Hands

21.60 Should voting by a show of hands be prohibited, particularly on contentious business?

21.61 Voting can be conducted by a show of hands or by a poll. In all the subject jurisdictions, unless otherwise provided in a company's articles, a resolution put

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164 Section 250L(1)(c) of the ACA. In *Second Consolidated Trust Limited v Ceylon Amalgamated Tea and Rubber Estates Limited* [1943] 2 All ER 567, the chair held proxies which would have defeated a resolution. The chairman decided not to demand a poll, with the result that the resolution was passed by a show of hands. It was held that the chairman had a legal duty to demand a poll and use the proxies, as this was part of his duty to ascertain the sense of the meeting.
165 *National Dwellings Society v Sykes* [1894] 3 Ch 159
166 *John v Rees* [1969] 2 All ER 274
167 *Re Indian Zoedone Co*. (1884) 26 ChD 70
168 The UK Report No.5, paragraph 4.62
169 The Australian Final Report, Issue 25, p.80
170 The Australian Final Report, paragraph 4.159, p.81
171 The Australian Final Report, Recommendation 25, p.82

to the vote at any general meeting shall be decided on a show of hands unless a poll is (before or on the declaration of the result of the show of hands) effectively demanded (Reg. 60 Table A of the CO, Reg. 46 Table A of the CA, sections 250J(1) & 250L of the ACA and Reg. 51 Table A of the SCA).

21.62 In the United Kingdom, the CLRSG considered the disadvantages of voting by show of hands. Although voting by a show of hands has the merit of enabling uncontroversial resolutions to be disposed of quickly, given the unrepresentative nature of the attendance at general meetings of large companies, voting by show of hands seems anomalous, particularly so if Table A applies, and proxies have no vote[172]. The CLRSG does not propose to rule out voting by show of hands by statute. However, it proposes to consider further the case for a regulatory rule requiring listed companies to proceed directly to a poll on any business likely, on the basis of proxies lodged, to prove contentious, and, perhaps, guidance requiring the chairman to call a poll where he has reason to believe that it would yield a different result from the show of hands[173].

21.63 In Australia, the CAMAC notes the argument of some respondents that voting by show of hands should be discontinued, particularly on any contentious matter, given that it is uncertain whether it represents the true view of shareholders. The CAMAC, however, supports retaining voting by show of hands as a method of dealing with non-contentious matters expeditiously and inexpensively[174]. The CAMAC also notes that a recent UK report has also taken the same view[175]. The CAMAC recommends that there should be no legislative prohibition on voting by show of hands. Furthermore, there should be no codification of the common law duty of the chair to demand a poll where the chair holds proxies which may overturn the decision on a show of hands[176].

Proposal

21.64 Members of the SCCLR had diverse views on this issue: some members proposed that voting by a show of hands should discontinue whereas others believed that the chairman's discretion to call a poll should remain intact. In view of this, the SCCLR would like to obtain further views before deciding how to proceed.

Absentee and Electronic Voting

21.65 Should direct absentee voting and/or electronic voting be permitted?

21.66 In all the subject jurisdictions, there is no legislation which expressly permits postal voting or electronic voting though the issue is currently under consideration by the law reformers. Those supporting postal or electronic voting submit that the shareholders should be encouraged to participate effectively and vote in shareholders' general meetings through the use of modern technology. It is noted that, in New Zealand, legislation expressly recognized postal voting in

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172 The UK Consultation Paper, paragraph 45
173 The UK Report No.5 paragraph 4.48
174 The Australian Final Report paragraph 4.108
175 The UK Report No.5 paragraph 4.48
176 The Australian Final Report paragraph 4.109 p.68

that a shareholder may cast a postal vote on all or any of the matters to be voted on at a general meeting by sending a notice at least 48 hours before the meeting[177].

21.67 Those opposing postal or electronic voting argue that direct absentee voting may detract from the significance of a physical meeting as a forum for discussion and debate by shareholders. They are also worried about unresolved technical difficulties in authenticating the identity of persons using electronic voting.

21.68 In the United Kingdom, the CLRSG recommends that the new legislation should permit members of the company to vote electronically and that the Standards Committee should develop non-statutory rules or guidance for voting procedure[178].

21.69 In Australia, the CAMAC favours any form of voting that would assist shareholder participation in corporate decision-making. Postal or electronic voting may be more attractive to some shareholders than proxy voting. The CAMAC recommends that the Corporations Law should permit directors of a listed public company to provide for direct absentee voting, subject to any restriction in the company's constitution[179].

21.70 In Singapore, the Committee on Corporate Governance in the Code of Corporate Governance sets out the principle and guidance notes in paragraphs 15 and 15.1 as follows: -

"15 " Companies should encourage greater shareholder participation at AGMs, and allow shareholders the opportunity to communicate their views on various matters affecting the company.

"15.1 Shareholders should have the opportunity to participate effectively and to vote in AGMs. They should be allowed to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia. In this regard, companies are encouraged to make the appropriate provisions in their articles of association to allow for absentia voting methods such as by mail, email, fax, etc, if the shareholders so consent."

Proposal

21.71 In view of the above, the SCCLR proposes that absentee voting should be permitted. Absentee voting by post should be done before and not after the meeting as signatures have to be verified. Postal votes should reach the company during the same period as for lodging of proxy forms.

21.72 The SCCLR also proposes that electronic voting should be permitted and there should be rules and guidance for such voting procedures (e.g. authentication, security and the precedence as between votes received electronically and by post).

[177] New Zealand Companies Act 1993 First Schedule cl 7.
[178] The UK Final Report Vol.1 paragraph 7.11
[179] The Australian Final Report, Recommendation 20, p.74.

The Companies Ordinance should be amended to enable rather than to compel electronic voting while the Listing Rules should encourage such voting.

One Proxy for Each Shareholding

21.73 Should members be permitted to appoint a proxy for each beneficial holding at a given meeting, thus ensuring that where a nominee or trustee member has beneficial holders who wish to vote in different ways, their wishes can be accommodated?

21.74 In all the subject jurisdictions, it is provided that any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of him (section 114C(1) of the CO, section 372(1) of the CA, section 249X(1) of the ACA and section 181(1) of the SCA).

21.75 In Hong Kong and Singapore, unless the articles otherwise provide, the number of proxies so appointed to attend on the same occasion shall not exceed two (section 114C(2) of the CO, section 181(1) of the SCA). In the United Kingdom, unless the articles otherwise provide, the number shall not exceed one (section 372(2)(b) of the CA). In Australia, a member may appoint two or more proxies if he is entitled to cast two or more votes at the meeting (section 249X(2)[180] of the ACA).

21.76 In the United Kingdom, the CLRSG notes the growing separation between the legal and beneficial ownership of shares because of the growth of such specialist institutions as custodians, depositories and broker nominees, each of which plays a key role in the efficient holding, transfer and recording of shares, but has no economic interest in taking an active part in corporate governance. The CLRSG sees it important that the law should provide convenient mechanisms by which the beneficial owners or their representatives can participate in governance, and that any unnecessary obstacles to their participation should be removed.

21.77 It is, of course, open to the legal owner to arrange for the beneficial owner to receive company information and to appoint the beneficial owner as his proxy at a company general meeting[181]. However, the CLRSG considers that the present section 372 of the CA is inadequate for it provides that each member of a private company may appoint only one proxy to attend and vote on his behalf unless otherwise provided in the Articles[182].

21.78 In view of this, the CLRSG recommends that section 372 of the CA should be amended to require all companies to permit a member to appoint a proxy for each beneficial holding at a given meeting, thus ensuring that where a nominee or trustee member has beneficial holders who wish to vote in different ways, their wishes can be accommodated.[183]

[180] It is a Replaceable Rule for proprietary companies. For the meaning of Replaceable Rules, please refer to footnote (48)

[181] The UK Final Report paragraph 7.2.

[182] Please note however that Reg. 59 Table A in the UK provides a member may appoint more than one proxy to attend on the same occasion.

[183] The UK Consultation Paper paragraph 50. It is however noted that in the UK Final Report, the

Proposal

21.79 In view of the above, the SCCLR proposes that, without prejudice to the general principle of company law that a company is not concerned with trusts over its shares, multiple proxies should be permitted.

Proxies to Vote on a Show of Hands

21.80 Should proxies be permitted to vote on a show of hands?

21.81 In the subject jurisdictions, a proxy appointed to attend and vote instead of a member shall have the same right as the member to vote on a poll and speak at the meeting[184] (section 114C of the CO, section 372 of the CA, section 249Y of the ACA and section 181 of the SCA), and to demand or join in demanding a poll (section 114D(2) of the CO, section 373(2) of the CA, section 249Y(2) of the ACA and section 178(2) of the SCA). In Hong Kong, the United Kingdom and Singapore, unless the articles otherwise provide, a proxy shall not be entitled to vote except on a poll (section 114C(1A) of the CO, section 372(2)(C) of the CA and section 181(1)(1) of the SCA). However, in Australia, unless forbidden to do so by a company's constitution, a proxy can also vote on a show of hands (section 249Y(2) of the ACA).

21.82 For the reasons set out in paragraphs 21.76 to 21.78 above, the CLRSG in the United Kingdom also considers that the present section 372 of the CA is inadequate for it only provides that a proxy may vote on a poll and may speak at a meeting of a private company; but he may not speak at a meeting of a public company, nor vote on a show of hands at either a public or a private company meeting, unless permitted to do so by the articles. The CLRSG therefore suggests that section 372 of the CA should be amended to permit proxies to vote on a show of hands and to speak at meetings of public as well as of private companies.

Proposal

21.83 The SCCLR proposes that proxies should be allowed to vote on a show of hands and to speak at the meeting. However, it is noted that, in the case of the chairman being appointed as the proxy for more than one shareholder, his vote, on a show of hands, would still be counted as one vote only.

Proxy Solicitation

21.84 Should proxy solicitations be regulated?

21.85 In Hong Kong, the SCCLR has considered the issue and came to the view that provisions for a proxy system should be further considered. According to the SCCLR, liability provisions for proxy solicitations, whether by management or shareholder, are important because the common law of misrepresentation is ill suited to penalize misleading proxy materials. The underdevelopment of the law in this area in one part may probably be due to the lack of demand. However,

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recommendation that a proxy may vote on a show of hands is missed out, see The UK Final Report Vol.1 paragraph 7.13

[184] In the United Kingdom, only a proxy of a private company can speak: section 372(2) of the CA.

with anticipated growth in pension funds, consideration should be given to formulating a proper proxy regime in company law, thus enabling investors effectively to exercise their collective voices which would be useful in improving corporate governance[185].

21.86 In Australia, the CAMAC has considered whether the Corporations Law should regulate proxy solicitation by requiring that any proxy solicitations be first filed with the company, the relevant Exchange and/or the Australian Securities and Investments Commission. It is noted that the filing of proxy solicitations would ensure equal access by shareholders to information that has been disseminated and assist in guarding against shareholders receiving false or misleading information in proxy solicitation documents. However, the CAMAC considers that, while proxy solicitations may become more important in the future, there is no current evidence of abuse that would justify introducing a proxy register at this time[186]. The CAMAC therefore recommends that there should be no statutory regulation of proxy solicitations[187].

Proposal

21.87 The SCCLR would like to seek the views of the public on whether proxy solicitations should be regulated.

Delivery of Proxy by Electronic Means

21.88 Should there be specific provisions for the delivery of proxies by electronic means?

21.89 In Hong Kong, unless the articles otherwise provide, the instrument appointing a proxy shall be in writing under the hand of the appointer or of his attorney duly authorized in writing, or if the appointer is a corporation, either under seal or under the hand of an officer or attorney duly authorized (Reg. 70 Table A of the CO). Singapore has similar provisions **(**Reg. 59 Table A of the SCA).

21.90 Lodgment of proxies by electronic means is not expressly permitted under the CO. However, by virtue of sections 5, 6 and 15 of the Electronic Transactions Ordinance (Cap. 553), which came into operation in early 2000, members may agree with the company that electronic record will satisfy the writing requirement and that a digital signature will satisfy the signature requirements under the statutes and Table A.

21.91 Lodgment of proxies by electronic means is now expressly permitted under the companies legislation of the United Kingdom and Australia.

21.92 In the United Kingdom, after the Companies Act 1985 (Electronic Communications) Order 2000 came into operation on 22 December 2000, in so far as the articles of the company do not make other provision in that behalf, the appointment of a proxy may be contained in an electronic communication sent to such address as may be notified by or on behalf of the company for that purpose

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[185] The SCCLR Report, paragraphs.7.33.and 7.34, p.102.
[186] The Australian Final Report paragraph 4.19
[187] The Australian Final Report, Recommendation 9, p.43

(section 372(2A) of the CA). In all relevant sections, the words *"the instrument appointing a proxy"* was replaced with *"the appointment of a proxy"* by the Companies Act 1985 (Electronic Communications) Order 2000 in order to avoid any doubt as to the formalities of proxy.

21.93 In Australia, it is also provided that an appointment authority can be sent by fax or electronic transmission. An appointment authority is treated as received if it is delivered to the company's registered office, or a fax number at the company's registered office, or a place, fax number or electronic address specified for the purpose in the notice of meeting (section 250B(3) of the ACA). Section 250BA of the ACA requires listed companies to specify a place and fax number for the purpose of receipt of proxy appointment, and give those companies the option to specify an electronic address.

Proposal

21.94 In view of the above, the SCCLR proposes that specific provisions should be made for the delivery of proxies by electronic means and that there should be guidance on how an electronic proxy is to be signed.

A Proxy to Vote on Poll according to their Terms

21.95 Should there be a requirement for any person put forward by the company board as a proxy to vote the proxies on any poll according to their terms?

21.96 In Australia, the CAMAC considers that the Corporations Law should stipulate that any person put forward by the board of the company as a proxy must vote the proxies on any poll at the meeting according to their terms and recommends that there should be such a legislative amendment. This would overcome the possibility of shareholders being disenfranchised by a person, other than the chair, who is put forward by the board as a proxy deliberately failing to vote that proxy in accordance with the shareholder's instructions[188].

21.97 There is little reference to this issue in the reform studies in the other subject jurisdictions.

Proposal

21.98 In view of the above, the SCCLR proposes that there should be a requirement for any person put forward by the company board as a proxy to vote by using on any poll according to their terms.

Disclosure of Proxy Voting Information

21.99 Should there be any requirement for disclosure of proxy voting information (i) prior to the meeting or (ii) after the meeting where resolutions have been decided by a show of hands?

21.100 In Australia, at a meeting of any company that is subject to the Replaceable Rules[189], the chair must disclose before any vote is taken whether any proxy

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[188] The Australian Final Report paragraph 4.43

[189] The ACA provides a set of rules applicable to all companies registered on or after 1 July 1998[189], called

votes have been received and how they are to be cast[190]. Further, all the Australian listed public companies must record in their minutes of meeting details of voting on any resolutions decided by a show of hands or on a poll[191]. There is no similar provision in Hong Kong and other subject jurisdictions.

21.101 The CAMAC has considered, (i) whether there should be any control on disclosing proxy voting details prior to debate at the meeting, (ii) whether the legislation should prohibit or require disclosure of the proxy figures in advance of the debate, and (iii) whether it should be left to the meeting or the discretion of the chair to determine whether to disclose the proxy position in advance of the debate. The CAMAC considers that it would be undesirable to attempt to prescribe by legislation whether proxy-voting figures should be disclosed in advance of the debate. In some instances, disclosure could be desirable to assist in working through the meeting agenda; in other instances, it might unduly prejudice the opportunity for discussion[192].

21.102 The CAMAC recommends that: -

(a) there should be no legislative provision dealing with access to or disclose of proxy voting details prior to a meeting but that each relevant Exchange, however, might consider introducing into its Listing Rules a requirement that an independent person receive and collate proxy votes[193];
(b) there should be no legislative provision dealing with the disclosure of proxy voting details prior to the debate at a meeting. This should remain a matter of discretion for the chair[194]; and
(c) the current requirement in section 251AA(1)(a) for disclosure of proxy voting information where resolutions have been decided by show of hands should be retained, and extended to include direct absentee votes, if introduced[195].

Proposal

21.103 In view of the above, the SCCLR proposes that there should be a requirement for the chairman of the meeting to disclose the number of proxies held by the company and the voting instructions (if any) thereunder to the meeting before the vote. If the proxy was a general proxy with no voting instructions, the way the chairman intended to use that proxy to vote should also be disclosed.

Inspection of Proxy Document

21.104 Should shareholders have a legislative right to inspect proxy document (i) before and/or (ii) after the conclusion of the general meeting?

"Replaceable Rules" governing their internal administration and management. Companies may be formed with a constitution that replaces or modifies any of the Replaceable Rules: section 135(2) of the ACA. Failure to comply with the Replaceable Rules applicable is not of itself a contravention of the ACA: section 135(3) of the ACA, but has effect as a breach of the company's constitution: section 140 of the ACA.

190 Section 250J(1A) of the ACA.

191 Section 251AA of the ACA.

192 The Australian Final Report, paragraph 4.69, p.56

193 The Australian Final Report, Recommendation 14, p.53

194 The Australian Final Report, Recommendation 15, p.57

195 The Australian Final Report, Recommendation 16, p. 62

21.105 There is no legislative provision for inspection of proxy document in the subject jurisdictions.

21.106 In Australia, the CAMAC recommends that any one or more shareholders who between them have at least 5% of the issued voting shares should have a legislative right to inspect proxy documentation for 48 hours after the conclusion of the general meeting of a listed public company[196].

Proposal

21.107 The SCCLR proposes that any shareholder should be able to inspect votes but the inspection should be made after the meeting so as not to disrupt the proceedings.

[196] The Australian Final Report, Recommendation 16, p. 62

CHAPTER 5

CORPORATE REPORTING

22. The Responsibilities, Liabilities and Independence of External Auditors

Background

22.01 Under the Companies Ordinance, companies are required to have an auditor, normally appointed by and confirmed in office yearly by the Annual General Meeting (AGM). The auditor's role is fundamental in ensuring both truth and comprehensiveness in financial reporting, and that a company's management is properly accountable to shareholders and to external stakeholders. The audit process also benefits these interests, indirectly, by encouraging good corporate governance. Furthermore, it reassures investors in the company that reporting is true and fair. In addition, by adding to the reliability of, and confidence in, financial statements, the independent audit improves the efficiency of resource allocation through the capital markets, and this should mean that the cost of capital is lower than would otherwise be the case. In view of this, it is important to note potentially problematic developments since the main provisions on auditing were first enacted.

22.02 The first development concerns the scope of the audit. A long-standing problem has been that more is expected of auditors than they are required under the law to deliver, or are able to without a much more costly and intrusive audit. For example, the general public often assumes that a primary task of the statutory audit is to expose fraud and other criminality. Furthermore, governments and regulators also expect an increased contribution by auditors towards the detection of fraud. Even among informed commentators there can be a reluctance to accept that corporate failure is an inevitable feature of the capitalist system and that the collapse of large companies will tend to expose accounting weakness and financial malpractice. In reality, auditors cannot be expected to detect a carefully planned and executed fraud. This has led to the so-called 'expectations gap', namely the gap between what auditors can achieve and what users think they can achieve. At the same time, the case of *Caparo Industries plc v Dickman (1989)* has aggravated this problem as it restricted the scope of an auditor's liability to a degree that has led to widespread criticism. However, the restrictive view of the range of liability adopted was itself prompted by a huge expansion over the past 35 years in the field of professional negligence liability for careless misstatement causing financial loss. The recent case of *Royal Bank of Scotland v. Bannerman Johnstone Maclay and others (The Times 1 August 2002)* appears to have extended the liability of auditors by determining that a company's auditors could hold a duty of care to lenders if they knew, or ought to have known, that the lender would rely on their client's accounts and the auditor did not disclaim exposure. The potential exposure of auditors is now very great.

22.03 A second important development is the radical change in the structure of the accountancy profession, which raises questions about the auditor's independence. In the early years of audit regulation, the big accountancy firms derived a high proportion of their revenue from auditing. Today these same firms are, in effect, financial service and consultancy conglomerates, offering advisory services that range from human resources consulting, actuarial and legal advice, to management consulting and much else. The provision of other services is also common among smaller firms. As a result, there is an inevitable concern that potential conflicts of interest arise from combining these activities with the statutory audit function.

22.04 Most recently, both these major concerns have come to a head with the various major corporate collapses in the U.S.A. in late 2001 and early 2002 e.g. Enron, Worldcom etc. All these events have raised very fundamental questions about auditors' independence and the regulation of the accountancy profession. In the U.S.A. and the United Kingdom, to name but two jurisdictions, a number of major reforms and reviews have been either implemented or initiated as a result of these events. Consequently, the background against which the SCCLR has been considering auditing issues and formulated proposals is very fast changing, and this needs to be taken into account when considering the proposals in this section.

22.05 As Hong Kong's Companies Ordinance is essentially derived from the United Kingdom's Companies Acts, the SCCLR, in formulating its proposals on auditors, paid particular regard to parallel proposals in the United Kingdom being developed by the Company Law Review Steering Group (CLRSG) in the context of the current review of the United Kingdom Companies Act. The issues are considered under the following headings, namely -

- Auditors' Functions
- Auditors' Independence
- Auditors' Duties
- Auditors' Liabilities

Auditors' Functions

Statutory Functions

22.06 The SCCLR believes that there are no real issues surrounding the current range of auditors' statutory functions. In the United Kingdom, the CLRSG has reached a similar conclusion but recommended that auditors should be required by legislation to :-

- Audit the financial statements, as at present, but report explicitly on the statement of cash flows; and

- Review the Operating and Financial Review (OFR), which would be a wholly new function.

22.07 At present, the accounting and auditing provisions in the Companies Ordinance are being comprehensively reviewed by the Joint Government/HKSA Working Group (JWG). In the context of this review, consideration is being given to changing the obligation for the directors of every company to lay before the company at its annual general meeting a profit and loss account and a balance sheet to an obligation to lay before the company annual financial statements or financial statements. As a consequence of this, the requirement of the auditors will be to report on the financial statements.

22.08 The objective of the OFR for listed companies in the United Kingdom, as stated in paragraph 8.32 of the CLRSG's Consultation Document No. 8 is as follows :-

> "to provide a discussion and analysis of the performance of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future, so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them."

In Hong Kong, the nearest equivalent to the OFR is the Management Discussion & Analysis (MD&A) which listed companies are required to prepare under the Listing Rules. In section 23 of the Consultation Paper on Phase I of the Corporate Governance Review, the SCCLR proposed that the MD&A should be amended to include more qualitative and forward looking disclosure in a number of areas. These are now being addressed by HKEx in the current review of the Listing Rules.

Auditing Standards

22.09 Paragraph 26.13(a) of the Consultation Paper on Phase I of the CGR stated that :-

"(a) Hong Kong does not need independent standard setting bodies for accounting and auditing standards, given that they are very closely modeled on International Accounting Standards (IASs) and International Auditing Standards (ISAs). The standard setting function should continue to be vested in the HKSA but the composition of the Financial Accounting Standards Committee (FASC) and the Auditing Standards Committee (AuSC) of the HKSA should be widened to cater for more involvement of the public."

Paragraphs 26.13(b) to (g) made various proposals regarding ways and means in which the membership of the FASC and AuSC could and should be broadened. These recommendations were supported by consultees. The HKSA has already taken action to broaden the membership of the two committees in line with the SCCLR's proposals.

22.10 On the basis of the HKSA'S programme, it is expected that Hong Kong statements of Standard Accounting Practice (HKSSAPs) and Hong Kong Statements of Auditing Standards (HKSASs) will largely conform with current IASs and ISAs by the end of 2003. As a result, the baseline for Hong Kong's accounting and auditing standards will be international standards, but any enhancement over and above these standards will be determined locally. In view of this, the issue is not so much the nature and membership of the standard-setting bodies in Hong Kong but the degree and nature of Hong Kong's involvement in the international accountancy bodies which set and develop the baseline standards.

22.11 A separate but related issue is the quality and monitoring of audit practice which was addressed in section 28 of the Consultation Paper on Phase I of the CGR. Paragraph 28.16 asked the following three questions -

(a) Whether the current 'one standard fits all' approach is appropriate? Should a higher standard be required for firms auditing public companies?

(b) Should the frequency of reviews be higher for those audit firms that audit public companies, bearing in mind the additional costs that might be involved and be borne by the audit firms, and eventually, the business community?

(c) Whether audit firms performing audits of listed companies or companies with significant public interest should be subject to additional scrutiny or a separate regulatory regime?

22.12 A total of 10 respondents, including most of the major professional bodies, commented on this proposal. Two of them considered that there should be a higher degree of scrutiny for public companies, five considered that this was unnecessary, and one supported 'measures to improve the Practice Review mechanism' i.e. have a review. The other two either did not express a view on the comments of the proposals or just 'agreed' with them. Consequently, having regard to the <u>specific</u> views expressed, there seems to be a majority in favour of having a single monitoring regime status. However, a number of the respondents stressed that a 'single tier' regulatory regime also had to be one conducted to the highest possible standards in order to protect the public interest.

Proposals

22.13 The HKSA has recently commissioned the Joint Monitoring Unit Ltd (JMU) from the United Kingdom to undertake a fundamental review of the Practice Review Programme (PRP) with the intention of introducing a review system based on 'risk-assessment'. The JMU is a body formed by the Institute of Chartered Accountants of England and Wales (ICAEW), the Institute of Chartered Accountants of Scotland (ICAS) and the Institute of the Chartered Accountants of Ireland (ICAI) to monitor member firms' compliance with, inter alia, the United Kingdom's audit regulations and encourage the raising of standards within the accounting profession. It is expected that the first phase of the consultancy will be completed by mid-2003 and the recommendations will be reviewed by the Task Force. No timetable has been set for the second phase of the consultancy. In view of this development, it would be premature to recommend any changes to the PRP at this stage. However, the SCCLR urges the Government to closely monitor developments in this area as public confidence in the integrity of the audit process is absolutely fundamental to Hong Kong's continued status as a major financial and business centre. Furthermore, the SCCLR recommends that the issue of whether there should be independent regulation of the auditing profession should be considered by the Government in the context of the current review of the HKSA's regulatory regime.

Remuneration of Auditors

22.14 The shareholders' resolution concerning the appointment of auditors and their remuneration almost invariably authorizes the directors to determine the remuneration. In reality, once the shareholders have agreed to the appointment of the auditors at the AGM, there would be little, if any, room for subsequently negotiating the remuneration with them although any dissatisfaction with the level of remuneration would probably lead to the auditors not being reappointed during the following year. While giving the directors the power to fix the auditors' remuneration may give rise to a perception of a very close relationship between the directors and auditors, a number of points can be made as follows :-

(a) Once the auditors' remuneration has been fixed, the shareholders are powerless to take any further action until the following AGM;

(b) In practice, shareholders have little say in determining the auditors' remuneration, given the very high percentage of listed companies with a controlling shareholder;

(c) Notwithstanding (a) and (b), increasingly, the power to determine the auditors' remuneration is passing to the audit committee which acts as a better safeguard for fixing the remuneration than the shareholders.

Proposal

22.15 In view of the above consideration, the SCCLR proposes that section 131(8) of the Companies Ordinance be amended to remove the requirement for the shareholders to fix the auditors' remuneration or determine the manner of how it is to be fixed.

Auditors' Access to Information

22.16 The auditors have rights to information in order to assist them in carrying out their functions. In view of this, section 141(5) of the Companies Ordinance requires the directors and officers to provide such information and explanations as the auditors think necessary. This is subject to the criminal sanctions in section 134 where the director or officer knowingly or recklessly provides misleading, false or deceptive information.

Proposals

22.17 The SCCLR proposes that this duty should be extended in two ways as follows :-

(a) Employees should be brought within the scope of the current duty to provide information to auditors and its criminal sanction;

(b) For directors and the directors or auditors of a subsidiary undertaking of a company, the duty should be widened to require them to volunteer information where the normal standards of directors' or auditors' care and skill require them to recognize that such information is needed. However, the criminal sanction should be applied only to breaches of this extension of the duty where the director or auditor knows that the information is material to the audit.

22.18 These extensions are recommended in part to ensure that companies and their officers carry a proper share of the responsibility for ensuring that their accounts, and the audit assurance accompanying them, are properly addressed. Consequently, these duties thus form part of the basis for tackling the issue of liability. Accordingly, the civil consequences of a breach of the duties are considered in paragraph 22.49 (below).

Outgoing Auditors

22.19 In the context of the CLRSG's Review, it has been recommended that, on retirement, resignation or removal, outgoing auditors should be relieved of the duty of confidentiality that they owe to their clients (or former clients) to the extent necessary to enable them to disclose any matters to any actual or proposed successor auditors which they regard as material for them to be aware of. This would be additional to the existing rights and duties of such auditors to bring matters to the attention of shareholders and creditors.

Proposal

22.20 The SCCLR considers that outgoing auditors ought to be required to volunteer material information to their successors, subject to obtaining the HKSA's views on the subject and undertaking further research on the opinions of interested parties in the United Kingdom.

Auditors' Independence

Ethical Framework

22.21 Auditor independence is crucial in providing an assurance of the credibility of financial statements and to assist in the efficient functioning of capital markets. However, there is an increasing tendency for auditors to perform more audit-related services for the companies they audit. Consequently, there is a need to ensure that auditors are not only independent but are seen to be so.

22.22 In January 2002, the International Federation of Accountancy Bodies (IFAC) issued a revised version of its Code of Ethics for Professional Accountants. Member bodies, which include the HKSA, are committed to meeting its requirements unless they conflict with national law. The Code essentially reflects the existing Hong Kong approach to ethical standards setting and auditor independence. It sets out a framework that focuses on the factors which pose a threat to independence for all assurance engagements (including audits) and the safeguards that auditors should put in place to preserve their independence. In order to help the implementation of the principles in the Code, it contains examples of how this approach is to be applied to specific circumstances and relationships.

22.23 The HKSA has circulated the Code to its members for comments. The consultation period ended on 31 December 2002 and the HKSA is currently considering the comments received. It is hoped that the Code with appropriate amendments, if any, can be used as the basis for ethical standards for the accountancy profession in Hong Kong starting later in 2003. Consequently, as far as ethical standards are concerned, the HKSA's standards will be largely compatible with international best practice.

Provision by the auditor of non-audit services to audit clients

22.24 Professional ethical guidance in Hong Kong already restricts the provision by an auditor of non-audit services to the audit client. It forbids the provision of such services when they could present a threat to auditor independence for which no adequate safeguards are available. Consequently, auditors should never take on work which involves a management decision nor should they ever audit their own work. In addition, auditors should never be involved in executive recruitment or the provision of management systems.

22.25 The Enron collapse has brought into sharp focus the issue of whether there should be an outright ban, or greater restrictions, on the provision of non-audit services. The nature of the audit services, their absolute level, and their level relative to the audit fee are all relevant factors. A less interventionist approach would be to require greater disclosure of the value and nature of non-audit work carried out by auditors for audit clients. A further option is that a company's audit committee should approve the purchase of any non-audit services from the auditor and justify to its shareholders why this did not impair the auditor's independence.

22.26 The SCCLR agrees that the perception of auditor independence can be adversely affected by the scale and scope of non-audit services provided by the auditor to audit clients. However, against that, some services are required by legislation or contract to be provided by the auditors such as regulatory returns to the SFC. Furthermore, and more importantly, there are also circumstances where it makes commercial and economic sense for the auditor to provide non-audit services either because of the auditors' existing knowledge of the business or because the information required is a by-product of the audit process, and any threats to independence can be managed through appropriate safeguards. For example, it would be beneficial for auditors to assist their clients in setting up financial systems for a company which they audited because they would be able to check whether they were working properly.

22.27 In the United Kingdom, the Department of Trade and Industry (DTI) has established a Co-ordinating Group on Audit and Accounting Issues (the "Group") which submitted its Interim Report on 24 July 2002 and Final Report on 29 January 2003. The Final Report's recommendations regarding auditor provision of non-audit service (paragraphs 1.41 to 1.48) are as follows :-

> " There should be a further strengthening, within the principles-based framework, of the requirements on the provision of non-audit services. In particular :
>
> — There should be a strong presumption against providing internal audit services other than in exceptional circumstances;
>
> — The standard setter should carefully review the circumstances in which it is permissible to provide the following services, with a view to

further clarification, as appropriate, of when this is permissible and when safeguards are needed: valuation services (in particular actuarial services and litigation support services), taxation services, and the design and supply of IT and financial information technology systems."

22.28 In the U.S.A., the Sarbanes-Oxley Act (2002) has introduced a wide spectrum of various regulatory measures for auditors including the blanket prohibition of nine non-audit services for audit clients and the pre-approval of audit and non-audit services and issuer disclosure. The nine prohibited non-audit services are as follows :-

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;
- Management functions or human resources;
- Broker or dealer, investment adviser, or investment banking services;
- Legal services and expert services unrelated to the audit; and
- Any other service that the Board determines is impermissible.

Proposals

22.29 Having regard to the above developments, the SCCLR proposes that the Government and HKSA undertake work to -

(a) identify the types of non-audit services which are incompatible with the principles underlying auditor independence;

(b) enhance the disclosure of the provision by auditors of the nature and value of all services provided by auditors to audit clients, defining what falls into the categories of audit, audit-related and non-audit.

Consequent to this work, it will be possible to decide whether or not to deal with the issue through statutory or non-statutory means and how a company's audit committee can be involved in the process.

Rotation of Audit Firms

22.30 There is no requirement for the mandatory rotation of the audit firm, unlike the audit engagement partner. The collapse of Enron and the close and long standing relationship which this revealed between the company and Arthur Andersen's Houston Office has generated a renewed interest in auditor rotation. At present, of all the major economies that are members of the Organization of Economic Co-operation and Development (OECD), only Italy has mandatory audit firm rotation. Spain introduced mandatory audit firm rotation but dropped it before it took practical effect. A study carried out in Spain in the mid-1990's offered two main reasons against firm rotation as follows :-

(a) Mandatory rotation reduces the incentive on a company to improve audit quality given that, after a set period, it will lose the audit;

(b) Mandatory rotation will increase the number of first-time audits, with the resulting loss of much of the knowledge base accumulated by the previous auditor.

22.31 In the United Kingdom, the DTI's Review acknowledges that the rotation of the audit firm is an obvious way of preventing or curtailing 'over cosy relationships' between auditor and audit. Furthermore, problems come to light in the first years of a new auditor appointment precisely because the new auditor, lacking the previous auditor's familiarity with the client, takes a more careful and thorough look (paragraph 3.30 of the Interim Report). However, the Review also notes that there are significant disadvantages to mandatory firm rotation as follows :-

(a) It is inflexible and does not relate the decision to change auditors to the circumstances of the individual company e.g. if there are major changes in a company's senior financial management, it may be important not to change the auditors;

(b) For major listed international companies, the choice of auditors is, in practice, restricted to the 'big four'. Any change would simply result in a game of 'musical chairs' in which the number of chairs and players remain the same;

(c) Any additional benefits may be small when considered in the context of other changes being proposed in the United Kingdom such as the existence of an effective Audit Committee able to review auditor appointments and work;

(d) There is little evidence to support audit firm rotation from other countries.

22.32 Consequently, the Final Report concluded that there should not be a requirement for the mandatory rotation of audit firms nor for mandatory tendering for the audit engagement (paragraphs 1.28 and 1.30). It should also be noted that, in the U.S.A., the Sarbanes-Oxley Act (2002) requires the conduct of a study by the Comptroller General, to be completed within one year, of the potential effects of mandatory rotation of registered public audit firms.

Proposal

22.33 In view of the above, the SCCLR does not believe that there is a case for mandatory audit firm rotation in Hong Kong.

Rotation of Audit Partner

22.34 At present, the HKSA does not provide any professional guidance on the rotation of the audit engagement partner. However, if the IFAC Code of Ethics is adopted, it will be recommended best practice that such partners should be rotated every seven years. The European Union (EU) recommendation on auditor independence recommends, as a minimum, rotation of the key audit partners within seven years of appointment to the engagement team. In the United Kingdom, the DTI's Review shares the view expressed in the EU recommendation that there is a need for rotation of audit partners to go beyond the lead audit partner. In view of this, the Final Report welcomes the adoption by the leading United Kingdom accountancy bodies of strengthened requirements on audit partner rotation, namely a maximum of five years for the audit engagement partner and seven years for other key audit partners (paragraph 1.22). This would tighten up the existing requirement but leave sufficient flexibility to allow for orderly succession planning. In the U.S.A. the Sarbanes-Oxley Act (2002) requires the mandatory rotation of the lead and concurring partner after five years, and who would then be subject to a five-year "time out" period. It also prescribes specific rules for the rotation of partners other than the lead and concurring partners.

Proposal

22.35 In view of the above, the SCCLR proposes that there should be mandatory rotation of the lead and concurring partners every five years with a "time out" period of five years. Furthermore, the SCCLR believes that the Sarbanes-Oxley model with regard to other partners has merit and recommends a detailed review of the final rules that have been implemented to determine their relevance and applicability in Hong Kong. The SCCLR would welcome views on these recommendations.

Auditors' Duties

22.36 Generally speaking, auditors owe a duty of care, as laid down by the courts (*Carparo Industries v Dickman (1990) AC 605 HL*) to the following categories of person :-

(a) Existing shareholders of the company but only to enable them to perform their supervisory rights as shareholders in accordance with the concepts underlying the current legislation i.e. for 'corporate governance' not for buying and setting of shares purposes;

(b) Any other person and purpose to whom and for which they have, or are deemed to have, expressly or implicitly agreed to owe such a duty.

22.37 In the United Kingdom, the CLRSG pointed out that for some time, the basis of the 'Caparo' ruling has been regarded as outdated and in need of reform to conform with the demands of a modern economy, where those who attach importance to the audit of financial statements include future investors/shareholders, suppliers, employees and creditors (including banks), to name but a few (paragraph 5.147 of Consultation Document No. 5). However, if this were done, it was important to see that any extension of the duty of care was not abused as the potential liability for financial losses may prove to be very large.

22.38 In view of this, the CLRSG initially proposed (paragraph 5.152 of Consultation Document No. 5) that an extension of auditors' duty of care should be governed by a mix of specific categories and certain criteria so that auditors owe a duty of care to :-

(a) those who fall into certain specified categories e.g. actual investors and creditors, prospective investors and creditors (including the company's suppliers); and

(b) can demonstrate that they have in that capacity (and not by implication) relied upon such published information; and that such reliance was a primary consideration in their decision-making process; and that in so acting, they acted reasonably (having regard to the information actually and/or potentially available to them and to the skills that they would ordinarily be expected to apply); and to

(c) those to whom they expressly or implicitly agree that they will owe a duty of care (as now).

22.39 As an alternative approach, the CLRSG suggested that there should be no specified categories and the range of liability should be left to the courts. However, this would reinstate the test in 'Caparo' of whether it was "fair, just and reasonable that the law should impose a duty of a given scope on the one party for the benefit of the other" which has led to the present somewhat unduly narrow approach (paragraph 5.154 of Consultation Document No. 5).

22.40 The CLRSG, however, also noted that any statutory extension of auditors' duties raises very major difficulties. First, the question is really a wider one than auditors' duties. It is a question of who may place reliance upon, and sue in respect of, representations in the accounts. Logically, directors who prepare the accounts should have the same range of liability as auditors. Thus, extension of directors' duties and those of companies vicariously on their behalf needs also to be taken into account. The other difficulty is the prevention of abusive exploitation by claimants of any such extension (paragraph 8.128 of the Final Report).

22.41 In the context of the CLRSG's consultation exercise, a large majority of respondents agreed that, if the auditors' liability was to be extended, it followed that the directors' liability in respect of the defective accounts which led to the misleading auditors' report in the first place should also be extended. However, a 'substantial number of considered responses' objected to any such extension, many also objecting to the proposed extension of auditors' liability. A major concern was whether adequate safeguards against abuse of the rights of action created could be devised e.g. actions to recover losses from major failed investment decisions made by professional investors who should rely on their own judgement in such cases (paragraph 8.129 of the Final Report).

22.42 As a result of considering these responses, the CLRSG did not believe that a case had been made for the statutory extension of the duty of care of auditors as outlined in paragraph 22.38 (above). Furthermore, the case against doing this was substantially strengthened by the implications for companies of the logical and consequential extension of the liability of directors and their companies. The additional safeguards proposed such as requiring a claimant, as a condition of establishing such a claim, to show that they had taken all reasonable steps to protect themselves from loss, was considered to be too high a test which would be very difficult to satisfy in practice and enable a defendant auditor to escape on the basis of showing a relatively minor failure on the part of the claimant. They would therefore considerably disrupt the law of negligence in this field and were neither appropriate nor effective for the purposes (paragraphs 8.133 and 8.134 of the Final Report).

Proposal

22.43 Consequently, the CLRSG's recommendation is that the 'Caparo' rule remains in place with any further development of negligence law being left to the normal process of case law (paragraph 8.135 of the Final Report). The SCCLR agrees to this conclusion but is prepared to consider other contrary views.

Auditors' Liability

22.44 Under section 165 of the Companies Ordinance and section 310 of the United Kingdom Companies Act, auditors and companies are prohibited from taking any contractual steps to limit auditors' liability for their work. The CLRSG noted that this provision is, arguably, now an anachronism as, while there appeared to be a case for preventing directors from limiting their liability to the company for negligence, both in public interest terms and because they are in a position to influence the outcome, the same arguments did not apply with the same force to auditors, particularly if any limitation of liability is approved by the shareholders who formally appoint them (paragraph 5.156 of Consultation Document No. 5).

22.45 In view of this, the CLRSG proposed in paragraph 5.158 of Consultation Document No. 5) that :-

(a) the prohibition upon auditors entering into contractual arrangements with directors and companies to limit their liability in contract, contained in section 310 of the Companies Act, should be repealed;

(b) steps should be taken to enable auditors to limit their liability in tort (or delict) to third parties (being those with whom they are not in contractual relations, but to whom they owe a duty of care) provided that the level of such liability were appropriately publicized in the audit report;

(c) any such limitation should require approval by the company in general meeting.

22.46 A further issue considered by the CLRSG was whether steps should be taken to prevent auditors from bearing a disproportionate share of any damages awarded to a successful plaintiff (paragraph 5.161 of Consultation Document No. 5). Both the accountancy bodies in the United Kingdom and the HKSA have expressed concern with the existing principle of "joint and several" liability which has resulted in defendants with so-called "deep pockets" bearing a disproportionate share of any damages award in cases where the other defendants do not have the means to meet their share.

22.47 The SCCLR notes that there is some support in the business community in the United Kingdom and Hong Kong for statutory proportional liability and precedents for reforming joint and several liability in certain jurisdictions such as Bermuda, Canada, Ireland and a number of the states in the U.S.A. Furthermore, the HKSA has forwarded a submission to the Government recommending that the existing system of "joint and several" liability in Hong Kong be replaced with one of proportionate liability. Despite this, such a step would, as noted by the CLRSG "face many difficulties of principle".

22.48 In the United Kingdom, the Law Commission's Report 'Feasibility Investigation of Joint and Several Liability' (1996) rejected a move towards proportionate liability. The CLRSG, in its various consultation documents, has also rejected as 'contrary to principle' the concept of proportionate liability. A key argument in rejecting the proportionate liability approach is the fact it depends on, in the CLRSG's view, the insupportable contention that, as between an innocent claimant and a guilty defendant, the innocent claimant should have his claim reduced because another (insolvent) person is also guilty.

22.49 However, while rejecting the proportionately solution, the CLRSG took the view that auditors should be able to rely on the contributory fault of the company attributed to it as a result of the failings of its directors or employees where they had been negligent or fraudulent in the preparation of the relevant accounts (paragraph 6.91 of Consultation Document No. 8). Consequently, the CLRSG's Final Report (paragraphs 8.136 to 8.144) recommended that :-

(a) A director's or employee's breach of the duty to assist the auditors (whether negligent or fraudulent) should give rise to civil liability, with vicarious liability for the company and the fault attributed to the company for contributory negligence purposes, subject to the normal principles. The assistance duties should be owed to the auditors in order to achieve clarity as to the auditors' rights to contribution and to assert contributory negligence without any need to consider the question of the range of wider liability;

(b) Auditors should be able to limit their liability contractually with the company and in tort (or delict) with third parties. Contractual limitation should be achieved by the repeal of the statutory prohibition on auditors' and companies' so limiting the liability. Such limitation should be publicized in the auditors' report and such notice should limit those who rely on the report, thereby achieving limitation of liability in tort. In both cases, the limitation would not be effective without prior shareholders' approval.

22.50 When the SCCLR considered the question of proportionate liability and capping auditors' claims, a number of points were made both for and against. The arguments against were as follows :-

(a) In law, a person was fully liable for any damage resulting from one's negligence and it would be difficult to limit an auditor's liability to a particular percentage of the damages without having all involved persons before the court;

(b) Auditors should be able to limit their liability either contractually or by incorporating as limited liability companies;

(c) However, if the auditors were able to limit their liability contractually, the directors would be responsible for the balance of the damages awarded in respect of such liability;

(d) Lawyers and other professions were not able to put a limit on their liability for negligence and, if there were to be such a principle, it should apply to all professions, including directors, not just auditors who should not be given favourable treatment;

(e) Proportionate liability was not the same as contributory negligence as, in the case of the latter, the opposing parties argued out their cases before the court rather than as, in the case of the former, the judge making a decision on the evidence of one defendant without hearing the other parties to whom he had to attribute some blame;

(f) Although a plaintiff could pursue all other parties under a proportionate liability scheme, this may not be a practical or realistic proposition as certain cases e.g. a company which had gone into liquidation.

22.51 Counter-arguments advanced during the discussion were as follows :-

(a) Auditors have a regulatory role, unlike other professions, and regulators regulate on the basis that they are immune from liability as they take risks when carrying out their regulatory role;

(b) Auditors' functions and duties were not the same as directors as they were the keepers of certain controls and standards;

(c) As leading jurisdictions, such as Australia, were considering the introduction of proportionate liability, the concept should not be rejected out of hand;

(d) Auditors were always sued because they, prima-facie, were able to satisfy a judgement through their personal indemnity insurance and personal assets. The accountancy profession considered this to be unfair, particularly when the real cause of the problem was the acts and deeds of other people.

Views sought from the public

22.52 In view of the above, the SCCLR was unable to reach a decision on the auditors' liability. However, one possible way forward might be to 'distinguish' the auditors from other parties such as directors, given their regulatory role. If this can be agreed, it should be possible to formulate appropriate proposals, possibly based on the CLRSG's proposals outlined in paragraph 22.49 (above). Be that as it may, the SCCLR agreed that the issue had to be looked at in a wider context covering not just auditors. In view of this, the SCCLR would welcome comments on the overall issue of auditors' liability with particular reference to the desirability or otherwise of proportionate liability and the CLRSG's proposals in the United Kingdom. Subsequently, the SCCLR will consider and make proposals regarding auditors' liability and proportionate liability.

CHAPTER 6

CORPORATE REGULATION

Introduction

23.01 The SCCLR has explored the need and options for enhanced corporate regulation in Hong Kong, focusing on the present system for enforcing the provisions in the Companies Ordinance (CO).

Nature of Company Law

23.02 Companies legislation has two main functions: enabling and regulatory. The enabling function empowers people to do what they could not otherwise achieve, namely to create a body with a distinct corporate personality. The regulatory function prescribes the conditions which have to be complied with in order to obtain incorporation and the rules that thereafter have to be observed in order to protect members, creditors and the public against the dangers inherent in such a body. This function can be considered in terms of both the applicability of company law and the enforcement of company law.

23.03 In Hong Kong, apart from the CO, the operations of listed companies are also governed by the Securities and Futures Ordinance (SFO) and the non-statutory Listing Rules of the Stock Exchange and Codes on Takeovers and Mergers and Share Repurchases promulgated by the Securities and Futures Commission (SFC). Depending on the nature of the activities undertaken by a company, its activities may be regulated by the SFC, the Stock Exchange of Hong Kong (SEHK) and other financial regulators. For example, in the case of an authorized institution, its activities are regulated by the Hong Kong Monetary Authority (HKMA) and in the case of an authorized insurer, by the Insurance Authority (IA) .

23.04 It should, however, be noted that the regulatory objectives of financial regulators may differ from the regulatory purpose of company law. For example, the IA's principal function as set out in section 4A of the Insurance Companies Ordinance is to regulate and supervise the insurance industry for the promotion of the general stability of the insurance industry and for the protection of existing and potential policy holders. Such a function may not coincide with, for example, the regulatory function of company law in relation to the protection of members of a company.

Hong Kong Companies

23.05 As at the end of 2002, there were 503,111 limited liability companies incorporated in Hong Kong, of which 6,922 were public, including 196 listed on the HKEx, and 496,189 were private. Companies which have incorporated overseas but established a place of business in Hong Kong must be registered under Part XI of the CO.

23.06 Hong Kong incorporated companies are subject to the requirements of the CO. These can be classified into requirements in respect of-

- company formation;

- maintenance of capital and organization of capital structure;

- financial and non-financial disclosure; and

- corporate administration, including for example, company meetings and resolutions, preparing and filing of annual returns etc.

Oversea Companies

23.07 Companies incorporated outside Hong Kong which establish a place of business in the Special Administrative Region are categorized as oversea companies under Part XI of the CO. Although these companies are principally subject to the company law of their home jurisdictions, principally Bermuda and the Cayman Islands, they are also required to comply with certain registration and continuing disclosure requirements under Part XI as well as other sections of the CO. Where an oversea company is listed in Hong Kong, it is also required to comply with the provisions of the SFO and the Listing Rules. As at the end of 2002, 782 (80%) of the 978 companies listed on the SEHK (both Main Board and GEM) were incorporated outside Hong Kong. The fact that such a high percentage of listed companies are also oversea companies presents Hong Kong with a unique regulatory problem regarding the applicability as well as the enforcement of company law.

23.08 The main reasons for requiring the registration of oversea companies under Part XI of the CO are –

- to help the local regulatory authorities to monitor the activities of foreign incorporated companies;

- to protect local creditors and businessmen by making available a minimum amount of information about the companies;

- to give local courts an in personam jurisdiction in order to permit lawsuits in Hong Kong; and

- to provide an incontestable means of serving legal process on the company should the need arise.

23.09 In addition, a very limited number of other statutory provisions in the CO also apply to oversea companies, in particular -

- Sections 80, 82, 85 and 91 regarding the registration of charges;

- Sections 142 to 151 regarding the investigation of companies;

- Section 152A regarding the inspection of a company’s books and papers;

- Part IVA regarding the disqualification of directors;

- Part X regarding the winding-up of unregistered companies;

- Part XII and section 346 regarding restriction of sale of shares and offers of shares for sale.

There are very good public policy reasons why such provisions should have extra-territorial effect. A SCCLR Sub-Committee, which recently reviewed the registration of companies incorporated outside Hong Kong, confirmed that these provisions should continue to apply to oversea companies.

23.10 More recently, in the context of Phase I of the Corporate Governance Review, it has been agreed that -

- the proposed statutory derivative action should also be available to the shareholders of oversea companies;

- section 168A of the CO, regarding the unfair prejudice remedy, should also be extended to the shareholders of oversea companies.

23.11 In view of this situation, the SEHK's Listing Rules, not the CO, are currently a principal mechanism for regulating oversea listed companies in Hong Kong. Moreover, the growing appreciation of the importance of corporate governance over the last decade has highlighted the need for regulation. In respect of many corporate governance issues this can best be accomplished through the Listing Rules. Regulation through the Listing Rules can be achieved more simply and can be changed more flexibly to cater for new issues that arise. Consequently, the Listing Rules have assumed the role of 'quasi company law', but without statutory status, to a greater extent than the listing rules in other jurisdictions. At present, there are no credible sanctions to enforce the Listing Rules as the only sanction with teeth e.g. de-listing, is a 'nuclear' option which has been used very rarely precisely because it is a 'nuclear' option. Effective sanctions would include the power to disqualify directors and to impose fines on directors and others responsible for breaches. In view of this, there has been considerable debate about giving statutory backing to either some or all the Listing Rules so that breaches would, where appropriate, attract effective sanctions.

23.12 It has been put to the SCCLR that regulating the capital markets in Hong Kong by relying primarily on non-statutory Listing Rules is no longer appropriate nor is it sufficient. Neither is it consistent with practice in other developed securities markets. There should be a level playing field for all listed companies wherever incorporated which should be subject to consistent regulation with an appropriate range of available sanctions.

Statutory Backing for Listing Rules

23.13 It is recognized that statutory backing does not necessarily mean that all the provisions in the Listing Rules will become primary legislation. For example, statutory backing can set out empowering provisions and fundamental principles in primary law, supplemented by rules (subsidiary legislation), codes and guidelines (non-statutory). Breaches of the statutory provisions would attract penalties, which can range from disqualification of directors, to fines down to reprimands. The Listing Rules would be interpreted in accordance with codes and guidelines.

23.14 The statutorily backed rules would have to be enforced by a statutory entity. It would be wholly inappropriate to give the powers of imposing the necessary penalties to a trading company. Since Hong Kong Exchanges and Clearing Ltd. (HKEx) has recently become a public company, it would be structurally flawed if it were to be charged with the responsibility of enforcing the Listing Rules by imposition of meaningful sanctions. It would mean that a trading company with an obligation to its shareholders would be required to impose sanctions and penalties of serious effect on persons outside its own organization.

23.15 The details of the new regime would have to be worked out. In particular the best method of providing statutory backing to balance flexibility with effectiveness, and of ensuring that sanctions are credible, proportionate and are applicable to all listed companies wherever incorporated. Furthermore, it is appreciated that it would be undesirable if there were any regulatory overlap between the body currently responsible for the Listing Rules and the statutory entity tasked to enforce statutory provisions. Structural change is thus inevitable. The SCCLR is, of course, aware that the Administration has vacillated in respect of the timetable for implementation of changes in relation to the body that will be responsible for the Listing Rules. It is understood that the most recent prognostication, in April 2003, was that any change would take place in about 18 months. The legislative process that would be necessary would no doubt take time. However, it must be recognized that corporate governance is not a matter that can be delayed without sound reason. Nor can it be subject to political infighting.

Views sought from the public

23.16 At this stage, SCCLR would like to seek the views of the public on whether, in principle, statutory backing should be given to the Listing Rules together with tougher statutory sanctions including civil fines against non-compliance.

Nature of Offences and Penalties in the Companies Ordinance

23.17 The CO contains a total of 171 offences under the 12^{th} Schedule which may be prosecuted either on indictment or summarily. The maximum penalties for most of the offences range from levels 1 to 6 (i.e. \$2,000 to \$100,000). More serious offences attract higher penalties, e.g. the maximum penalties for breach of section 152E (furnishing false information) on indictment is \$1.5 million in fines and 3 years imprisonment. In many instances daily fines are also applicable. Part IVA of the CO further provides for the disqualification of directors for varying periods by the court.

23.18 The authority to prosecute offences under the CO rests with the Department of Justice (DoJ). Since 2 July 1982, the Companies Registry (CR) and the Official Receiver's Office (ORO) have been delegated with the authority to prosecute most of the summary offences. The SFC has similar delegated authority to prosecute summary offences under Parts II and XII of the CO with particular reference to offences regarding prospectuses.

23.19 Essentially, the offences under the CO can be divided into filing and non-filing offences.

Filing Offences

23.20 The CR can monitor, to a certain extent, the filing of documents which have to be filed according to a specific statutory timetable e.g. annual returns. However, the department cannot monitor the filing of other documents whose filing is triggered by the occurrence of certain events, e.g. change of director(s) or registered office address, but will react to complaints that these documents have not been filed. Filing offences, which are classified as strict liability offences, are relatively easy to detect, and it is not necessary to have a detailed, complex investigation before taking prosecution action.

Non-filing Offences

23.21 Non-filing offences tend to be those of a more serious nature e.g. directors failing to take reasonable steps to ensure that proper books of account are kept (section 121(4)); officers recklessly or knowingly making false statements to auditors (section 134(1)) etc. Failure to comply with some of the relevant offence creating provisions can be detected by the auditor, members of a company, creditors etc. In such circumstances, the auditor, members and creditors may lodge a complaint with the CR or, where the nature of offence is very serious and entails criminal sanctions, with the Commercial Crime Bureau (CCB). If the CR receives a complaint, the department will undertake an investigation. In those cases of non-compliance with the disclosure provisions, for example, a failure to allow inspection of registers, the CR will conduct investigation work, such as issuing enquiry letters. Subsequently, if a prima facie breach is established, the CR will request the company involved to rectify the situation and, if it refuses to do so, prosecution action may be taken.

23.22 If, however, the case involves detailed complex investigation, there is a limit to CR's investigation capabilities as the department is currently structured and resourced to undertake primarily the functions of a registry of companies. Consequently, in practice, the CR can only investigate and prosecute methodically those offences under the CO which are directly related to the department's core functions such as monitoring the disclosure (filing) requirements of the CO.

23.23 In 2002, the CR issued 139 summonses of which 88 resulted in convictions and 44 were withdrawn because the companies subsequently complied with the filing requirements (the remaining seven cases are still to be heard). If there is no prima facie breach of law, or if the complaint relates to the companies' internal disputes, the CR will normally not take any action.

23.24 Since July 1994, the CR has established a central index of company complaints. As at the end of December 2002, the CR had received a total of 1,317 complaints, involving 1,679 counts of complaint. The bulk of the complaints relate to alleged failure to comply with the provisions in relation to the registered office of the company (20%) , annual returns to be made by the company (14%), register of directors and secretaries (9%) and false statements (20%). Since the establishment of the central index, only six cases relating to alleged fraud or other criminal offences have been referred to the CCB. A detailed analysis of the complaints received over the past four years is given in the following table :-

		July 1994 – Dec. 2002	1999	2000	2001	2002
Total no. of complaints received		1317		218	296	263
Total no. of counts of complaints		1679	282	316	342	303
Complaints relating to :-						
i)	Registered office	20.19%	27.30%	24.68%	18.71%	15.51%
ii)	Annual returns	14.41%	8.16%	8.86%	28.65%	19.14%
iii)	Register of director & secretary	8.99%	12.41%	15.82%	4.09%	3.96%
iv)	De-registration applications under s.291AA	10.30%	-	9.81%	18.42%	26.07%
v)	False statements under s.349	17.15%	24.11%	16.14%	10.23%	9.90%
No. of cases referred to CCB		6 cases	-	-	-	2 cases

23.25 Overall, there has been a marked increase in the number and counts of complaints received in 2001, approximately 35% over the number of complaints received during the previous year and an upward trend since 1999 until 2002, when the drop is mainly accounted for by decreases in the numbers of complaints filed in respect of four out of the five categories shown in the table. There was a significant increase in 2001 in the number of complaints made in respect of annual returns and de-registration applications which may be explained by the downturn in the economy. As companies were struggling to stay alive financially or had already ceased trading, they would be less likely to file an annual return with the result that the public would be unable to search for the required information, thereby leading to complaints. The poor economy could similarly be the underlying factor for the increase in complaints made by creditors in respect of their debtors who may have falsely declared the absence of any debt in their deregistration applications.

23.26 In situations involving suspected fraud or false accounting, members of a company, creditors and other stakeholders, the CR can file a report with the CCB. However, it should be stressed that such crimes are offences under the Theft Ordinance (Cap 210), rather than the CO.

Shareholder Remedies

23.27 Apart from lodging complaints mentioned above, aggrieved parties such as shareholders may also enforce the provisions of the CO by seeking remedies from the court. These remedies include –

- Relief in respect of unfairly prejudicial conduct under section 168A of the CO; and

- A just and equitable winding-up order under section 177(1)(f) of the CO.

Shareholders may also seek remedies under common law by initiating derivative actions or personal actions.

23.28 However, as the cost and time required to initiate shareholders' actions can be prohibitive there are major disincentives to bringing such actions. There are also structural impediments in bringing a case to court as evidenced by the difficulty of commencing derivative actions as well as the over-riding issue of costs. In view of this, it is believed that, in many instances, the shareholders of companies whose shares are publicly traded vote with their feet and opt for selling their shares instead of litigating.

23.29 Subsequent to the Consultation Paper on Phase I of the Corporate Governance Review, it is proposed to introduce a statutory derivative action, and expand the unfair prejudice remedy under section 168A of the Companies Ordinance. The former would represent a significant improvement over the current common-law action as it would not be necessary for an applicant to prove his bona fides before commencing such an action. Both remedies would be open to the shareholders of oversea companies as well as Hong Kong companies and all shareholders would be able to recover their costs from the court. The relevant provisions are contained in the Companies (Amendment) Bill 2003.

Company Inspections under the Companies Ordinance

Sections 142 to 150: Inspection

23.30 The provisions in sections 142 to 149 of the CO deal with the investigation of a company's affairs by independent inspectors appointed by the Financial Secretary (FS). Inspectors appointed under these sections are vested with extensive inquisitorial powers. However, it is important to make a very clear distinction between these powers and the powers of law enforcement agencies such as the Police. According to the English Court of Appeal ……. "the inspectors' function is, in essence, to conduct an investigation designed to discover whether there are facts which may result in others taking action: it is no part of their function to take a decision as to whether action be taken and a fortiori it is not for them finally to determine such issues as may emerge if some action eventuates" (*Re Pergamon Press Ltd [1970] WLR 1075*). Section 146(4) of the CO provides that, if during the course of his investigation, an inspector discovers matters which indicate that an offence has been committed, he may inform the FS of such matters and it is for the FS to then pass on those matters to a law enforcement agency for action.

23.31 Inspections may be carried out only by an inspector approved by the FS. Section 146A of the CO also permits the FS on an exceptional basis to appoint an inspector to investigate the affairs of companies incorporated outside Hong Kong, provided that they have or have had in the past, a place of business in Hong Kong. The appointment of an inspector to investigate the affairs of any company may be made for a variety of reasons and on the application of a number of different people.

23.32 Section 142 permits the following groups to apply to the FS for the appointment of an inspector –

(a) the holders of one-tenth of the company's share capital;

(b) 100 members; or

(c) one-tenth of the company's members, if the company has no share capital.

The applicants must provide sufficient evidence to support that they have good reason to make the application. The appointment is, however, left to the FS's discretion.

23.33 Under section 143 of the CO, the FS is required to appoint an inspector if he receives a court order to that effect. Furthermore, under section 143(1)(c), the FS is permitted to appoint an inspector if he believes that there are circumstances suggesting that –

(a) the company is being run with the intention of defrauding, inter alia, its creditors;

(b) any of the company's members are being oppressed by the manner in which the company is being run;

(c) the company was formed for a fraudulent or unlawful purpose;

(d) anyone involved in the management or formation of the company has been guilty of fraud, misfeasance or other misconduct towards the company or its members; or

(e) the members have not been given all the information about the company's affairs which they could reasonably expect to receive.

23.34 In practice, in deciding whether or not an inspector should be appointed, the FS would invariably require the presence of significant or substantial public interest. In the past 15 years, there have been 38 applications for the appointment of inspectors, and 37 investigations have been conducted. Section 148 of the CO stipulates that the expenses of an investigation shall, with some exceptions, be defrayed in the first instance out of the general revenue.

23.35 The powers granted to an inspector are very wide ranging and should enable him to conduct a very detailed investigation into the company's affairs. The inspector is also required by law to make a final report on his findings to the FS. The report is admissible in legal proceedings as evidence of the inspector's opinion on any matter dealt with in the report.

23.36 The appointment of an inspector under the CO is essentially a fact-finding exercise undertaken in a civil law context. However, the fact that company inspections can and do take place may have a deterrent effect on potential non-compliance with the provisions of the CO. The inspector may uncover facts on the basis of which a regulator or law enforcement agency may make further enquiries and take prosecution action. However, a significant limitation on such inspections is that, because of the potentially adverse implications for a company, strong justifications are needed before inspectors can be appointed to investigate its affairs. Furthermore, company inspections have been criticized as being costly and time consuming.

Sections 152A to 152F : Inspection of Companies' Books and Papers

23.37 Section 152A of the CO gives the FS the power to require a company to produce books and papers to a person authorized by the FS if it appears to the FS that there is good reason to do so. Section 152A(1)(b) of the CO makes clear that the provisions also apply to oversea companies. This section is modelled on section 447 of the United Kingdom Companies Act 1985. While there is no statutory definition of 'good reason', the Department of Trade and Industry's (DTI) handbook on company investigations states that, for the purposes of considering such investigations under section 447, it is taken to include grounds for suspicion of fraud, misfeasance, misconduct, conduct unfairly prejudicial to shareholders and failure to supply shareholders with information they may reasonably expect.

23.38 This power enables the DTI, using full-time inspectors from the department's Company Law and Investigations Directorate, to carry out discreet enquiries into a company's affairs, including enquiries for determining whether a full-scale investigation by inspectors under the Companies Act 1985 or any other Act would be justified. By making such enquiries, it may be possible to avoid the potential damage to a company which could result from the knowledge that inspectors have been appointed under, for instance, sections 431, 432 or 433 of the Companies Act 1985. It may also be possible to avoid the expense and delay inherent in the more searching investigations under these sections.

23.39 Section 152A was last amended in 1994 to lower the threshold for the FS to appoint an inspector to carry out preliminary inspections of companies, and remove the requirement that only a public officer can be appointed as an inspector. The then Secretary for Financial Services indicated in the first reading of the relevant Companies Amendment Bill in 1993 that such inspections represented a discreet and less costly way to assess whether a full scale investigation was warranted. Such enquiries can avoid the potential disruption to a company that might be caused by a full scale investigation.

23.40 Section 152A envisages two scenarios under which the FS may give directions to a company to produce specified books and papers to a person authorized by the FS. The first is when an application is made to the FS under section 142 to investigate the affairs of a company. The second is where the FS believes that there is good reason to do so. To date, no action has been taken under either of these two scenarios doubtless because, to enable the FS to take a proactive approach, designated resources would be required.

Legislative Reform

23.41 In order to address the concerns outlined above, the SCCLR has undertaken, in the context of the Overall Review of the CO, a review of the inspection and investigation provisions of the CO, having regard to a similar review considered by the Department of Trade and Industry (DTI) in the United Kingdom in 2001. As a result of this review, the SCCLR has recommended that these provisions should be reformed and made a number of proposals including, inter-alia, the following :-

- The powers for inspections under sections 142 and 143 and investigations under 152A should be assimilated;

- The scope of enquiries should be extended to include a wider definition of associated companies, partnerships, and individuals as well as foreign companies targeting Hong Kong customers;

- There is a need to include computer and electronic records in what may be investigated and be the subject of a search warrant;

- The relevant regulatory body should have power to seek interim relief;

- The evidential value of an inspection's finding and conclusions should be clarified.

23.42 Appropriate legislative amendments will be drafted for inclusion in a future Companies Amendment Bill.

Company Inspections under the Securities and Futures Ordinance

Sections 179 and 359

23.43 In examining corporate regulation, the SCCLR has focused its attention on compliance with the CO. Nonetheless, section 179 of the Securities and Futures Ordinance (SFO), which was implemented on 1 April 2003, contains provisions for conducting preliminary enquiries into the records and documents of listed companies, which are similar to those on the preliminary investigations under section 152A of the CO. Section 359 obliges listed companies to produce their books and records pursuant to the power contained in section 356 for the FS to investigate the true ownership of a listed company. In view of this, it is therefore appropriate to examine the background to these provisions in the previous Securities and Futures Commission Ordinance (SFCO)

23.44 In 1994, in conjunction with the amendments to the CO mentioned in paragraph 23.39 (above), a new section 29A was included in the SFCO to empower the SFC to undertake preliminary inquiries into the records and documents of listed companies. This power is similar to that of the FS under section 152A of the CO. Prior to being given this power, the SFC was encountering circumstances suggesting fraud, misfeasance or misconduct in the management of the affairs of listed companies as well as failure by them to disclose information to their shareholders. However, despite the fact that it was the securities regulator with a legitimate interest in such matters, the SFC did not have the statutory authority to investigate such cases and this was considered undesirable. Section 29A of the SFCO empowered the SFC to inspect the books and records of a listed company when directors are suspected of impropriety in the management of the company's affairs. Where appropriate, it might conduct a full-scale investigation under section 22 of the SFCO. If impropriety was revealed, the SFC might, following consultation with the FS, commence an action under section 37A of the SFCO for various orders in respect of the listed company. Other follow up options included referral to the CCB or ICAC for further criminal investigation, and recommending that the FS institutes proceedings before the Insider Dealing Tribunal. To date, however, there have been only 14 inquiries under section 29A and only two actions under section 37A. It should be noted that the SFC would generally not carry out an inquiry under section 29A where the matter is also being investigated by the CCB or the ICAC.

Recent Improvements under the Securities and Futures Ordinance

23.45 The SFO seeks, inter alia, to close gaps in the existing legislation governing the powers of the SFC in conducting preliminary inquiries into corporate misconduct, and in applying to the court for remedies to protect the rights of shareholders. Specifically, under the SFO, the SFC is now empowered to request assistance from the auditors, bankers and transaction counter-parties of the company in question (section 179). The SFC is also empowered to apply to the court on broader grounds for a wider range of injunctions and orders, for example, disqualifying senior management of a listed company (section 214). Under the SFO, the SFC is also empowered to investigate into a wider range of market misconduct concerning listed securities which may culminate in referrals to the FS for instituting proceedings before the Market Misconduct Tribunal, established to subsume the work of the Insider Dealing Tribunal (section 252).

Overseas Experience

United Kingdom

23.46 In the United Kingdom, the DTI carries out company investigations under the Companies Act. Most of the DTI's inquiries are conducted under section 447 of the Companies Act by in-house DTI staff who are, generally speaking, accountants seconded from the Insolvency Service. In the case of full scale company investigations under sections 431, 432 or 433, private sector accountants and lawyers are invariably appointed as inspectors. The position in the United Kingdom is therefore similar to that in HK, with the very important difference that there is a designated inspectorate in the DTI which adopts a relatively pro-active approach in conducting enquiries under section 447 of the Companies Act. In 2000-01, the DTI completed 177 such enquiries. However, the results of these enquiries are not announced because to do so would undermine the effectiveness of the enquiries and could damage the business of the companies concerned before any evidence of wrong doing had been established.

Australia

23.47 In Australia, the Australian Securities and Investments Commission (ASIC) covers compliance with both the Corporations Act, which regulates both listed and unlisted companies, and the Australian Securities and Investments Commission Act (ASICA). The functions of the ASIC are to maintain and control the performance of companies, securities markets and futures markets; to maintain the confidence of investors and the securities markets and futures markets by ensuring adequate protection for such investors; to perform functions similar to those performed by the Registrar of Companies in Hong Kong in relation to the documents and information given to the ASIC; to make those documents available to the public by search; and to take necessary and appropriate action to enforce and give effect to the Corporations Act and ASICA. The ASIC monitors the conduct of company directors and inspects financial statements. The public may also lodge complaints with the ASIC about how a company is managed if they believe that there has been any misconduct or illegal activity on the part of the company. The ASIC assesses the complaints and selects and investigates those cases where the commission believes that it can do something to stop unlawful actions or prosecute the people involved or protect consumers' confidence in financial markets, products or services. The ASIC has a general power "to do whatever is necessary for or in connection with, or reasonably incidental to, the performance of its functions" (Section 11(4) of the ASICA)) and has wide powers to make orders affecting the affairs of a corporation or dealings in securities or futures contracts in the event that a person fails to comply with a requirement. The ASIC will be assisted by the Australian Federal Police in the performance of its investigative role. Specific investigative powers, in addition to this general power, include powers to investigate on its own instigation suspected contraventions of the Corporations Act involving mismanagement, fraud or dishonesty relating to a body corporate or securities or futures contract, in addition to suspected unacceptable circumstances in the acquisition of a substantial interest in a corporation.

Singapore

23.48 In Singapore, the Companies Act is mainly enforced by two departments, namely, the Registry of Companies and Businesses (RCB) under the Ministry of Finance and the Commercial Affairs Department (CAD) under the Singapore Police Force. The RCB enforces the Companies Act by actively prosecuting companies and directors for failure to comply with the various requirements of the Act, including the filing of annual returns and conduct of AGMs. The CAD investigates and prosecutes offences under the Companies Act with a greater emphasis on complex commercial frauds and 'white-collar' crimes. In addition, the Corruption Practices Investigation Bureau under the Prime Minister's Office from time to time investigates and prosecutes matters relating to corrupt practices by directors and /or employees of companies.

The Current Regulatory Regime

23.49 As indicated in paragraphs 23.20 and 23.21 (above), the 171 offences engendering breaches of the CO can usually be detected either upon investigation following a complaint; or can be self-enforced by affected parties e.g. provisions that require filing of a certain document at a certain time; or can be identified by the shareholders, creditors , liquidators, auditors and the Official Receiver; or as the result of a company inspection. This situation reflects to some extent one feature of company law which is that law confers rights and duties upon stakeholders (shareholders and creditors) and envisages that stakeholders assume a positive role in protecting their own interest by exercising their rights where necessary. However, it would also be reasonable to expect that there is a safety net of third party intervention to tackle the situation where self-enforcement mechanism fails to work. Auditors, liquidators, inspectors and regulators are all part of that safety net.

23.50 In Hong Kong, enforcement of the provisions in the CO is mainly complaint driven and, to a large extent, relies on shareholders' and creditors' awareness of their rights and their willingness to take action. However, the propensity to lodge complaints has been relatively low, with only 1,317 complaints being received since records began in 1994. Many of them involve civil disputes, where it is appropriate for the aggrieved parties to take direct action in the civil courts, while the CR has been able to handle the overwhelming majority of the breaches of the regulatory provisions which largely concern disclosure and filing offences.

23.51 However, the fact that the statistics seem to suggest that a problem does not exist cannot necessarily be construed to mean that a problem does not exist in practice. In this respect, it may well be the case that people do not make complaints simply because 'there is no point in making a complaint'; there is no obvious body to whom they can complain other than the CCB (which would only get involved in certain commercial crime cases) or the CR; and the existing channels for redress are ineffective.

23.52 By comparison, the DTI in the United Kingdom receives about 4,000 complaints every year of which about 250 are selected for detailed investigations. The overwhelming majority of these investigations concern private companies. While it would be wrong to assume that a similar pattern would prevail in Hong Kong, the very fact that this is the situation in a jurisdiction which has a more elaborate and well-established regulatory machinery and, arguably, a less 'free booting' corporate culture than Hong Kong suggests that the situation in Hong Kong could be the same, if not worse. The overall objective of the DTI's Companies Investigations Branch, according to the department's material on company investigations, is 'to increase the confidence of consumers, the business community and investors by contributing to the reduction of commercial malpractice through the just, cost effective and timely use of the Department's powers to expose, prosecute and/or seek to disqualify people or wind-up companies which have engaged in significant commercial malpractices; and to be seen to be effective in this by investors, consumers and the business community and thus to deter potential wrong-doers'.

23.53 Having regard to the existing regulatory framework in Hong Kong, as outlined in paragraphs 23.17 to 23.45 (above), a number of gaps can be identified as follows :-

(a) The CR is not structured and resourced to investigate and prosecute the more serious non-filing offences under the CO (paragraph 23.22);

(b) There is a public perception that full-scale company investigations are too costly and time-consuming, and serve no useful purpose (paragraph 23.36);

(c) The Government has no 'in-house' resources to undertake investigations under section 152A of the CO (paragraph 23.40);

23.54 The question then arises as to what, if anything, should be done about these ‘gaps’ having regard to the considerations outlined in paragraphs 23.49 to 23.52 (above), in addition to the proposed reform of the inspection and investigation provisions (paragraphs 23.41 and 23.42). In the first place, when considering an effective and healthy corporate regulation regime, it is necessary to be mindful of one of the inherent elements of company law which is that it is, to a certain extent, self-enforcing. Although the old fashioned concept of ‘caveat emptor’ does not strike a chord in this era, it can still be reasonably argued that shareholders and creditors should take an active interest in their investments. Consequently, in the United Kingdom, the DTI’s Companies Investigations Branch will not assume responsibility for a case if a civil remedy is available to the complainant. Furthermore, the ‘public interest’ element of any complaint has to be fully considered before an investigation is authorized.

23.55 While it is the Government’s policy that companies should comply with the provisions of the CO, given the existence of over 500,000 companies incorporated and registered in Hong Kong, it would be financially and practically not viable to establish an elaborate system to monitor compliance with the CO. Realistically, a viable corporate regulation regime should be reactive to complaints or events rather than initiating proactive investigations. A possible middle path could be the selective monitoring of various companies from time to time. However, this would be very difficult, if not impossible, to achieve in practice given that an investigation under the CO can be held only in certain statutorily specified circumstances or where the FS has ‘good reason’ to believe that such an investigation should be held. Investigations launched by a regulator without any statutory control would amount to arbitrary ‘fishing expeditions’ and, as such, would probably receive little, if any, support.

Proposals

23.56 On the basis of the review of the current regulatory regime in Hong Kong, it would appear that, while the necessary legislation to ensure effective corporate regulation is either largely in place or will be reformed, there remain major issues regarding enforcement on the ground. As regards listed companies, the SFC has the necessary powers under the SFO to investigate a listed company’s books and papers and, where appropriate, take enforcement action. Whether or not the SFC has adequate resources to undertake this function at an appropriate level is not an issue on which the SCCLR feels that it is competent to pronounce. However, the SCCLR would urge the Government and SFC to review the adequacy of the SFC’s existing resources to undertake such investigations.

23.57 As regards unlisted companies, the SCCLR notes that the provisions of section 152A of the CO have never been used as explained in paragraph 23.40 (above). This problem of resources is remedied, to some extent, by the fact that the SFC can undertake investigation of a listed company’s books and papers under the relevant provisions of the SFO, this still leaves the matter of 500,000 unlisted companies. However, although this may appear to be a major lacuna in Hong Kong’s regulatory structure, the SCCLR notes the difficulties in both justifying and acquiring additional resources within the civil service, particularly at a time of considerable financial stringency, for the following reasons :-

(a) The current relatively low number of received complaints and the fact that they can be handled without recourse to investigatory powers;

(b) The comparatively less degree of public interest in unlisted companies, the overwhelming majority of which are private companies.

23.58 Notwithstanding this, the SCCLR believes that the regulation of unlisted companies can and should be improved having regard to the factors outlined in paragraph 23.52 (above). In this respect, the SCCLR urges the Government to consider whether and, if so, how resources should be made available in-house e.g. within the CR, to handle investigations under section 152A of the CO.

23.59 In view of the above, there are, therefore, two issues which need to be considered as follows :-

(a) whether the regulation of unlisted companies needs to be improved; and if so

(b) how should this be addressed in terms of institutional change.

The SCCLR would welcome comments on these issues.

Conclusion

23.60 Corporate regulation is, however, not the same as corporate governance. The reality is that corporate governance is a complex, multi-faceted subject involving not just legislation and regulation – although these are essential elements – but also what is usually known as 'best practice'. In other words, the law can lay down a basic minimum standard on, for example, disclosure of directors' remuneration. However, a company can choose to go one better by disclosing and doing more than the law requires. As such, best practice is very much a matter of corporate culture, mind-set and education. Furthermore, underpinning good corporate governance is an essential respect for the basic ethical values of decency, fairness, honesty and integrity. These cannot be legislated for and, although the law must and does provide appropriate punishments for wrong-doers, it cannot create either 'goodness' or 'good-doers'.

23.61 In the final analysis, laws and regulations can do only so much as it is simply not possible to legislate for every eventuality. Furthermore, there are major problems associated with following an over-prescriptive route. First, it tends to undermine the basic responsibility for directors to run their companies within an enabling legal framework. Secondly, laws and regulations are essential tools to take appropriate enforcement action after corporate abuses have taken place. However, the over-riding emphasis should be on ensuring that these abuses do not take place in the first place which relates back directly to the issue of corporate culture. Thirdly, by the time that a corporate abuse has taken place, it can, in many instances, only be rectified, if at all, by a disproportionate outlay in time, money and resources by the Government's regulatory and enforcement agencies. By any standard, prevention is better than cure.

23.62 The SCCLR believes that the proposals outlined in this Consultation Paper as well as the Consultation Paper on Phase I of the Corporate Governance Review will help to raise the standard of corporate governance in Hong Kong. However, to be implemented fully and effectively, they require the strong commitment of the Government, regulators, professional bodies and the business community. In a number of areas, difficult choices and decisions will have to be made. Furthermore, by its nature, corporate governance reform is a continually evolving concept and, in formulating these proposals, the SCCLR is fully aware of the fact that it is considering a moving target. Consequently, this Consultation Paper, as with any other such document, can never be the final word. However, a start has to be made somewhere and the SCCLR believes that the proposals outlined in both Consultation Papers represent a good start. In this spirit, they are commended to the Hong Kong community.