Standing Committee on Company Law Reform (SCCLR)

The Thirteenth Annual Report

1996/97

Standing Committee on Company Law Reform (SCCLR)

Thirteenth Report to the Chief Executive in Council

Subjects considered by the

Standing Committee during 1996/97

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(i)

Terms of Reference of the Standing Committee on Company Law Reform

(1) To advise the Financial Secretary on amendments to the Companies Ordinance as and when experience shows them to be necessary.

(2) To report annually through the Secretary for Financial Services to the Chief Executive in Council on those amendments to the Companies Ordinance that are under consideration from time to time by the Standing Committee.

(3) To advise the Financial Secretary on amendments required to the Securities Ordinance and the Protection of Investors Ordinance with the objective of providing support to the Securities and Futures Commission in its role of administering those Ordinances.

(ii)

Membership of the Standing Committee for 1996/97

Chairman : The Hon Justice Rogers

Members : Mr Richard E T Bennett
Mr Roger T Best
Mr John R Brewer
Mr Moses CHENG Mo-chi
Mr Marvin CHEUNG Kin-tung
Mr CHOW Man-Yiu, Paul
Mr Henry FAN Hung-ling
Mr Betty HO May-foon
Mr Robert G Kotewall, QC
Mrs Angelina P L Lee, JP
Mr David Shaw
Mr Alan H Smith, JP
Professor Edward L G Tyler

Ex-Officio Members : M A R Hearder, JP
The Official Receiver

Mr Gordon Jones, JP
The Registrar of Companies

Mr David T R Carse, OBE, JP
Deputy Chief Executive (Banking)

Mrs Lessie Wei
Deputy Secretary for Financial Services

Mr J T Allen
Deputy Crown Solicitor

Mr Gerard McMahon, JP
Executive Director, Enforcement Division
Securities and Futures Commission

In Attendance : Mr Ermanno Pascutto

Secretary : Mr E T O'Connell

Meetings held during 1996/97

One Hundredth and Eleventh Meeting	-	9 March 1996
One Hundredth and Twelfth Meeting	-	27 April 1996
One Hundredth and Thirteenth Meeting	-	8 June 1996
One Hundredth and Fourteenth Meeting	-	13 July 1996
One Hundredth and Fifteenth Meeting	-	21 September 1996
One Hundredth and Sixteenth Meeting	-	9 November 1996
One Hundredth and Seventeenth Meeting	-	7 December 1996
One Hundredth and Eighteenth Meeting	-	25 January 1997

(iv)

Executive Summary of Recommendations/Remarks

Chapter	Subject Matter	Recommendations/Remarks
1	Overall Review of the Companies Ordinance	Members updated on the progress to date by the consultant appointed to undertake the review at the 111th, 113th, 114th and 116th meetings.
2	Section 141 of the Companies Ordinance - Auditors commenting on the directors reports in the Financial Accounts	It was agreed to defer discussions pending the outcome of the response of the accounting profession to the issue of a new auditing guideline by the HKSA and also the outcome of discussions between the HKSA and the Administration on the question of statutory immunity for auditors of listed companies.
3	The investigation of serious commercial crime under the Companies Ordinance	Any proposal to extend police powers of investigation should be examined within the context of the criminal law, not the Companies Ordinance.
4	Section 71A of the Companies Ordinance - Procedures for the replacement of lost share certificates	It was agreed to defer discussions pending the outcome of an agreement between the SEHK and the Federation of Share Registrars on the best way forward.
5	Relief for minority shareholders; controlling directors remuneration; reforming the law of private companies	Three discussion papers tabled for members' information.
6	Section 264 of the Companies Ordinance - Interest on debts and extortionate credit transactions	Proposals endorsed to amend the Companies Ordinance by providing for interest on debts and empowering a liquidator to challenge extortionate credit transactions.

Chapter	Subject Matter	Recommendations/Remarks
7	Section 194 - Appointment of liquidators	Members endorsed Official Receiver's proposals to (a) amend the Companies Ordinance to allow private insolvency practitioners when appointed as provisional liquidator to continue in office after the winding-up order; (b) require an outside liquidator to summon meetings of creditors and contributories; and (c) empower the Official Receiver to apply to court at any time to appoint an outside insolvency practitioner in his place.
8	Sections 209A and 209B of the Companies Ordinance - Powers of court to convert a compulsory winding-up into a creditor's voluntary winding-up	No amendments to the current wording of the sections. Subject referred to insolvency sub-committee for it to consider their possible repeal.
9	Sections 141A and 141B of the Companies Ordinance	Members endorsed a proposal to repeal those transitional provisions as they were spent and of no further effect.
10	Section 14 of Companies Ordinance - Changes to a company's memorandum	Members recommended that the Companies Ordinance should be amended to allow companies which had the clause : "Crown colony of Hong Kong" as part of their registered address to amend it and replace it with "Hong Kong". Attorney General's Chambers had advised that all documents, certificates, and contracts valid prior to the establishment of the SAR Government would be adopted as valid. In view of that advice, the Administration did not feel that references in existing private documents to 'The Crown Colony of Hong Kong' would be in breach of the Basic Law and as a consequence, it would not be necessary to introduce legislation to address this matter.

Chapter	Subject Matter	Recommendations/Remarks
11	'Smart Cards'	Members appraised of HKMA's proposals to amend the Banking Ordinance to regulate the issue of 'Smart Cards' by financial institutions.
12	Composite Securities & Futures Bill and consultation paper	Consultation paper and draft bill with regard to SFC's proposals to codify all statutes under its purview into one.
13	Statutory immunity for auditors of listed companies	Members asked that the draft legislation tabled should be referred back to the Administration's working party for further consideration and refinement.
14	Minimum age limits for directors - Section 158(5) of Companies Ordinance	No change to the current legislation.
15	The introduction of migration provisions into the Companies Ordinance	Members deferred discussions to await the outcome of the consultant's report on the overall review of the Companies Ordinance
16	12th Annual Report of the SCCLR	Comments from HKAB tabled for consideration and discussion.
17	Corporate communications	Consultation paper prepared by the SEHK and titled : "Corporate Communications" was tabled for discussion. SEHK in conjunction with the Federation of Share Registrars was endeavouring to ensure that corporate information was widely disseminated to the beneficial owners of shares.
18	Transparency of Advisory Boards	Meetings of the SCCLR not to be open to the public.
19	Table 'A' to the Companies Ordinance	Sub-committee's recommendations for a new Table 'A" considered.

Chapter	Subject Matter	Recommendations/Remarks
20	Arrangements and reconstructions - Section 166(2) of Companies Ordinance and paragraph 2.10 of the Hong Kong Code on Takeovers	No changes necessary.
21	Unanimous informal consent - Section 116 of Companies Ordinance	Sub-committee set up to review the scope and workings of section 116B of Companies Ordinance.
22	Minimum no. of shareholders - Section 4 of Companies Ordinance	Members directed that the business, professional and commercial communities should be consulted.
23	Property valuations in company prospectuses - Third Schedule of Companies Ordinance	Members recommended that the property valuation requirements of the Third Schedule should be updated and simplified as should the listing rules in that regard. SFC should publish a list of criteria to be met when companies are seeking exemptions from the requirements of the listing rules on property valuations.
24	Loans to directors - Sections 157H and 157J of Companies Ordinance	No changes to the legislation recommended.
25	Limited Liability Companies	Discussions deferred until the consultant had made public his recommendations arising out of the review of the Companies Ordinance.
26	Corporate rescue and insolvent trading	Members endorsed proposals of the Law Reform Commission to introduce legislation to provide for corporate rescue and insolvent trading which was to be modelled on similar provisions in the UK Insolvency Act.
27	Companies Registry Annual Report	The Annual Report was tabled for comment and discussion.

Chapter	Subject Matter	Recommendations/Remarks
28	Section 336 of Companies Ordinance : Accounts of overseas companies	No change to the current legislation.
29	Alterations to a company's capital : Sections 53 and 55 of Companies Ordinance	The requirements of Form III - Notice of any increase in the nominal capital of a company - should be extended to all alterations of capital.

Chapter 1

Overall Review of the Companies Ordinance

1.1 In his budget speech of 1994, the Financial Secretary announced :

> "We have tried in the past to respond to developments in the corporate world through piecemeal amendment of the Companies Ordinance. I believe we have reached a stage when a thorough review became essential. We now need an ordinance for the 21st century. I have therefore asked the Secretary for Financial Services to take this forward."

The terms of reference of and the reasons for the review were set out in Chapter 10 of the 11th Annual Report of the Standing Committee (1994/95).

1.2 The subject was a regular agenda item during the 1995/96 year of the SCCLR (please see Chapter 23 of the 12th Annual Report of the Standing Committee (1995/96)) and it was again discussed at the 111th, 113th, 114th and 116th meetings.

<u>111th Meeting</u>

1.3 A number of separate yet inter-related briefing documents were tabled for discussions. They included :

(a) a Briefing Book on corporate formalities dated November 1995;

(b) a report on the identification of core company law issues;

(c) an article titled : "Reform and Enforcement of Australian Stock Exchange Rules and the New Continuous Disclosure Laws" by Roman Tomasic; and

(d) a paper on the need to reform the companies legislation.

1.4 During the discussions that followed, a number of members again raised whether it was right, at this critical juncture in Hong Kong's history, to embark upon a fundamental rethink of the companies legislation given the fact that certain sections of the business community were quite happy with the status quo. The current legislation was familiar to practitioners and, whilst not perfect, hitherto no-one could point to specific areas where radical reform and change was necessary. It was necessary to identify the current failings of the legislation before putting forward proposals which were said to be an improvement.

1.5 As against those sentiments, however, other members welcomed the

Administration's decision to embark upon the Review. Irrespective of the final recommendations of the consultants, a number of problems with the existing law were apparent and which needed to be addressed. In addition there had been little seminal input into the process of company law reform by Hong Kong itself. Rather, the approach to reform had largely been dictated by changes in the UK, which was increasingly bound by European community directives. It was timely to examine a range of alternatives. The piecemeal approach to reform which had been adopted hitherto had resulted in inconsistencies and contradictions appearing in the legislation. Whatever conclusions the Review reached would still be subject to a lengthy consultation process sometime in the future. It was premature to decide that the Review was unnecessary.

113th Meeting

1.6 A paper titled : "UK Company Law Reform : Towards a 21st Century Corporate Revolution" by Saleem Sheikh was tabled for information purposes. The paper contained a short recital of the history of company law reform in the UK and argued in favour of a shorter and simpler form of companies legislation like that found in South Africa, Australia and New Zealand.

114th Meeting

1.7 Mr Ermanno Pascutto, the consultant appointed by the Government to undertake

the Review updated members on its progress. The Inception Report which had been delivered to the Administration and tabled at a previous meeting of the SCCLR had endeavoured to set out the 'modus operandi' of the Review. This included the setting up of working parties whose membership were drawn from leading accountancy and legal firms, business organisations and tertiary institutions to consider different aspect of the companies legislation.

116th Meeting

1.8 Mr Pascutto again updated members on progress. Meetings of the various working parties set up to tackle different topics had more or less finished. Work had commenced on the draft of the Final Report and it was hoped to have it ready by April 1997. (N.B. It has since been issued.) In addition Professor Len Sealy, a Cambridge Professor of Law, and Mr John Howard, a member of the team reviewing the provisions of the Canadian Business Corporations Act, had been helping with the Review. In addition they had addressed members of the SCCLR on the Review in December of last year.

Chapter 2

Section 141 of the Companies Ordinance (CO) - The Auditors Reports and the Rights of Auditors of Access to Books of Account and the Right to Attend and be Heard at Company Meetings

2. **Summary of Recommendations**

2.1 At the 111th meeting, members agreed to defer further debate firstly to enable the Hong Kong Society of Accountants (HKSA) to ascertain the response of the Accounting Profession to a new draft of an accounting guideline recently issued by it on the subject and, secondly, to await the outcome of a further consultation exercise between the HKSA and the Financial Services Branch on the question of Statutory Immunity for auditors when reporting fraud or wrongdoing to the appropriate authorities.

Background

2.2 The HKSA in a submission on possible amendments to the CO had proposed that section 141 of the CO should be amended to enable auditors of a company to consider whether the information given in the directors' reports for the financial

year for which the annual reports were prepared was consistent with those accounts. In support of its proposal, the HKSA had stated :

> "The scope of the statutory audit is restricted to the financial statements of a company consisting the balance sheet, profits and loss account and notes.
>
> However, financial information contained in a company's annual report is not confined to these statements encompassed by the auditor's report. Other financial information may be included in the statutory directors' report or in other unaudited statements such as a chairman's statement, a report on operations or a summary of past results.
>
> The auditor has no statutory responsibility in respect of these other financial information. This puts the auditor in a dilemma where the unaudited financial information issued with the audited financial information are found by the auditor to be inconsistent with the audited financial statements.
>
> For the purpose of discharging his responsibility, he may wish to refer to the inconsistent information in his audit report. However, the qualified privilege (i.e. the defence to an action for defamation)

which an audit report normally enjoys may not extend to comments on items of other financial information which appear to be inconsistent with the audited financial statements. Similarly, no qualified privilege may attach to statements made by him on such matters at a general meeting pursuant to his right under sections 141(7) of the Companies Ordinance.

We note that the UK 1985 Companies Act has introduced an additional requirement for the auditor to consider where the information given in the directors' report for the financial year to which the annual accounts are prepared is consistent with those accounts; and if they are of opinion that it is not they shall state that fact in their report. The same provisions should be adopted for Hong Kong."

2.3 During discussions certain members opposed the proposal. An examination of the directors' reports contained in the more recent accounts of listed companies disclosed that the information contained therein was a replication of the statutory information set out elsewhere. Any anomalies would be contained in the management report or the chairman's statement, not the directors' reports. There were other ways of addressing the concerns of the HKSA. It was common for accountants to verify e.g. information contained in prospectuses by way of comfort letters or verification notes, if there was concern over the quality of

information contained in annual reports outside of the annual accounts. Perhaps such an approach could be adopted for the issue in hand.

2.4 As against those sentiments other members clearly supported the proposal. If auditors, having examined the directors' reports, found inconsistencies with the audited accounts they should be free to comment and be protected by the doctrine of qualified privilege. The HKSA proposal arose from the introduction of a new auditing standard which replicated an existing international standard. Auditors should not allow their financial statements to be placed in a document which gave a contradictory message without having the legal right to point it out. If auditors exercised their rights in this regard it was perfectly proper for them to be protected by the doctrine of qualified privilege.

2.5 At the conclusion of discussions, the majority of members felt it wise to await the outcome of the further proposed consultation exercises referred to in paragraph 2.1 before coming to a decision.

Chapter 3

The Investigation of Serious Commercial Crime Cases Under the Companies Ordinance (CO)

3. Summary of Recommendations

3.1 At the 111th meeting, members recommended that any proposal to extend police powers in the investigation of serious commercial crime should be examined within the context of the criminal law, and not the CO.

Background

3.2 The Commercial Crime Bureau (CCB) of the Royal Hong Kong Police contended that one of the major problems confronting them when an investigation into serious commercial crime was underway was the obtaining of documentary evidence, especially where a deliberate policy of fraud had been embarked upon at the highest levels of a company's management.

3.3 Under sections 142 and 143 of the CO, the Financial Secretary was empowered to appoint one or more competent inspectors to investigate the affairs of a company. The powers of such inspectors included :

- under section 145(1) the power to compel officers and agents of the company to produce all books and documents relating to the company;

- under section 145(1A), to compel persons, other than officers and agents of the company, to produce books etc. in his possession and attend and give the inspectors such information as he may reasonably give;

- under section 145(2), the power to examine under oath any officer or agent of the company with regard to the affairs of a company;

- under section 145(3) the power to refer any matter to the court where there has been a referral to produce books or answer questions and to lay contempt of court proceedings;

- under section 145(3A), a person was not excused from answering a question put by an inspector on the grounds that his answer might incriminate him - neither the question nor the answer were admissible in any criminal proceedings, other than for perjury;

- under section 152A, the Financial Secretary had the power to require the production of documents for inspection by public officers.

3.4 Notwithstanding the powers of investigation conferred upon inspectors under the CO, there were still severe difficulties confronting them. These included :

(a) Self-incriminatory evidence was inadmissible in any subsequent criminal proceedings. Experience had shown that this was a serious hindrance to the prosecution of commercial fraud;

(b) The term 'Public Officer' in section 152A could not be extended to a police officer;

(c) The photocopies of documents discovered during inspections could not be used by the police in any subsequent criminal proceedings;

(d) There was no provision in the Companies Ordinance to enable the authorities to reopen an inspection following the discovery of material discrepancies by the police in their own enquiries following an inspection;

(e) Company directors instructing staff members to keep silent;

(f) The three year time bar for prosecution under section 351A of the CO.

3.5 There was a range of possible solutions to those perceived shortcomings and these included :

(a) The creation of a new section in the CO to provide police officers with additional powers to compel witnesses to supply information and answer

questions;

(b) The three year time bar against prosecutions under section 351A should be extended to 5 or 7 years;

(c) To enable the prosecution to produce copies of documents obtained from inspectors, provisions should be included to allow the inspector to obtain certified true copies from a responsible officer of the company under investigation;

(d) Amending the Evidence Ordinance to allow any statement contained in a document produced by a computer as a prima facie evidence.

3.6 During the course of discussions which followed, members, whilst extremely sympathetic to the difficulties confronting the CCB in their investigations of commercial crime, nevertheless felt that the CO was not the right place to include provisions governing the seizure and use of evidence in criminal investigations of commercial fraud. Whilst there was certainly a case for enhanced powers the appropriate home for them was in the criminal law or possibly a separate ordinance, but not the CO. This was for a number of reasons :

(a) The interaction of the police and inspectors during an investigation or inspection could undermine the criminal investigation;

(b) There was a very important difference between company inspections and criminal investigations. It was vital for inspectors to be able to ascertain what had happened to a company. If the protection against self-incrimination were to be abolished, it was probable that the very people who were in the best position to assist the inspectors would refuse to co-operate;

(c) There were major difficulties with regard to the certification of copy documents. Who from the company would be authorised to undertake this task? Which documents were to be certified? Would there be difficulties in sustaining any subsequent criminal proceedings if documents had been certified by inspectors?

(d) The three year time bars referred to in section 351A of the CO was only applicable to summary offences, not indictable offences.

3.7 Other members opined that the difficulties set out in the CCB paper tabled for discussion were only applicable to a very small number of cases. The difficulties should be addressed in any amending criminal legislation and not the CO.

Chapter 4

Procedures for the Replacement of Lost Share Certificates - Section 71A of the Companies Ordinance (CO)

4. **Summary of Recommendations**

4.1 At the 111th meeting, members agreed to defer further discussions until the Hong Kong Stock Exchange (SEHK) and the Federation of Share Registrars had reached agreement on a new system to replace the one provided for in section 71A of the CO.

Background

4.2 This subject had been discussed and analysed at the 107th and 110th meetings and full details of the background can be found in Chapter 10 of the 12th Annual Report of SCCLR for 1995/96. The Hong Kong Institute of Company Secretaries (HKICS) had recommended legislative changes to section 71A of the CO which laid down the procedures to be followed in the event of share certificates being mislaid or lost. In support of its proposal, the HKICS contended :

"With the advent of central clearing, the procedure contained in section 71A for replacement of lost share certificates in respect of listed companies is rapidly becoming out of date. A number of listed company secretaries have suggested that it would cause the companies concerned no great problem to substitute section 71A arrangements with the rather simpler requirement for a letter of indemnity. We accordingly recommend such a change."

4.3 During the course of discussions it was pointed out that in respect of Bermudan companies it was possible to provide for the loss of share certificates within their constitutions. Hong Kong's current system was time consuming, laborious and above all, rather expensive. To try and address those concerns, the SEHK in conjunction with the Federation of Share Registrars was proposing the establishment of a Public Register which would serve as a centralised source of information for lost share certificates and which could be searched. This obviated the necessity of placing advertisements in newspapers and the Government Gazette. As an alternative, it might be possible for each listed company to set up its own central share register, and it was also being suggested that listed companies should be allowed to execute share transfer forms so that share transfer could be more expeditiously effected to those who claimed that their shares had been lost. Most of the recommendations of the SEHK had been informally endorsed by the Federation of Share Registrars.

4.4 In conclusion, it was agreed that the SEHK and the Federation of Share Registrars should finalise their discussions and thereafter revert to the Standing Committee with a set of proposals.

Chapter 5

Miscellaneous Items :

(1) Relief for Minority Shareholders;

(2) Controlling Directors' Remuneration;

(3) Reforming the Law of Private Companies

5.1 At the 111th meeting, three papers dealing with relief for minority shareholders, the control of directors remuneration and the reform of the law relating to private companies were tabled primarily for information purposes only.

Relief for Minority Shareholders

5.2 The UK Law Commission is presently undertaking a review of shareholders' remedies with particular reference to the rule in Foss v Harbottle and its exceptions and also to sections 459 - 461 of the 1985 UK Companies Act (the remedy for unfairly prejudicial conduct). In a penetrating analysis of Barrett v Duckett 1995, 1 BCLC 243 CA, contained in Volume 16 No. 6 of Company Lawyer, Professor Len Sealy of Gonville & Caius College, Cambridge argued that the Court of Appeal decision :

> "highlights dramatically the need for an entirely fresh approach to this question of shareholders' remedies, and the case will have done something for future generations if its sorry lesson helps to spur our reformers to take radical action. If reform is to come, is it too much to ask from our judges that the type of procedural hurdle which they have in the past seemed all too ready to allow to slip in to any minority-shareholder litigation should in future be the subject of a self-denying ordinance? It is surely possible for the courts, when approached by a victimised shareholder crying 'Help!", to find some way of responding positively rather than finding some pretext or another to say 'Go away'.

5.3 During the course of discussions, members commented that similar procedural hurdles and difficulties confronted minority shareholders in Hong Kong, not to mention the question of cost. The listing committee of the Hong Kong Stock Exchange had endorsed a proposal to form a working party on corporate governance when, inter alia, the position of minority shareholders would be considered. One member suggested that a possible method of simplifying procedures was for the aggrieved minority shareholder to serve a demand on the directors to convene a meeting. If at the meeting the majority of shareholders sanctioned the 'wrongdoing', it would be prima facie evidence that the majority were in control thus giving the aggrieved shareholder the right to commence proceedings. A refusal by directors to convene a meeting would also act as a

trigger for the minority shareholder to bring proceedings. Similar procedures were in place in Japan.

Controlling Directors' Remuneration

5.4 Over the years members had expressed concern how to raise and improve standards of corporate governance in Hong Kong. At the 111th meeting, a paper titled : "Controlling Directors' Remuneration" which appeared in the 3rd February 1995 issue of the Solicitors Journal was tabled for information. Pay awards to company directors in the UK had been rising dramatically, so much so that over the past ten years the basic pay of senior UK directors had gone up by more than twice as much as that of ordinary employees without taking into account bonuses and other elements of executives packages. What could shareholders do? The short answer was not very much. As the author had put it :

> "Unless shareholders have sufficiently large shareholdings to remove a director or change a company's Articles of Association, their ability to restrict payments made to directors is very limited. Directors are bound by general duties to act in the company's interest and not make unjustifiable or excessive pay awards or severance payments but these remain rather crude instruments of control. A likely solution is a combination of enhanced disclosure requirements and a strengthened code of conduct to be

introduced ....."

<u>Reforming the Law of Private Companies</u>

5.5 This was an analysis of a UK Department of Trade publication of a consultation paper on the subject of : "Company Law Review: The Laws Applicable to Private Companies" and which appeared in issue No. 6 of Volume 16 of the Company Lawyer. The writer concluded :

> "The original purpose of limited liability was to protect passive investors in major enterprises; its large-scale adoption by small businesses is a chance occurrence that the legislature has never seriously reviewed. Small businesses take the limited liability form with all its continuing compliance costs because there is no alternative corporate form available to them. If limited liability is granted, to ensure that a proper balance of interests is preserved with creditors, regulation will unavoidably be extensive. There is therefore a limit to which limited companies can properly be deregulated. The best way to deregulate and to provide a suitable vehicle for the many small businesses that currently do not incorporate is to provide them with the option of a 'business corporation' without limited liability. Most writers on company law assert that the purpose and benefits of forming a limited company are

to obtain limited liability, to raise capital by issuing shares, to achieve free transferability of shares and to enhance creditworthiness by being able to borrow on the security of floating charges. Our empirical research persuades us that for the vast majority of companies, few if any of these benefits are either sought or achieved.

The current DTI exercise in reform of company law provides a valuable opportunity for the imbalance between the needs of small businesses and the vehicles available to them to be addressed. It is also an opportune moment to consider the very style and format of the Companies Act itself. The consolidation of 1985 was a major step forward but once more the Augean stables need attention. The legislation requires comprehensive pruning and restructuring as a more manageable Companies Act with accompanying regulations."

Chapter 6

Interest on Debts and Extortionate Credit Transactions : Section 264 of the Companies Ordinance (CO)

6. Summary of Recommendations

6.1 At the 112th meeting, members endorsed the Official Receiver's proposal that firstly in the event of a surplus occurring in an insolvent winding-up interest should be paid on debts provable in the winding-up either at the judgment rate for the time being or at the contractual rate, whichever was the higher; and secondly, as a consequence, to empower the court, upon application by the liquidator, to rule a transaction extortionate if (inter alia) the interest rate being charged is considered excessive. It was proposed to amend section 264 of the CO by the addition of sections 264A and 264B to provide for those proposals. These were contained in the Bill which has now been enacted as the Companies (Amendment) Ordinance 1997 which was implemented on 10 February 1997.

Background

6.2 Clause 44 of the Bankruptcy (Amendment) Bill 1996 which was introduced into the Legislative Council on 13 March 1996 provides for interest on bankruptcy debts to be provable at contractual or statutory rates so as to avoid the complicated and time consuming exercise of re-calculating interest, sometimes over many years, at 8% per annum. By virtue of section 264 of the CO, clause 44 of the Bankruptcy (Amendment) Bill will be applied to insolvent companies which are being wound. However, in the event of a surplus a wound up company would not be insolvent and thus the provisions of clause 44 would not apply. The introduction of section 264A would remedy that.

6.3 Section 264A is largely drawn from the provisions of section 189 of the UK Insolvency Act 1986 and follows a recommendation of the Law Reform Commission Report on Bankruptcy that it should be adopted into the Companies Ordinance in respect of winding-up.

6.4 With regard to the enactment of a new section 264B, this would entitle the court upon application to determine whether or the amount of contractual interest being charged was extortionate and to make appropriate orders. This new section was modelled on section 244 of the UK Insolvency Act 1986.

Chapter 7

Section 194 of the Companies Ordinance (CO) - Appointment of Liquidators

7. **Summary of Recommendations**

7.1 At the 112th meeting, members endorsed the Official Receiver's proposal to amend section 194 of the CO by the addition of 3 new provisions :

(a) to enable a private insolvency practitioner who has been appointed provisional liquidator before the making of the winding-up order to continue in office afterwards. At present the Official Receiver automatically dispossessed a private provisional liquidator on that date;

(b) to require an outside provisional liquidator to summon separate meetings of creditors and contributories of the companies for the purpose of determining whether or not an application was to be made to the court to appoint another person in his place as liquidator; and

(c) to empower the Official Receiver at any time when he is liquidator to apply to court for an outside insolvency practitioner to be appointed liquidator in his

place.

Background

7.2 Government had directed the Official Receiver's Office to contract out more insolvency cases with a reasonable level of assets to experienced insolvency practitioners in the private sector. That level had been agreed with the Hong Kong Society of Accountants (HKSA) at HK$200,000.00 in estimated realisable assets. Agreement had also been reached with the HKSA on the establishment of an Administrative Panel of firms, possessing the necessary expertise and resources, from which appointments would be made on a roster basis.

7.3 The aim of the policy was to relieve pressure on the Official Receiver's Office which was faced with an increasing number of insolvencies each year. Members endorsed the proposals. These were contained in the Bill which has now been enacted as the Companies (Amendment) Ordinance 1997 which was implemented on 10 February 1997.

Chapter 8

Sections 209A and 209B of the Companies Ordinance (CO) - Powers of the Court to Convert a Compulsory Winding-Up into a Creditor's Voluntary Winding-Up

8. **Summary of Recommendations**

8.1 At the 112th meeting, members agreed to refer the matter to the Insolvency Law Reform Sub-committee under the chairmanship of Professor Ted Tyler for it to consider whether it was timely to seek the repeal of sections 209A and 209B from the CO. In the meantime, no changes to the wording of the sections were required.

Background

8.2 The Hong Kong Bar Association (HKBA), in a submission on amendments to the CO, had proposed that the cross reference in section 209B of the CO (this sets out the consequences once a compulsory winding-up has been converted into a creditor's voluntary winding-up pursuant to section 209A) to sections 182, 183 and 186 of the CO should be deleted. Those provisions only applied in respect of a compulsory winding-up by the court. In support of its proposal, the HKBA

had stated :

> "The purpose of a voluntary winding-up, whether members or creditors, is to divorce its control from the court, including the right to bring proceedings against the company in liquidation. Thus it is difficult to see any basis for the application of sections 182, 183 and 186 in the case of a voluntary winding-up converted from a compulsory winding-up when an ordinary member's or creditor's voluntary winding-up is not governed by any of these provisions. Moreover section 182 does not apply once a company has been ordered to be wound-up as all directors become functus. No liquidator has ever applied to the court for the disposal of an asset under that provision as its powers and duties are governed by the ordinance. In the circumstances, it is all the more puzzling why section 182 remains applicable to a creditor's voluntary winding-up."

8.3 The proposal was examined by the SCCLR last year at its 105th meeting (chapter 4 of the 1995/96 Annual Report of the SCCLR sets out the background) when discussions were deferred to await an expected Court of Appeal decision on the point in question.

8.4 During the course of discussions, it was pointed out that it might be necessary to retain the cross references especially where there was an unlawful transfer of

assets whilst the status of the liquidation was compulsory but which was only discovered after the status of the liquidation had been changed into that of a creditor's voluntary. In addition, the Court of Appeal decision had not indicated that such provisions were either undesirable or unnecessarily duplicative. Rather the court had used the provisions as an aid to determining the meaning of sections 209A and 209B. If the cross references were excised, it could produce undesirable and unforeseen consequences.

8.5 Other members pointed out that the intention underlying the introduction of sections 209A and 209B was to ensure that any orders made under sections 182, 183 and 186 during a compulsory liquidation continued after its conversion into a creditor's voluntary. Certain members believed it was timely for both sections to be repealed given that the real purpose behind seeking a conversion was the avoidance of the Official Receiver's fees. Section 209A was originally enacted in 1984 and had its genesis in a recommendation of the Jenkins Committee in 1967 in the UK. It was never enacted in the UK nor did it exist elsewhere.

8.6 In conclusion, members thought the best course was for the Insolvency Law Reform Sub-committee to consider the subject within the context of Insolvency Law Reform.

Chapter 9

Sections 141A and 141B of the Companies Ordinance (CO) - Transitional Provisions with regard to the Financial Years Ending before 30 September 1975 and the First Financial Year after 29 September 1975

9. Summary of Recommendations

9.1 At the 112th meeting, members supported the proposal to repeal sections 141A and 141B from the CO.

Background

9.2 Sections 141A and 141B were enacted by the 1974 Companies (Amendment) Ordinance which brought about a large number of changes to the financial disclosure requirements set out in the CO. The legislative changes were largely the result of recommendations contained in the Second Report of the Companies Law Revision Committee.

9.3 The 1974 Companies (Amendment) Ordinance effected some 21 amendments to the then existing provisions dealing with the accounts and audit requirements set

out in the CO. As a consequence it was necessary to enact transitional provisions to give effect to the substantive changes and these were in the form of sections 141A and 141B which were modelled on section 10 of the 1967 UK Companies Act. It was clear those sections were now spent and of no further effect and should therefore be formally removed from the Ordinance.

Chapter 10

Section 14 of the Companies Ordinance (CO) - Amendments to the Memorandum of Association of a Hong Kong Incorporated Company

10. **Summary of Recommendations**

10.1 At the 112th meeting, members endorsed a proposal to amend the CO to enable companies which had the clause : "Crown Colony of Hong Kong" (or something similar thereto) as part of the address of their registered office to amend it and replace it with the phrase "Hong Kong".

Background

10.2 A private firm of solicitors advice had been sought by clients in connection with proposals to amend their Memorandum of Association to delete a reference to "Crown Colony of Hong Kong" where it appeared in the second clause of its Memorandum of Association in relation to the location of its registered office and to replace it with the more "de-politicised" description of "Hong Kong".

However, following an examination of the legislation governing the amendment to a Hong Kong company's Memorandum of Association, it was concluded that no such amendment was possible. Accordingly the SCCLR was invited to consider the issue with a view to recommending to the Administration the introduction of legislation to remedy the problem.

10.3 Under Section 14 of the CO, the form of the Memorandum of Association of a company limited by shares shall be in the form (or as near as the circumstances admit) set out in Table B to the First Schedule. It is a requirement under the second paragraph of Table B that a clause is inserted stating that the registered office of the company is situated in Hong Kong.

10.4 By virtue of section 7 of the CO, a company cannot alter its memorandum ..... "except in the cases, in the mode and to the extend for which express provision is made in this ordinance". However, it is only the objects clause, pursuant to section 8, of a company's memorandum which can be altered and only then by way of a special resolution. The description of the company's registered office is not susceptible to be changed by way of a special resolution.

10.5 During the course of discussions, members were supportive of the proposal. There was no way of knowing the scope of the problem but it was thought that it related primarily to companies incorporated prior to 1980. It might be necessary to enact a short 'deeming' statute to address the problem. It was

necessary to ensure that any amending legislation should conform with the provisions of the Basic law. It was also pointed out that the Localisation and Adaptation of Laws Unit of the Attorney General's Chambers would be consulted to see whether the issue should be dealt with as an 'adaptation of law' issue.

10.6 Attorney General's Chambers had advised that all laws previously in force in Hong Kong prior to the establishment of the SAR Government would be adopted except those declared to be in contravention of the Basic Law by the National People's Congress. This would extend to all documents, certificates, and contracts valid under the laws in Hong Kong provided that they too would not contravene the Basic Law. In view of that advice, the Administration did not feel that references in existing private documents to 'The Crown Colony of Hong Kong' would be in breach of the future Basic Law and as a consequence, it would not be necessary to introduce legislation to address this matter.

Chapter 11

'Smart Cards' -

Amendments to the Banking Ordinance

11.1 At the 112th and 113th meetings members were appraised of the Hong Kong Monetary Authority (HKMA)'s proposals to amend the Banking Ordinance to regulate the issue and use of 'Smart Cards'. 'Smart Cards' were 'front loaded' multi purpose financial instruments which could be used both for the purchase of goods and services as well as to extract money from ATM machines. Although the HKMA had considered whether the credit balance on a 'Smart Card' should be treated as a deposit for the purposes of claiming preferential status in the event of the winding-up of a bank under the Companies Ordinance, it had been decided not to make any special provision. Rather, it was proposed to leave that question to the liquidator to determine assuming the point ever arose. Please see also paragraph 11.3 below for up date of position.

11.2 Draft legislation had been introduced into LegCo. HKMA considered that it was important to have legislation in place to regulate the various 'Smart Card' schemes which would soon be brought to the market place. A plethora of different schemes were in the pipeline and it was proposed to equip the HKMA with an authorisation scheme to enable it to set conditions for the issue of the different types of 'Smart Cards'.

11.3 Following discussions in The Bills Committee which considered the Banking (Amendment) Bill 1996, it was decided to introduce a provision to clarify that where value stored on a multi-purpose card was recorded as a liability on the balance sheet of the issuer, the amount concerned should be treated as a deposit for the purposes of claiming preferential status in the event of a winding up.

Chapter 12

Composite Securities & Futures Bill

(1) Consultation Paper and Draft Bill

(2) Main Proposed Revisions to the Draft Bill

12.1 At the 113th meeting, papers titled :

(a) "A consultation paper on a draft for a Composite Securities & Futures Bill"; and

(b) "A draft for a Composite Securities & Futures Bill"

were tabled for information and discussion. An executive summary of (a) is at Appendix 1.

12.2 The Securities & Futures Commission (SFC) was proposing a codification of the various existing ordinances under its purview into a composite piece of legislation. However, there were two significant changes in the draft legislation from the existing legislation: firstly, it was proposed to introduce a unitary system for the licensing of all intermediaries in the financial services industry; and secondly it was intended to change the current practice of exempting banks - originally the practice was only applied to banks and finance houses not engaged

in the retail securities business. However, Hong Kong was one of the few international centres where the retail business of banks in securities was not regulated.

12.3 Currently the securities industry was affected by 11 pieces of legislation - 8 were to be re-enacted with some refinements, whilst of the remaining 3 one was defunct, the second, the Commodities & Exchange Ordinance was regulated by the police whilst the third, the Securities (Disclosure of Interests) Ordinance was to be the subject of a further consultation exercise. The SFC had striven to ensure that all of the rights and privileges enjoyed by the securities industry in the current legislation had been included in the Composite Bill.

12.4 At the 118th meeting, a paper titled : "Draft Composite Securities & Futures Bill - Main Proposed Revisions" was tabled for discussion. This paper reported on the outcome of the consultation exercise undertaken by the SFC in respect of the Composite Bill referred to in 12.1(b) above. A copy of the executive summary of this paper is at Appendix 2.

12.5 By November 1996, the SFC had received 50 written submissions to the consultation paper and had also organised 20 briefings attended by more than 1,000 people. As a consequence some 200 major and minor amendments had been made to the draft bill.

12.6 Matters on which representations had been made could be conveniently divided into 3 groups :

(a) those changes which were of a policy nature e.g. the SFC had dropped the proposal to grant itself the power to prescribe criminal offences in rules, leaving it rather to the Governor-in-Council to enact subsidiary legislation;

(b) views which after due consideration, the SFC had rejected e.g. the dismantling of the monopoly status of the Hong Kong Stock Exchange and the opposition to the SFC being empowered to regulate screen based electronic trading systems and other off-exchange trading activities; and

(c) suggestions which were outside the ambit of the consultation paper but which were relevant to the continued development of the capital markets and which would be separately reviewed at a future date.

12.7 The task of codifying all of the relevant legislation was a long, complex and arduous task.

Executive Summary

The Securities and Futures Commission has prepared a draft of a composite Securities and Futures Bill to consult the market on the consolidation of the existing laws governing the securities and futures markets currently administered by it.

Background

At present, the applicable laws are spread over some 11 Ordinances and parts of the Companies Ordinance. This is unsatisfactory because the laws governing certain issues, for example the regulation of the Exchanges, are spread over several Ordinances, with duplication and inconsistencies of wording between the Ordinances. This creates uncertainty and even traps for the unwary. As well, many provisions cannot be properly understood without reference to other peices of legislation, for example in the definitions, and some of the provisions and even entire Ordinances have been overtaken by events.

Pursuant to a recommendation of the Securities Review Committee, the SFC commenced a review of the legislation in 1990 with a view to rationalising them into a composite Bill. In the course of this work, a degree of "updating" of the laws was inevitable to take account of developments in the markets, technological advances and changes in regulatory philosophy/emphasis since the main body of the laws was enacted in the 1970's. Other changes have been indicated from our experience in implementing the Ordinances.

The market was publicly consulted on some of the key areas of the proposed updating beforehand, for example changes to the licensing regime, the system of exemptions and the disclosure of interest regime. In other cases, the changes were developed following a series of informal consultations with industry bodies and practitioners.

Structure of the Draft Bill

The resultant draft Bill, published with this document to seek the markets' views, consists of 15 Parts and eight Schedules. It repeals and replaces eight of the existing eleven Ordinances. These are:

(1) The Securities and Futures Commission Ordinance;
(2) The Securities Ordinance;

(3) The Commodities Trading Ordinance;
(4) The Protection of Investors Ordinance;
(5) The Stock Exchanges Unification Ordinance;
(6) The Securities and Futures (Clearing Houses) Ordinance;
(7) The Securities (Insider Trading) Ordinance; and
(8) The Leveraged Foreign Exchange Trading Ordinance.

Three Ordinances have not been rationalised into the composite Bill because:

(a) The Commodity Exchanges (Prohibition) Ordinance, which regulates wholesale markets in soft commodities, has no real bearing on the financial markets.

(b) The Securities (Disclosure of Interests) Ordinance was the subject of public consultation in 1995 and the updating work is still being drafted.

(c) The Exchanges (Special Levy) Ordinance is now defunct.

Content of the Draft Bill

A brief description of the various parts and the main areas of change are:

Part I - Preliminary

This part deals with definitions. However, due to the volume involved, these have been set out in a schedule with no implications for their legal status. The main change in this area is to the definitions of "securities" and "futures" to avoid regulatory gaps arising from growing product innovation.

Part II - Securities and Futures Commission

This part deals with the functions and powers of the Commission. The main changes are the addition of an explicit SFC function to safeguard the interests of investors; a statement of objective to achieve fair, efficient, competitive and informed markets and a power to make rules to exclude classes of transactions from the transaction levy.

Part III - Securities and Futures Appeals Panel

This part re-enacts the existing legislation on the SFC Appeals Panel. Most of the procedural provisions affecting the conduct of proceedings have been removed to a schedule. In addition, a new provision has been included to

enable the SFC to give effect to decisions to revoke or suspend a licence prior to the completion of the appeals process in the interest of the investing public.

Part IV - Exchanges

This part largely re-enacts the existing provisions governing the stock and futures markets. While it effectively retains the statutory monopoly of the Stock Exchange, to enable the SFC to regulate trading facilities outside the monopoly, such as cross-border electronic screen-based trading systems, the SFC is given the power to impose rules to govern their operations by authorising them. The details of regulation of such systems, when worked out, will be the subject of market consultation.

Part V - Clearing Houses

This part re-enacts the Securities and Futures (Clearing Houses) Ordinance without changes of substance.

Part VI - Licensing of Intermediaries

This parts sets out the regime for licensing of intermediaries. As agreed during the public consultation exercise undertaken in 1990, the definition of advisers will be amended to require persons who hold client assets to be licensed as dealers. Also pursuant to a public consultation exercise undertaken in 1990, the exemption provision will be narrowed to restrict exempt dealer status to persons whose securities dealings are directly incidental to their principal business activities, which must be non-securities dealing related. Finally, a provision has been added to empower the SFC to impose limited financial penalties for technical offences.

Part VII - Supervision and Investigations

This part re-enacts the existing supervisory and investigative powers of the SFC. In so doing, the power to investigate compliance with guidelines and codes of conduct has been specifically spelt out to avoid misunderstanding. To enhance the protection of assets held by intermediaries on behalf of clients, powers to order a licensed person to transfer such assets to a trustee are provided if a risk of their being dissipated exists.

Part VIII - Financial Regulation of Intermediaries

This part re-enacts the existing legislation governing the financial regulation of intermediaries. The only substantive change is to give the SFC a monitoring role over licensed or exempt person controlled nominee companies which hold client securities to improve the safeguards over these assets.

Part IX- Business Conduct

This part restates in more direct terms the SFC's power to issue codes of conduct and makes it clear that disciplinary inquiries may be undertaken in case of breaches of such codes.

Part X - Investor Compensation

This part covers the compensation arrangements for investors in the event of a default. To streamline the current system in relation to members of the two Exchanges, the operation and management of the Compensation Funds will be delegated to the Exchanges through rules made by the SFC. At the same time, the current inadequate compensation arrangements for dealers who are not Exchange members will be replaced by their taking out fidelity insurance satisfactory to the SFC.

Part XI - Insider Dealing

This part re-enacts the present Securities (Insider Dealing) Ordinance. The only change is to enable the Insider Dealing Tribunal to include expenses incurred by the SFC in the costs of the investigation.

Part XII - Market Manipulation

This part sets out the law against market manipulation. Clarifications regarding transborder manipulation activities and price stabilisation schemes have been included as well as some new provisions on misleading statements and "bucketing" offences.

Part XIII - Offers of Investments

This part sets out the law governing offers of investments. The existing arrangements are largely retained although the definitions of units trusts and mutual fund corporation have been amended to accommodate developments in the market.

Part XIV - Miscellaneous

This part consolidates and rationalizes the miscellaneous provisions in the various Ordinances. It includes provisions governing the SFC's powers to make rules, its powers to prosecute offences, time limits for prosecuting, its duties of confidentiality etc. It also sets out the penalties for offences. As requested by the Legislative Council on a number of occasions, all penalties in the existing legislation have been reviewed and updated.

Part XV - Repeals, Transitional Provisions and Consequential Amendments

This part provides the transitional arrangements and the repeal of the existing Ordinances for the smooth implementation of the draft Bill.

The Consultation Period

Members of the public and the industry are invited to give their views on the draft Bill to the SFC by July 15, 1996.

EXECUTIVE SUMMARY

BACKGROUND

1. A consultation paper and a draft for a Composite Securities and Futures Bill were published on 15 April 1996 inviting comments from the public and the financial services industry on the proposed legislation. This document sets out the Commission's views in relation to comments received on major policy matters.

2. The consultation process after the publication of the draft bill included some 20 private briefings or public seminars, listed at Annex I, given by the Chairman and senior executives of the Commission. Altogether approximately 1,000 persons from the industry attended these briefings.

3. 50 written submissions, listed at Annex II, on the draft bill were received from the industry. The original period for receipt of comments was three months. This period was extended so that all comments received during the seven month period to 14 November 1996, including those of the Stock Exchange of Hong Kong Ltd. (SEHK) received on 22 October 1996, have been considered.

MAJOR POLICY MATTERS

4. The primary aim of the Draft Bill is to consolidate the various pieces of legislation covering securities and investments, futures and leveraged foreign exchange markets. In the process, some updating of the regulatory regime were inevitable to take account of changes in the markets since enactment of the main body of laws more than twenty years ago. These objectives have received widespread support. There is general agreement that the law on these subjects should be rationalized and enacted into a single ordinance. In addition to expressing support for individual proposals a number of commentators expressed reservations about, or opposition to, particular elements of the rationalization but only the SEHK indicated that "it would have tremendous difficulties in giving support to the passing of the draft bill in its published form".

Major changes stemming from the consultation process

5. In many cases, the Commission agrees with the thrust of representations received and has modified or introduced proposals accordingly; examples in the case of policy matters include -

- not proceeding with the proposal to empower the SFC in particular circumstances to suspend or revoke licences with immediate effect;

- following receipt of comments from the Hong Kong Association of Banks (HKAB), the Hong Kong Monetary Authority (HKMA), and bodies in the securities industry, making certain new proposals relating to exempt status within the licensing regime, which seek to address the concerns of all parties in the light of the serious policy concerns expressed by the Securities Review Committee in 1988;

- introducing a new class of exempt persons, i.e. exempt futures dealers and exempt futures advisers;

- clarifying the implications for fund managers and advisers of the definition of holding clients' assets;

- redefining 'assets' for the purpose of Part VII to include derivatives;

- repealing the 'sole business' requirement for leveraged foreign exchange trading companies;

- agreeing that audited accounts should be lodged with the SFC within four months of the end of the financial year and not within three months as originally proposed;

- abandoning the proposal in clause 8.6(2) to prohibit authorized financial institutions realizing securities except for repayment of loans/advances in relation to which securities were deposited as security;

- removing specific directors' liability provisions for contract notes and statements of accounts other than for companies and directors involved in the leveraged foreign exchange trading industry;

- restricting the scope of clause 8.6(4) in respect of intermediaries nominees in light of criticisms that the present provisions are too wide;

- introducing public interest amendments to the insider dealing regime mainly suggested by the judiciary;

- amending clause 12.5(1)(c) to limit its scope to untrue and misleading statements and to provide a reasonable belief defence similar to that in section 40A of the Companies Ordinance;

- amending clauses 12.3 and 12.16 to clarify that stabilization activities are currently not permitted in Hong Kong or in Hong Kong listed securities;

- proposing the inclusion of a 'good faith' defence to clauses 12.7 and 12.11 after considering concerns about the 'ought reasonably to know' test for culpability;

- relaxing the unsolicited calls regime to limit prohibition to visits in person and telephone calls and to allow unsolicited calling of existing customers and professionals;

- proposing that, with one exception (clause 9.2), only the Governor in Council should be enabled to make subsidiary legislation creating criminal offences and stipulating criminal sanctions and deleting the SFC's proposed powers to prescribe offences in rules (clause 14.13(3));

- increasing pecuniary penalties in respect of misconduct to a maximum of $500,000;

- redrafting clause 14.8, concerning the short selling regime, to reflect certain comments made. Proposed rules will be published prior to enactment of the Bill;

- amending the definition of 'securities' in Schedule 1.

Major matters on which the Commission has maintained its view

6. Subjects on which the Commission has maintained its original views, or the thrust of the consultation paper and draft bill as published, include -

- its normal policy of consulting appropriately on the implementation of new or amended rules;

- the sufficiency of checks and balances in place to ensure that the independent and statutorily established SFC cannot successfully sustain abuses of its powers;

- the functions of the SFC to safeguard the interests of investors and to ensure that market transactions are conducted in fair, efficient, competitive and informed markets;

- the 'monopoly' status of the SEHK;

- the existence of the markets outside the SEHK and improving the Commission's ability to regulate them;

- the disposal of shares in the exchange companies when the owners are no longer licenced dealers;

- the levels of penalties;

- the powers to require a licensed person, or person to whom a licensed person is accountable, to transfer assets to a trustee;

- the making of Financial Resources Rules (being of a highly technical nature and which in any event are the subject of prior market consultation) without prior consultation with the Financial Secretary;

- the investor compensation proposals;

- the preservation of a limited number of strict liability offences which make directors liable for contraventions by the licenced entity. It will however be a defence for a director to show that he acted with reasonable diligence.

Matters to be considered further outside the context of the Bill

7. Whilst the Commission is sympathetic to certain other policy issues raised during the consultation, they will be dealt with separately from the rationalization process. They are -

- whether there should be a professionals exemption for futures dealing and futures advising;

- the making of rules permitting dealers to confer outside the Stock Exchange options on shares listed in the Stock Exchange where mischief will not ensue;

- whether the professional exemption should be extended to include "institutional" or "accredited" or "sophisticated" investors or similar categorizations;

- the lawfulness or otherwise of the grey market;

- observations that the opportunity has not been taken to reform the area of the law relating to the offering of securities to the public;

- further study of the insider dealing regime;

- Part XIV secrecy provisions.

Minor policy matters and detailed technical points

8. In addition to comments on major policy issues, a large number of technical submissions were received regarding the detail of the draft bill. All points made have been considered; altogether some 200 amendments have been proposed to the draft bill. It is not feasible to include them in this document but they will, of course, be subject to scrutiny by the market and the legislature both when the bill is published and throughout the legislature process.

SCOPE OF CONSULTATION

9. The scope of the public consultation has been set out in paragraphs 1 - 3 above. However, the SEHK has expressed the view that it does not think the public consultation on the draft Composite Bill is or has been a complete one. The SEHK has also stated that "it is most unfortunate during the drafting stage of the Composite Bill over the last seven years, the Commission has not considered it appropriate to involve and to consult the Exchange on this piece of important legislation" and that had it been consulted some provisions on major issues which are, in its view, "either not practicable or disagreeable ..... would not have been included in the draft Composite Bill in its present form".

10. From the Commission's viewpoint there has been a large measure of consultation over the years, particularly from 1990 since when the SEHK has been kept informed of the proposals, invited to make representations, supplied with draft drafting instructions, supplied with a detailed policy paper, and invited to be involved in discussions on proposals for the draft Bill and its contents. Some details of this involvement are given at Annex III.

CONCLUSION

11. The Commission welcomes any further comments on its proposed changes following the receipt of comments given in relation to the consultation paper and the draft for a Composite Securities and Futures Bill published in April 1996. Further comments, if any, should reach the Commission's offices by 6 January 1997 to enable the Commission to finalize its proposals to the Administration.

12. Any further comments received thereafter will be forwarded to the Administration to enable these to be taken into account during the normal legislative process. In due course, the usual consultation will be undertaken in the case of any related rules to be made by the Commission.

Chapter 13

Statutory Immunity for Auditors of Listed Companies

13. **Summary of Recommendations**

13.1 At the 114th meeting, members, whilst supportive in principle of the Government's proposal to extend statutory immunity to auditors of listed companies when reporting fraud to the authorities, requested that the matter should be referred back to the Administration's working party to consider firstly whether the proposal should be widened to include also other officers of the company and secondly to set out precisely what obligations and duties an auditor was subject to when reporting fraud or other wrongdoing which the draft legislation tabled before the SCCLR did not address.

Background

13.2 In 1993, the SCCLR had approved in principle Government's proposal that auditors of listed companies should receive the same statutory protection enjoyed by auditors of banks, insurance companies, commodity brokers and security houses, when reporting fraud or other wrongdoing. (Please refer to Chapter 10, page 22 of the 1993/94 Annual Report of the SCCLR). However, the Administration had also agreed to refer the issue back to the SCCLR once the

draft legislation was ready and this was tabled at the 113th meeting. That meeting reaffirmed the principle based on which the committee had earlier supported the proposal in principle. The details of the draft Legislation on which some members had different views was a matter for the Administration to take forward. But at the 114th meeting the matter was raised again at the request of one member who had previously been absent.

13.3 Since 1993, Government had been in discussion with the Hong Kong Society of Accountants (HKSA) and other interested bodies about the proposal. It was the Administration's case that the draft legislation did not impose any duty on auditors to report nor did it grant any additional powers to the regulators. The need for the legislation arose out of the implied term of confidentiality between an auditor and his client. Any breach of that term could expose the auditor to the risk of civil liability and a damages claim. That factor had, in Government's view, acted as a deterrent to auditors reporting fraud.

13.4 The Administration was faced with very strong objections from the HKSA over the proposal. In particular it had been pointed out that, unlike the regulatory system in place for financial institutions and securities dealers, there was no body to whom reports on fraudulent activity and other wrongdoing could be sent. However Government believed that reports should be deposited with the SFC. A further objection of the HKSA was that the proposal would seriously damage and imperil the auditor/client relationship. The Administration disagreed and

pointed to the fact that, notwithstanding the introduction of statutory immunity legislation to auditors of financial institutions and insurance companies in 1992/93, it had not changed the role of auditors for those categories of companies.

13.5 A number of papers setting out strong counter arguments were tabled at the 114th and 117th meetings. It was pointed out that the proposal struck at the very heart of the auditor/client relationship. Clients of auditors handed over any information sought by an auditor on the clear understanding that it was to be used solely in connection with the audit. If there was any suggestion that it was to be used for other purposes, it was likely that the client would be somewhat reluctant to provide the information. Without full access to all information in relation to the affairs of the company an auditor would be unable to fulfil his primary function which was to give a report to the company on whether the accounts gave a true and fair view of the company's financial health. This was to the clear disadvantage of the company, its shareholders and the investing public in general.

13.6 Certain members thought that the draft legislation was unclear and imprecise with regard to the nature of the obligations being imposed on auditors. Under the guise of immunity, the draft legislation was in fact imposing obligations. It was extremely important to spell out precisely what those obligations were and thereafter to include an immunity clause in respect thereof. Whilst there was

general agreement that auditors should be able to report fraud freely, the proposal was much wider than this and in effect covered any breach of the listing rules. This was clearly wrong in principle.

13.7 Other members thought the proposal went beyond the claim by the Administration that it was merely a re-statement of the common law position. Indeed, paragraph 32 of the Auditing Guidelines issued by the HKSA stated that :

> "Where it is in the public interest to disclose and where information is disclosed to an appropriate body or person and there is no malice motivating the disclosure, the auditor is protected from the risk of breach of confidence or defamation."

What was the point of introducing legislation already adequately covered by the common law? HKSA had legal advice that the extent of the common law protection was unclear - hence the need to introduce legislation.

13.8 Members also queried why statutory immunity was being confined to just auditors; why not also to directors, company secretaries, lawyers etc. who may be in just as good as, if not better, position to discover fraud and other wrongdoing and disclose it to the authorities? There was no empirical evidence to suggest that the auditing profession was fearful of reporting fraud under the

protective umbrella currently granted by the common law.

13.9 At the 117th meeting, members were advised by the Administration that the draft legislation with some amendments had been tabled in LegCo. Following on from the 114th meeting, further discussions had been held within the working group, but the Administration had failed to reach full agreement with the HKSA. In the meantime, the HKSA had sought legal advice from a Queen's Counsel who had advised, inter alia, that in his view the concerns of the HKSA over the draft legislation were unjustified. The issue had been referred back to ExCo in November 1996 together with the legal opinion and a report was duly made. ExCo advised and the Governor ordered that the Bill should be introduced into LegCo. The Administration was bound to comply with that direction.

13.10 At the 118th meeting, with the agreement of the HKSA, a copy of the legal opinion was made available to members. The Administration also circulated the LegCo Brief on the Bill, adding that the legal opinion in question had not affected Government's position or the plan to consult Executive Council. A further briefing paper was also tabled for discussion. Some members expressed the view that both the legal opinion and the LegCo brief addressed inadequately or not at all many of the concerns raised by members at previous meetings. These included : the question of auditor/client relationship and whether the proposal would imperil that relationship; the widening of the

proposal to grant immunity to those who may be in just as good as, if not better, position to report fraud. In addition, the legal opinion had advised that the draft legislation was deficient and needed to be changed. Yet, those changes had not been included in the bill as tabled before LegCo. Other members doubted the conclusion in the opinion that no duty was being imposed on auditors to report. Clearly, with regard to similar provisions in the Banking Ordinance and the Insurance Ordinance, there was an expectation on the part of the regulators of those sectors that auditors would report anything untoward. Once an expectation had been created, the dynamism of the law was not far behind creating in turn duties to report.

13.11 In response, the Administration contended that -

(a) the proposal in the Bill would not create an inferior auditor-client relationship. The Bill did not seek to discourage or prevent an auditor from reporting any irregularity he discovered in the course of auditing work to the company's senior management. Nor did the Bill seek to impose on auditors any duty to report or on regulators any right to obtain information.

(b) The bill did not create a duty to report. The Administration had researched the point quite extensively and was also encouraged by the legal opinion provided by counsel instructed by the HKSA. It contended that it was not the case that the existing common law power

to act could be converted into a duty to exercise that power. It was also thought that recent case law supported the opinion that that is also the situation where there is a statutory power to act.

(c) the Administration felt that in the absence of relevant experience and perhaps on public survey, it was doubtful whether there was or would be a public expectation that auditors would report any fraud or misfeasance just because they are provided with statutory protection. In respect of the regulated sectors, the professional guidelines were drawn up in consultation with HKSA after the respective pieces of legislation were enacted. The Administration had reached an understanding with HKSA that if the Bill is enacted, the provisions in the Bill would not come into force until the guidelines for auditors are worked out and agreed with the HKSA. This was a departure from past practice and a major concession to address the HKSA's concerns.

(d) the Explanatory Memorandum had been drafted as such at the suggestion of the HKSA.

The Administration was concerned to advance the debate on the standard of corporate governance including the standard of financial reporting by providing auditors with a wide and safe harbour to permit them to report, as soon as possible and/or in more detail and without fear of inhibitory litigation, a wide

range of issues relevant to those standards.

13.12 The view was expressed that views opposing the Administration's had not been adequately set out in the LegCo Paper, it was agreed and approved that the Chairman should take the unusual step of drawing the views of those who did not agree with the Administration to the attention of LegCo. Thus after the meeting, the Chairman wrote to the Chairman of the Bills Committee drawing attention to matters which were thought not to have been drawn to LegCo's attention. Subsequently the Chairman reported to the Committee that a letter was written by the Secretary for Financial Services to the Chairman of the Bills Committee, that he did not agree with the contents of that letter but, in view of the fact that by the time that letter was received it was clear that no consideration would be given to the Bill which would inevitably lapse with the previous Legislative Council, in order to avoid any unnecessary friction he had not taken the matter further and no response was sent.

Chapter 14

Minimum Age Limits for Directors

Sections 157C and 158(5) of the Companies Ordinance (CO)

14. **Summary of Recommendations**

14.1 At the 113th meeting, members rejected the proposal to repeal section 158(5) of the CO, which provides that a director, when first appointed, should confirm that he has attained the age of 18 in the written consent to act.

Background

14.2 The Hong Kong Institute of Company Secretaries (HKICS) in a submission on amendments to the Companies Ordinance had suggested that the requirement set out in section 158(5) of the CO for a director to confirm that he has attained the age of 18 in the consent to act should be deleted. In support of its submission, the HKICS stated :

> "The minimum age limit prescribed by section 157C is a strict legal requirement, and we feel that nothing sensible is achieved by repeating this requirement as a condition of validity of the form of consent required of section 158(5). In cases where

form of consent required of section 158(5). In cases where non resident individuals are appointed and fail to include this declaration in their consent, considerable administrative inconvenience is caused in having to request the completion of a fresh form of consent."

14.3 During the course of discussions, members were advised that the objective of the proposal was to streamline some of the procedures provided for in the Companies Ordinance. The minimum age requirement was clearly set out in section 157C and it was HKICS's view that the obligation for each director to state in the consent to act that he had reached the age of 18 years was unnecessary. It also created very real administrative difficulties when omitted, especially where directors resided overseas.

14.4 Members, however, concluded that no changes to the legislation was necessary. It was very important that prospective directors were made aware of the requirement. The wording was clear and unambiguous. The forming and operation of a limited liability company was a serious matter and it was important that legal obligations were carefully observed. The present wording of section 158(5) achieved this objective.

Chapter 15

The Introduction of Migration Provisions into the Hong Kong Companies Ordinance (CO)

15. **Summary of Recommendations**

15.1 At the 114th meeting, members agreed to defer further discussion on the proposal and to await the outcome of the consultant's recommendations within the context of the overall review of the Companies Ordinance.

Background

15.2 The Hong Kong Association of Banks (HKAB) in a submission on amendments to the CO had asked the SCCLR to consider the introduction of corporate migration provisions into the CO to enable a company to alter its place of incorporation either into or out of Hong Kong whilst remaining the same legal entity. In support of its proposal, HKAB stated :

> "A number of jurisdictions now provide for corporate migration ..... This requires the company law of the existing jurisdiction and the new jurisdiction to permit this. Migration provisions in the Companies Ordinance should be considered

subject to appropriate provisions for the protection of creditors ..... The only way that this is possible at the moment is by way of special ordinance and an example of this was The Hong Kong & China Gas Company Ltd. which by special ordinance changes its place of incorporation from England to Hong Kong whilst remaining the same legal entity. What we propose is that there should be some general body of law contained in the Companies Ordinance which subject to certain procedures being compiled with and subject to the relevant foreign law so permitting a Hong Kong company could change its place of incorporation to the jurisdiction of the relevant foreign law."

15.3 In common law jurisdictions the domicile of a company is the country in which it is incorporated or registered and this domicile remains with it throughout its existence unless the law of the company's domicile permits a transfer of domicile. There are perhaps three main reasons why companies seek to change their domicile :

- to change to a jurisdiction where the heart of their business operations are being undertaken;

- government policy within a jurisdiction to effect greater local ownership of and participation in the primary industries of the relevant country; and

– asset protection.

15.4 The CO contains no procedure whereby the incorporation of a company can be transferred from Hong Kong to another jurisdiction. The same applies to immigration to Hong Kong. With regard to the migration of the Hong Kong and China Gas Co. Ltd. from the UK to Hong Kong in 1982, a private bill was enacted in the UK. In addition special legislation (The Hong Kong & China Gas Company (Transfer of Incorporation) Ordinance) was required in Hong Kong and this provided for the deemed incorporation of the company under the Hong Kong Companies Ordinance.

15.5 In certain overseas jurisdictions, the companies legislation contains specific provisions dealing with the ability of companies incorporated in those jurisdictions to transfer their domicile to another jurisdiction or for companies incorporated elsewhere to immigrate and be treated as if they had been incorporated locally. However, the legislation in those jurisdictions differs markedly from country to country.

15.6 During discussions, a number of members were of the view that at this juncture in Hong Kong's history the Administration would be unlikely to accept such a recommendation. The redomiciling phenomenon by Hong Kong companies out of Hong Kong elsewhere was now largely a matter of history. Many of the new listings on the stock exchange were of overseas companies. It was appropriate

for the consultants conducting the overall review of the companies legislation to consider the issue. As a consequence it was agreed to defer further discussions. (N.B. The consultants have now issued their report and have recommended the inclusion of migration provisions in any new CO.)

Chapter 16

12th Annual Report of the SCCLR - Responses

16.1 In July 1996 the 12th Annual Report of the SCCLR was tabled before ExCo and in LegCo. Thereafter it was sent out to those business, professional and commercial organisations usually consulted by the SCCLR.

16.2 The Hong Kong Association of Banks (HKAB) responded in September 1996 commenting on a number of the recommendations set out in the 12th Report :

(a) **Chapter 1, Corporate Governance**

HKAB agreed with the views of the SCCLR that it was important to promote corporate governance and business ethics and recommended that further steps should be taken to educate directors as to their duties.

(b) **Chapter 2, Declarations of Solvency**

HKAB supported the recommendation of the SCCLR.

(c) **Chapter 3, Section 168A of the Companies Ordinance**

HKAB believed it was important to uphold the principle that Hong Kong law should not be extended to an overseas company simply because some of the shareholders were resident in Hong Kong.

(d) **Chapter 7, Corporate Communications**

HKAB stated :

"We note the suggestion that means should be devised to ensure that beneficial owners of shares in listed companies receive corporate communications. We would point out that custodians already provide all copies of corporate communications to account holders who request them, whether securities are held through CCASS or otherwise, as part of the custody service package. Furthermore, retail investors can easily obtain the information from newspapers. The costs involved, regardless of how they are distributed, will ultimately fall on the investors, whether by means of reduced dividends or increased charges."

(e) **Chapter 9, Declaration of Interests by Members of Advisory Boards and Committees**

HKAB stated :

"It is important that interests are declared and also made available for public inspection."

(f) **Chapter 11, Definition of the term 'Place of Business' - Overseas Companies and Section 341 of the Companies Ordinance**

HKAB stated :

"The term 'place of business' is also used, without definition, in section 91 of the Companies Ordinance, in relation to registration of charges. It is important that the term should be clarified."

However, after discussion members agreed that the subject should not be revisited. The SCCLR had considered the issue several times in the past. It should be left to the courts to determine whether or not a company had established a place of business in Hong Kong. In addition the consultant undertaking the Overall Review may want to consider the topic and therefore it was appropriate to await his comments.

(g) **Chapter 12, Resignation of the Auditor of a Company Sections 140A (2)(a) and 140A(3)(b) of the Companies Ordinance**

HKAB stated :

"The filing of an auditor's resignation statement with the Companies Registry might not give timely or effective notice to existing creditors. Since the statement is intended to state any circumstances when the auditor considers should be brought to the notice of members or creditors, we suggest that the statement should be advertised."

Members believed that the filing of the resignation notice of auditors with the Companies Registry was sufficient for these purposes.

(h) Chapter 13, Disqualification of Company Directors

HKAB stated :

"We appreciate that it may be desirable to prevent a disqualified person from being a director of a foreign company carrying on business in Hong Kong. However if the proposed extension of the legislation would apply, e.g., to all directors of a foreign company including an overseas director who manages only the overseas part of a foreign company's business, it might be contrary to the "territorial" principle."

(i) Chapter 14, Transparency of Advisory Boards and Committees

HKAB stated :

"We suggest that in addition to a brief summary of the main recommendations to be released shortly after each meeting of the SCCLR, a brief summary of the reasons for the recommendations should be released at the same time."

However members pointed out that it had been agreed already that recommendations were to be released to the public by way of press releases only when the secretary had been directed to do so.

(j) **Chapter 15, De-regulation of Company Forms**

HKAB stated :

"We agree that the power to determine format should be de-regulated, but not the content insofar as it relates to the information which may be required to be filed at the Companies Registry."

Members were advised that the Administration had acknowledged the force of that argument. As a consequence, whilst the Registrar of Companies could still determine the format the power to determine the content had been substantially reduced in the draft legislation.

Chapter 17

Corporate Communications

17.1 At the 114th meeting, a consultation paper, prepared by the Hong Kong Stock Exchange (SEHK), on 'Corporate Communications' was tabled for comment and discussion.

17.2 With the advent of the central clearing and settlement system (CCASS), the number and amount of securities registered in the name of HKSCC Nominees Limited (HKSCC Nominees) had substantially increased. This had resulted in a large number of underlying owners not being registered as members of listed companies. In recognition of the desirability and need for those non-registered owners of securities to receive corporate information, it was felt that the flow of corporate information between listed issuers and non-registered owners can be improved by linking intermediaries and share registrars through Hongkong Clearing. CCASS was a system established and operated by Hongkong Clearing in which securities transactions between the two counterparties were settled by means of book entry transfer without the movement of certificates. A copy of the Executive Summary of the consultation paper is at Appendix I.

17.3 During discussions, members were advised that with the advent of 'CCASS' corporate communications issued by listed companies were not finding their way to the ultimate beneficial owners of the shares. Several years ago, the SEHK,

after conducting a survey, discovered that 75% to 80% of all shares were registered in the names of nominees. The SEHK in conjunction with the Hong Kong Securities Clearing Co. Ltd. (HKSC) and the Federation of Share Registrar had settled the consultation paper. The HKSC was willing to receive the names of the non-registered owners of shares from the brokers and custodians. Those names would be passed to the Share Registrars who would then despatch the corporate news to the beneficial owners. The position of bank nominees had not been addressed in the consultation paper because, if successfully implemented, it could place an intolerable burden on them.

17.4 Certain members wondered how practical it would be to produce lists of constantly changing share ownership. Whilst the idea of disseminating corporate communications widely was a step in the right direction, the onus should be placed on the nominee account holders to let the Share Registrars know how may copies of documents were required for onward transmission. Many members opined that it should be up to the beneficial owners of shares in listed companies to opt whether or not to receive the information. Many shareholders had fictitious names and the task of disseminating the volume of information released by the various companies would be very onerous indeed. That was the position in Australia and Canada.

17.5 The SEHK agreed to keep the members of the SCCLR abreast of developments and to advise on the outcome of the consultation process.

EXECUTIVE SUMMARY

With the introduction of CCASS, the number and amount of securities registered in the name of HKSCC Nominees Limited (HKSCC Nominees) have substantially increased. This has resulted in a large number of underlying owners not being registered as members of listed companies. In recognition of the desirability and need for these non-registered owners of securities to receive corporate information, it is felt that the flow of corporate information between listed issuers and non-registered owners can be improved by linking intermediaries and share registrars through Hongkong Clearing. A Working Group consisting of representatives from the Federation, the Commission, Hongkong Clearing and the Exchange was formed in June 1995 with the mandate to recommend a model for improving corporate communications between listed issuers and non-registered owners of securities kept in CCASS under the name of HKSCC Nominees.

In this study, corporate communications are defined as corporate documents that listed issuers are required by the Rules Governing the Listing of Securities (Exchange Listing Rules) to deliver to registered shareholders, for their information and/or action, such as interim and annual reports and notices of meetings.

The working model that the Working Group is now proposing is that listed issuers be required, under the Exchange Listing Rules, to despatch corporate documents to non-registered owners of securities which are kept in CCASS under the name of HKSCC Nominees, in accordance with lists of clients provided by CCASS broker and custodian participants to registrars through Hongkong Clearing. Non-registered owners of securities will be free to choose whether they wish to receive corporate documents and listed issuers will only be obliged to send the corporate documents to those who have chosen to receive them. All non-registered owners of securities kept in CCASS and all CCASS segregated accounts statement recipients will be able to participate in this service. The lists of clients will be event-driven. A new list will have to be furnished by CCASS broker and custodian participants to the registrar of the listed issuer through Hongkong Clearing for each single despatch of document by the listed issuer, and this will help ensure that the lists are kept up-to-date by broker and custodian participants.

Other existing alternatives for receiving corporate communications will not be affected by the proposed working model.

Under this proposed working model, CCASS broker and custodian participants will be strongly urged to encourage their clients to utilise this service. Although at the initial stage of implementation, CCASS broker and custodian participants will not be obliged to participate in this service, it is hoped that if the service is widely accepted by non-registered owners of securities, it will become mandatory for broker and custodian participants to provide this service. Amendments to the Exchange Listing Rules will require listed issuers to despatch the corporate documents.

The proposed working model has several constraints. First, the generation of an accurate and timely client list will depend very much on the readiness of CCASS broker and custodian participants to provide the data. Depending on the back office systems in use by broker or custodian participants, there may be problems in supporting the service if client records are kept manually and there is a large amount of data. Second, there may be cases when only very short notice can be given by the listed issuer. Under these circumstances, some brokers or custodians may not be able to furnish up-to-date client lists on time to enable non-registered owners to receive the documents. Third, although Hongkong Clearing will perform a reasonableness checking of the client lists provided by brokers and custodians, the checking will be limited to a comparison of the number of clients appearing on the lists with the equivalent number of board lots of the respective holdings of brokers or custodians in CCASS. Listed issuers should be aware that Hongkong Clearing cannot be held responsible for ensuring the accuracy of the names and addresses that appear on the lists.

The Working Group believes that the recommended working model will be the most acceptable design to the market, taking into account the cost and workload to be borne by each party in the chain of communication.

Chapter 18

Transparency of Advisory Boards & Committees

18. **Summary of Recommendations**

18.1 At the 114th meeting, members recommended that the meetings of the SCCLR should not be open to the public. However, it was also re-affirmed that press releases on the more important subjects, to agument the annual report, should be issued from time to time to keep the community abreast of the activities of the SCCLR.

Background

18.2 The Financial Services Branch, at the request of the Secretary for Home Affairs, had asked the Standing Committee on Company Law Reform to consider the views expressed by LegCo members during a motion debate held on 8 May 1996 to review the workings of advisory and statutory bodies. At the conclusion of the debate LegCo carried a motion by 37 votes to one asking Government to conduct a comprehensive review on the roles and functions of existing advisory and statutory bodies with a view to enhancing their representativeness, accountability and transparency.

18.3 This topic had previously been discussed at the 107th meeting when members agreed that neither the meetings nor the minutes should be made public (please refer to Chapter 14 of the 12th Annual Report). It was unnecessary for the meetings to be open to the public for the following reasons :

- An annual report on the activities of the SCCLR was tabled before ExCo & LegCo and was, in addition, circulated to a wide range of business, professional and commercial bodies in Hong Kong;
- It was agreed that, when appropriate, a brief summary of the recommendations made at each meeting could be released shortly thereafter;
- Press releases would be issued as and when necessary to keep the public abreast of the more important topics being considered;
- It was undesirable for the views of members who were appointed in their personal capacity to be quoted in the press as this would inhibit full and frank discussions;
- The discussions of the SCCLR were analogous to a government 'think tank' and it was unlikely that other government think tanks were open to public scrutiny.

18.4 During discussions, it became clear that members were against the proposal for the reasons spelt out in the 12th Annual Report (please see para. 18.3 above).

It could inhibit full and open discussions which would be clearly counterproductive. The Annual Report which was tabled before ExCo and LegCo was adequate for this purpose. Any proposals for legislative changes recommended by the SCCLR were invariably considered by LegCo.

Chapter 19

Report of the Sub-Committee Reviewing the Provisions of Table A of the Companies Ordinance (CO)

19. **Summary of Recommendations**

19.1 At the 115th meeting, members agreed to defer further discussions on the recommendations for a new 'Table A' to enable the sub-committee set up for that task to consider the points raised by members during the course of discussions.

Background

19.2 In 1993 the SCCLR discussed the question of 'unsoundness of mind' in relation to whether or not a director was able to carry out his duties. Table A to the CO provides that being of unsound mind disqualifies a person from acting as a director. During discussions, members opined that it was timely to undertake a review of the provisions of 'Table A' given that it remained very much the same as when it was originally enacted some time ago. It was agreed therefore to set up a sub-committee under the chairmanship of Professor Ted Tyler to review the workings of 'Table A' and to make appropriate recommendations.

19.3 Table A was rarely used. Most law firms, some accountants and the specialist commercial firms providing company services had their own standard form sets of memorandum and articles. Most of these sets of articles were in common form.

19.4 The Chairman of the sub-committee contacted various firms and was able to make a collection of Hong Kong precedents and also precedents from overseas jurisdictions - British Virgin Islands, Cayman Islands, Isle of Man, various Channel Islands, etc.

19.5 Professional bodies were asked to provide suggestions for improvements. Only Hong Kong Association of Banks (HKAB) responded to that request. HKAB and the Hong Kong Society of Accountants (HKSA) had made some suggestions in 1993 when the idea of a review of Table A was first proposed.

19.6 The members of the sub-committee thought the best approach was to "cherry pick" the best from the various precedents. In the event the majority of the Committee was favourably impressed by the 1985 UK Table A. It should be remembered that Hong Kong Table A, though amended in 1984, was more or less an exact copy of the Table A to the Companies Act 1948. One immediate advantage of the 1985 UK Table A was the use of more modern English language and its style was clearer and more precise.

19.7 The modus operandi of the sub-committee was to compare the current Table A, with a typical Hong Kong print of a set of Articles (the Hong Kong Standard Model - HKSM) and the UK Table A and generally to adopt the UK Table A regulations if appropriate or, if not, the HKSM. The sub-committee had recommended the retention of very few of the current provisions found in Hong Kong Table A.

19.8 The work of the Committee had been somewhat overtaken by events, because in the meantime Mr Ermanno Pascutto had been appointed to undertake a major review of the Companies Ordinance. To amend Table A while the Ordinance itself might be changed sooner or later was rather putting the cart before the horse. Nevertheless it was decided to submit a new form of Table A within 6 months, if possible. In the circumstances, with the Ordinance subject to review, the most sensible course of action was to produce a modern English style Table A based on the current law as soon as possible.

19.9 Beside simpler language, the major changes in the proposal were to make the private company the model, rather than the public company which was the current position, and to make Table A more flexible to any changes in the legislation by omitting references in Table A to specific sections of the Ordinance. There were also a number of instances where Table A simply repeated what was stated in some section of the Ordinance. Allowance had been made for teleconferencing and written resolutions in lieu of physical meetings.

19.10 During discussions, members pointed out that substantive changes to Table A were being proposed. Some of the proposals had the effect of enabling incorporators to contract out of established case law. Although the precedents used for the new draft were in common use by the major legal and accounting firms, it was clear that they were biased towards the incorporators.

19.11 In view of those objections, the chairman deferred further discussion to allow the sub-committee time to consider what weight should be attached to them and whether they could be incorporated into the new draft.

Chapter 20

Arrangements and Reconstructions

Section 166(2) of the Companies Ordinance (CO) and

The Hong Kong Code on Takeovers and Mergers

20. **Summary of Recommendations**

20.1 At the 115th meeting, members recommended that no changes should be made to either section 166(2) of the CO or paragraph 2.10 of the Hong Kong Code on Takeovers and Mergers notwithstanding their apparent inconsistency.

Background

20.2 The Hong Kong Bar Association (HKBA) in a submission on amendments to the CO had voiced concerns regarding the incompatibility of 2.10 of the Takeovers Code with section 166(2) of the CO. In support of its contention, the HKBA stated :

> "The statutory majority for the Court to sanction a scheme of arrangement is a majority in number representing 3/4 in value of the persons voting at the meeting. However, paragraph 2.10 of the "The Code of Takeovers and Mergers" recently introduced by the

"The Code of Takeovers and Mergers" recently introduced by the Securities and Futures Commission seems to have usurped the function of the Court in sanctioning schemes for privatisation of companies. The new rule requires the approval of a privatisation scheme by a majority in number representing 90 percent in value of those voting at "a duly convened general meeting." The Code, as evidenced by paragraph 1.5, applied not only to listed companies but also public companies. The provision was introduced despite the vehement objections of the professional advisers involved in schemes. Although the Code does not affect directly the provisions in the Companies Ordinance it has, however, the effect of overriding the legislative intent that 3/4 in value (as opposed to 90 percent) of those approving a scheme will be sufficient to have a binding effect as well as defeating the object of the Court in sanctioning a privatisation scheme. This is so notwithstanding paragraph 1.3 of the Code which says that it does not have the force of law.

Moreover, the rule requires the approval at a "duly convened general meeting," which suggests a meeting of members convened by the company. It should not and could not be the meeting convened by the Court under Section 166, and it is doubtful if the SFC wishes to interfere with a Court convened meeting with

requirements and procedures laid down by the Ordinance and the Court. At present, there is no provision in the Ordinance or in any article or constitution of any company for the passing of a resolution of 90 percent majority, or the procedure for convening such "general meeting" such as the period of notice or manner of service.

The non-compliance with the requirement of the Code notwithstanding the sanction of the Court having been obtained would have drastic consequences on a company and, in the case of a listed company, might result in it being de-listed from or suspended from trading on The Stock Exchange of Hong Kong Limited."

20.3 The primary purpose of the Takeovers Code is clearly set out in the introduction to the code :

"The primary purpose of the Takeovers Code and the Share Repurchase Code (collectively, the "Codes") is to afford fair treatment for shareholders who are affected by takeover and merger transactions and share repurchases. The Codes seeks to achieve fair treatment by requiring equality of treatment of shareholders, mandating disclosure of timely and adequate information to enable shareholders to make an informed decision as to the merits of an offer and ensuring that there is a fair and informed market in the

shares of companies affected by takeover and merger transactions and share repurchases. The Codes also provide an orderly framework within which takeovers, mergers and share repurchases are to be conducted."

20.4 The general principles of the code are :

"(1) All shareholders are to be treated even-handedly and all shareholders of the same class are to be treated similarly.

(2) If control of a company changes or is acquired or is consolidated, a general offer to all other shareholders is normally required.

(3) During the course of an offer, or when an offer is in contemplation, neither an offeror, nor the offeree company, nor any of their respective advisers may furnish information to some shareholders which is not made available to all shareholders. This principle does not apply to the furnishing of information in confidence by the offeree company to a bona fide potential offeror or vice versa.

(4) An offeror should announce an offer only after careful and responsible consideration. The same applies to making acquisitions which may lead to an obligation to make a general offer. In either case the offeror

and its financial advisers should be satisfied that it can and will continue to be able to implement the offer in full.

(5) Shareholders should be given sufficient information, advice and time to reach an informed decision on an offer. No relevant information should be withheld. Documents and advertisements issued in connection with takeovers and mergers should be prepared with the highest possible degree of care, responsibility and accuracy.

(6) All persons concerned with takeovers and mergers should make full and prompt disclosure of all relevant information and take very precaution to avoid the creation or continuance of a false market. Parties involved in offers must take care that statements are not made which may mislead shareholders or the market.

(7) Rights of control should be exercised in good faith and the oppression of minority or non-controlling shareholders is always unacceptable.

(8) Directors should have regard to the interests of the shareholders as a whole, and not to their own interests or those derived from personal and family relationships.

(9) At no time after a bona fide offer has been communicated to the board

of the offeree company, or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may any action be taken by the board of the offeree company in relation to the affairs of the company, without the approval of shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.

(10) All parties concerned with takeovers and mergers are required to co-operate to the fullest extent with the Executive, the Panel and the Takeovers Appeal Committee, and to provide all relevant information."

Section 166

20.5 The financial structure of a company can be altered by a number of methods including :

- a reduction of capital pursuant to Sections 58 - 63 of the CO;
- a buy back of shares;
- an alteration of share capital;

where the arrangement or reorganisation involves members or creditors or where one class of shareholders is treated in a different fashion from others or where it

has been the usual vehicle for the reorganisation of a group of companies endeavouring to incorporate their holding companies off-shore. It has also been widely used by listed companies to privatise.

20.6 Under Section 166 it is necessary first to convene meetings and secondly to petition the court for sanction if the appropriate majorities have been obtained at the meetings. The court must be satisfied that the procedures have been complied with and that the majority in favour of the Scheme have acted bona fide. The Scheme must be one also that businessmen acting bona fide and honestly would wholly endorse.

20.7 During the course of discussions, many members expressed concern over the clear conflict between the provisions. It was objectionable in principle for the courts, on the one hand, to be able to endorse e.g. a privatisation scheme pursuant to section 166 of the CO with the requisite 75% vote in favour whilst on the other for the takeovers panel to strike down a scheme because the 90% requirement under the code had not been attained. Indeed, one member opined that if such a situation did arise, it could be susceptible to a judicial review by the courts.

20.8 Other members, however, whilst acknowledging the apparent conflict, felt that the provisions in the Takeover Code were there for investors protection and were working well in practice. They thought it would be more appropriate to amend

section 166(2) to bring it into line with the code. Another member believed that all 'privatisations' of companies should be undertaken by the use of section 168 and the Ninth Schedule. The Ninth Schedule set out very detailed requirements relating to the acquisition of minority shares after a successful takeover off.

20.9 However, in conclusion it was pointed out that at the initial stage of a privatisation scheme, the offeror had to state the percentage of votes required for the scheme to be passed. That was always pitched at 90% as the Securities & Futures Commission would not allow the despatch of any documentation containing a lower percentage. That figure tallied with paragraph 2.10 of the code. In view of this, notwithstanding the discrepancy, it was agreed that no further action should be taken.

Chapter 21

Section 116B of the Companies Ordinance (CO) - Unanimous Informal Consent

21. **Summary of Recommendations**

21.1 At the 115th meeting, members agreed to the establishment of a sub-committee to review the workings and scope of section 116B of the CO and whether or not further legislation was required to clarify as to when section 116B would or would not override the wording of those provisions of the CO which state that certain powers or functions of a company can only be exercised in a general meeting.

Background

21.2 The Hong Kong Institute of Company Secretaries (HKICS) in a submission on amendments to the CO had voiced concerns with regard to the scope of section 116B of the CO. In its submission HKICS had stated :

> "The origins of section 116B of the Companies Ordinance lie in the Company Law Revision Committee's second report, where the relevant recommendation of the Jenkins Committee (made as long ago as 1962)

were endorsed and finally saw legislative effect in Hong Kong as of 31st August, 1984. This provision has proved a welcome and useful development for professionals who, along with their client owners of private companies, find it a legitimate and straightforward means of dispensing with certain of the grand architecture of meetings, which dates back to the 1844 Registration Act. Practice, however, has revealed a series of problems and conflicts, which we recommend would benefit from a simple amending provision.

Prior to the introduction of section 116B there was clear provision that alterations (eg, objects, capital) or powers could only be exercised in general meeting. Certain other provisions have been added after the introduction of section 116B, and these too indicate that a meeting must be held. The main question that concerns practitioners is whether the words at the beginning of section 116B ("Notwithstanding anything to the contrary ....") do indeed override the requirement for a meeting in situations including the following -

- Section 53; "The powers conferred by this section must be exercised by the company in general meeting."
- Section 57B; "The directors shall not without the prior approval of the company in general meeting exercise any power of the company to allot shares."

- Section 47E; "Unless the company proposing to give the financial assistance is a wholly-owned subsidiary, the giving of assistance under this section shall be approved by special resolution of the company in general meeting."

If regarded as merely directory, then we understand that the failure to comply with the requirements to convene and hold a valid meeting would not invalidate the issue resolved, and that section 116B would provide a valid alternative; on the other hand, if the requirement for a meeting is regarded as mandatory, then section 116B would be of no use. Ascertaining legislative intention has never been a straightforward matter and we therefore recommend that the administration introduce clarification as to when section 116B will and will not override the clear wording of those provisions of the Ordinance which separately call for certain powers or functions to be exercised in general meeting."

21.3 Section 116B recognises the validity of a resolution in writing signed by or on behalf of all persons for the time being entitled to receive notice of and vote at general meetings of the company. Such a resolution will be treated as an ordinary or special resolution duly passed at a general meeting of the company held on the date on which it was signed by the last member to sign it.

21.4 As the HKICS has pointed out in its submission, the extent to which a resolution in writing can be used under this provision is unclear. The ordinance requires a company to hold an AGM and a default in doing so could result in a fine. Whilst the business of the AGM could be dealt with by written resolution, the meeting itself must be convened and held in the usual way. Likewise, section 8 of the CO requires that notice of a special resolution for the alteration of the company's objects must be sent to all members in order for the resolution to be valid; section 132(2) requires special notice to be sent to the former and prospective auditors (both of whom are non-members) to enable them to address members on the issue. A resolution in writing therefore may be inadequate to displace those requirements leaving open the question of whether the members (and any other person entitled to vote e.g. debenture holders) can waive the statutory provisions designed for their benefit, and protection.

21.5 During the course of discussions, members agreed that there was ambiguity in the legislation which required clarification. It was therefore decided to set up a sub-committee to consider the issue and thereafter to report back to the SCCLR with its recommendations.

Chapter 22

Section 4 of the Companies Ordinance (CO) - Minimum Number of Shareholders

22. **Summary of Recommendations**

22.1 At the 115th meeting, members agreed to undertake a consultation exercise with the business, commercial and professional communities to see if there was support for a proposal to reduce the minimum number of shareholders for a company from 2 to 1.

Background

22.2 The Hong Kong Society of Accountants (HKSA) in a submission on amendments to the CO had proposed that the minimum number of shareholders for a company under section 4 of the CO should be reduced from 2 to 1. In support of its proposal the HKSA had stated :

> "We question the need for a company to have 2 shareholders where in substance there is only 1. Other jurisdictions seem to manage quite successfully without the concept of a company requiring more than one shareholder."

22.3 Section 4 of the CO provides that any two or more persons may form an incorporated company. By section 29(1) of the CO, a private company means :

- a company which by its articles restricts the right to transfer its shares;
- limits the number of members to 50; and
- prohibits any invitation to the public to subscribe for shares or debentures.

Other jurisdictions, notably the UK, Canada and New Zealand, have in recent years reduced the minimum number from 2 to 1.

22.4 During the course of discussions, many members thought the proposal sensible and doing no more than reflecting current commercial reality because of the widespread use of nominee companies as shareholders. By simplifying corporate procedures, it was likely to reduce the chances of commercial fraud.

22.5 The consultant appointed by Government to undertake the overall review of the companies legislation has recommended in his report that any new Companies Ordinance should provide for one person/one director companies.

Chapter 23

Property Valuations in Company Prospectuses - Third Schedule of the Companies Ordinance (CO)

23. **Summary of Recommendations**

23.1 At the 116th meeting, members endorsed a proposal that firstly the requirements with regard to property valuations in a company's prospectus and set out in the Third Schedule to the CO should be updated and amended; and, secondly, that the listing rules of the Securities & Futures Commission (SFC) and the Hong Kong Stock Exchange (SEHK) on property descriptions and valuations in a company's prospectus should be revised to make them simpler and easier to follow. In addition the SFC and SEHK were to be requested to draw up a list of criteria to be applied when companies sought exemptions from the property valuation requirements of the Third Schedule.

Background

23.2 At the 115th meeting, a member of the SCCLR recommended that the requirement set out in paragraph 34 of the Third Schedule to the CO - a full valuation report of a company's interests in land or buildings where the last available accounts disclose either a value exceeding 10% of the company's assets

or a value of not less than HK$3,000,000.00, - should be amended by deleting the necessity of having to include particulars of properties having no commercial value. In support of the proposal reference was made to the recent flotation of a company on the SEHK where the issued prospectus was 332 pages which, with the Chinese translation, came to 664 pages. Of that, 174 pages (348 with the Chinese translation) related to property valuations. The property valuation amounted to HK$39.4 million of which sum $28.5 million related to one factory. The property valuation covered 359 properties the vast majority of which were shown as having no commercial value. Given that :

(a) the primary undertaking of the company was manufacturing;

(b) the market capitalisation of the company on the issue price was $1.6 billion; and

(c) profits were forecast at %168 million.

it seemed somewhat anomalous that so much of the prospectus had to be devoted to a detailed examination of worthless property.

23.3 Subject to the provisions of section 38A of the CO, section 38(1) of the CO requires that every prospectus issued by a company must (inter alia) set out the reports specified in Part II of the Third Schedule. Section 38A of the CO

empowers the SFC to grant exemptions from all or some of the provisions set out in section 38(1) subject however to such conditions as the SFC thinks fit.

23.4 Paragraph 34 of the Third Schedule applies in the case of every company whose accounts at the last date to which accounts have been made up disclose that either a value exceeding 10% of the value of the assets of the company or a value of not less than $3 million is placed on the company's properties. A copy of paragraph 34 is at Appendix 1.

23.5 Chapter 5 of, and Practice Note 12 to, the Listing Rules of the SEHK set out the requirements of the Stock Exchange with regard to the valuation of and information on properties. Paragraph 5.01 of Chapter 5 requires valuations of and information on all the issuers' interests in land or buildings to be included in the listing document. Chapter 5 then goes on to stipulate in very great detail what information must be provided. Chapter 5 is supplemented by Practice Note 12 which mandates what further information must be contained in valuation reports in respect of property situated in developing property markets.

23.6 Section 342 of the CO sets out the restrictions with regard to an overseas company wishing to circulate a prospectus in Hong Kong. In particular, a prospectus of an overseas company must, inter alia, set out the reports specified in Part II of the Third Schedule, similar to section 38(1). Section 342A, like section 38A, empowers the SFC to exempt an applicant from some or all of the

conditions of, inter alia, 342(1) on such conditions as the SFC lays down.

23.7 During the course of discussions, certain members opined there was a perception that prospectuses in Hong Kong were getting longer which was in sharp contrast to the practice in UK and the USA where they were being shortened and simplified. The property valuation requirements set out in the CO and in the listing rules were clearly out of date. They needed to be substantially shortened and simplified and to be brought into line with comparable requirements in the UK and the USA.

34. (1) This paragraph shall apply in the case of every company whose accounts at the last date to which the accounts have been made up disclose that either a value exceeding 10 per cent of the value of the assets of the company or a value of not less than $3,000,000 is placed on the company's interests in land or buildings.

(2) A valuation report with respect to all the company's interests in land or buildings which shall include the following particulars of each property—

(*a*) the address;
(*b*) a brief description;
(*c*) the use at the date of the report;
(*d*) the nature of the tenure;
(*e*) a summary of the terms of any sub-leases or tenancies, including repair obligations, granted by the company;
(*f*) the approximate age of buildings;
(*g*) the present capital value;
(*h*) the estimated current net rental, being the estimated average net annual income from the property accruing to the company over a long period of years (not being less than 3 years) before taking into account tax and any interest or mortgage expenses but after taking into account management and maintenance expenses.

(3) A report for the purposes of sub-paragraph (2) shall state—

(*a*) whether the valuation—
  (i) is the current value in the open market, stating whether—
    (A) on an investment basis, or
    (B) on a development basis, or
    (C) on a future capital realization basis;
  (ii) is the current value as an asset of a going concern;
  (iii) is the value after development has been completed; or
  (iv) has any other basis (which should be stated);
(*b*) where the valuation is based on value after development has been completed—
  (i) the date when the development is expected to be completed;
  (ii) the estimated cost of carrying out the development or (where part of the development has already been carried out) the estimated cost of completing the development; and
  (iii) the estimated value of the property in the open market in its present condition.

(4) If the company has obtained more than one valuation report regarding any of the company's interests in land or buildings within 6 months before the issue of the prospectus then all other such reports shall be included.

PART III

PROVISIONS APPLYING TO PARTS I AND II OF SCHEDULE

35. Paragraphs 15 (so far as it relates to preliminary expenses) and 19 shall not apply in the case of a prospectus issued more than 2 years after the date at which the company began to carry on business.

36. Every person shall, for the purposes of this Schedule, be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase, or for any option of purchase, of any property to be acquired by the company, in any case where—

(*a*) the purchase money is not fully paid at the date of the issue of the prospectus;
(*b*) the purchase money is to be paid or satisfied wholly or in part out of the proceeds of the issue offered for subscription by the prospectus;
(*c*) the contract depends for its validity or fulfilment on the result of that issue.

Issue 11 Authorized Loose-leaf Edition, Printed and Published by the Government Printer, Hong Kong

Chapter 24

Loans to Directors -

Sections 157H and 157J of the Companies Ordinance (CO)

24. **Summary of Recommendations**

24.1 At the 120th meeting, members agreed that no changes were necessary to the current legislation.

Background

24.2 The Hong Kong Association of Banks (HKAB) in its submission on amendments to the CO has proposed that section 157H of the CO should be amended to allow private companies to retrospectively ratify the giving of loans to, or the providing of guarantees for, their directors. In support of its proposal, HKAB stated :

> "Section 157H prohibits a private company from giving a loan to, or guarantee on behalf of, its directors (Subsection 2) unless it is first approved by all shareholders (subsection 3(b)). The consequence is that the guarantee is unenforceable unless the bank, or other beneficiary of the guarantee, had no knowledge of the "relevant circumstances" (section 157I(3)(a)) at the time the security was provided.

Other jurisdictions allow shareholders of a private company to ratify the security, even after the security has been provided. We suggest that Hong Kong allows this as well as it is difficult to say what the relevant circumstances were at the time and whether banks ought to have known despite the circumstances."

24.3 Under section 157H, a company is precluded, whether directly or indirectly, from :

- making a loan to a director of the company or its holding company;

- entering into any guarantee or providing any security in connection with a loan made by any person to a director of the company or its holding company;

- if any director of the company holds a controlling interest in another company, making a loan to that controlled company or entering into any guarantee or providing security in connection with a loan made by any person to that controlled company.

This general prohibition is extended in the case of listed companies and members of a group which includes a listed company to include members of director's

families and include :

- a spouse, child or stepchild;

- a person acting as trustee of a trust where the beneficiaries include the directors, or their spouses and children;

- a person acting as a partner of any director, or spouse or child of that director.

24.4 The Section also provides a number of exceptions to the general rule on the prohibition of granting loans to directors. The following transactions are exempted:

- where a company is a member of a group of companies, a loan, guarantee or the provision of security to another company which is a member of the same group;

- anything done by a private company which has been approved by the company in general meeting save where the company is a member of a group which includes a listed company;

- anything done which provides a director with funds to meet expenses

incurred for the purposes of the company or in performance of his duties provided the conditions set out in section 157H(4) are met;

- a loan to facilitate the purchase of residential premises for the use of the director provided the conditions set out in section 157H(5) are met;

- where the ordinary business of the company includes lending money and giving guarantees in connection with loans made by other persons provided the conditions set out in Section 157H(6) and (8) are met.

24.5 The consequences of breaching any of the provisions of section 157H are set out in sections 157I and 157J under the headings of civil consequences and criminal penalties respectively.

24.6 The civil consequences following from a breach of section 157H are basically twofold:

(a) the transaction itself is not necessarily invalid but the person who receives the loan is liable to repay it unless he is not a director of the company or its holding company and he shows that at the time the loan was made, he did not know of the relevant circumstances. Any guarantee or security given is generally unenforceable. However this general rule is inapplicable if either of the conditions provided for in section 157I(3) are met;

(b) a director of a company which has breached section 157H is firstly liable to account to the company for any gain made by the transaction and secondly to jointly and severally to indemnify the company against any loss or damage if he knowingly and wilfully authorised or permitted the transaction etc. (section 157I(4)).

24.7 Under section 157J, where a company enters into a transaction in breach of section 157H, the following persons are guilty of an offence :

- the company;

- any director who wilfully authorised or permitted the transaction to be entered into;

- any person who knowingly procured the company to enter into the transaction.

The punishment for an offence under this Section is imprisonment and a fine.

24.8 Section 157H was enacted into law in 1984 under cover of the Omnibus 1984 Companies Amendment Bill. It arose out of the recommendations from Second Report of the Companies Law Revision Committee which reported in 1973. It was based on section 190 of the 1948 UK Companies Act as

extended by the UK Jenkins Committee Report which recommended that the prohibition on loans to directors should be extended to loans to another company in which one or more of the directors of the lending company hold, directly or indirectly, a controlling interest.

24.9 The subject was discussed at the 116th meeting following which the secretary was directed to ascertain from the Commercial Crime Bureau and the Commercial Crime Unit of AGC how many criminal prosecutions had been undertaken for breaches of these sections - the answer was none. In addition, it was important to ascertain from HKAB to what extent the sections were a problem in practice for its members.

24.10 During discussions, many members, whilst sympathetic to members of HKAB that due to an administrative oversight loans to directors could be declared invalid, nevertheless felt that caution was necessary before recommending any changes to the qeustion of criminal liability. Investor protection was important. It was common for many just and equitable winding-up petitions which came before the courts of Hong Kong to be based on directors improperly making loans to themselves from the company's assets.

24.11 Other members pointed out that the provision which allowed Hong Kong private companies to make loans to directors with the consent of shareholders was not replicated in other jurisdictions. It was certainly not recommended in

the 2nd Report of the Company Law Revision Committee in 1973. There was also a difficulty with HKAB's recommendation that the sanctioning of the loans should be retrospective given that breaches of the section could give rise to criminal proceedings. This was not possible. Members were subsequently advised that HKAB, having tried unsuccessfully to ascertain the extent of the problem amongst its members, did not wish to proceed with the proposal and suggested that it was dropped.

Chapter 25

Limited Liability Companies

25. Summary of Recommendations

25.1 At the 117th meeting, members considered a paper prepared by Professor Peter Willoughby titled : "Limited Liability Companies : An Opportunity for Hong Kong?". After due consideration it was agreed to keep the subject under review and to consider it again in conjunction with the recommendations of the consultant appointed to undertake the 'Overall Review of the Companies Ordinance'.

Background

25.2 A 'Limited Liability Company' (LLC) was in substance an incorporated partnership whose principal features were :

- corporate personality;
- limited liability;
- minimal administrative requirements; and
- simple tax treatment.

In American parlance, where the concept first originated, it meant a firm or association with limited liability. Such an entity was similar to but not the same as a limited partnership.

25.3 Whilst its distinctive form and significance owed much to the framework of the US federal tax system, incorporators around the world found much to admire and developed their own prototypes in their own jurisdictions e.g. British Virgin Isles where more than 32,848 International Business Companies were incorporated in 1994. Today more than half of the States in the USA have or plan to have their own whilst the Isle of Man and Alderney and Guernsey have been considering models for their respective jurisdictions.

25.4 In particular the chief characteristic of the Isle of Man legislation on LLC when it became law would be :-

- corporate personality;
- limited liability for the members, limited to the capital they have introduced;
- involvement in the management of all members;
- no separate board of directions;
- a maximum number of members of, say, 25 and a minimum of one;

- non-transferability of members' interests;
- liquidation in the event of the resignation or death of a member unless the remaining members unanimously resolve to continue when a retiring member or his estate will be paid a sum by the LLC equal to his entitlement in a liquidation;
- liquidation after 80 years; and
- deeming as a partnership for all taxation purposes with income, gains, expenses and credits being attributed to the individual members on a pro rata basis.

In summary, the overall effect will be to provide :-

- a simple form of corporate entity with limited liability for domestic use by small traders and for use as a simple holding entity;
- a first class corporate entity for sale in the international market place to rival the Caribbean IBCs; and
- an entity of great appeal to U.S. persons.

The relevance of this type of entity for Hong Kong was that of a simple corporate body for the smaller business.

25.5 During the course of discussions, it was pointed out that the real reasons for the

use of BVI companies were savings in stamp duty and tax, not because they were cheap and easy to form. Unless there were changes to Hong Kong's tax and stamp duty laws, there would be little incentive to use LLC. The explosion in numbers of LLCs in the USA arose because of advantageous tax loopholes. Other members referred to the fact that the US Federal Reserve was about to introduce regulations to require banks and financial houses to ascertain the beneficial owners of shell companies. Shell companies were commonly used to launder drug monies and members were concerned about marketing such entities in Hong Kong to the international business community. In response, however, it was stressed that the major use of BVI companies was to hold assets, which was perfectly proper, and not to launder illegal funds.

25.6 In conclusion, members opined that it would be necessary to undertake some empirical research to ascertain the requirements of the business community in Hong Kong. Consequently it was preferable to revisit the proposal once the consultants recommendations within the context of the overall review were known.

Chapter 26

Corporate Rescue and Insolvent Trading

26. **Summary of Recommendations**

26.1 At the 117th meeting, members endorsed the proposals of the Law Reform Commission of Hong Kong to introduce legislation to provide for corporate rescue and Insolvent trading in Hong Kong.

Background

26.2 On 14th September 1990, the Attorney General and the Chief Justice referred the following topic to the Law Reform Commission :

"(1) To review the law and practice relating to the insolvency of both individuals and bodies corporate in Hong Kong, and in particular :

(a) the provisions of the Bankruptcy Ordinance, Chapter 6, in their application both to business and non-business debtors; and

(b) the winding-up provisions of the Companies Ordinance, Chapter

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taking into account existing and proposed legislation in other jurisdictions, in particular the UK Insolvency Act 1986 and Chapter 11 of the US Bankruptcy Code, and to consider what reforms are necessary or desirable.

(2) To submit an early interim report on :

(a) such changes in the Bankruptcy Ordinance as are considered to be required for simplifying bankruptcy procedures; and

(b) any other aspects of insolvency law or practice which the Commission considers should be introduced in advance of the Commission's final report."

26.3 A sub-committee on insolvency under the chairmanship of Professor Ted Tyler consisting primarily of members from the business and professional communities was established. The sub-committee on insolvency considered that provisions of the Companies Ordinance relating to arrangements and reconstructions were inadequate as they were not capable of providing the legislative and procedural support required to propose and formulate a voluntary arrangement. The sub-committee considered that Hong Kong needed a comprehensive system to enable and encourage the reorganisation of companies in situations where liquidation was not the appropriate solution. The sub-committee noted that reorganisation

or rescue provisions had been introduced in a number of jurisdictions in recent years and have generally been well received.

26.4 A copy of the executive summary of the Commission's proposal dated October 1996 is set out at Appendix 1.

26.5 During discussions, members raised a number of points which needed to be addressed by the sub-committee. These included :

- Any proposal to have a moratorium on the claims of creditors would have to include the support of secured creditors who were only interested in securing their indebtedness, not participating in any rescue scheme;
- Consideration would have to be given to procuring priority for super priority lenders over other secured lenders; otherwise they would be unwilling to inject fresh funds;
- There should be a mechanism to enable the provisional supervisor to resign e.g. over unpaid fees;
- On the question of insolvent trading and the decision to adopt the cash flow test to determine solvency, it was thought that a mixture of the cash flow and balance sheet tests would be a better determinant of solvency;
- With regard to senior management and their potential liability for insolvent

trading there was a lack of a clear definition of what constituted 'Senior Management';

– Provisional supervisors should also be obliged to keep shareholders of listed companies abreast of any re-organisation.

26.6 Members believed it was very timely that the proposals of the sub-committee should be brought to the statute book.

SUMMARY OF REPORT ON CORPORATE RESCUE AND INSOLVENT TRADING ISSUED BY THE LAW REFORM COMMISSION OF HONG KONG

Provisional Supervision : (Chapters 1 and 3 of the Report)

1. At present, Hong Kong companies that get into financial difficulties may try to come to an arrangement with their creditors by means of a non-statutory arrangement or by means of the arrangement and reconstruction provisions under section 166 of the Companies Ordinance. The major deficiency of these arrangements is the lack of a moratorium (stay of proceedings) that can bind creditors while an arrangement plan is being formulated.

2. Provisional supervision leading to a voluntary arrangement would be a vehicle which would facilitate a company in avoiding winding up, to survive in whole or in part as a going concern, or satisfy its debts in whole or in part through a more advantageous realisation of the company's assets or a better return for creditors and members than would result from a winding up. These general purposes could be achieved in a variety of ways through voluntary arrangements; such as/by :

(a) an extension of time for payment of debts,
(b) a composition in satisfaction of its debts,
(c) the compromise of any claims against the company,
(d) the variation or the reordering of the rating for payment of its debts or any class of its debts,
(e) the conversion of its debts in whole or in part into shares or other securities to be issued by the company, or
(f) any other scheme or arrangement in relation to the affairs of the company.

3. Provisional supervision would:

(a) provide a solid basis on which to calculate the costs and time involved in putting a proposal to creditors.
(b) provide a flexible framework to allow a provisional supervisor to work under court protection from the outset.
(c) limit the costs of court appearances as the provisional supervisor would only have to go to court after 30 days and after that only when an extension of provisional supervision was sought or the company was deemed to be wound up as a creditors' voluntary winding up.
(d) set out the role of the provisional supervisor, give the provisional supervisor the power of management, prevent creditors from threatening proceedings as a form of leverage, permit super priority borrowing, allows creditors to vote on the proposal and provide a transition into a company voluntary arrangement or winding-up.
(e) provide certainty. Creditors could be sure that after not more than six months they would have their say on a proposal.

Benefits of provisional supervision

4. If a company can achieve a voluntary arrangement under supervision, there are good prospects that it can return to profitability. This is attractive to the shareholders, who generally have the lowest priority when it comes to the distribution of the assets of a company that has gone into liquidation from a winding up.

5. The preservation of jobs is of the utmost importance. For additional comment on employees see paragraph 19 below.

6. Unsecured creditors are often considered to have a raw deal in a liquidation. In the fours between 1991/92 and 1994/95 it took an average time of 5.12 years to pay an average rate of 27.78% first and final dividend to ordinary creditors.

7. It is not unusual for there to be multiple secured creditors with varying securities and priorities over the assets of a company. Because of the nature of floating charges in particular, which permit a company to deal with the assets covered by the floating charge in the ordinary course of business, the value of a company's assets can diminish, leaving some or all of the secured creditors under-secured.

Companies To Whom Provisional Supervision Would Apply (Chapter 2 of the Report)

8. The procedure should apply to companies formed and/or registered under Parts I and XI of the Companies Ordinance but excluding certain regulated industries. Provisional supervision would apply to both listed and unlisted companies. Companies registered under Part I of the Companies Ordinance account for most companies in Hong Kong, including both private and public companies. Part XI of the Companies Ordinance relates to companies incorporated outside Hong Kong, which are referred to in Part XI as "oversea companies".

9. The inclusion of oversea companies is important as Hong Kong is a major international trading, manufacturing and financial centre and there are a considerable number of international companies operating in Hong Kong in one form or another. Oversea companies operating in Hong Kong have the choice of forming a Hong Kong subsidiary under Part I of the Companies Ordinance or registering as an oversea company under Part XI.

Companies to whom the procedure would not apply

10. The procedure should not apply to industries that were already regulated by statute and which have provision for the relevant authority to assume control of the business or oblige a business to act in a certain manner. The regulatory powers of each industry differ substantially, according to their needs. Provisional supervision should not therefore be imposed on regulated industries but the relevant regulatory bodies should consider whether to apply a remedial procedure through their own legislation. The regulated industries recognised were banking, insurance and securities and futures.

Purposes Of Provisional Supervision (Chapter 3 of the Report)

11. A company should be able to go into provisional supervision whether it was able to pay its debts or not. A solvent company which recognised that it was trading into

difficulties should be able to avail itself of supervision. It would stand a better chance of a successful reorganisation than a company that continued trading until it was insolvent. It would be good management practice to act earlier rather than later in initiating provisional supervision.

Those Who May Initiate The Procedure (Chapter 4 of the Report)

12. In addition to the company or its directors, liquidators and receivers should be able to initiate, or give their consent to initiate, the procedure in appropriate circumstances. The intention is that whoever has power to initiate should do so from a position of knowledge of the company's financial position and prospects. It is for this reason that creditors should not be able to initiate the procedure.

The Moratorium (or Stay of Proceedings) : (Chapter 5 of the Report)

13. The moratorium should commence upon the filing of a resolution of the company or the board of directors and the consent of the provisional supervisor to act. The initial moratorium period should be for 30 days from the commencement of provisional supervision after which, if the provisional supervisor has not formulated a proposal for creditors, he may apply to the court for an extension or extensions.

14. The provisional supervisor need only apply to the court for an extension if he is unable to complete an arrangement plan within the initial 30 day period. After that, the court should grant an extension or extensions of 30 days or more. If the provisional supervisor reports that he is likely to be able to complete the plan but not within a further 30 days, the court should have the discretion to extend the moratorium for any period up to a maximum of six months from the commencement of the moratorium.

15. Eligible financial contracts, which occur in certain closed markets such as the central clearing and settlement system of the Stock Exchange of Hong Kong Limited, should be exempted from the moratorium.

16. At the end of six months, the court would cease to have any role in monitoring the provisional supervisor as regards extensions of the moratorium. If the creditors resolved to extend the moratorium beyond six months they could impose such conditions as they wished on the provisional supervisor relating to reviewing the extension.

17. If the court was satisfied that the moratorium was causing significant financial hardship to a creditor, the court could exempt that creditor from the moratorium and any voluntary arrangement and the moratorium would cease to apply to that creditor and the creditor would not be subject to any subsequent voluntary arrangement.

18. The provisional supervisor should have the power to exclude any class or classes of creditors from the moratorium, in which case the moratorium would cease to apply to them.

19. At present, employees who are laid off by a company that does not go into liquidation are not able to make a claim for compensation from the Protection of Wages on Insolvency Fund, as the Fund is only triggered by the winding-up of the company or by advice from Legal Aid that the company is unable to pay its debts. On a provisional supervision, employees could therefore be cut out and left without the prospect of any

interim payment from the Fund. It would be desirable for employees who have been laid off as a consequence of provisional supervision to be accommodated under the provisions of the Protection of Wages on Insolvency Ordinance. Until that happens, a provision similar to section 79 of the Companies Ordinance should be made to the effect that, where a provisional supervisor is appointed to a company the debts of employees which in every winding-up are preferential payments under section 265 of the Companies Ordinance, be paid in priority to all other debts according to their respective priorities under section 265, out of the assets coming into the hands of the provisional supervisor in priority to any other claim.

20. The moratorium should cease upon a resolution being passed either to terminate the provisional supervision or that the company should be wound up or on the approval or rejection by creditors of a voluntary arrangement plan.

Initiating The Procedure (Chapter 6 of the Report)

21. A proposal for a voluntary arrangement should not have any effect until a resolution of the company or the board of directors proposing a voluntary arrangement, or, if appropriate, of the proposal of a liquidator in a compulsory winding up, a consent to act of the provisional supervisor, and an affidavit of the directors setting out the reasons for initiating provisional supervision, have been filed at both the Supreme Court Registry and the Companies Registry. The effect of the filing of the documents would be to put the company into provisional supervision, the commencement date being the date of last filing of the resolution and the consent to act.

22. The affidavit of the board of directors should set out the reasons for initiating provisional supervision and a declaration to the effect that in the opinion of the directors the interests of the company and creditors would be best served by the process of provisional supervision. The affidavit would be useful to the court in considering later applications for extensions of the moratorium and would also give some reassurance to the creditors.

Who May Be The Provisional Supervisor (Chapter 7 of the Report)

23. In most cases provisional supervisors should only be selected from a panel of practitioners which would be operated by the Official Receiver. In addition to appointment of provisional supervisors through a panel the court may approve the appointment of a person who was not on the panel but who was particularly suited to the task of rescuing a particular company. Once a provisional supervisor is appointed he would not only assume control of the company but would also be involved in the day to day business of the company in addition to formulating an arrangement plan.

Role Of The Provisional Supervisor (Chapter 8 of the Report)

24. If the provisional supervisor was to leave the day to day running of a company in the hands of the management and to limit himself with examining the records of the company and working behind the scenes to formulate a plan there would be a danger on two fronts. First, the provisional supervisor might fail to gain the confidence of the creditors if it was perceived that he was not in full control. Second, if a provisional supervisor did not have control over the management of a company, it would increase the

chances of a company's assets being dissipated by unscrupulous directors. It would not therefore be appropriate to allow management retain full control of a company and accordingly the provisional supervisor should have executive functions.

25. The functions of the provisional supervisor would be:

(a) to assess the financial position of the company, after which he should;
(b) decide whether or not any of the purposes of a voluntary arrangement were capable of being achieved;
(c) if he decided that any of the purposes of a voluntary arrangement were capable of being achieved, he should then formulate a plan to achieve the intended purpose;
(d) once he formulated a plan, he should submit it to a meeting or meetings of creditors for acceptance or otherwise by the creditors within the initial moratorium period in so far as that was possible;
(e) if the provisional supervisor, having assessed the financial position of the company, decided that none of the purposes of a voluntary arrangement were capable of being achieved he should call a meeting of creditors;
(f) if the provisional supervisor, having commenced the formulation of an arrangement plan, found that he was unable to complete the formulation of the plan, he should call a meeting of creditors to provide them with a final opportunity to come up with a plan to save the company or to resolve that the company should be wound up;
(g) during the provisional supervision period he should do all things necessary to protect the assets of the company;
(h) during the provisional supervision he should manage the affairs, business and property of the company with the primary purpose of preserving the assets of the company for the creditors as a whole;
(i) he should act in the best interests of the company;
(j) he should make a report to the Official Receiver if a director was or had been a director of a company which had at any time become insolvent whether while he was a director or subsequently and that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or companies, made him unfit to be concerned in the management of a company.

Duties, Rights And Liabilities Of The Provisional Supervisor (Chapter 9 of the Report)

26. Subject to his overriding duty to supervise the affairs of the company and to carry out his functions, the provisional supervisor should be under a duty to do all things necessary to protect the assets of a company for the benefit of the creditors The provisional supervisor should have the right to approach the court for directions. The provisional supervisor should not be liable for any of the debts of the company which arose before his appointment.

27. The provisional supervisor should be entitled to such remuneration as would be agreed between him and whoever initiated the procedure and caused him to act. The level of the remuneration should be specified in a prescribed form in the consent to act.

Ascertaining The Company's Affairs (Chapter 10 of the Report)

28. When a provisional supervisor is appointed he will need to assimilate a great deal of information in a short time, including establishing the extent and whereabouts of the assets of the company and taking control of them. In order to achieve this, the provisional supervisor would need powers to require information to be put at his disposal without undue delay and for assistance to be afforded to him by those who had knowledge of the company's affairs. The provisional supervisor should therefore have the power to obtain a statement of affairs of the company from specified persons, including directors and employees, within a relatively short time after his appointment.

Removal And Resignation Of The Provisional Supervisor (Chapter 11 of the Report)

29. The provisional supervisor should only be capable of removal for cause shown.

30. The provisional supervisor should be able to resign without cause shown where a majority of the creditors and the provisional supervisor himself agree to such a course and another provisional supervisor agrees to be appointed to the position. Resignation should not otherwise be possible other than where a provisional supervisor died or through mental incapacity.

Super Priority (Chapter 12 of the Report)

31. Provision should be made for a company to borrow during provisional supervision and such borrowing should receive priority over all existing debts, with the exception of fixed charges. This is because, in all likelihood, a company in provisional supervision would need to raise capital to fund its operations during the provisional supervision period. Existing lenders should be given first refusal on any super priority lending the company may require. If existing lenders declined to provide the lending, the provisional supervisor should then be able to seek super priority lending from other sources. Super priority lending would apply only to funds provided for working capital for the company and these funds should not be used to discharge, in whole or in part, any liability of the company to the provider of the funds existing at the commencement of the provisional supervision period.

Secured Creditors (Chapter 13 of the Report)

32. Any substantial charge, whether it was fixed or floating, or a combination of both, should carry the right to elect whether to participate in provisional supervision The effect of an election not to participate and thus effectively end provisional supervision would return a company to the position it was in just a few days previously. Creditors, secured and unsecured, could take the usual forms of action. Other secured creditors, that is, holders of charges whose level of exposure or lending would not warrant a charge over the whole or substantially the whole of a company's assets, would be bound by a moratorium in the same way as unsecured creditors, and would not have the option to elect whether to participate in provisional supervision.

Procedures For Meetings Of Creditors (Chapter 16 of the Report)

33. Any meeting of creditors to consider any matter relating to provisional supervision, creditors should form one class. The quorum for any meeting of creditors should be one creditor present and entitled to vote. For any resolution to pass at a meeting of creditors approving a proposal, there should be a majority in number and in excess of two thirds in value of the creditors present in person or by proxy and voting on the resolution.

34. Where a voluntary arrangement plan is approved by creditors, the provisional supervision should cease and the terms of the voluntary arrangement should take effect. The voluntary arrangement would be binding on every creditor who was entitled to vote at a meeting at which the arrangement plan was approved, and on the company and its members.

Consequences Of The Approval Of A Voluntary Arrangement (Chapter 17 of the Report)

35. Even after a company enters into a voluntary arrangement it would need protection. It should be a condition of every voluntary arrangement that, while it was in effect, the parties to the voluntary arrangement should be prohibited from taking actions that would be to the detriment of the other parties to the arrangement; therefore:

(a) no creditor bound by the arrangement may commence or continue any winding up proceedings against the company;
(b) no resolution may be passed or made by the members or the directors of the company for the winding up of the company:
(c) no receiver of the company may be appointed by a creditor bound by the arrangement or, if already appointed, no receiver may exercise any powers incidental to the office;
(d) no creditor bound by the arrangement may take any step to enforce or continue to enforce any security over the company's property or to repossess goods in the company's possession;
(e) no creditor bound by the arrangement may commence any proceedings, execution, distress or other legal process against the company.

The Supervisor Of A Voluntary Arrangement (Chapter 18 of the Report)

36. The supervisor of a voluntary arrangement should only be capable of appointment from the Official Receiver's panel. In most cases he would probably be the provisional supervisor. A supervisor of a voluntary arrangement should perform such duties and functions and have such powers as may be specified in the arrangement and ascertain on behalf of the creditors that the arrangement was being adhered to and implemented by the company in accordance with its terms. The supervisor should supervise the arrangement having regard to the interests of the creditors of the company, the company itself and the shareholders of the company.

37. Directors of a company should be subject to liability for insolvent trading once a company traded while insolvent or if the company continued to trade when there was no reasonable prospect of preventing the company becoming insolvent. A lesser duty should be imposed on senior management of a company. Directors and senior management, collectively known as "responsible persons" would be liable to pay compensation to the company if they were found by the court to have failed in their respective duties. Insolvent trading provision should encourage responsible persons to face the fact that a company was slipping into insolvency and cause them to take action rather than to trade on regardless of the consequences.

38. Provisional supervision would be a civil remedy only; there should be no criminal element. There is no reason for making an application for insolvent trading unless a company had gone into insolvent liquidation as, in practical terms, if a company remained in business there would be no one, such as a liquidator, who would be in a position to form a view that insolvent trading had taken place. The power to make an application in respect of insolvent trading should vest in a liquidator only.

39. Insolvent trading should apply to all directors whether they were validly appointed directors, persons who held themselves out to be directors though they had not been validly appointed, and shadow directors. Liability for insolvent trading should not be collective and liquidators should take account of a director's actions prior to liquidation. The ability and expertise of a director should be taken into account. A responsible director should, therefore, be able to protect himself by showing that he had warned the board about insolvent trading and that he had opposed the course of action the company had taken which resulted in insolvent liquidation.

40. Senior management should be liable to pay compensation for insolvent trading if they failed to warn the board of directors that the company was trading into insolvency. Senior management's duty would be lower than that of directors as the power to wind-up a company voluntarily or to initiate provisional supervision would only lie in the board of directors. Liability should extend to those in management who would know, who ought to have known or who had reasonable grounds for suspecting that a company was insolvent or would become insolvent and failed to warn the board of directors of the situation.

41. As most companies operate on a cash flow basis and can readily establish whether a company is able to discharge its liabilities as they fall due the cash flow test is the basis on which liability should be founded.

42. In order for a liability for insolvent trading to arise certain factual conditions would have to be established. These are (i) that a director is or has been a director of an insolvent company at the time when the debt or debts were incurred and that (ii) the company was insolvent at that time or there was no reasonable prospect of avoiding becoming insolvent. A liquidator must then consider whether a director, at that time, (i) knew the company was insolvent, or (ii) ought to have known that the company was insolvent or would so become, or (iii) that there were reasonable grounds for suspecting that the company was insolvent or would become insolvent and failed to take action to prevent the company from incurring the debt. The third limb of the factual conditions refers to reasonable grounds for suspecting insolvency. A director would be considered to have suspicions if, (i) he was aware at the time that there were grounds for so suspecting, or (ii) if a director in a like position in a company, in the company's circumstances, would be so aware.

43. In determining whether warning was given in good time the same factual conditions as set out above in respect of directors would be applied to senior management.

Presumptions

44. The effect of a presumption of continuing insolvency is that, if it is proved that a company was insolvent at a particular time during the 12 months ending on the date of commencement of its winding up, it would be presumed that the company was insolvent throughout the period beginning at that time and ending with the winding up of the company. This would prevent responsible persons defending an application for trading while insolvent by claiming that the company was actually solvent at a particular date, or for a certain period, during the period between the date when insolvency is shown and the date of winding up. Where circumstances of insolvency are established as having existed at a particular time within 12 months of winding up, it would shift the burden of proving the contrary on to the responsible persons.

45. If it is proved that a company had, at a particular time during the 12 months ending on the date of commencement of the winding-up, contravened section 121 of the Companies Ordinance by failing to keep proper accounting records there should be a presumption that the company was insolvent throughout the relevant period.

Defences

46. A director should have a defence to an application against him for insolvent trading if he could satisfy the court that, at the time when he knew or ought to have known that the company was insolvent or would become so or that there were reasonable grounds for suspecting that the company was insolvent or would become insolvent, he took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken. For the purposes of the defence, the facts which a director ought to have known or ascertain, or the conclusions which he ought to reach and the steps he ought to take, are those which would be known and ascertained, or reached or taken, by a reasonably diligent person having both the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and the general knowledge, skill and experience that director has.

47. A senior manager would have a defence to an application against him for insolvent trading if he could demonstrate that he had given the board of directors notice in the prescribed form that a company was trading insolvently or was about to trade insolvently.

Responsible persons may be liable to compensate the company

48. If the court finds a responsible person liable for insolvent trading it should be able to order the responsible person to pay compensation to the company for the benefit of the general body of creditors which would equal the general deficiency when it was wound up. It should be left to the discretion of the court to decide the amount of compensation that should be awarded against a responsible person as the actions of each responsible person would have to be judged separately. Compensation recovered should be paid to the company for the benefit of the general body of creditors in accordance with the existing priorities, unless the court orders otherwise.

49. If the court makes a declaration that a responsible person, whether he is a director or senior manager, is liable to pay compensation for insolvent trading, the court should have the discretion to make an order disqualifying that person from being a director of

any company under Part IVA of the Companies Ordinance. If a person acted as a director of a company which went into insolvent liquidation at a time when he was disqualified as a director under Part IVA of the Companies Ordinance, he may be held liable for the debts of the company.

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Chapter 27

Companies Registry Annual Report

27.1 At the 117th meeting, the Companies Registry Annual Report for 1995/96 was tabled for discussion. The workload statistics disclosed that compared to the previous financial year there had been an increase of 10.2% and a decrease of 8.9% in the numbers of incorporations of public and private companies respectively whilst the numbers of overseas companies registering under Part XI of the Companies Ordinance had declined by 1.5%. For full details of those statistics please refer to Appendix I.

27.2 Members were advised that the Companies (Amendment) Bill 1996, containing, inter alia, provisions to de-regulate the statutory forms under the Companies Ordinance and to abolish the ultra-vires rule would be resubmitted to LegCo. This Bill has now been enacted as the Companies (Amendment) Ordinance 1997, which was implemented on 10 February 1997 when the Registry replaced the most commonly used forms with 11 bilingual and more user-friendly forms. The provisions of the Companies (Amendment) Ordinance 1995, enabling documents to be filed in either English or Chinese, were also implemented on the same date.

27.3 Members were also informed that, on the technical side, the major project being undertaken was the expansion of the computerised data base to include details of a company's name, number, registered office, share capital structure, details of directors and secretary, and whether or not a charge had been lodged. In addition, work would commence on making this information available 'on-line' by early 1998. Over the past year a CD-ROM containing the companies names and document indices had been introduced, but this was only an interim measure pending the implementation of the on-line service.

27.4 During subsequent discussions it was pointed out that the number of newly incorporated companies was in fact the lowest in five years. However, the numbers of incorporations had always fluctuated greatly and recently there had been a marked increase with over 5,000 new companies alone being incorporated in October 1996. A decrease in the numbers of incorporations did not necessarily presage an economic downturn.

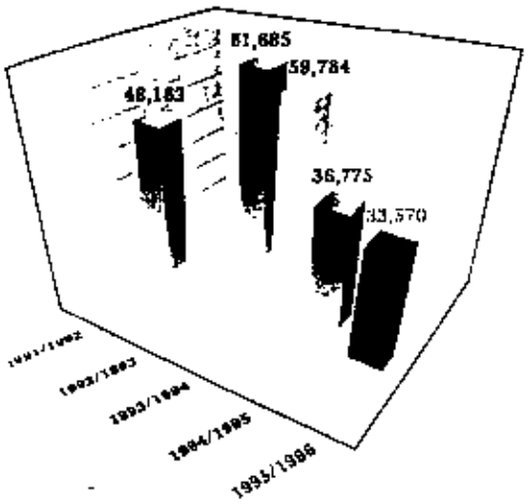
COMPANIES REGISTRY
公 司 註 冊 處

Workload Statistics 工作量統計數字

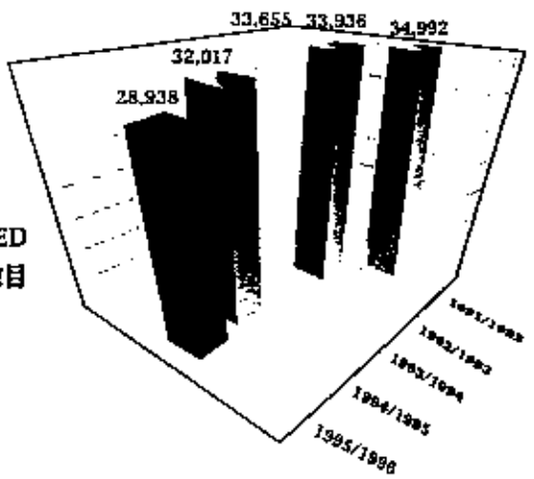
APPENDIX ***A*** *附錄*

Year to 31 March 截至3月31日止年度

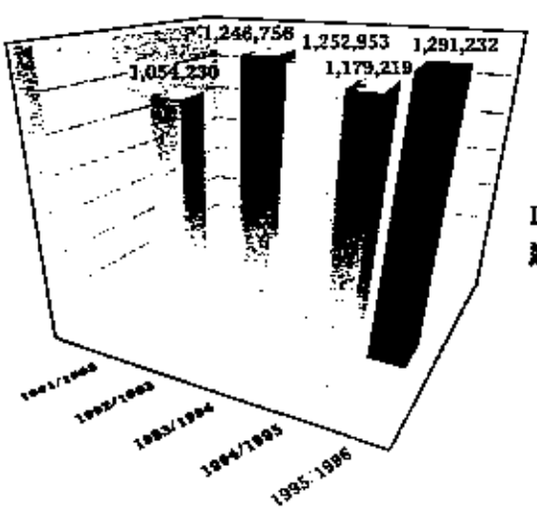
	1996	1995	% Change 增/減百分比 (%)
New companies 新公司			
Incorporations 註冊成立			
- public 公眾公司	280	254	10.2
- private 私人公司	33,290	36,521	(8.9)
Overseas companies registered 登記的海外公司	583	592	(1.5)
General registration of documents 登記公司文件			
Charges registered 登記的押記			
- number 數目	28,938	32,017	(9.6)
- amount secured ($m) 擔保款額（以百萬元計）	73,989	67,948	8.9
Documents received 所收到文件的數目	1,291,232	1,179,219	9.5
Change of name applications 更改名稱申請書	10,163	12,075	(15.8)
Voluntary liquidation notices 自動清盤通知書	3,578	3,128	14.4
Search facilities 查冊設施			
Searches made 進行查冊	1,851,177	1,936,033	(4.4)
Prosecution 檢控			
Summonses issued 發出傳票	298	226	31.9
Conviction rate 定罪率	95%	91%	4.4
Striking off action 剔除行動			
Action commenced 已展開行動	27,308	26,561	2.8
Companies struck off 被剔除的公司	7,795	5,073	53.7



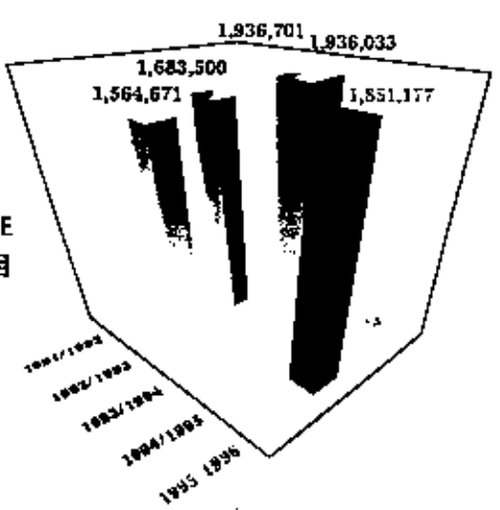
NUMBER OF COMPANIES INCORPORATED
註冊成立公司總數



NUMBER OF CHARGES REGISTERED
押記登記數目



DOCUMENTS RECEIVED FOR FILING
遞交登記文件數目



NUMBER OF SEARCHES MADE
查冊數目

Chapter 28

Definition of a Private Company for the Purposes of Section 336 of the Companies Ordinance (CO)

28. **Summary of Recommendations**

28.1 At the 120th meeting, members were advised that the proposal of the Hong Kong Society of Accountants (HKSA) to amend the definition of 'private company' for the purposes of section 336 of the CO with a view to reducing the numbers of overseas companies having to file their accounts with the Registrar of Companies had been withdrawn at the request of the HKSA.

Background

28.2 The HKSA in a submission on amendments to the CO had asked the SCCLR to consider the simplification of the definition of 'private company' for the purposes of section 336 of the CO as it was of the opinion that too many overseas companies registered under Part XI of the CO were having to unnecessarily file their accounts with the Registrar of Companies. In support of its proposal, the HKSA had stated :

"In substance a private company is one which does not have very

many shareholders. This is covered by section 29(1)(b) of the Ordinance. Section 29(1)(a) and (c) does not really have anything to do with defining a private company. They are merely things which private companies incorporated in Hong Kong are required by Hong Kong legislation to do.

Section 29 in itself does not give rise to any problems. However, when the definition is applied to oversea companies under section 336(6), many overseas companies which are in substance private company cannot qualify for the exemption granted by section 336(6). This is because in the countries of their incorporation there is no requirement or provision for the matters specified in section 29(1)(a) and (c). If the "definition" of private companies were simplified this problem would be removed. In any event, the existing legislation recognises that there are differences in definitions as between jurisdictions and therefore included section 336(6)(b). However, the opinion of the Registrar is apparently that all the conditions contained in section 29 are required to be met before he will consider an oversea company to have "substantially the same characteristics" as a Hong Kong private company. This subsection is therefore of no use in relevant circumstances."

28.3 Under section 336 of the CO, every overseas company must deliver to the

Registrar of Companies a certified copy of its balance sheet, profit and loss account, group accounts, directors' report and auditors' report in respect of its last financial year and in the form and containing the particulars and copies of documents the company is required to prepare by the law of its place of incorporation. If the Registrar is of the view that the documents specified above do not sufficiently disclose the company's financial position, he may require the company to deliver a balance sheet and profit and loss account which, inter alia, a company incorporated in Hong Kong is required to produce.

28.4 If an overseas company is not required by the law of its place of incorporation to prepare a balance sheet and profit and loss account the company must deliver to the Registrar such documents as it would be required to produce if incorporated in Hong Kong together with a report by qualified auditors on its balance sheet and profit and loss account.

28.5 Section 336, however, does not apply to a company which if incorporated under the Ordinance, would satisfy section 29 of the CO and therefore constitute a private company or to a company which in the opinion of the Registrar has substantially the same general characteristics as a private company and in either case which is not required by the law of its place of incorporation to publish its accounts or to deliver copies to any office where they may be inspected by members of the company (section 336(6)).

28.6 Section 336 with its present wording was enacted in 1974 and followed a recommendation contained in the 2nd Report of the Companies Law Revision Committee in 1973.

28.7 Circulars issued by the Companies Registry in 1977 and 1985 advising the professional and business committees of its requirements under section 336 were eventually superseded by the issue of a circular on 2 June 1994 which set out updated criteria as to when overseas companies had to file their accounts. A copy of that circular is at Appendix I. Members were advised that its issue was preceded by extensive consultation with the business and professional community in Hong Kong which included the HKSA. Since publication there had been very few queries/complaints by practitioners and indeed the current system was working well in practice. According to Company Registry statistics, approximately 68% of all overseas companies had filed their accounts with the remaining 32% having filed for exemption.

28.8 Following discussions at the 118th meeting, members directed the secretary to ascertain from the HKSA if it still wished to proceed with its proposal, given the fact that since the issue of the current circular there had been few if any complaints. In response, the HKSA asked for its proposal to be withdrawn.

Appendix 1

Ref (251) in CR 231 Pt. II

Companies Registry
15th Floor,
Queensway Government Offices,
66 Queensway,
HONG KONG.

2 June 1994

Companies Registry External Circular No. 4/94

Companies Ordinance Cap. 32
Part XI Section 336(6)
Accounts of overseas companies

1. The practice of the Registry in respect of the accounts of overseas companies falling within the ambit of section 336(6) was last set out in Circular Memorandum No. 3 of 1985. As a result of experience in administering the provisions of this section, the Registry's requirements have been reviewed and this Circular is issued to supersede Circular Memorandum No. 3 of 1985.

2. Section 336(6) provides that section 336 shall not apply to an overseas company if it meets both of the following conditions:-

(1) (a) If the company were incorporated under the Companies Ordinance in Hong Kong it would be a private company within the meaning of section 29, i.e. a company which by its articles:

(i) restricts the right to transfer its shares; and

(ii) limits the number of its members to 50, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company; and

(iii) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

/.....2

OR

(b) In the opinion of the Registrar the company has substantially the same general characteristics of such a private company.

AND

(2) The company is not required by the law of the place of its incorporation or origin to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

Companies incorporated in the U.S.A. (American Companies)

3. An application for the purposes of section 336(6) by an American company should be supported by a certificate made by a lawyer or auditor practising or licensed to practise in the place where the oversea company is incorporated, or by an independent solicitor or auditor practising in Hong Kong, confirming that throughout the period since the date of incorporation or since the first day of its last financial year, whichever applies:-

(a) (i) the company has been either a wholly-owned subsidiary of another company;

OR

(ii) the actual number of its members has not exceeded 35;

(b) there has been no provision in its constitution, articles or by-laws for the creation or issue of bearer shares, or share warrants, and its shares have not been transferable by delivery; and

/.....3

(c) the company has not by the law of its place of incorporation or origin been obliged to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

(Please see Samples 1 and 2).

4. If the Registrar agrees that the oversea company falls within the ambit of section 336(6), the oversea company will not be required to deliver any accounts under section 333(1)(f) or any accounts and annual return under section 336 until the expiry of its financial year. Thereafter, if the circumstances remain the same, exemption is considered and granted on an annual basis, upon submission each year within one month from the expiry of its last financial year the annual certificate as referred to in paragraph 3 above.

Other oversea companies

5. The criteria applied in respect of oversea companies registered in countries other than the U.S.A. must depend on the particular circumstances applying in each country and it is not practical to attempt to deal with all of them in this Circular.

6. If appropriate, an oversea company may apply to the Registrar for an opinion as to whether the company falls within the ambit of section 336(6). The application should be supported by a certificate made by a lawyer or auditor practising or licensed to practise in the place where the oversea company is incorporated, or by an independent solicitor or auditor practising in Hong Kong, confirming that throughout the period since the date of incorporation or since the first day of its last financial year, whichever applies:-

(a) the actual number of members of the company has not exceeded 50 (not including past or present employees);

(b) the company has not offered any shares or debentures to members of the public, has not been quoted on any stock exchange and has been prohibited by the law of its place of incorporation and/or its constitution, articles or by-laws to offer shares or debentures to the public;

(c) there has been no provision in its constitution, articles or by-laws for the creation or issue of bearer shares, or share warrants, and its shares have not been transferable by delivery; and

(d) the company has not by the law of its place of incorporation or origin been obliged to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

(Please see Samples 3 and 4).

7. If on considering the facts of each case the Registrar agrees that the oversea company falls within the ambit of section 336(6), the oversea company will not be required to deliver any accounts under section 333(1)(f) or any accounts and annual return under section 336 until the expiry of its financial year. Thereafter, if the circumstances remain the same, exemption is considered and granted on an annual basis, upon submission each year within one month from the expiry of its last financial year the annual certificate as referred to in paragraph 6 above.

8. Samples (1 - 4) of Certificates are annexed for reference.

G.N.E. Jones

(G.N.E. JONES)
Registrar of Companies

Sample 1

For U.S.A. companies

Re: Name of Company ("the Company")

*I/We _____ (name) _____, being the *lawyer(s)/auditor(s) *practising/licensed to practise in (the Company's place of incorporation) hereby confirm that throughout the period since *the date of the Company's incorporation/the first day of its financial year ended (Date) :-

(a) *the Company has been a wholly owned subsidiary of another company/the actual number of its members has not exceeded 35;

(b) there has been no provision in its constitution, articles or by-laws for the creation or issue of bearer shares, or share warrants and its shares are not transferable by delivery; and

(c) the Company has not by the law of its place of incorporation or origin been obliged to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

Date: _____

_____ (Signature)
Name and Capacity

*Delete as appropriate

Sample 2

For U.S.A. companies

Re: Name of Company ("the Company")

*I/We (name), being the independent *solicitor(s)/auditor(s) practising in Hong Kong hereby confirm that throughout the period since *the date of the Company's incorporation/the first day of its last financial year ended (Date):

(a) *the Company has been a wholly owned subsidiary of another company/the actual number of its members has not exceeded 35;

(b) there has been no provision in its constitution, articles or by-laws for the creation or issue of bearer shares, or share warrants and its shares are not transferable by delivery; and

(c) the Company has not by the law of its place of incorporation or origin been obliged to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

Date: _____ (Signature)
Name and Capacity

*Delete as appropriate

Sample 3

For other oversea companies

Re: Name of Company ("the Company")

*I/We _____(name)_____, being the *lawyer(s)/auditor(s) *practising/licensed to practise in (the Company's place of incorporation) _____ hereby confirm that throughout the period since *the date of the Company's incorporation/the first day of its last financial year ended ___(Date)___ :-

(a) the actual number of members of the Company has not exceeded 50 (not including past or present employees);

(b) the Company has not offered any shares or debentures to members of the public, has not been quoted on any stock exchange, and has been prohibited by the law of the place of its incorporation and/or its constitution, articles or by-laws to offer shares or debentures to the public;

(c) there has been no provision in its constitution, articles or by-laws for the creation or issue of bearer shares, or share warrants and that its shares have not been transferable by delivery; and

(d) the Company has not by the law of the place of its incorporation or origin been obliged to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

Date: _____

_____(Signature)_____
Name and Capacity

*Delete as appropriate

Sample 4

For other oversea companies

Re: Name of Company ("the Company")

*I/We (name), being the independent *solicitor(s)/auditor(s) practising in Hong Kong hereby confirm that throughout the period since *the date of the Company's incorporation/the first day of its last financial year ended (Date):-

(a) the actual number of members of the Company has not exceeded 50 (not including past or present employees);

(b) the Company has not offered any shares or debentures to members of the public, has not been quoted on any stock exchange, and has been prohibited by the law of the place of its incorporation and/or its constitution, articles or by-laws to offer shares or debentures to the public;

(c) there has been no provision in its constitution, articles or by-laws for the creation or issue of bearer shares, or share warrants and that its shares have not been transferable by delivery; and

(d) the Company has not by the law of the place of its incorporation or origin been obliged to publish its accounts or to deliver copies to any person in whose office they may be inspected as of right by members of the public.

Date: _____

(Signature)
Name and Capacity

*Delete as appropriate

Chapter 29

Alterations to a Company's Capital

Sections 53, 55 and Form III of the Companies Ordinance (CO)

29. **Summary of Recommendations**

29.1 At the 118th meeting, members endorsed a proposal that the requirements of Form III - notice of any increase in the nominal capital of a company must be filed with the Companies Registry - should be extended to all alterations of capital but that the obligation to file the resolution authorising the change should remain unchanged.

Background

29.2 The Hong Kong Institute of Company Secretaries (HKICS) in a submission on amendments to the CO proposed that the requirements of Form III should be extended to all alterations of capital and that the filing of an ordinary resolution should be dispensed with in the case of increases in capital. In support of its proposal, HKICS stated :

> "The provisions of section 53 cover several types of capital alteration. Whereas increases in capital require filing of a

prescribed form and copy resolution, other instances of alteration, unless sanctioned by way of special resolution, require filing of a notice (no prescribed form) alone. Since all of these instances are regarded as changes to a company's memorandum we see no reason to require, in the case of an increase in capital, the filing of two documents, particularly as they will both invariably contain identical relevant information. We recommended that the requirements of Form III be extended to all alterations of capital (drafting changes to the form would be few and the added certainty of reporting formality would be of benefit to practitioners) and that filing of an (ordinary) resolution be dispensed with in the case of increases in capital. In the event that alterations were sanctioned by way of special resolution, section 117 would of course apply in the usual way."

29.3 Under section 53, a company may, if authorised by its articles, alter the capital clause in its memorandum. Articles 45 and 46 of Table A provide that a company may, by passing an ordinary resolution, do any of the following matters :

– increase the company's authorised capital by new shares of such amount as the resolution provides. Notice of the resolution in the prescribed Form III must be given to the Registrar (please see section 55(2)) within 15 days;

- a consolidation and division of all or any of its share capital into shares of larger amount;

- conversion of paid-up shares into stock and reconversion of that stock into paid-up shares;

- sub-division of shares into shares of a smaller nominal value than is fixed by the memorandum;

- cancellation of shares which have not been taken or agreed to be taken and diminishing the amount of its authorised share capital by the total of the nominal value of the shares cancelled. (Such a cancellation is deemed not to reduce the capital);

Within one month of passing the resolution to do any of the above, the company must give notice to the Registrar pursuant to section 54 of the CO.

29.4 Under section 117 of the CO, special resolutions must be registered with the Registrar within 15 days of them being passed. Ordinary resolutions do not generally need to be registered. However a resolution to, inter alia, increase the authorised capital under section 53 must be registered pursuant to section 55 which accounts for HKICS's suggestion that resolutions to increase capital should not have to be registered. However the criminal sanctions provided for in section 55(3) would, if HKICS's suggestion was acceptable, have to be abolished. In the UK resolutions to increase share capital are registrable and

like here, failure to do so, gives rise to criminal sanctions.

29.5 After a short discussion members agreed to support the proposal save that the requirement to file the resolution authorising the change should remain unchanged. It was important to maintain transparency in a company's activities.