

**Standing Committee on Company Law Reform
(SCCLR)**

The Nineteenth Annual Report

2002/2003

Standing Committee on Company Law Reform (SCCLR)

Nineteenth Report to the Chief Executive in Council

Subjects considered by the

Standing Committee during 2002/2003

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PREFACE

(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 and the Treasury 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 Ordinance¹ 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 2002/2003

Chairman : The Hon Mr Justice Rogers, V-P, JP

Members : Mr Roger T Best, JP
Mr Henry Fan Hung-ling, SBS, JP
Ms Betty Ho May-foon (up to 31.7.2002)
Mrs Angelina Lee Wong Pui-ling, JP (up to 31.1.2003)
Mr Ian K Perkin (up to 31.10.2002)
Mr Winston Poon Chung-fai, SC
Mr Alvin Wong Tak-wai
Mr Randolph G Sullivan

¹ These two ordinances have been consolidated into the Securities and Futures Ordinance since 1 April 2003.

Mr Peter Wong Shiu-hoi
Mr Richard J Thornhill
Mr Michael W Scales
Mr William Tam Sai-ming
Professor Stephen CHEUNG Yan-leung (from 1.2.2003)
Mr John POON Cho-ming (from 1.2.2003)
Mr David P R Stannard (from 1.2.2003)

Ex-Officio

Members :

Mr Ashley Alder
Executive Director (Corporate Finance)
The Securities & Futures Commission

Mr Lawrence Fok, Chief Executive (up to 31.12.2002)
The Stock Exchange of Hong Kong Limited

Miss Karen Lee (from 1.1.2003)
Head of Listing, Regulation & Risk Management
The Stock Exchange of Hong Kong Limited

Mr Charles Barr
Department of Justice

Mr E T O'Connell
The Official Receiver

Mr Gordon W E Jones, JP
The Registrar of Companies

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

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

Secretary : Mr J S Bush (up to 30.1.2003)

Mr Edward Lau (from 31.1.2003)

(iii)

Meetings held during 2002/2003

One Hundred and Sixty First Meeting	-	4 th May 2002
One Hundred and Sixty Second Meeting	-	6 th July 2002
One Hundred and Sixty Third Meeting	-	14 th September 2002
One Hundred and Sixty Fourth Meeting	-	26 th October 2002
One Hundred and Sixty Fifth Meeting	-	7 th December 2002
One Hundred and Sixty Sixth Meeting	-	18 th January 2003
One Hundred and Sixty Seventh Meeting	-	22 nd February 2003
One Hundred and Sixty Eighth Meeting	-	22 nd March 2003

(iv)

**Meetings held by the three Sub-Committees
established under the SCCLR during 2002/2003**

Directors Sub-Committee

Twelfth Meeting	-	27 th May 2002
Thirteenth Meeting	-	18 th June 2002
Fourteenth Meeting	-	23 rd July 2002
Fifteenth Meeting	-	9 th December 2002

Shareholders Sub-Committee

Eleventh Meeting	-	15 th May 2002
Twelfth Meeting	-	12 th June 2002
Thirteenth Meeting	-	30 th October 2002

Corporate Reporting Sub-Committee²

Special Meeting	-	3rd October 2002
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² The Sub-Committee held a special meeting on 3rd October 2002 and decided to disband the Sub-Committee as all the tasks covered by its terms of reference had either been completed or referred to appropriate bodies for follow-up action.

EXECUTIVE SUMMARY

The Standing Committee on Company Law Reform (SCCLR) was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance and other related ordinances. The SCCLR reports annually, through the Secretary for Financial Services and the Treasury, to the Chief Executive in Council on amendments that are under consideration.

From 1 April 2002 to 31 March 2003, the SCCLR held eight meetings. In addition to their work on matters discussed at the meetings covered in this report, members continued their review of corporate governance in Hong Kong, partly through the three sub-committees set up thereunder (namely, the Directors Sub-Committee, the Shareholders Sub-Committee and the Corporate Reporting Sub-Committee) and partly through the Standing Committee itself. The three sub-committees altogether held eight meetings in the reporting period.

On 11 June 2003, a consultation paper on the proposals made in Phase II of the Corporate Governance Review was released to the public for comment. The consultation ended on 30 September 2003 and a total of 25 submissions were received from institutions, lawyers, accountants, bankers and other interested persons. The submissions are being analysed and the results will be submitted to the SCCLR for consideration in due course.

During the reporting period, the SCCLR considered, in addition to

topics³ under the Corporate Governance Review, six other discussion papers :-

Title	Prepared by
Pseudo-Foreign Companies	Ms Betty Ho May-foon
Proposals for a Scripless Securities Market and related amendments to the Companies Ordinance	The Financial Services and the Treasury Bureau and Securities and Futures Commission
Issue of Financial Products – Amendments to the Companies Ordinance	The Financial Services and the Treasury Bureau and Securities and Futures Commission
Inspection and Investigation Provisions in the Companies Ordinance	Companies Registry
Taking enforcement action against overseas listed companies : Extra-territorial application of the Companies Ordinance and statutory backing of the Listing Rules	Companies Registry
Prospectuses and Intermediaries Liability	Securities and Futures Commission

³ They include “Report of the Consultancy on a Survey on International Institutional Investors’ Attitudes towards Corporate Governance Standards in Hong Kong”, “Report of the Consultancy Study on the Roles and Functions of Audit, Nomination and Remuneration Committees” and “Responsibility, Liabilities and Independence of External Auditors”.

A brief summary of the ten chapters in this Annual Report is set out in the following table :-

Chapter	Subject Matter	Recommendations/Remarks
1	Corporate Governance Review	The SCCLR issued on 11 June 2003 a consultation paper on Phase II of the Corporate Governance Review which detailed its proposals (relating to directors, shareholders, corporate reporting and corporate regulation) to enhance Hong Kong's corporate governance regime. The consultation ended on 30 September 2003 and the comments received are being analysed.
2	Pseudo-Foreign Companies	Members were unable to come to a decision at the meeting but agreed to closely monitor developments concerning the administration of the relevant Listing Rules and the possibility of their being given statutory backing.
3	Scriptless Securities Market and related amendments to	Members approved the proposals for a scriptless securities markets and related

	the Companies Ordinance	amendments to the Companies Ordinance.
4	Issue of Financial Products	Members supported the proposals in principle but raised concerns on practical issues particularly in relation to pre-registration awareness marketing, publicity during the offer period by using mini prospectuses and fact sheets, pre-issue press speculation and the additional costs of issuing mini-prospectuses.
5	Report of the Consultancy on a Survey on International Institutional Investors' Attitudes towards Corporate Governance Standards in Hong Kong	Members considered the findings, particularly those relating to independent non-executive directors (INEDs) very useful. Members agreed that there should be tougher enforcement against directors and that the introduction of INEDs should be done on an incremental basis.
6	Review of the Inspection and Investigation Provisions in the Companies Ordinance	Members endorsed a series of proposals to improve the inspection and investigation provisions in the Companies Ordinance, including the lowering of the inspector appointment threshold in s.142(1)(a) to 50 members; and the extension of the

		investigation provisions to companies incorporated outside Hong Kong but doing business here.
7	Taking Enforcement Action against Oversea Listed Companies : Extra-territorial Application of the Companies Ordinance and Statutory Backing of the Listing Rules	Members agreed to reconsider the matter at a later stage in the context of an omnibus submission with specific proposals on the legal provisions and Listing Rules that would be affected.
8	Report of the Consultancy Study on the Roles and Functions of Audit, Nomination and Remuneration Committees	Members agreed to endorse the proposals that audit committees should be made mandatory in the Listing Rules for listed companies; and nomination and remuneration committees should be included as a recommended best practice in the Code of Best Practice.
9	The Responsibility, Liabilities and Independence of External Auditors	Members agreed to a number of proposals to enhance and strengthen the functioning and quality of external auditors. These included the imposition of a duty on

		employees (in addition to directors and officers) to provide information to auditors; and the mandatory rotation of lead and concurring audit partners every five years.
10	Prospectuses and Intermediaries Liability	Members were not prepared to endorse the proposals to make sponsors and other intermediaries civilly and criminally liable for mis-statements in prospectuses.

CHAPTER 1

Corporate Governance Review

Background

- 1.1 Members continued their review of corporate governance in Hong Kong, partly through the Directors, Shareholders and Corporate Reporting Sub-committees and partly through the Standing Committee itself.
- 1.2 The Sub-committees held a total of eight meetings during the reporting period.
- 1.3 The Standing Committee considered corporate governance related issues at four of its meetings as follows :-
 - At the 165th meeting, members considered a paper concerning the responsibilities, liabilities and independence of external auditors.
 - At the 166th and 167th meetings, members considered another paper concerning proposals in the SCCLR's Consultation Paper on Phase I of the Corporate Governance Review which overlapped with the proposals in the HKEx's Consultation Paper.
 - At the 168th meeting, members considered the proposal to adopt the test of control through the exercise of dominant influence to

determine whether a company was associated with another for the purposes of connected party transactions.

- At the 168th and 169th meetings, members considered the draft of the SCCLR's Consultation Paper on the Proposals made in Phase II of its Corporate Governance Review ("the Draft Paper").

1.4 The Draft Paper set out the issues considered and proposals made by the SCCLR and its sub-committees (see paragraphs 1.5 – 1.26 below). It also contained a progress report on the proposals made in Phase I of the SCCLR's Corporate Governance Review and a summary of the findings of the four consultancy studies commissioned by the Government under the Corporate Governance Review.

Directors

Directors' Duties

1.5 The SCCLR recommended the adoption of non-statutory guidelines to state the principles of law in relation to directors' duties. A model set of guidelines have been drafted for the reference of all company directors and potential directors.

Voting by Directors in relation to Directors' Self-dealing

1.6 The SCCLR reconfirmed its previous proposals that the law should require directors to abstain from voting at board meetings on transactions in which they had an interest, with exceptions for immaterial transactions.

Shareholders' Approval for Connected Transactions of Significance involving Directors

- 1.7 For transactions or arrangements above a certain threshold limit involving directors or persons connected with them, the approval of disinterested shareholders voting on a poll should be obtained.

Transactions between Directors or Connected Parties with an Associated Company

- 1.8 Requirements for disinterested shareholders' approval for connected party transactions should be extended to transactions or arrangements with an "associated company". The SCCLR was inclined to adopt the test of control through the exercise of dominant influence for the purpose of defining "associated companies".
- 1.9 The proposals in paragraphs 1.6 – 1.8 should apply to all listed and unlisted companies in Hong Kong including companies registered under Part XI of the Companies Ordinance and failure to comply with the proposed requirements would render the transactions voidable at the instance of the company or any shareholder.

The Roles and Functions of Chairman and Chief Executive Officer

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

Board Procedures

- 1.11 Board procedures including the frequency of full board meetings, the delivery of agenda and board papers to all directors, and directors' access to the services and advice of company secretaries and to other professional advice, should be improved. Relevant provisions should be included in the Code of Best Practice.

Audit, Nomination and Remuneration Committees

- 1.12 The Listing Rules should be amended to make it mandatory that all listed companies should establish an audit committee. At least one independent non-executive director (INED) on a listed company's audit committee should have some "financial expertise". A retired partner of a firm auditing the company's accounts should be prohibited absolutely from being the chairman or member of an audit committee.
- 1.13 The Code of Best Practice should be amended to make the establishment of nomination and remuneration committees in listed companies a recommended best practice.

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

- 1.14 The boards of listed companies should have a minimum of three INEDs, and sources of non-executive directors (NEDs) should be broadened to bring in able directors with a wider range of skills and experience.
- 1.15 The Code of Best Practice should provide that listed companies should disclose the system for deciding the remuneration of their NEDs in their

annual reports. The Code should also provide that directors should disclose the number of other directorships they held, other than in wholly-owned subsidiaries, in their companies' annual report.

Directors' Qualifications and Training

- 1.16 The Code of Best Practice should contain a requirement that listed companies should disclose the arrangements made to train their directors, in particular new NEDs, on both an initial and continuous basis.

Directors' Remuneration

- 1.17 The Companies Ordinance and the Listing Rules should be amended to require listed companies to disclose full details of all elements of individual directors' remuneration packages.
- 1.18 The Companies Ordinance should be amended to require unlisted public companies or private companies, if directed to do so by holders of not less than 5% of all nominal issued share capital of the company to disclose full details of all elements of individual directors' remuneration packages.

Shareholders

Self-dealing by controlling shareholders

- 1.19 The SCCLR reconfirmed its previous proposals on self-dealing by controlling shareholders, including –
- subject to certain exceptions, connected transactions must be disclosed and subject to disinterested shareholders' approval on a

vote by poll;

- the definition of connected person in relation to controlling shareholder should be incorporated in the law;
- failure to comply with the rule should render the transaction voidable at the instance of the company or any shareholder;
- these proposals should apply to all listed and unlisted companies in Hong Kong including companies registered under Part XI of the Companies Ordinance.

Substantial Transactions

- 1.20 Section 155A of the Companies Ordinance should only be optional for private companies and the provisions of this section should be aligned with the corresponding Listing Rules for listed companies.

Variation of Class Right

- 1.21 The SCCLR did not recommend any legislative changes to define what would constitute a variation of class rights.

The Suitability of Judicial Control, Multiplicity of Provisions and Class Votes

- 1.22 The SCCLR was unable to reach a consensus but would like to seek the public's comments on issues relating to the definition of class composition, rationalization of sections 58, 166 and 168 and suitability of judicial control.

Company General Meetings

1.23 The SCCLR made a number of proposals to enhance the effectiveness and transparency of company general meetings, including –

- a company should be permitted to hold a general meeting at more than one location;
- a general meeting should take place at the venue specified by the notice of the meeting (the principal venue), but subsidiary or satellite venues should be allowed;
- visual and audio real time communications should be permitted by legislation;
- the timing of the Annual General Meeting should be changed to within a certain period after the end of each financial year of the company. For private companies with share capital and companies limited by guarantee, the period should be nine months. For public companies, the period should be six months;
- notices should be given personally or sent by post to shareholders unless the shareholders agreed to adopt electronic means of communications;
- there should be a requirement of minimum information to be given in the meeting notices regarding the proposed resolutions;

- absentee voting and electronic voting should be permitted;
- the empowerment of proxies should be reformed.

Corporate Reporting

The Responsibilities, Liabilities and Independence of External Auditors

1.24 The SCCLR proposed that the law should be amended to remove the requirements for the shareholders to fix auditor's remuneration and made also a number of proposals to enhance and strengthen the functioning and quality of external auditors, including –

- the present requirement for directors and officers of a company to provide information and explanations as auditors thought necessary should be extended to employees;
- subject to the Hong Kong Society of Accountants' further research and views outgoing auditors should be required to volunteer material information to their successors;
- the government and HKSA should undertake work to identify the types of non-audit services incompatible with the principles underlying auditor independence; to enhance the disclosure of the nature and value of all services provided by auditors to audit clients; and to define what services should fall within the categories of audit, audit-related and non-audit;

- there should not be mandatory rotation of audit firms but there should be mandatory rotation of both lead and concurring audit partners every five years.

1.25 No decision was reached on auditors' liability and the desirability of proportionate liability. The SCCLR would like to seek the public's views on these issues.

Corporate Regulation

1.26 The public's comments were sought on whether in principle statutory backing should be given to the Listing Rules together with tougher statutory sanctions including civil fines against non-compliance, and whether the regulation of unlisted companies needs to be improved and, if so, how that should be addressed in terms of institutional change.

Present Position

1.27 The consultation exercise on Phase II of the Corporate Governance Review was formally launched on 11 June 2003 and ended on 30 September 2003.

1.28 25 submissions from institutions, lawyers, accountants, bankers and other interested member of the community on the proposals made in the Consultation Paper on Phase II of the Review were received. The submissions are being analysed and the results will be submitted to the SCCLR for consideration in due course.

CHAPTER 2

Pseudo-Foreign Companies

- 2.1 At the 161st meeting, members considered a discussion paper prepared by Ms Betty Ho May-foon on “Pseudo-Foreign Companies”. The focus was particularly on whether these companies should be made subject to at least part of the legal standards applicable to companies formed and registered under the Companies Ordinance (“Domestic Companies”). Members were unable to come to a decision at the meeting but agreed to closely monitor developments concerning the administration of the relevant Listing Rules and the possibility of their being given statutory backing.

Background

- 2.2 As a result of the decision at the 155th meeting, the SCCLR agreed that it would review the problem relating to foreign incorporated companies existing in Hong Kong which had not established any place of business in Hong Kong but which held Hong Kong assets and had Hong Kong shareholders. At present, these companies were not caught by the Companies Ordinance.
- 2.3 The Paper defined these companies as “pseudo-foreign companies” and argued that at least part of the legal standards applicable to Domestic Companies by the Companies Ordinance should be made applicable to them in order to provide a level playing field for all companies and to maintain an

adequate level of investor protection.

2.4 The Paper considered the questions of outside perception of the assertion of jurisdiction by Hong Kong over pseudo-foreign companies and the coherence of the law. It examined the questions by looking at the bases of jurisdiction, conflict of laws and international practice. The Paper concluded that selective application of the Companies Ordinance to pseudo-foreign companies could be justified by the strictest standards of international law and practice without disturbing the coherence of the existing law of conflict of laws.

2.5 Members were well aware of the phenomenon of pseudo-foreign companies and the issues which they created. However, they did not consider the proposals in the Paper feasible as there were many difficulties concerning the definition of a pseudo-foreign company, taking particularly into account the fact that its operations and shareholders might change from time to time.

2.6 Members generally felt that the preferable way of dealing with the problem was to give the Listing Rules statutory backing and transfer the regulation of listed companies to the Securities and Futures Commission. However, they were unable to come to any firm decisions as proposals in that respect were also being considered by other authorities in other contexts.

CHAPTER 3

Proposals for a Scripless Securities Market and Related Amendments to the Companies Ordinance

- 3.1 At the 162nd meeting, members approved the Securities and Futures Commission's proposals for a scripless securities market and related amendments to the Companies Ordinance.

Background

- 3.2 Members considered a paper prepared by the Securities and Futures Commission on their proposals for a scripless securities market in Hong Kong. The main objectives of the proposals were to enable shares to be issued and transferred electronically and to integrate the Hong Kong's Central Clearing and Settlement System (CCAS) with the share registrars who maintained registers of shareholders for listed companies. The paper set out a proposed scripless working model which was under development pursuant to the Consultation Paper on Proposals for A Scripless Securities Market in Hong Kong issued by the Securities and Futures Commission in February 2002 for public consultation.
- 3.3 The Paper also explained the proposed legislative amendments required to give effect to the proposals.

3.4 After discussion, members approved the proposals.

CHAPTER 4

Issue of Financial Products – Amendments to the Companies Ordinance

- 4.1 At the 162nd meeting, members considered a discussion paper prepared jointly by the Financial Services and the Treasury Bureau and the Securities and Futures Commission, and gave views and comments on the intermediate-term measures proposed by the Financial Market Development Task Force for updating the prospectus regime under the Companies Ordinance.

Background

- 4.2 The Financial Secretary's Budget Speeches in 2001 and 2002 highlighted the need to streamline procedures and lower associated costs for the issue of financial products to facilitate market development and innovation. Subsequently, the Financial Market Development Task Force, chaired by the Secretary for Financial Services was set up in December 2001 to identify bottlenecks and draw up proposals to take the matter forward.
- 4.3 The Task Force proposed a number of intermediate-term measures as part of the exercise and sought the SCCLR's views and comments on these proposals including –

- establishing an alternative regulatory framework for programme offers permitting a prospectus to be made up of a base document and a supplemental document both of which could be authorized, registered and issued separately;
- permitting and regulating pre-registration awareness marketing, and publicity during the offer period using mini prospectuses and fact sheets;
- permitting applications through channels such as Internet and ATM, and filing with the regulators through electronic means;
- rationalizing and tailoring the information requirements for equity and debt securities under the Third Schedule to the Companies Ordinance;
- adding to the Companies Ordinance certain express exclusions from the meaning of “offer to the public”;
- removing certain discrepancies in the regulatory requirements applicable to Hong Kong and oversea companies;
- extending the prospectus liability provisions in the Companies Ordinance expressly to cover omissions from prospectuses and their application to other documents issued during the offer period such as mini prospectuses and fact sheets.

4.4 Members supported the proposals in principle but raised concerns on practical issues particularly in relation to pre-registration awareness marketing and publicity during the offer period by using mini prospectuses and fact sheets. Members were concerned about the quality of information to be provided in the pre-registration awareness marketing, pre-issue press speculation and the additional costs of issuing mini prospectuses.

CHAPTER 5

Report of the Consultancy on a Survey on International Institutional Investors' Attitudes towards Corporate Governance Standards in Hong Kong

- 5.1 At the 162nd meeting, members considered the Final Report of the Consultancy on a Survey on International Institutional Investors' Attitudes towards Corporate Governance Standards in Hong Kong prepared by Professor Judy Tsui and Professor Ferdinand Gul of the Accounting and Corporate Law Centre, Department of Accountancy of the City University of Hong Kong.
- 5.2 Members considered the findings of the survey very useful, particularly those aspects concerning independent non-executive directors (INEDs). Members agreed that there should be tougher enforcement against directors and that the introduction of INEDs should be done on an incremental basis because of practical problems relating to short supply of INEDs.

Background

- 5.3 The Consultancy on a Survey on International Institutional Investors' Attitudes towards Corporate Governance Standards in Hong Kong was one of the research and survey projects commissioned by the then Financial

Services Bureau⁴ for the Corporate Governance Review. The consultants were required to conduct a comprehensive review and survey on institutional investment to identify the corporate information needs of institutional investors.

5.4 The findings of the consultants included inter alia the following :-

- Most respondents ranked quality management as the most important factor in the investment decisions of international institutional investors and integrity was an important ingredient of quality.
- Many respondent believed that past and future financial performance, cash flows and quality of disclosure in financial statements were very important factors affecting investment decisions.
- Respondents recognized that corporate governance was important but did not take account of it explicitly in any evaluation criteria in their investment decisions.
- Most respondents believed that the most important mechanism for good corporate governance was the quality of INEDs but many were however skeptical about the existence of “truly independent” INEDs in Hong Kong. They also pointed out that family ownership in Hong Kong was an impediment to good corporate governance.

⁴ Called “Financial Services and the Treasury Bureau” since 1 July 2002.

- All respondents believed that good corporate governance would lead to better company performance in the long term.
- On enforcement, some respondents felt that the Securities and Futures Commission should have wider investigatory powers in respect of companies which did not comply with the Listing Rules. Others felt that corporate governance could not be legislated for nor regulated.

CHAPTER 6

Inspection and Investigation

Provisions in the Companies Ordinance

6.1 At the 163rd meeting, members considered a discussion paper prepared by the Companies Registry which analyzed the proposals made by the Department of Justice after reviewing the inspection and investigation provisions in the Companies Ordinance and the proposals made by the Department of Trade and Industry of the United Kingdom on similar provisions in the Companies Act 1985.

6.2 Members agreed that inspections and investigations served a valuable purpose and should both be retained. In addition, co-operation with overseas regulatory authorities should be enhanced. The proposed amendments to the Companies Ordinance included the following :-

- extending the scope of persons who could be investigated in conjunction with the inspection of a company to include a wider definition of associated companies, partnerships and individuals;
- including computer and electronic records in what might be sought in relation to an inspection and be the subject of a search warrant;

- giving the Financial Secretary the power to seek interim relief;
- reducing the number of members applying for the appointment of an inspector under s.142(1)(a) to 50;
- taking account of the public interest in deciding whether to appoint an inspector, and updating the language to describe the grounds of appointment;
- extending the inspection and investigation provisions in the Companies Ordinance to companies incorporated outside Hong Kong but doing business here and any other companies within a group comprising such companies wherever incorporated;
- including an express provision to enable the Financial Secretary to define the terms of an inspector's appointment and to limit or expand the scope of investigation if necessary in the course of investigation;
- giving the Financial Secretary a discretion as to whether an inspection should be suspended pending criminal proceedings;
- making dissemination of the inspector's report subject to greater control;

- making a finding of fact by an inspector acceptable as evidence of that fact for civil proceedings but requiring a higher standard of proof for criminal proceedings;
- clarifying the provisions for recovering the expenses of an inspection from other parties;
- enabling the civil courts to enforce compliance with the investigator's reasonable requirements and repealing the criminal sanction except for destruction or falsification of evidence or the provision of false evidence;
- introducing the power to place restrictions on share dealings;
- retaining powers to wind up a company or seek a disqualification order;
- permitting restraining orders to be imposed during or at the end of an inspection;
- assimilating the powers of investigations under s.152A and inspection under ss142 and 143.

Background

6.3 At the 156th meeting of the SCCLR held on 13 October 2001, members considered a paper entitled "Corporate Regulation – Enforcement of the

Companies Ordinance and agreed (inter alia) that –

- the inspection provisions in the Companies Ordinance should be closely examined;
- consideration should be given as to whether and, if so, how arrangements should be made available in-house to prepare for possible requests for preliminary investigations under section 152A of the Companies Ordinance.

6.4 The Registrar of Companies sought the views of various interested parties on the existing investigation provisions in the Companies Ordinance and in particular those of the Department of Justice. In May 2002, the Department of Justice produced a paper on the subject.

6.5 In the United Kingdom, the Department of Trade and Industry had also undertaken a review of similar provisions in the Companies Act 1985 and published a Consultation Paper in October 2001.

6.6 The Paper prepared by Registrar of Companies contained a comparative analysis of the proposals made by the Department of Justice and the Department of Trade and Industry of the United Kingdom.

6.7 Members discussed the subject and agreed to most of the proposals made by the Department of Justice and adopted some of the Department of Trade and Industry's proposals.

CHAPTER 7

Taking Enforcement Action against Oversea Listed Companies : Extra-territorial Application of the Companies Ordinance and Statutory Backing of the Listing Rules

- 7.1 At the 164th meeting, members agreed to reconsider the matter at a later stage in the context of an omnibus submission with specific proposals on the legal provisions and Listing Rules that would be affected.

Background

- 7.2 The Companies Registry introduced a paper on this subject to seek the advice of the SCCLR on which of the two options to regulate listed overseas companies should be preferable, namely –

Option 1 Listed companies to be regulated mainly through the Listing Rules and supplemented by a limited number of provisions in the Companies Ordinance.

Option 2 Listed companies to be regulated through both the Companies Ordinance and the Listing Rules with an expanded number of provisions of the Companies Ordinance being given extra-territorial application.

- 7.3 Members generally agreed that there was, at present, no effective sanction to enforce the Listing Rules and, as a result, taking enforcement action against oversea companies listed in Hong Kong was a real problem. They accepted that the solution was either to give the Listing Rules appropriate statutory backing or enact laws which had an extra-territorial effect.
- 7.4 Members recognized the limitations of giving all regulatory type provisions an extra-territorial application and the difficulties likely to follow as a result of having no appropriate independent regulator to enforce the Listing Rules if they were given statutory backing.
- 7.5 After discussion, members agreed that the matter should be further examined in the context of an omnibus submission with specific proposals on the legal provisions and Listing Rules that would be affected.

CHAPTER 8

Report of the Consultancy Study on the Roles and Functions of Audit, Nomination and Remuneration Committees

8.1 At the 164th meeting, members considered the Final Report of the Consultancy Study on the Roles and Functions of Audit, Nomination and Remuneration Committees prepared by Professor Judy Tsui and Professor Ferdinand Gul of the Accounting and Corporate Law Centre, Department of Accountancy of the City University of Hong Kong. Members agreed that :-

- the Listing Rules should be amended to make it mandatory that all listed companies should establish an audit committee;
- the Code of Best Practice should be amended to make the establishment of nomination and remuneration committees in listed companies a recommended best practice;
- at least one independent non-executive director on a listed company's audit committee should have some "financial expertise". A retired partner of the firm auditing the company's

accounts should be prohibited absolutely from being the chairman or member of an audit committee.

Background

8.2 The Consultancy Study on the Roles and Functions of Audit, Nomination and Remuneration Committees was one of the research and survey projects commissioned by the then Financial Services Bureau⁵ for the Corporate Governance Review. The consultants were required to undertake a thorough review of the operation of audit, nomination and remuneration committees in other comparable jurisdictions as well as Hong Kong to make recommendations as to whether or not the establishment of such committees within companies would enhance corporate governance standards in Hong Kong.

8.3 The consultants recommended inter alia that –

- all listed companies should establish audit, nomination and remuneration committees;
- an audit committee should have at least three non-executive directors with the chairman and the majority of its members being independent;
- all the non-executive and independent non-executive directors on

⁵ Called “Financial Services and the Treasury Bureau” since 1 July 2002.

the audit committee should have some “financial expertise”;

- the chairman and the majority of the members of a nomination committee should be independent non-executive directors;
- a remuneration committee should consist wholly of non-executive directors with the chairman and majority of its members being independent.

8.4 The Report was considered by the Directors Sub-committee at its 14th meeting. The Sub-committee recommended that :-

- the Listing Rules should be amended to make it mandatory that all listed companies should establish an audit committee;
- the Code of Best Practice should be amended to make the establishment of nomination and remuneration committees a recommended best practice;
- further thought be given to the consultants’ recommendation concerning the “financial expertise” of all non-executive directors and independent non-executive directors on audit committees as this was an impractical proposition.

8.5 After discussion, members endorsed the first two recommendations of the Directors Sub-committee. With regard to the third recommendation,

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

CHAPTER 9

The Responsibilities, Liabilities and Independence of External Auditors

9.1 At the 165th meeting, members considered a discussion paper prepared by the Companies Registry on the responsibilities, liabilities and independence of external auditors. It was agreed *inter alia* that –

- the government should closely monitor developments concerning auditors' functions and standards;
- the issue of whether there should be independent regulation of the auditing profession should be considered by the government in the context of the current review of the HKSA's regulatory regime;
- s.131(8) of the Companies Ordinance should be amended to remove the requirement for shareholders to fix auditors' remuneration;
- The present requirement under s.141(5) of the Companies Ordinance on directors and officers of the company to provide information and explanation as the auditors thought necessary

should be extended to employees;

- subject to the Hong Kong Society of Accountants' further research and views, outgoing auditors should be required to volunteer material information to their successors;
- the government and HKSA should undertake work to identify the types of non-audit services which are incompatible with the principles underlying auditors' independence and enhance the disclosure of the nature and value of all services provided by auditors to clients, defining what services should fall into the categories of audit, audit-related and non-audit;
- there should not be mandatory rotation of audit firms in Hong Kong but there should be mandatory rotation of lead and concurring audit partners every 5 years;
- the public's comments should be sought on the issue of auditors' liability and the desirability of proportionate liability.

Background

9.2 The subject was within the terms of reference of the Corporate Reporting Sub-committee. However, due to conflicts of interest considerations as a result of the Chairman of the Sub-committee being the then President of the Hong Kong Society of Accountants (HKSA) and two of its members being members of the HKSA, the subject was referred to the SCCLR for

consideration.

- 9.3 The Paper set out the latest position on various issues regarding audit and auditors taking into account the review of the UK Companies Act by the Company Law Review Steering Group; the US Sarbanes-Oxley Act 2002, which introduced a wide spectrum of regulatory measures for auditors; and the HKSA's proposals on auditor's liability recommending a system of proportionate liability.
- 9.4 Members discussed the issues raised in the paper and agreed inter alia to the proposals mentioned in paragraph 9.1 (above).

CHAPTER 10

Prospectuses and Intermediaries Liability

- 10.1 At the 166th meeting, members considered a discussion paper entitled “Prospectuses and Intermediaries Liability” but were not prepared to endorse the proposals therein.

Background

- 10.2 The Paper was prepared by the Securities and Futures Commission to seek the SCCLR’s approval on proposals to make sponsors civilly liable under s.40 of the Companies Ordinance for mis-statements in prospectuses subject to existing defences in s.40(2); and to extend criminal liability under s.40A to sponsors and other intermediaries whose reports were included in the prospectuses and where consent was given under s.38C. The Paper also sought the SCCLR’s views on whether the statutory liability (civil or criminal) should be extended to other professionals involved in Initial Public Offerings who did not produce reports for inclusion in the prospectus.
- 10.3 Members considered the proposals problematic particularly in relation to cases where the sponsor or intermediary had come to knowledge of the mis-statement only after the completion of his work. Members were also concerned that the proposals might make the process of preparing a prospectus very expensive and serious problems could arise as persons involved in it might find ways to cover their liability by means of

indemnities, opinion letters etc. They considered that it was preferable that provisions be made to remove the licences of intermediaries involved in dishonest prospectuses.

10.4 After discussion, members declined to endorse the proposals.