Standing Committee on Company Law Reform

(SCCLR)

The Twentieth Annual Report

2003/2004

Standing Committee on Company Law Reform (SCCLR)

Twentieth Report to the Chief Executive in Council

Subjects considered by the

Standing Committee during 2003/2004

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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 Ordinance[1] 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 2003/2004

Chairman	:	The Hon Mr Justice Rogers, V-P, JP	(up to 31.1.2004)
		Mr Benjamin Yu, S.C.	(from 1.2.2004)
Members	:	Mr Roger T Best, JP	
		Mr Henry FAN Hung-ling, SBS, JP	(up to 31.1.2003)
		Mr Winston Poon Chung-fai, SC	
		Mr Alvin Wong Tak-wai	
		Mr Randolph G Sullivan	
		Mr Peter Wong Shiu-hoi	
		Mr Richard J Thornhill	

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

Mr Michael W Scales
Mr William Tam Sai-ming
Professor Stephen CHEUNG Yan-leung
Mr John POON Cho-ming
Mr David P R Stannard

Ex-Officio Members :

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

Miss Karen Lee (up to 3.5.2003)
Head of Listing, Regulation & Risk Management
The Stock Exchange of Hong Kong Limited

Mr Paul Chow (from 1.11.2003)
Chief Executive
Hong Kong Exchanges and Clearing 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 (up to 6.9.2003)
Deputy Chief Executive
The Hong Kong Monetary Authority

Mr William Ryback (from 7.9.2003)
Deputy Chief Executive
The Hong Kong Monetary Authority

Miss Susie HO Shuk-yee, JP (up to 15.10.2003)
Deputy Secretary for Financial Services and the Treasury

Mrs Clarie K L Lo, JP (from 16.10.2003)
Deputy Secretary for Financial Services and the Treasury

Secretary : Mr Edward Lau

(iii)

Meetings held during 2003/2004

One Hundred and Sixty Ninth Meeting	-	3rd May 2003
One Hundred and Seventieth Meeting	-	6th September 2003
One Hundred and Seventy First Meeting	-	1st November 2003
One Hundred and Seventy Second Meeting	-	29th November 2003
One Hundred and Seventy Third Meeting	-	13th December 2003
One Hundred and Seventy Fourth Meeting	-	10th January 2004
One Hundred and Seventy Fifth Meeting	-	21st February 2004
One Hundred and Seventy Sixth Meeting	-	22nd March 2004

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 2003 to 31 March 2004, the SCCLR held eight meetings and most of which, were related to its comprehensive review of corporate governance in Hong Kong (Corporate Governance Review), a task commissioned by the Financial Secretary on the SCCLR in March 2000.

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 market regulators, professional organizations, trade bodies, bankers and other interested persons. The submissions were analysed and the results were considered by the SCCLR at two separate meetings held on 29 November and 13 December 2003 respectively.

On 20 January 2004, the SCCLR issued its Final Recommendations arising from the proposals made in Phase II of the Corporate Governance Review, which concluded nearly four years' work by the SCCLR on the Corporate Governance Review.

During the reporting period, the SCCLR considered, in addition to topics under the Corporate Governance Review, four other discussion papers prepared and submitted by the Companies Registry, namely :-

- Review of section 157I of the Companies Ordinance : Civil remedies for Contravention of Prohibited Loans (or similar transactions) to Directors under section 157H
- Proportionate Liability for Auditors
- Limited Liability Partnerships
- Overall Review of Companies Ordinance – Progress Report No. 4

The SCCLR held also a special meeting on 22 March 2004 to discuss issues raised by the Bills Committee during the scrutiny of the Companies (Amendment) Bill 2003 on proposals relating to statutory derivative action.

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

Chapter	**Subject Matter**	**Recommendations/Remarks**
1	Corporate Governance Review	On 20 January 2004, the SCCLR issued its Final Recommendations arising from the Consultation Paper on Proposals made in Phase II of the Corporate Governance Review. The

		recommendations covered a wide range of aspects including directors' roles, duties, qualifications, training and remuneration as well as connected transactions, board procedures, board committees, shareholders' rights and conflict of interests, company general meetings, corporate reporting with the focus mainly on external auditors, and corporate regulation.
2	Review of section 157I of the Companies Ordinance : Civil Remedies for Contravention of Prohibited Loans (or similar transaction) to Directors under section 157H	Members agreed that section 157I should be further reviewed together with other related provisions in the Companies Ordinance in the context of the overall rewrite of the Companies Ordinance.
3	Proportionate Liability for Auditors	Members agreed that the subject of proportionate liability should be referred to the Law Reform Commission for study and consideration in the context of civil liability reform.

4	Promulgation on the Guidelines on Directors' Duties	Members approved the draft guidelines on directors' duties having regard to the responses received from the public during the consultation exercise, and suggested specific promulgation methods.
5	Limited Liability Partnerships	Members recommended that a consultation exercise should be conducted to seek the public's view on limited liability partnerships and to assess the level of public support to their introduction in Hong Kong. This would be considered after further consultation and examination of the implications of the various issues arising from limited liability partnerships within the Administration.
6	Overall Review of the Companies Ordinance (Progress Report No. 4)	Members agreed on a number of key points on the process and procedure of the proposed rewrite of the Companies Ordinance. These included the following :- • the focus of the rewrite should

		be on structural and drafting changes as well as the review of some of the concepts in order to modernize Hong Kong's company law to bring it into the 21st century; • a decision on the overall structure of the new Companies Ordinance should come before the allocation of responsibilities between the different working groups; • draft terms of reference should be prepared; and • the rewrite should be done within government.
7	Imposition of a "Leave Requirement" for the Commencement of the Proposed Statutory Derivative Action	Members were mostly of the view that there should be no "trial within a trial" for the purpose of determining the standing of an applicant to commence a derivative action on behalf of the company but, if a leave requirement was unavoidable, the threshold should be set at a meaningfully low level.

CHAPTER 1

Corporate Governance Review

Background

1.1 The three sub-committees set up under the SCCLR to undertake the Corporate Governance Review, namely, the Directors Sub-committee, the Shareholders Sub-committee and the Corporate Reporting Sub-committee, completed their work in December 2002.

1.2 At the 168th and 169th meetings held on 22 March 2003 and 3 May 2003 respectively, members considered and approved the draft of the SCCLR's Consultation Paper on Proposals made in Phase II of the Corporate Governance Review The Consultation Paper was released for public consultation on 11 June 2003.

1.3 The consultation period ended on 30 September 2003. A total of 25 submissions were received from market regulators, professional organizations, trade bodies, bankers and other interested persons.

1.4 The submissions were analysed and the results were submitted to the SCCLR for consideration at the 172nd and 173rd meetings held on 29 November 2003 and 13 December 2003 respectively.

1.5 On 20 January 2004, the SCCLR issued its Final Recommendations arising from the Consultation Paper on Proposals made in Phase II of the Corporate Governance Review, which together with the recommendations in Phase I of the Review, concluded nearly four years' work by the SCCLR on the Corporate Governance Review. Details of the Final Recommendations are as set out in the following paragraphs.

Directors

Directors' Duties

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

Principle 1 : Duty to act in good faith for the benefit of the company as a whole

Principle 2 : Duty to use powers for a proper purpose for the benefit of members as a whole

Principle 3 : Duty not to delegate powers except with proper authorization and duty to exercise independent judgment

Principle 4 : Duty to exercise care, skill and diligence

Principle 5: Duty to avoid conflicts between personal interests and interests of the company

Principle 6 : Duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law

Principle 7 : Duty not to gain advantage from use of position as a director

Principle 8 : Duty not to make unauthorised use of company's property or information

Principle 9 : Duty not to accept personal benefit from third parties conferred because of position as a director

Principle 10 : Duty to observe the company's memorandum and articles of association and resolutions

Principle 11 : Duty to keep proper books of account

Voting by Directors in relation to Directors' self-dealing[2]

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

- There should be a general prohibition against directors voting on transactions in which they had an interest in accordance with paragraph 13.3 of Part C[3] of the HKEx's Consultation Paper on Proposed

[2] There was a fair amount of overlapping between the recommendations made in respect of –
- voting by directors in relation to directors' self-dealing
- shareholders' approval for connected transactions of significance involving directors
- transactions between directors or connected parties with an associated company, and
- self-dealing by controlling shareholders

as they dealt with different aspects of conflicts of interest on the part of those who had influence over the conduct of companies. The recommendations under those topics should therefore be read together.

[3] Paragraph 13.3 of Part C of the HKEx's Consultation Paper made the following recommendation: - *"We will amend the Rules to require a director to abstain from voting on any matter in which he or any of his associates (as defined in the Rules) has any interest which is different from other shareholders and not to be bound towards the quorum of the relevant board meeting. There will be*

Amendments to the Listing Rules relating to Corporate Governance Issues (HKEx's Consultation Paper) which was issued in January 2002.

- The Companies Ordinance should set out the exceptions to the general voting prohibition as currently provided in Note 1 of Appendix 3 to the Listing Rules[4] and the additional exception proposed in paragraph 13.3 of Part C of HKEx's Consultation Paper on immaterial interest.

- The Companies Ordinance should be amended in accordance with the Listing Rules so that contracts, transactions and arrangements in which directors (or connected persons) had an interest should be disclosed to shareholders and be subject to their approval if the value or consideration thereof was equal to or above certain de minimis thresholds. The de minimis thresholds should be consistent with those in the relevant provisions in the Listing Rules[5].

- The Companies Ordinance should be amended to set out the civil consequences of a breach of the general rule which should be as follows :-

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an exception to the general prohibition if the relevant interest is immaterial. The existing exceptions to the general voting prohibition as currently provided in the Rules will continue to apply".

4 The exceptions acceptable to the HKEx include, for example, the giving of security or indemnity to a director for loans made to the company for the benefit of the company; the giving of security to a third party for obligations of the company for which the director is a surety; contracts made by a director to underwrite shares or debentures of the company, and certain contract or arrangement in which the director is interested only as an officer of the company or as holder of shares or other securities.

5 Please see rules 14A.31(2), 14A.32, 14A.33 and 14A.34 of the Listing Rules. The thresholds are by reference to certain percentage ratios and the amount of the total consideration involved.

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

– without prejudice to any other liability that might be imposed by law, the director or connected person would be liable to account to the company for any gain, or to indemnify the company for any damage resulting from the contract, transaction or arrangement.

- The ambit of section 162 of the Companies Ordinance[6] should be widened to cover "transactions", "arrangements" and "connected persons".

- The above proposals should not apply to private companies, oversea public companies not listed in Hong Kong and oversea public companies with a secondary listing in Hong Kong. For listed companies, the proposals should be implemented through giving statutory backing to the relevant Listing Rules.

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[6] Section 162 of the Companies Ordinance requires a director of a company who is in any way directly or indirectly interested in a contract or proposed contract with the company to declare the nature of his interest at the earliest meeting of the directors if his interest in such contract or proposed contract is material.

Shareholders' approval for connected transactions of significance involving Directors

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

- The Companies Ordinance should be amended by adopting a new provision on the basis of section 320 of the United Kingdom Companies Act 1985 to provide that connected transactions should be subject to disclosure and shareholders' approval if the total consideration or value was greater than or equal to certain de minimis thresholds. The de minimis thresholds should be consistent with those in the relevant provisions in the Listing Rules[7].

- "Connected persons" should include the following :-

  (a) director's or controlling shareholder's [8] children or step-children;

  (b) spouse;

  (c) trustee of any trusts in which the director or controlling shareholder, his spouse, children or step children were beneficiaries under the trust;

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[7] Please see Footnote 5 under the heading *"Voting by Directors in relation to Directors' Self-dealing"* (above).

[8] Please see the second paragraph under the heading *"Self-dealing by Controlling Shareholders"* (below). The SCCLR recommended that *"controlling shareholder"* should be defined for the purposes of connected transactions using the same criterion as that under the Listing Rules for *"substantial shareholder"*.

(d) any corporation associated[9] with the director or controlling shareholder.

- The Companies Ordinance should be amended in accordance with the Listing Rules so that any connected person (including connected persons in relation to controlling shareholders) having an interest in a contract, transaction or arrangement should abstain from voting at the general meeting where the contract, transaction or arrangement is considered for the purpose of approving it.

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

- The Companies Ordinance should be amended to set out the civil consequences of a breach of the general rule which should be as follows :-

  - The contract, transaction or arrangement should be voidable at the instance of the company or any shareholder subject to rights of

[9] Please see the first bullet point of the SCCLR's proposals under the heading *"Transactions between Directors or Connected Parties with an Associated Company"* (below). The SCCLR recommended that *"associated company"* should be defined by using the dominant influence concept under section 258 of the United Kingdom Companies Act 1985.

bona fide third parties for value, the impossibility of restitution or ratification (where permissible) within a reasonable time by disinterested shareholders;

- Without prejudice to any other liability that might be imposed by law, the director or connected person would be liable to account to the company for any gain, or to indemnify the company for any damage resulting from the contract, transaction or arrangement;

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

- The above proposals should not apply to private companies, oversea public companies not listed in Hong Kong and oversea public companies with a secondary listing in Hong Kong. For listed companies, the proposals should be implemented through giving statutory backing to the relevant Listing Rules.

Transactions between Directors or Connected Parties with an Associated Company

The SCCLR reconfirmed the following proposals :-

- The Listing Rules relating to connected transactions should be extended to an "associated company". An "associated company" for

these purposes should be defined by using the "dominant influence" concept[10] under section 258 of the United Kingdom Companies Act 1985.

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

- The scope of the provision in the Companies Ordinance (which implements the above proposals relating to shareholders' approval for connected transactions of significance involving directors) should be widened to cover contracts, transactions or arrangements between the associated company and directors or connected persons.

- The above proposals should not apply to private companies, oversea public companies not listed in Hong Kong and oversea public companies with a secondary listing in Hong Kong. For listed companies, the proposals should be implemented through giving statutory backing to the relevant Listing Rules.

[10] Section 258(2)(c) of the United Kingdom Companies Act 1985 provides that an undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if, inter alia, it has the right to exercise a dominant influence over the undertaking by virtue of provisions contained in the undertaking's memorandum or articles or by virtue of a control contract. Paragraph 4(1) of Schedule 10A to the Act provides that, for the purposes of section 258(2)(c), an undertaking shall not be regarded as having the right to exercise a dominant influence over another undertaking unless it has a right to give directions with respect to the operating and financial policies of that other undertaking which its directors are obliged to comply with whether or not they are for the benefit of that other undertaking.

The Roles and Functions of the Chairman and Chief Executive Officer

The SCCLR did not recommend mandatory separation of the roles and functions of the Chairman and Chief Executive Officer but considered it a best practice to separate these functions.

Board Procedures

The SCCLR recommended that the following provisions should be included in the HKEx's Code of Best Practice :-

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

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

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

  – The management should have an obligation to supply the board with full and adequate information in a timely manner. The

board should have separate and independent access to the company's senior management for such information.

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

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

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

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

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

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

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

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

Audit, Nomination and Remuneration Committees

Whilst noting that there were practical difficulties in establishing truly effective board committees, the SCCLR agreed that their establishment had become a recognized benchmark of the standard of corporate governance. In view of this, the SCCLR made the following proposals :-

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

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

- At least one independent non-executive director (INED) on a listed company's audit committee should have some "financial expertise". A retired partner of the firm auditing the company's accounts should be prohibited absolutely from acting as the chairman of an audit committee, but should be allowed to act as a member subject to a "cooling off" period of 3 years.

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

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

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

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

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

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

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

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

However, the SCCLR considered that there should be no statutory distinction between executive directors and NEDs, and that the "monitoring" role of NEDs should not be achieved through either a two-tier board[11] or having INEDs elected by minority shareholders.

Directors' Qualifications and Training

The SCCLR recommended that the Code of Best Practice should contain a requirement that a listed company had to disclose the arrangements made to train its directors, and in particular new NEDs, on both an initial and

[11] Under a two-tier board system, a management board of the executive directors is monitored by a *"supervisory board"*. The members of the supervisory board have some of the characteristics of NEDs and include employees as well as shareholders and management representatives although this is not a necessary feature of a two-tier board system. Germany is one of the countries adopting this system. For more details, please see paragraph 14.17 of SCCLR Consultation Paper on Proposals made in Phase II of the Corporate Governance Review.

continuous basis, with particular reference to knowledge of company law, the Listing Rules and the Code of Best Practice. Listed companies should also be required to disclose in their annual reports their compliance, or reasons for non-compliance, with this requirement. However, the SCCLR did not recommend mandating directors' training and qualifications.

Directors' Remuneration

The SCCLR noted the increasing public concern about the remuneration of directors of listed companies and made the following proposals :-

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

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

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

The SCCLR further recommended that there should be a requirement to make specific disclosures on key aspects of a company's remuneration policy.

However, the SCCLR did not recommend that requirements along the lines of the United Kingdom's Directors' Remuneration Regulations 2002 which require shareholders' approval of remuneration reports, including details of directors' remuneration packages, should be introduced at the present time in Hong Kong. The issue should be reviewed at a later date to see how such requirements had worked in other jurisdictions

Shareholders

Self-dealing by Controlling Shareholders

The SCCLR reconfirmed its previous proposals that :-

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

- The definition of a connected person in relation to controlling shareholder should be identical to the one adopted for connected transactions involving directors.

- The general rule should be subject to certain exceptions such as transactions entered into by liquidators during the course of compulsory winding-up or on a general reduction of capital; the limited exemptions[12] allowed under the relevant Listing Rules and other de minimis exceptions, along the lines of those adopted for connected transactions involving directors.

- Voting on connected transactions must be on a poll.

- The court's power to determine whether or not a transaction constitutes a waste of corporate assets[13] should be preserved.

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[12] The limited exemptions allowed under the Listing Rules include certain intra-group transactions (rule 14A.31(1)); issue of new securities (rule 14A.31(3)); Stock Exchange dealings (rule 14A.31(4)); purchase of own securities (rule 14A.31(5)); directors' service contracts (rule 14A.31(6)); consumer goods or consumer services (rule 14A.31(7)) and sharing of administrative services (rule 14A.31(8))

[13] The term "*Waste of corporate assets"* is a US concept and is defined in Section 1.42 of *Principles of Corporate Governance: Analysis and Recommendations ("ALI Corporate Governance Project" or "Project")* published by the American Law Institute in March 1994 as –

"(1) an expenditure of corporate funds or a disposition of corporate assets for which no consideration is received in exchange and for which there is no rational business purpose, or

(2) if consideration is received in exchange, the consideration the corporation receives is so inadequate in value that no person of ordinary sound business judgment would deem it worth that which the corporation has paid."

The SCCLR recommended that, if such a concept is introduced in Hong Kong, a definition would probably be required (Paragraph 17.14 of SCCLR's Consultation Paper on Proposals made in the Phase II of the Corporate Governance Review).

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

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

- The above proposals should not apply to private companies, oversea public companies not listed in Hong Kong and oversea public companies with a secondary listing in Hong Kong. For listed companies, the proposals should be implemented through giving statutory backing to the relevant Listing Rules.

The SCCLR further recommended that "controlling shareholders" should be defined for the purposes of connected transactions using the same criterion as that under the Listing Rules for "substantial shareholder" (i.e. a person controlling 10 percent or more of the voting power at any general meeting of the company) and that connected persons should be taken into account[14].

[14] The voting power of the connected persons of a shareholder should be taken into account in determining whether that shareholder is controlling 10% or more of the voting power at any

Substantial Transactions

The SCCLR was basically of the view that compliance with section 155A[15] of the Companies Ordinance should only be optional for private companies and that the provisions of this section should be aligned with the corresponding Listing Rules for listed companies. Accordingly, the SCCLR recommended that section 155A should be transferred to Table A.

Variation of Class rights

The SCCLR considered that variation of class rights was an area which should better be left for further case law development. It did not therefore make any recommendations for legislative changes in this respect.

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

- On class composition –
  - As the current practice of the courts in determining fairness as between controlling shareholders and minority shareholders was considered adequate, the SCCLR did not therefore make any

general meeting of the company.

[15] Section 155A of the Companies Ordinance requires that directors of a listed company or a company which is a member of a group in which there is a listed company, who seeks to dispose of any fixed asset of the company which exceeds 33% of the value of the company's fixed assets as shown in the latest balance sheet laid before the company in general meeting must first obtain the approval of the general meeting before the company can dispose of such fixed assets. The prohibition does not apply to the charging of any fixed assets or the granting of an interest over

recommendations for legislative change in this respect.

- On the multiplicity of provisions[16] –
  - The SCCLR recommended that section 58 should be amended to ensure greater consistency with section 166 so that, where a reduction of capital might result in the different treatment of shareholders of equal standing or not rateably as between classes of shareholders, the procedure should be the same as that under section 166;

  - Sections 58, 166 and 168 should be rationalized so as to prevent compulsory acquisition being achieved other than under section 168.

- On the suitability of judicial control –
  - As judicial control was considered suitable in the context of Hong Kong, the SCCLR did not therefore make any recommendations for legislative change in this respect.

such assets by way of securities.

[16] There is a multiplicity of provisions in the Companies Ordinance providing for different forms of corporate restructuring. Section 58 provides a statutory scheme for companies to reduce their share capital. Section 166 provides for reorganization under which compromises or arrangements between a company and its creditors or between a company and its shareholders may be effected. Section 168 allows a transferee company to compulsorily acquire the shares of dissenting minorities in an amalgamation or merger. For more details, please see paragraphs 20.18 to 20.36 of SCCLR's Consultation Paper on Proposals made in Phase II of the Corporate Governance Review.

Company General Meetings

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

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

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

- Annual General Meeting (AGM) required by Statute

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

- Timing of AGM

  The timing of the AGM should be changed to within a certain period after the end of each financial year of the company. For private companies with a share capital and companies limited by guarantee,

the period should be nine months and for other public companies, the period should be six months.

- Minimum Period of Notice

  The existing minimum periods of notice for the AGMs and the Extraordinary General Meetings (EGMs) should be maintained. Any variation for EGMs of listed companies can be included in the Listing Rules.

- Service of Notice

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

- Contents of Notice

  There should be a requirement of minimum information, such as text of the resolution and a brief explanation of the reasons behind the resolution, to be given in the meeting notices regarding the proposed resolutions. Such a requirement should be put in the Listing Rules for listed companies and in the Companies Ordinance for unlisted companies.

- Agenda of AGM

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

- Members' Resolution

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

  – There should be no limit on the number of nominations by shareholders for election of directors at general meetings. In addition, there should not be any criteria or shareholding requirement for such nominations.

- Written Resolution

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

- Functions and Duties of Chairman of a Meeting

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

- Voting on a Show of Hands

  Voting by a show of hands should continue subject to certain specified matters[17] which must be voted by a poll and the chairman's discretion to call a poll should remain intact. The common law duty of a chairman to demand a poll if he knew that the result of a voting by a show of hands would be different from that of voting by a poll because significant number of proxies were against the proposal should be written into the law.

- Absentee and Electronic Voting

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

[17] For example, voting on connected transactions. Please see the fourth bullet point of the SCCLR's proposals under the heading *"Self-dealing by Controlling Shareholders"* (above). The SCCLR

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

- One proxy for each shareholding

  Without prejudice to the general principle of company law that a company should not be concerned with trusts over its shares, multiple proxies should be permitted.

- Proxies to vote on a show of hands

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

- Proxy Solicitation

  Proxy solicitation should not be regulated.

recommended that voting on connected transactions must be on a poll.

- Delivery of Proxy by Electronic Means

  Specific provisions should be made for the delivery of proxies by electronic means and there should be guidance on signing of an electronic proxy.

- A Proxy to vote on Poll according to their Terms

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

- Disclosure of Proxy Voting Information

  There should be a requirement for the chairman of the meeting to disclose to the meeting before the voting the number of proxies held by the company and the voting instructions (if any) thereunder. If the proxy was a general proxy with no voting instructions, the way the chairman intended to use that proxy to vote should also be disclosed.

- Inspection of Proxy Document

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

Corporate Reporting

The Responsibilities, Liabilities and Independence of External Auditors

To enhance and strengthen the regulation and functioning of external auditors, the SCCLR recommended that :-

- Auditors' Function and Regulation
  - In view of the review of the Practice Review Programme currently being undertaken by the Hong Kong Society of Accountants (HKSA)[18] which aimed at introducing a system based on "risk-assessment", the SCCLR made no specific proposal at this stage with regard to auditor's quality of work but urged the Government to closely monitor developments in this area.

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

[18] Hong Kong Society of Accountants (HKSA) has been renamed as Hong Kong Institute of Certified Public Accountants starting from 8 September 2004.

- Auditors' Remuneration

  – Section 131(8)[19] of the Companies Ordinance should be amended to remove the requirement for the shareholders to fix the auditors' remuneration or determine the manner of how it should be fixed.

- Auditors' Access to Information

  The present requirement under section 141(5) of the Companies Ordinance on directors and officers of the company to provide such information and explanation as the auditors think necessary and the corresponding criminal sanction should be extended by bringing employees within its scope.

- Outgoing Auditors

  The working group set up by the HKSA to review the communication problems between the outgoing auditors and their successors should be charged with the duty of examining this issue further. The SCCLR would consider the way forward after the review.

- Auditors' Independence

  The Government and HKSA should undertake work to :-

[19] Section 131(8) of the Companies Ordinance provides that the remuneration of the auditor of a company (a) in the case of an auditor appointed by the directors or by the court, may be fixed by the directors or by the court, as the case may be, and (b) subject to paragraph (a), shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

- identify the types of non-audit services which are incompatible with the principles underlying auditor independence beyond those already contained in HKSA's current ethical standards;

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

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

- Rotation of Audit Partners
  - This issue is already dealt with in HKSA's current ethical standards but should be further considered by the HKSA.

- Auditors' Duties

  The 'Caparo' rule[20] should remain in place with any further development of negligence law being left to the normal process of case law.

[20] The 'Caparo' rule is a common law rule laid down by the court in *Caparo Industries v Dickman (1990) AC 605HL* that auditors owe a duty of care to the following categories of person: -
(a) existing shareholders of the company but only to enable them to perform their supervisory rights as shareholders in accordance with the concepts underlying the current legislation i.e. for 'corporate governance' not for buying and selling of shares purposes; and
(b) any other person and purpose to whom and for which they have, or are deemed to have, expressly or implicitly agreed to owe such a duty.

- Auditors' Liability

  The issue concerning proportionate liability for auditors should be referred to the Law Reform Commission for further study and consideration in the context of civil liability reform.

Corporate Regulation

The SCCLR recommended that statutory backing should be given to the Listing Rules together with tougher statutory sanctions including civil fines against non-compliance.

The SCCLR further recommended that consideration should be given to making the Companies Registry a fully-fledged corporate regulator, in the same way as the DTI in the UK, whose Companies Investigation Branch focused mostly on the investigation and regulation of private companies. Improvements should, however, be made on an incremental basis.

CHAPTER 2

Review of Section 157I of the Companies Ordinance : Civil Remedies for Contravention of Prohibited Loans (or similar transactions) to Directors under Section 157H

2.1 At the 170th meeting, members considered a discussion paper prepared by the Companies Registry on section 157I of the Companies Ordinance with regard to civil remedies for contravention of prohibited loans (or similar transactions) to directors under section 157H of the Ordinance. Members reached no conclusion on the matters raised but agreed that section 157I should be further reviewed together with other related provisions in the Ordinance in the context of the overall rewrite of the Companies Ordinance[21].

Background

2.2 During its deliberations on the legislative amendments to sections 157H and 157I as proposed in the Companies (Amendment) Bill 2002, the Bills Committee raised particular queries on the legislative intent and effect of section 157I. There were comments that the section was unclear in its meaning and unsatisfactory in so far as the protection of third parties interests was concerned. In view of the Bills Committee's concerns, the

[21] See chapter 6. The Government plans to commence to rewrite the Companies Ordinance in early 2005.

Administration agreed to look at the policy and drafting of section 157I and refer the matter to the SCCLR, taking into account the views of the Bills Committee and the UK equivalent of the provision, to which the Bills Committee had referred.

2.3 The Paper explained in detail the civil consequences of transactions contravening section 157H of the Companies Ordinance as presently provided under section 157I, the enactment history of the section, the policy intention behind, and the queries raised by the Bills Committee. The paper also set out a comparative review of how the contravention of similar prohibitions of financial assistance to directors was being dealt with in other jurisdictions including the United Kingdom, Australia and Singapore.

2.4 Members discussed the queries raised by the Bills Committee and in particular how the issue concerning protection of innocent third parties' interests could be addressed. Members reached no conclusion on the matter but agreed that the section should be further studied together with other related provisions in the Companies Ordinance in the context of the overall rewrite of the Companies Ordinance.

CHAPTER 3

Proportionate Liability for Auditors

3.1 At the 171st meeting, members agreed that the subject of proportionate liability should be referred to the Law Reform Commission for study and consideration in the context of civil liability reform.

Background

3.2 The issue on proportionate liability for auditors was first raised by the HKSA on 27 September 2001. On 16 April 2002, the HKSA made a formal written submission to the then Financial Services Bureau recommending that the existing system of joint and several liability should be replaced by one of proportionate liability.

3.3 At the 165th and 168th meetings of the SCCLR held on 7 December 2002 and 22 March 2003 respectively, the issue on proportionate liability was addressed by members in the context of the Corporate Governance Review and it was agreed that the issue should be separately considered by the SCCLR.

3.4 The Companies Registry produced a Discussion Paper on the subject of proportionate liability for the purpose of discussion. The paper mentioned that in recent years, the accounting profession had been increasingly concerned about the liability crisis emanating from an increasing amount of

litigation against auditors and the expansion of their liability. The profession had identified the existing joint and several liability regime as the most serious threat facing the independent audit function. Under the existing regime, auditors could be liable to fully compensate a plaintiff when their degree of fault was minor when compared to that of other defendants (e.g. directors at fault).

3.5 The paper described the system of proportionate liability, its development/consideration in other jurisdictions such as Australia, Canada, the United Kingdom and the United States, and analyzed the pros and cons of the system. Members' views were sought on whether the system should be introduced in Hong Kong for auditors and other professionals.

3.6 Members considered the paper and agreed that, as claims were primarily against directors, a proposal should be made to the Hong Kong Stock Exchange to make it a recommended best practice that directors should be required to purchase professional indemnity insurance.

3.7 Members further noted that the impact of joint and several liability amongst co-defendants was the same across all the professions. Consequently, the issue on proportionate liability had very wide implications which went beyond the ambit of company law. As a result, it was agreed that the issue on proportionate liability should be referred to the Law Reform Commission for further study and consideration in the context of civil liability reform. The referral was made on 28 November 2003. The Law Reform Commission was asked to give the matter priority.

CHAPTER 4

Promulgation on the Guidelines on Directors' Duties

4.1 At the 171st meeting, members reviewed the Draft Guidelines on Directors' Duties ("Guidelines") published in the Consultation Paper on Proposals made in Phase II of the Corporate Governance Review, having regard to the responses received from the public during the consultation exercise, and suggested minor amendments to the Guidelines and their promulgation methods. The Guidelines were published in January 2004 by the Companies Registry.

Background

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

4.3 In the Consultation Paper on Proposals made in Phase II of the Corporate Governance Review, the SCCLR published the Guidelines, laying out 11 general principles on which the public's views were sought. In response to the consultation exercise, which ended on 30 September 2003, 25 responses had been received.

4.4 The respondents generally welcomed the proposed non-statutory guidelines

on directors' duties although one respondent favoured a statutory approach.

4.5 Having regard to the responses received from the public, members made certain amendments to the Guidelines and suggested the following promulgation methods:-

- All newly appointed directors should be required to sign an acknowledgment of having read the Guidelines;

- The effect of the acknowledgment should be that the director had read and understood the Guidelines;

- A statement to the effect that "all directors of the company (no matter whether they had signed on the annual return) had been supplied with a copy of the non-statutory Guidelines on Directors' Duties" should be added to the annual return form; and

- A similar statement acknowledging receipt of the non-statutory Guidelines should be added to the Consent to Act form (Form D3), which is required to be completed and filed with the Companies Registry by every newly appointed director.

CHAPTER 5

Limited Liability Partnerships

5.1 At the 174th meeting, members recommended that a consultation exercise should be conducted to seek the public's views on limited liability partnerships ("LLPs") and to assess the level of public support for their introduction in Hong Kong.

Background

5.2 Members considered a Discussion Paper on Limited Liability Partnerships prepared by the Companies Registry. The paper addressed the problems of "deep pockets" and "unlimited liability" of professionals arising from the joint and several liability which was inherent in the partnership regime, and explained the concept of LLPs which had originated in the United States.

5.3 The Paper also discussed the development of LLPs in other jurisdictions such as the United States, the United Kingdom and Singapore and analyzed the advantages and disadvantages of LLPs. Members' views were sought as to whether LLPs should be introduced in Hong Kong in view of the problems relating to join and several liability and the recent developments regarding LLPs in other jurisdictions.

5.4 Members considered that, although LLPs were not necessarily an answer to the problems relating to joint and several liability, it was a global trend that should be duly regarded. After discussion, members recommended that a consultation exercise should be carried out to ascertain the public's views on LLPs. Members subsequently noted that the consultation exercise would be considered after further consultation and examination of the implications of the various issues arising from LLPs.

CHAPTER 6

Overall Review of the Companies Ordinance

(Progress Report No. 4)

6.1 At the 175th meeting, members considered a progress report on the Overall Review of the Companies Ordinance prepared by the Companies Registry. They agreed on the following key points on the process and procedure with regard to the proposal to rewrite the Companies Ordinance:-

- The rewrite of the Companies Ordinance should cover not only structural and drafting changes, but also more importantly, focus on the review of some of the concepts in order to modernize Hong Kong's company law to bring it into the 21st century.

- A decision would have to be reached on the overall structure of the new Companies Ordinance, before a decision could be made on how the existing Ordinance should be divided up amongst the Working Groups to ensure that all the provisions within one Working Group's ambit would be considered in a consistent manner with all other related provisions within another Working Group's ambit so that no part would be left unattended.

- Draft terms of reference for the rewrite of the Companies Ordinance should be prepared.

- The rewrite of the Companies Ordinance should be done within government.

Background

6.2 The Overall Review of the Companies Ordinance ("ORCO") by the SCCLR resulted in 62 recommendations for legal reform. These have been divided into four phases, namely Phases I to IV, for follow-up action.

6.3 All the recommendations in Phase I have already been enacted into law through the Companies (Amendment) Ordinance 2003. Some of the recommendations in Phases II (corporate governance-related) and III have been included in the Companies (Amendment) Ordinance 2004. The remaining corporate governance-related recommendations will be the subject of a further companies amendment bill in 2005. The rest of the recommendations cannot, by their nature, proceed in the context of stand-alone companies amendment bills and will have to proceed in the overall rewrite of the Companies Ordinance.

6.4 The Progress Report summarized the development of the ORCO and the present position with regard to the Corporate Governance Review undertaken by the SCCLR, the Review of Accounting and Auditing Provisions of the Companies Ordinance undertaken by the Joint

Government/HKSA Working Group and the consultation study on No Par Value shares. The Report also contained a brief account of parallel company law reviews in other jurisdictions and set out a preliminary plan as to how the rewrite of the Companies Ordinance should be tackled.

6.5 Members considered the proposed structure and time-table of the rewrite, the proposed allocation of responsibilities between the working groups and the financial and resource implications of the whole project.

6.6 Members agreed inter alia to the key points on process and procedure as mentioned in paragraph 6.1 (above).

CHAPTER 7

Imposition of a "Leave Requirement" for the Commencement of the Proposed Statutory Derivative Action

7.1 At the 176th (special) meeting, members reviewed a recommendation previously made by the SCCLR to introduce a statutory derivative action, and considered a proposal made by the Bills Committee set up by the Legislative Council to scrutinize the Companies (Amendment) Bill 2003 to impose a "leave requirement" for the commencement of such action. Members were mostly of the view that :-

- there should be no "trial within a trial" for the purpose of determining the standing of an applicant to commence a derivative action on behalf of the company;

- if a leave requirement was unavoidable, the threshold should be set at a meaningfully low level.

Background

7.2 In its Consultation Paper on Proposals made in Phase I of the Corporate Governance Review, the SCCLR proposed, inter alia, the introduction of a statutory derivative action to make it clear that there would be no "trial

within a trial" for the purpose of determining the standing of an applicant to commence a derivative action on behalf of the company.

7.3 The proposal was accepted by the Government and incorporated into the Companies (Amendment) Bill 2003 which was introduced into the Legislative Council on 25 June 2003.

7.4 The Bills Committee set up by the Legislative Council to scrutinize the Bill was concerned that the "no leave" arrangement for the commencement of statutory derivative action as proposed under the Bill might result in the proliferation of derivative actions. It strongly recommended that a leave requirement should be imposed.

7.5 Having heard the views of the Bills Committee members, the Administration considered that a leave requirement would, prima facie, serve to discourage frivolous derivative actions. The Financial Services and the Treasury Bureau sought the SCCLR's views on 5 March 2004 on the proposal made by the Bills Committee to insert a "leave requirement" for the commencement of statutory derivative action.

7.6 In response, the SCCLR held a special meeting on 8 March 2004 to discuss the proposal. Members generally felt that the statutory derivative action procedure as drafted in the Bill did not reflect the intention of the SCCLR's recommendation i.e. to clarify the law, remove uncertainties and facilitate derivative action. They were mostly of the view that there should be "no trial within a trial" for the purpose of determining the standing of the

applicant to commence a derivative action on behalf of the company. However, if a leave requirement was unavoidable, members considered that the threshold should be set a meaningfully low level to reduce the risk of the leave application being turned into a "trial within a trial".