Standing Committee on Company Law Reform

The Twenty-Second Annual Report

2005/2006

Standing Committee on Company Law Reform
Twenty-Second Report
Subjects considered by the
Standing Committee during 2005/2006

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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[Note 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 2005/2006

Chairman : Mr Benjamin YU, SC, JP

Members :

Mr Randolph G SULLIVAN	(up to 31.1.2006)
Mr Peter WONG Shiu-hoi	(up to 31.1.2006)
Mr Michael W SCALES	
Mr William TAM Sai-ming	
Mr John POON Cho-ming	
Mr David P R STANNARD	
Ms Teresa KO Yuk-yin	
Mr Godfrey LAM Wan-ho	
Mrs Vanessa STOTT	

[Note 1] These two Ordinances were consolidated into the Securities and Futures Ordinance which commenced on 1 April 2003.

		Mr Carlson TONG	
		Mr Paul F WINKELMANN	
		Mr Patrick WONG Chi-kwong	
		Mr Stephen HUI Chiu-chung, JP	(from 1.2.2006)
Ex-Officio		Mr Andrew YOUNG	
Members	:	Chief Counsel, Legal Services Division	
		The Securities & Futures Commission	
		Mr Paul CHOW	
		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 William RYBACK	
		Deputy Chief Executive	
		The Hong Kong Monetary Authority	
		Ms Emma Lau, JP	(up to 14.6.2005)
		Deputy Secretary for Financial Services and the Treasury	
		Mr Albert Lam	(from 15.6.2005)
		Deputy Secretary for Financial Services and the Treasury	(up to 10.2.2006)
		Mr John Leung	(from 11.2.2006)
		Deputy Secretary for Financial Services and the Treasury	

Secretary : Mr Edward LAU

(iii)

Meetings held during 2005/2006

One Hundred and Eighty-Ninth Meeting	-	2 April 2005
One Hundred and Ninetieth Meeting	-	28 May 2005
One Hundred and Ninety-First Meeting	-	25 June 2005
One Hundred and Ninety-Second Meeting	-	17 September 2005
One Hundred and Ninety-Third Meeting	-	5 November 2005
One Hundred and Ninety-Fourth Meeting	-	10 December 2005
One Hundred and Ninety-Fifth Meeting	-	11 February 2006

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 ("CO") 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 2005 to 31 March 2006, the SCCLR held seven meetings, of which about half were spent on examining the proposals and recommendations made by the Joint Government/Hong Kong Institute of Certified Public Accountants ("HKICPA") Working Group ("JWG") set up to review the accounting and auditing provisions of the CO, including a paper on matters previously considered by the SCCLR but referred back to the JWG for further study; and two other papers on the JWG's proposals in respect of the directors' remuneration and directors' report provisions in the CO [Note 2].

Another subject which occupied a significant amount of the SCCLR's time was the consultation paper issued by the Securities and Futures Commission ("SFC") on possible reforms to the prospectus regime in the CO. The SCCLR spent two meetings discussing in detail each of the 21 proposals set out in the Consultation Paper and made a formal submission to the SFC.

During the reporting period, the SCCLR also considered one other consultation paper issued by the Financial Services and the Treasury Bureau on the legislative proposals to establish the Financial Reporting Council and a paper submitted by the Companies Registry on section 5 of the CO and the problems relating to the registration of hybrid company names.

Note 2 The Administration's current plan is to launch a public consultation on the JWG's major recommendations in early 2007 before taking a final view on them in the light of the comments received during the consultation.

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

Chapter	Subject Matter	Recommendations/Remarks
1	Consultation Paper on Legislative Proposals to Establish the Financial Reporting Council	Members were generally in support of the proposals to establish the Financial Reporting Council, underpinned by the Audit Investigation Board and Financial Reporting Review Committees, to investigate irregularities committed by auditors or reporting accountants of listed entities in auditing accounts and in preparing financial reports for prospectuses or other listing documents, and to enquire into non-compliance of financial reports of such entities with the relevant legal, accounting or regulatory requirements. They put forward a number of recommendations on specific issues, including the setting up of a legal cost reclaim mechanism and the expansion of the remit of the Audit Investigation Board and the Financial Reporting Review Committees.
2	Review of Section 5 of the Companies Ordinance in respect of the Registration of Hybrid Company Names	Members were mostly of the view that hybrid company names should be allowed and that protection of intellectual property rights should not be a factor to be taken into account in determining the registrability of a company name.
3	Matters regarding the Draft Drafting Instructions and the Mock-Up of the Accounting and Auditing Provisions of the Companies Ordinance that are referred by the Standing Committee on Company Law Reform to the Joint Government/Hong Kong Institute of Certified	Members agreed that :- • The meaning of the word "account" in the definition of the terms "book and paper" and "book or paper" in section 2 of the CO should be clarified. • Subject to certain proposed changes, the JWG's proposal to impose a declaration requirement on directors with regard to financial statements should in principle be supported.

Chapter	Subject Matter	Recommendations/Remarks
	Public Accountants Working Group for Further Consideration and Provisions in the Singaporean Companies Act and the Australian Corporations Act 2001 that are referred to the Standing Committee by the Joint Working Group for a Steer	• Section 129D(3)(g) of the CO should be further reviewed in the context of directors' report and the operating and financial review ("OFR"). • The appointment of a provisional liquidator of a company should not be a situation under which the office of an auditor would cease. • A new provision should be added to the CO to empower the court to grant an inspection order for somebody to inspect the accounts of the company on behalf of the directors, similar to section 199(5) of the Singaporean Companies Act and sections 290(2) – (4) of the Australian Corporations Act 2001.
4	Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance	Members agreed that the proposals set out in the Consultation Paper had rightly focused on a number of important issues where significant improvement was required. However, as many of these issues were inter-linked with each other (e.g. pre-deal research, incorporation by reference, the 3-day rule etc.), they should more appropriately be looked at, as a whole, within the wider context of a formal review of the offering structure and process in Hong Kong. Members also felt strongly that Part IV of the Securities and Futures Ordinance ("SFO") should be reviewed as part and parcel of the current exercise, and raised the following specific points :- • There were a lot of anomalies, inequities and unfairness in the current offering structure and process which the SCCLR

Chapter	Subject Matter	Recommendations/Remarks
		believed to be the cause of many of the issues identified in the Consultation Paper. A formal review of the offering structure and process should be undertaken to address these anomalies and inequities. • There was an urgent need to reduce the bulk of the prospectus by including in it only important and necessary information. • A lot of information could be standardized and removed from a prospectus or incorporated into it by reference. This should be implemented as soon as possible.
5	Draft Drafting Instructions in respect of the Directors' Remuneration Provisions in the Companies Ordinance and Mock-Up of the Proposed Directors' Remuneration Provisions Prepared by the Joint Government/Hong Kong Institute of Certified Public Accountants Working Group	Members endorsed the following proposals made by the JWG :- • Improving the provisions on directors' remuneration to make them more user-friendly. • Adopting with modifications, the UK provisions on directors' remuneration, including the placing of the principal disclosure requirements in the body of the CO and the details in the schedules and the division of the detailed disclosure requirements into four parts. • Requiring more information regarding directors' remuneration from listed companies. • Retaining most of the disclosure requirements under the current section 161B of the CO. • Not adopting certain UK provisions on directors' remuneration, including the drawing of a distinction between "quoted" and "unquoted" companies for determining the information required to

Chapter	Subject Matter	Recommendations/Remarks
		be disclosed; the requirement to disclose a statement of the company's policy on directors' remuneration and a performance graph etc. • Implementing the SCCLR's recommendations in Phase II of the Corporate Governance Review:- – to require listed companies to disclose individual directors' remuneration packages by name in their annual financial statements. – to require unlisted public companies and private companies to make similar disclosures if directed to do so by 5% or more of the companies' shareholders. • Adopting, with modifications, the UK provisions regarding the approval and signing of the directors' remuneration report. • Shareholders' approval of the directors' remuneration report should not be required. Members rejected the JWG's proposal to introduce a two-tier approach in respect of the disclosure requirements regarding directors' emoluments for unlisted companies. However, they agreed that provisions regarding directors' remuneration and the directors' remuneration report should apply to non-Hong Kong listed companies, not by giving extra-territorial effect to the relevant provisions in the CO, but by including them in the Listing Rules and giving them statutory backing.

Chapter	Subject Matter	Recommendations/Remarks
		In addition, members also raised concerns on a number of practical issues and on the mock-up of the proposed directors' remuneration provisions.
6	Draft Drafting Instructions in respect of the Directors' Report Provisions in the Companies Ordinance and Mock-Up of the Proposed Directors' Report Provisions Prepared by the Joint Government/Hong Kong Institute of Certified Public Accountants Working Group	Members endorsed the first eight proposals as listed below made by the JWG and support, in principle, the last two :- • The OFR should be dealt with by incorporating the relevant requirements in the Listing Rules and giving statutory backing to these Rules. • Improving the provisions on the directors' report to make them more user-friendly and comprehensible. • Adopting, with modifications, certain UK provisions on the directors' report, including placing the principal requirements in the body of the Ordinance and the detailed disclosure requirements in the schedules to enable easy amendment. • Directors of companies not falling within section 141D of the CO should be required to include in the directors' report a business review of the company save as in specified circumstances. • The total amount of donations made by the company for whatever purposes, if not less than $10,000, should be stated in the directors' report. • Section 234(3) of the UK Companies Act, which suggested what should be given greater emphasis in a group directors' report, should not be adopted. • Sections 300(8) and (9) of the Australian Corporations Act 2001 concerning the

Chapter	Subject Matter	Recommendations/Remarks
		inclusion of information regarding indemnities and insurance premium for officers or auditors in the directors' report should not be adopted. • Section 307C of the Australian Corporations Act 2001 on auditor's independence declaration should not be adopted. • Material information relating to environmental and employee matters should be given in the business review of the directors' report. • Section 234ZA of the UK Companies Act concerning directors' statements as to disclosure of information to auditors should be adopted. They agreed also, subject to modifications, the following recommendations made by the JWG:- • Certain specified important information should be stated in the directors' report in a conspicuous and express fashion. • All companies, save as private companies falling within section 141D of the CO or private companies with unanimous shareholders approval, should be required to produce a directors' report which complied with all the directors' report requirements. Dormant companies should, however, be exempted. • Equity-linked agreements should be required to be disclosed in a directors' report if there was a possibility that the issuance of shares under such agreements had a potential to dilute the existing shareholders' interests.

Chapter	Subject Matter	Recommendations/Remarks
		• Paragraph 1 of Schedule 7 of the UK Companies Act should be adopted provided that the values of non-current assets based on the directors' honest and reasonable opinion should be included as a matter to be dealt with in a directors' report.

CHAPTER 1

Consultation Paper on Legislative Proposals to Establish the Financial Reporting Council

Background

1.1 In December 2002, the Secretary for Financial Services and the Treasury requested the then Hong Kong Society of Accountants ("HKSA") (now the HKICPA) to put forward proposals to strengthen the regulatory regime for the profession. One of the HKSA's key proposals [Note 3] was to set up an independent investigation board to investigate irregularities of auditors of listed corporations. Besides, the Administration, together with relevant parties, had also stated that a financial reporting review panel should be established to check the compliance of financial reporting of listed corporations with relevant accounting requirements.

1.2 In September 2003, the Administration conducted the first round of consultation to gauge the views of the public on the broad proposals[Note 4]. In the light of the strong support received, the Administration worked out the detailed proposals in consultation with the HKICPA, SFC and Hong Kong Exchanges and Clearing Limited ("HKEx") and put them for a second round of consultation in late February 2005 under a Consultation Paper entitled "Legislative Proposals to Establish the Financial Reporting Council". The second round of consultation, which ended on 15 April 2005, indicated strong public support for the establishment of the Financial Reporting Council ("FRC").

1.3 At the 189th meeting held on 2 April 2005, members considered the detailed proposals set out in the Consultation Paper on Legislative Proposals to Establish the FRC.

Note 3 Parts of the proposals relating to the governance of the HKICPA have been effected through the Professional Accountants (Amendment) Ordinance 2004 which provides for the Chief Executive's appointment of lay persons to the governing Council and the Investigation and Disciplinary Panels of the HKICPA with a view to enhancing the independence and transparency of the relevant bodies. The relevant part of the Amendment Ordinance came into effect in November 2004.

Note 4 A Consultation Paper entitled "Proposals to Enhance the Oversight of the Public Interest Activities of Auditors and Establish a Financial Reporting Review Panel" was issued in September 2003.

Recommendations

1.4 Members were generally in support of the legislative proposals:—

(i) to establish a FRC to investigate irregularities committed by auditors or reporting accountants of listed entities in auditing accounts and in preparing financial reports for prospectuses or other listing documents, and to enquire into non-compliance of financial reports of such entities with the relevant legal, accounting or regulatory requirements; and

(ii) to establish an Audit Investigation Board ("AIB") and Financial Reporting Review Committees ("FRRCs") to carry out such investigations and enquiries respectively.

They recognized also that, if the proposed FRC was to be successful, it must be adequately funded[Note 5] and gain public recognition and acceptance through achieving demonstrable results in good time.

1.5 They were also shown, for reference, a set of draft drafting instructions in relation to the proposed consequential amendments to the CO. The amendments were to provide for the voluntary revision of accounts to ensure compliance of company accounts with the relevant accounting requirements, and followed basically the recommendation of the SCCLR as set out in paragraph 29.10 of the Consultation Paper on Proposals made in Phase I of the Corporate Governance Review published in July 2001.

1.6 In addition, members discussed and made recommendations regarding a number of specific issues as follows :-

- The remits of the AIB and the FRRCs should be expanded to cover situations where financial reports would be required to be prepared and widely circulated.

- A legal cost reclaim mechanism should be established to enable the HKICPA to recover costs in relation to cases referred to them by the

Note 5 The Companies Registry ("CR") Trading Fund, HKICPA, SFC and HKEx have agreed to each contribute $2.5 million per annum to the funding of the FRC for the first three years, plus a contribution of $5 million to set up a "Reserve Fund". Moreover, the CR will provide the FRC with accommodation free of charge.

FRC for taking disciplinary proceedings.

- There should be clear provisions in the FRC Ordinance: –

    - ✧ to give a FRRC discretion to decide whether to take a "pro-active approach" in performing its functions;
    - ✧ to permit cross referral of cases between the AIB and a FRRC;
    - ✧ to enable the FRC to engage full time staff to assist in the work of the AIB and a FRRC; and
    - ✧ to enable the FRC to refer those matters beyond its remit to other relevant authorities for follow-up action.

- Whether the FRC should be empowered to publish AIB/FRRC investigation reports.

- Whether the FRC could refer a case or disclose relevant information obtained to liquidators.

CHAPTER 2

Review of Section 5 of the Companies Ordinance in respect of the Registration of Hybrid Company Names

Background

2.1 According to the existing section 5(1) of the CO enacted in 1997, every company, which is limited by shares or guarantee, must have a name which may be in English or Chinese, or in both languages with a reference to its limited liability[Note 6].

2.2 Since at least the early 1950s, hybrid company names made up of Roman letters and Chinese characters, numbers or symbols, had been accepted for registration by the Registrar of Companies on a case merit basis, in the absence of a specific provision governing the registration of Chinese names in the former section 5(1). However, this practice ceased in July 2002 following the advice of the Department of Justice that hybrid company names should not be accepted for registration under existing section 5(1) because hybrid company names were incompatible with the requirements stipulated in section 5 of the CO. A formal circular to notify the public that the practice had ceased with immediate effect was issued on 8 July 2002[Note 7].

2.3 The discontinuance of the practice has not, however, brought to an end legal arguments relating to the registrability of hybrid company names. Applications have continued to be received by the Registrar challenging his decision not to register hybrid names. Coupled with this problem are the problems relating to the proliferation of "shadow" companies in Hong Kong, a term informally used to refer to locally incorporated companies usually with mainland directors and shareholders and with company names containing famous brand names or logos. The main purpose of incorporating such "shadow" companies is to "franchise" or "license" the

Note 6 Section 5(1) of the CO provides that the memorandum of every company limited by shares or by guarantee must state the name of the company and
(a) if the name is in English, with "Limited" as the last word of the name;
(b) if the name is in Chinese, with "有限公司" as the last 4 Chinese characters of the name and
(c) if the name is both in English and Chinese, with "Limited" as the last word of the name in English and "有限公司" as the last 4 Chinese characters of the name in Chinese respectively.

Note 7 Companies Registry External Circular No. 1/2002 issued on 8 July 2002.

company name which incorporate famous brand names or logos to another Mainland company which is involved in manufacturing and selling of counterfeit goods bearing famous brand names and logos. In order to put the matter entirely beyond doubt and to help restrain the growth of "shadow" companies in Hong Kong, the Registrar proposed that section 5 of the CO be amended to make it clear that a company could not be registered with a hybrid name.

Recommendations

2.4 At the 190th meeting on 28 May 2005, the SCCLR considered the registration of hybrid company names, including the arguments for its adoption such as facilitating the conduct of business by international companies, and those against its adoption such as the proliferation of "shadow" companies in Hong Kong.

2.5 Members were mostly of the view that hybrid company names should, as a matter of policy, be allowed as there was a genuine need in some cases such as conducting business by international companies even though it might lead to administrative difficulties and aggravate the problems of "shadow" companies. In addition, they firmly believed that protection of intellectual property rights ("IPR") should not be a factor to be taken into consideration in determining the registrability of a company name.

2.6 Members suggested that the matter should be further considered in the context of the rewrite of the CO, taking into account particularly the following points :-

- Whether the policy on prohibition of hybrid company names should be changed;
- Whether the prohibition should be absolute or conditional;
- The extent of power that should be given to the Registrar in approving company names for registration; and
- Whether it should be expressly stated in the law that the fact of registration of a company name should not be pleaded as any evidence of the legality of the activities of the concerned companies or any IPR related matter.

CHAPTER 3

Matters regarding the Draft Drafting Instructions and the Mock-Up of the Accounting and Auditing Provisions of the Companies Ordinance that are referred by the Standing Committee on Company Law Reform to the Joint Government/Hong Kong Institute of Certified Public Accountants Working Group for Further Consideration and Provisions in the Singaporean Companies Act and the Australian Corporations Act 2001 that are referred to the Standing Committee by the Joint Working Group for a Steer

Background

3.1 At the SCCLR's 185th and 186th meetings held on 27 November and 8 December 2004, the SCCLR considered the draft drafting instructions ("DDIs") and the mock-up of the accounting provisions of the CO prepared by the JWG and raised queries on several matters which it considered should be referred back to the JWG for further consideration[Note 8].

3.2 At the SCCLR's 187th meeting held on 29 January 2005, the SCCLR considered the DDIs and the mock-up of the auditing provisions of the CO[Note 9]. It was suggested that the JWG should ensure that the proposed provision on cessation of office of an auditor upon the appointment of a liquidator should expressly exclude a provisional liquidator.

3.3 The JWG met subsequently to consider the matters raised. They accepted some of the suggestions made by the SCCLR and made a number of refinements to their original proposals. In addition, the JWG found, in the course of their review, some provisions in other jurisdictions relating to corporate governance issues which, they considered, should be adopted in Hong Kong. They took the liberty to refer the provisions to the SCCLR for a steer even though the provisions were outside the JWG's remit.

Note 8 For details, see Chapter 6 of the 21st Annual Report of the SCCLR for the year 2004/2005 (available at the website: http://www.cr.gov.hk/en/standing/reports.htm).

Note 9 For details, see Chapter 7 of the 21st Annual Report of the SCCLR for the year 2004/2005.

Recommendations

3.4 At the 191st meeting on 25 June 2005, the SCCLR considered a paper which set out, in the first part, the JWG's revised proposals or responses to the matters referred back to them for further consideration by the SCCLR and, in the second part, provisions in the Singaporean Companies Act and the Australian Corporations Act 2001 that were referred to the SCCLR by the JWG for a steer.

3.5 As a result of the discussion, members agreed, inter alia, the following:-

- The meaning of the word "account" in the definition of the terms "book and paper" and "book or paper" in section 2 of the CO[Note 10] should be clearly defined to avoid any confusion that might arise as a result of the JWG's proposal to change the word "accounts" in the CO to "financial statement".

- The JWG's proposal to impose a declaration requirement on directors with regard to financial statements[Note 11] should in principle be supported subject to the following :-

  - ✧ It should be made clear that the primary responsibility in relation to the preparation of financial statements was on the board as a whole, with appropriate saving for dissenting directors.

  - ✧ Information with regard to dissenting votes against the resolution to make the required declaration should be disclosed to the shareholders so that they could raise

Note 10 "Book and paper" and "book or paper" is defined in section 2 of the CO as including "accounts, deeds, writings and documents".

Note 11 The JWG proposed that a new provision should be added to require that every set of annual financial statements laid before a company in general meeting should be accompanied by a directors' declaration stating whether in their opinion –

(a) the financial statement gave a true and fair view of the financial position and financial performance of the company; and

(b) there were reasonable grounds to believe that the company would be able to pay its debts as and when they fell due.

The proposed provision was based on sections 295(4) of the Australian Corporations Act 2001 and the requirement under (b) differs from a more onerous declaration that the company is able to pay its debts as and when they fall due. According to Practice Note 22 issued by the Australian Securities and Investment Commission on preparing the directors' declaration, the director could, in appropriate cases, qualify the statement or make a negative statement stating that the company is unable to pay its debts as and when they fall due.

questions at the general meeting.

- ✧ The threshold for criminal and civil liability for non-compliance with the declaration requirement and for making false statements should be further studied.

- The JWG's proposal with regard to section 129D(3)(g) of the CO[Note 12] should be further reviewed in the context of the directors' report and the OFR.

- The proposed provision setting out the circumstances under which the office of an auditor would cease should be amended to exclude the appointment of a provisional liquidator of a company.

- A new provision similar in effect to section 199(5)[Note 13] of the Singaporean Companies Act and sections 290(2), (3) and (4) of the Australian Corporations Act 2001 should be added to the CO to empower the court to grant an inspection order for somebody to inspect the accounts of the company on behalf of the directors.

Note 12 Subsection 129D(3)(g) of the CO requires that if in a financial year, the company has issued any shares, the directors' report shall state the reason for making the issue, the classes of shares issued and, as respects each class of shares, the number issued and the consideration received by the company for the issue. The JWG recommended that this subsection should be retained while some other subsections under section 129D(3) should be removed because they were concerned with matters which had already been covered by the accounting standards. The SCCLR suggested that subsection 129D(3)(g) should be expanded to include equity-linked assets.

Note 13 Section 199(5) of the Singaporean Companies Act provides as follows :-

"(5) The Court may in any particular case order that the accounting and other records of a company be open to inspection by a public accountant acting for a director, but only upon an undertaking in writing given to the Court that information acquired by the public accountant during his inspection shall not be disclosed by him except to that director."

Section 290(2), (3) and (4) of the Australian Corporations Act 2001 provides as follows :-

"(2) On application by a director, the Court may authorise a person to inspect the financial records on the director's behalf.

(3) A person authorised to inspect records may make copies of the records unless the Court orders otherwise.

(4) The Court may make any other orders it consider appropriate, including either or both of the following:

(a) an order limiting the use that a person who inspects the records may make of information obtained during the inspection;

(b) an order limiting the right of a person who inspects the records to make copies in accordance with subsection (3)."

CHAPTER 4

Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance

Background

4.1 On 29 August 2005, the SFC released a Consultation Paper launching the final phase of a three-part review and reform exercise designed to modernize the regime governing the public offering of shares and debentures set out in the CO. The overriding purpose of the three-part review was to encourage capital raising and the issue of securities in Hong Kong by adjusting and refining the legal framework to facilitate offers while ensuring satisfactory standards of investor protection.

4.2 The Consultation Paper on Possible Reforms to the Prospectus Regime in the CO was basically a "concept release" designed to promote discussion and feedback. It contained 21 proposals covering a wide range of subjects, some of which, such as, pre-deal research; the extension of the right to claim compensation for losses resulting from untrue statements in a prospectus to secondary market purchasers; and removal of the need to prove that the investor had relied on the prospectus, were complex or challenging and would present a range of possible solutions.

4.3 At the 192nd and 194th meetings held respectively on 17 September 2005 and 10 December 2005, members considered the 21 proposals as set out in the Consultation Paper.

Recommendations

Proposal 1 – Transfer the CO prospectus regime to the SFO [Note 14]

4.4 Members agreed with the proposal and had no strong views on whether the prospectus regime should be placed in either a separate ordinance or the SFO.

[Note 14] This proposal followed-up the recommendation made by the SCCLR in its Report on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance published in February 2000 that provisions regulating prospectuses be removed from the CO and placed in securities regulations (paragraph 5.77 and recommendation 38 of the Report).

Proposal 2 –Regulate the act of offering rather than the document containing the offer

4.5 Members agreed that the focus of the prospectus regime should be changed from a "document-based" approach to a "transaction-based" approach.

Proposal 3 – Scope of the prospectus regime should be extended to cover options or other rights

4.6 Members agreed in principle with the proposal but suggested that the matter should be further examined when the details were available, as practical complications might arise, particularly with warrants, which must be remedied at the same time.

Proposal 4 – Scope of the prospectus regime should apply to "bodies" rather than "companies"

4.7 Members agreed generally with the proposal subject to the following caveats :-

- practical issues were likely to arise in relation to the formulation of the carving out and exemption provisions;

- the design process must be very carefully carried out, taking into account all the relevant factors, including any possible knock-on effects.

Proposal 5 – Merger of the CO prospectus regime with the SFO investment advertisement regime to create an unified offering regime

4.8 Members agreed in principle with the proposal that there should be an unified regime for all regulated investment arrangements and instruments currently falling under the CO prospectus regime and the SFO instrument advertisement regime. They queried, however, the appropriateness of making the CO prospectus regime a code under the SFO and suggested that the public should be further consulted on this issue when the details were available.

4.9 Members agreed that the meaning of the term "debenture" should be clarified but doubted if that could be achieved by replacing the reference to "other securities" with "other debt securities"[Note 15].

[Note 15] Please see paragraph 9.11 of the Consultation Paper.

Proposal 6 – Exempt from the CO prospectus regime offers made to holders of shares or debentures in the context of a takeover or merger or under a scheme of arrangement if the offers are in compliance with the law of the company's home jurisdiction

4.10 Members agreed that the proposal, in trying to ensure that Hong Kong investors in an overseas company were not excluded from offers that complied with the company's home market standards, was good in principle. However, members felt uncomfortable about giving definite support because the matter was more complicated than it appeared. In this respect, there might be situations where Hong Kong investors were unable to make a reasonable decision because the information requirements in the company's home jurisdiction were totally inadequate. A blanket rule might not therefore be the right answer.

Proposal 7 – Adjust anti-avoidance mechanism to prevent circumvention of the offering regime via offers for sale in circumstances where the transaction should be subject to full regulation

4.11 Members agreed that the problem relating to section 41 of the CO[Note 16] was one which had to be addressed. However, it was premature at this stage to make any specific comments on the appropriateness of the proposed exemptions and carve-outs because they were matters of detail which should be dealt with only when the draft legislation was available for consideration.

Proposal 8 – Alter scope of prospectus liability regime to include issuers, sponsors and persons who accept responsibility for prospectus and remove promoters and persons who authorize the issue of prospectus

4.12 Members agreed that the prospectus liability issue should be clarified. However, they considered it more appropriate for the whole issue to be looked at separately from the present exercise because the whole area of prospectus liability was unsatisfactory. In this respect, Hong Kong should make reference to the regulatory requirements in the UK and the US. Any move to subject entities listed in Hong Kong to a higher level of liability than the entities listed elsewhere would diminish the competitiveness of Hong Kong in attracting listings.

Note 16 Where an offer to the public for the sale of shares or debenture is to be made in any document, pursuant to an allotment or an agreed allotment of shares or debenture in a company, that document will be deemed by section 41 to be a prospectus. Consequently, the provisions of the CO relating to prospectuses will apply.

Proposal 9 – Extend the classes of persons who may claim compensation for a misstatement in a prospectus to secondary market purchasers

4.13 Members were of the view that this area was extremely difficult and Hong Kong should avoid implementing measures in this respect unless they had already been implemented elsewhere and proved successful.

4.14 In any event, if the right to claim compensation for losses resulting from misstatements in a prospectus were to be extended to secondary market purchasers, consideration should be given to capping the liability.

Proposal 10 – Remove the requirement for claimants to prove actual reading and reliance on the prospectus

4.15 Members disagreed with the proposal to remove the requirement for the claimants to prove that they had relied on the prospectus in a claim for compensation for losses resulting from misstatements in a prospectus. The proposed removal would have the effect of discouraging investors from reading the prospectus while, at the same time, encouraging them to lay claims for compensation whenever a misstatement occurred in a prospectus.

Proposal 11 – Provision of due diligence defence for those liable

4.16 Members agreed that there should be a due diligence defence but had reservations on establishing it on an "all reasonable inquiries" basis. Such a basis was too onerous and might lead to endless search on the part of those involved in the preparation and issue of prospectuses.

Proposal 12 – Move "overall disclosure standard" for a prospectus to the body of legislation and supplement the standard with prescribed contents requirements in subsidiary legislation

4.17 Members considered it inappropriate to decide on whether the overall disclosure standard and contents requirements as set out in the Third Schedule to the CO[Note 17] should be adopted without also reviewing Part IV of the SFO. They recommended strongly that Part IV of the SFO[Note 18] should also be reviewed in the harmonisation process so that the new investment products regime would be an improved self-contained regime. The ideal structure for the new regime would be one having different codes for different investment products which clearly laid down all the requirements.

[Note 17] The Third Schedule contains details as to matters to be specified in prospectus and reports to be set out therein.

[Note 18] Part IV of the SFO deals with offers of investments.

4.18 Members objected to any intended move on the part of the SFC to simply include everything else in the existing SFO investment products regime. They considered it important to consider the issue holistically and get everything right.

Proposal 13 – Prospectus for rights issues should comply with reduced (rather than negligible) content requirements

4.19 Members agreed in principle with the proposal but had reservations on the application of the "overall disclosure standard"[Note 19] to the reduced disclosure obligation. The application of such a standard might give people the impression that the company had to disclose everything in a rights issue prospectus to its existing shareholders or debenture holders, including information which had previously been published and was already in the public domain. Instead, members believed that the company should only be required to update information as was presently required under the Listing Rules. This could be achieved by adding a provision in the CO requiring compliance with the relevant Listing Rules. Rights issues by public unlisted companies should be dealt with in the same way. However, the way in which the relevant Listing Rules were to be applied to public unlisted companies should be further studied.

Proposal 14 – Incorporation by reference should be permitted

4.20 Members generally supported the idea of permitting information located outside the prospectus to be incorporated in the prospectus by reference. This would help address the current problems relating to prospectus length and complexity. Furthermore, they believed that some common information in all prospectuses, such as instructions on how to apply for shares, Bermudan law, property valuation reports (save in the situation where the issuer was a property developer), could and should either be standardised so that there was no need to include such information in the prospectus, or incorporate it by reference.

4.21 Care must, however, be taken in the process so that the description of the information incorporated by reference in the prospectus was either not as lengthy as the actual document itself or only marginally shorter.

[Note 19] Please see paragraph 23.3 of the Consultation Paper.

4.22 Clear guidelines should be provided as to what information could be incorporated by reference in the prospectus. In this respect, the UK guidelines could be used as a reference model.

4.23 It was important also that incorporation by reference should only be used as a stopgap and should never be allowed to replace the need to look at the necessity of including a certain item of information in the prospectus. If the information was not necessary or important, it should be excluded.

Proposal 15 – Publication of pre-deal research reports if the research enters the public arena or prohibition of pre-deal research by connected analysts

4.24 Members agreed that publication of pre-deal research should, in the long term, be totally banned, because there should be equal and fair access to all investors (both institutional and retail) of material information. As the current law already prohibited the publication of pre-deal research, the regulators should seriously consider taking appropriate enforcement action after giving sufficient prior notice to the market.

4.25 In order to ensure that there was more timely information to assist potential investors in making investment decisions, members proposed that draft prospectus should be permitted to be publicly filed shortly prior to the opening of the offers. Furthermore, they urged that serious consideration should also be given to shorten and reduce the length and size of the prospectus so that it became more readable which, in turn, would assist in resolving the pre-deal research problem because potential investors would read the prospectus in the first place. In their view, this was something which could be done very quickly by cutting out unnecessary information such as property valuation reports currently mandated by the Third Schedule and through incorporation by reference.

Proposal 16 – Supplemental prospectus should be published if there is a significant change and rights of withdrawal should be provided to the applicants in such circumstances

4.26 Members agreed that there should be a statutory obligation on the part of the issuer of prospectus to publish a supplemental prospectus if it became aware of a significant change affecting any of the prospectus disclosures. Care must, however, be taken in determining what should be regarded as a

significant change and who should make that judgment.

4.27 Whether investors should be given the right to withdraw in the case of an issuer publishing a supplemental or replacement prospectus as a result of a significant change, would very much depend on how far it was considered necessary to protect investors' rights. As a matter of general principle, investors should not be allowed to back out from their investment risks.

Proposal 17 – Remove or extend the 3-day rule[Note 20]

4.28 Members were of the view that the real problem here was not so much the length of the minimum waiting time in the prospectus regime for allotments but the amount and usefulness of the information in the prospectus coupled with the inflexibility of the current present offering structure.

4.29 The 3-day rule was merely a part of the whole offering structure and process which was full of anomalies, inequities and unfairness (e.g. retail investors were required to pay upfront before allotment while institutional investors did not have to pay until shares were formally allotted to them). Members did not consider it right that the 3-day rule should be isolated and looked at on its own. Instead, they believed that the offering structure and process, as a whole, should be formally reviewed with a view to placing all investors effectively on the same time-scale and providing them with the same amount of information.

4.30 As many of the issues raised in the Consultation Paper were inter-linked and were basically problems caused by the offering structure and process (e.g. pre-deal research, incorporation by reference, the 3-day rule etc.), they should be looked at together within the wider context of a formal review of the offering structure and process in Hong Kong. In this respect, members strongly urged that such a review be carried out as early as possible and, if at all possible, concurrently with the present prospectus law review.

4.31 Although members had no strong objections to slightly extending the 3 days minimum waiting period by a few days, the general feeling was that the focus should be more on reducing the length of prospectuses to make them more readable.

[Note 20] Section 44A(1) of the CO requires that no proceedings shall be taken on application for allotment of shares or debenture until the third day after the prospectus was issued.

Proposal 18 – Application forms and procedures for shares not be distributed or implemented unless accompanied by or contained in a prospectus

4.32 Members agreed generally with the proposal and were of the view that the requirement should be regarded as being satisfied so long as the prospectus was available either physically at the location where application forms were handed out or electronically through the Internet.

Proposal 19 – Repeal the requirements relating to statements in lieu of prospectus

4.33 Members did not consider that section 43 of the CO relating to statements in lieu of prospectus could satisfactorily be replaced by section 41 which deemed all documents containing offers of shares or debentures for sale to be prospectuses for the following reasons:-

- Section 43 was an anti-avoidance provision specifically designed to address the possible avoidance by companies of their prospectus disclosure obligations by disposing of shares by means of placing, which were then on-sold by the placee to the public. Section 41 of the CO did not apply in such a situation.

- Section 43 was better than section 41 in the sense that one had to prove under section 41 that the company had allotted the shares with a view that those shares would be offered for sale to the public.

- Section 41 could easily be avoided by allowing more than 6 months to lapse between the time of allotment and subsequent offer to the public.

- Section 41 did not apply if the shares were offered to the public by the placee after being allotted with shares through placings.

- Section 41 would be defeated if there was no document in the first place because section 41 was premised upon there being a document by which the offer for sale to the public was made.

In the light of the above considerations, the SCCLR did not therefore agree that section 43 should be repealed.

Proposal 20 – Introduce a separate regulatory regime for employee offers

4.34 Members did not consider it appropriate that employee offers, which were meant to be a benefit to employees, should be over-regulated. They disagreed with the proposal that: –

- there should be a separate regulatory regime to regulate employee offers;

- there should be a requirement for the provision of a declaration of solvency and going concern by the directors and auditors of a company whose shares were being offered to employees.

4.35 In any event, as far as share option schemes were concerned, there were already strict guidelines and appropriate checks and balances in the sense that the schemes had to be adopted by the shareholders and any material changes had to be approved by them again. Share offerings exclusively to employees were extremely rare and did not need to be dealt with separately.

Proposal 21 – An issue of sale of securities in contravention of the law should be void or voidable

4.36 Members did not consider the proposal workable in practice because all shares bought and sold under the current system would have to go through a pool. As a result, tracing was impossible once the shares had been traded.

4.37 A formal submission in writing was subsequently sent to the SFC on 31 December 2005.

CHAPTER 5

Draft Drafting Instructions in respect of the Directors' Remuneration Provisions in the Companies Ordinance and Mock-Up of the Proposed Directors' Remuneration Provisions Prepared by the Joint Government/Hong Kong Institute of Certified Public Accountants Working Group

Background

5.1 The JWG reviewed and examined the directors' remuneration provisions in the CO and prepared detailed draft drafting instructions and a mock-up of the proposed directors' remuneration provisions.

Recommendations

5.2 At the 193rd meeting on 5 November 2005, the SCCLR considered the draft drafting instructions in respect of the directors' remuneration provisions in the CO and the mock-up of the proposed directors' remuneration provisions prepared by the JWG.

5.3 As a result of the discussion, members endorsed the following proposals made by the JWG to improve and modernise the directors' remuneration provisions of the CO :-

- Improving the provisions on remuneration and other benefits of directors and officers to make them more user-friendly and comprehensible.

- Adopting, with modifications, the UK provisions on directors' remuneration and other benefits of directors and officers, including: -

  ✧ Placing the principal disclosure requirements in the body of the CO and the detailed disclosure requirements in the schedules to the CO, namely the proposed 'X' and 'Y' Schedules, to enable easy amendment.

  ✧ Dividing the disclosure requirements in the proposed 'X' Schedule into four parts.

    Part I : emoluments of directors (including emoluments waived), pensions of directors and past directors,

compensation for loss of office to directors and past directors and sums paid to third parties in respect of directors' services.

Part II : loans, quasi-loans and other dealings in favour of directors and connected persons.

Part III : transactions, arrangements and agreements made by the company or a subsidiary for officers of the company other than directors.

Part IV : special provisions for authorized financial institutions.

- ✧ Requiring more detailed information regarding directors' remuneration from listed companies than unlisted companies.

- ✧ Retaining the alternative disclosure requirements in the current sections 161B(2), (5) and (7) of the CO to enable companies to provide an aggregate of the amounts outstanding in the case of relevant transactions that consisted of quasi-loans or credit transactions, or guarantees and securities in connection with such transactions.

- ✧ Retaining the current sections 161B(8), (9), (10), (14) and (15) of the CO whereby authorized financial institutions, such as banks, were exempted from certain disclosure requirements in respect of loans etc made to directors or connected persons if the conditions (such as certain financial limits) were satisfied.

• Not adopting the following UK provisions on directors remuneration:-

- ✧ The distinction between 'quoted' and 'unquoted' companies for determining the information required for disclosure of directors' remuneration in the UK[Note 21].

- ✧ The provisions requiring the directors' remuneration report to disclose consideration by the directors of matters relating to directors' remuneration and a statement of the company's policy on directors'

[Note 21] The JWG considered that the distinction should be between 'listed' and 'unlisted' companies as both terms are used and defined in the CO.

remuneration; to contain a performance graph comparing the total shareholder return on the company's equity shares and the return that would have been obtained on a hypothetical holding of shares from which a 'broad equity market index' was calculated over the five years ending with the one reported on[Note 22].

- Implementing the SCCLR's recommendation in Phase II of the Corporate Governance Review to require:-

  - ✧ listed companies to disclose individual directors' remuneration packages by name in their annual financial statements, including full details of all elements involved, 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[Note 23]; and

  - ✧ an unlisted public company or private company, if directed to do so by holders of not less than 5% of the nominal issued share capital of the company ("the 5% shareholders' requisition mechanism") , to disclose the details of individual directors' remuneration packages and share options by name as in the case of a listed company[Note 24].

- Adopting, with modifications, the UK provisions regarding the approval of the directors' remuneration report by the board of directors and signing of the directors' remuneration report by a director on behalf of the board[Note 25].

Note 22 The JWG considered that Hong Kong should wait a number of years to ascertain the effectiveness of these disclosure requirements in the UK.

Note 23 For details, see bullet point no. 1 under Directors' Remuneration on page 23 of the 20th Annual Report of the SCCLR for the year 2003/2004 (available at the website: http://www.cr.gov.hk/en/standing/reports.htm).

Note 24 For details, see bullet point no. 3 under Directors' Remuneration at the top of page 24 of the 20th Annual Report of the SCCLR for the year 2003/2004. The JWG considered that the SCCLR's recommendation was equivalent to requiring an unlisted public company or a private company to produce a directors' remuneration report and recommended that an unlisted company be required to produce a directors' remuneration report if directed to do so by members of not less than 5% of the nominal issued share capital of the company, or, in the case of an unlisted company not having a share capital, members of the unlisted company representing not less than 5% of the total voting rights of all the members having a right to vote at general meetings.

Note 25 The UK provisions provide that the directors' remuneration report shall be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company. The JWG considered that only a director rather than the secretary should sign the directors' remuneration report as the secretary was not responsible for the truth of the report.

- Following the SCCLR's recommendation in Phase II of the Corporate Governance Review not to require shareholders' approval of the directors' remuneration report along the lines of the UK's Directors' Remuneration Regulations 2002[Note 26].

5.4 However, members rejected the JWG's proposal to introduce a two-tier approach in respect of the disclosure requirements regarding directors' emoluments for unlisted companies[Note 27] on the ground that the 5 percent shareholders' requisition mechanism, if implemented, would provide sufficient protection for the shareholders.

5.5 Members agreed that the JWG's recommendations regarding directors' remuneration and the directors' remuneration report should not be given extra-territorial effect in the CO. Rather, the relevant provisions should apply to non-Hong Kong incorporated listed companies by including such provisions in the Listing Rules and giving statutory backing to these Rules.

5.6 In addition, members raised concern on a number of practical issues as follows :-

- the actual operation of the 5 percent shareholders' requisition mechanism;
- enforcement problems relating to non-compliance with the proposed disclosure requirements in respect of directors' remuneration and the directors' remuneration report.

5.7 Member also suggested that the JWG should further consider a few minor points in the mock-up of the proposed directors' remuneration provisions:-

- the relevance of the five year period referred to in section 129AA(4) of the mock-up and the appropriateness of extending the proposed obligation to officers other than directors (i.e. managers and secretaries); and [Note 28]

Note 26 For details, see the last paragraph under Directors' Remuneration on page 24 of the 20th Annual Report of the SCCLR for the year 2003/2004.

Note 27 The JWG recommended the introduction of a two-tier approach in respect of the disclosure requirements regarding directors' emoluments for unlisted companies. If the aggregate of the directors' emoluments exceeded $2.5 million, unlisted companies would be required to disclose the amount paid to the highest paid director and the number of directors whose emoluments had fallen within specific bands. If the aggregate of the directors' emoluments was below $2.5 million, only the total of all directors' emoluments would have to be disclosed.

Note 28 The proposed section 129AA(4) of the mock up imposes a duty on the director of a company, and any officers of the company in the preceding five years, to notify the company of any matter relating to directors' emoluments etc.

- the appropriateness of the monetary figures in section 22 of the proposed X Schedule [Note 29].

[Note 29] The proposed section 22 of the X Schedule excludes certain transactions with the company in which a director has a material interest from disclosure in the company annual financial statements if certain monetary thresholds are met.

CHAPTER 6

Draft Drafting Instructions in respect of the Directors' Report Provisions in the Companies Ordinance and Mock-Up of the Proposed Directors' Report Provisions Prepared by the Joint Government/Hong Kong Institute of Certified Public Accountants Working Group

Background

6.1 The JWG reviewed and examined the directors' report provisions in the CO; the requirements to prepare an OFR and certain other related matters. On the basis of the recommendations, detailed draft drafting instructions and a mock-up of the proposed directors' report provisions were prepared.

Recommendation

6.2 At the 195th meeting on 11 February 2006, the SCCLR considered the draft drafting instructions and the mock-up of the proposed directors' report provisions prepared by the JWG.

6.3 As a result of the discussion, members endorsed the first eight proposals as listed below made by the JWG in relation to the directors' report provisions of the CO and supported, in principle, the last two proposals :-

- The OFR should be dealt with by incorporating the relevant requirements in the Listing Rules and giving statutory backing to these Rules[Note 30].

[Note 30] The JWG had taken into account, inter alia, the following considerations in coming to that recommendation:-

- the law and experience regarding OFR in other comparable jurisdictions;
- the need to give extra-territorial effect to the relevant statutory provisions if an OFR requirement was included in the CO as more than 80 percent of the companies listed in Hong Kong were non-Hong Kong companies incorporated outside Hong Kong;
- listed companies in Hong Kong were already encouraged to prepare a management discussion and analysis;
- the proposal to give statutory backing to certain Listing Rules, particularly those regarding financial disclosure and connected transactions;
- the fact that the UK had, on 12 January 2006, repealed the statutory requirement for an OFR notwithstanding the enactment of the requirement only on 21 March 2005;
- the Stock Exchange of Hong Kong's concurred with JWG's view that an OFR requirement should be introduced for listed issuers through the Listing Rules and be enforced by the Securities and Future Commission.

- Improving the provisions on the directors' report to make them more user-friendly and comprehensible.

- Adopting, with modifications, the UK provisions on the directors' report, including placing the principal disclosure requirements in the body of the Ordinance and the detailed disclosure requirements in a schedule to the Ordinance, to enable easy amendment.

- Requiring the directors of companies not falling within section 141D of the CO to include in the directors' report a business review of the company subject to the modifications detailed in paragraph 6.4 below.

- The directors' report should state the total amount of any donation made by the company for charitable or other purposes if it was not less than $10,000. There should be no need to separately state any political donations and expenditure.

- Section 234(3) of the UK Companies Act, which suggested what should be given greater emphasis in a group directors' report, should not be adopted.

- Sections 300(8) and (9) of the Australian Corporations Act 2001 concerning the inclusion of information regarding indemnities and insurance premium for officers or auditors in the directors' report should not be adopted.

- Section 307C of the Australian Corporations Act 2001 on auditor's independence declaration should not be adopted.

- Information relating to environmental matters and employee matters should be given in the business review of the directors' report if such matters had a significant impact on the company [Note 31].

Note 31 The SCCLR recommended that when drafting the relevant provisions, reference should be made to the wording used in paragraph 52 of Appendix 16 to the Listing Rules which set out the recommended additional disclosures to be made in the management and discussion analysis prepared by listed companies as including, inter alia :-

- a discussion on the listed company's environmental policies and performance including compliance with the relevant laws and regulations; and
- an account of the listed company's key relationship with employees, customers, suppliers and others, on which its success depended.

- Section 234ZA of the UK Companies Act [Note 32] should be adopted.

6.4 Members also agreed with the following proposals made by the JWG but recommended that they be modified in certain respects as follows:-

- The directors' report requirements should not be applied to every Hong Kong company without exemption. However, instead of the JWG's suggestion [Note 33], the SCCLR recommended that the cut-off point should be set as follows :-

  - ✧ All private companies falling within section 141D of the CO[Note 34] should be required only to produce a simplified form of directors' report.

  - ✧ All other private companies should be required to prepare a directors' report that complied with all the directors' report requirements unless the shareholders unanimously agreed otherwise, in which case, a simplified form of directors' report as used under section 141D should be produced.

  - ✧ All public companies should be required to prepare a directors' report that complied with all the directors' report requirements.

Note 32 Section 234ZA of the UK Companies Act provides that a directors' report should contain a statement that, so far as such director is aware, there is no relevant audit information of which the auditors are unaware, and that the director has taken all the steps he should have taken as a director to make himself aware of such information and to establish that the auditors are aware of it.

Note 33 The JWG originally proposed two alternatives for the SCCLR's consideration.

"(a) Subject to the JWG's recommendations, if section 141D of the Ordinance is amended to adopt the criteria proposed by the HKICPA for determining whether a company is a small private company, companies which apply section 141D will prepare a section 141D directors' report that is a simplified form of the directors' report. The other companies that do not apply section 141D will prepare a directors' report that complies with all the directors' report requirements; or

(b) All public companies, and private companies where the shareholders agree that the directors should produce such a directors' report, should be required to produce a directors' report that complies with all the directors' report requirements. All other companies will prepare a simplified form of directors' report."

Note 34 Existing section 141D of the CO provides that certain private companies may be exempt from most of the provisions concerning accounts if all the shareholders of the company agree. Their agreement must be in writing and must be obtained every financial year. In April 2006, the SCCLR considered a separate proposal by the JWG to relax the qualifying criteria for private companies to apply section 141D.

- ✧ Dormant companies should continue to be exempted from the requirement to prepare a directors' report.

- Certain important information including the names of the directors; the principal activities of the company or group; the amount of the recommended dividend; particulars of any material matters for the appreciation of the state of the company's affairs by its members and the business review, should be stated in the directors' report in a conspicuous and express fashion and should not be disclosed by way of cross-reference.

- Equity-linked agreements should only be required to be disclosed in a directors' report if there was a possibility that the issue of shares under such agreements had a potential to dilute existing shareholders' interests[Note 35].

- Paragraph 1 of Schedule 7 of the UK Companies Act[Note 36] should be adopted provided that the values of "non-current assets of the company as consist in interests in land" rather than "assets of the company as consist in interests in land" as originally proposed by the JWG should be included as a matter to be dealt with in a directors' report. The valuation might be based on the directors' honest and reasonable opinion[Note 37].

Note 35 The JWG's original proposal is that the disclosure requirement with regard to equity-linked agreements should apply to all cases where the equity-linked agreements have values derived by reference to the shareholding and not only to those cases where there would be a possibility of dilution of the shares. This proposal was made in response to the SCCLR's previous recommendation at the 186th meeting held on 8 December 2004 that section 129D(3)(g) of the CO should be expanded to cover all equity-linked issues.

Note 36 Paragraph 1 of Schedule 7 of the UK Companies Act provides that in the case of land, if the market value at the end of the year differs substantially from the amount indicated in the balance sheet and the directors consider that the difference requires the attention of members or debenture holders, the difference must be indicated in the directors' report. If the difference in value does not require the attention of members or debenture holders, it does not have to be mentioned in the directors' report.

Note 37 The JWG's original proposal reads as follows :-
"If, in the case of such of the assets of the company as consists in interests in land, their market value differs substantially from the amount at which they are included in the statement of financial position, and the difference is, in the directors' opinion of such significance as to require that the attention of members of the company should be drawn to it, the report shall indicate the difference with such degree of precision as is practicable."