Standing Committee on Company Law Reform

The Twenty-Seventh Annual Report

2010/2011

Standing Committee on Company Law Reform (SCCLR)
Twenty-Seventh Report
Subjects considered by the
Standing Committee during 2010/2011

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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 to the Financial Secretary 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 and Futures Ordinance on matters relating to corporate governance and shareholders' protection.

(ii)

Membership of the Standing Committee for 2010/2011

Chairman	:	Mr Benjamin YU, S.B.S., S.C., J.P	(up to 31.1.2011)
		Mr Godfrey LAM Wan-ho, S.C.	(from 1.2.2011)
Members	:	Mr Stephen BIRKETT	
		Mrs Anne CARVER	
		Mr Rock CHEN Chung-nin, B.B.S., J.P.	
		Mr CHEW Fook-aun	
		Mr Vincent FAN Chor-wah	
		Professor GOO Say-hak	
		Mr Peter W GREENWOOD	
		Ms Roxanne ISMAIL	(from 1.2.2011)
		Ms Teresa KO Yuk-yin, J.P.	(up to 31.1.2011)
		Mr Johnson KONG Chi-how	
		Mr Rainier LAM Hok-chung	(from 1.2.2011)
		Mr Godfrey LAM Wan-ho, S.C.	(up to 31.1.2011)

	Mrs Catherine MORLEY	
	Mr Kenneth NG Sing-yip	(from 1.2.2011)
	Ms Edith SHIH	
	Mr Paul F WINKELMANN	(up to 31.1.2011)
	Mr Patrick WONG Chi-kwong	(up to 31.1.2011)
	Dr Kelvin WONG Tin-yau	
	Ms Benita YU Ka-po	(from 1.2.2011)

Ex-Officio Members : Mr Andrew YOUNG
Chief Counsel, Legal Services Division
The Securities & Futures Commission

Mr Mark DICKENS, J.P.
Head of Listing Division
Hong Kong Exchanges and Clearing Limited

Professor Edward L G TYLER
Department of Justice

Mr E T O'CONNELL, J.P.
The Official Receiver

Ms Ada CHUNG, J.P.
The Registrar of Companies

Mr Stefan GANNON, J.P.
General Counsel/Executive Director
The Hong Kong Monetary Authority

Mr John LEUNG, J.P.
Deputy Secretary for Financial Services and the Treasury

Secretary	:	Mrs Karen HO	(up to 31.1.2011)
		Ms Phyllis MCKENNA	(from 1.2.2011)

(iii)

Meetings held during 2010/2011

Two Hundred and sixteenth Meeting	-	24.4.2010
Two Hundred and seventeenth Meeting	-	12.6.2010
Two Hundred and eighteenth Meeting	-	18.9.2010
Two Hundred and nineteenth Meeting	-	29.1.2011

EXECUTIVE SUMMARY

The Standing Committee on Company Law Reform ("SCCLR") was formed in 1984 to advise the Financial Secretary ("FS") on amendments to the Companies Ordinance ("CO") and other related ordinances. The SCCLR reported annually to the Financial Secretary through the Secretary for Financial Services and the Treasury ("FSTB") on amendments that are under consideration.

The main focus of the SCCLR in the past few years was on the CO Rewrite exercise that commenced formally in mid-2006 following the setting up of the Companies Bill Team ("CBT"). A draft Companies Bill ("CB") had been put out for consultation in two phases. During the year, the SCCLR considered the draft consultation conclusions on the draft Companies Bill and on the review of corporate rescue procedure legislative proposals, the proposed codification of certain requirements to disclose price sensitive information by listed companies and the review of the code on corporate governance practices and associated listing rules.

From 1 April 2010 to 31 March 2011, the SCCLR held four meetings and considered five discussion papers.

A summary of the recommendations/remarks made by the SCCLR is set out below:-

(I) <u>Consultation on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations (Chapter 1)</u>

- Members were generally in favour of the proposed statutory codification but some expressed concern that the proposed legislation had not dealt with the interests of the shareholders.

- There should be further consideration in relation to safe harbours and on how the conflict between the interests of the existing shareholders and the investing public should be resolved.

- Some members suggested that a business judgment rule be introduced.

(II) First Phase Consultation on the draft Companies Bill (Chapter 2)

- A majority of the members were in favour of abolishing the headcount test for members' schemes of listed companies. However, some members considered that the headcount test should be retained while the court should be given the discretion to dispense with the test in appropriate circumstances.

- Access to directors' residential addresses and the full identity numbers of person on the public register should be restricted. The existing records should only be purged upon application.

- Common law derivative actions should be retained.

- "Relevant private companies" should be confined to those private companies which were subsidiaries of a public company for the purpose of regulating directors' fair dealings.

- There should be no change to the draft provision in the CB on the standard of directors' duty of care, skill and diligence.

(III) Review of Corporate Rescue Procedure Legislative Proposals – Consultation Feedback and Controversial Issues (Chapter 3)

- Post commencement debts except employees' entitlements should also be subject to the moratorium.

- The requirement to show financial hardship for exemption from the moratorium should be dropped.

- The general prohibition against set-off should be removed.

- The scope of personal liability of the provisional supervisor should extend to liabilities under pre-commencement contracts adopted by him in the performance of his functions.

- The provisional supervisor would not have personal liability for the use or occupation of a property within the first 10 working days,

during which he could give notice to the owner that the company would not use or occupy the property.

- Only specified categories of persons could be appointed provisional supervisor and the court's power of disqualification should be expanded to prohibit a person from being a provisional supervisor.

- Senior management should be excluded from being liable for insolvent trading; and the ground of "reasonable grounds for suspecting" should be dropped.

- Secured creditors' rights should be retained.

- The "headcount test" for creditors' meeting should be abolished.

(IV) Second Phase Consultation on the draft Companies Bill (Chapter 4)

- The restrictions on financial assistance should be retained until the insolvent trading provisions to be included in the statutory corporate rescue procedure were enacted, but companies may provide financial assistance if any one of the three specified procedures was complied with.

- The proposal to require the preparation of directors' remuneration reports should be dropped.

- The investigatory powers of an inspector appointed by the FS should be enhanced and the categories of companies that may be subject to investigation should be extended. The safeguards for confidentiality of information and protection of informers should be improved.

- New but limited powers should be given to the Registrar of Companies ("the Registrar") to obtain documents, records and information relating to specified offences under the CB.

- Companies should give reasons explaining its refusal to register a transfer of shares upon request.

- The proposed option for large private companies to opt for simplified reporting requirements based on members' approval should be removed.

- Companies that prepared simplified financial reports would be exempt from the "true and fair view" requirement.

- The proposal to extend the disclosure of auditor's remuneration to cover non-audit services and the requirement for a directors' declaration should be dropped.

- The following modification to the requirements for a business review should be made :

  - private companies could opt out of the requirement by special resolution
  - wholly-owned subsidiary companies were exempted from the requirement
  - the requirement for a balanced and comprehensive analysis of the development and performance of the company's business was dropped
  - a "safe harbour" provision should be added
  - the provision which prohibited disclosure by cross-reference should be deleted.

- The provisions on auditor's right to information should be modified.

(V) <u>Consultation on Review of the Code on Corporate Governance Practices and Associated Listing Rules (Chapter 5)</u>

- Members were generally supportive of the proposals and recommendations put forward in the Review and in general supported the proposed amendments to the Code and the Rules.

- Members did not support imposing a numerical cap on the number of appointments an INED could hold, as most members agreed that the issue depended upon the quality and ability of the individual INED, which would vary. It was agreed that the proposals to increase disclosure of time commitments of directors was welcome.

- A few members expressed concern at the proposal to remove the need for a Hong Kong qualified company secretary but the majority supported mandatory continuing professional training.

CHAPTER 1

Consultation on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations

Background

1.1 At the 216th meeting held on 24 April 2010, representatives from the Securities and Futures Commission ("SFC") and the FSTB conducted a consultation with the SCCLR on the Administration's proposal to codify certain requirements to disclose price sensitive information by listed corporations[1].

1.2 The Administration proposed a statutory disclosure regime that would oblige a listed corporation to make available any price sensitive information ("PSI") that had come to the knowledge of the listed corporation. The proposal would be taken forward by way of amendments to the Securities and Futures Ordinance (Cap 571) ("SFO"). The key elements of the proposal were:

- The concept of "relevant information" currently used in section 245 of the SFO[2] in relation to prohibiting any person from dealing in securities using "inside information" under the "insider dealing"[3] regime would be adopted for the purpose of defining PSI. Under the proposal, PSI would be the same set of information which was prohibited from being used for insider dealing.

- A listed corporation would be required to disclose to the public as soon as practicable any "inside information" that had come to its knowledge. A listed corporation would be regarded as having knowledge of the inside

[1] The "Consultation Paper on the Proposed Statutory Codification of Certain Requirements to Disclose Price Sensitive Information by Listed Corporations" was issued in March 2010 and is available on FSTB's website *www.fstb.gov.hk*

[2] "Relevant information" as set out in section 245 of SFO, in relation to a corporation, means specific information about –
(a) the corporation;
(b) a shareholder of officer of the corporation; or
(c) the listed securities of the corporation or their derivatives,
which is not generally known to the persons who are accustomed or would be likely to deal in the securities of the corporation, but which would, if it were generally known to them, be likely to materially affect the price of the listed securities.

[3] See section 270 of the SFO.

information if a director or an officer[4] had come into possession of that information in the course of the performance of his duties.

- Directors and other officers involved in the management of the listed corporation should take reasonable measures from time to time to ensure compliance. Individual directors and officers would be liable if the listed corporation breached the disclosure requirements and the breach was a result of any intentional, reckless or negligent act on the part of the director or officer.

- The disclosure should be made in a manner that could provide for equal, timely and effective access by the public to the information disclosed. A listed corporation would have to ensure that any disclosure made to the public was not false or misleading as to a material fact, or false or misleading through the omission of a material fact.

- Safe harbours would be provided to cater for legitimate circumstances wherein disclosure of inside information could be delayed or withheld. The proposed safe harbours were:

  (a) when the disclosure would constitute a breach against an order made by a Hong Kong court or any provisions of other Hong Kong statutes;

  (b) when the information was related to impending negotiations or incomplete proposals the outcome of which could be prejudiced if the information was disclosed prematurely;

  (c) when the information was a trade secret; and

  (d) when the Government's Exchange Fund or a central bank provided liquidity support to the listed corporation.

- To allow for flexibility and to cater for unforeseen circumstances as a result of rapid market development in the financial services industry, the

[4] As specified under Part 1 of Schedule 1 to the SFO, an "officer' in relation to a corporation means a director, manager or secretary of, or any other person involved in the management of, the corporation.

SFC would be empowered to make rules under the SFO to prescribe further safe harbours.

- Listed corporations would not be obliged to respond to mere rumours, unless there was leakage of inside information that was intended to be kept confidential.

- To facilitate compliance, the SFC would promulgate guidelines on what would constitute inside information and when would safe harbours be applicable. Listed corporations could consult the SFC on how to apply the disclosure provisions.

- The jurisdiction of the Market Misconduct Tribunal ("MMT")[5] would be extended to cover cases regarding breaches of the statutory disclosure requirements. One or more of the following civil sanctions could be imposed –

  (a) a regulatory fine up to $8 million on the listed corporation and/or the director;

  (b) disqualification of the director or officer from being involved in the management of a listed corporation for up to five years;

  (c) a "cold shoulder" order on the director or officer (i.e. the person was deprived of access to market facilities) for up to five years;

  (d) a "cease and desist" order on the listed corporation, director or officer (i.e. an order not to breach the statutory disclosure requirements again);

  (e) an order that any body of which the director or officer was a member be recommended to take disciplinary action against him; and

  (f) payment of costs of the civil inquiry and/or the SFC investigation by the listed corporation, director or officer.

[5] The MMT is established under section 251 of the SFO to hear and determine market misconduct in accordance with Part XIII and Schedule 9 of the SFO. The Chairman of the MMT is a judge and is appointed by the Chief Executive. He is assisted by two persons from the business sector or professional bodies. The MMT proceedings are civil and inquisitorial in nature.

- Persons suffering pecuniary loss as a result of others breaching the disclosure requirements could rely on the MMT findings to take civil actions to seek compensation.

- The statutory disclosure requirements would be enforced by the SFC with the existing investigation power under the SFO. The SFC would be empowered to institute proceedings before the MMT, without having to first submit the case to the FS for his decision to do so.[6]

- The SFC would provide informal consultation for listed corporations with regard to the statutory disclosure requirements for an initial period of 12 months.

1.3 Subject to public views, the Administration would submit the Securities and Futures (Amendment) Bill to the Legislative Council in the 2010/11 legislative session.

Recommendations/Remarks

1.4 Members were generally in favour of the proposal but some had expressed concern that the proposed legislation appeared to be geared towards protecting the investing public, but had not dealt with the interests of the shareholders. Members considered that there should be further consideration in relation to safe harbours and on how the conflict between the interests of the existing shareholders and the investing public should be resolved.

1.5 Some members suggested that a business judgment rule[7] be introduced to address the concern that directors making a judgment which they believed was reasonable could subsequently be impeached for making a wrong decision.

[6] Currently under sections 252(2) of the SFO, it is the FS who institutes proceedings before the MMT.

[7] See sections 180(2) and (3) of the Australian Corporations Act 2001 ("ACA"). The business judgment rule adopts the US concept which was developed to acknowledge that directors should not be liable for business decisions that had turned out badly but were made in an honest, informed and rational way. It protects directors from personal liability for breaches of the duties of care, skill and diligence under section 180(1) of the ACA and their equivalent duties at common law and in equity if they satisfy the specified requirements. "Business judgment" as defined in section 180(3) of the ACA means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation.

CHAPTER 2

First Phase Consultation on the Draft Companies Bill

Background

2.1 The FSTB issued a consultation paper on the First Phase Consultation of the Draft Companies Bill on 17 December 2009. The consultation ended on 16 March 2010. At the 217th meeting held on 12 June 2010, the SCCLR considered the recommendations in the draft consultation conclusions prepared by FSTB.[8]

2.2 The following issues were discussed at the meeting :

- "headcount test" for a compromise or arrangement
- disclosure of directors' residential addresses and directors' and company secretaries' identity (ID) numbers
- common law derivative action
- regulating directors' fair dealings of private companies associated with a listed or public company
- codification of directors' duty of care, skill and diligence

2.3 The headcount test was previously discussed at the 214th meeting held on 31 October 2009. The SCCLR considered the three options (i.e. the headcount test should be retained, abolished, or retained with a discretion given to the court to dispense with the test) put forward by the CBT to deal with the headcount test and agreed that the proposed options should be put out for consultation.[9]

2.4 In addition to seeking views on whether directors' residential address[10] and directors' and secretaries' ID numbers should continue to be made available

[8] The consultation conclusions are issued in August 2010. The consultation paper and the consultation conclusions are available at the Companies Ordinance Rewrite website (*www.fstb.gov.hk/fsb/co_rewrite*).

[9] The SCCLR's previous recommendation/remarks on the headcount test are summarized in Chapter 2, SCCLR's Annual Report 2009/2010.

[10] Company secretaries are required by the CO to provide their residential addresses to the Registrar of Companies for incorporation and registration purposes. Under the draft Companies Bill, the residential address of a company secretary is not required to be provided.

for inspection on the public register of the Companies Registry ("CR"), the consultation paper also asked for views on whether the Australian approach[11] or the UK approach[12] should be adopted if directors' residential addresses were not to be made available for public inspection.

2.5 The issue of whether common law derivative action should be abolished was previously considered by the SCCLR at its 212th meeting held on 7 March 2009. It was recommended that the issue should be highlighted for public consultation in the context of consultation on the draft CB.[13]

2.6 The SCCLR had previously recommended that the general exception of members' approval to the prohibitions on loans and similar transactions currently applicable to private companies other than "relevant private companies"[14] should be extended to all companies. Nevertheless, the question of treatment of private companies associated with listed companies should be highlighted for public consultation on the draft CB and reviewed afterwards.[15]

Recommendation/Remarks

(I) Headcount test for a compromise or arrangement

2.7 A majority of the members were in favour of abolishing the headcount test for members' schemes of listed companies. However, some members

[11] The ACA requires the personal particulars, including the usual residential address, of new directors and company secretaries to be lodged with the Australian Securities and Investments Commission (ASIC"). Such information collected is put on the public register and available for public inspection. Section 205D(2) of the ACA, however, allows a director/company secretary to have an alternative address to be substituted for his usual residential address if the ASIC determines, upon application, that including the residential address in the public register will put at risk his or his family members' personal safety. A person taking advantage of the alternative address provisions is still required to lodge with the ASIC notice of his usual residential address. Information concerning his usual residential address may be disclosed to the court for purposes of enforcing a judgment debt ordered by the court.

[12] Under the Companies Act 2006 ("CA 2006"), every director is given the option of providing a service address for the public record, with the residential address being kept on a separate record to which access is restricted to specified public authorities and credit reference agencies. Existing addresses already on the public record would be purged upon application. Similar protection is provided for directors' residential addresses in respect of overseas companies.

[13] The SCCLR's previous recommendation is summarized in Chapter 3, SCCLR's Annual Report 2008/2009.

[14] Under section 157H(10) of the CO, a private company that is a member of a group of companies which includes a listed company is a "relevant private company".

[15] The SCCLR's previous recommendation is summarized in paragraph 4.3(a), Chapter 4 of the SCCLR's Annual Report 2007/2008.

considered that the headcount test should be retained but the court should be given the discretion to dispense with the test in appropriate circumstances.[16]

2.8 It was generally agreed that the treatment of members' schemes of non-listed companies should follow that for listed companies. As for creditors' schemes, a majority of the members were in favour of abolishing the headcount test.

(II) Disclosure of directors' residential addresses and the ID numbers of directors and company secretaries

2.9 The SCCLR noted that the majority of respondents to the consultation opined that directors' residential addresses should not be disclosed on the public register and that certain digits of the ID numbers of directors and company secretaries should be masked. Members generally agreed that access to directors' residential addresses should be restricted.

2.10 Members expressed the view that the Australian approach would offer less effective protection to directors' personal information as they could only apply for substitution of the residential address with an alternative address after the risks in relation to their or their family's personal safety were established. The SCCLR considered that the UK approach of maintaining a public record for directors' service addresses and a confidential record of residential addresses to which access would be restricted to specified entities was a better option and should be adopted. The existing records containing the residential addresses on the public register should only be purged upon application and the payment of a fee.

2.11 The SCCLR also endorsed the recommendation that for new companies and documents filed by existing companies after a cut-off date, certain digits of the ID numbers of directors and company secretaries would be masked and the full ID numbers would be held on a confidential register by the CR with

[16] The responses to the consultation on the headcount test are diverse. Given the divided views received, the Administration considers that the market is not ready for abolition of the test. Taking into account the fact that the headcount test serves to protect the interests of minority shareholders and small creditors, the CBT has decided to retain the headcount test in the Companies Bill and add a provision to give the court a discretion to dispense with the test in respect of members' schemes in appropriate cases. The decision was reported to the SCCLR at the 218th meeting held on 18 September 2010 and the committee noted the Administration's decision.

access restricted to regulatory/enforcement authorities, liquidators and those acting pursuant to a court order. As regards existing data on the public register, the CR should mask certain digits upon application and the payment of a fee.

(III) Common law derivative action

2.12 Members generally agreed to retain the right to bring a common law derivative action in the CB.

(IV) Regulating directors' fair dealings of private companies associated with a listed or public company

2.13 The SCCLR endorsed the recommendation that "relevant private companies" should be confined to those private companies which were subsidiaries of a public company, whether listed or non-listed so that the more stringent restrictions should only apply to such companies[17].

(V) Codification of director's duty of care, skill and diligence

2.14 Most of the respondents to the public consultation supported the codification in principle. Some respondents expressed reservation over the introduction of a mixed objective/subjective test[18] and the concern was that the subjective test would set a higher standard for those directors having special knowledge or experience.

2.15 Some members expressed concern that non-executive directors who subjectively was well-qualified but objectively did not participate in the daily operations and affairs of a company might be required under clause 10.13 of the CB to use the same care, skill and diligence of executive directors. Members, however, generally agreed that clause 10.13 had made it clear that the courts must also take into account the "functions carried out by the relevant director", that meant the courts should consider the different functions

[17] Under the CB, public companies are prohibited from entering into certain transactions without the prescribed approval of the members i.e. approval by a resolution passed after disregarding the votes of members regarded as interested in the proposed transaction.

[18] Clause 10.13 of the CB defines the standard of care, skill and diligence as the standard that would be exercised by a reasonably diligent person with-
(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director; and
(b) the general knowledge, skill and experience that the director has.

of executive and non-executive directors when determining whether a particular director had exercised reasonable care, skill and diligence.

2.16 The SCCLR endorsed the recommendation that no change should be made to clause 10.13 of the CB which codified director's duty of care, skill and diligence along the lines of section 174 of the UK Companies Act 2006 ("UKCA 2006").

CHAPTER 3

Review of Corporate Rescue Procedure Legislative Proposals – Consultation Feedback and Controversial Issues

Background

3.1 The FSTB issued the "Review of Corporate Rescue Procedure Legislative Proposals Consultation Paper" on 29 October 2009. The consultation ended on 28 January 2010. At the 217th meeting held on 12 June 2010, the SCCLR considered the recommendations in the draft consultation conclusions prepared by the FSTB[19].

Recommendations/Remarks

3.2 The SCCLR generally endorsed the recommendations in the draft consultation conclusions. The recommendations are summarized below.

(I) Exemption from moratorium

3.3 The original proposal[20] that debts and liabilities incurred by the company after the commencement of provisional supervision were not subject to the moratorium should be dropped. However, post-commencement claims in respect of arrears of wages and other employment claims under the Employment Ordinance incurred after commencement should be exempted from the moratorium.

3.4 The requirement that the court must be satisfied that there would be financial hardship to a creditor before it could grant an order exempting the creditor's debt from the moratorium should be removed, so that the court would have the

[19] The proposed statutory corporate rescue procedure was discussed by the SCCLR at its 213th meeting held on 11 July 2009. Please see Chapter 1 of SCCLR's Annual Report 2009/2010 which is available at the Companies Registry website www.*cr.gov.hk*. The consultation paper and the consultation conclusions issued in July 2010 are available at the FSTB's website *www.fstb.gov.hk*.

[20] The original proposal was contained in the Companies (Corporate Rescue) Bill 2001 ("the 2001 Bill") which lapsed in 2004 as it was not possible to complete the scrutiny of the Bill by the end of the LegCo term.

discretion to decide whether a particular creditor should be exempted from the moratorium.

3.5 The original proposal that any set-off would be disallowed except with the consent of the provisional supervisor or in relation to certain financial contracts[21] should be dropped.

(II) Personal liability of the provisional supervisor

3.6 The scope of personal liability of the provisional supervisor should be extended to cover the liability in respect of contracts entered into by the company prior to the commencement of provisional supervision and adopted by the provisional supervisor in the performance or exercise of his/her functions[22].

3.7 The provisional supervisor should not be personally liable in respect of the possession, use or occupation of property by the company during the provisional supervision within the first 10 working days of the provisional supervision[23], during which period the provisional supervisor could give notice to the property owner stating the company would not use or occupy the property[24]; and the court should be given a discretion to exempt the provisional supervisor from liability where it appeared that he ought fairly to be excused.

(III) Qualification requirement for provisional supervisor

3.8 There should be no change to the original proposal that only solicitors holding a practicing certificate issued under the Legal Practitioners Ordinance (Cap 159) and certified public accountants registered in accordance with the Professional Accountants Ordinance (Cap 50) may take up appointment as a provisional supervisor.

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[21] In the consultation paper, views were invited on whether the list of financial contracts to be exempted from the moratorium needed to be revised. Views were diverse. The Administration will consider whether there is still a need to have such a list if the prohibition against set-off is dropped.

[22] Indemnity for the provisional supervisor against personal liability will be first out of the assets of the company.

[23] Payments falling due during this period will be a claim against the company only.

[24] Whilst the notice is in force, the provisional supervisor is not liable for rent, but the liability of the company is not affected. The notice will cease to be in force if the provisional supervisor gives a written notice of revocation to the property owner, or if the company uses the property or asserts a right against the property owner to continue to use the property.

3.9 Section 168D of the CO[25] should be amended to expand the court's existing powers of disqualification to prohibit a person from being a provisional supervisor

(IV) Insolvent trading

3.10 The following adjustments to the original formulation in the 2001 Bill of the offence of "insolvent trading"[26] should be made -

(a) excluding senior management from being liable under the insolvent trading provisions;

(b) modifying the standard in establishing liability by dropping the ground of "reasonable grounds for suspecting"; and

(c) replacing the phrase "failed to take any steps to prevent insolvent trading" with "failed to prevent insolvent trading"[27].

(V) Major secured creditors' right to veto

3.11 The provisions with respect to protection of the secured creditors' rights, including major secured creditors' right to veto the provisional supervision[28] should be retained.

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[25] Section 168D of the CO provides that the court may make against a person a disqualification order i.e. an order that he shall not, without leave of the court, be a director, liquidator, receiver or manager, or be concerned or take part in the promotion, formation or management of a company on the ground that his conduct as a director makes him unfit to be concerned in the management of a company.

[26] The original formulation required that for a responsible person (i.e. a director, a shadow director or a member of senior management) to be liable for insolvent trading, the person knew or ought reasonably to have known the company was insolvent or knew or ought reasonably to have known that there was no reasonable prospect that the company could avoid becoming insolvent; or there were reasonable grounds for suspecting that the company was insolvent or there was no reasonable prospect that the company could avoid becoming insolvent.

[27] It was considered that the word "any" might lead to an interpretation that a responsible person could easily circumvent the insolvent trading offence by proving that he has taken at least one step to prevent insolvent trading.

[28] The rights of all secured creditors may not be affected by the provisional supervision except with their consent. The major secured creditor has three working days to decide whether or not to participate in the provisional supervision. If a major secured creditor objects, the provisional supervision will cease.

(VI) The "headcount test"

3.12 The "headcount test" in the voting at meetings of creditors[29] should be abolished.

(VII) Employees' outstanding entitlements

3.13 The majority of the respondents to the consultation supported option Alternative B (i.e. according priority to employees' protected debts in the rescue plan) as set out in the consultation paper[30]. However the labour sector expressed clear reservations and the concern was that it would delay repayment of employees' entitlements in the event of winding up[31].

3.14 In view of the diverse views, the Administration proposed a modified Alternative B under which there would be a phased payment schedule for the outstanding employees' entitlements, with initial payment within 30 days after the start of the moratorium, and the remainder paid in full within 12 months after the voluntary arrangement had come into effect. If the company failed to pay according to the schedule, the employees would no longer be bound by the moratorium and would be able to petition for the winding up of the company.

3.15 Some members expressed concern that the period of 30 days was not sufficient for a provisional supervisor to negotiate and secure the source of funds for the initial payment.

3.16 The SCCLR generally agreed that employees' entitlement was a political issue on which the Committee would not have much contribution.

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[29] Under the 2001 Bill, for any resolution to pass at a meeting of creditors, one of the conditions to be met was that a majority in number of the creditors present in person or by proxy and voting on the resolution ("headcount test") voted for the resolution. The majority of submissions in the consultation considered that the headcount test should be abolished.

[30] Under this option, employees' debts capped at the level under the Protection of Wages on Insolvency Fund ("PWIF"), currently at $36,000 per employee, will be settled within 45 to 60 days after the start of the moratorium, and any outstanding amounts above the cap will be settled within 12 months of approval of the rescue plan.

[31] Other submissions noted that Alternative B would require the expansion of the ambit of PWIF to cover creditors' voluntary winding up cases and this might not be consistent with the original intent of setting up the PWIF.

CHAPTER 4

Second Phase Consultation on the Draft Companies Bill

Background

4.1 The FSTB issued a consultation paper on the Second Phase Consultation of the Draft Companies Bill on 7 May 2010. The consultation ended on 6 August 2010. At the 218th meeting held on 18 September 2010, the SCCLR considered the recommendations in the draft consultation conclusions prepared by the FSTB.[32]

4.2 The following issues were discussed at the meeting :-

- restrictions on financial assistance
- director's remuneration reports
- investigations and enquiries by the Financial Secretary ("FS")
- enquiries by the Registrar of Companies ("Registrar")
- providing reasons to explain refusal to register a transfer of shares
- proposed changes to provisions in Part 9 (Accounts and Audits)

Recommendations/Remarks

(I) Restrictions on financial assistance

4.3 Members had reservations on the proposal to abolish the financial assistance restriction for private companies[33] even though the majority of respondents to the consultation favoured its abolition. Some members were concerned that there would not be sufficient protection for minority shareholders and creditors if the restriction was abolished.

[32] The consultation conclusions are issued in 25 October 2010. The consultation paper and the consultation conclusions are available at the Companies Ordinance Rewrite website (www.fstb.gov.hk/fsb/co_rewrite).

[33] Section 47A of the CO imposes a broad prohibition on a Hong Kong company and its subsidiaries giving financial assistance to a party (other than the company itself) for the purpose of acquiring shares in the company. Under section 47D of CO, special restrictions apply to listed companies.

4.4 The SCCLR recommended that the restriction on financial assistance should be retained in the Companies Bill for the time being until the insolvent trading provisions to be included in the statutory corporate rescue procedure were enacted[34] and that companies (private or public) may provide financial assistance if one the following procedures was complied with:

(a) if the amount of financial assistance did not exceed 5% of the shareholders' fund, the approval of the board of directors was obtained;

(b) the approval by the board of directors and the unanimous approval of the shareholders were obtained for the financial assistance; or

(c) the approval by shareholders by ordinary resolution and allowing shareholders holding at least 10% of the total voting rights to object to the court.

(II) Directors' Remuneration Reports

4.5 Members noted that a majority of the respondents to the consultation agreed with CBT's proposal to drop the requirement to prepare separate directors' remuneration reports for all listed companies incorporated in Hong Kong and unlisted companies incorporated in Hong Kong where members holding not less than 5% of voting rights had so requested[35].

4.6 The SCCLR endorsed the recommendation that the proposal to require the preparation of directors' remuneration reports should be dropped.

(III) Investigations and Enquires by the FS

4.7 It was proposed in the consultation paper that the following key changes should be made to the provisions concerning the investigation of, and enquiry into, a company's affairs that may be initiated by the FS:

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[34] Please see Chapter 1 of the SCCLR Annual Report for the year 2009/2010 which is available at the Companies Registry website *www.cr.gov.hk*.

[35] The SCCLR has recommended during Phase II of the Corporate Governance Review that the level of transparency in respect of the disclosure of directors' remuneration packages should be enhanced and proposed that the CO should be amended to require the disclosure of individual directors' remuneration packages by name in the annual accounts. Please see paragraphs 16.22 and 16.23 of "A Consultation Paper on Proposals made in Phase II of the Review" issued in June 2003 which is available at the Companies Registry website *www.cr.gov.hk*.

(a) enhancing the investigatory powers of an inspector[36];

(b) extending the categories of companies that may be subject to investigation to cover companies incorporated outside Hong Kong but doing business in Hong Kong (even if not having a place of business in Hong Kong) and any other companies within a group comprising such companies, wherever incorporated. The latter extension is also applicable to enquiries by the FS; and

(c) improving safeguards for confidentiality of information and protection of informers[37].

4.8 The SCCLR endorsed the proposal to make the above changes to the provisions concerning investigations and enquiries by the FS.[38]

(IV) Enquiries by the Registrar

4.9 The SCCLR endorsed the recommendation to give new but limited powers for the Registrar to obtain documents, records and information for the purposes of ascertaining whether any conduct that would constitute specified offences under the CB had taken place[39]. The offences would be confined to those concerning the giving of false or misleading information in connection with an

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[36] The following new powers are proposed:
(a) to require a person to preserve records or documents before production to the inspector;
(b) to require a person to verify by statutory declaration any answer or explanation given to the inspector; and
(c) if a person does not give any answer for the reason that the information is not within the person's knowledge or possession, to require the person to verify that reason and fact by statutory declaration;
Criminal sanctions for non-compliance with a request made by an inspector will be introduced. The court will be given a power to punish a person who failed to comply with an inspector's requirement as if he had been guilty of contempt of the court and also to order the person to comply with the requirement made by the inspector.

[37] The following new provisions are proposed to be introduced:
(a) expressly defining how information obtained pursuant to an investigation of a company's affairs or enquiry into a company's affairs may be disclosed to other regulatory authorities;
(b) giving protection (by granting immunity from liability for disclosure) to persons who volunteered information to facilitate an investigation of a company's affairs or enquiry into a company's affairs; and
(c) keeping the identity of an informer anonymous in civil, criminal or tribunal proceedings.

[38] Taking into account some respondents' views that it would be impractical and rarely possible to conduct effective investigation into the affairs of overseas companies that do not have a place of business in Hong Kong, the Administration has decided not to adopt the proposal to subject those companies to investigation.

[39] Under the CO, investigation of a company's affairs and inspection of books and papers are initiated by the FS and not by the Registrar.

application for deregistration of a company or the making of a statement that was misleading, false or deceptive in any material particular.

(V) Providing reasons to explain refusal to register a transfer of shares

4.10 The SCCLR endorsed the recommendation to require companies to give reasons explaining its refusal to register a transfer of shares upon request[40].

(VI) Proposed Changes to Provisions in Part 9 (Accounts and Audits)

4.11 The SCCLR endorsed the following recommendations:

- The proposed option for private companies or a group of private companies that did not qualify for simplified reporting to opt for simplified reporting based on approval by members holding 75% voting rights with no objection from the remaining members should be removed.[41]

- Companies that prepared simplified financial reports would be exempted from the requirement that their annual financial statements or annual consolidated financial statements must give a true and fair view of the financial position and financial performance of the company and the subsidiary undertakings (if applicable).[42]

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[40] Under section 69(1) of the CO, there is no requirement for a company to give reasons for refusal to register a transfer.

[41] Under the CB, a private company (except for specified categories of companies) will automatically be qualified for simplified reporting if it satisfies any two of the following conditions:

- total annual revenue of not more than HK$50 million
- total assets of not more than HK$50 million
- no more than 50 employees

A private company that is the holding company of a group of companies that satisfies any two of the following conditions is also qualified for simplified reporting:

- aggregate total annual revenue of not more than HK$50 million net
- aggregate total assets of not more than HK$50 million net
- no more than 50 employees

[42] The draft CB requires that annual financial statements and annual consolidated financial statements must give a true and fair view of the financial position and financial performance of the company and its subsidiary undertakings (for a holding company). According to the SME-Financial Reporting Framework issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), a company that satisfies the requirements for simplified accounting and reporting under section 141D of the CO is qualified for reporting based on the SME-Financial Reporting Standards ("SME-FRS"). Currently auditors are not permitted to express a "true and fair" opinion on financial statements prepared under SME-FRS, as the SME-FRS is considered to be a compliance framework, as defined in the Hong Kong Standard on Auditing (HKSA) 200 (Clarified). For financial statements prepared under SME-FRS, therefore, auditors should express an opinion as to whether the relevant financial statements are prepared, in all material respects, in accordance with the framework.

- The proposal to extend the disclosure of auditor's remuneration to cover non-audit services undertaken by the auditor and its associates should be dropped. The existing disclosure requirement in relation to auditor's remuneration under paragraph 15 of the Tenth Schedule of the CO should be restated.[43]

- The proposal to require the financial statements to be accompanied by a directors' declaration stating whether, in the directors' opinion, the financial statements or consolidated financial statements (as the case may be), give a true and fair view of the company or the groups' financial position and financial performance should be dropped[44].

- The following modifications should be made to the requirements for a business review[45] –

  (a) private companies (other than those eligible for reporting exemption) could opt out of the business review requirement by special resolution;

  (b) wholly-owned subsidiary companies would be exempted from the business review requirement;

  (c) the requirement that the business review must be a balanced and comprehensive analysis, consistent with the size and complexity of the company's business, of the development and performance of the company's business during the financial year and of the position of the company's business at the end of the financial year should be dropped

[43] Paragraph 15 of the Tenth Schedule to the CO provides that the amount of the remuneration of the auditors shall be shown under a separate heading, and for the purposes of this paragraph, any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression "remuneration".

[44] Some respondents to the consultation expressed concern that directors who were not accountants might have difficulty opining on the financial statements and that complications would arise in a situation in which the directors made a declaration that, in their opinion, the financial statements gave a true and fair view of the financial position and the financial performance of the company, but the auditor held a different view.

[45] Under the draft CB, all public companies and "large" private and guarantee companies (i.e. other than those qualified to apply the simplified accounting and reporting requirements) are required to prepare as part of the directors' report, an analytical and forward-looking business review that consists of a fair review of the company' s business, and to the extent necessary for an understanding of the development, performance or position of the company's business, the business review must include, inter alia, an analysis using financial key performance indicators.

as the contents of the business review are already adequately covered by other provisions;

(d) a "safe harbour" provision along the lines of section 463 of the UKCA 2006[46] should be added so as to provide directors with protection from civil liability for statements or omissions in directors' reports; and

(e) the provision which prohibited disclosure by cross-reference should be deleted so as to provide more flexibility for companies in preparing the business review and directors' report.

4.12 On the proposal regarding auditor's rights to information, the SCCLR endorsed the following recommendations:

- employees and ex-employees of a company and its subsidiary undertaking should be excluded from the category of persons required to provide information to the auditor;

- the requirement to give "assistance" (in addition to "information and explanation") to the auditor should be removed because "assistance" could be too broad and over-reaching;

- the obligation to provide the auditor with any information or explanation "that the auditor thinks necessary" and "without delay" should be replaced with the obligation to provide any information or explanation "that the auditor reasonably requires" and "as soon as practicable".

4.13 As regards the proposal to remove auditors of a company's subsidiary undertaking from the scope of persons liable to give information or explanation to the auditor of the company, members considered it unreasonable to exclude auditors and ex-auditors from the scope. The SCCLR recommended that ex-auditors of the company and auditors and

[46] Section 463 of UKCA 2006 provides that directors are liable solely to the company, and no other person, for a loss suffered by the company if statements are untrue or misleading or there is an omission of anything required to be in the director's report. The directors are liable if they knew a statement is made in bad faith or recklessly, or an omission is made for deliberate and dishonest concealment of material facts. The protection does not affect any other liability for a civil penalty or criminal offence.

ex-auditors of its Hong Kong subsidiary undertakings should be included in the categories of persons required to provide the information or explanation.[47]

[47] Taking into account other relevant provisions in Part 9 of the CB, in particular clause 9.58 of the draft CB which has the effect of facilitating exchanges of information between the current and former auditors and having regard to the requirements of professional ethics on this subject, the Administration is of the view that ex-auditors of a company need not be included in the scope of persons required to provide information or explanation to the auditor of the company.

CHAPTER 5

Consultation on Review of the Code on Corporate Governance Practices and Associated Listing Rules

Background

5.1 At the 219th meeting held on the 29 January 2011, representatives from The Hong Kong Exchanges and Clearing Limited (HKEx) conducted a consultation with the SCCLR on their consultation paper on "Review of the Code on Corporate Governance Practices and Associated Listing Rules" ("the Review").[48]

5.2 The Review proposed changes to the Code on Corporate Governance Practices ("the Code") and amendments to the Rules Governing the Listing of Securities ("the Rules") to promote a higher level of corporate governance among issuers in Hong Kong and to bring the Code and the Rules in to line with international best practice.

5.3 The major proposal were:

- There should be greater disclosure of time commitments by directors, particularly independent non-executive directors (INEDs) and an open question was posed as to whether to cap the number INED positions an individual should hold. A Rule that INEDs should constitute one-third of an issuer's board ("the one-third rule") should be introduced and the recommended best practice ("RBP") that shareholders vote to retain an INED who had already served nine years on the issuer's board should be upgraded to a code provision ("CP")

- Various board committees should be established by the issuer to assist with corporate governance. There should be a remuneration committee comprising majority INEDs and chaired by an INED with specific terms of reference. The RBP relating to the establishment, composition and terms of reference of the nomination committee should be upgraded to a CP and

[48] HKEx published the consultation paper on 17 December 2010 and a copy of the paper is available at http://www.hkex.com.hk/eng/newsconsul/hkexnews/2010/101217news.htm

there should be an RBP on establishment of a corporate governance committee, with a CP to set out the duties and the composition. The audit committee should meet with the external auditor at least twice a year and an RBP was proposed for the setting up of a whistle blowing policy.

- The RBP on continuous professional development by directors would be upgraded to a CP and directors should spend at least eight hours per year on director's training. Management should provide board members with monthly updates in the form of management accounts or training updates, and issuers should conduct a regular evaluation of the board's performance.

- An issuer should disclose the appointment or resignation of a Chief Executive Officer ("CEO") in the same way as a director and his remuneration should be disclosed.

- The RBP's on responsibilities of the chairman would be upgraded to CP's and the chairman should be a leader in corporate governance and ensure effective contribution from INEDs and non-executive directors, so that board decisions fairly reflect board consensus.

- The rules relating to who could act as a company secretary should be less Hong Kong focused to reflect the fact that more and more issuers operate outside Hong Kong, and the requirement for the company secretary to be ordinarily resident in Hong Kong should be removed. The emphasis should be on qualifications and experience rather than formal requirements. Professional training of 15 hours per year should be undertaken and the board should appoint and dismiss the company secretary who should report to the board chairman or the CEO.

- The remuneration of senior management should be disclosed by band.

- The appointment and removal of auditors should require shareholders approval and, at a general meeting to remove an auditor before the end of his term, he must be allowed to make representation. Management should ensure that auditors attend the AGM to answer questions and auditors should meet with the audit committee of the issuer at least twice a year.

- A number of new measures to improve communication with shareholders , like publication of the procedures for election of directors on the issuer's website, and a new rule for disclosure of the details of attendance at general meetings of each director by name.

- To amend the current rule, which requires any vote by shareholders at a general meeting to be taken by poll, such that there would be an exception for procedural and administrative matters.

Recommendations/Remarks

5.4 Members were generally supportive of the proposals and recommendations put forward in the Review and in general supported the proposed amendments to the Code and the Rules.

5.5 Members did not support imposing a numerical cap on the number of appointments an INED could hold, as most members agreed that the issue depended upon the quality and ability of the individual INED, which would vary. It was agreed that the proposals to increase disclosure of time commitments of directors was welcome.

5.6 A few members expressed concern at the proposal to remove the need for a Hong Kong qualified company secretary but the majority supported mandatory continuing professional training.