STANDING COMMITTEE ON COMPANY LAW REFORM

FOURTH REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subjects considered by the Standing Committee during 1987

TABLE OF CONTENTS

.../P.2

1. Audit Committees

1.1 The White Paper on the Conduct of Company Directors issued in the UK in 1977 summarised the nature and purpose of audit committees in the following terms :

> "In the United States and Canada a practice has developed in recent years whereby the boards of public companies appoint an audit committee composed wholly or mainly of non-executive directors. The duties of the audit committee are flexible depending on the needs of the company, but the core functions are to review the financial statements and to review the audit arrangements and the company's internal financial controls. The audit committee works closely with the auditors who are normally invited to attend its meetings. It has been found in the United States and Canada that audit committees play a useful role in strengthening the influence of non-executive directors and the position of the auditors..... The time may come when it will be appropriate to legislate in this field, but the government believes initially at least it will be better for companies, investors and their representative bodies to work out schemes which can benefit from a degree of flexibility which the law could not provide. It has been found in North America that one of the conditions for the successful operation of audit committees is that the board should contain a sufficient number

.../P.2

of strong and independent non-executive directors to serve on them. This means that companies must be willing to allow members of their senior management or directors to serve as non-executive directors on the baords of other companies, to the general advantage of industry."

1.2 There is still no requirement for the appointment of audit committees in the U.K. but the Government there has continued to do its best to encourage their voluntary appointment and the Bank of England published a consultation paper in January 1987 setting out its stated aim of encouraging larger banks to have both non-executive directors and audit committees.

1.3 The Registrar General submitted to the Standing Committee that we should consider whether there was any need for legislation on the subject in Hong Kong.

1.4 After careful consideration of a substantial amount of material on the subject, we reached the conclusion that there appeared to be a general agreement among the experts that banks, more than any other category of company, should have audit committees. On enquiry, however, we found that audit committees are not yet common among banks here, although we understand that the Hongkong & Shanghai Banking Corporation has set an example in that direction.

.../P.3

1.5 We feel that it would be preferable to wait and see what developments take place in the banking sector regarding the use of audit committees before we reach any conclusion on whether a general statutory requirement for their appointment would be appropriate. We understand that the Banking Advisory Committee will be looking into this question.

2. Company Names

Sections 20 - 22A

2.1 At our November meeting, we considered a submission from the Registrar General, in his capacity as Registrar of Companies, in which he expressed his concern about the number of complaints he receives regarding delays in incorporating new companies. He explained that the main cause of these delays was the length of time it was taking to get approval for a proposed new company name - an average of $5\frac{1}{2}$ weeks.

2.2 The Registrar General was of the opinion that the length of time it took to get a proposed new name approved was due, partly, to the nature of the existing legislation and partly to lack of the resources necessary to handle the volume of work involved.

2.3 With regard to the nature of the existing legislation, the Registrar General explained that, in the vast majority of cases, proposed new company names (either for new companies or for change of name of

.../P.4

existing companies) are reserved under section 20A. Section 20A allows a proposed name to be reserved on payment of a fee of $30 for a period of 3 months if -

(a) it is not already reserved, and

(b) it could be reserved without contravention of the provisions of section 20. The reservation can be renewed on payment of a fee of $15 for a further period of 3 months and such renewals can continue indefinitely.

2.4 Section 20 sets out the legal criteria on the basis of which the Registrar General must decide whether or not a particular proposed name is acceptable. It provides to the effect that, before he approves the proposed name, he must satisfy himself that it is not identical to, or so nearly resembles the name of -

any company incorporated in Hong Kong,
any oversea company registered under Part XI of the Companies Ordinance, or
any statutory body.

as to be "calculated to deceive". There is both U.K. and Hong Kong case law to the effect that "calculated to deceive" in this context means "likely to deceive" i.e. it is not necessary to show that the proposed name is actively intended to deceive.

.../P.5

2.5 The problem lies, of course, in deciding whether the proposed name 'so nearly resembles' the name of any existing Hong Kong registered company, oversea company registered under Part XI or statutory body, as to be likely to deceive. There is considerable case law on the subject and the Companies Registry issues quite detailed guidelines. However, it is inevitable that the decision in any particular case will, inevitably, be subjective to an appreciable extent. The names reservation system in the Registry has been computerised to a large extent but the decision-making process cannot be computerised.

2.6 With regard to the volume of work involved, there was an average of 16,000 applications per month for reservations under section 20A during January-August 1987. There is at present a backlog of about two thousand proposed companies waiting for eight thousand names to be checked. These applications have to be compared with the names of approximately 180,000 existing Hong Kong registered companies, about 39,000 names already reserved under the section, approximately 2,260 overseas companies registered under Part XI and approximately 150 statutory bodies. Fortunately, a computer system has been introduced which identifies which of these existing names are most likely to involve "resemblance" problems in any particular case and this has helped greatly. Nevertheless, the Registrar General considers that sufficient staff have not in the past been provided to operate the names system satisfactorily, although there is hope of reducing the underprovision to some extent during the current financial year.

.../P.6

2.7 However, the Registrar General felt that, even if sufficient staff were provided, it was unlikely that a proposed new name could be reserved under the existing system in less than 10 days because of the need for a decision on the degree of similarity in each case.

2.8 The Registrar General drew our attention to the names system which was introduced in the U.K. by Part II of the Companies Act 1981 and is now contained in Chapter II of the Companies Act 1985. Basically, the U.K. system provides that if a proposed new company name is not the same as an existing company name, it is registrable. The promoters of a company can, of course, check this for themselves and the Registrar of Companies is, for most practical purposes, taken out of the name-approval process.

2.9 The legislation also provides that where a company has been registered by a name which "is the same as or, in the opinion of the Secretary of State, too like a name appearing at the time of the registration in the registrar's index of company names", the Secretary of State may, within 12 months of the registration, direct the company to change its name within such a period as he may specify.

2.10 It was obvious that, before reaching any conclusion on what, if any, changes to the names provisions in the Companies Ordinance are desirable we would need the comments of the usual professional and business organisations. These have been duly requested and a time limit of 15th January 1988 set for their submission. We have also instructed the Secretary to obtain certain information for us on how the UK system is working in practice, although all the preliminary indications are that it

.../P.7

is doing so to everyone's satisfaction. We hope to complete our review of this subject, which is of great practical importance, in the first quarter of 1988.

3. General Fiduciary duty of directors

3.1 The Standing Committee's Annual Report for 1985 gave the history of the previous unsuccessful attempt to introduce legislation on this subject in 1980. Paragraphs 9.5 and 9.6 of that Report read as follows -

"9.5 There are at present two opposing schools of thought among the Members of the Committee on this subject. The first group agree with the Jenkins Committee and the Companies Law Revision Committee that it is desirable that there should be a codification of the basic principles of the law on fiduciary duties of directors which will be readily available for reference by all directors and especially by those who are new to their posts and are perhaps not familiar with these basic principles. At present, the principles can only be studied by referring to legal textbooks and decided cases. The second group agree with the objections expressed by the Law Society of Hong Kong and the Hong Kong Society of Accountants to the proposed codification contained in the draft Bill published as a White Paper in 1980. They consider that the law on the subject is, by its nature, very detailed and complicated and that any attempt to codify its basic principles would be bound to be seriously incomplete and would be a trap for laymen directors who would easily be misled by its apparent simplicity. They feel that the attempted codification would give rise to

.../P.8

more problems than it would solve and that it would be best to continue with the present system where, if a director feels that there may be a question involving his fiduciary duties to his company, he should consult his professional advisers. Both sides agree that before any decisions are reached on any recommendations, the up-to-date views of the professional bodies concerned will require to be obtained. We have also written to the United Kingdom to see if we can obtain further information as to why the 1978 proposals were abandoned.

9.6 Investigation and consideration of the subject are still proceeding."

3.2 The views of the relevant professional organisations were subsequently obtained and were as follows :

"The Hong Kong Bar Association

3.3 "The Bar Committee is provisionally of the view that codification is desirable without prejudice to any rule of law or equity with respect to the duties or liabilities of directors or to other provisions in the Company Ordinance or any other Ordinance."

"The Hong Kong Society of Accountants

3.4 "After due consideration the Society does not consider that it should remain opposed to the concept of codifying the fiduciary duty of directors since it believes it to be vital that directors are reminded of their duties and responsibilities. It considers, however, that there are a number of dangers inherent in the proposed amendment discussed in the attachment to your letter and, in particular, it believes that there would

.../P.9

be a serious risk of oversimplifying the director's duties with the result that the detailed duties and responsibilities established in case law might be overlooked.

3.5 The Society therefore believes that, whilst there is merit in introducing such a statutory codification, careful consideration should be given to the drafting and the proposals should be subjected to wide consultation before they are introduced on to the statute books."

The Law Society of Hong Kong

3.6 "Having spoken with the Chairman of the Law Society's Company Law Committee, I can state that there has been no change in the views previously expressed to you in the above matter. A statutory list of the fiduciary duties of directors could not be exhaustive and a voluntary code of conduct is to be preferred."

3.7 The Secretary reported that he had been unable to obtain any information from the U.K. authorities as to why their 1978 proposals had been abandoned.

3.8 After careful consideration of the up-to-date views of the professional organisations and having regard to the events which have taken place in the business and financial worlds since the Standing Committee last looked at this subject, we decided that a short statutory codification of directors' fiduciary duties is now needed, but that this should be without prejudice to common law and the other provisions of the Companies

.../P.10

Ordinance imposing duties or liabilities on directors. We therefore recommend that a new provision be inserted in the Companies Ordinance, in the following terms :

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"(1) The directors of a company (whether performing their functions or acting individually) shall act honestly in relation to the company and observe the utmost good faith towards it and accordingly shall perform their functions in what they consider to be the best interests of the company as a whole.

(2) The directors of a company shall not perform any of their functions for a purpose not contemplated by the instrument or resolution conferring or imposing that function.

(3) A director of a company shall not

(a) allow a conflict to arise between the duties of his office and his private interests or any duties he owes to any other person; or

(b) do anything which, at the time it was done, could reasonably be expected to involve his contravening paragraph (a) above.

(4) Without prejudice to subsections (1) to (3) above, a director of a company or a person who has been a director of a company shall not, for the purpose of gaining, whether directly or indirectly, an advantage for himself -

.../P.11

(a) make use of any money or other property of the company; or

(b) make use of any relevant information or of a relevant opportunity -

(i) if he does so while a director of the company in circumstances which give rise or might reasonably be expected to give rise to such a conflict; or

(ii) if while a director of the company he had that use in contemplation in circumstances which gave rise or might reasonably have been expected to give rise to such a conflict.

(5) In this section -

"relevant information", in relation to a director of a company, means any information which he obtained while a director or other officer of the company and which it was reasonable to expect him to disclose to the company or not to dislcose to persons unconnected with the company;

"relevant opportunity", in relation to a director of a company, means an opportunity which he had while a director or other officer of the company and which he had -

(a) by virtue of his position as a director or other officer of the company; or

(b) in circumstances in which it was reasonable to expect him to disclose the fact that he had that opportunity to the company.

.../P.12

(6) If any person contravenes subsection (4) above, he shall be liable to account to the company for any gain which he has made directly or indirectly from the contravention and shall be liable to compensate the company for any loss or damage suffered directly or indirectly by the company in consequence of the contravention.

(7) A person shall not be regarded as contravening any of the foregoing provisions of this section by reason of any act of omission which is duly authroised or ratified; but the foregoing provision shall not be construed as permitting the authorisation or ratification of any act or omission which cannot be authorised or, as the case may be, ratified apart from this section.

(8) This section has effect without prejudice to the following -

(a) any rule of law with respect to the fiduciary duties of directors of companies;

(b) any remedies which may be available apart from this section for a breach of any such duty; and

(c) any other provisions of the Companies Ordinance imposing duties or liabilities on such directors or defining their duties or liabilities, and compliance with any requirement of that Ordinance shall not of itself be taken as relieving a director of a company of any liability imposed by this section."

.../P.13

4. Ultra Vires

4.1 The Standing Committee's previous Annual Report dealt with this subject at some length. We explained the history of the previous unsuccessful attempt to legislate on it in 1980 and that we were in the process of consulting the various professional and business organisations for their up-to-date views. We also noted that, in Britain, the Report of Dr. Dan Prentice of Oxford University, who was appointed in December 1985 "to conduct a study into the legal and commercial implications of the proposed abolition of the ultra vires rule as it applies to registered companies", had been published and stated that we were sure that his proposals would also be of the greatest interest and help when we took the subject up again.

4.2 The Committee studied Dr. Prentice's report (which was published as part of a Department of Trade of Industry consultative document) during the period covered by the present Report and noted that the main recommendations could be summarised as follows :

"(a) a company should have the capacity to do any act whatsoever;

(b) a third party dealing with a company should not be affected by the contents of a document merely because it is registered with the Registrar of Companies or with the company (this does not apply to the registration of company charges);

.../P.14

(c) a company should be bound by the acts of its board of directors;

(d) a third party should be under no obligation to determine the scope of the authority of a company's board or an individual director or the contents of a company's memorandum or articles;

(e) a third party who has actual knowledge that a board or individual director does not have actual authority to enter into a transaction on behalf of the company should not be allowed to enforce it against the company but the company should be free to ratify it;

(f) companies should not be required to register objects but should provide a statement of their principal business activities when they commence business and thereafter as part of their annual return;

(g) no additional safeguards are required to protect the interests of shareholders and creditors against imprudent or unfair gratuitous distributions;

(h) existing remedies are sufficient to protect the interests of shareholders generally even if full capacity is conferred on a company."

.../P.15

4.3 We noted that a number of points should be kept in mind when considering Dr. Prentice's recommendations:

(1) We do not yet have in our Companies Ordinance an equivalent of section 35 of the Companies Act 1985 (previously section 9(1) of the European Communities Act 1972) referred to throughout the consultative document and explained on pages 8 -12.

(2) In Chapter VI, page 47, of the consultative document, Dr. Prentice deals with the subject of "Gratuitous Distributions". He points out in paragraph 2 on page 47 : "If a company is given capacity to do any act whatsoever, the question inevitably arises as to whether this would give the green light to unreasonable, non-commercial depletions of a company's assets to the prejudice of its creditors and shareholders. This fear was voiced by a number of consultees in connection with the suggestion that a company be given all the powers of a natural person. It is submitted that this fear is unfounded.".

He then goes on to specify why the fear is unfounded. On pages 51-57, he describes the provisions of section 15, 101 & 102 of the Insolvency Act 1985* as being "designed to

(Note : * These provisions are now in sections 214 and 215; 238, 239 and 240; and 241 of the Insolvency Act 1986)

.../P.16

protect the interests of creditors against the dissiplation by a company of its assets in non-commercial transactions." (para. 13 page 51). Again, in paragraph 25 on page 56 he states "Sections 15, 101 and 102 of the Insolvency Act 1985, and section 615A of the Companies Act 1985, provide creditors with adequate protection against the depletion of a company's assets by gratuitous disbursements which might prejudice their interests.".

It will be recalled that the Standing Committee have considered section 15 of the Insolvency Act 1985 (Responsibility for company's wrongful trading) on a number of occasions and stated in paragraph 11.7 page 56 of the previous Annual Report :

"Having regard to the obvious problems in defining Wrongful Trading and to the forebodings of experts about the practicability of the provisions which have been enacted in Britain we have decided that the sensible approach is to defer a decision on the matter until there has been a reasonable opportunity to see how the British provisions work out in practice."

Section 101 of the 1985 Act (Transaction at an undervalue and preferences) and section 102 (Orders under s. 101) are greatly extended and improved versions of sections 266 (Fraudulent preference) and 266A (Liabilities and rights of

.../P.17

certain fraudulently preferred persons) of our Companies Ordinance. Section 615A of the Companies Act 1985 is a Scottish provision of no relevance in the present connection.

It will be seen, therefore, that the U.K. legislation on which Dr. Prentice relies for his claim that fears about unreasonable, non-commercial depletion of a company's assets in the event of abolition of the ultra-vires rule either does not exist here at all (section 15 of the Insolvency Act 1985) or exists in a very much weaker form (sections 101 & 102 of the I.A.).

Accordingly, the statement in paragraph 31 on page 59 that "Adequate safeguards already exist to protect the interests of shareholders and creditors against imprudent or unfair gratuitous distributions and the conferral of full capacity on a company will not impair their effectiveness" may be open to debate here as far as the interests of creditors are concerned.

On the other hand, there is one statutory protection against dissipation by a company of its assets in non-commercial transactions which exists in Hong Kong but not in the U.K., viz section 155A of the Companies Ordinance (Approval of company required for disposal by directors of company's

.../P.18

fixed assets). Under this section, the directors of a listed company, or of a company which is a member of a group which contains a listed company, cannot dispose of more than 33% of the company's fixed assets unless the disposal has been approved by the company in general meeting.

4.4 The Committee also note that, although Dr. Prentice's recommendations have been welcomed in principle in the U.K., a number of amendments have been suggested in, for example, the Journal of Business Law.

4.5 As far as we are aware, the Department of Trade and Industry in the U.K. has not yet announced the results of its consultations on Dr. Prentice's Report or its proposals for amendments to the legislation in the U.K.

4.6 Having regard to all the circumstances, we decided that before reaching any decision on this matter we would like, in view of the special importance and complexity of the subject, to know the views of individual solicitors and accountants as well as those of their Societies. We therefore instructed the Secretary to prepare a questionnaire on the subject and to ask the Law Society and the Society of Accountants to circulate this to their members. When the results of this exercise are available, we will consider the subject again.

.../P.19

5. Section 18 (Conclusiveness of certificate of incorporation)

Formation of Companies

5.1 In the normal case, the only documents which need to be presented to the Registrar of Companies for the incorporation of a new company are :

(a) the memorandum and articles of the company, both duly signed and witnessed in accordance with the relevant provisions of the Companies Ordinance, and

(b) a statutory declaration under section 18(2) of the Ordinance; Section 18(2) reads :

> "A statutory declaration by a solicitor of the High Court, engaged in the formation of the company, or by a person named in the articles as a director or secretary of the company, of compliance with all or any of the said requirements shall be produced to the Registrar, and the Registrar may accept such a declaration as sufficient evidence of compliance."

5.2 The Association of the Institute of Chartered Secretaries and Administrators in Hong Kong wrote to the Standing Committee stating that a number of local firms which are not solicitors, accountants or members of the Association are holding themselves out as incorporators and salesmen of

.../P.20

'shelf companies'. They name themselves as the first secretaries of the companies in the articles of association and are thus legally entitled to make the statutory declaration under section 18(2). In fact, however, claim the Association, in only a few cases will these firms truly have the ability, linguistic or professional, to make the statutory declaration in the required manner. The Association suggest that only persons having legal, accounting or secretarial qualifications should be permitted to make a statutory declaration under section 18(2).

5.3 We have asked the Law Society of Hong Kong for their comments on the Association's views and are awaiting these before taking this matter any further.

6. Section 20 (Restriction on registration of companies by certain names)

6.1 Section 20 (2)(a) provides that, except with the consent of the Governor, no company shall be registered by a name which contains the words "Royal" or "Imperial" or in the opinion of the Registrar suggests, or is calculated to suggest, the patronage of Her Majesty or of any member of the Royal Family or connexion with Her Majesty's Government or any department thereof.

6.2 The Registrar General informed the Standing Committee that some doubt had arisen as to whether "Her Majesty's Government" in this context refers to the Government of Hong Kong or to the Government of the United

.../P.21

Kingdom or indeed to either of them. His own view was that the sub-clause should be amended to make it clear that the phrase should comprehend either the United Kingdom Government or the Hong Kong Government.

6.3 After consideration of the definition of "Government" in the Interpretation of General Clauses Ordinance and of the origins of section 20(2)(a), we agreed that there appeared to be some doubt on the matter and, in order to clear this up, we recommend that section 20 (2)(a) be amended to make it clear that it applies to connexion with either the Government of Hong Kong or the Government of the United Kingdom or any department of those Governments.

7. Section 38D (Registration of prospectus)

7.1 Section 38D (5) of the Companies Ordinance provides that the Registrar of Companies may refuse to register a prospectus delivered to him for registration if it does not comply in all respects with the Companies Ordinance or contains any information likely to mislead or misleading in the form and context in which it is included.

7.2 Section 38D (7) provides that any person aggrieved by the refusal of the Registrar to register a prospectus may appeal to the court.

7.3 These provisions appear to have been introduced in implementation of the recommendations in paragraph 8.16 of the First Report of the Companies Law Revision Committee (June 1971) relating to paragraph 252 of

.../P.22

the Jenkins' Report. The Jenkins Committee's recommendation has never been implemented in the U.K. and there is therefore no equivalent of Section 38D (5) and (7) in the companies legislation there.

7.4 The Registrar General wrote to the Standing Committee stating that he had become increasingly concerned over the past year or so about the number of prospectuses which contained vague statements of general intention by the directors or as to the intentions of third parties e.g. statements as to a company's future plans or as to undertakings by third parties to hold shares in the company as long term investments. He felt that ordinary members of the investing public placed a great deal of reliance on these statements. In the case of newly-formed companies in particular, the statements were, in the absence of actual track records, all that the investing public had available to assist in forming a judgement. The Registrar General had been unhappy about the excessive vagueness of these statements in some cases and, in discussing the draft prospectus with the company's representatives, had endeavoured to introduce a greater degree of precision by attempting, for example, to persuade the company's representatives to state approximately how long third parties intended to hold shares as "long term investments' or, if in fact there has been no agreement on a particular length of time, to make that clear in the prospectus. However, his efforts met with only varying success.

7.5 The Registrar General considered that his position, as Registrar of Companies, in negotiations regarding draft prospectuses would be much stronger if Section 38D (5) were amended to make it clear that the Registrar could refuse to register where <u>in his opinion</u> a prospectus did not fully comply with the Companies Ordinance or contained misleading

.../P.23

information. He pointed out that the corresponding provision in the New South Wales legislation (Section 103(2)(e) of the Companies (New South Wales) Code), which shows every sign of having been based on the same Jenkins Committee's recommendation which led to our provision, does refer to the opinion of the National Companies and Securities Commission. The section does not, however, provide for an appeal to the court.

7.6 We agree with the Registrar General's views and recommend that Section 38D (5) of the Companies Ordinance be amended to read as follows (proposed additions underlined) :

> "(5) The Registrar may refuse to register a prospectus delivered to him for registration if he is of the opinion that it does not comply in all respects with this Ordinance or that it contains any information likely to mislead or misleading in the form and context in which it is included."

8. Section 48 (Prohibition of provision of financial assistance by a company for the purchase of its own shares)

8.1 In the Standing Committee's previous Annual Report, the history of the unsuccessful attempt in 1980 to revise the existing section was given in same detail.

.../P.24

8.2 The Report concluded by explaining that we had instructed the Secretary:

(1) To draft proposals for an amended section 48 which would allow unlisted companies only to provide financial assistance for the purchase of their own shares, based on the proposed new version of section 48 which appeared in the Companies (Amendment) Billl which was published as a White Paper in 1980 but subject to -

(a) incorporating all the exemptions and clarifications in section 42 of the U.K.'s Companies Act 1981,

(b) bringing the statutory declaration requirements into line with those in the 1981 Act,

(c) incorporating the net assets/distributable profits provision in section 43(2) of the 1981 Act,

(d) imposing heavy monetary and custodial penalties for breach of the provisions.

However, the provisions in section 43(8) of the 1981 Act regarding an auditors report were not to be included;

(2) To send these proposals to the usual professional and business organisations for their views; and

.../P.25

(3) To inform the organisations at the same time that the Standing Committee will consider recommending that listed companies be allowed to provide financial assistance for the purchase of their own shares in due course, after satisfactory legislation has been enacted on the following four subjects:

(a) Disclosure of beneficial ownership of shareholdings,

(b) Insider dealing,

(c) Distributable profits, and

(d) Fiduciary duties of directors.

8.3 In implementing part (1) of our instructions, the drafting of a suggested new version of section 48, the Secretary found that the only practical approach was to adopt and adapt the form of the up-to-date legislation in the U.K. (sections 152-158 of the Companies Act 1985). It would not be practical to include a copy of the draft in this Report because of its size (8½ closely-typed pages) but anyone interested can obtain a copy by contacting the Secretary to the Standing Committee.

8.4 The draft of the proposed new legislation was circulated to the usual professional and business organisations with a request for their comments. Replies were received from four of these and a considerable number of points were raised, perhaps the most important being -

.../P.26

(1) Why was it considered not necessary to have the requirement for an auditors' report in the proposed legislation? and

(2) Were some of the statutory definitions appropriate for Hong Kong?

8.5 Discussions are continuing on these points and we hope to be able to agree on our final recommendations early next year.

9. Section 79 (Payment of certain debts out of assets subject to floating charge in priority to claims under the charge) and Section 265 (Preferential payments)

9.1 In the Standing Committee's Reports for 1985 and 1986, we considered the question of "when is a floating charge not a floating charge" for the purposes of section 79, which deals with preferential payments where a receiver is appointed on behalf of the holders of any debentures of a company secured by a floating charge and the company is not in the course of being wound up. Problems were being caused by the argument that, if a floating charge had crystallised automatically before the receiver was appointed (and such automatic crystallisations were becoming increasingly common) then the charge became a fixed charge and the provisions of section 79 no longer applied. This, of course, meant that the preferred creditors under section 265, particularly employees, lost their preferential rights in the receivership proceedings. To deal with

.../P.27

this problem, we recommended the solution adopted in the U.K.'s Companies Act 1985 i.e. to change the reference to "a floating charge" in section 79 to a reference to "a charge which, as created, was a floating charge". A simple solution to a very technical problem.

9.2 This recommendation was implemented by the Companies (Amendment) Ordinance 1987.

9.3 At the same time, the Administration decided that as our section 265(3B) dealt with the problem of a similar floating charge where there was a winding-up in progress, and as the U.K. had adopted the same amendment to their equivalent of section 265(3B) as the Standing Committee had recommended for section 79, our section 265(3B) should also be amended by changing the reference to "a floating charge" to "a charge which, as created, was a floating charge".

9.4 A leading firm of solicitors has written to the Standing Committee suggesting that the amendment to section 265(3B) may be unfair to the holder of the floating charge in circumstances where a receivership is still in existence at the time of commencement of the winding up of a company because, sections 79 and 265(3B) may no longer be mutually exlcusive in their operation.

9.5 We have asked the usual professional and business organisations, and also certain Government Departments, for their views and when these are available we shall resume consideration of this point.

.../P.28

10. Section 103 (Power for company to keep branch register)

10.1 Under section 103 the Registrar General in his capacity as Registrar of Companies may issue an annual licence to any company whose objects comprise the transaction of business outside Hong Kong, empowering it to keep in any place in which it transacts a substantial part of its business, a register of members. An annual fee is payable at the rate of 4 cents for every $100 of the paid up capital of the company.

10.2 The Second Report of the Companies Law Revision Committee recommended extensive amendments. The Committee saw no need for any restriction as to the place at which a branch register may be kept or for a system of annual licensing.

10.3 The recommendations in the Second Report have not been implemented. Instead, minor amendments were effected by the Companies (Amendment) Ordinance 1984 to deal with a number of minor anomalies in the drafting of the section.

10.4 The Registrar General reported to the Standing Committee that he had received the first-ever application by a company for a second branch register. This had revealed a number of still-existing anomalies in the section relating as to whether more than one branch register could be permitted and, if it could, whether a separate fee should be charged for each register. He suggested that the Standing Committee consider what amendment were necessary to deal with these anomalies or, alternatively, consider whether basic amendments of the nature already recommended by the Companies Law Revision Committee were required.

.../P.29

10.5 We consider that we should have the views of the usual professional and business organizations before reaching any decisions and when these are available we shall resume our consideration of this subject.

11. Section 123 (General provisions as to contents and form of accounts)

11.1 Subsections 123(1) and (2) require a company's annual accounts -

(a) to give a true and fair view of the state of the company's affairs, and

(b) to comply with the requirements of the Tenth Schedule to the Companies Ordinance as to the contents of accounts.

11.2 Section 123(6) sets out the penalties (6 months imprisonment and a fine of $10,000) applicable to any director of a company who fails to take all reasonable steps to secure compliance with the requirements of subsections (1) and (2), but there are two provisos -

Proviso (a) states that it shall be a defence for the director to prove that he had reasonable ground to believe, and did believe, that a competent and reliable person was charged with the duty of seeing that the said requirements were complied with and was in a position to discharge that duty; and

Proviso (b) states that the director shall not be imprisoned unless, in the opinion of the court, the offence was committed wilfully.

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11.3 There is a similar statutory defence to being charged with an offence under section 122 i.e. failure to lay a balance sheet and profit and loss account before the annual general meeting of a company.

11.4 The Registrar General has pointed out to the Standing Committee that our section 123(6) was lifted straight from section 149(6) of the U.K.'s Companies Act 1948. A new section 149(6) was substituted by section 42(1) of, and Schedule 2 to, the Companies Act 1976. The new form of defence in the substituted version of section 149(6) is repeated in the Companies Act 1985, section 245(3).

11.5 The Registrar General has submitted to us that we should reconsider the statutory defence in section 123(6) in the light of the new provisions in the U.K. and the corresponding provisions in Singapore and Australia.

11.6 We have asked the Registrar General for further information about the use of the statutory defence in Hong Kong and also about the corresponding legislation in other comparable jurisdictions. We shall resume consideration of this subject when this information is available.

.../P.31

12. Section 141D (Power of shareholders of certain private companies to waive compliance with requirements as to accounts)

12.1 Section 141D is an unusual provision with no direct equivalent in the UK's companies legislation. It was introduced by the Companies (Amendment) Ordinance 1974, which implemented many of the recommendations of the Second Report of the Companies Law Revision Committee regarding company accounts. Section 141D itself, however, did not form part of those recommendations.

12.2 The section provides that where all the shareholders of a private company agree in writing that the section shall apply with respect to a financial year of that company, then the normal provisions regarding the company's annual accounts, directors' report and auditors' report shall not apply and instead they shall comply with the much simpler requirements of the section regarding the directors' and auditors' report and of the Eleventh Schedule regarding the annual accounts. The section does not apply to a private company which has any subsidiary or is a subsidiary of a Hong Kong company or which carries on banking insurance business, is a registered dealer under the Securities Ordinance, accepts loans of money at interest by way of trade or business, other than banking business, otherwise than on terms involving the issue of debentures or other securities, or owns or operates ships or aircraft engaged in the carriage of cargo between Hong Kong and places outside Hong Kong.

12.3 In a case where section 141D does apply, subsection (1)(e) provides that the auditors' report shall state -

.../P.32

(i) whether or not the auditors have obtained all the information and explanations which they have required; and

(ii) whether in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

12.4 It will be noted that the auditors' report does not deal with the company's annual profit and loss account at all.

12.5 The Hong Kong Society of Accountants wrote to the Standing Committee raising two points with respect to the provisions of section 141D which were causing them concern -

(i) Under section 141D auditors are required to state whether in their opinion the balance sheet of a company exhibits "a true and correct view" of the state of the company's affairs. Under the normal provisions of the Companies Ordinance, i.e. section 141(3), auditors are required to state whether the balance sheet give "a true and fair view". Neither "a true and correct view" nor "a true and fair view" is defined in the Ordinance. The Society were concerned that most companies which produced accounts under section 141D appeared to believe that it exempted them not merely from the full reporting requirements of the

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Ordinance but also from the rigours of a full audit and there was consequently pressure on auditors not to carry out all the procedures which the Society believed to be necessary. The Society hoped that the issue of an auditing guideline on this topic, drawing attention to the Society's view that a full audit should be carried out, would help to resolve the difficulties experienced by auditors in this regard. They also believed, however, that the existence of dual reporting requirements which are not defined in the law would inevitably result in double standards which should be discouraged. They therefore recommended that section 141D should be amended to require the auditors to report or whether the balance sheet gives a "true and fair view" on the basis of the disclosure exemptions permitted under the section.

(ii) The auditors' report is not required to deal with the company's profit and loss account. The Society believed, however, that this should be required since a balance sheet on its own is not sufficient to give a true and fair view of a company's affairs.

12.6 The Society also pointed out that, if their views on amendments required to section 141D were accepted, it would be necessary to cancel the exemption in section 141D(1)(a) from the provisions of section 121(2) (which requires a company to keep such books of account as are necessary to give a true and fair view of the state of the company's affairs).

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12.7 After careful consideration of the points raised by the Society, we agree that they are reasonable and recommend that section 141D be amended -

(1) to require the auditors to report on whether the accounts show a true and fair view on the basis of the disclosure exemptions permitted under the section;

(2) by extending the references to the company's balance sheet in the section to include the company's profit and loss account; and

(3) by deleting the exemption from section 121(2).

13. Section 157H (Prohibition of loans to directors, etc.) & Section 161B (Particulars in accounts of loans to officers, etc.)

13.1 The Hong Kong Society of Accountants wrote to the Standing Committee setting out a number of problems arising from the practical implementation of sections 157H and 161B, e.g. they did not contain provisions corresponding to the U.K. provisions in respect of "quasi-loans" to directors and the legal status of such loans in Hong Kong was therefore unclear.

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13.2 The Standing Committee consulted the usual professional and business organisations for their views on the Society of Accountants' comments. Their replies were detailed and consideration of several aspects of this subject is continuing.

14. Section 161 (Particulars in accounts of directors emoluments, pensions etc.)

14.1 The Registrar General has pointed out to us that there is a reference in section 161(5)(a) to section 163(4) but that section 163(4) was deleted by the Companies (Amendment) 1984, being replaced by the provisions of section 163B (2) and (3) of the amended Ordinance. He suggested that, from the context, the reference in section 161(5)(a) should now be to section 163B (3).

14.2 We agree and recommend that section 161(5)(a) be amended by deleting '163(4)' and substituting '163B(3)'.

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15. Section 233 (Statutory declaration of solvency in case of proposal to wind up voluntarily

15.1 Section 233(2)(a) states that the statutory declaration of solvency made by the directors of a company for the purposes of the proposed members' voluntary winding up of the company shall have no effect unless "it is made within the 5 weeks immediately preceding the date of the passing of the resolution".

15.2 The Registrar General reported to the Standing Committee that there have, however, been cases where the statutory declaration bears the same date as the date of the resolution for winding-up, and there used to be argument as to whether in such a case the declaration could be said to have been made within the 5 weeks immediately preceding the date of the passing of the resolution. The Registrar General took the view that the word 'date' means 'day' or 'day of the date' and thus had a policy of rejecting a declaration which was not of a date earlier than the date of the passing of the resolution for winding-up.

15.3 The view taken by the Registrar General coincided with the view taken by the Registrar of Companies in England on a similar provision in the 1948 Companies Act. That provision, however, had been amended by section 577 of the Companies Act 1985, the relevant part of which read as follows :

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"(a) it is made within the 5 weeks immediately preceding the date of passing of the resolution for winding-up, or on that date but before the passing of the resolution" (Empasis added).

15.4 The Registrar General's view of the effect of the existing provision in section 223(2)(a) has been upheld in a recent court decision. He considers that, as a matter of practice, it is desirable that directors shall be allowed to make the statutory declaration on the same day as, but before, the resolution for winding-up, as in England.

15.5 We agree and recommend that section 233(2)(a) be amended to read:

"(a) it is made within the 5 weeks immediately preceding the date of the passing of the resolution for winding up the company, or on that date but before the passing of the resolution, and is delivered...." etc.

16. Section 305 (Inspection, production and evidence of documents kept by Registrar)

16.1 Section 305(3) provides that a copy of or extract from a document registered at the Companies Registry, which is certified by the Registrar General as Registrar of Companies to be a true copy, shall in all legal proceedings be admissible in evidence as of equal validity with the original document.

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16.2 The Registrar General has informed the Standing Committee that, under the above provision, it is still necessary, if a certified copy of a document registered in the Companies Registry is being produced in court proceedings, for a duly authorised officer from the Companies Registry to attend at court to produce the copy.

16.3 The Registrar General has submitted to us that it would be more appropriate to amend section 305(3), along the lines of similar provisions in the Evidence Ordinance, Cap. 8 section 23, and the Land Registration Ordinance, Cap. 128 section 26A, to provide that a document purporting to be such a copy or extract and duly certified shall be admissible in evidence in any proceedings before any court on its production without further proof and that, until the contrary is proved, the court shall presume that the signature and certification is genuine and that the document is a true and correct copy.

16.4 We agree with the Registrar General and recommend that section 305(3) be amended as suggested by him.

17. Section 333 (Documents etc. to be delivered to Registrar by oversea companies which establish a place of business in Hong Kong)

17.1 Section 333 was substantially amended by the Companies (Amendment) Ordinance 1984.

.../P.39

17.2 A new provision was included requiring an oversea company seeking registration under Part XI of the Companies Ordinance to produce, amongst other documents, under section 333 (1)(e) a certified copy of the company's certificate of incorporation.

17.3 The Registrar General, as Registrar of Companies, has informed the Standing Committee that experience has revealed a serious complication with this requirement, namely, that a considerable number of oversea companies and domiciled in jurisdictions which do not have a Companies Registry as such and therefore cannot produce a certificate of incorporation. The Registrar General explained that he had been following a policy of accepting the nearest equivalent which was usually a certificate of registration or an extract from the commercial register but that there were continuing practical difficulties in this regard. He therefore suggested that it was desirable that he be given statutory discretion in the matter and that section 333(1) be amended accordingly, possibly by the addition of a third sub-paragraph to the proviso to the subsection as follows :-

> "(iii) If the Registrar is satisfied that it is not the practice to issue a certificate of incorporation in the company's place of incorporation, a certified copy of such other certificate or document, which establishes to his satisfaction that the company is duly incorporated in and under the laws of that place, will be sufficient."

17.4 We agree with the Registrar General's suggestion and recommend that section 333(1) be amended accordingly.

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18. Section 341 (Interpretation of Part XI)

18.1 Part XI of the Companies Ordinance requires an oversea company to register with the Registrar of Companies in Hong Kong if it establishes "a place of business" here.

18.2 The interpretation of the phrase 'place of business' has always caused problems in practice. The definition in section 341 states that it includes a share transfer or share registration office and any place used for the manufacture or warehousing of any goods but does not include a place not used by the company to transact any business which creates legal obligations. The words underlined were added in 1984 in implementation of recommendations in the Second Report of the Companies Law Revision Committee designed to make the definition clearer.

18.3 The Association of the Institute of Chartered Secretaries & Administrators in Hong Kong wrote to the Standing Committee, however, stating that it had become apparent that significant difficulty was still being encountered by the way in which "place of business" was interpreted. They thought that although the statutory definition excluded such places as were not used for the creation of "legal obligations", it was almost impossible to do anything without creating some kind of legal obligation. The Association therefore requested the Standing Committee to consider amending the definition of "place of business" in section 341 to provide that an oversea company shall not be regarded as having established a place of business here simply by reason of meeting only one of the following tests :-

.../P.41

(a) it is or becomes a party to an action or suit or an administrative or arbitration proceeding or effects settlement of an action, suit or other proceeding or of a claim or dispute;

(b) it holds meetings of its directors or shareholders or carries out other activities concerning its internal affairs;

(c) it maintains a bank account;

(d) it effects a sale through an independent contractor;

(e) it solicits or procures an order that becomes a binding contract only if the order is accepted outside Hong Kong;

(f) it creates evidence of a debt or creates a charge on property;

(g) it secures or collects any of its debts or enforces its rights in regard to any securities relating to such debts;

(h) it conducts an isolated transaction that is completed within a period of 31 days, but not being one of a number of similar transaction repeated from time to time; or

(i) it invests any of its funds or holds any property.

We have noted that the tests listed are very similar to those laid down in Australian legislation dealing with circumstances where a company is deemed not to be carrying on business in a State.

18.4 We have obtained the views of two other organisations on these proposals and at the same time are reconsidering the effect of the legislation in Australia, we shall return to the question in due course.

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19. Tenth Schedule (Accounts)

19.1 Under section 123(2) the annual balance sheet and profit and loss account of a company must comply with the requirements of the Tenth Schedule.

19.2 Paragraphs 9(1)(a), 12(11), 13(1)(g) and 31(a) of the Tenth Schedule contain references to "listed investments" and "unlisted investments". For example, paragraph 9(1)(a) provides that a company's balance sheet must show under separate headings "the aggregate amounts respectively of the company's listed investments and unlisted investments".

19.3 Paragraph 31(a) of the Schedule defines "listed investment as meaning an investment as respects which there has been granted a listing on the Hong Kong Stock Exchange, or on any stock exchange of repute outside Hong Kong, and provides that the expression "unlisted investment" shall be construed accordingly.

19.4 Prior to 1984, the terms "quoted investments" and "unquoted investments" had been used in the Tenth Schedule but these had been amended to "listed investments" and "unlisted investments" respectively in that year to bring them into line with the corresponding British legislation.

19.5 A leading firm of accountants wrote to the Standing Committee suggesting that the amendment had had undesirable consequences because, in their view, the term "listed investment" appeared to have a more restricted meaning than "quoted investment". This meant that -

.../P.43

(a) The resulting disclosure was misleading to the readers of accounts since those investments which were quoted but not listed (e.g. shares on the USs Over-the-counter market or the UK's Unlisted Securities Market) were treated as unlisted investments, although their market value was as readily available as that of listed investments.

(b) The requirements were causing significant difficulties for some companies, particularly overseas securities dealers incorporated in Hong Kong, where investments holdings were complex and where accounting systems were not designed in such a way that income from listed investments could readily be extracted from quoted investment income.

19.6 We consulted the Hong Kong Society of Accountants for their views on the matter.

19.7 The Society replied agreeing that there was a problem and adding that this was part of a larger problem, namely, continuing interpretational difficulties experienced with the Tenth Schedule's requirements. They recommended that the Schedule be reviewed by the Standing Committee with a view to its complete revision. They advised that they were requesting their members views on and experience of the Tenth Schedule's requirements and that they would revert with detailed comments in due course. They also recommended that consideration be given to incorporating into the Companies Ordinance a provision which sets out the relationship between the Tenth

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Schedule and the statutory requirement that the annual accounts show a true and fair view. The suggested that section 228 of the British Companies Act 1985 might be an appropriate model.

19.8 We informed the Society that we awaited the outcome of their consultations with their members with interest. We will resume our consideration of this subject when the members' comments are available.

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Appendix 1

Interim Reports submitted to the Financial Secretary during 1987

Second Interim Report dated March 1987 : Insider Dealing

Third Interim Report dated July 1987 : B Shares

Copies of the Reports are annexed.

Appendix 2

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 Monetary Affairs to the Governor in Council on those amendments to the Companies Ordinance that are under consideration from time to time by the Standing Committee.

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

Appendix 3

Membership of the Standing Committee
as at 31st December 1987

Chairman : The Hon. Mr. Justice Cons

Members : Mr. Malcolm A. Barnett,

The Hon. Mr. Thomas Clydesdale,

.../P.46

Mr. D.E. Connolly, JP,

Mr. Kenneth Fang Hung, JP,

Mr. Raymond P.L. Kwok,

Mr. Andrew Li Kwok-nang, JP,

Mr. Eric K.C. Lo,

Mr. P.J. Pearson,

Professor L.G. Edward Tyler

Mr. Charles H. Wilken,

Professor P.G. Willoughby, JP,

Mr. C.H. Wong, JP,

Mr. F. Charles Wrangham,

Ex-officio Members :

Mr. Stephen S.K. Ip, Deputy Secretary for Monetary Affairs (1), as representative of the Secretary for Monetary Affairs,

Mr. Noel M. Gleeson, OBE, JP, Registrar General,

Mr. A.W. Nicolle, Commissioner of Banking,

Mr. Ray Astin, JP, Commissioner for Securities and Commodities Trading,

Mr. J.R. Sulan, Consultant, Commercial Crimes Unit, Attorney General's Chambers

Secretary : Mr. P. Murphy, Registrar General's Department

.../P.47

Appendix 4

Meetings held during 1987

Twenty-ninth Meeting	-	5th January
Thirtieth Meeting	-	7th February
Thirty-first Meeting	-	21st February
Thirty-second Meeting	-	14th March
Thirty-third Meeting	-	4th April
Thirty-fourth Meeting	-	2nd May
Thirty-fifth Meeting	-	6th June
Thirty-sixth Meeting	-	4th July
Thirty-seventh Meeting	-	3rd October
Thirty-eighth Meeting	-	7th November
Thirty-ninth Meeting	-	12th December

SECOND INTERIM REPORT OF THE STANDING

COMMITTEE ON COMPANY LAW REFORM, DATED 16TH MARCH 1987

Insider Dealing Legislation

The present legislation with respect to insider dealing, which is to be found in Part XIIA of the Securities Ordinance, was enacted in 1978. In particular Section 141B defines when insider dealing takes place, and Section 141C establishes the Insider Dealing Tribunal, which is, upon request by the Financial Secretary, required to determine in any particular circumstances whether culpable insider dealing has taken place, the identity of persons involved therein, and the extent of their culpability. Culpability is not defined within the ordinance, but Section 141C sets out circumstances in which a person is, or may be held to be, not culpable. Persons found to be culpable may be named in the report published by the Tribunal, but there is no provision in the ordinance for any further sanction.

2. Apart from a preliminary consideration in 1984 the Standing Committee has now discussed the legislation fully at some seven meetings, the last being on the 21st February. Members are unanimous in the view that the present legislation is not satisfactory. Public censure is not a sufficient, if any, deterrent to those intending to take unfair advantage of confidential price-sensitive information in their possession. More effective deterrents are essential.

3. The Committee are also concerned over the breadth of the concept of culpability. While culpable insider dealing may in some instances comprehend conduct which is downright dishonest, it is now

/2 .....

confirmed by the judicial review of the Clough Tribunal's Report that it may at the other extreme extend to conduct which is no more than simple negligence in a director's control of his own company's affairs. In the Committee's view, despite judicial suggestion to the contrary, many commercial men do equate culpable insider trading with fraud or dishonesty and find difficulty in accepting less reprehensible conduct as insider trading at all.

4. It is also felt that a finding of culpable insider trading based on conduct which is basically honest, although reprehensible for other reasons, may be misunderstood by persons in other jurisdictions who would not appreciate the finer points of our legislation vis-a-vis their own and who are unlikely to read the report of an Insider Dealing Tribunal in detail, but would rely instead on more generalised press reports. This misunderstanding could unfairly detract from the reputations of the individual in question and of the Hong Kong commercial community in general.

5. If the Tribunal is to be retained the Committee would therefore recommend that the question of culpability as such be removed from the ambit of the inquiry and the term "insider dealing" be reserved for conduct which is deliberately intended to take advantage of privileged information. However the Committee are concerned that lesser conduct tending in the same direction should not be ignored, and suggest the introduction of some other term which would indicate conduct, including negligence, which is not in itself insider dealing but which may lead to, induce or allow

/3 .....

insider dealing by others. An arresting name or description is desirable to make the distinction immediately clear, but this should not be beyond the wit of the draftsman. Moreover a clear definition of the concept within the legislation will assist those in the legal profession who at the moment experience difficulty in advising what may or may not be acceptable in this respect.

6. Furthermore the definition in Section 141B is not as extensive as that found in other jurisdictions, and, again if the Tribunal is to be retained, the Committee would recommend amendments be made to extend the section (a) to cover cases in which the relevant information relates not to the corporation with which the person under inquiry is connected but to some other corporation with which that corporation is involved; and (b) to make it clear that tippees are liable for acting on information which has been passed to them.

7. However, the crucial question which has given rise to much anxious consideration within the Committee and on which we still remain divided, is whether insider dealing should be made a crime, subject to normal criminal process, or whether the present Tribunal should be retained, but with extended powers. It has been suggested that it might be helpful to await the outcome of the investigations currently taking place in London, and in particular to see what, if any, convictions are obtained. But in the light of the world-wide publicity given to those investigations, and to the extensive activities of the Securities Exchange Commission in the United States of America, it was thought that the image of Hong Kong as a reputable financial centre would be seriously tarnished if it were not seen to be giving active consideration to the problem here.

/4 .....

8. We have been advised by the Attorney General that there is no legal impediment to the imposition of financial penalties by the Tribunal, although questions may be raised as to the need then for mens rea or as to the necessary standard of proof. We have already commented on the former. As to the latter we note that although Mr. Justice Kempster in his review of the Clough Tribunal's Report concluded that the Tribunal had applied a standard higher than that actually required by the law, the Tribunal had in fact insisted that the dealing be "established beyond doubt by the most cogent evidence". We would expect subsequent tribunals to do likewise.

Criminalisation

9. If criminalisation is to be adopted as a matter of policy a convenient precedent is immediately available in the form of the English legislation which could be conveniently adopted in Hong Kong with no substantial change.

10. There are two forcible arguments in favour of this course. Firstly it has a very great deterrent value. The mere possibility of imprisonment has an in terrorem value far in excess of the financial penalties that might otherwise be imposed and which would probably be looked upon as no more than calculable commercial risks.

11. Secondly, the failure of Hong Kong to take the ultimate step may decrease international confidence in Hong Kong as a financial centre of integrity. Most of the major financial jurisdictions throughout the world have already made insider dealing an offence, although it is interesting to note that the

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federal legislation under which insider dealers are usually charged in the United States of America deals with securities frauds in general terms and does not specifically refer to insider dealing. Hong Kong is seen as the odd man out.

12. Furthermore, say those in favour of criminalisation, it is a question of basic morality. They observe that as long ago as 1973 the Second Report of the Companies Law Revision Committee recommended that insider dealing should be made a criminal offence (paragraph 7.130). The Committee referred to it there as "these dishonest transactions", and later mentioned with approval the comments of an American court that "the fraud involved in buying or selling on the basis of inside information is based first on the user's relationship with the corporation being such as to allow him access to information intended only for a corporate purpose and not for his personal benefit, and secondly upon the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.". For this reason those who advocate criminalisation would limit it to 'real' insider dealing and would not extend criminal sanctions to negligent conduct of the kind referred to in paragraph 5.

13. The main argument against criminalisation is the difficulty of obtaining sufficient admissible evidence to obtain convictions. The track record so far in those countries where it has already been adopted is seen to be extremely poor. For example in England, where insider dealing has been a crime since 1980, out of 100 referrals by the Stock Exchange only 9 have resulted in prosecution, and of those only 5 have led to a conviction.

/6 .....

However, the recent spate of prosecutions there may alter the situation.

14. The relevant powers of an inspector appointed either by the Financial Secretary or by the Securities Commission, which go further than those accorded, until last year, to a similar inspector in England, are to be found in Section 145 of the Companies Ordinance and Section 127 of the Securities Ordinance. In effect the person being questioned is bound to answer all questions that are put to him, but if, before answering, he claims that the answer might tend to incriminate him, then neither the question nor the answer may be subsequently given in evidence against him in criminal proceedings. Those on the Committee who have experience in criminal prosecutions are of the opinion that only by removal of that proviso, that is by depriving the suspect of his "right to silence", could prosecutions be mounted with confidence or the criminal process be made truly effective. The "right to silence" has long been considered one of the most important bastions of justice and to remove it would be a most serious step. Whether that has been done in England by Sections 177 and 178 of the Financial Services Act 1986 is a moot point, although highly respectable authority suggests that it has (Professor Gower, informally, in a letter to one member of the Committee). We respectfully think the question will have to await judicial decision. In any event it would, at this stage of Hong Kong's evolution, be a most dangerous precedent.

The Tribunal System

15. By contrast Tribunal proceedings are investigative in nature and do not lend themselves to such tactical manoeuvring. Procedure is also much more flexible. No particular charge as

such need be laid and, within the confines of its terms of reference, the Tribunal is free to pursue its investigations in such directions and against such persons as it finds appropriate during the course of its entire proceedings. This, too, may of course result in unduly prolonging process, but lessons have been learnt from experience and it is not expected that the terms of reference of any future tribunal will be so widely drawn as the last. It is also expected that more use will be made of inspectors in the preparatory stages of the inquiry, and possibly in support of the Tribunal during the course of the inquiry itself.

16. Those in favour of retaining the Tribunal see it as a Hong Kong solution to a Hong Kong problem. They recognise that the market here has features of its own, in particular that many, if not most, of the major listed companies are controlled, not by professional managers, but by shareholding directors who will intervene in the market from time to time as they think necessary for the protection of share values. The others point to what they see as a growing international flavour within the market and are firmly of the view that controlling shareholding directors, however well intentioned, ought to be discouraged from thus trading in their own shares.

17. Those in favour are also concerned to preserve what they view, in a matter of this nature, as the very considerable advantages enjoyed by the inquisitorial, as opposed to the adversarial system employed by the Tribunal. They also point out that to extend the powers of the Tribunal at this stage would not necessarily preclude reconsideration of criminalisation in the future should experience indicate that this was desirable.

/8 .....

Conclusion

18. It became apparent in the course of our discussions that however long they might be continued total agreement was not going to be reached. It was therefore thought appropriate to conclude the matter by recording the number of those in support of the various options. It was thus found that one member supported criminalisation to the extent of depriving a suspect of his right to silence, six further members were in favour of this course with the powers of inspectors to remain as they now stand, and ten members preferred to retain the present Tribunal system with extended powers.

Extended Powers

19. The Committee had already discussed at earlier meetings, the ways in which the powers of the Tribunal could profitably be extended if, as a matter of policy, the Tribunal system were to be retained, and in this respect the Committee is in general agreement.

20. It is thought that the most useful approach is to exclude offenders so far as is possible, from the field where their conduct has offended. In its First Report for the year 1984 the Committee recommended that a finding of culpable insider dealing should be a further ground for application to the court under Section 157E of the Companies Ordinance. That section provides that, broadly speaking, where a person has been found guilty of acting fraudulently in the formation or management of a company, the court may make an order that he shall not, for a period generally not in excess of five years, without the leave of the court, be a director or a liquidator or a receiver or manager of the property of a company or take part in the management of a company in any way.

/9 .....

21. On further consideration this appears to be an unnecessary duplication of proceedings. The Tribunal will already be in possession of all the relevant material and its Chairman will be at least a High Court Judge. It seems to the Committee then that it would be more appropriate, and certainly more convenient, for the question to be considered by the Tribunal itself. It therefore recommends that the Tribunal be empowered to make such an order as would be open in other circumstances to a court under Section 157E. At the same time the Committee realise that not all offenders or potential offenders will be directors of limited companies or directly involved with management of the same, but may be instead persons engaged in professions or occupations closely involved with the securities market. So that such others may be equally deterred the Committee recommend that a similar power be given to the Tribunal to disqualify them from giving advice in relation to securities or from dealing in securities by way of profession, or, where such persons are members of a profession or association which has its own disciplinary procedures, formally to report their conduct to the appropriate committee.

22. It is also thought highly desirable that an offender should be required to disgorge any profit improperly made or the amount of any loss improperly avoided. That in itself is unlikely to have much deterrent value, but in addition the Committee suggest the possibility of a financial penalty of up to three times the amount of that profit. It is thought that a penalty of that kind, together with the publicity of its announcement, would give pause

/10 .....

for thought to those tempted to misbehave or to manage their companies' affairs too casually. The figure of three is taken from American legislation and annexed hereto is a draft provision, adopted from an Australian suggestion, which might prove suitable for enacting the recommendations contained in this paragraph.

23. For conduct falling within the lesser statutory definition now proposed the Committee suggest a power in the Tribunal to record a formal note of censure or "no order".

24. Enforcement of fair dealing in the market is an expensive undertaking. It is necessary only because there are those who transgress. The Committee see no reason why those who have been found to transgress should not contribute financially towards the cost of such enforcement and recommend therefore that where the Tribunal makes any order in respect of a person, it may also make an order for costs in such amount as it thinks fit.

25. The Committee are not inclined for the moment to recommend the introduction of specific civil remedies, whether to be brought privately or by the Commissioner for Securities. Serious problems of causation would arise and it might be difficult to restrict the liability of the offender within limits reasonably proportionate to his misconduct. If the Tribunal's powers are increased in the manner suggested it may be desirable to enable the report of or the record of evidence given before the Tribunal to be used in the enforcement of individual rights to compensation held by parties affected by insider dealing in a particular case. That is something the Committee would like to consider in due course. In the meantime, it may be necessary for any amending legislation to provide that the Tribunal's powers are without prejudice to such individual rights, although this is eminently a matter for the draftsman concerned.

/11 .....

Appeal

26. The only avenue by which a person at present aggrieved by the decision of a Tribunal can question its correctness is by way of judicial review. This is a proceeding in the High Court, conducted by a single judge of that court with recourse thereafter, if appropriate, to the Court of Appeal. Both at first instance and on appeal only questions of law can be raised. The Tribunal's decision in other respects cannot be challenged. In the Committee's view the jurisdiction of judicial review is too restrictive in the context of an Insider Dealing enquiry. A person's reputation, and perhaps his or her whole commercial career, is at stake. And if the Committee's other recommendations are accepted there may be significant sums of money also at risk. In these circumstances the Committee feel that a general right of appeal is merited.

27. Moreover judicial review is not normally available in respect of decisions of the High Court. Yet the Chairman of the Tribunal must be at least a judge of that Court, and in the two held so far has been a Justice of Appeal. The determination of questions of law within an inquiry are for the Chairman alone. It may therefore be thought invidious that they should be subject to review by an authority of equal or perhaps lesser standing. The Committee therefore recommend that judicial review of a Tribunal's decision be expressly excluded by legislation, and that instead a general right of appeal to the Court of Appeal be granted.

Public Hearings

28. The Clough Tribunal recommended that, subject to a discretion to sit in camera where the interest of justice so required, the sittings of the Tribunal should be in public. Their report quoted the comments of the Salmon Report that

/12 .....

investigations conducted behind closed doors -

> "will always tend to promote the suspicion, however unjustified, that they are not being conducted sufficiently vigorously and thoroughly or that something is being hushed up."

and continued -

> " The main purpose of the insider dealing legislation is to preserve the integrity of the market place for the benefit of the investing public at large. We suggest that if inquiries into suspected culpable insider dealings are not held in public, then public confidence in the implementation of the insider dealing legislation, and indirectly in the market place, will be diminished. If a connected person, who is of high standing or a professional man, is found not culpable of insider dealing it may be because his conduct has been wholly vindicated or, at the other extreme, because the finding of the Tribunal was the equivalent of 'not proven'. As the law stands now, he alone can decide whether or not the public is to know the facts and the reason why the Tribunal has found him not culpable."

29. The Standing Committee recognised the force of the arguments thus set out, but the majority are concerned at the unwarranted prejudice that would be caused to those who in the end are cleared of all wrongdoing and for this reason would prefer that the hearings continue to be held in private.

Enforcement

30. The Committee cannot emphasize too strongly their view that the provision of an effective legal process will not in itself prevent the occurrence of insider dealing. It is only part, albeit an essential part, of a composite attack. The first step must be the enactment of the disclosure provisions consequent upon the recommendations made by the

Committee in December 1985. Without that legislation it will be impossible to do more than scratch the surface. The next step is to provide the Commissioner for Securities with sufficient resources to monitor regularly and comprehensively the information that will thus be disclosed. It is only by such surveillance of the market that he will be able to pinpoint situations in which insider dealings may have taken place. Thirdly, it will be necessary then to make proper and thorough investigation to see whether that is indeed the case. Only then can penal action be taken against the offender.

31. For the Commissioner to carry out effectively what will be expected of him he will need a capable and qualified staff. This will of course cost money, although, as we suggested earlier, some may perhaps be recouped if an offender is successfully dealt with. Even so, there will be significant initial outlet at least. However, unless the administration is willing to make sufficient investment in this way, amendment to the legislation will bring only cosmetic change to the situation.

Education

32. The Clough Tribunal's Report on the trading in International City Holdings Ltd commented on the lamentable and general ignorance of the law in this respect. There may even still be some who do not think insider dealing is to be deplored. The provision and enforcement of effective legal process will be one way in which the dishonesty of the practice will undoubtedly be brought home. There may be others. For example, if the Tribunal system is to be retained it may be that its public image will be enhanced if, rather than appointing a separate tribunal on each occasion, something on a more permanent

footing were to be established. Again, the Commissioner for Securities has drawn our attention to the requirement of the London Stock Exchange that all companies listed on the Exchange or trading on the unlisted securities market must, in regard to insider dealing, possess and operate internal compliance procedures which are no less stringent than the Model Code published by the London Stock Exchange. We propose to consider in the future whether similar requirements might be suitably imposed here through the Listing Rules. There may well be other avenues of approach which have not yet been suggested. However we have thought fit not to delay the presentation of this report further, for we are satisfied that, for the sake of confidence both within the territory and outside, there is an urgent need that some action be taken soon to indicate that Hong Kong is not prepared to countenance further insider dealing within its own market.

ANNEX

Financial penalties for insider dealing

The Tribunal shall have power to include in its Report an order requiring an insider dealer to pay into the general revenue:

(a) the amount of the profit gained from or the amount of the loss avoided by any purchase or sale of a security of a company (or of an option or other right to purchase or sell such a security) made by him in the course of the insider dealing; and

(b) an additional sum of up to three times the amount of the said profit.

For the purposes of this section, the profit resulting from or the loss avoided by a purchase or sale is the difference between the price at which a security was purchased or sold and the price at which it traded a reasonable time after the information relating to the purchase or sale became public, multiplied by the number of securities purchased or sold in connection with or as a result of the insider dealing.

THIRD INTERIM REPORT OF THE STANDING COMMITTEE ON COMPANY LAW REFORM: B SHARES

The phrase "B shares" is a convenient expression to describe shares of a company which, although forming part of its common stock, have been accorded greater or lesser voting rights, either by direct allocation or by being issued with a different par value from that of the other ordinary or "A" shares. The position is sometime referred to as "dual class capitalisation", especially in the United States of America.

2. Five companies so capitalised are presently listed on the Unified Stock Exchange –

1. Swire Pacific Limited
2. Hong Kong Realty & Trust Co. Ltd.
3. Lane Crawford Limited
4. Local Property Co. Ltd.
5. Realty Development Co. Ltd.

3. Recent proposals to follow suit by three further well-known companies, namely Jardine Matheson Holdings Ltd., Hutchison Whampoa Ltd. and Cheung Kong (Holdings) Ltd., caused considerable concern within the territory. The proposals have since been withdrawn, but the Standing Committee have been asked to consider the situation and in particular "whether or not the present ability of companies to issue shares with voting rights disproportionate to their nominal value is in the general interest of shareholders, and in the public interest, and if not, to identify whether any changes to the present legislative framework are desirable".

4. Comments have been sought and received from the companies concerned and from professional and commercial organisations. An invitation through the press to the general public has brought answers from three interested individuals.

5. The Committee have also obtained, through the good offices of the Secretary for Monetary Affairs, copies of the many and detailed submissions made to the Securities and Exchange Commission of the United States of America in the course of that Commission's inquiry into a proposal by the New York Stock Exchange Inc. to resile from its normal practice of refusing listing to companies having classes of common stock with disparate voting rights. (We understand that the American Stock Exchange Inc. has less stringent voting rights requirements, while the National Association of Securities Dealers Inc. in this respect imposes no restrictions whatsoever.)

6. The quotation of companies with B shares on the London Stock Exchange, which we are told presently lists fifty-five such companies, including for example Reuters Holdings P.L.C., Great Universal Stores P.L.C. and Whitbread & Co. P.L.C., and the few exceptions on the New York Stock Exchange, such as Ford, General Motors and Dow Jones is largely historic. But the practice is common on other major American markets and in Canada. We understand too that legislation in many states of continental Europe permits equity financing by the issue of securities which do not carry voting rights at all.

7. The leading argument against B shares is that they breach the democratic principle of one share one vote and thus facilitate the control of a company by a self-perpetuating oligarchy. Academic submission to the Securities and Exchange Commission placed great emphasis upon this factor and suggested that with management being thus accountable to no one but itself, and having little financial stake in a company, the economic performance of the company would inevitably decline, to the detriment of the general shareholders. Research in the United States has shown that when B shares are issued as part of a recapitalization of an existing listed company, the A shares almost invariably suffer a fall in value, usually in the order of 5%. A further and more direct result would be the inability of the general shareholders to participate in the increase in share value which usually accompanies a take-over bid because a predator will normally prefer to concentrate on acquiring, probably at a higher price, the shares which carry the greater voting rights. He may even make no offer at all for the other shares. That however is unlikely to be the case in Hong Kong, for Rule 22 of the Code on Takeovers and Mergers provides that "the offeror must make arrangements to ensure that the interests of the holders of all classes of equity share capital ..... are safeguarded and should make appropriate offers or proposals to those holders." In addition, the effect of Rule 33(1) of the Code is that where a person has acquired shares which carry 35% or more of the total voting rights of a company, he is obliged to make an offer for the shares owned by the other holders of any class of voting shares in which he already has a holding, and "a comparable offer shall be extended to the holders of any other class of equity share capital whether such capital carries voting rights or not". Rule 33(4) lays down how the offer price is to be calculated and specifically states that "the Committee (on Takeovers and Mergers) should also be consulted where there is more than one class of share capital involved".

8. In the present circumstances it is the possibility of a hostile take-over bid that will probably underlie the desire of a company to issue B shares. Such shares can be

effectively used to build up a sound, although not necessarily invincible, defence against an attack of that kind. And it is understandable that companies controlled by founding families or entrepreneurs should wish to retain that control, yet still have the opportunity to employ equity financing when needed. Other factors, for example, national security or the interests of the community as a whole, may also in particular circumstances make it desirable that ultimate control should be concentrated in particular hands, although there is support for the view that the use of B shares for these purposes is normally acceptable only when a company first applies for a listing and there is no question of protection for minority shareholders. In addition to these circumstances a flexible approach, which is not available in a one share one vote situation, can be useful with regard to corporate restructures and mergers.

9. Section 114A(1)(e) of the Companies Ordinance, Cap. 32, provides that "in the case of a company originally having a share capital, every member shall have 1 vote in respect of each share or each $100 of stock held by him, and in any other case every member shall have 1 vote." This is reflected in Art. 64 of Table A which provides that "Subject to any rights or restrictions for the time being attached to any class or classes of shares, on a show of hands every member present in person shall have 1 vote, and on a poll every member shall have 1 vote for each share of which he is the holder".

10. However a company may provide by its own Articles for the allocation of voting rights in any way that it wishes. If so, the express provisions will displace those contained in the statute. Moreover a company always retains the ability to change its Articles and thus the voting rights attached to any particular class of shares. The method of doing so will be governed by its Memorandum or Articles, and further statutory provisions are to be found in Section 63A of the Ordinance. There are both statutory and common law safeguards against the unfair use of the power to change a company's Articles. Firstly, Section 64 of the Companies Ordinance provides that ten per cent of the holders of a special class of shares may appeal to the court against any change in the Articles varying their rights. Secondly, under Section 168A of the Ordinance, any shareholder can apply to the court for protection where he considers that his interests are being unfairly prejudiced. Thirdly, the common law provides that any change in a company's Articles must be made not only in accordance with the technical provisions of the Companies Ordinance, but also bona fide for the benefit of a company as a whole. The provisions of Section 63A of the Companies Ordinance are extremely complicated and in themselves alone illustrate how difficult it would be to

draft effective controls over differential voting rights. It would also be a radical departure from established legislative policy in this and similar jurisdictions. Moreover the inherent inflexibility of any such legislation might well give rise to other problems as yet unforeseen.

11. If legislation controlling such a basic fundamental as voting rights were justified in principle, it would logically have to apply to all companies incorporated under the Ordinance, and the Committee are firmly of the view that private and unlisted public companies should remain free to arrange their constitutions according to their own needs and desires. A similar view was expressed by all those whom the Committee consulted and who had addressed their minds to this particular aspect.

12. The Committee have to accept that in the particular circumstance of Hong Kong's reversion to Chinese sovereignty in 1997 an issue of B shares could be used by a majority interest to free substantial portions of its capital for transfer overseas while still maintaining actual control within the territory. The adoption of such a practice to any significant extent could easily lead to a lessening of confidence in Hong Kong as a major financial centre. The Committee are therefore opposed to the indiscriminate issue of shares of this kind. Nevertheless it is felt that there is a legitimate need for their continued availability in exceptional circumstances of the kind mentioned above and perhaps in others. For the reasons given the Committee do not think that suitable restrictions can be satisfactorily achieved by legislative amendment. It is felt that control should be maintained instead by approval on a case to case basis governed by listing rules promulgated by the Securities Commission under Section 14 of the Securities Ordinance, Cap. 333. Such a course was advocated by several companies and organisations in their submissions to the Committee.

13. The Committee do not wish to seem to usurp the function of the Commission to establish the appropriate criteria but would respectfully suggest the consideration, inter alia, of a requirement that the issue be supported by the prior approval of a substantial number of shareholders, other than those who hold a controlling interest in the company, and perhaps that of a specific ratio between the B and other shares. (Such suggestions would, of course, be dependent upon the passing of legislation of the kind proposed by the Securities (Disclosure of Interests) Bill 1987 published last month following recommendations in our First Interim Report of December 1985). A requirement that any new issue of B shares must in any event be offered to all existing shareholders on a pro rata basis would be in line with several comments we received.

14. The Committee do not feel that any particular action is necessary with regard to the five companies which have already issued B shares. These have been accepted by and incorporated into the existing market. Furthermore, to interfere with established contractual rights would be contrary to general principle and might raise questions of compensation. Any future issue of further B shares by the companies would, of course, require approval in the manner suggested.

15. For these reasons the Committee do not recommend any change to primary legislation.

D. Cons
Chairman

July 1987.