STANDING COMMITTEE ON COMPANY LAW REFORM

FIFTH REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subject considered by the Standing Committee during 1988

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1. Audit of Company Accounts

1.1 During the year a number of topics connected with this subject were considered.

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

1.2 Under sub-section 123(1) of the Companies Ordinance, the balance sheet of a company must give a true and fair view of its state of affairs at the end of its financial year and its profit and loss account must give a true and fair view of the profit or loss for the financial year. Under sub-section 123(2), the balance sheet and profit and loss account must also comply with the requirements of the Tenth Schedule of the Ordinance as to contents of accounts

1.3 Under sub-section 123(6), any director of a company who fails to take all reasonable steps to ensure compliance with any of these or other requirements in the Ordinance is liable to imprisonment for six months and a fine of $10,000. (There is a statutory defence to any charge under the section, which we refer to separately in (2) below.)

1.4 The Auditing Guidelines issued by the Hong Kong Society of Accountants contemplate various types of "qualified" reports by company auditors. The first is the "disclaimer" type of certificate where, basically, the auditor states that he is unable to form an opinion as to whether or not the accounts give a true and fair view and goes on to detail the reasons why he is unable to do so. Another type of qualified report is the "adverse opinion" certificate where the auditor states positively that in his opinion the accounts do not give a true and fair view and lists the reasons why they do not.

1.5 The Registrar General has drawn our attention to the fact that while it is not uncommon for the accounts of listed companies filed in the Companies Registry to contain examples of the "disclaimer" type of audit certificate, he seldom, if ever, sees an "adverse opinion" certificate.

1.6 The Registrar General has explained that he cannot prosecute any director where a "disclaimer" type of certificate has been given by the auditor because, of course, the auditor has not stated that the accounts do not give a true and fair view; he has only stated that he cannot form an opinion as to whether or not they do so.

1.7 It seems to us that the reasons why there are so few, if any, "adverse opinion" audit certificates in respect of the accounts of listed companies and, relatively speaking, so many "disclaimer" certificates require further consideration. We have raised the point with the Hong Kong Society of Accountants and they in turn are consulting their colleagues in London on the subject. We look forward to resuming our discussion on this subject in the near future.

1.8 (2) Statutory form of defence open to a director charged with an offence under section 123. As we explained in our Fourth Report (subjects considered during 1987), proviso (a) to sub-section 123(6) states that in any proceedings against a person under the section, it shall be a defence to prove that he had reasonable ground to believe and did believe that a competent and a reliable person was charged with the duty of seeing that the statutory requirements were complied with and was in a position to discharge that duty. We understand that, in practice, this provision means that directors can normally shelter behind a plea that they delegated all matters relating to preparation of their company's accounts to professional advisers and relied entirely on that advice. It seems debatable whether they should be able to absolve themselves from

responsibility so effectively in view of the fact that the Ordinance provides no sanction at all against the company's auditors.

1.9 The situation under the Australian and Singaporean legislations is different. In Australia, if a director is charged with failure to take all reasonable steps to ensure that his company's accounts give a true and fair view, the statutory defence requires him to prove that the information omitted was immaterial and did not affect the giving of a true and fair view. The position is the same in Singapore, but the director must also prove that the failure to comply with the statutory requirement was unintentional.

1.10 When we have concluded our discussions with the Society of Accountants regarding the form of auditors' certificates, we intend to take up consideration of whether the form of defence available under section 123(6) should be revised in accordance with the present legislation in Australia or Singapore.

(3) Off balance sheet financing

1.11 At our November Meeting, we noted U.K. press reports to the effect that, after intensive lobbying from the accounting profession, the Department of Trade

and Industry intended to introduce legislation which would prohibit the non-consolidation in annual accounts of artificially created "non-subsidiaries" which had been produced specifically to take borrowings off the balance sheet. The proposed legislation would reinforce the principle that accounts must, above all, show "a true and fair view".

1.12 We have asked the Hong Kong Society of Accountants for their views on the need for similar legislation in Hong Kong.

(4) Inner reserves of banks

1.13 We also noted in the local press during the year, various comments attributed to individual professional accountants on the subject of inner reserves of banks. Part III of the Tenth Schedule to the Companies Ordinance exempts banks, insurance and shipping companies from certain of the requirements as to contents of annual accounts set out in Parts I and II of the Tenth Schedule.

1.14 We agreed with the Commissioner of Banking that the subject of the form of auditor's certificate in respect of banks' annual accounts and certain related matters would be discussed in the first instance

between himself, the Hong Kong Association of Banks, and the Hong Kong Society of Accountants and that he would come back to us on this subject after these discussions.

(5) Tenth Schedule

1.15 We referred in our Fourth Report to the fact that the Hong Kong Society of Accountants had reported that their members were experiencing interpretational difficulties with the provisions of the Tenth Schedule as to the contents of the annual accounts. The Society had advised us that they were consulting their members on the amendments required and that they would refer back to us with detailed comments in due course.

1.16 We have now heard that, after further careful consideration, the Society do not feel that it would be appropriate to make any recommendations for amendments at this stage.

2. Registration of Charges

2.1 In September 1987 the Department of Trade and Industry in England circulated to interested parties for comment a note containing outline proposals for various amendments to the provisions on registration of charges in sections 395-424 of the Companies Act 1985.

2.2 We considered this document at our Meeting in March and reached the preliminary conclusion that a number of the proposals would be suitable for adoption in Hong Kong.

2.3 However, in view of the great practical importance of the subject and the need to ensure that any proposed amendments do not involve unforeseen difficulties for the profession, we agreed that, before reaching any final conclusions on our recommendations, the Law Society of Hong Kong should be asked for their views. The Secretary duly wrote asking for these and we await the Society's reply with interest.

2.4 In addition to considering the proposals for amendments being discussed in the U.K., we also dealt with two specific subjects :

Section 85 of the Companies Ordinance (Entries of satisfaction and release of property from charge)

2.5 This section provides that the Registrar General, on evidence being given to his satisfaction with regard to any registered charge -

(a) that the debt for which the charge was given has been paid or satisfied in whole or in part; or

(b) that part of the property or undertaking charged has been released from the charge or has ceased to form part of the company's property or undertaking,

may enter in the register a memorandum of satisfaction in whole or in part, or of the fact that part of the property or undertaking has been released from the charge or has ceased to form part of the company's property or undertaking, as the case may be.

2.6 It will be noted that the provision is voluntary i.e. there is no obligation on the part of anyone connected with the original charge to arrange for the satisfaction of the debt to be entered in the register of charges. This means that, in practice, "dead" charges sometimes remain on the register because no one wants to go to the trouble and expense of having them formally removed. The Department of Trade and Industry's outline of proposals for amendment to the corresponding provision in the U.K. (section 403 of the Companies Act 1985) discussed whether the system should remain voluntary or whether companies

should be required to file instruments of satisfaction of charges, with failure to file being made an offence in the same way as failure to register a charge is now. The outline recognized that a statutory obligation to file instruments of satisfaction or release would be impossible to police effectively and suggested that nobody would suffer in the event of non-compliance except the company itself.

2.7 The Department asked : "Would any increase in the filing rate be worth the additional regulation involved?"

2.8 When we considered this point in the Department of Trade and Industry's outline, we took the view that it would not be worth the additional regulation and reached the preliminary conclusion that the present voluntary system should be retained. This, of course, is subject to consideration of the views of the Law Society when these become available.

2.9 However, the Registrar General took the opportunity to raise another point about the provisions of section 85. He explained that the effect of the present provision is to require him to examine the reassignments, deeds of discharge, instruments of release and other documents presented to him as evidence of the payment or satisfaction of debt or of the release of part of the security property from the charge. He has to satisfy himself that the document in each case is indeed reasonable evidence of payment/satisfaction or release.

2.10 The Registrar General also explained that section 403 of the Companies Act 1985 provides that the Registrar "on receipt of a statutory declaration in the prescribed form verifying" that the debt has been paid or satisfied or that part of the security property has been released, may enter the relevant memorandum in the register of charges. This relieves the Registrar from having to consider whether the instrument employed in each case is effective; he only has to satisfy himself that the statutory declaration is in the prescribed form.

2.11 The Registrar General suggested that the U.K. provisions are superior from both his own and the professions' points of view and should be introduced here. We agree and recommend that the existing section 85 of the Companies Ordinance be repealed and replaced by the equivalent of section 403 of the Companies Act 1985.

Mortgages on Ships

2.12 As is well known, the Administration has appointed a Steering Group to oversee the development of the modified Hong Kong Register of Shipping and to advise the Administration with regard to the detailed requirements for that register.

2.13 We were approached during the year by the Working Group on Maritime Liens and Mortgages which has been established by the Steering Group and which was considering the provisions of the

Merchant Shipping Act 1894 relating to the registration of charges on ships with a view to deciding what changes to the present system would be desirable.

2.14 The Working Group explained to us that sections 31-46 of the 1894 Act deal with mortgages on ships. These are made in accordance with either of the standard forms set out in the First Schedule to the Act. The Registrar of Ships in Hong Kong (The Director of Marine) is obliged under section 31 of the Act to record the mortgages.

2.15 In addition, section 80(2)(h) of the Companies Ordinance requires a company incorporated in Hong Kong to register in the Companies Registry any mortgage created by it on a ship or any share on a ship. Section 91 extends that requirement to any company incorporated outside Hong Kong which has a place of business in Hong Kong.

2.16 We think that the Working Group's representations to us can be summarised as saying that registration of a mortgage on a ship in both the Shipping Registry and the Companies Registry is unnecessary both as a matter of principle and as a matter of practice. They thought that it was not necessary to register a mortgage on a ship in the Companies Registry at all but that, if we disagreed with this view, a notation system in the Companies Registry would be sufficient.

2.17 We had a very useful Meeting with representatives of the Working Group at which the situation was discussed in detail and the Group's representatives explained the various special aspects of the shipping industry which make the requirement for registration in both the Shipping and Companies Registries unnecessary.

2.18 We found the Group's arguments convincing and recommend:

(a) That Part III of the Companies Ordinance be amended to provide that, in the case of a mortgage on a ship or any share on a ship, it will only be necessary to file in the Companies Registry a notification that the mortgage has been created.

(b) The form of the notification should be agreed within the Administration after further discussion between the Department concerned and the proposed new Shipping Registry.

(c) The penalty for failure to file the notification should be the same as the penalty for failure to file the prescribed particulars of any other type of charge i.e. the mortgage should become void in the circumstances set out in section 80(1) of the Companies Ordinance.

Mortgages on Aircraft

2.19 Lastly, while considering section 80(2)(h) of the Companies Ordinance for the purposes of our discussion with the Working Group on Maritime Liens and Mortgages, we noted that while it requires registration of -

"a charge on a ship or any share in a ship",

the corresponding section 396(1)(h) of the U.K.'s Companies Act 1985 requires registration of -

"a charge on a ship **or aircraft**, or any share in a ship"
(Our underlining)

2.20 The fact that in Hong Kong a company does not require to register a mortgage on an aircraft is the only substantive difference between the U.K. law and our own on registrability of charges. We asked the Administration about this point and were informed that it was considered that there was no requirement for a register of aircraft mortgages in Hong Kong. In view of this, and also in view of the fact that we have never been approached on the subject, we decided that no further action need be taken in this connection unless and until we are approached.

3. Company Names

Sections 20-22A

3.1 In our Fourth Report (subjects considered during 1987) we explained that the Registrar General had submitted a paper to us in which he had expressed his concern regarding the length of time, now about three months, required to incorporate a new company, a period that is much greater than that found in other jurisdictions. He had explained that the main cause of the delays was the length of time it was taking to get approval for the proposed new companies' names. He was of the opinion that the excessive length of time taken was due, partly, to the nature of the existing legislation and partly to the lack of resources necessary to handle the volume of work involved.

3.2 The Registrar General had explained that in the vast majority of cases proposed new company names (either for new companies or for the change of name of existing companies) were reserved under section 20A of the Companies Ordinance. Section 20A allows a proposed name to be reserved on payment of a fee of $30 for a period of three months if -

(a) It is not already reserved; and

(b) It could be reserved without contravention of the provisions of section 20.

3.3 The reservation can be renewed on payment of a fee of $15 for a further period of three months and there is no limit on the number of renewals.

3.4 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.

3.5 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 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.

3.6 There is a very large volume of applications for reservations of names under section 20A. In 1988 there was a monthly average of more than 20,000 applications.

3.7 The Registrar General had reported to us that he had never been provided with sufficient staff to deal with the applications satisfactorily. However, he also advised us that, even if sufficient staff were to be provided, it was unlikely that a proposed new name could be reserved under the existing legislation in less than 10 days because of the need for a decision on the degree of similarity to existing names in each case.

3.8 The Registrar General had also drawn our attention to the new names system which was introduced in the U.K. by Part II of the Companies Act 1981, subsequently in Chapter II of the Companies Act 1985. Basically this 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.

3.9 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 period as he may specify.

3.10 We concluded our consideration of this subject in the Fourth Report by saying that it was obvious that, before reaching any conclusion on what, if any, changes to the names provisions in the Companies Ordinance were desirable, we would need the comments of the usual professional and business organisations and that we had written to them for these. We also instructed the Secretary to obtain certain information for us on how the U.K. system was working in practice.

3.11 At our February Meeting we considered detailed information which the Secretary had obtained from the U.K. authorities regarding the names system there and noted that it appeared to be working satisfactorily, with no major problems. This view was supported by comments obtained from a leading firm of solicitors in London.

3.12 We also considered at the February Meeting the views of the various organisations consulted. Four of them were against replacing our present system with legislation based on the U.K.

model and five were in favour of such a change. Those in favour of retaining the existing system, subject to certain amendments aimed at making it more efficient, were :

The Hong Kong Association of Banks
The Law Society of Hong Kong
The Association of the Institute of Chartered Secretaries and Administrators in Hong Kong
The Hong Kong Productivity Council

3.13 Those in favour of replacing the existing system with one based on the U.K. legislation were :

The Hong Kong Society of Accountants
The Hong Kong General Chamber of Commerce
The Chinese Manufacturers Association of Hong Kong
The Chinese General Chamber of Commerce
The Hong Kong Management Association

3.14 We think that the main objections put forward to the introduction of a new system based on the U.K. model can be summarised as follows :

(1) The disappearance of the independent check by the Registrar of Companies would mean that the statutory safeguards for existing company names would disappear.

(2) The twelve-month period within which the Registrar of Companies could require a new company name to be changed under the new system would cause hardship.

(3) There would be a significant risk of abuse of the proposed new system, particularly with regard to Chinese names. For example, with regard to English names, the name "Mervyn Edward Software Limited" would be registered under the new system, notwithstanding the existence of a company named "P. Mervyn Edward Software Limited". In addition, Chinese names which were identical phonetically but made up of different characters would also be registrable under the proposed new system.

(4) If the U.K. system was introduced here, existing companies would have to rely on name-watching services to protect their names.

3.15 We noted, however, that no one questioned that a new system based on the U.K. legislation could eliminate the delays in incorporating new companies.

3.16 The parties who objected to the suggested new system also made several proposals for improving the efficiency of the existing system i.e. :

(a) Government should provide additional resources to cope with demand more efficiently;

(b) Various relaxations in the policies followed in deciding whether a proposed new name is too similar to an existing name e.g. :

(i) Allowing "series names" i.e. a series of names with a common "stem" and distinguishing numbers e.g. "Widget (Number One) Limited", "Widget (Number Two) Limited" etc.

(ii) Allowing companies to be incorporated with "number names" i.e. names consisting of the Companies Registry incorporation number e.g. "300, 472 Limited".

3.17 The Registrar General's views on the 2nd and 3rd of the main objections to the new system were :

(2) The promoters of the proposed company could protect themselves against the possibility of a change to a new company's name being ordered during the 12-month period after its incorporation, by making an adequate search of existing names before incorporation. He recognised that this meant that members of the public would have to have adequate means of access to the Companies

Registry's records of existing names to enable them to make such a search before reaching a decision on whether to incorporate in any particular case. Such access could be accomplished either by the Companies Registry's staff carrying out the search on behalf of the members of the public or by members of the public being able to make the search themselves. The actual method chosen if the proposed new system was introduced would depend on the relevant technical considerations in respect of the Companies Registry's computer.

(3) He recognised the possibility of abuse of the suggested new system in the shape of unscrupulous promoters incorporating new companies with names similar to those of existing companies in the expectation of the owners of the existing companies being prepared to buy the new companies rather than resort to appeals under the statutory provisions or to passing-off actions in the courts. However, the information obtained from the U.K. authorities, where the legislation had been in effect since 1981, was to the effect that there was no evidence of any such abuse of the system there. He pointed out that there were far more companies in the U.K. with internationally-known names.

3.18 With regard to the suggestions for improving the efficiency of the existing system, the Registrar General's views were -

(a) Although the provisions of large numbers of additional staff would obviously help to reduce delays the fact remained that, as previously noted, he would still not be able to reduce the period for processing an application to reserve a company name to below 10 days because the existing system required a decision on similarity with existing names which involved a substantial degree of subjectivity.

(b) (i) He thought that he could not agree to "series names" under the existing legislation.

(ii) Similarly, he thought that "number names" would be in breach of the existing legislation. He pointed out that Ontario had had to pass specific legislation to enable a "number names" system to be introduced there.

3.19 We discussed this subject at length during three of our monthly Meetings and in the course of these we also considered a very considerable amount of technical material. We found it to be one of the most controversial subjects we have ever dealt with.

3.20 We think that the range of views put forward within the Standing Committee during our discussions can be summarised as follows :

<u>Against a change to a new system based on the U.K. legislation</u>

(1) The existing system serves a very useful purpose in that it ensures to a large extent that the names of existing companies are protected against new companies being incorporated with names which are confusingly similar.

(2) The new system would remove the existing protection and companies would have to be constantly on the watch for new names that were too similar to their own; in the U.K. this had led to companies which can afford it employing "name-watching" firms.

(3) The fact that the legislation in the U.K. does not appear to be abused to any great extent by would-be-immitators does not mean that a similar system would not be abused in Hong Kong. Indeed, there is a strong probability of such abuse in Hong Kong, because the attitude to company names is different here. The position regarding Chinese names is also a complicating factor which increases the possibility of abuse.

(4) The position regarding delays under the existing system is not unacceptable. A businessman can always get a new shelf-company when he wants one.

(5) In any case, the existing system could be greatly improved by -

(a) The provision of further resources in the Companies Registry and this could be financed by the imposition of higher fees which would also have the effect of cutting down the number of applications, thus reducing pressure on the Registry.

(b) The introduction of amendments to allow "series names" and "number names"; these would be particularly appropriate in the case of companies which never actually carry on business, such as a company formed solely to own a flat.

(c) The introduction of a two-tier system i.e. if a person wanted an urgent decision on any particular application he could pay an additional fee for the application to be expedited.

In favour of a change

(1)& (2) It should not be a function of Government to ensure that no one incorporates a company with a name that is similar to that of an existing company. That is a matter for the private sector and, if necessary, the courts. In any case the existing system is not a completely reliable safeguard because there are in fact passing-off actions involving company names in the courts from time to time. Under the new system, if a new company was incorporated with a name which was "too like" that of a pre-existing company, the pre-existing company could, within 12 months of incorporation of the new company, appeal to the Registrar of Companies to require the new company to change its name. After the expiry of the 12 months period, the pre-existing company would still be able to start a passing off action in the courts.

(3) There are many times more companies in existence in the U.K. and many more really large companies. If there is no evidence of abuse of the names legislation in the U.K., there is no realistic ground for anticipating it here.

(4) The volume of complaints received by the Registrar General's Department indicates that there is indeed a serious problem with delays under the existing system. The fact that it takes an average of 6-8 weeks to reserve a company name is

clear evidence of the problem. In fact, even some of the consulted organisations who objected to a new system agreed that there was a problem with the existing system; the difference was that they thought that it could be dealt with by amendments to the existing system.

(5) The suggested amendments to the existing system are only palliatives and introduce their own problems. For example, with regard to suggestion (a), the fees necessary to provide the required resources for the Companies Registry would probably involve increases to a level where they would be regarded by small businessmen as a tax on new companies. In addition, these increases would probably not result in any substantial reduction in demand because most shelf-companies were incorporated by professional firms or printers who would simply pass on the increased fees to the end-users.

As for suggestion (b), it was impossible to tell at the formation stage which companies would be mere vehicles for ownership of property and which would trade actively. As for those which were wanted for trading, it was likely that many buyers would want to change the "series names" or "number names" to conventional names before commencing business. This would mean large numbers of applications for change of name i.e. the problems of comparison with existing names would simply have been postponed until after incorporation.

With regard to the proposals for a two-tier system in suggestion (c), the additional fee payable for expedited processing would have to be very high indeed or everyone would use the expedited service as a matter of course. There would also be considerable technical problems in having a two-tier system because the present system is based on priority according to date of receipt of the application.

3.21 Everyone agreed on one thing, namely, that an efficient system for searching the Companies Registry's records of company names which was available for use by the public was an essential pre-requisite for a change to a system based on the U.K. legislation.

3.22 After a very full debate, we agreed to recommend :

(a) That the existing provisions of the Companies Ordinance on registrability of company names be amended by deleting the existing criteria and substituting those in the U.K. legislation;

(b) That consequential amendments be made to the other relevant provisions in the Companies Ordinance including the provision of an equivalent of section 28(2) of the Companies Act 1985 (right of objection by a pre-existing company); and

(c) That the bringing into operation of the amended legislation be delayed until satisfactory arrangements are in place for public search of Government's records of company names.

3.23 We are concerned to hear from the Registrar General that during subsequent discussions within the Administration on implementation of Part (c) of our recommendation, it has been suggested that it might take two years or even longer for the necessary alterations to be made to the Companies Registry's computer system. We find it very difficult to believe that such a delay could be justified, particularly in the light of the urgent nature of this problem.

4. Default in Filing Annual Returns

4.1 It is common knowledge that large numbers of private companies regularly delay filing their annual returns and in some cases fail to file them for years on end.

4.2 The Companies Ordinance has always provided the Registrar General with methods of enforcing statutory obligations to file documents. For example, it is invariably an offence to fail to file a particular document and the company and any officer of it who is in default can be prosecuted. Thus, in the

case of failure to file an annual return, the Registrar General could prosecute under section 109(4) of the Companies Ordinance which renders the company and each officer who is in default liable to a fine of $200 for every day during which the default continues. Alternatively, in the case of persistent offenders, the Registrar General could petition under section 177(2)(e) for the winding up of a company which has been persistently in breach of its filing obligations under the Companies Ordinance. The trouble with these and other similar methods of enforcement is that they all involve court proceedings and the Registrar General has never been provided with the resources necessary to undertake such proceedings on a scale large enough to deal with the problem effectively. Nor apparently is there any realistic prospect of him ever getting these resources.

4.3 As a first step towards attempting to deal with the problem, legislation was enacted during the year which introduced penalties for late filing of annual returns in the shape of filing fees which increase with the length of delay involved.

4.4 However, while it appears that this new measure is proving very effective in persuading the directors of active companies to file their annual returns on time, there is still the problem of companies which have become moribund. Their directors and shareholders have simply abandoned them and, since they have no intention of ever filing any documents again, they are unmoved by the arrears of late filing fees building up.

4.5 At first sight, section 291 of the Companies Ordinance (Registrar may strike defunct company off register) appears to provide a suitable method for dealing with such companies. Under this section, if the Registrar General has reasonable cause to believe that a company is not carrying on business or in operation, he may initiate a procedure under which, unless good cause is shown, he can strike the company off the register and it is automatically dissolved. The procedure involves the Registrar General in serving two notices on the company and inserting two notices in the Gazette. We know from our consultations with interested organisations that this procedure is regarded by the professions as being very useful for dealing with cases where a company has ceased trading for some time and has no assets or liabilities. In such cases, the directors often approach the Registrar General with the request the he exercise his discretion to take action under section 291.

4.6 The problem with using section 291 to deal with cases of failure to file annual returns is that it involves the exercise of his discretion by the Registrar General in each case and, since there are thousands of cases of default, it would be very time-consuming to deal with them on that basis. Further, by the very nature of the cases it would be very difficult or impossible for the Registrar General to get any replies from the companies or their directors giving the up-to-date information necessary for him to make a proper exercise of his discretion. The only practical approach would be to have a system under which

the Registrar General could start the procedure automatically as soon as the delay in filing annual returns went beyond a certain limit. In addition, the procedure ought to be somewhat simpler than that under section 291 to enable him to deal with the anticipated larger number of cases.

4.7 After consultation with the usual professional and business organisations we agreed with this approach and recommend that a new section(s) be introduced to implement the following procedure -

(1) If a company were to fail to file its annual returns for a period of 2 years, a notice would be served by registered post on it and on each of its directors (at his or her address as shown in the last annual return filed in the Companies Registry) by the Registrar -

(a) drawing its and their attention to the default, and

(b) informing it and them that, if all outstanding annual returns were not filed within 1 month from the date of the letter and a penalty of $X paid, a notice would be published forthwith in the Gazette stating that, unless all outstanding annual returns were filed within 3 months from the date of the Gazette, and a penalty of $Y paid, the company would be dissolved on expiry of

that period. The penalty of $Y would cover the cost of the Gazette notice and the administrative work involved plus a punitive element.

(2) If no remedial action was taken by the company, the Registrar would be able to strike the company off the register on the expiry of the 3 months period and a notice of this would be published in the Gazette; a copy of the notice would also be served by post on company.

(3) There would be a provision, similar to section 292 of the Companies Ordinance, for all the assets of the dissolved company to be bona vacantia and vested in the Crown, but subject to the claims of creditors and subject also to a right by the Crown to disclaim any bona vacantia. Details of a procedure for adjudication of any claims by creditors, probably by the Official Receiver, would be worked out later. These would probably have to include an option for the adjudicator to refer the matter to the court if he found that the dissolved company had substantial assets.

(4) There would be a provision for an application by the company itself, or any member or creditor thereof, to the Registrar for the company to be restored to the register (i.e. an administrative procedure similar in principle to the existing provisions in section 291(7) for a petition to the court for restoration of a dissolved company). If approved,

the restoration would be effected by a notice by the Registrar published in the Gazette. The restoration would be subject to payment of a substantial fee. The fee would be deemed to be a debt due by the company to the party who made the application for restoration. Section 265 of the Companies Ordinance would be amended to provide that, for the purposes of any subsequent liquidation of the restored company, the fee be given priority after Crown debts.

(Note : To avoid any doubt, we confirm that the existing section 291 procedure should be retained for the type of case in which it is currently used.)

5. Rights of Shareholders to Inspect Company's Books of Account

5.1 There is no general right in common law for a shareholder to inspect the company's books of account.

5.2 There is no statutory provision directly on the subject either although it is thought likely that section 168A of the Companies Ordinance ("Alternative remedy to winding-up in cases of unfair prejudice") gives the court power to order inspection of a company's books where there is oppression of a shareholder. The position is the same in the U.K.

5.3 However, our attention was drawn to the fact that new provisions were introduced in Australia in 1986 (sections 265B and 265C of Division 6 of Part IV of the Companies Code) which give shareholders a statutory right to apply to the court for inspection by their solicitors or accountants of the company's books, subject to the court being satisfied that the application is made "in good faith" and "for a proper purpose".

5.4 From the case law which has so far appeared it seems that the right is used mostly in takeover situations.

5.5 We noted that the provisions did not appear to have attracted any significant interest or comment in the U.K.

5.6 We decided to defer further consideration of the need for a similar provision here until there was more evidence of public interest in it in Hong Kong.

6. Report of the Securities Review Committee ("The Davison Report")

6.1 The Report of the Securities Review Committee on "The operation and regulation of the Hong Kong securities industry" was published in May 1988.

6.2 We were asked by the Administration to consider a number of the recommendations in the Report which relate to provisions in the Companies Ordinance i.e. with regard to -

(1) Registration of prospectuses.

(2) Company accounts : true and fair view.

(3) Section 155A (Approval of company required for disposal by directors of company's fixed assets).

(4) Purchase by listed companies of their own shares.

6.3 Our views on these subjects may be summarised as follows :

(1) Registration of prospectuses

6.4 A copy of the relevant paragraphs 11.45 - 11.64 of the SRC Report is at Annex 1.

6.5 It will be noted that paragraph 11.54 states that: "The existing system should be rationalised and streamlined so that only one body vets and approves documentation on new issues".

6.6 In paragraph 11.45, the Report explains that new issues are subject to vetting by and permission from :

Listed securities:	Registrar General OCS (The Office of the Commissioner for Securities) SEHK (The Stock Exchange of Hong Kong)
Unlisted securities requiring a prospectus:	Registrar General

6.7 Obviously, there are no problems of duplication of effort in respect of unlisted securities so we can concentrate on the position regarding listed securities.

6.8 It is clear that the SRC thought that the existing system involves the waste of scarce regulatory resources by duplication of effort (paragraph 11.54). They therefore recommended in paragraph 11.55 -
"The vetting of prospectuses for issues of listed securities should be undertaken by the SEHK, subject to the very important conditions that satisfactory safeguards should be put in place and the change should

only occur when there has been a sufficient improvement in the professionalism and independence of the Exchange's Listing Division".

6.9 During our discussions of this subject, we were interested to learn from the Registrar General that, prior to the setting up of the SRC, he had already recommended to the Administration that the provisions of the Companies Ordinance on vetting and approval of prospectuses should be removed from that Ordinance and placed in the Securities Ordinance and that vetting and approval should be exclusively a function of the Commissioner for Securities. The function of the Registrar General would then be purely one of registering the prospectuses approved by the Commissioner. Consideration of these proposals had been overtaken by the events of October 1987. The Registrar General had then proposed to the SRC that the function of vetting and approval should be transferred to the proposed new Securities and Futures Commission. However, as can be seen from Annex 1, the SRC had recommended that it be transferred to the revamped SEHK.

6.10 The Registrar General further commented that he personally had reservations about transferring vetting and approval of prospectuses to the SEHK. Approving

prospectuses was an important matter. It required a number of qualities. No doubt, the SEHK would possess all of these in due course, but, in the meantime, it would be better to have the function of vetting and approving vested in the statutory body which would be dealing with all other functions relating to listed companies, i.e. the proposed new SFC. He suggested that the matter might be left over until the new SFC was operational and could then be looked at again.

6.11 All Members agreed that there was a great deal of duplication of effort in the existing system and they agreed with the SRC that the SEHK was the appropriate body to deal with matters of this nature. Some were reluctant to see the proposed new SFC having any residual function in respect of vetting and approval of prospectuses as this would tend to result in duplication of the function again, as had happened under the existing system.

6.12 After considerable discussion, we agreed :

(a) That it would be undesirable to make any amendment to the existing provisions of the Companies Ordinance on registration of prospectuses in the meantime; and

(b) That, when an appropriate time for change in the system occurs, the exact nature of the amendments would best be left to be decided by the proposed new SFC, in consultation with the SEHK, in the light of the circumstances then applying.

(2) Company accounts : true and fair view

6.13 A copy of the relevant paragraphs 12.8 - 12.11 of the SRC Report is at Annex 2.

6.14 A copy of sections 123 and 126 of the Companies Ordinance is at Annex 3.

6.15 It will be noted that paragraph 12.11 of the SRC Report states that -
"We believe that companies and their auditors should be brought to understand that providing a "true and fair view" is the over-riding requirement."

6.16 It seems to us that this statement implies that the need for a company's accounts to give a "true and fair view" is not clearly the over-riding requirement at present.

6.17 We regret that we cannot accept such a view. We think that the provisions of section 123(3) in Annex 3 make it clear that the "true and fair view" requirement is the over-riding one and that mere compliance with the requirements of the Tenth Schedule as to the contents of a company's accounts is not sufficient. We are satisfied that the members of the Hong Kong Society of Accountants are aware that this is the case. One of our Members who is a partner in a leading firm of professional accountants was good enough to provide us with a copy of the introduction section to a pamphlet issued by his firm in January 1975 when sections 123 and 126 were introduced. A copy of this is at Annex 4. It will be seen that part (iv) of the 1st paragraph emphasizes that the true and fair view requirement is an over-riding one.

6.18 Paragraph 12.11 of the SRC Report states that : "We understand that the U.K. law has recently been amended to stress the over-riding requirement". The position is that until 1981, the requirements of the U.K. legislation on accounts giving a true and fair view were almost the same as those in our sections 123 and 126. We are satisfied from references in U.K. text-books that it was clearly understood there prior to 1981 that the true and fair view requirement was an over-riding one.

6.19 In 1981, a completely new system of prescribed formats of annual accounts was introduced in the U.K. in compliance with an EEC directive and the relevant legislation required substantial amendments. The relevant provisions are now in sections 228 - 231 of the Companies Act 1985 and a copy of section 228 is at Annex 5. We assume that the reference in paragraph 12.11 of the SRC Report is to section 228(3).

6.20 We are not aware of any demand either from the professions or from the business sector in Hong Kong for a change to the new system of accounts introduced in the U.K. in 1981.

6.21 In these circumstances and because, as already explained, we consider that the provisions of sections 123 and 126 already make it clear that the "true and fair view" requirement for annual accounts is an over-riding one, we do not think that any amendment to the existing legislation is necessary.

(3) Section 155A (Approval of company required for disposal by directors of company's fixed assets)

6.22 A copy of the relevant paragraphs 12.17 - 12.21 of the SRC Report is at Annex 6.

6.23 It will be seen that para. 12.20 recommends that the Stock Exchange of Hong Kong should require listed companies to seek shareholders' prior agreement before major transactions and to seek independent shareholders' prior approval for transactions in which a director or a substantial shareholder has a material interest.

6.24 Paragraph 12.21 explains that the SRC have not considered in detail the definition of "major transactions" or "material interest". They suggest that the SEHK should study the practice of the International Stock Exchange in London in these connections.

6.25 Footnote (3) refers to section 155A of the Companies Ordinance as requiring prior approval for disposals exceeding one-third of the company's fixed assets and states that the problem with the provision is that the threshold is too high and that it refers only to fixed assets owned directly by the parent company itself.

6.26 We feel that before reaching any conclusions on whether section 155A should be amended, or indeed deleted, we would like to see the finalized versions of

the provision on this subject in the SEHK's new Listing Rules which are still in draft form and the subject of consultation with interested parties.

6.27 We note from the latest draft available to us that the proposed approach is that any "major transaction" must be made conditional on approval by the shareholders in general meeting and the Listing Committee reserve the right to require that any shareholder shall abstain from voting if he has a material interest in the transaction.(Draft Rule 14.10)

6.28 A "major transaction" is defined as any acquisition or realisation of assets (including securities) by a listed company or any of its subsidiaries where -

(1) the value of the assets being acquired or realised represents 33 per cent or more of the assets or consolidated assets, as the case may be, of the acquiring or realising group; or

(2) the net profit (after deducting all charges except taxation and excluding extraordinary items) attributable to the assets being acquired or realised represents 33 per cent or more of such

net profit attributable to the assets or consolidated assets, as the case may be, of the acquiring or realising group.

6.29 We note that the figure of 33% is retained.

6.30 As already indicated, when the final version of the Listing Rule is approved, we shall reconsider the position regarding section 155A. Obviously, it would be highly undesirable for the provisions of the Listing Rules and the section to differ substantially. Our feeling at present is that this subject is one which can be better regulated by the SEHK than by a statute. It is usually regulated by the stock exchange authorities overseas and there is no equivalent of section 155A in the U.K. legislation (although the section is derived from recommendations in the Jenkins Committee Report). If the final version of the Listing Rules is satisfactory, our present intention is to make a recommendation that section 155A be repealed.

(4) Purchase by a company of its own shares

6.31 A copy of paragraphs 13.7 - 13.11 of the SRC Report, dealing with "The Hong Kong Code on Takeovers and Mergers" is at Annex 7.

6.32 It will be noted that the last sentence in paragraph 13.11 reads :

"…. we recommend that the Administration should favourably consider the merits of introducing a treasury stock rule in Hong Kong" i.e. of allowing companies to purchase their own shares.

6.33 We dealt with this subject in our Third Report (subjects considered during 1986) and recommended that -

(a) unlisted companies only should be allowed to purchase their own shares in accordance with the same procedures as applied in Britian;

(b) that the question of allowing listed companies to purchase their shares should be considered again after satisfactory legislation had been enacted dealing with -

(i) disclosure of beneficial ownership of shareholdings;

(ii) insider dealing;

(iii)distributable profits;

(iv) fiduciary duties of directors.

6.34 We have already submitted recommendations on the amendment of the law on all of the subjects listed at (i) - (iv). With regard to item (i), our recommendations on the subject were duly enacted in the Securities (Disclosure of Interests) Ordinance 1988, referred to elsewhere in this Report. Drafting Instructions have already been given to the Law Draftsman regarding item (ii) and are being prepared for items (iii) and (iv). We hope that it would not be unrealistic to expect to see legislation on subjects (ii) - (iv) enacted by the end of 1989.

6.35 We are keeping in mind recent developments in connection with this subject in Hong Kong, particularly the fact that the shares of a number of listed companies are, at the time of writing, at a discount to their net asset values.

a single Ordinance. In our view, this should involve private sector securities lawyers, preferably with experience of US and UK law and practice.

Duplication of effort

11.45. At present, new issues are subject to the following approvals :-

Type of issue	Vetting by and permission from
Listed securites	Registrar General OCS SEHK
Unlisted securities requiring a prospectus	Registrar General
Marketing of CDs, CP, etc.	Securities Commission

11.46. We believe that this involves unnecessary duplication and have, therefore, considered in some detail the questions of whether prospectuses should be vetted at all; and if so, by whom?

11.47. On the first question, we believe it is appropriate to distinguish between listed and unlisted issues. The prospectus to an issue of listed securities provides the market with the information needed for investors to assess the securities and will be kept up to date by on-going disclosure in accordance with market rules. For example, in addition to regular reports, any

price-sensitive developments will have to be reported to the market when they occur. In this case, pre-vetting is a logical part of the Exchange's regulation of the market.

11.48. A prospectus to an unlisted issue, by contrast, is a one-off snapshot intended to form the basis of a contract between offeror and individual subscribers. There will be no on-going disclosure except that required periodically by company law.

11.49. The case for vetting unlisted issues is that it is the surest way to ensure compliance with the statutory requirements and that high standards are maintained. The argument against is that it should be sufficient to rely on professional advisors (lawyers, accountants and merchant bankers) to ensure compliance and the maintenance of standards, with the regulatory body merely acting as an enforcement agency. Indeed, pre-vetting might dilute the responsibility of issuers and their advisers for the completeness and accuracy of their offer documents.

11.50. In addition, there are doubts about the effectiveness of pre-vetting, as a pre-vetting authority cannot be expected to check the accuracy or completeness of an offer document in any meaningful way. The fact that a document has been pre-vetted may therefore give investors a false sense of security.

11.51. On balance, we are not convinced that it is essential to continue with the pre-vetting of unlisted issues. This question should be reviewed by the Administration.

11.52. As to who should vet, it is helpful to understand the historical basis of the current arrangements. The

Registrar of Companies has been vetting prospectuses, for both listed and unlisted issues, since 1972 when amendments were made to the Companies Ordinance upon the recommendation of the First Report of the Companies Law Revision Committee. In fact, the Committee pointed out[4] that there would be advantages in the new Commissioner of Securities also being the Registrar of Companies. This suggestion was not implemented, so there has been some duplication of effort all along.

11.53. As we understand it, the Commission's Rules have their origins in the variable low listing and disclosure standards prior to the unification of the four exchanges in 1986 and also the uncertainty in the minds of the authorities about the quality of regulation the new Unified Exchange would provide. They, therefore, represented minimum statutory standards for the Unified Exchange.

11.54. Notwithstanding this background, we believe it is critical not to waste scarce regulatory resources by duplication of effort. We therefore recommend that the existing system should be rationalised and streamlined so that only one body vets and approves documentation on new issues.

11.55. We further recommend that the vetting of prospectuses for issues of listed securities should be undertaken by the SEHK, subject to the very important conditions that satisfactory safeguards should be put in place and the change should only occur when there has been a sufficient improvement in the professionalism and independence of the Exchange's Listing Division.

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(4) Para. 6.20 of the CLRC Report of 1971.

11.56. As regards the current duplication between the OCS administering the Commission's Rules and the SEHK administering the Exchange's rules, we recommend that, if the SEHK is to be the sole "vetter" of listed issues, the Commission's Rules should be repealed. In their place, the Securities Commission should be given reserve powers in the main legislation to forbid, suspend or cancel a listing. The disclosure provisions of the Commission's Rules would become part of the SEHK's rulebook and the current Undertaking would become part of the SEHK's own continuing obligations.

11.57. It is arguable that, as in London, the Listing Agreement should be dispensed with since companies and their directors undertake in their application to comply with the continuing obligations in the Listing Rules. However, we believe that having to sign a further agreement helps to bring listed companies' attention to their on-going obligations.

11.58. As regards the Companies Ordinance, we believe that the prospectus to a listed issue should continue to be delivered to the Companies Registry. It is important that all the significant documents relating to a company should be on the public record and, for convenience, should be in a single place.

11.59. As to the substantive position under the Companies Ordinance, it might be possible to give the SEHK, as the recognised Exchange Company, authority to approve a document as complying with the Third Schedule. However, we recommend that a listing document should simply be exempt from the Third Schedule requirements if it complies with the SEHK's rules and is approved as doing so by the SEHK.

11.60. As to unquoted securities, there is a strong case for the Registrar General transferring its responsibilities to the new Securities Commission (SC)[5], the body charged with having specialist expertise on new issues and related commercial matters. We therefore recommend that, if it is decided to vet unquoted issues, the task of approving the prospectus should fall to the specialist statutory securities market regulator i.e. the new SC.

11.61. To achieve this transfer of responsibilities, provision would need to be made in the Companies Ordinance to enable the Registrar General to register a document which had been approved by the SC as complying with the Third Schedule.

Summary

11.62. To sum up, the problems are :-

(a) that the requirements are overly complex, difficult to use because they are scattered through too many statutes and rulebooks and, in many cases, badly need updating to cater for developments in securities market practices; and

(b) that the administration and application of the law and rules is also overly complex with duplication of effort by the Registrar General's Department, the OCS, the Securities Commission and the SEHK.

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(5) See Chapter IX.

11.63. Our main recommendations therefore are :-

(a) that statutory provisions on new issue documentation and advertising should be thoroughly reviewed with the objective of their being consolidated and updated in a single statute; and that, in particular, there should be a review of -

(i) the "private placement" exemptions;

(ii) the scope and consistency of the "professional investors" exemptions; and

(iii) the effectiveness of Sections 72-74 of the Securities Ordinance;

(b) that the Administration should review whether it needs to continue pre-vetting the documentation to unquoted issues;

(c) that, where there is vetting, it should be by only one body rather than two or three;

(d) that, in particular, once its Listing Division is sufficiently improved, the SEHK should have sole responsibility for vetting and approving listed issues, and that to facilitate this -

(i) the Commission's Rules should be repealed, with the SEHK rules being expanded where necessary;

(ii) listed issues should be exempted from the Third Schedule; and

(iii) the new SC should have reserve powers to act if SEHK falls down on the job; and

(e) that, if pre-vetting of unlisted issues continues, the new SC should assume responsibility from the Registrar General's Department for vetting and approving prospectuses.

11.64. Finally, it is essential that the transfer of responsibilities to the SEHK should only occur when its Listing Division has proved itself up to the job. We therefore recommend that the new SC should initially audit the SEHK Listing Division at six monthly intervals and that its role under the Commission's Rules (and the Registrar General's role under the Companies Ordinance) should not be transferred until it is satisfied that the SEHK is up to the job. For this purpose, the new SC should appoint outside inspectors, with international experience, to advise it.

12.7. The main problem areas highlighted in the submissions were : -

(a) disclosure in annual accounts and prospectuses;

(b) disclosure of material shareholdings;

(c) directors' dealings; and

(d) approval of major transactions.

We examine each of these areas in the following paragraphs.

Accounting information

12.8. The consensus of expert opinion is that the disclosure requirements relating to the published accounts of listed companies in Hong Kong are broadly in line with international practice. The major problems with published accounts are that compliance with the existing regulations is unsatisfactory and is not adequately monitored, and that companies are reluctant to disclose additional information, beyond that specifically required, even where this appears to be necessary for the accounts to give a true and fair view of the company (which is required under the Companies Ordinance).

12.9. The following specific enhancements have been called for : -

(a) disclosure of related party transactions: in particular, there is no requirement to disclose material, non-arm's-length transactions between related parties or major transactions between a listed group of companies and a private group under common control;

(b) disclosure of substantial shareholdings;

(c) disclosure of dealings with shadow directors;

(d) full profit and loss accounts, identifying inter alia cost of sales, operating expenses and interest income and expense (as required by the Fourth Schedule to the UK Companies Act 1985). The present procedures only require the disclosure of turnover, operating profit and certain narrowly defined categories of expense; and

(e) five year summaries of results and financial position.

12.10. We believe that the proposed enhancements are in the right direction and therefore recommend that the SEHK should carefully review current disclosure requirements with a view to making improvements.

12.11. Moreover, there is concern that accounts may not always show a true and fair view; although current regulations may be complied with to the letter, companies may not go far enough to provide a true and fair view. We believe that companies and their auditors should be brought to understand that providing a "true and fair view" is the over-riding requirement. We understand that the UK law has recently been amended to stress the over-riding requirement. Hong Kong should consider following suit. <u>We therefore recommend that the Companies Ordinance should be amended to provide that the requirement for accounts to show a true and fair view overrides other provisions</u>.

<u>Material shareholdings</u>

12.12. In June 1987, the Government published the Securities (Disclosure of Interests) Bill which is, to quote the long title, a bill "to require certain persons holding shares in or debentures of listed companies to disclose their interest in those shares or debentures". The main objects of the Bill are : -

(a) to force disclosure of shareholdings of 10% or more within five days of the duty arising. The Bill looks through corporate interests to get at the reality of the controlling shareholder;

(b) to give companies the right to require a shareholder to provide information about his holding;

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(2) The directors shall cause to be made out in every calendar year, and to be laid before the company* ~~in general meeting,~~ a balance sheet as at the date to which the profit and loss account, or the income and expenditure account, as the case may be, is made up.

(3) If any person being a director of a company fails to take all reasonable steps to comply with the provisions of this section he shall, in respect of each offence, be liable on summary conviction to imprisonment for 6 months and to a fine of $10,000:

Provided that—

(a) in any proceedings against a person in respect of an offence under this section, it shall be a defence 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 provisions of this section were complied with and was in a position to discharge that duty; and

(b) a person shall not be sentenced to imprisonment for such an offence unless, in the opinion of the court dealing with the case, the offence was committed wilfully.

(Replaced, 80 of 1974, s. 12)

General provisions as to contents and form of accounts. 1948 c. 38, s. 149.

123. (1) Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.

Tenth Schedule.

(2) A company's balance sheet and profit and loss account shall comply with the requirements of the Tenth Schedule, so far as applicable thereto.

(3) Save as expressly provided in the following provisions of this section or in Part III of the Tenth Schedule, the requirements of subsection (2) and the said Schedule shall be without prejudice either to the general requirements of subsection (1) or to any other requirements of this Ordinance.

(4) The Financial Secretary may, on the application or with the consent of a company's directors, modify in relation to that company any of the requirements of this Ordinance as to the matters to be stated in a company's balance sheet or profit and loss account (except the requirements of subsection (1)) for the purpose of adapting them to the circumstances of the company.

(5) Subsections (1) and (2) shall not apply to a company's profit and loss account if—

(a) the company has subsidiaries; and

(b) the profit and loss account is framed as a consolidated profit and loss account dealing with all or any of the company's subsidiaries as well as the company and—

*at its annual general meeting or at such other general meeting of the company as may be specified by the court under subsection ~~(1A)~~ (1B)

(i) complies with the requirements of this Ordinance relating to consolidated profit and loss accounts; and

(ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company.

(6) If any person being a director of a company fails to take all reasonable steps to secure compliance as respects any accounts laid before the company in general meeting with the provisions of this section and with the other requirements of this Ordinance as to the matters to be stated in accounts, he shall, in respect of each offence, be liable on summary conviction to imprisonment for 6 months and to a fine of $10,000:

Provided that—

(*a*) in any proceedings against a person in respect of an offence under this section, it shall be a defence 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 provisions or the said other requirements, as the case may be, were complied with and was in a position to discharge that duty; and

(*b*) a person shall not be sentenced to imprisonment for any such offence unless, in the opinion of the court dealing with the case, the offence was committed wilfully.

(7) For the purposes of this section and the following provisions of this Ordinance, except where the context otherwise requires,—

(*a*) any reference to a balance sheet or profit and loss account shall include any notes thereon or document annexed thereto giving information which is required by this Ordinance and is thereby allowed to be so given; and

(*b*) any reference to a profit and loss account shall be taken, in the case of a company not trading for profit, as referring to its income and expenditure account, and references to profit or to loss and, if the company has subsidiaries, references to a consolidated profit and loss account shall be construed accordingly.

(Replaced, 80 of 1974, s. 12)

Obligation to lay group accounts before holding company. 1948 c. 38, s. 150.

124. (1) Where at the end of its financial year a company has subsidiaries, accounts or statements (in this Ordinance referred to as "group accounts") dealing as hereinafter mentioned with the state of affairs and profit or loss of the company and the subsidiaries shall, subject to subsection (2), be laid before the company in general meeting when the company's own balance sheet and profit and loss account are so laid.

(2) Notwithstanding anything in subsection (1)—

(a) a consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;

(b) a consolidated profit and loss account dealing with the profit or loss of the company and those subsidiaries.

(2) If the company's directors are of opinion that it is better for the purpose—

(a) of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries; and

(b) of so presenting it that it may be readily appreciated by the company's members,

the group accounts may be prepared in a form other than that required by subsection (1), and in particular may consist of more than one set of consolidated accounts dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries, or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

(3) The group accounts may be wholly or partly incorporated in the company's own balance sheet and profit and loss account.

(Replaced, 80 of 1974, s. 12)

Contents of group accounts. 1948 c. 38, s. 152.

126. (1) The group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.

(2) Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts shall, unless the Financial Secretary on the application or with the consent of the holding company's directors otherwise directs, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year.

Tenth Schedule.

(3) Without prejudice to subsection (1), the group accounts, if prepared as consolidated accounts, shall comply with the requirements of the Tenth Schedule, so far as applicable thereto, and if not so prepared shall give the same or equivalent information:

Provided that the Financial Secretary may, on the application or with the consent of a company's directors, modify the said requirements in relation to that company for the purpose of adapting them to the circumstances of the company.

(Replaced, 80 of 1974, s. 12)

Financial year of holding company and subsidiary. 1948 c. 38, s. 153.

127. (1) A holding company's directors shall secure that except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year.

INTRODUCTION

The Companies (Amendment) (No. 4) Ordinance 1974 has been enacted to give effect to certain recommendations contained in the Second Report of the Companies Law Revision Committee relating to company accounts and directors' reports. The amendments are extensive and the major revisions may be briefly summarised as follows:—

(i) company balance sheets must now show a true and fair view of the state of affairs of the company and profit and loss accounts must show a true and fair view of the company's profit or loss for its financial period;

(ii) companies with subsidiaries must prepare audited group accounts which must also show a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby, so far as concerns members of the company;

(iii) considerable additional information must be given in balance sheets, profit and loss accounts and directors' reports;

(iv) it is emphasised that the concept of a "true and fair" view for both the balance sheet and the profit and loss account overrides the requirements of disclosure as provided for in the Companies Ordinance and it is therefore possible that accounts may be deemed not to show a true and fair view even when all the provisions of the Companies Ordinance regarding disclosure of information have been complied with.

These revisions to a large extent bring Hong Kong in line with the current company law requirements in the United Kingdom.

Section 141D of this Ordinance refers to the "Accounts of certain private companies". These companies do not have to comply with all the requirements as to disclosure and special attention should be paid to this section.

The references in the following pages refer to the Companies Ordinance, as amended, and the letters as set out below and shown against each paragraph indicate the special type of company exempted from that particular requirement:—

B = Banking Company

I = Insurance Company

S = Shipping Company

P = Private Company [to which Section 141D applies (see paragraphs 97-100)]

It is emphasised that this booklet has been prepared to highlight, for clients' use, the more important amendments. Certain minor amendments to the Companies Ordinance have not been referred to in this booklet and, accordingly, it should not be regarded as a substitute for the statutory provisions contained in the Companies (Amendment) (No. 4) Ordinance 1974, which should be referred to on points of difficulty. An attempt has been made to interpret certain sections of the Ordinance but as this is a legal matter, clients should approach their solicitors for advice in cases of doubt.

The Firm will be very pleased to assist clients in regard to any queries they may have regarding the implementation of these far reaching amendments to the Company Law of Hong Kong.

Hong Kong, 15th January, 1975

Form and content of company individual and group accounts

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Form and content of individual accounts.

228.—(1) A company's accounts prepared under section 227 shall comply with the requirements of Schedule 4 (so far as applicable) with respect to the form and content of the balance sheet and profit and loss account and any additional information to be provided by way of notes to the accounts.

(2) The balance sheet shall give a true and fair view of the state of affairs of the company as at the end of the financial year; and the profit and loss account shall give a true and fair view of the profit or loss of the company for the financial year.

(3) Subsection (2) overrides—

(*a*) the requirements of Schedule 4, and

(*b*) all other requirements of this Act as to the matters to be included in a company's accounts or in notes to those accounts;

and accordingly the following two subsections have effect.

(4) If the balance sheet or profit and loss account drawn up in accordance with those requirements would not provide sufficient information to comply with subsection (2), any necessary additional information must be provided in that balance sheet or profit and loss account, or in a note to the accounts.

(5) If, owing to special circumstances in the case of any company, compliance with any such requirement in relation to the balance sheet or profit and loss account would prevent compliance with subsection (2) (even if additional information were provided in accordance with subsection (4)), the directors shall depart from that requirement in preparing the balance sheet or profit and loss account (so far as necessary in order to comply with subsection (2)).

(6) If the directors depart from any such requirement, particulars of the departure, the reasons for it and its effect shall be given in a note to the accounts.

(7) Subsections (1) to (6) do not apply to group accounts prepared under the next section; and subsections (1) and (2) do not apply to a company's profit and loss account (or require the notes otherwise required in relation to that account) if—

(*a*) the company has subsidiaries, and

(*b*) the profit and loss account is framed as a consolidated account dealing with all or any of the company's subsidiaries as well as the company, and—

(i) complies with the requirements of this Act relating to consolidated profit and loss accounts, and

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(ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the company's individual accounts.

If group accounts are prepared, and advantage is taken of this subsection, that fact shall be disclosed in a note to the group accounts.

Group accounts of holding company.

229.—(1) If at the end of its financial year a company has subsidiaries, the directors shall, as well as preparing individual accounts for that year, also prepare group accounts, being accounts or statements which deal with the state of affairs and profit or loss of the company and the subsidiaries.

(2) This does not apply if the company is at the end of the financial year the wholly-owned subsidiary of another body corporate incorporated in Great Britain.

(3) Group accounts need not deal with a subsidiary if the company's directors are of opinion that—

(*a*) it is impracticable, or would be of no real value to the company's members, in view of the insignificant amounts involved, or

(*b*) it would involve expense or delay out of proportion to the value to members, or

(*c*) the result would be misleading, or harmful to the business of the company or any of its subsidiaries, or

(*d*) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking;

and, if the directors are of that opinion about each of the company's subsidiaries, group accounts are not required.

(4) However, the approval of the Secretary of State is required for not dealing in group accounts with a subsidiary on the ground that the result would be harmful or on the ground of difference between the business of the holding company and that of the subsidiary.

(5) A holding company's group accounts shall be consolidated accounts comprising—

(*a*) a consolidated balance sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts, and

(*b*) a consolidated profit and loss account dealing with the profit or loss of the company and those subsidiaries.

(6) However, if the directors are of opinion that it is better for the purpose of presenting the same or equivalent information about the state of affairs and profit or loss of the company and

12.16. We recommend that the SEHK should introduce a Code governing securities transactions by directors of listed companies. This would complement the insider trading laws.

Major and related-party transactions

12.17. Rule 6 of the Undertaking between a listed company and the SEHK, prescribed under the Securities (Stock Exchange Listing) Rules, requires a listed company to deliver to the Commissioner for Securities a draft press notice giving brief particulars of any notifiable transaction as soon as reasonably practicable after agreement in principle has been reached and, as soon as practicable thereafter, to cause the notice, as amended to take account of any comment by the Commissioner, to be delivered to the SEHK and published in the newspapers. Briefly, notifiable transactions are defined as : -

(a) any acquisition or disposal of assets by the company, including its subsidiaries, which -

(i) accounts for more than 15% of the company's assets; or

(ii) involves their directors or chief executive; and

(b) any transaction by a subsidiary which is -

(i) a loan or other financial assistance to a parent company;

(ii) a provision of security for the discharge of any obligations of a parent company; or

(iii) other than in the ordinary course of business.

12.18. It was argued in submissions that these requirements do not go far enough and that there is a need generally to tighten the rules and their implementation, because public investors in Hong Kong companies are not in a satisfactory position vis-a-vis managing shareholders, particularly where a company is family controlled. It has been suggested that many Hong Kong businessmen do not distinguish between their own interests and those of their outside shareholders; or, if they do, that they do not sufficiently understand their obligation to put their fiduciary duties first.

12.19. However, it has also been suggested that investors in Hong Kong invest in particular companies precisely because they believe in the business acumen of the managing shareholder and that he can help them by helping himself. It was, therefore, argued that a general tightening up of the rules in this area would not be appropriate in the particular circumstances of Hong Kong's corporate world. We believe that there is some merit in this argument. Nevertheless, we feel that it is anomalous that Hong Kong's major corporate entities should escape international standards in this area when they have a large body of local and international professional and institutional shareholders and are now actively investing and acquiring companies in other countries.

12.20. We recommend therefore that the SEHK should require listed companies to seek shareholders' prior agreement before major transactions, such as large acquisitions or disposals of assets are entered into and to seek independent shareholders' prior approval for transactions in which a director or a substantial shareholder has a material interest[3].

12.21. We have not considered in detail how to define major transactions or material interest. We suggest that, in devising such rules in Hong Kong, the Exchange should study the practice of the International Stock Exchange in London.

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(3) The Companies Ordinance, at S.155A, requires such approval for disposals exceeding 1/3 of the company's fixed assets. The problem with this provision is that the threshold is too high and it only refers to fixed assets owned directly by the parent company itself.

13.6. We would, however, point out that the subject is extremely complicated, in particular the definition of an insider, the question of tipper/tippee liability[4], the distinction between mere possession and misappropriation of price sensitive information etc. Furthermore, the call for tougher sanctions against insider trading should not be regarded as synonymous with a call for its criminalisation. We believe that penalties such as desegregating profits, debarring directorships and freezing voting rights could be effective deterrents. However, as we have not considered the question in detail, we are not in a position to make any recommendations in this regard. We note that work on this area is currently being undertaken by the Administration and urge that this be completed as soon as possible.

(C) The Hong Kong Code on Takeovers and Mergers

13.7. The Hong Kong Code on Takeovers and Mergers is based on the original UK Code of the mid-1960s which has now been substantially revised and up-dated. This has prompted calls from professional advisers for a review. Some have also argued for a Hong Kong equivalent of the UK Rules governing substantial acquisitions of shares (the so-called Dawn Raid Rules), which in broad terms restrict the speed with which a person can increase his shareholding from 15% to 30%; and require accelerated disclosure of share purchases relating to such acquisitions.

13.8. The main focus of concern, however, has been that companies are not willing to comply with the Code. We believe that given the relatively small number of hostile

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(4) In the US, any insiders passing on price sensitive information (tippers) and certain persons receiving such information (tippees) may be liable to penalties.

bids in Hong Kong, the issues which are most important in London are not as pressing here. The main problem in Hong Kong appears to be non-compliance with the requirement for a general offer once a shareholding exceeds 35%. In this respect, it has been suggested that the sanction of a public reprimand has not been sufficient to enforce the Code.

13.9. We are of the view that the general offer requirement is fundamental to ensuring broad equality of treatment for all shareholders. The question of whether a breach of the Code should be made a criminal offence and the sanction for such a breach is, however, vexed. Different major markets have adopted different approaches. In the time available, we have not considered the question in sufficient detail to make detailed recommendations.

13.10. We recommend that the new Securities Commission should review the Hong Kong Code on Takeovers and Mergers concentrating on :-

(a) general housekeeping improvements;

(b) the administration of the Code; and

(c) the enforcement provisions and the sanctions backing the Code.

Moreover, the review should not simply opt for incorporating the new UK provisions but should consider the main issues that arise in the light of the particular nature of Hong Kong's corporate finance market.

13.11. Before we leave the subject, we wish to draw the Administration's attention to one particular point. We believe that, whatever the merits of the post-crash temporary waiver of the trigger point and creeper provision

of the Code[5], such ad hoc departures from a fundamental principle create undesirable precedents and, in the long term, tend to undermine the credibility of the entire body of rules. We are of the view that if the situation demanded such an initiative, it would have been preferable to introduce a relaxation similar to the treasury stock rule applied in the US, i.e. to allow companies to purchase their own stock for retirement. Such a move, while offering similar possibilities to the action taken in the aftermath of the October crash, would have benefitted all shareholders to an equal degree. In any case, we recommend that the Administration should favourably consider the merits of introducing a treasury stock rule in Hong Kong.

(D) Margin trading

13.12. Another area which requires urgent attention is the regulation of margin trading by members of the Stock Exchange of Hong Kong (SEHK). The submissions alleged that some brokers have been allowing 100% margins to clients and that unrealised profits on margined shares are accepted as security for further margin trading. While we acknowledge that this did not create any serious difficulties for brokers in the events of October 1987, it has been suggested to us that this was because the market closed

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(5) Under the Hong Kong on Takeovers and Mergers Code, any person with 35% or more of the voting rights of a company (the trigger point) and any person with between 35% and 50% who acquires more than an additional 5% of the voting rights within any 12-month period (the creeper provision), must bid for the entire share capital of the company. On 26 October 1987, the Commissioner for Securities announced a one-month waiver of these two provisions subject to full disclosure and a requirement to place out the additional shares within 12 months.

7. The Draft Securities and Futures Commission Bill 1988

7.1 As is well known, one of the main recommendations of the Report of the Securities Review Committee ("The Hay Davison Report") was that the existing Securities Commission and Commodities Trading Commission, together with the Office of the Commissioner for Securities and Commodities Trading, be replaced by a new body to be known as the Securities and Futures Commission.

7.2 In the last quarter of the year, we were asked by the Administration for our comments on two drafts of the proposed Bill for setting up the new body. We understand that these drafts were also the subject of consultations with a wide range of professional and business organisations.

7.3 We held a special Meeting on 15th October for the sole purpose for considering the First Draft and spent all of the December Meeting considering the Second Draft, the other business scheduled for that meeting having to be adjourned.

7.4 As well as points of principle, many technical points were raised but we do not think that it would be appropriate to deal with the latter in this Report and we therefore restrict ourselves to commenting on the more important points of principle.

First Draft

7.5 To be strictly correct, this document was a set of proposed clauses rather than a draft Bill in the conventional sense of the term.

(1) Constitution of the SFC

7.6 We made a number of comments on the relevant clauses :

(A) We suggested that it should be made clear that the functions of the SFC would include helping to foster a healthy securities industry.

(B) We noted that the provisions regarding membership of the Board were so framed that, at a full meeting, the executive directors would have a majority of votes. Some of us thought that it would be preferable to have equal numbers. Others wondered whether the minimum number of 7 directors would be enough to deal with the SFC's heavy workload. However, it was recognised that these provisions were in implementation of the SRC Report regarding the SFC i.e. "a small board, preferably with seven members : a chairman, deputy

chairman, two other full-time directors and three non-executive directors" (paragraph 9.38 of the SRC Report).

(C) We observed that the draft did not actually specify the differences between the respective functions, powers and duties of executive and non-executive directors and simply provided for these to be specified in the individual letters of appointment.

(2) Board of Appeal

7.7 We noted that the relevant clause provided that the Securities and Futures Board of Appeal would consist of the non-executive directors of the SFC, one of whom would be the chairman.

7.8 Some of us considered that such a Board would be seen as not being sufficiently independent and would not inspire full public confidence. These Members considered that the Board should be made up of third parties appointed by the Governor. They thought that if third parties were not involved in the appeal process, the Bill might as well give the SFC final authority, with no appeal provisions at all.

7.9 Other Members, however, thought that the draft was entirely acceptable. They pointed out that the non-executive directors of the SFC would be independent and respected members of the public who could be relied on to deal with appeals in an unbiased manner.

7.10 After a lengthy discussion of this subject, both on the principles involved and with reference to comparable existing bodies in Hong Kong and the U.K., we were unable to reach a common viewpoint on the proposals.

(3) Powers of intervention in intermediaries business

7.11 This part of the draft contained a number of provisions, the general effect of which was that where the SFC considered that there was "a reasonable likelihood that a registered person is insolvent or is, or is likely to become, unable to meet his obligations as a registered person" the SFC could "assume control of and otherwise manage and carry on the business of the registered person.... or direct a person other than the registered person to assume such control and manage and carry on such business".

7.12 We fully understood and appreciated the policy intent to protect the interests of clients and other creditors, but noted that, where the registered person was a company, the proposals appeared to cut across all the normal provisions of company law to the effect that a company is controlled by the directors and general meetings of shareholders. We also noted that the draft did not appear to contain any provisions to deal with anomalies resulting from this situation.

7.13 (These provisions were deleted from the Second Draft but we understand that they are receiving further consideration for possible reinstatement at some future date.)

(4) Information, investigation and entry to premises

7.14 (A) We noted that the clauses on this subject included provisions to the effect that an investigator appointed by the SFC could require not only the registered person under investigation but, as appropriate, a fellow company director, his partner, employee, agent, banker, auditor, solicitor and (if the registered person was a company) any significant shareholder to, inter alia, attend before the investigator who might "require him to answer truthfully, and to the best

of his ability" any question "whether incriminating or not" relating to the registered person or other person being investigated.

7.15 There was a separate provision that any statement made by a person under the foregoing provision could "be used in evidence against him (or otherwise)".

7.16 In effect, these provisions would, if enacted, have taken away the normal right to silence.

7.17 These draft provisions can be contrasted with the corresponding situation where an inspector is appointed under the Companies Ordinance. Under section 145(3A) of the Companies Ordinance a person is not excused from answering a question put to him by an inspector on the ground that the answer might tend to incriminate him but, if such person claims, before answering the question, that the answer might tend to incriminate him, neither thequestion nor the answer are admissible against him in criminal proceedings other than a charge of perjury in respect of the answer.

7.18 We recommended to the Administration that the Bill be amended to provide that any incriminating statement made by a person under the proposed provisions could not be used in subsequent legal proceedings against him, except in a charge of perjury in respect of the statement.

7.19 (B) We also noted a proposal to allow an investigator to enter the business premises of a registered person without a warrant.

7.20 We advised the Administration that we were opposed to forced entry to any premises without a warrant.

(5) Annual Report

7.21 We recommended the insertion of a new provision in the Bill requiring the SFC to publish an annual report.

Second Draft

(1) Board of Appeal

7.22 We noted that the new draft provided for an Appeals Tribunal consisting of -

The Chairman of the Board, who must be a barrister or a solicitor;

A non-executive director of the SFC; and

A member who is not a director or an employee of the SFC.

7.23 We suggested that it would be desirable to provide specifically that the non-executive director of the SFC should not have taken part in the decision under appeal.

(2) Regulation of registered person's business

7.24 (A) We were pleased to note that the provisions on the right of silence of a person being questioned by an investigator, which we had found unsatisfactory in the First Draft, had been amended to bring them into line with the corresponding provisions in the Companies Ordinance. We also found the new provisions on the investigator's right of entry to premises acceptable.

7.25 (B) We noted a clause giving powers to an authorised person to enter business premises of a registered person and "inspect and make copies of any record or other document or part thereof, or make or take any abstract of or extract from, any record or document relating to the business to which such certificate of registration applies".

7.26 Some of us felt strongly that "record or other document" should be restricted to records or documents which the registered person was obliged to keep under the companies legislation and the securities legislation.

7.27 Others, however, felt that the registered person should not be provided with an excuse for refusing to produce documents for inspection. These members felt that the practical purpose of an investigation was to find out if a registered person had complied with his statutory obligations and that, if a provision along the lines suggested was inserted, it would be open to serious abuse.

7.28 After discussion, we suggested a compromise provision that the authorised person could inspect anything on the business premises but could only

make copies of, or take extracts from, records relating to the registered person's business.

(3) <u>Restrictions on dealing with assets</u>

7.29 We noted the provisions of a clause that the SFC might, as regards any assets in Hong Kong or elsewhere, and whether they were assets of the registered person or not, by notice in writing -

(a) prohibit the registered person from disposing of such assets or prohibit him from dealing with them in a manner specified in the notice; or

(b) require the registered person to deal with such assets in, and only in, a manner specified in the notice.

7.30 We supported the obvious intention of the clause to give the SFC power to intervene to protect assets in the interests of clients and other creditors. However, we expressed the view that, unless additional provisions were inserted, the powers would be liable to be largely ineffective in practice. This was because the restrictions imposed under such a section would be an inhibition on the registered person concerned, but would

not place an inhibition on the assets themselves. The registered person would still be able to sell the assets to an innocent third party (although the exact legal status of such a sale might be open to question; please see the discussion of this aspect in (4) below). Of course, the registered person would have committed an offence under the section and could be prosecuted for this, assuming he could still be found, but if the sale was valid, this would not be much use to the creditors. We pointed out that section 67 of the Financial Services Act 1986 provided for assets to be vested in a trustee and that such a provision would prevent the registered person from disposing of them.

(4) Legal status of contracts made in prohibition of restrictions imposed by the SFC

7.31 Various clauses in the draft Bill gave the SFC substantial powers of intervention, including powers to prohibit a registered person from doing many things e.g. prohibiting him from carrying on certain types of business, from disposing of certain assets, etc.

7.32 When a statute prohibits something, the question inevitably arises of the legal status of any contract which is in breach of the prohibition. It is a fairly

common misconception that any contract entered into in contravention of a statute is void. The actual situation, however, is much more complicated. Halsbury's Laws, (4th edition: 1972) states in volume 9, paragraph 424 :

"In deciding whether a statute affecting a contract contains an implied prohibition of the contract or things done thereunder so as to render it unenforceable by one or both parties, the whole context and purpose of the statute must be taken into account and no single consideration, however important, is conclusive."

7.33 Paragraph 426 states :

"Sometimes a statutory provision affecting a contract will make express provision as to the civil rights of the parties and in that event the provisions of the statute must, of course, be applied."

7.34 As a matter of principle, we thought it highly desirable that the Bill should clearly state the legal status of any contract entered into in contravention of an order made by the SFC.

7.35 However, the only express provision on the subject in the Second Draft was to the effect that where a contract -

(a) relates to a security or a futures contract; and

(b) purports to have been made on the date of a notice served under a notice of powers of intervention vested in the SFC,

then nothing in the clause or in the notice shall render the contract unenforceable by a party thereto who proves that he acted in good faith.

7.36 The very limited nature of this provision is apparent e.g. it relates only to a security or futures contract made on the date of the notice. It does not deal with such contracts made after that date. Nor does it cover, for example, the sale of a flat by a registered person in breach of a prohibition of disposal of assets. In Hong Kong, real property quite often forms a substantial part of a registered person's assets. What would be the status of such a sale, especially in view of the fact that the Second Draft does not provide for the SFC to register any notice of inhibition in the Land Office when it prohibits a sale of assets?

7.37 The limited nature of the proposed provision can be contrasted with section 129 of the Banking Ordinance which simply states :

"The contravention of any prohibition in this Ordinance or in any Ordinance repealed by this Ordinance on the entering into of any contract shall not render that contract unenforceable."

The situation is perfectly clear and all contracts remain fully enforceable by the parties thereto.

7.38 We are not necessarily suggesting that there should be a similar provision in the present Bill. There is room for considerable debate. For example, some of us feel that only parties who have acted in good faith should be entitled to enforce contracts. Others feel that, while there should be realistic criminal sanctions for the breach of any statutory prohibition, any contract entered into should, in a commercial society like Hong Kong, remain fully enforceable in the same way as is provided for in the Banking Ordinance. These members also point out that if contracts were only to be enforceable by clients, this would be unfair because the clients would be exercising the option with the great advantage of knowing market movements subsequent to the effective dates of the contracts.

7.39 What we do feel strongly is that this is a subject which requires a policy decision and clear provisions in the Bill. If the eventual policy decision is not to

follow the precedent of the Banking Ordinance and some contracts will thus be unenforceable, we also feel strongly that there should be a requirement for the SFC to enter an inhibition in the Land Office registers when they issue a notice prohibiting disposal of any interest in land by a registered person, so that third parties will be fully aware of the situation. Consideration should also be given in such circumstances to requiring notice of the prohibition of disposal being given in respect of any assets which are registered in public registers e.g. listed shares.

7.40 (This particular draft provision was not included in the published Bill but we understand that the subject is under further consideration.)

8. The Securities (Disclosure of Interests) Bill 1988

8.1 We took up the question of compulsory disclosure of beneficial ownership of shareholdings in 1985.

8.2 In September 1985, we issued a press statement explaining in some detail that we had drafted an Interim Report to the Financial Secretary in which we stated that we were very

strongly inclined to think that the time had come to introduce legislation along the lines adopted in the U.K. We explained that the Interim Report had annexed to it an Outline of the suggested basis for legislation in Hong Kong. We also explained that, before actually submitting the Interim Report to the Financial Secretary, we would like to have the benefit of the views of any interested members of the public and invited them to apply for a copy of the Interim Report and Outline of legislation. The Secretary wrote separately to ten professional and business organisations enclosing copies of the Interim Report and Outline and inviting them to comment.

8.3 There was a good response to the request for comments and, after consideration of these, we amended our proposals in certain respects. We then submitted our amended recommendations to the Financial Secretary in December 1985.

8.4 Our recommendations were approved by the Financial Secretary and the Executive Council but drafting of the legislation took longer than expected and the Bill was not published until June 1987. Because it was anticipated that there would be a great deal of interest in the proposals, it was published as a White Bill and a 3-month period was allowed for public comment.

8.5 A great many comments were received from the public and we were asked for our views on these by the Administration. We considered them at our Meeting in March and recommended amendments to the Bill where we thought appropriate.

8.6 We also recommended the enactment of subsidiary legislation consisting of Regulations setting out further exemptions from the notification requirements in the Bill.

8.7 We were pleased to note that the Securities (Disclosure of Interests) Ordinance 1988 was gazetted on 15th July and that the Securities (Disclosure of Interests)(Exclusions) Regulations 1988 were gazetted on 26th August. However, the legislation will only come into operation on a date to be appointed by the Governor by notice in the Gazette. No such notice has yet been published. We appreciate that it would not be practical to bring the new legislation into effect until the new Securities and Futures Commission is in being and has the necessary resources, but we hope that the operational date will not be postponed for too much longer because we remain firmly of the view that this legislation has a very important part to play in the regulation of the securities industry in Hong Kong.

9. Section 161B (Particulars in accounts of loans to officers, etc.)

Section 161BA (Further provisions relating to loans to officers, etc. of authorised financial institutions)

9.1 Section 161B was introduced in 1984. It requires certain information on loans by companies to their directors and other officers to be included in the company's annual accounts.

9.2 In our Second Report (subjects considered during 1985) we explained that, after consideration of representations from the Hong Kong Association of Banks, we recommended that amendments be introduced to the section in respect of loans by authorised financial institutions i.e. banks and deposit-taking companies. Basically, these amendments were to provide that the information on loans to directors and other officers of authorised financial institutions would not require to be included in the institution's annual accounts but would instead be set out in a statement which would be open to inspection at the institution's registered office by members of the public for 14 days before and 7 days after the institution's annual general meeting.

9.3 These recommendations were eventually implemented in the Companies (Amendment) Ordinance 1988.

9.4 At our September Meeting, we considered a letter from the Association of the Institute of Chartered Secretaries and Administrators in Hong Kong which raised three points :

(1) The phrase "maximum aggregate" in sections 161B(4B)(b) and (4C)(b). The Association suggested that "aggregate maximum" would be preferable. We appreciated the Association's argument in support of this view but reached the conclusion that the existing provision was not causing any substantial problem in practice and that, subject to any further representations being received from interested parties, the provision should be left in its present form.

(2) <u>Section 161B(4A)</u>

The Association drew attention to the situation which might arise in the case of a banking group with its holding company incorporated in Hong Kong and banking subsidiaries incorporated overseas. The fact that the sub-section applies only to "any loan made to any person by the authorised financial institution or.... any guarantee entered into or security provided by the authorised financial institution in connection with a loan made to any person" means that loans made, and

guarantees or securities provided, to a director or other officer by an overseas incorporated subsidiary would still have to be included in the holding company's annual accounts. We agree that the intention was that details of such loans, guarantees and securities should appear in the annual statement, not in the accounts and that the sub-section should be amended to that effect. However, it appears that the point would only arise in a very limited number of cases and we suggest that the amendment be held over until there are other amendments to be made to the sections.

(3) Copies of statement of loans

Section 161BA(10) provides for any member of the public to require a copy of the annual statement of loans to officers. There is no time limit on when such copies may be required and the Association suggested that one should be imposed i.e. that members of the public should only be able to require such a copy during the period of 14 days before and 7 days after an authorised financial institution's annual general meeting. We

agreed to defer consideration of this point to see if any complaints are forthcoming from authorised financial institutions on the subject.

10. Section 209A (Power of court to order winding-up to be conducted as creditors' voluntary winding-up)

10.1 The Registrar General has proposed substantial amendments to the section and we are proceeding with consideration of these as a matter of some urgency.

11. Section 341 (Interpretation of Part XI)

11.1 In our Fourth Report (subjects considered during 1987) we explained that we had received representations from the Association of the Institute of Chartered Secretaries and Administrators in Hong Kong suggesting amendments to the interpretation of the phrase "place of business" contained in section 341 of the Companies Ordinance. We noted that the Association's suggestions were based on provisions in the corresponding Australian legislation which set out various circumstances where a company is deemed not to be carrying on business in a particular State. We also explained that we had

obtained the views of other organisations on the proposals and were enquiring into the effect of the legislation in Australia, after which we would return to consideration of this subject.

11.2 We resumed our considerations at our April Meeting.

11.3 We noted that research had shown that the Australian legislation contains an important difference from our own provisions on registration of oversea companies in that it prohibits overseas companies from either establishing a place of business (the only criterion for registration under Part XI of our Ordinance) or from commencing to carry on business (the basis used in the Revenue legislation in Hong Kong) unless it is registered under the Australian equivalent of Part XI of our Ordinance. Clearly therefore the Australian requirements for registration by overseas companies are, in principle, more comprehensive than our own.

11.4 The Australian legislation does not define "a place of business", it does list certain circumstances which do not constitute "carrying on business" and this helps in the interpretation of "place of business". As already indicated, it is this list of circumstances which forms the source of the amendments to our legislation suggested by the Association.

11.5 Does the Australian approach solve all or most of the problems associated with interpretation of "place of business"? Apparently not. In his book "Australian Company Registration Practice" (1972) Mr. F.J.O. Ryan, the Commissioner for Corporate Affairs, New South Wales, commented that, although the definition of what is not to be regarded as "carrying on business" is obviously of considerable assistance, "it is often a matter of great difficulty to determine whether a foreign company has established a place of business or commenced to carry on business so as to bring it within the registration requirements of the Act. The question is largely one of fact to be determined according to the circumstances of each case. The Commissioners will seldom assume the responsibility of advising that a foreign company has not established a place of business or commenced to carry on business, this being a matter for determination by the company or its legal advisers".

11.6 We also noted that the Law Society of Hong Kong was of the general view that to define the establishment of a place of business by reference to specified exclusions was undesirable, particularly when the exclusions imposed relate in character rather than to the carrying on of business. They also thought that it was arguable that any fault (if such there was) lay rather in the revenue treatment of persons establishing a place of business in Hong Kong than in the registration requirement, which was not burdensome in itself and perhaps imposed a useful discipline.

11.7 In the end we felt that the question which we had to ask ourselves was whether we should recommend the suggested amendments when it was known from the Australian experience that they would by no means solve all problems.

11.8 After careful consideration, we decided that we would not recommend any amendments to section 341.

Appendix 1

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 2

Membership of the Standing Committee as at 31st December 1988

Chairman : The Hon. Mr. Justice Cons

Members : Mr. Malcolm A. Barnett,

Mr. Marvin K.T. Cheung,

The Hon. Mr. Thomas Clydesdale, J.P.,

Mr. D.E. Connolly, J.P.,

Mr. Kenneth Fang Hung, J.P.,

Mr. Raymond P.L. Kwok,

Mr. Andrew Li Kwok-nang, J.P., Q.C.,

Mr. Eric K.C. Lo,

Mr. Alan Smith,

Professor L.G. Edward Tyler,

Mr. Charles H. Wilken,

Professor P.G. Willoughby, J.P.,

Mr. C.H. Wong, J.P.,

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, J.P., Registrar General,

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

Mr. Robert Owen, Commissioner for Securities and Commodities Trading,

Mr. Michael McMahon, Consultant, Commercial Crimes Unit, Attorney General's Chambers

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

Appendix 3

Meetings held during 1988

Fortieth Meeting	-	9th January
Forty-first Meeting	-	6th February
Forty-second Meeting	-	5th March
Forty-third Meeting	-	16th April
Forty-fourth Meeting	-	7th May
Forty-fifth Meeting	-	4th June
Forty-sixth Meeting	-	2nd July
Forty-seventh Meeting	-	3rd September

Forty-eighth Meeting	-	1st October
Forty-ninth Meeting	-	15th October
Fiftieth Meeting	-	5th November
Fifty-first Meeting	-	10th December