# STANDING COMMITTEE ON COMPANY LAW REFORM

## SIXTH REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subject considered by the Standing Committee during 1989

TABLE OF CONTENTS

## 1. Audit of Company Accounts

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

1.1 In our Fifth Annual Report (Subjects considered during 1988) we referred to a number of topics connected with audit of company accounts. In connection with section 123 of the Companies Ordinance, we remarked (para. 1.7 of the Fifth Annual Report) that the reasons why there were so few "adverse opinion" audit certificates in respect of the accounts of listed companies and, relatively speaking, so many "disclaimer" certificates required further consideration. We mentioned that we had raised the point with the Hong Kong Society of Accountants and looked forward to resuming discussion on this subject.

1.2 Some background explanation seems desirable although it must be stressed that what follows is a simplification of what is, in practice, often a very complicated subject.

1.3 The Statement of Auditing Standard Reporting issued by the Hong Kong Society of Accountants (Statement 3.102) states inter alia :

1.4 "10. There are occasions when, in order to convey clearly the results of his audit, the auditor needs to depart from the form of wording normally used for unqualified audit reports. Such departures are generally referred to as qualifications...."

1.5 "11. When the auditor is unable to report affirmatively ... he should qualify his report by referring to all material matters about which he has reservations...."

1.6 "13. The nature of the circumstances giving rise to a qualification of opinion will generally fall into one of two categories :

(a) where there is an uncertainty which prevents the auditors from forming an opinion on a matter (uncertainty); or

(b) where the auditor is able to form an opinion on a matter but this conflicts with the view given by the financial statements (disagreement)"

1.7 "22. The forms of qualification which should be used in different circumstances are shown below.

| Nature of circumstances | Material but not fundamental | Fundamental |
|---|---|---|
| Uncertainty | 'Subject to' opinion | Disclaimer of opinion |
| Disagreement | 'Except for' opinion | Adverse opinion |

- In a 'subject to' opinion the auditor effectively disclaims an opinion on a particular matter which is considered material but not fundamental.

- In an 'except for' opinion the auditor expresses an adverse opinion on a particular matter which is considered material but not fundamental.

- In a disclaimer of opinion the auditor states that he is unable to form an opinion as to whether the financial statements give a true and fair view.

- In an adverse opinion the auditor states that in his opinion the financial statements do not give a true and fair view."

1.8 In practice a "disclaimer of opinion" certificate is usually in approximately the following terms :

"In view of the significance of the matter referred to in the preceeding paragraph(s) **we are unable to form an opinion** as to whether the financial statements give a true and fair view of the state of the company's affairs as at 31 December 19 " (Underlining added).

1.9 An "adverse opinion" certificate is normally in approximately the following terms :

"In view of the impact of the failure to (, say, provide for the losses on the contracts referred to above) in our opinion the financial statements **do not give** a true and fair view of the state of the company's affairs as at 31 December 19 " (Underlining added).

1.10 As was explained in our Fifth Annual Report, the Registrar General has been advised that he could not prosecute a director under section 123 of the Companies Ordinance where a "disclaimer of opinion" 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 whether or not they do so.

1.11 The Society reported to us in May of 1989 on the results of their investigations into the situation in England.

1.12 One part of the information was that the comment from England was that ""disclaimers of opinion" are not common in this country". This rather surprised us because certain differences in the terminology used in respect of "disclaimer of opinion" certificates in the auditing standards issued in Hong Kong and England respectively, led us to expect that "disclaimer of opinion" certificates would be more common in England than in Hong Kong. Apparently, the reverse was true, however, because according to the Registrar General, as reported in paragraph 1.5 of our Fifth Annual Report, it was relatively common for the accounts of listed companies in Hong Kong to contain "disclaimer of opinion" certificates but there were seldom, if ever, any "adverse opinion" certificates.

1.13 We had further extensive discussion as to the reasons for the alleged greater prevalence of "disclaimers of opinion" certificates in Hong Kong and whether this greater prevalence was justified.

1.14 One suggestion which we considered was that some directors in Hong Kong were unconvinced of the need for statutory audit and were reluctant to pay the fees associated with comprehensive programmes of audit checks. This, it was suggested, encouraged auditors to play safe by issuing "subject to" opinions. We asked whether in such circumstances an auditor should not give an "adverse opinion" certificate but it was explained to us that many auditors would not issue an "adverse

opinion" certificate unless they had in fact carried out a full programme of checks. It was suggested to us that it might be necessary to consider introducing legislation on the extent of checks which must be carried out during a statutory audit.

1.15 It was also suggested to us that one way of dealing with the problem would be to alter the legislation to provide that a qualified audit opinion should be deemed to be an "adverse opinion" i.e. it should be deemed to be an opinion that the accounts did not give a true and fair view. However this and the question raised in the paragraph above would be radical departures from the corresponding provisions in comparable jurisdictions and we are unwilling to take such a step at the present time.

1.16 It became clear during our discussions that many of the points being made related to actual practice, i.e. to the interpretation of auditing standards in practice, rather than the contents of the standards. We decided that before reaching any conclusion on this subject, discussions should continue between the Registrar General and the Society to see if they could reach agreement on what amending legislation, if any, was necessary.

1.17 We shall resume consideration of the subject when we hear from the Registrar General on the outcome of these discussions.

1.18 We also noted that the new U.K. Companies Act 1989 which was enacted on 16 November 1989 contains (Part II) extensive new provisions on the regulation of auditors and we will study these in detail as soon as possible.

(2) Off balance sheet financing

1.19 We also referred to this subject in our Fifth Annual Report. We explained that we had noted U.K. press reports to the effect that, after extensive lobbying from the accountancy 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".

1.20 We also explained that we had asked the Hong Kong Society of Accountants ("the Society") for their views on the need for similar legislation in Hong Kong.

1.21 At the same time, we asked the Society for their views on Exposure Draft 42 on the subject of "special purpose transaction" which had been issued by the accountancy profession in England for comments.

1.22 The Society replied in early 1989. They explained that a familiar form of off balance sheet financing was a "financial lease" which was a lease that transferred substantially all the risks and rewards of ownership (other than the legal title) of an asset from a lessor to a lessee. This subject had already been dealt with by the Society's Statement of Standard Accounting Practice No. 14, which had become effective in a case of lessees for accounting periods beginning on or after 1st January 1988. They also explained that another main issue addressed in Exposure Draft 42 was the "controlled non-subsidiary" referred to in our Fifth Annual Report i.e. an entity which, though in substance a subsidiary of a reporting group, did not fall within the Companies Ordinance definition of a subsidiary, resulting in its assets and liabilities being excluded from the reporting group's consolidated balance sheet. The Society advised that at the time of their writing, there were no indications that companies in Hong Kong were using this or other types of off balance sheet device.

1.23 The Society also advised that, in view of the foregoing, they had no immediate plan to issue an exposure draft or guidelines along the lines of the U.K.'s Exposure Draft 42, which we understand in any event is still ony in draft form. They would, however, monitor closely any instances of apparent abuse in Hong Kong as well as developments on this subject, whether in the U.K. or elsewhere.

1.24 Finally, the Society advised that they would like to draw a clear distinction between off balance sheet financing as dealt with in Exposure Draft 42 and the off balance sheet transaction of financial institutions. The latter had of course been around for a much longer time and the current concern was to arrive at a fair measure of risks for capital adequacy purposes.

1.25 Some of us expressed surprise at the Society's comment that there were no indications that companies in Hong Kong were using the "controlled non-subsidiary" or other types of off balance sheet device. The view was expressed that business people in Hong Kong were just as ingenious as those anywhere else when it came to such matters.

1.26 We noted that the new U.K. Companies Act 1989, which was enacted on 16 November 1989, contained a number of new provisions which are intended to deal with the problem of "non-controlled subsidiaries" by requiring them to be consolidated in group accounts. We intend to study these provisions in detail as soon as possible.

(3) Inner reserves of Banks

1.27 We reported in our Fifth Annual Report that we had agreed with the Commissioner of Banking that the subject of the form of auditor's certificate in respect of bank's 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.

1.28 The discussions are still in progress.

## 2. Increase of penalties under the Companies Ordinance

2.1 The Registrar General, Mr. Gleeson, in his capacity as Registrar of Companies, submitted to us for information a schedule prepared by him showing proposed increases in the penalties for offences against the provisions of the Companies Ordinance. He explained that the increases had been the subject of intensive discussions within the Administration and that the main reasons for the increases were :

(1) the fact that many penalties had probably been too low even when they were originally imposed;

(2) the effects of inflation; and

(3) the increasing awareness of the need to enforce all the requirements of the Companies Ordinance more effectively.

2.2 Mr. Gleeson confirmed that, when the proposals for the increases were under consideration, there had been a penalty-by-penalty comparison with the corresponding provisions in the U.K. which were thought to be very relevant in this connection.

2.3 Mr. Gleeson also confirmed that the proposals did not include the creation of any new offence and that they did not substitute a prison sentence for what had previously been a fine.

2.4 We advised Mr. Gleeson that we had no objections to the proposals.

2.5 The proposals were subsequently contained in the Companies (Amendment) (No. 2) Bill 1989 published on 22 December 1989.

## 3. Insider Dealing

3.1 Our Fourth Annual Report (Subjects considered during 1987) contained as an Appendix a copy of our Second Interim Report, dated 16 March 1987, to the Financial Secretary on the subject of insider dealing.

3.2 In very brief summary, we concluded that insider dealing should not be criminalised and that instead the existing Insider Dealing Tribunal system provided for in Part XIIA of the Securities Ordinance should be retained, with the Tribunal being given powers to impose substantial monetary penalties on insider dealers and to ban them from acting as directors of, or being involved in the management of, any company for a period up to 5 years.

Draft Securities (Insider Dealing) Bill

3.3 During the year, we were given an opportunity, albeit on very short notice, to comment on a draft of the Securities (Insider Dealing) Bill. We noted that the Administration had taken the opportunity to deal with many aspects of the subject which had not been referred to in our Second Interim Report. We also noted that the draft departed in a number of respects from our recommendations viz. :

3.4 (1) Our Second Interim Report recommended that the existing provisions under which the Tribunal determined degrees of culpability should be abolished and that the term "insider dealing" should be reserved for conduct which was deliberately intended to take advantage of privileged information. However, we also explained (Paragraph 5, page 2 of the Second Interim Report) that we were concerned that conduct tending in the same

direction should not be ignored and suggested the introduction of some other term which would indicate conduct, including negligence, which was not in itself insider dealing but which might lead to, induce or allow insider dealing by others.

3.5 However, in the draft Bill the Administration decided to adhere to the approach in the existing section 141H(3) and (4) of the Securities Ordinance, suitably amended to remove the notion of culpability. The aim was to give the Tribunal a free hand to decide who was an insider dealer, whether or not an immediate party to the dealing, and who was simply negligent, without being tied by possibly restrictive definitions. This was thought to be particularly important in the case of a corporate insider dealing.

3.6 A number of us regretted that the Bill did not introduce the two-tier system recommended by us. It was regretted that the relevant sub-clause (Sub-clause 13(4) in the published Bill) did not make it clear that negligent conduct would not be an insider dealing. Under the sub-clause, a person in control of a company could be named as an insider dealer even though he had been found to have been only negligent. The term

"insider dealer" carries a stigma of dishonesty, particularly in other countries where the technicalities of our legislation are not understood.

3.7 (2) Our Second Interim Report contained a recommendation in paragraph 27, page 11 to the effect that judicial review of a Tribunal decision should be expressly excluded and that instead a general right of appeal to the Court of Appeal should be granted.

3.8 However, the draft did not exclude the right to a judicial review and provided for an appeal on a point of law alone.

3.9 (3) Our Second Interim Report contained a recommendation in paragraph 29, page 12, to the effect that hearings of the Tribunal should continue to be held in private.

The draft, however, provided that proceedings should be held in public unless the Tribunal considered that, in the interest of justice, a sitting or any part thereof should be held in camera.

3.10 During the short time available, we only had an opportunity to express views on a restricted number of other points in the draft including :

3.11 (1) The statutory defence that a deal entered into by a person "otherwise than with a view to the making of a profit or the avoiding of a loss (whether for himself or another) by the use of relevant information." (Clause 9(3) of the published Bill).

3.12 Mr. Owen pointed out that, at the time of our meeting, the draft Bill had not yet been considered by the Board of the SFC and explained that he did not wish to take up a position on this or any other point in the draft on behalf of the SFC until such a discussion had taken place. However, he pointed out that there was no corresponding "test of intent" defence in the U.S. legislation on insider dealing.

3.13 Other Members, however, supported the inclusion of this defence.

3.14 (2) The clause dealing with awards of costs in the draft allowed the Tribunal to award costs against a person even if he was not found to have been involved in insider dealing. There was also no provision for appeal against the order made under the clause.

(Suitable amendments were incorporated in the published Bill.)

3.15 (3) The question was raised of whether the Bill should exclude bona fide arbitrage deals, particularly those relating to taking advantage of inconsistencies in the respective prices of A and B shares in a company.

Securities (Insider Dealing) Bill 1989 published on 30 June 1989

3.16 Subsequently, we had an opportunity to consider the published version of the Bill and made a substantial number of comments to the Administration. Many of these were of a technical drafting nature but the following were of more general interest :

(1) Clause 5 (dealing in securities)

3.17 The question was raised of whether the exercise of rights or warrants in respect of shares was covered by the Bill i.e. were warrants within the meaning of "securities" in the Bill?

3.18 It was observed that there were substantial differences between the exercise of a warrant and a dealing on the Stock Exchange. For example, a person exercising a warrant was dealing directly with the company and the exercise was made at a fixed price. The company had a contractual obligation to sell the

holder of the warrant shares at a fixed price and could not claim that it had lost an opportunity to sell at a higher price.

3.19 On the other hand, if the person exercising the warrant made his decision on whether or not to exercise it on the basis of inside knowledge, he could thereby make a profit or avoid a loss when he eventually disposed of the shares.

3.20 We recommended to the Administration that the Bill should be clarified on this point.

(2) Clause 9 (certain transactions not insider dealing)

3.21 (i) We have already referred to the discussion which took place when we considered the statutory defence in clause 9(3) in the draft Bill. We resumed this debate when considering the published Bill.

3.22 Mr. Owen confirmed that the SFC was strongly of the view that clause 9(3) should be deleted. It was considered that clause 9(3) constituted a loophole large enough to vitiate the operation of the legislation. He pointed out that Canada, Australia, the U.S. and the major European centres

did not have a "motive" test. There was one in the U.K. legislation but he understood that it would be deleted soon in order to comply with the proposed EC directive on insider dealing. There had formerly been a "motive" test in the Canadian legislation but it had been found to offer many loopholes and had been repealed.

3.23 Mr. Owen's views were supported by a number of Members.

3.24 Other Members felt that since the Bill laid the burden of proof on the person under investigation by the Tribunal and since, in the special circumstances of Hong Kong, there might from time to time be special pressures to sell for reasons not connected with making a profit, for example for emigration purposes, the defence should be retained. The defence was in the existing provisions on insider dealing in the Securities Ordinance and there was no formal indication that it would actually be repealed in the U.K.

3.25 On a show of hands, it appeared that a majority of Members did not feel strongly about the provision and that those who did were evenly divided about it.

3.26 (ii) One of our Members was of the view that, up to clause 9, the Bill was drafted in very wide terms and extended the definition of "insider dealing" beyond that found, for example, in the U.K.. He thought that it was only reasonable that clause 9 should be in similarly wide terms. Specifically, he suggested two exemptions :

(a) arbitrage (which had already been suggested at our previous meeting when we discussed the draft Bill); and

(b) dealings between two insiders e.g. between two companies within the same group or between two brothers who were both shareholders in a family-controlled company. The purpose of the legislation should be to protect the general public, not "equal insiders".

3.27 It was indicated to us that while the Administration might be sympathetic to an exemption for category (b), an exemption for (a) was not practical because of the technical problems involved in defining "arbitrage" satisfactorily. It was pointed out to us that there was no precedent in the legislation in other comparable jurisdiction for an exemption of arbitrage.

3.28 Another member was concerned that if Hong Kong introduced an innovative exemption such as one for arbitrage, there would be further demands for exemptions e.g. for computer trading. The member in favour of exemption for arbitrage thought that if Hong Kong did not permit such an innovation it would be left behind by other international financial centres.

3.29 It was indicated to us that there was a view within the Administration that the lack of an exemption for arbitrage dealings of the type suggested would have a very small effect on the overall arbitrage market.

3.30 We agreed to note the suggestion of an exemption for arbitrage dealings and to recommend that an exemption for dealings between "equal insiders" be considered further.

(3) Clause 13 (Inquiries into insider dealing)

Sub-clause (4) : "negligent directors"

3.31 This subject had also been discussed at our previous Meeting when we considered the draft Bill.

3.32 It was suggested to us on behalf of the Administration that a reasonable compromise would be for the Bill to be amended :

(a) to treat as an insider dealer a director of an insider dealing corporation who consents to, connives in or knows of the insider dealing in question; and

(b) to introduce a new category of "negligent director" who is not an insider dealer but whose acts or omissions contribute to the insider dealing and who is liable to the imposition of penalties by the Tribunal.

3.33 We regarded these proposals as being basically an acceptance of our original proposal for a two-tier system and confirmed that we supported them.

(4) Clause 16 (Incriminating answers)

3.34 One member raised the question of how this provision would fit in with the proposed Bill of Rights.

3.35 It was commented that there appeared to have been a change in public attitude to some matters such as insider dealing and that requiring witnesses to answer incriminating questions in such circumstances appeared to be acceptable nowadays.

(5) Clause 20 (Orders etc. of Tribunal)

3.36 It was pointed out that an order made by the Tribunal under clause 20(1)(a) only allowed the Tribunal to ban an insider dealer from being a director of, or being involved in the management of, a Hong Kong incorporated company.

3.37 It was suggested that the provision should be extended to enable the ban to cover overseas incorporated companies listed on the Hong Kong Stock Exchange.

3.38 Our feeling was that the proposed extension was desirable but there were technical problems involving extra-territoriality.

3.39 We await with interest the outcome of the continuing consideration of the Bill by the Ad Hoc Committee appointed by the Legislative Council.

## 4. Purchase by a company of its own shares

4.1 We referred to this subject in our Fifth Annual Report (pages 44-46) in the context of our consideration of the relevant recommendation in the Report of the Securities Review Committee ("The Davison Report"). The Davison Report recommended 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.

4.2 We explained that we had dealt with this subject in our Third Report (Subjects considered during 1986) and had recommended there that -

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

4.4 (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.

4.5 We further explained that our recommendations on item (i) of the list in (b) above had already been implemented earlier in 1988 in the form of the Securities (Disclosure of Interests) Ordinance 1988 and that drafting instructions had been given to the Law Draftsman in respect of item (ii) and were being prepared

for items (iii) and (iv). We hoped that it would not be unrealistic to expect to see legislation on subjects (ii) - (iv) enacted by the end of 1989.

4.6 In the event, at the end of 1989 the position regarding the four items of legislation was as follows :

Item (i) : Securities (Disclosure of Interests) Ordinance 1988

4.7 This Ordinance had not yet been brought into operation. Various proposals for amendment to it were submitted to us by the SFC and the SEHK during the year and more details of these discussions are given in the relevant section of this Report. We understand that the Administration's intention is that the Ordinance should be amended as soon as possible to require a person who is under an obligation to notify a listed company of an item of information, to notify the SEHK at the same time. Once this amendment has been made, the Ordinance will be brought into operation. The other amendments which have been under discussion will be considered further once the Ordinance is in operation.

Item (ii) : Insider Dealing

4.8 We had an opportunity to discuss the draft of the Securities (Insider Dealing) Bill 1989 before its publication on 30 June 1989 and more details can be found in the relevant section of this Report. When the Bill was published a number of organisations submitted their views to the Ad Hoc Committee appointed by Omelco to deal with the Bill. Some of these views were highly critical of certain aspects of the Bill and discussions between the organisations concerned and the Ad Hoc Committee of Omelco were still continuing at the end of 1989. We await the final decision of the Legislative Council with great interest.

Item (iii) : Distributable Profits and
Item (iv) : Fiduciary Duties of Directors

4.9 We understand that drafting instructions for these two items were delivered to the Law Draftsman during the year and hope to have an opportunity to comment on the draft legislation at an early date.

4.10 We decided early in 1989 that, in view of the progress with the implementation of our recommendation for legislation on the above four subjects, and in view of the continuing and increasing general interest in the subject, it would be desirable

to resume consideration of the subject of allowing purchases of their own shares by listed companies. We therefore wrote to the SFC and the SEHK in March asking for their views.

4.11 They submitted to us for consideration a detailed Joint Report setting out their views and recommendations on the subject. This Joint Report was the only item on the Agenda at a Special Meeting of the Standing Committee held on 9 September. At the risk of oversimplifying the comprehensive and detailed contents of the Joint Report, we think that it can be said that the main points made by the SFC and the SEHK were :

4.12 (i) Favourable consideration should be given to permitting companies to purchase their own shares because :

(a) the benefits to be derived from a comprehensive share repurchasing scheme generally outweigh related costs;

(b) investors' and creditors' protection concerns associated with share repurchases can be addressed by amendments to company law and securities regulatory requirements;

(c) the collective experience of the U.K., Canada, Australia and the U.S.A. supports the views set out in (a) and (b) above and can be used to Hong Kong's advantage;

(d) it would help to level the playing field for Hong Kong incorporated companies listed on the SEHK by allowing them to engage in buy backs of their own shares to the same extent as foreign domiciled companies so listed and by subjecting both categories of companies to common buy back requirements.

4.13 The Joint Report repeated the arguments which are generally advanced in favour of allowing companies to purchase their own shares i.e. :

(a) it permits a company to buy out a dissenting shareholder;

(b) it facilitates the retention of family control;

(c) it provides a shareholder, or the estate of a deceased shareholder, of a company the shares of which are not listed, with another potential buyer for its shares;

(d) it permits a company to purchase shares in connection with the operation of employee share purchase plans, stock option plans or acquisition programmes;

(e) it provides a company with excess cash with an alternative method of returning cash to shareholders for the purpose of enhancing shareholder value rather than having to retain the cash when faced with unattractive investment opportunities;

(f) it provides management with a defence against coercive takeover bids;

(g) it provides management with an alternative method of achieving or maintaining an optimal capital structure;

(h) it permits a company to support the market for its shares when share prices are depressed; and

(i) it permits a company to realize cost savings by purchasing redeemable shares when they are trading at a price that is less than their redemption amount.

4.14 A number of these arguments, of course, apply only or mainly to private companies.

4.15 The Joint Report also listed the arguments usually advanced against allowing companies to purchase their own shares i.e. :

(i) insider dealing;

(ii) reduction of capital to the detriment of creditors;

(iii) share price manipulation by controlling shareholders through the use of corporate funds;

(iv) greenmail; and

(v) non-arm's length transactions with favoured shareholders.

4.16 As already indicated, the Joint Report argued that the benefits from permitting purchases outweigh the disadvantages and that investors' and creditors' protection concerns can be addressed by amendments to company law and securities regulatory requirements.

4.17 (2) With a view to allowing purchases, the Companies Ordinance should be amended to provide for the following points :

(a) Section 58(1A) of the Companies Ordinance should be amended to permit companies to purchase their own shares provided such purchases are expressly permitted by their articles of association.

(b) Any purchases should be subject to prior shareholders' approval.

(c) Only fully-paid shares can be purchased.

(d) There should be provisions designed to protect the creditors of a company which buys back its own shares, from the possibility of a default associated with a capital reduction attributable to the purchase; in the U.K. this protection is provided by a condition that the shares can only be purchased out of distributable profits or out of the proceeds of a fresh issue of shares made for the purpose of the purchase.

(e) Shares bought back should be cancelled.

4.18 The corresponding provisions in the U.K. Companies Act 1985 set out detailed provisions on the mechanics of the purchases, including price and time limits, and depending on whether they are "market" or "off-market" purchases. There are also important supplementary provisions in the Stock Exchange's Listing Rules. The SFC and SEHK recommended in their Joint Report that the detailed provisions regulating the mechanics of purchases should be contained in the Takeover Code (in the case of a general offer) and the SEHK's Listing Rules (in the case of a share buy-back programme). We do not think that it is necessary for the purposes of this Report to set out these proposals in detail, especially as they will be the subject of a separate public consultation exercise by the SFC and the SEHK, scheduled for January 1990.

4.19 After careful consideration of the arguments and recommendations in the Joint Report, we eventually agreed with its conclusion that the benefits of allowing listed companies to purchase their own shares outweigh the associated risks. Our decision was influenced to a substantial extent by a paper prepared by the City Capital Markets Committee which appeared in the August 1988 issue of the Bank of England Quarterly Bulletin and which we considered at our January 1989 Meeting. The Markets Committee examined in some details the arguments for and against allowing companies to purchase their shares and after a review of

the actual experience since the introduction of the power to purchase in the U.K. in 1981, reached the conclusion that "the ability to repurchase shares is a useful weapon in a company's financial armoury".

4.20 We therefore recommend that the Companies Ordinance be amended to allow companies to purchase their own shares subject to the following conditions :

(a) the purchase must be permitted by the company's articles of association;

(b) the prior approval of the shareholders to any purchase must be obtained;

(c) the shares to be purchased must be fully paid;

(d) the shares must be purchased out of distributable profits;

(e) the shares purchased must be cancelled; and

(f) there must be prompt public disclosure of all purchases.

4.21 It is obvious that the detailed regulation of the mechanics of purchases made under the general enabling provisions set out above will be of the utmost importance but we do not think that it is desirable to set out any detailed recommendations on this aspect until the results of the forthcoming public consultation exercise by the SFC and the SEHK are known.

## 5. Qualifications of Companies' Secretaries

5.1 We first referred to this subject on pages 17 and 18 of our First Report (Subjects considered during 1984).

5.2 Very briefly, the position is that the Companies Ordinance requires every company to appoint a secretary (section 154) but does not require the possession of any qualifications by the holder of the post. The position was the same in the U.K. until section 79 of the Companies Act 1980 introduced certain requirements regarding qualifications to be held by secretaries of public companies. The section required the directors of a public company to secure that the secretary of the company was a person who, firstly, appeared to them to have the requisite knowledge and experience to discharge the functions of the secretary and, secondly, was either an existing company secretary, or possessed certain legal, accountancy or secretarial

qualifications or was "a person who, by virtue of his holding or having held any other position or his being a member of any other body, appear(ed) to the directors to be capable of discharging those functions" (section 79(1)(e)). The section is now section 286 of the Companies Act 1985. There is still no statutory requirement in the U.K. for the secretary of a private company to hold any qualification.

5.3 In 1984, the Association of the Institute of Chartered Secretaries and Administrators in Hong Kong ("the Association") had approached us with a proposal for the introduction of a requirement for companies' secretaries in Hong Kong to possess qualifications, and, in a number of respects, their suggested requirements were more strict than those in the U.K.

5.4 We observed that the principal justification for the introduction of qualifications of this kind would seem to be the public interest in securing the due observance of the provisions of the Companies Ordinance. We acknowledged that the then existing situation in Hong Kong regarding such compliance was not satisfactory. However, we also thought that the situation could not, generally speaking, be attributed to a lack of knowledge on the part of those responsible and that increased compliance was far more likely to be achieved by firm enforcement of the law than by the imposition of qualifications.

5.5 We concluded that it would not be appropriate at that time to recommend that legislation be introduced along the lines of section 79 of the U.K. Companies Act 1980 but we left it open to take up consideration of the matter again at a future date.

5.6 The subject was raised again by the Association early in 1989 and was referred to us for further consideration.

5.7 In the course of its detailed submission, the Association made the following points, among others :

(1) Directors were, quite properly, concerned with the business of the company rather than with its administration. Many had no recognised professional qualifications and those who did were more likely to have qualifications and expertise in professional fields other than the administration of the company as a legal entity. Additionally, there was a growing recognition that a company was part of the economic and social life of the community and therefore had responsibilities not only to its shareholders but also to its employees, its customers, its suppliers and the community at large. While it had to be recognised that directors of most companies did remarkably well in reconciling all or most of these conflicting claims, no individual director had this function of the administration of the company as his major

responsibility. In practice, the company secretary was considered to be the guardian of the law and even the moral conscience of the company. The directors typically relied on him to ensure that the company was fulfilling its responsibilities under the law and beyond that, to society at large. He held a unique position at the heart of the business.

5.8 (2) Whatever legislation might be produced in the present increasingly strict regulatory environment, it was clear that there were likely to be more far-reaching changes in corporate administration. The fact of these changes would undoubtedly make the work of the company secretary even more demanding and responsible, which would not only involve an increase in the work which must be done but was sure to raise challenging problems for the secretary concerning the interpretation and implementation of the legislation. In this regard, it was the secretary who would be the directors' guide.

5.9 The Association claimed that experience showed that there was a need for a person capable of exercising impartiality, integrity and professional competence, employed in a position of sufficient seniority to influence policy and in a position of strength not less than that of the company's auditor but who, because he was working within the company, could prevent abuses before they happened rather than report on them after the event.

5.10 The Association thought that the company secretary was the person most likely to be in that postion. He represented the company to the outside world. He signed important communications for the company. In less formal matters he was the person whom most outsiders, as well as shareholders and employees, would regard as a person to whom complaints or suspicions of malpractice should be made.

5.11 The Association also thought that while legal penalties must exist as a long stop, it was preferable to prevent defaults and the need for criminal proceedings by ensuring that the persons responsible for complying with the law were fully aware of their duties and fully capable of performing them. The Association submitted that this could be done most effectively by the appointment to positions of responsibility of qualified people who were concerned for the maintenace both of the law and of professional standards of performance and behaviour. They also submitted that it was wrong in principle to impose legal liabilities which were highly complex and technical on the company secretary, without ensuring by law that he was appropriately equipped to accept them. The Society insisted that doctors, dentists, lawyers and accountants, for example, could not practice unless they were properly qualified, on account of the possible harm which society could suffer when innocently exposed to the quack or the amateur. The same principle should apply to public listed companies. The investor should be able to assume, and society had come to except, that those on whom the

law imposed obligations and responsibilities in the public interest should be qualified by law to accept them and that the public should not unwittingly be exposed to the uncertain abilities and standards of the unqualified.

5.12 The Association made it clear that it was not suggesting that the appointment of qualified officers would end abuse of the system but argued that it must tend to reduce the probability of such abuse taking place. They submitted that a requirement for qualifications and membership of a professional body would produce the following benefits :

(a) The participation of skilled and qualified personnel in decision making would greatly reduce the risk of decisions being made in ignorance of the legal position or the requirements of codes of practice such as the Code on Takeovers and Mergers.

(b) The participation in decision making of professional personnel owing a duty to their professional body would produce a check on incipient abuse.

(c) In the performance of his duties, the member of a professional body would be both assisted and controlled by that body. The body could offer advice and assistance to the member concerned at possible abuse and support to the member confronted by actual abuse.

5.13 The Association pointed out that auditors of a company and its lawyers must be recognised by an appropriate body and submitted that the same principles should be applied to the company secretary. They submitted that it was inconsistent to require external advisors to be qualified yet to accept that internal advisors, with whom the company had far more direct contact might have no qualifications whatsoever.

5.14 The Association was of the view that section 154 of the Companies Ordinance should be extended so as to provide that, at least for listed companies, the secretary should possess defined qualifications with a statutory requirement that after a specified date, no one could be appointed the secretary of a listed company, unless he was a member of a professional body recognised for this purpose by the Financial Secretary. Naturally, the Association considered that it should be one of these professional bodies.

5.15 The Association therefore recommended the inclusion of a clause along the following lines in the Companies Ordinance :

"Qualification for appointment as Secretary

(i) Subject to subsection (iv) below, a person shall not be qualified for appointment as secretary of a company to which this section applies unless either -

(a) he is a member of a professional body recognised in Hong Kong and for the time being recognised by the Financial Secretary for the purposes of this provision;

or

(b) he has such other qualification adequate for the purposes of this provision as may for the time being be recognised by the Financial Secretary.

(ii) A body corporate shall not be qualified for appointment or qualified to act as secretary of a company to which this section applies.

(iii) A company to which this section applies is a company the shares or debentures of which are listed on a recognised stock exchange.

(iv) Nothing in the foregoing provisions of this section shall disqualify a person, other than a body corporate, from acting as secretary of a company to which this section applies if he was so acting on..... 198 *

* The date to be inserted will be the date of the publication of the Bill or the date of any earlier White Paper."

5.16 After consideration of the Association's latest submissions we decided that, before reaching any decision, we should consult a number of organisations for their views on :

(a) The Association's proposal that the secretary of a listed company should be required by statute to have certain qualifications.

(b) If the answer was in the affirmative, what these qualifications should be?

(c) Whether the requirment should be extended to secretaries of unlisted companies which were subject to prudential supervision under statute.

5.17 The organisations consulted were :

The Hong Kong Association of Banks
The Hong Kong Management Association
The Hong Kong Federation of Insurers
The Hong Kong General Chamber of Commerce
The Chinese General Chamber of Commerce
Hong Kong Society of Accountants
The Law Society of Hong Kong
The Hong Kong Deposit-taking Companies Association
The Hong Kong Bar Association
The Stock Exchange of Hong Kong Limited

5.18 In summary, all the respondents were in favour of requiring secretaries of listed companies to have qualifications. Two of them, the Society of Accountants and the Deposit-taking Companies Association thought that the requirements should be dealt with in the Stock Exchange Listing Rules, not in the Companies Ordinance. The Association of Banks commented that if it was thought necessary to list the qualifications in both the Companies Ordinance and the Listing Rules then the requirements should be the same in each case.

5.19 The following organisations commented that corporate secretaries should continue to be permitted :

The Hong Kong General Chamber of Commerce
The Chinese General Chamber of Commerce
The Law Society of Hong Kong

5.20 With regard to unlisted companies subject to prudential supervision, there was no general consensus among the consulted organisations. Some supported the principle that there should be qualifications requirements for secretaries of some types of these companies, such as banks and insurance companies, but not for others such as travel agents and money lenders. We noted that in any event secretaries of banks already require the Commissioner of Banking's approval under the Banking Ordinance.

Others thought that there should not be statutory requirements and that the matter should be left to the individual regulatory authorities.

5.21 No one supported the idea of extending statutory requirements for qualifications to the secretaries of ordinary private companies.

5.22 The Stock Exchange supplied us with a copy of the draft of their then proposed new Listing Rule 8.16 which, in effect, implemented the Association's recommendations, including a ban on corporate secretaries. The Rule, in the same form as the draft supplied to us, came into operation on 1 December 1989.

5.23 As the Association's recommendations in respect of listed companies have, in practice, been implemented by the new Stock Exchange Listing Rule, we have agreed to resume consideration of this subject again after we have had an opportunity to see how the new Listing Rule operates. We will also consider the position of secretaries of unlisted companies subject to prudential supervision under statute at that time.

## 6. Securities (Disclosure of Interests) Ordinance, Cap. 396

6.1 The Securities (Disclosure of Interests) Ordinance ("Cap. 396") was enacted in July 1988 but has not yet come into operation.

6.2 During the year, we were asked to consider a number of amendments to the Ordinance proposed by the SFC :

### (1) Reporting requirements

6.3 Reporting requirements arise in respect of the interests of substantial shareholders, directors and chief executives of a listed company.

6.4 In summary, a substantial shareholder has to inform the company when he reaches the 10% threshold and when that holding subsequently changes by 1%, plus or minus. A director has to inform the company about every sale and purchase of his shares in the listed company, its subsidiaries and associated companies, as well as those of shares in the listed company's parent company, its subsidiaries and associated companies. The same obligations apply to a chief executive. All these reporting obligations must be fulfilled within 5 days of the event concerned.

6.5 When the company receives a notification from a substantial shareholder, director or chief executive, it is obliged :

(a) to pass the information on to the SEHK and the SFC by the close of the next business day; and

(b) to make the information available for public inspection in the relevant registers within 3 days of receipt.

Where the listed company is itself an authorised financial institution, i.e. a bank or a deposit-taking company, or the holding company of an authorised financial institution, the company must also inform the Commissioner of Banking by the close of the next business day.

6.6 When the SEHK receives an item of information under (a) above, it must "forthwith" publish it in such manner and for such period as may be approved by the SFC. This requirement is different from that in the U.K. in that, after the Stock Exchange there has been informed of the event by the listed company, the Stock Exchange can publish the information or not, at its discretion.

6.7 The SFC informed us that it considered that the existing requirements did not facilitate the release of, what would usually be, price-sensitive information to the public. More particularly, they pointed out that the requirements meant that the listed company could, potentially, be in possession of price-sensitive information for up to 2 days before it passed it on to the SEHK for publication. The SFC thought that this created delays and perhaps opportunities for insider dealing by officers of the listed company.

6.8 The SFC therefore proposed that substantial shareholders etc. should be under an obligation to report the information to the SEHK and the listed company at the same time, ensuring that, in any event, the information did not reach the listed company before it reached the SEHK. It was also proposed to delete the obligation on the listed company to inform the SFC. Instead, the SEHK would liaise informally with the Commission and deliver the information to them as quickly as possible.

6.9 Some of us thought that the additional work involved for the shareholders by these proposed amendments was not justified. The reason was that the great majority of notifications under Cap. 396 will be routine, especially since directors and chief

executives have to report every transaction. Surely, they argued, only a small proportion of these notifications would contain what could be regarded as price-sensitive information and these should be dealt with under the Insider Dealing legislation, not Cap. 396.

6.10 However, the majority of us accepted the SFC's argument and recommend that the necessary amendments be made in Cap. 396.

6.11 On the same subject, the SEHK submitted to us that if the proposed amendments were to be enacted, they should be given the same statutory immunity in respect of information published by them bona fide as had been given to the SFC under their incorporating Ordinance. The SEHK pointed out that they would be under an obligation to publish a very large volume of information within tight time limits and that, although they would do their best to check on information which seemed to be price-sensitive in nature, there was always the chance that the checking procedures would not be perfect and that an important item of information would be published which would subsequently turn out to be false. The SEHK and their staff ought to be given a statutory immunity in respect of information published by them bona fide under Cap. 396.

6.12 We agreed with this argument and recommend that the SEHK be given a statutory immunity but we do so on the understanding that the SEHK will implement a satisfactory checking procedure for all items of information received which could reasonably be regarded as price-sensitive. We make this recommendation with some misgivings because we recognise that it means that an investor who has made a bad decision on the basis of a false piece of information published by the SEHK under the Ordinance, will have no recourse against any one except in the highly unlikely event of his being able to discover who perpetrated the fraud. However, this is an unavoidable consequence of granting a statutory immunity.

(2) Application of Cap. 396 to listed companies incorporated outside Hong Kong

6.13 Cap. 396 only applies to dealings in shares in "listed companies". The definition of "listed companies" in section 2 of Cap. 396 makes it clear that it covers only companies incorporated in Hong Kong or statutory bodies incorporated under Hong Kong Ordinances.

6.14 This situation is the same as that which exists under the corresponding legislation in the U.K., from which Cap. 396 is derived. This situation is consistent with the usual U.K. approach which is to leave overseas companies which have established a place of business in the U.K. to be regulated to a very large extent by their domestic Companies legislation and to require them to comply with only a limited number of provisions in the U.K. legislation. The U.K. leaves it to the Stock Exchange Authorities and the Listing Rules to require overseas listed companies to impose conditions in their articles of association or equivalent which in effect constitute a contractual obligation for the shareholders to comply with the disclosure requirements.

6.15 We made it clear when we submitted our original recommendations on which Cap. 396 was based that we expected the same procedure to be followed in respect of overseas incorporated companies listed in Hong Kong.

6.16 During the year, however, the SFC submitted to us that it would not now be appropriate to follow the U.K. precedent. They pointed out that Hong Kong is now unique in respect of the number of overseas companies having their primary listings here. The phenomenon is political in origin and is too well-known to require

any explanation of the mechanics here. What is important is that, in most cases, although the listed holding company of a group is incorporated in, typically, Bermuda, all the real assets of the group and almost all of its staff and actual operating subsidiaries remain here in Hong Kong. In most cases, the majority of the shareholders also reside in Hong Kong. The number of such companies is large and is growing monthly.

6.17 The SFC argued that it was not appropriate to try to apply Cap. 396 to these overseas holding companies by means of the Listing Rules and individual companies' articles of association. Such a non-statutory approach might work in London where there were only a comparatively few overseas companies listed but it would not work satisfactorily in Hong Kong where overseas companies make up a very large and growing percentage of the total number of listed companies. The SFC pointed out that the only remedy for breach of Listing Rules was delisting and this would often be inappropriate in disclosure situations.

6.18 The SFC therefore recommended that the definition of "listed company" in section 2 of Cap. 396 be amended to cover overseas incorporated companies with a primary listing on the SEHK. This proposal was strongly supported by the SEHK.

6.19 To help us with our consideration of the proposal, our Secretary produced a detailed paper in which he referred to the many problems, particularly with regard to extra-territoriality and enforcement of the so-called "freezing orders" made under Cap. 396, which would arise if we agreed the SFC's and SEHK's recommendation.

6.20 The SFC accepted that technical problems would exist if we agreed with their recommended amendments but assured us that they were confident that, if the Ordinance was amended to extend to overseas incorporated listed companies as proposed, they would be able to overcome these problems in practice and to enforce the legislation effectively.

6.21 We accept that it is highly desirable that the disclosure requirements of Cap. 396 should apply to overseas listed companies with primary listings in Hong Kong. Whatever the technicalities may be, we have no

doubt that these groups are, for all practical purposes, Hong Kong groups with the great majority of their assets, staff and shareholders situated here.

6.22 Accordingly, on the basis of the SFC's assurance that they can overcome the technical problems pointed out by the Secretary in respect of enforcement, we recommend that Cap. 396 be extended to apply to overseas incorporated holding companies with primary listings in Hong Kong. It may be that the best method of achieving this end would be to extend the Ordinance to all overseas incorporated companies and grant the SFC a power to exempt any company which the SFC are satisfied has its primary listing outside Hong Kong.

(3) Proposed deletion of exemption for discretionary trusts in section 14(1)(a)

6.23 Section 14 of Cap. 396 contains a list of interests in shares which are to be disregarded for the purposes of the reporting obligations imposed on substantial shareholders by the Ordinance i.e. such interests need not be reported.

6.24 Included in the list, at section 14(1)(a), is "any discretionary interest" i.e. any interest in respect of a discretionary trust.

6.25 This exemption is based on the corresponding exemption in section 209 of the U.K. Companies Act 1985. It was originally introduced by the Companies Act 1967.

6.26 During the year, the SFC urged us to recommend that this exemption should be repealed because it constitutes an obvious loophole for avoiding the requirements of Cap. 396.

6.27 The SFC explained that the settlor of a discretionary trust might not, as a matter of law, direct the trustees as to how they should exercise their discretion. In practice, however, the settlor usually controlled the trustees' discretion by one of several means. Firstly, the settlor could be a trustee of the trust. Secondly, the settlor could make it a condition precedent to the exercise the trustees' discretion that consent from a specified person (including himself) to the exercise of the discretion be obtained by the trustees before the discretion was exercised. Thirdly, the settlor will have appointed the trustees to act and may have retained a power of revocation and appointment.

6.28 But, said the SFC, most frequently the settlor's views on the ways in which he hoped (and in practice secured) that the trustees would exercise their discretion was set out in a written statement. Such a statement was normally expressed not to constitute a legal obligation or restriction on the trustees and was commonly called "a statement of wishes". As the trustees would often be professional trustees, such as solicitors, accountants, bankers or trustee companies, they would have no interest in exercising their discretion contrary to the settlor's wishes and would have the strongest motive for complying with those wishes viz. the maintenance of a good relationship with the settlor.

6.29 The SFC submitted that it would be seen from the above that a discretionary trust provides a sound vehicle for a person to divest himself of the legal ownership of an interest in securities which should otherwise be disclosed, while still maintaining an effective control of that holding. This, said the SFC, enables the settlor to defeat the purposes of the Ordinance easily.

6.30 The SFC also pointed out that the exemption did not apply in the case of directors and chief executives, who had to give details of discretionary

interests. In addition, when a listed company conducted an investigation into share ownership under section 18 of Cap. 396, the person who was requested to give details of his interests in the shares under investigation must reveal any discretionary interests.

6.31 Why should the company have to go to the expense and trouble of an investigation under section 18 to obtain details of discretionary interests?

6.32 The SFC accepted that, although the exemption had been in existence in the U.K. since 1967, there was no evidence of any concern by the authorities there about abuse of it to avoid the disclosure requirements. The SFC argued, however, that the authorities there were not aware of the extent of the problem of avoidance of the disclosure requirements because, by definition, interests held in discretionary trusts were not disclosed to them. Though examples of abuse might have come to their attention, the lack of concern apparently shown by the authorities in the U.K. could not be conclusive that no serious problem existed. In Hong Kong, on the other hand, the SFC had evidence of plans to use the exemption to avoid disclosure on a serious scale and they were anxious to stop this happening.

6.33 The SFC's proposals led to lengthy discussions with some of us in favour of deletion and some against.

6.34 Those in favour of deletion of the exemption for discretionary trusts agreed with the SFC that it provided an obvious loophole for avoidance of Cap. 396 on a serious scale and should therefore be closed. It was pointed out that, at one time, discretionary trusts had been the favourite method of avoiding estate duty in the U.K. until the authorities there had taken steps to control their use. Nowadays the use of discretionary trusts could actually involve some tax disadvantages in the U.K. and that was the reason why they were not as popular as in Hong Kong, although there seemed to have been a mild resurgence in their popularity recently.

6.35 Those against the deletion of the exemption argued that, by definition, a discretionary object, i.e. a potential beneficiary under a discretionary trust, could not know whether he had an interest in the trust; he would not know until he actually received a share. How, therefore, could he notify a company about his interest in it?

6.36 The opponents of deletion pointed out that, from a legal point of view, any "statement of wishes" given to the trustees by the settlor was just that, and did not bind the trustees. Any trustees who simply followed the settlor's wishes without exercising genuine discretion might find themselves held to be in breach of trust if proceedings were taken by a discretionary object who did not actually receive any share in the trust. The opponents of deletion thought that the advocates were arguing that there were few, if any, genuine discretionary trusts in Hong Kong i.e. that most so-called discretionary trusts were shams and that the trustees did not exercise bona fide discretion. But surely, the opponents of deletion argued, a sham discretionary trust would not be entitled to the exemption in section 14(1)(a) anyway? How could the SFC confidently predict abuse of the exemption, which had not yet even come into operation, when it had existed in the U.K. for 22 years without complaint from any one? If it was being abused in the U.K., surely the Government or the Stock Exchange or the listed companies would have become aware of this in the course of their numerous investigations into share ownership in the U.K.?

6.37 The opponents of deletion of the exemption pointed out that discretionary trusts were used bona fide on a large scale in Hong Kong for personal financial planning purposes and urged that the exemption should not be deleted unless further intensive consultation with the private sector took place first.

6.38 After lengthy discussions, we all reached common ground in agreeing that there should not be a requirement for genuine discretionary objects to report under Cap. 396. However, we also agreed that the exemption for discretionary interests should not provide a loophole for avoiding the disclosure requirements of Cap. 396.

6.39 At one stage we reached the tentative conclusion that we should recommend :

(a) that the existing exemption for discretionary interests in Cap. 396 be deleted; and

(b) there should be a new provision requiring disclosure by any person who retains a measure of control over the capital of a beneficiary trust or in accordance with whose instructions as to the management of the capital assets of the trust, the trustees are accustomed to act.

6.40 Eventually, however, we concluded that a preferable approach would be :

(a) to retain the existing exemption of discretionary interests in section 14(1)(a), but

(b) to set out the circumstances in which an arrangement would be deemed not to be a discretionary interest for the purposes of Cap. 396.

6.41 We understand that the Administration will carry out further consultations with the banking sector and the professions on this proposed amendment. Once this has been done and the draft legislation prepared, the matter will be referred to us for consideration again.

6.42 For the avoidance of doubt, we confirm that there should not be a requirement for disclosure where the instructions referred to in (b) relate only to payment of dividends received on the shares concerned.

(4) "Concert party" provisions

6.43 The SFC drew our attention to an inspection recently concluded in the U.K. into the County Natwest/Blue Arrow transaction in 1987. In the

inspector's report, certain provisions of the U.K. Companies Act had been commented upon. The same provisions appear in Cap. 396.

6.44 The comments concerned the application of the concert party provisions. Under these provisions, agreement between concert parties which require disclosure are limited to those which include provisions "imposing obligations or restrictions on any one or more of the parties ..... with respect to their use, retention or disposal of their interests".

6.45 In the County Natwest case, the shares in question had been "parked" with another party under a profit or loss sharing and indemnity agreement. The inspectors concluded that such an arrangement fell outside the concert party provisions and accordingly did not give rise to an obligation to disclose. The inspectors considered that the concert party provisions ought to be re-examined by the legislature.

6.46 The SFC believed that the concert party provisions of Cap. 396 should be expanded to cover the arrangements employed in the County Natwest case.

6.47 When we discussed the SFC's recommendation, one point of the view was that since the report was based on a U.K. inspector's report but no amendments had yet been made to the U.K. legislation, it would be preferable to wait and see the outcome there before taking action here. It was commented that the concept of "parking" shares was common in the U.S and that the problem lay in how to define "parking" without catching bona fide transactions.

6.48 Eventually, however, we decided that there appeared to be a substantial flaw in the concert party provisions and that we should not wait for the U.K. to take action.

6.49 We therefore recommend :

(a) that "parking" of shares for the purposes of avoiding disclosure obligations should be prohibited, but

(b) the amendments should be framed so as to ensure that they do not catch legal contracts which in truth did not offend the principles of the Disclosure Ordinance or the Takeover Code.

## 7. Small Private Companies

7.1 Our attention was drawn to a letter on the subject of small private companies from a Mr. C. Yee published in the South China Morning Post on 9 January 89 and to the reply from the Registrar General, Mr. Gleeson, in his capacity as Registrar of Companies, published in the issue of 13 January. Copies of the letters are appended at pages and .

7.2 It seemed to us that Mr. Yee's letter raised five points :

7.3 (1) There should be no need to file an annual return when there had been no intervening change in the particulars contained in the last annual return filed

7.4 We noted Mr. Gleeson's reply that the provisions of section 107(3) of the Companies Ordinance required only the filing of a short certificate in such circumstances. However, it appeared that Mr. Yee wished to dispense with filing completely. We felt that the provisions of section 107(3) were not an unreasonable requirement for an operational company.

7.5 Mr. Gleeson went on to explain to us that he was considering the possibility of introducing a "dormant company" procedure under which a company could be "put

to sleep". Under such a procedure the directors would file a statutory declaration undertaking not to engage in any business activities while the company was dormant. During the "dormant" period it would not be necessary to file anything in the Companies Registry. The company would be capable of being resurrected at any time by the filing of a statutory declaration by the directors. It seemed obvious that there would have to be provisions for heavy penalties against any breach of the undertaking not to do business while the company was dormant. Some of us thought that there was a danger of such a procedure leading to a pile up of abandoned companies and of its being regarded as an alternative to liquidation; directors would make a company dormant and then forget about it.

7.6 Mr. Gleeson agreed that these were the possibilities which would have to be taken into account when considering the pros and cons of such a procedure.

7.7 (2) <u>There was no need for AGMs for private companies</u>

7.8 We thought that, as Mr. Gleeson had pointed out, regard must be had as to "public interest" aspects of this matter.

7.9 Mr. Gleeson also observed that the basic problem with this and other similar proposals lay in deciding what was "a small private company". He referred us to the relevant definitions in the U.K. legislation (section 248(1) of the Companies Act 1985) and the Ontario legislation (section 148(1)(a) of the Business Corporations Act 1982). He pointed out that both definitions were based on turnover and assets, plus workforce in the case of the U.K., and that using anything similar in Hong Kong would mean that, for the first time, private companies would have to start filing their accounts to enable their claims to be in the "small company" category to be checked.

7.10 Quite apart from the question of the public reaction to a proposal that private companies be required to file their accounts, Mr. Gleeson informed us that the checking process would mean an increase in work for the Companies Registry which could not cope with the existing workload.

7.11 (3) <u>The Companies Ordinance was too big</u>

7.12 We thought that many people would agree with this view but felt that there did not seem to be any practical possibility of reducing its size in present-day conditions. Quite the reverse in fact. There is

constant public demand for additional legislation on various aspects of company law. It is also a fact that the Companies legislation in comparable jurisdictions is much longer than our own.

7.13 (4) Section 141D of the Companies Ordinance (Power of shareholders of certain private companies to waive compliance with requirements as to accounts) : many shareholders probably did not understand what was involved when they agreed to apply this section

7.14 We felt that, as a matter of principle, shareholders should not agree to anything they did not understand. If they did agree to something which they did not understand, they had only themselves to blame for any unfortunate consequences.

7.15 (5) "Companies Ordinance" should be "Companies Act"

7.16 We agreed but it was pointed out to us that this was a constitutional matter which applied to all Hong Kong legislation, not just to the Companies Ordinance. Any proposals for change would have to be referred to the Law Reform Commission, not to ourselves.

7.17 We instructed the Secretary to write to Mr. Yee informing him of our views, as summarised above, on the points raised by him and thanked him for his interest in the subject.

7.18 We await details of the Registrar General's proposals for a "dormant company" procedure with interest.

7.19 We have also noted that the U.K.'s Companies Act 1989, which was enacted in November 1989, contains a number of important provisions regarding the regulation of private companies e.g. section 115(2) of the Act introduces a new section 366A into the Companies Act 1985, under which a private company may elect, if all the shareholders entitled to vote so resolve at a general meeting, to dispense with annual general meetings. We shall study these provisions in detail as soon as possible with a view to deciding which of them would be appropriate for adoption in Hong Kong.

## 8. Section 209A of the Companies Ordinance (Power of court to order winding up to be conducted as creditors' voluntary winding up)

8.1 We mentioned briefly in our Fifth Annual Report (Subjects considered during 1988) that the Registrar General had proposed substantial amendments to this section and that we were proceeding with consideration of these as a matter of some urgency.

8.2 This section was introduced into the Companies Ordinance in 1984 in implementation of a recommendation originally made in the U.K. by the Jenkins' Committee and adopted in Hong Kong by the Second Report of the Companies Law Revision Committee published in April 1973 (para. 8.19 of that Report). It is interesting to note that the Jenkins' Committee's recommendation has never been implemented in the U.K..

8.3 The section is a deceptively short one. Subsection (1) provides that the court may, on the application of the liquidator or any creditor, direct that a compulsory winding up shall be conducted as if it were a creditors' voluntary winding up.

8.4 Subsection (2) provides that in the exercise of the power under this section, the court shall have regard to the wishes of the creditors and the contributories of the company.

8.5 The Registrar General, in his capacity as Official Receiver, submitted to us that there were three problems with the provisions of the section :

(1) It introduced a system which cut across the basis on which the Official Receiver's Division was financed.

(2) There were circumstances in which a liquidation under control of the courts should not be removed from that control e.g. where criminal proceedings against one or more of the company's directors were being contemplated.

(3) There were a number of technical deficiencies in the section in that it did not contain sufficiently detailed provisions on certain aspects of the conversion to a creditors' voluntary winding up.

8.6 The first problem requires further explanation. Firstly, the Official Receiver has been advised that the law does not permit him to act as liquidator in a voluntary liquidation. Therefore, in any case where the Official Receiver was acting in a compulsory liquidation and there was a successful application under section 209A for conversion to a voluntary liquidation, the Official Receiver would automatically be obliged to stop acting. It also has to be appreciated that the commercial basis on which the Official Receiver operates in a compulsory liquidation is a

scheme of payments by results i.e. he receives percentages of assets recovered and distributions made. In other words, he is only remunerated towards the close of the liquidation. Let us assume a case where the Official Receiver has carried out most of the preliminary work in a compulsory liquidation, including litigation, set-off disputes in proofs of debts by creditors, complications over title of assets held under floating charges or lease agreements, etc. Then, just before the final stages of liquidation of the assets and distributions to creditors, the liquidation is converted to a voluntary liquidation under section 209A. The percentage fees would not be payable in such circumstances. Of course, the Official Receiver would still be entitled to appropriate fees on a time-cost basis for the work done, but he has informed us that this would involve very substantial administrative problems for him. He would require to introduce a time-costing system for every liquidation on the basis that it <u>might</u> be converted to a voluntary liquidation under section 209A at some future time.

8.7 The Registrar General suggested to us that the difficulties mentioned above could be dealt with by amending the section as follows :

(1) In order to remove the problems for the Official Receiver associated with a change in the type of liquidation at a later stage, the option to apply under section 209A should be exercisable only at the first

meeting of the creditors of the company, which must be held within 3 months of the date of the winding up order. The Registrar General also explained that the Cork Insolvency Review Committee in the U.K. had formed the view that the appropriate time to take a decision about the best administrative method for dealing with an insolvent company was at the first meeting of creditors.

(2) The legislation should specify certain "public policy" considerations which the court must take into consideration in considering any application under the section.

(3) The court should be given a wide general power to give directions in the event of a successful application under the section and a number of specified technical provisions should apply unless the court directed to the contrary.

8.8 We consulted the Law Society of Hong Kong and the Hong Kong Society of Accountants for their views on the Registrar General's proposals.

8.9 They were not sympathetic. They thought that the Official Receiver's administrative problems in applying for fees on a time-cost basis was not a sufficient reason for imposing a

time limit on applications under section 209A. They also thought that the other two proposed amendments were not immediately necessary and that any perceived deficiencies in these aspects of the section should be dealt with in the context of a general review of Insolvency law, not on a piecemeal basis. They were also concerned that the transitional provisions in any amendments to the existing section should not involve retrospective legislation.

8.10 However, with regard to the first of the problems set out by the Registrar General, we feel that we must have regard to the Administration's existing policy on financing of the Official Receiver's Division of the Registrar General's Department, not to what that policy may be at some future date. On this basis, we feel that the Registrar General's proposal to impose a time limit for making application under section 209A is a reasonable one, having regard to all the circumstances. We also feel that the Registrar General's suggested amendments in connection with the second and third problems listed by him are useful and that it would be appropriate to include them in the amending legislation.

8.11 We therefore recommend that section 209A be repealed and replaced by the following :

1 "Power of court to order winding up to be conducted as creditors' voluntary winding up

209A (1) The court may on the application of the liquidator or any creditor made -

(a) in the case of a company in respect of which an order has been made under section 227F, not later than 3 months from the date of such order; and

(b) in any other case, not later than 3 months of any resolution to make such an application passed at a meeting of creditors or contributories held pursuant to section 194 or any adjournment thereof, or such further period as the court in its discretion may permit*

order that the winding up of a company ordered to be wound up by the court shall, from the date of the order made on such application, be conducted as if the winding up were a creditors' voluntary winding up.

---

* "or such further period.....may permit" added as a result of subsequent discussions.

(2) Where an application is made under subsection (1), before exercising its powers under this section in relation to such application, the court shall have regard to -

(a) the wishes of the creditors and contributories of the company, as proved to it by sufficient evidence;

(b) the progress of the liquidation (including in particular assets realized, proofs of debts submitted by creditors and whether a statement of affairs has been submitted under section 190);

(c) whether any report has been made to the court under -

(i) section 191(1); or

(ii) section 191(2) that in the liquidator's opinion a fraud has been committed;

(d) whether any director, former director or other officer of the company has been convicted pursuant to this Ordinance or any other law for any offence involving fraud, dishonesty, fraudulent trading, misfeasance or breach of duty in relation to the affairs of the company;

(e) whether any criminal proceedings in respect of any offence referred to in paragraph (d) are being contemplated or have been instituted against any person referred to in that paragraph;

(f) whether the company forms part of a network of companies the affairs of which are proposed to be investigated or are being investigated under this Ordinance or any other law;

(g) whether there has been a failure on the part of the directors to provide a statement of affairs which the court considers satisfactory or to co-operate with the Official Receiver or liquidator or to comply with any requirement under this Ordinance in relation to the winding up of the company;

(h) whether any director or former director of any other company which has gone into liquidation within 5 years of the date that the company in respect of which the application is made went into liquidation, is concerned whether directly or indirectly in the management of the company;

(i) the fact that the insolvency of the company is a matter of public concern; and

(j) any other matter which the court considers appropriate in the particular circumstances.

(3) Where an application is made under subsection (1), without affecting the generality of subsection (2)(a) and subject to subsection (4), the court shall direct that meetings of the creditors and contributories be called, held and conducted in such manner as the court may direct for the purpose of ascertaining the wishes of the creditors and contributories and may appoint a person to act as the chairman of any such meeting and to report the result thereof to the court.

(4) Where the court is of the opinion that it is impractical to hold meetings of the creditors or contributories, the court may order that such other course of action as directed by the court be taken to ascertain the wishes of the creditors and contributories.

(5) In an order made under this section, nothwithstanding any other provision of this Ordinance, the court may, after taking into consideration the wishes of the creditors and contributories, direct either that the liquidator of the winding up by the court appointed under section 192 continue to act as the liquidator or appoint any other person as the liquidator.

Consequences of an order under section 209A

209B. (1) Where an application is made under section 209A(1) -

(a) the Official Receiver, if he is the liquidator in the winding up by the court; or

(b) the liquidator and the Official Receiver, if the Official Receiver is not the liquidator in such winding up,

shall submit to the court a report or reports as the case may be with regard to the application.

(2) On the hearing of any application made under subsection (1), the Official Receiver may appear and call, examine or cross-examine any witness if he so thinks fit and may support or oppose the application.

(3) Where an order is made under section 209A directing that the winding up of a company be conducted as if it were a creditors' voluntary winding up -

(a) (i) the date of the commencement of the winding up shall be the date deemed under section 184 to be the date of the commencement of the winding up by the court;

(ii) the date of the appointment of the liquidator shall be the date of the appointment (or first appointment) of a provisional liquidator in the winding up by the court; and

(iii) the date of the order for winding up shall be the date on which the order for winding up by the court is made,

for any purpose for which the date of the commencement of the winding up, the date of the appointment of a liquidator or the date of the winding up order respectively is relevant under this Ordinance;

(b) sections 182, 183 and 186 shall continue to apply;

(c) any rights under section 257 shall not be affected;

(d) the fees of the liquidator, any charges or expenses due and payble under the Companies (Fees and Percentages) Order (Cap. 32 sub. leg.) or under any other provision in this Ordinance up to the date of the order shall be paid forthwith out of the assets of the company in priority to all the other claims;

(e) the statement of the affairs of the company required to be submitted under section 190 and the accounts of the liquidator up to the date of the order may be inspected by the creditors;

(f) any creditor is entitled to have a copy of any document referred to in paragraph (e) on payment of reasonable photocopy charges (if any);

(g) the court shall make such other orders as it considers appropriate to safeguard the books, records and documents of the company in the custody of the liquidator or the Official Receiver and nothwithstanding section 283 or any other provision of this Ordinance they shall not be disposed of otherwise than as specified in such order.

Transitional

209C.(1) Any application for an order that the winding up of a company ordered to be wound up by the court be conducted as if it were a creditors' voluntary winding up made before the coming into operation of the Companies (Amendment)(No.____) Ordinance 1989 ( of 1989) (in this section referred to as "the amending Ordinance") shall be considered or continued with as if the amending Ordinance had not been enacted.

(2) The liquidator or any creditor of any company in respect of which an order for winding up by the court had been made after 30 August 1984, may, before the expiration of 3 months from the date of coming into operation of the amending Ordinance, apply to the court under the law in force immediately before the coming into operation of the amending Ordinance, for an order that such winding up be conducted as if it were a creditors' voluntary winding up.

(3) Any application made under subsection (2) shall be considered and dealt with as if the amending Ordinance had not been enacted.".

## 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 annualy 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 1989

Chairman : The Hon. Sir Derek Cons, V-P

Members : Mr. Malcolm A. Barnett,

Mr. Ambrose Cheung,

Mr. Marvin Cheung,

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

Mr. Kenneth Fang Hung, J.P.,

Mr. Raymond P.L. Kwok,

Mr. Eric K.C. Lo,

Mr. Alan Smith,

Mr. Richard Stoneman,

Professor L.G. Edward Tyler,

Mr. Charles H. Wilken,

Professor P.G. Willoughby, JP,

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, JP, Registrar General,

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

Mr. Robert Owen, Chairman, Securities and Futures Commission,

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

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

## Appendix 3

### Meetings held during 1989

| | | |
|---|---|---|
| Fifty-second Meeting | - | 7th January |
| Fifty-third Meeting | - | 11th February |
| Fifty-fourth Meeting | - | 4th March |
| Fifty-fifth Meeting | - | 1st April |
| Fifty-sixth Meeting | - | 13th May |
| Fifty-seventh Meeting | - | 5th August |
| Fifty-eighth Meeting | - | 2nd September |
| Fifty-ninth Meeting | - | 9th September |
| Sixtieth Meeting | - | 7th October |
| Sixty-first Meeting | - | 4th November |
| Sixty-second Meeting | - | 2nd December |