STANDING COMMITTEE ON COMPANY LAW REFORM

SEVENTH REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subjects considered by the Standing Committee during 1990

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1. Audit of Company Accounts

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

1.1 We referred to the subject of auditors' reports, and the question of why there are so few "adverse opinion" reports in respect of the accounts of listed companies in Hong Kong, in our last Report (6th Report : pages 1-7).

1.2 We said in paragraph 1.16 of that Report that it had become 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 to the contents of the standards. We decided that, before reaching any conclusion on this subject, discussions should continue between the Registrar General and the Hong Kong Society of Accountants to see if they could reach an agreement on what amending legislation, if any, is necessary.

1.3 The discussions between the Registrar General and the Society did continue during 1990 and the parties' different points of view were reported to us at our November Meeting in considerable detail. We also had the benefit at our December Meeting of a very detailed

and useful paper from one of our Members, Mr. Marvin Cheung, who is, of course, the past President of the Society.

1.4 The positions of the Registrar General and the Society on the subject still differ and the discussions are continuing. We do not wish to make any recommendation until these are completed and hope that this will take place in the first half of 1991.

1.5 In the meantime, we would like to record our approval of the introduction by the Society of a system of practice reviews which we are sure will be of great assistance in continuing the development of auditing standards in Hong Kong.

(2) Off Balance Sheet Financing

1.6 This subject was referred to in our last Annual Report (Sixth Report : pages 7-9).

1.7 We explained that we had ascertained from the Hong Kong Society of Accountants that the Society were of the view that there were no indications that companies in Hong Kong were using the "controlled non-subsidiary" or other types of off balance sheet device. We also referred to the fact that the Companies Act 1989 in the

U.K. contained a number of new accounting provisions which, although they were primarily introduced to comply with European Community directives, were also intended to deal with the problem of such "non-subsidiaries" by requiring them to be consolidated in group accounts. We said that we intended to study these provisions.

1.8 We duly considered a paper on the new provisions at our February Meeting. We noted that, prior to 1989, the definition of "subsidiary" in the U.K. legislation was similar to our own, although there were some differences.

1.9 We also noted that over the years concern had grown in the U.K. at the growing practice there of "off balance sheet accounting" by certain groups of companies i.e. the way in which these groups were able to produce accounts which, although they met the requirements of the Companies Act in that they consolidated the results of all subsidiaries within the definition in the Act, did not give complete information about the financial affairs of the group. The best known example of this practice was where a group arranged its affairs in such a way that major debt obligations were undertaken by entities which were undoubtedly part of the group in the

economic sense, but the accounts of which did not require to be consolidated because the entities did not come within the statutory definition of "subsidiary".

1.10 The Companies Act 1989 has attempted to deal with this type of abuse by a fairly complicated set of new provisions. These replaced the old terms "holding company" and "subsidiary" with "parent company" and "subsidiary undertaking". As before, every parent company must produce group accounts and these must consolidate the results of every subsidiary undertaking of the parent company.

1.11 It seems to us that the essential part of the reform is the definition of "subsidiary undertaking" in the new section 258 of the Companies Act 1985 introduced by section 21(1) of the Companies Act 1989, as supplemented by the new Schedule 10A of the 1985 Act introduced by Schedule 9 of the 1989 Act.

1.12 In addition to retaining the old bases of holding a majority of voting rights or controlling the board of directors, the new definition introduces the bases of "dominant influence" and "managed on a unified basis". Under the new definition, company A will be the parent company of subsidiary undertaking B if :

(a) A holds a majority of voting rights in B;

(b) A is a member of B and has the right to appoint or remove a majority of B's directors;

(c) A has the right to exercise a "dominant influence" over B by virtue of B's memorandum and articles or a control contract;

(d) A is a member of B and controls alone, pursuant to an agreement with other shareholders, a majority of voting rights in B; or

(e) A has a participating interest in B; and

(i) actually influences a dominant influence over it; or

(ii) A and B are managed on a unified basis.

The new Schedule 10A assists in interpretation of these provisions.

1.13 Another development is that "undertaking" is defined to include partnerships and unincorporated associations (new section 259(1)). This means that for

the first time group accounts will include the results of partnerships and unincorporated associations controlled by the parent company.

1.14 It is obvious that the new provisions will severely restrict the opportunities for off balance sheet accounting.

1.15 In view of the practical implications of the new U.K. provisions, we decided to consult with interested organisations for their views on :

(a) whether there was a problem with off balance sheet accounting in Hong Kong; and

(b) if there was, whether the new U.K. provisions would be a suitable precedent for tackling the problem.

1.16 The Secretary duly wrote to the organisations we normally consult on these matters and replies were received from :

The Hong Kong Bar Association
The Hong Kong Association of Banks
The Hong Kong Society of Accountants
The Association of the Institute of Chartered Secretaries and Administrators in Hong Kong

The Stock Exchange of Hong Kong Limited
The Hong Kong General Chamber of Commerce
The Hong Kong Chinese General Chamber of Commerce
The Hong Kong Deposit-taking Companies Associations

1.17 Of these, none said that off balance sheet financing was a problem in Hong Kong. On the contrary, five of the organisations said specifically that it was not a problem and the others were in favour of following the U.K. legislation on the basis that it was desirable to keep our legislation up-to-date.

1.18 There is no doubt in our minds that the new U.K. provisions are complicated and that their introduction in Hong Kong would involve considerable practical problems in connection with, for example, the interpretation of the new bases of "dominant influence" and "managed on a unified basis". We are aware that the U.K. accountancy bodies have issued a complicated exposure document, ED 50, designed to assist practitioners there in interpreting the legislation. We are also aware that a number of knowledgeable observers have considerable doubts as to whether the new U.K. legislation can actually accomplish what it is intended to do.

1.19 In view of all the circumstances, we have decided not to take any further action in this matter unless and until there is evidence of a problem with off balance sheet financing in Hong Kong.

(3) Inner Reserves of Banks

1.20 We reported in our 5th Annual Report that we had agreed with the Commissioner of Banking that the subject of the form of auditors' 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.

1.21 We understand that the Commissioner has held discussions with the Society of Accountants and that it has been agreed to defer further consideration until a definition of 'distributable reserves' is included in the Companies Ordinance. We also understand that this definition will be included in an amendment Bill to be published in the first quarter of 1991.

2. Charge Card Case

2.1 It has long been a common practice for banks to secure loans or lines of credit by taking charges over cash deposit placed with them by the borrowers.

2.2 However, the validity of this practice was called into question by a U.K. court case, Re Charge Card Services Limited (1986) 3WLR 697. In summary, the judge in that case decided that, although a person might take a valid security over a debt due by another, he could not take such a security over a debt due by himself. Therefore, while a bank might take a valid charge over a deposit held by a third party, for example another bank or its own subsidiary deposit taking company, it could not take a charge over a deposit lodged by the borrower with itself.

2.3 Because of certain amendments to the U.K. law on insolvency which were introduced subsequent to the case, the decision is not, according to our information, causing any significant problems in the U.K.

2.4 However, there have not been any corresponding amendments to the law on insolvency in Hong Kong and we understand that the banking sector here is concerned about the possibility of the decision being followed in Hong Kong, with considerable resultant uncertainty and inconvenience.

The decision is not legally binding on the Hong Kong courts but the banks are concerned that they would find it persuasive and follow it in practice.

2.5 We understand that some banks have introduced certain new procedures designed to protect themselves against the consequences of the Charge Card decision being applied here but that these procedures themselves involve some disadvantages.

2.6 In September, we were approached by the Secretary for Monetary Affairs for our views on the situation and the steps, if any, which should be taken to deal with it.

2.7 After careful consideration, we agreed that it was highly desirable that legislation should be introduced as soon as possible to establish that the law was what everyone had formerly thought it was i.e. that a debtor A could give his creditor B a charge over any debt due by B to A.

2.8 The Secretary for Monetary Affairs had drawn our attention to a very short piece of Bermudan legislation designed to deal with the situation i.e. The Charge and Security (Special Provisions) Act 1990. The Act has only two sections of substance viz :

2.9 "2. Any charge purportedly created, or any security purportedly given, by a creditor in favour of a debtor over a debt due or to become due to that creditor from that debtor, for the purpose of securing any obligation of that creditor to that debtor, shall be valid and enforceable by that debtor to the same extent as if the charge had been created or security given, as the case may be, over that debt in favour of a person other than that debtor.

2.10 3. This Act applies to any charge purportedly created or security purportedly given before or after the coming into operation of this Act."

2.11 We agreed that this Act would form a very suitable basis for our proposed Hong Kong legislation.

2.12 The Government subsequently decided to base the proposed legislation on a draft provision prepared by Sykes, QC, as amended by a House of Lord's Committee, rather than the Bermuda model. The Government considered that the amended version of the Sykes' proposal was more readable and dealt more directly with the problem caused by the Charge Card case.

3. Purchase by a company of its own shares

3.1 In our last Annual Report, we recorded that we had decided, after much careful and sometimes anxious consideration, to recommend that listed companies should be allowed 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.

3.2 At our Meeting in January 1990 we urged the Administration to give the highest priority to the drafting of the relevant legislation.

3.3 The detailed contents of the proposed legislation were obviously of great importance to everyone with an interest in Companies and Securities law. The proposals of the Securities and Futures Commission and the Stock Exchange of Hong Kong Limited for the provisions in respect of listed companies differed in many respects from the U.K. legislation on the subject.

3.4 Basically, the proposals contemplated that repurchases would be made by way of a general offer to all shareholders, thus ensuring that no individual shareholder, or small group of shareholders, would get preferential treatment. The terms of the general offer would have to get prior approval from a general meeting of the company and there were detailed provisions to ensure that the offer document itself contained all the information necessary to enable a shareholder to make a reasoned decision on the offer. It was also proposed that the general offer rule would not apply to certain exempt transactions. One of the more important exemptions would enable a company to make comparatively limited repurchases on the stock market, again subject to prior approval at a general meeting of the company and subject also to detailed restrictions on volume and price to ensure that this method of repurchasing would not be abused either. All these provisions were to be contained in a Code to be issued by the SFC. The SFC and SEHK Limited therefore issued a comprehensive Joint Consultation Document

dated 19 January 1990 detailing these proposals and inviting comments from all interested members of the public. The SFC and the SEHK Limited also held a joint seminar on 17 February to provide a forum for interested parties to air their views. The closing date for submission of comments was 2 March, later extended to 16 March.

3.5 At our April Meeting, we considered an annotated summary, prepared by the SFC and the SEHK Limited, of the submissions on the Joint Consultation Document received from interested parties.

3.6 We formed the opinion that there were three basic questions on which there were differences of the opinion :

(1) Protection of creditors

The choice was between using the U.K. legislation on distributable profits and using the insolvency test contained in the Canadian legislation.

(2) Treatment of shares repurchasesd

Should the shares be cancelled as in the U.K. or should they continue in existence as treasury stock as in the U.S.?

(3) The question of whether the Listing Rules which prevented foreign-incorporated companies from exercising their rights to repurchase their own shares should be lifted before the Hong Kong legislation allowing repurchases was enacted.

3.7 There were also a considerable number of areas of lesser importance which required careful consideration. For example -

(a) whether the percentage limit on annual repurchases on the stock market should be based on a company's total issued capital or on its public float;

(b) the limit on daily repurchases;

(c) arrangements for reporting repurchases.

3.8 We were informed that the SFC and the SEHK Limited were proceeding with arrangements for joint discussions with the members of the public who had submitted comments on the Joint Consultation Document. It was suggested to us that, after these discussions had been completed, the SFC and SEHK Limited should return to us with their final proposals for amendments to the Companies Ordinance. We agreed to this arrangement.

3.9 The SFC and the SEHK Limited duly submitted their detailed recommendations for amendments to the Companies Ordinance to us for consideration at our Meeting in June. After careful consideration, we reached the following conclusions on the main points referred to above -

(1) Protection of creditors

3.10 We agreed to recommend that we should follow the U.K. precedent which is, basically, that shares can only be repurchased out of "distributable profits". We have already made separate recommendations for the introduction of legislation defining "distributable profits" which was also based closely on the corresponding U.K. legislation, subject to certain amendments designed to reflect the special circumstances of Hong Kong (Third Annual Report : subjects considered during 1986).

3.11 There is one special problem in connection with this recommendation. The recommended legislation on "distributable profits" only allows realised profits to be distributed i.e. it does not allow a property company to distribute an unrealised reserve arising from the revaluation of a building. Some members of the public who commented to the SFC and the SEHK Limited had been strongly of the view that a listed property

company should be able to use such a reserve, or at least a certain percentage of it, for the purpose of making a repurchase of its shares. The figure of 50% of the valuation surplus was suggested.

3.12 However, many of us felt that such a proposal involved many difficult questions and that the preferable course of action would be to enact the proposed legislation on the basis already recommended, i.e. following the U.K. model, and then to appoint a sub-committee to consider the suggestion regarding property companies further. Among the questions which would have to be considered by such a sub-committee would be : How would "a property company" be defined? Why should only such a company be allowed to use an unrealised valuation surplus; why not allow any company which happened to own land and buildings? If the proposal was agreed in respect of land and buildings, why should it not be extended to revaluations of other assets, for example listed shares, owned by companies?

3.13 We concluded that this was the correct course of action and recommended accordingly i.e. that after enactment of the legislation allowing repurchases, further consideration should be given to relaxing its

provisions to allow property companies to use unrealised reserves arising from the revaluation of property for the purpose of repurchasing their shares.

3.14 We would like to take the opportunity to record that, during our consideration of this problem, one of our Members, Mr. Tony Nicolle, Commissioner of Banking, referred to the fact that from time to time during the discussions, reference had been made to the point that, in his capacity as Commissioner of Banking, he allowed 50% of unrealised reserves in respect of revaluations of property to be used for the purposes of the Capital Adequacy Rules applying to authorised financial institutions. There had been suggestions that this was a precedent for allowing part of such a reserve to be used for share repurchases. Mr. Nicolle stated that he wished to point out the significant differences between the two situations. In particular, the Standing Committee's recommendations relate to <u>distributable</u> profits while the Capital Adequacy Rules relate to assets which will remain in the authorised financial institutions. Also, the Capital Adequacy Rules relate to secondary capital only.

(2) Treatment of shares repurchased

3.15 We considered carefully the arguments advanced by the members of the public who felt that Hong Kong should allow companies to retain, and if they so wish, to sell again, the shares which they have repurchased. We eventually concluded, however, that it would not be appropriate for companies to be able to trade in their own shares. We therefore recommended that Hong Kong follow the U.K. precedent and provide that repurchased shares are cancelled. We also recommended that we further follow the U.K. precedent and provide that the amount of the company's issued capital is diminished by the nominal value of the shares repurchased but that the authorised capital is not reduced in the same way. The effect of the last recommendation, i.e. that authorised capital is not reduced, is that new shares can later be issued up to the nominal value of the shares repurchased without the company having to pay the $6 per $1000 registration fee on any increase in authorised capital provided for in the Eighth Schedule to the Companies Ordinance.

(3) Timing of lifting of Listing Rules on repurchases by foreign incorporated companies

3.16 We concluded that this was a matter which should properly be left to the SEHK Limited to decide in consultation with the SFC. We did advise, however, that a majority of us were in favour of the principle of maintaining a "level playing field" in this context.

3.17 We also discussed at considerable length many other aspects of the proposals, some of which are referred to at (a) – (c) in paragraph above but do not think it necessary to record the detailed recommendations here.

3.18 We again urged the Administration to proceed with the drafting of the legislation as soon as possible and were advised that it would probably be submitted to the Executive Council in early 1991.

3.19 One aspect of the proposals which emerged from time to time during our discussions was the question of which provisions should be contained in the Companies Ordinance and which should go into the Code on Repurchases to be promulgated by the SFC.

3.20 The matter is not as simple as it might appear at first sight. The approach adopted in the U.K. has been to put the basic requirements for prior shareholders' approval in the Companies Act and have the detailed technical requirements as to volume, etc. in the Stock Exchange Rules. Thus, the Companies Act only requires approval by an ordinary resolution at a general meeting and that the ordinary resolution must set out the maximum number of shares to be repurchased and the maximum and minimum prices to be paid for them.

3.21 The problem with having even the basic requirements of the procedure in the legislation, however, is that there is little room for flexibility in a crisis situation.

3.22 When the world's stock markets crashed in October 1987, many large U.S. listed companies announced large scale repurchases of their shares. Many commentators considered that this contributed substantially to steadying the market. This quick action by the companies was possible because the directors of U.S. companies do not require any prior approval by shareholders for repurchases and were thus able to react immediately to the circumstances.

3.23 In contrast, few, if any, U.K. listed companies announced similar repurchase programmes. We suspect that this was at least in part due to the fact that the pre-existing authorisations for repurchases held by the directors were not appropriate to the emergency situation which had arisen and, of course, there simply was not the time available to call general meetings to have the terms varied.

3.24 We anticipate that, over the next few years, there will be occasions when it will be highly desirable for listed companies in Hong Kong to be able to support their share prices in unusual circumstances. We would therefore like to see a system of share repurchases which will be as flexible as possible, consistent with satisfactory protection of shareholders and creditors.

3.25 One aid to flexibility would be for as much as possible of the system to be included in the proposed Code on Repurchases with its inherent flexibility.

3.26 The problem with such an approach is the difficulty in applying criminal sanctions for a breach of the Code. We feel that the opportunities for large scale profit from an abuse of the repurchases system are so great that it is essential to have effective sanctions against such abuses.

3.27 It will not be easy to decide on the best solution to this dilemma and we think it must be left to the Administration in consultation with the Law Draftsman.

3.28 Finally, we would like to repeat our previous view that the proposed legislation allowing share repurchases should not be brought into operation before -

(a) the Securities (Insider Dealing) Ordinance and the Securities (Disclosure of Interests) Ordinance have been brought into operation; and

(b) the legislation on distributable profits also recommended by us is in operation.

We would also prefer to see the legislation on fiduciary duties of directors in operation but do not now regard this as a pre-requisite for the proposed legislation on repurchases.

4. Options Trading

Directors of Listed Companies

4.1 At our June Meeting, the Secretary of the Standing Committee drew our attention to reports in the press that the Stock Exchange of Hong Kong Limited had instructed a firm of Swiss consultants to carry out a preliminary study into whether options trading should be started in Hong Kong.

4.2 He drew our attention to the fact that although there is a prohibition in the U.K. against directors of a listed company (and their spouses and minor children) dealing in options for shares or debentures in their company, there is no such provision in Hong Kong. The relevant U.K. legislation can be found in sections 323 and 327 of the Companies Act 1985.

4.3 Mr. Mark Hanson of the SEHK Limited, who is a Member of the Standing Committee, explained that the investigations of the possibility of introducing options trading were still at a preliminary stage. He confirmed that the subject would be discussed with the Securities and Futures Commission and that the question of directors of listed companies was one of the issues which would be considered. He also confirmed that the SEHK Limited and the SFC would present a joint paper to us in due course.

5. Proxies

Stock Exchange of Hong Kong Limited

5.1 The Report of the Securities Review Committee, usually referred to as "the Davison Report", recommended at paragraph 4.59 that elections to the Council of the Stock Exchange of Hong Kong Limited should be in person by secret ballot and that proxy voting should not be permitted.

5.2 In March 1990, we were asked for our views on the implementation of this recommendation.

5.3 We noted that section 114C of the Companies Ordinance provides that any member of a company who is entitled to vote at a meeting of the company shall be entitled to appoint another person (whether a member or not) as his proxy to attend and vote instead of him. It also provides that the proxy shall have the same right as the member to speak at the meeting.

5.4 We were unanimous that we would not agree to any proposal that proxy voting be banned generally for companies limited by shares. (We have already recommended in our Third Annual Report that section 114C should be amended to bring it into line with the corresponding U.K. legislation by not allowing proxy voting in the case of companies limited by guarantee, the vast majority of which are private clubs.)

5.5 We had a serious problem in commenting on the proposal for banning proxy voting in the case of this particular company, the SEHK Limited, because we did not have available for consideration the evidence on which the Securities Review Committee based their recommendation.

5.6 Although some Members had strong personal opinions on the recommended ban, we eventually agreed that, in view of our being unable to consider the evidence on which it was based, it would not be appropriate for us to submit any comments on its implementation or otherwise.

6. Proposed New Central Clearing and Settlement System (CCASS)

Amendments to the Companies Ordinance

6.1 During 1990, we received a number of Consultation Documents on the proposed new Central Clearing and Settlement System (CCASS) from the Hong Kong Securities Clearing Company Limited.

6.2 There seems to be general agreement in the industry that such a system is urgently required if Hong Kong is to maintain its position as a sophisticated international financial centre although there also seems to be some lack of agreement on certain details.

6.3 For our part, we will assist in every way we can in implementing the system in its finally-agreed form.

6.4 As yet, no specific proposals have been made for amendments to the Companies Ordinance but we shall give them our close attention when they are presented to us.

6.5 We have noted that in the U.K. the legislative approach which has been adopted for the purposes of their own electronic clearing and settlement system has been to give a general power to the Secretary of State to make provision by regulations for enabling title to securities to be evidenced and transferred without a written instrument - section 207 of the Companies Act 1985.

6.6 It may be that we should adopt a similar approach here rather than have amendments to individual sections of the Companies Ordinance, but we shall have to wait until more details of the actual amendments required for the purpose of the CCASS are available before we can decide on our recommendations.

7. Part III of the Companies Ordinance

Registration of Charges

7.1 We have from time to time made various recommendations for amendments to the provisions of Part III of the Companies Ordinance dealing with registration of charges.

7.2 The corresponding U.K. legislation, on which our own provisions are very closely based, remained unaltered for many years but the Companies Act 1989 introduced extensive new provisions.

7.3 For example, section 83(2) of the Companies Ordinance provides that the Registrar of Companies must give a certificate of registration of a charge by him and that "the certificate shall be conclusive evidence that the requirements of this Part as to registration have been complied with". Many practitioners regard this conclusiveness of the certificate as being of considerable practical importance. Under the new U.K. system, however, the Registrar will only give a certificate that the statutory particulars of the charge have been delivered to him on a particular date and the certificate will only be evidence that the particulars were delivered to him on that date.

7.4 In view of the great practical importance of the many new provisions introduced in the U.K. by the 1989 Act, we appointed a Sub-committee, consisting of Mr. Barnett, Mr. Kotewall and Professor Tyler, chaired by Mr. Wrangham, to consider the new U.K. legislation and report back to us.

7.5 This they duly did in September. In brief summary, they reported :

(1) The new U.K. legislation dropped the old "Bill of Sale" basis for registration of a charge and replaced it with a "Charge on Goods" basis. They thought that interested parties in Hong Kong should be consulted for their views on whether this change was suitable for adoption in Hong Kong.

(2) The Hong Kong legislation should be extended to require registration of charges on aircraft, which do not require to be registered at present.

(3) The definition of a charge on "book debts" should be amended to exclude charges on credit balances with authorised financial institutions (This recommendation has particularly important implications for practitioners).

(4) The Standing Committee had previously recommended that a copy of every charge should require to be registered in the Companies Registry. The new U.K. provisions, however, did not contain such a requirement. The views of interested parties on this point should be obtained.

(5) The new U.K. provisions regarding the Registrar's certificate of registration should be adopted i.e. the certificate should no longer be conclusive evidence that the requirement of the Ordinance as to registration had been complied with.

(6) The time limit for registration of a charge should be 14 days, as against the existing time limit of 5 weeks.

(7) In general, the new U.K. legislation was a very significant improvement on the existing legislation in Hong Kong and should be adopted here, subject to the various amendments mentioned above and subject also to prior consultation with all interested parties.

7.6 We agreed that, before reaching any decisions on this subject, we should obtain the views of all interested parties.

7.7 The Secretary wrote accordingly to all the organisations usually consulted on these matters asking for their comments on the Sub-committee's proposals. A time limit on 30 November was set for submission of the comments.

7.8 Very detailed and helpful replies were received from :

The Hong Kong General Chamber of Commerce
The Hong Kong Society of Accountants
The Hong Kong Association of Banks
The Association of the Institute of Chartered Secretaries and Administrators in Hong Kong
The Chinese General Chamber of Commerce
The Law Society of Hong Kong
The Hong Kong Bar Association

7.9 These replies were considered at our Meeting in December. We noted that certain aspects of the proposals seemed to be quite controversial. We therefore referred the replies to the Sub-committee for consideration and report and we expect to receive this report in early 1991.

8. Sections 157E and 157F of the Companies Ordinance Disqualification of Company Directors

8.1 Under sections 157E and 157F of the Companies Ordinance, the court may make an order against any person who falls into the categories summarised in the following two paragraphs, stating that he may not, without the leave of the court, be a director or a liquidator or a receiver or a manager of the property of any company or in any way be concerned or take part in the management of any company for such period not exceeding 5 years as may specified in the order.

8.2 Section 157E requires a conviction (relating to the promotion, formation or management of a company or any other offence involving fraud) or evidence of reckless of fraudulent conduct. The section is based on section 93 of the U.K. Companies Act 1981.

8.3 Section 157F provides for the disqualification of a person who has been a director of two companies which have gone into liquidation within 5 years of each other and whose conduct as a director of either of these companies makes him unfit to be concerned in the management of a company. This section is based on section 9 of the U.K. Companies Act 1976.

8.4 In the U.K., the sections upon which sections 157E and 157F were based were consolidated and replaced by sections 296-299 of the Companies Act 1985, which were considerably wider in scope.

8.5 In 1986, the relevant U.K. provisions were extended still further and were placed in their own Act - The Company Directors Disqualification Act 1986. This Act retained the basic essentials of the preceeding legislation but introduced important new grounds for applications to the court for a disqualification order i.e.

(1) Under section 6 of the Act, an application for disqualification can be made after <u>any</u> insolvency on the ground that a person's conduct as director of that insolvent company (taken alone or together with his conduct as a director of any other company) makes him unfit to be concerned in the management of any company.

(2) Under section 8, the Secretary of State can apply for a disqualification order, if he considers it to be in the public interest to do so, on the basis of an inspector's report or of an informal investigation made by the Department of Trade and Industry.

8.6 The Act also provides for the disqualification period to be 15 years in certain cases.

8.7 At our November Meeting we considered a detailed paper submitted by Mr. Gleeson, Registrar General, who is a Member of the Standing Committee, in which he proposed that our sections 157E and 157F be repealed and replaced by new legislation based closely on the U.K.'s 1986 Act. He pointed out that no application had ever been actually made to the court under section 157E or section 157F because of their out-of-date wording and impractically high standards of proof required. The sections were achieving nothing in practice. He submitted that the provision of realistic arrangements for applications to the court for imposition of disqualification orders was as basic to improving corporate discipline as was improving auditing standards. He was strongly of the view that the introduction of new legislation on the same lines as the U.K. provisions would improve company administration in Hong Kong to the benefit of shareholders generally.

8.8 We agreed to instruct the Secretary to write to all interested organisations asking for their views on the Registrar General's proposals.

8.9 We expect to have the replies available for consideration early in 1991.

9. Section 158C of the Companies Ordinance (Registrar to keep an index of directors)

9.1 Section 158C(1) of the Companies Ordinance provides that the Registrar of Companies shall, as from a date to be appointed by the Governor in Council by notice in the Gazette, keep and maintain an index of every person who is a director of a company, which shall in respect of each director show his name and address and the latest particulars sent to the Registrar under section 158 relating to such director, and the name of each company of which he is a director.

9.2 Sub-section (2) provides that the index shall be open to inspection by any person on payment of the prescribed fee.

9.3 The section has never been brought into operation i.e. no notice has ever been published in the Gazette.

9.4 The Registrar of Companies, Mr. N.M Gleeson, who is a Member of the Standing Committee, proposed to us that the section should be repealed. He explained that very considerable resources would be needed for preparation and maintenance of the index and that there was no prospect of these resources being made available in the foreseeable

future. He suggested that it was bad in principle to have a provision on the statute book which would probably never be brought into operation.

9.5 We approached various regulators for their views on the subject and found that all of them were very much in favour of such an index being made available to them. In view of this, we concluded that, while the point made by Mr. Gleeson was a very good one and one with which we would normally agree, we could not agree to recommend the repeal of this particular section. Instead, we expressed the hope that Government will be able to find the resources to bring it into operation at some reasonably early future date.

9.6 Mr. Gleeson also explained to us that, while the resources have never been made available to implement section 158C, his department has prepared, on an administrative basis, a limited form of index which covers the directors of listed companies only. This index is not available for public inspection. He suggested that the index could be expanded at modest cost to give the information on all directorships held by directors of listed companies i.e. including directorships held in ordinary private companies which are not connected with listed companies. He thought that this expanded index would meet many, perhaps most, of the requirements of the regulators. The regulators we consulted with did not agree with this expanded index would

meet most of their requirements but agreed that it would be very useful. We therefore recommend that the index should be expanded as suggested by Mr. Gleeson. The expansion of the index would require amendments to section 158 of the Companies Ordinance and to the form of annual return for listed companies to require the return to give details of all directorships in Hong Kong incorporated companies held by the directors of listed companies. We recommend that such amendments be made as soon as possible. We would like to make it clear, however, that we regard this limited form of index as an interim measure only and repeat our hope that Government will be able to find the resources to provide the full index contemplated by section 158C at some reasonably early future date.

10. Section 290 of the Companies Ordinance (Power of court to declare dissolution of company void)

10.1 Section 290(1) of the Companies Ordinance provides that, in the case of a company which has been dissolved under section 226A, 227, 239 or 248, the court may at any time within 2 years of the date of the dissolution, on an application being made for the purpose by the liquidator of the company or by any other person who appears to the court to be interested, make an order, upon such terms as the court

thinks fit, declaring the dissolution to have been void and that thereupon such proceedings may be taken as might have been taken if the company had not been dissolved.

10.2 The position regarding the corresponding section 651 of the U.K.'s Companies Act 1985 is rather interesting. It originally contained the same 2 years time limit for applications to the court as is laid down in our section 290. It is clear from paragraph 45 of Schedule 6 to the Insolvency Act 1985 that it was intended to extend this period to 12 years but, for reasons which are not entirely clear to us, this proposed change was never actually implemented and was allowed to lapse.

10.3 Section 651 of the 1985 Act was, however, extensively amended by the Companies Act 1989 and the present position is that the time limit for applications is still 2 years except where the application to the court is made for the purpose of suing the dissolved company for damages for personal injury or death, in which case the application can be made at any time (sub-section (5)).

10.4 We received representations early in 1990 to the effect that the time limit in our section should also be altered.

10.5 We agreed that there may be circumstances in which the 2 years time limit in section 290 causes injustice because it is too short. We do not think, however, that the exemption in the amended version of section 651 of the 1985 Act is sufficiently wide and we therefore recommend that section 290 of the Companies Ordinance should be amended to provide that the court may extend the 2 years time limit for an application under the section "in exceptional circumstances" and that the application for an extension may be made at any time.

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 1990

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

Members : Mr. Malcolm A. Barnett,

Mr. Ambrose Cheung,

Mr. Marvin K.T. Cheung,

Mr. D.E. Connolly, JP,

Mr. Mark Hanson,

Mr. Kenneth Fang Hung, OBE, JP,

Mr. Robert G. Kotewall, Q.C.,

Mr. Raymond P.L. Kwok,

Mr. Eric K.C. Lo,

Mr. Alan Smith,

Professor L.G. Edward Tyler,

Mr. Charles H. Wilken,

Professor P.G. Willoughby, JP,

Mr. C.H. Wong, JP,

Mr. F. Charles Wrangham

Ex-officio Members :

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

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

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

Mr. 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 1990

Sixty-third Meeting	–	6th January
Sixty-fourth Meeting	–	3rd February
Sixty-fifth Meeting	–	3rd March
Sixty-sixth Meeting	–	7th April
Sixty-seventh Meeting	–	5th May
Sixty-eighth Meeting	–	2nd June
Sixty-ninth Meeting	–	1st September
Seventieth Meeting	–	6th October
Seventy-first Meeting	–	3rd November
Seventy-second Meeting	–	8th December