STANDING COMMITTEE ON COMPANY LAW REFORM

EIGHTH REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subjects considered by the Standing Committee during 1991

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1. Audit of Company Accounts

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

As we explained in paragraph 1.1 of our Seventh Report (subjects considered during 1990) we have been considering 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, for some time.

As we also explained in the Seventh Report, it had become clear during our previous discussions that many of the points being made related to actual practice, i.e. to the interpretation of auditing standards, rather than to the contents of the standards. We had therefore decided that, before reaching any conclusion on the subject, discussion 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, was necessary.

We concluded the Seventh Report by noting that the position of the Registrar General and the Society on the subject still differed and that discussions were continuing.

We stated that we did not wish to make any recommendation until these had been completed and hoped that this would take place in the first half of 1991.

However, we have to record that the present position is still as formerly, i.e. that the discussions between the Registrar General and the Society are continuing. We hope that they will be concluded during 1992.

(2) Inner Reserves of Banks

We reported in our Seventh Report, page 8, that we had previously agreed with the Commissioner of Banking that the subject of the form of auditor's certificate in respect of banks' annual accounts and certain related matters would be discussed in the first instance between himself, the Hong Kong Association of Banks and the Hong Kong Society of Accountants and that he would come back to us on this subject.

We also explained that the Commissioner had held discussions with the Society of Accountants during 1990 and that it had been agreed to defer further consideration until a definition of "distributable reserves" was included in the Companies Ordinance. We noted that this definition would be included in an amendment Bill to be published in the first quarter of 1991.

We are glad to report that the definition of distributable reserves was indeed dealt with in the Companies (Amendment) Ordinance 1991 which came into operation on 1st September 1991. We understand that the promised discussions between the Commissioner of Banking and the Society have commenced and hope that we will have a report from him during 1992 on this important and controversial subject.

(3) Proposal to allow auditors to incorporate

Under section 140(2)(c) of the Companies Ordinance, a body corporate cannot be an auditor of a company incorporated under the Ordinance.

At our February Meeting, we considered a paper from the Monetary Affairs Branch of the Administration regarding a request from the Hong Kong Society of Accountants for repeal of this provision.

We noted that incorporation of auditors is now allowed in the U.K. as a result of changes in the law introduced by the Companies Act 1989.

We also noted that this change was part of a package of far-reaching changes in the law on regulation of auditors in the U.K. As far as we were aware, there was no proposal for corresponding changes in the law on this subject here.

Mr. Gleeson, in his capacity as Registrar of Companies, thought that, in considering any proposal to amend the provisions of section 140(2)(c), the question of the level of local auditing standards must be a central factor. He thought that it was clear that in the recent past the Society of Accountants had achieved significant improvements in standards and, in his opinion, the proposal to introduce a system of practice review was the most significant step in the right direction since the Society was established. He suggested that, if the practice review system was approved by the members of the Society, it would be a sufficient improvement to allow the Standing Committee to support the proposal to allow incorporation.

The representative of the Monetary Affairs Branch at the Meeting confirmed that Government always preferred efficient self-regulation.

A number of Members commented that before any conclusion could be reached on this matter, it would be necessary to have more information, including details of the

situation regarding provision of professional indemnity insurance, if the law was to be amended as suggested by the Society.

It was pointed out during our discussions that incorporation in the U.K. was being allowed in the context of increased regulation of the profession by Government. On the other hand, it was also pointed out that, prior to the new legislation, the position in the U.K. had been that an auditor could belong to any one of at least six accountancy bodies. This had made regulating the profession very complicated and was thought to be the main reason why the new legislation giving more control to Government had been introduced. There was no such complication in Hong Kong because all auditors were members of, and regulated by, the Society of Accountants and Government had representatives on the Society's Council.

We advised Monetary Affairs Branch that we were generally sympathetic to the proposal. However, we felt that we could not reach any final conclusion pending further information, particularly with regard to arrangements for provision of professional indemnity insurance by incorporated auditors. The representative of the Branch confirmed that the matter would be referred back to us for further consideration in due course.

2. Central Clearing and Settlement System

In our Seventh Annual Report (subjects considered during 1990), we explained that during the year we had received a number of consultative documents on the proposed new Central Clearing and Settlement System (CCASS) from the Hong Kong Securities Clearing Company Limited (HKSCC).

We noted that there seemed to be a general agreement in the industry that such a system was urgently required if Hong Kong was to maintain its position as a sophisticated international financial centre, although there also seemed to be some lack of agreement on certain details. We stated that, for our part, we would assist in every way we could in implementing the system in its finally-agreed form.

At our Meeting in April 1991, we considered further consultative documents, which, for the first time, set out specific proposed amendments to the Companies Ordinance.

We should explain that a Sub-committee of the Law Reform Commission had previously been set up under the Chairmanship of one of our own Members, Professor Tyler, to consider the need for amendments to the law on insolvency in Hong Kong i.e. amendments to both the law relating to individuals contained in the Bankruptcy Ordinance and the law on liquidation of companies in the Companies Ordinance. It

was agreed by all concerned that the many important amendments to the law on liquidation of companies proposed in connection with CCASS should be dealt with by this Sub-committee of the Law Reform Commission.

The remaining proposed amendments to the Companies Ordinance were only outlined in broad terms and appeared, on the face of it, to be relatively simple. The main one was a proposed amendment to section 115 of the Companies Ordinance which deals with representation of company A at meetings of company B in which A holds shares. Basically, it provides that company A may, by resolution of its directors, authorise such person as it thinks fit to act as its representative, and vote on its behalf, at any meeting of company B.

Under CCASS, all the shares in the Clearing System will be registered in the name of the system's "common nominee"

The proposed new amendment to section 115 would allow the recognised clearing house or its nominee to authorise one or more corporate representatives, who will in practice be the beneficial owners or controllers of the shares in the system, to attend and vote the shares at the general meetings of the listed companies concerned.

However, our Secretary advised us that he had been at a briefing conducted by the HKSCC at which it had been explained that it was proposed that the forthcoming legislation would contain a general provision to the effect that the legislation would over-ride any provision in any other ordinance which was in conflict with the proposed legislation. For example, the proposed legislation would over-ride the provisions of section 100 of the Companies Ordinance under which the court can order that an entry in the register of members of a company be amended. Under this provision, the court would be able to order that an entry showing shares registered in the name of the Clearing System's common nominee be amended to show another person as the owner. The HKSCC was anxious to ensure that, once shares had been registered in the name of the common nominee, the entry should not be open to challenge.

We advised the HKSCC that, if the suggested over-riding provision was to go ahead, we were anxious to have as soon as possible a list of all the provisions in the Companies Ordinance which would be over-riden.

At our June Meeting, we were provided with a draft of the Administration's proposed Drafting Instructions in respect of the proposed legislation.

With regard to the "over-riding" clause in the Drafting Instructions, we were pleased to note that in fact they specifically provided that this clause would <u>not</u> affect the rights of any person to apply to the court under section 100 of the Companies Ordinance. We were also advised that it was not thought that any other provisions of the Ordinance would be over-ridden by implication.

Professor Tyler gave us a very interesting explanation of the points in the Drafting Instructions relating to insolvency which were continuing to give considerable concern to the Sub-committee of the Law Reform Commission but, as these will be dealt with by the Sub-committee's own report, we do not think that it is appropriate to deal with them any further here.

With regard to the proposed amendments to section 115 of the Companies Ordinance, we agreed with the proposals but noted that the amendment was, quite properly, in very general terms, simply giving the HKSCC power to appoint corporate representatives in respect of shares registered in the name of the common nominee. In practice, these representatives will be, as already noted, the beneficial owners or controllers of the shares. We informed the Administration that we were concerned that proper steps should be taken to ensure that, in practice, this power would be exercised fairly and efficiently. We explained that we

thought it essential for the proper governance of listed companies that the beneficial owners or controllers of the shares in the Clearing System should be able to attend and vote at general meetings of the companies concerned. We expressed the hope that detailed regulations to ensure this would be issued and that these would provide for penalties for any breach.

At our December Meeting, we considered a draft of the proposed Bill. We noted that, as a reult of extensive consultations with other interested parties which the Administration had been conducting since we considered the draft Drafting Instructions at our June Meeting, the form of the draft Bill (it was in fact the Sixth draft) had altered considerably.

We noted that the draft Bill still preserved the operation of section 100 of the Companies Ordinance, which was satisfactory. Similarly, we noted that it still contained the amendment to section 115 allowing the HKSCC to appoint representatives in respect of shares in the system registered in the name of the common nominee.

One provision which caused us some concern was a clause stating to the effect that, where shares or certain other types of property were subject to a market charge, i.e. a charge in favour of the HKSCC, or had been provided as

market collateral, no execution or legal process for the enforcement of a judgement or order could be commenced or continued, and no distress could be levied, against the shares, etc. by a person not seeking to enforce any interest in or securities over the shares, etc, except with the consent of the HKSCC.

It seemed to us that this provision went too far. For example, it would mean that if a bank had obtained an order against shares, etc. which had been given as security for a loan by it and, in the meantime, the shares and other property had been used as market collateral, the order would not run except with the consent of the HKSCC.

We therefore recommended that "except with the leave of the court" be substituted.

One of our Members remarked that the protection given to CCASS by the draft Bill in respect of shares registered in the name of the common nominee was so comprehensive that it seemed that the system would be protected even if a fraudulent transaction had been fed into it. A representative of the HKSCC at the Meeting explained, however, that this was not so. As already mentioned, the operation of section 100 of the Companies Ordinance would be maintained i.e. if a person thought that he had been defrauded and that shares registered in the name of the

common nominee were rightfully his, he could apply to the court under the section for rectification of the register of members. There was also a provision that, where an insolvency was involved, and a broker or his client had entered into a fraudulent transaction, the profits made by the fraudulent party would be available to the liquidator.

Professor Tyler again gave us a very useful and interesting explanation of the main aspects of the draft Bill with regard to insolvency law which were causing continuing concern to the Sub-committee of the Law Reform Commission but, as already explained, we think that these should be left to be dealt with in the Sub-committee's own Report. We would like to record, however, that we supported his view that there should be an adequate compensation fund to protect members of the public. At the date of our Meeting, a maximum figure of $8M per client was being discussed within the Administration but, like Professor Tyler, we did not think that this was adequate. Professor Tyler explained to us that the Sub-committee of the Law Reform Commission would be making recommendations for an increased figure at a Meeting with the Administration which was scheduled to be held in early 1992.

We would like to close by repeating our view that, if the beneficial owners or controllers of shares in the CCASS are to be able to take a responsible role in the

running of listed companies concerned, it is essential to ensure that the proposed system of appointing these beneficial owners or controllers as corporate representatives of the common nominee to attend and vote at meetings of the companies, is run fairly and efficiently.

3. Dormant Companies

At our April Meeting, we considered a paper by Mr. Gleeson, in his capacity as Registrar of Companies, on this subject.

He expressed the view that it is a fact of commercial life both here and in the U.K. that some private companies go "dormant" at various periods in their lives.

Section 252 of the U.K. Companies Act 1985 provides that a company is "dormant" during any period in which no transaction occurs which is, for the company, a significant accounting transaction. A significant accounting transaction is one which requires to be entered into the company's accounting records. Mr. Gleeson suggested that the definition seemed sensible and could conveniently be adopted for use in Hong Kong.

in the U.K., it had been decided that a dormant company should not require to have its accounts audited.

Mr. Gleeson explained that there were at present no provisions in our Companies Ordinance regarding dormant companies and suggested that the subject merited early consideration. However, he also felt that it would be logical, and realistic, to go further than in the U.K. and to relieve dormant companies not only of the need to prepare accounts at all but also to relieve them of the need to file Annual Returns and certain other documents. They would only be required to continue to file certain documents which were necessary for the protection of any pre-existing creditors.

The reasoning behind Mr. Gleeson's views was as follows :

(1) There were at that time more than 260,000 companies on the Register. Without an extensive and time-consuming survey it was not possible to say precisely how many of these could be classified as "dormant" companies, but a figure of 30 - 40% would not be surprising. Most firms of lawyers and accountants kept in reserve a great number of "shelf" companies for use by their clients, and the use of small, inactive private companies was also very common for personal property holdings e.g. the

ownership of a flat by a man and his wife. These companies did not trade or operate in any normal commercial sense and in this way could be said to be "dormant".

(2) Notwithstanding that they were dormant these companies were required to comply with nearly all of the administrative provisions of the Companies Ordinance e.g. -

(a) they had to keep accounts in a certain form;

(b) the accounts had to be audited;

(c) the accounts and the auditors' report had to be circulated to members;

(d) an annual general meeting had to be held and certain formalities observed;

(e) annual and other returns had to be filed in the Companies Registry.

(3) These administrative requirements involved a lot of work and effort on the part of both the companies themselves, their proprietors, and the Companies

Registry, all of which, so far as one could see, served no very useful purpose in the practical sense.

The system which Mr. Gleeson proposed would operate along the following lines :

(i) The shareholders would pass an ordinary resolution authorising the directors to make and file a statutory declaration to the effect that the company was a dormant company (no such authorisation would be required for a statutory declaration filed within, say, 3 months of the date of incorporation since at that stage the company would still probably be only a shelf company with only two shareholders).

(ii) The company would deliver to the Companies Registry for filing on the public file a statutory declaration by its directors that the company was, or would from a specific date be, "dormant".

(iii) In the statutory declaration the directors would also undertake to file a further statutory declaration to that effect if and when the company ceased to be dormant.

(iv) As from the filing of the statutory declaration, the company would not need to comply with the administrative requirements of the Companies Ordinance referred to in (2)(a) - (e) above.

(v) All other provisions of the Companies Ordinance would continue to apply including the requirements to file -

(a) notice of change of directors;

(b) notice of change of registered office;

(c) particulars of a charge created by the company;

(d) notice of voluntary winding-up, and

(e) notice of appointment of a receiver or manager.

All of these would still be required for the protection of pre-existing creditors.

(vi) The exemption would cease to have effect as from the date on which the company ceased to be dormant. As mentioned in (iii), the directors would

forthwith file a further statutory declaration stating this fact i.e. that it had ceased to be dormant.

(vii) If the company entered into any "significant accounting transaction" between the filing of the statutory declaration referred to in (ii), or the date specified in it for commencement of the "dormant" period, and the filing of the statutory declaration referred to in (iii), all the directors and shareholders would be personally liable for any debt or liability of the company arising out of that transaction.

(viii) Dormant company status would not be available to -

(a) public companies;

(b) institutions authorised under the Banking Ordinance;

(c) (i) an insurer as defined in the Insurance Ordinance;

(ii) a corporation of which an insurer is a subsidiary; or

(d) dealers and advisers registered under the securities legislation.

Mr. Gleeson also made the following comments by way of further explanation of certain aspects of the proposed system :

(a) As mentioned above, it was considered that the U.K. definition of "dormant" was sensible and appeared to be the most suitable precedent available. At a preliminary stage, he had considered as an alternative basis for the definition of "dormant", a provision that it should mean a company which does not "carry on any business". However, this phrase is open to too many interpretations and might even cover the sale of shares by the shareholders. For instance, the definition of "place of business" in section 341 of the Companies Ordinance includes a share transfer or share registration office.

(b) Dispensing with the filing of the annual return could be justified on the ground that, if no significant accounting transaction had taken place, the only events of any real importance which could have happened in respect of the company would be changes in its shareholders or directors. Such

changes could, of course, be better ascertained by exercising the rights to inspect the shareholders' register and the directors' register maintained by the company itself, which everyone has under section 98(1) and section 158(7) of the Companies Ordinance.

(Note : The annual return of shareholders etc. filed in the Companies Registry is merely a snap-shot of the position at a certain point in time and it can become ever more out-of-date from the date it is completed until the next annual return is filed. The company's own shareholders' and directors' registers must be updated at all times by the company.)

(3) There is the possibility that a company might, although not entering into any significant accounting transaction, still carry out certain functions e.g. have a meeting to consider resolutions changing rights to certain classes of shares, and, taking advantage of the proposed legislation, not file either an annual return or a copy of any special resolution which might have been passed at the Meeting. Even if this occurred,

it is rather difficult to envisage circumstances in which third parties would be prejudiced by any such action.

(4) Under the U.K. legislation a **special** resolution is required to enable the directors to file a statutory declaration that a company is a "dormant company". Mr. Gleeson suggested that an **ordinary** resolution would suffice in the practical sense having regard to the type of company he had in mind.

Mr. Gleeson confirmed that the Commissioner of Inland Revenue, the Commissioner of Banking and the Commissioner of Insurance had all confirmed that they had no objections to his proposals.

At our April Meeting, a Member asked if, when the proposals were being prepared in the Companies Registry, the possibility of limiting them to companies below a certain size had been considered.

The Secretary confirmed that this had been given a good deal of thought. The basic problem was that private companies in Hong Kong did not file their accounts and it would therefore not be possible for the Companies Registry to check the claim of a company wishing to take advantage of the

procedure, as to its "size". The main criteria which had been used in other jurisdictions where there were procedures involving limitation on size had included net assets, annual turnover and size of staff. It had eventually been decided that there would be no point in introducing a procedure based on criteria of this nature, none of which could be checked by the Registry in practice.

After careful consideration of all the circumstances, we agreed to recommend the new legislation on the lines proposed by the Registrar General, subject to a special resolution of the company concerned being required instead of an ordinary resolution as proposed.

4. Fiduciary Duties of Directors

The Companies (Amendment) Bill 1991, Gazetted on 25 January, sought to implement the recommendations which we had made with regard to a statutory statement of the general fiduciary duties of directors.

At our Meeting in June, we were advised by the representative of the Monetary Affairs Branch that, while the Bill had received support from a number of organisations, there had also been strong objections, particularly from the Law Society of Hong Kong and the Hong Kong Bar Association.

All of these representations had been considered at considerable length by the Omelco Ad Hoc Group dealing with the Bill, which had had a number of meetings with the interested parties.

In the end, it had been decided not to proceed with the Bill.

The Monetary Affairs Branch wished to know our views on what course of action should now be taken.

We advised that it was highly desirable for there to be a voluntary code for educational purposes, perhaps along the lines of that issued by the Institute of Directors in the U.K., at least for directors of listed companies.

5. Offences under the Companies Ordinance Powers of arrest, detention, search and seizure

At our July Meeting, Mr. Gleeson explained to us that, in his capacity as Registrar General, he had been consulted by the Secretary of the Arrest Sub-committee of the Law Reform Commission. The Sub-committee were giving

consideration to the possible introduction in Hong Kong of legislation based on the U.K.'s Police and Criminal Evidence Act 1984 ("PACE").

It had been explained to him that PACE provides for "arrestable offences" and "serious arrestable offences". The definitions are in fact very complicated but for present purposes, we would attempt to summarise them as follows. An "arrestable offence" is one for which a person may be sentenced to 5 or more years imprisonment. A "serious arrestable offence" is one which is an arrestable offence **and** the commission of which has led to, or was intended to lead to, either substantial financial gain to any person or serious financial loss to any person.

The Act provides for arrest without warrant in the case of an arrestable offence. In the case of a serious arrestable offence, there are additional police powers such as the right to use road checks, to delay in permitting access to legal advice, etc.

Mr. Gleeson had been advised that the Sub-committee had reached a provisional view that in Hong Kong "arrestable offence" should be defined as an offence carrying 2 years imprisonment, together with a Schedule of offences carrying less than 2 years imprisonment. He was asked for his views on whether a Hong Kong definition of "serious arrestable

offence" should adopt the provisionally proposed "arrestable offence" basis (i.e. 2 years imprisonment) or the "5 years imprisonment" basis used in the U.K.

Mr. Gleeson advised us that, before expressing any opinions to the Sub-committee, he would like our views on the proposed definitions in so far as they would apply to offences under the Companies Ordinance.

We noted that, under the Companies Ordinance, there are 2 offences punishable by 5 years or more imprisonment i.e. under sections 275 (responsibility of directors for fraudulent trading) and 349A (penalty for dishonest destruction etc. of registers, books or documents in the Companies Registry). There are 17 offences which provide for a maximum of 2 years imprisonment. They vary considerably in seriousness from failure to give notice of resignation of auditors to falsification of documents.

After considerable discussion, we asked for more information as to why the Sub-committee had provisionally taken 2 years imprisonment as a basis for its definition of "arrestable offence".

We resumed consideration of this matter at our September Meeting when we were given details of some of the matters which were relevant to the Sub-committee's

provisional view that a 2 years imprisonment basis was appropriate. We formed the view that the various points made did not apply in the case of offences under the Companies Ordinance.

After further debate, we advised Mr. Gleeson that, in our opinion, the nature of the offences under the Companies Ordinance for which a penalty of imprisonment was provided was such that they should be excluded from the proposed definitions of "arrestable offence" and "serious arrestable offence". We did not think that provisions for arrest without warrant, or for road blocks, delaying access to legal advice, etc. could be justified in the case of any such offence.

6. Prospectuses

In our Fifth Annual Report (subjects considered during 1988) we dealt with the Report of the Securities Review Committee, popularly known as "the Davison Report".

We considered the parts of the Davison Report dealing with registration of prospectuses in paragraphs 6.4 - 6.12, pages 35-46 of our Report.

In paragraph 6.5, we noted that paragraph 11.54 of the Davison Report stated that -

"The existing system should be rationalised and streamlined so that only one body vets and approves documentation on new issues".

Paragraph 6.12 of our Report was as follows -

"After considerable discussion, we agreed :

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

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

At our November Meeting, we considered a paper setting out detailed proposals for amendment to the existing provisions on this subject which would implement the recommendation of the Davison Report.

We supported the proposals and agreed that they should be implemented as soon as possible. However, since we understand that there may be further consultations on the proposals, or some of them, we do not think it appropriate to detail them in this present Report.

7. Proxies : Stock Exchange of Hong Kong Limited

In our Seventh Annual Report (subjects considered during 1990) we explained that the Report of the Securities Review Committee, usually referred to as "The Davison Report", had recommended that elections to the Council of the Stock Exchange of Hong Kong Limited ("SEHK Limited") should be in person by secret ballot and that proxy voting should not be permitted. We reported that in March 1990 we had been asked for our views on the implementation of this recommendation. 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 to the effect that the proxy shall have the same right as the member to speak at the meeting. We stated that we had a serious problem in commenting on the proposal for banning proxy voting in the case of this particular company, SEHK Limited, because we did not have available for

consideration the evidence on which the Securities Review Committee had based their recommendation. We therefore concluded that, although some Members had strong personal opinions on the recommended ban, it would not be appropriate for us to submit any comments on its implementation or otherwise.

The matter came back before us for consideration at our meeting in September 1991 in the shape of a detailed paper on the subject by the Securities and Futures Commission which recommended a ban on the use of proxies at meetings of the SEHK Limited for the election of Council members. (Strictly speaking, the correct title of the Council is "the Committee" but "Council" is invariably used in practice.)

The SFC paper contained a good deal of interesting and relevant information on the past use of proxy voting at general meetings of the SEHK Limited. In particular, it showed that at the 1989 election of the Exchange Council, individual members in attendance had cast 28% of the total votes and proxies 72%; 3 members had cast 42% of the total votes. At the 1990 election there had been 16% individual attendances and 84% proxies; 3 members had cast 52% of the total votes.

The representative of the SFC at the September Meeting confirmed that the Commission appreciated that the proposed ban would be a departure from normal company law but felt that the particular circumstances of the company justified this. The SFC's paper emphasized that, in the light of the SEHK Limited's quasi-public nature, its monopoly and privileges, the SFC believed that the structure of the Council and the system by which it was then selected should be changed. Specifically, the SFC was of the view that the system then prevailing did not ensure that the principal groups who participated actively in the market and which had an interest in the development of a sound, progressive and well-regulated stock market in Hong Kong were represented on the Council in a balanced and fair manner which avoided excessive influence developing in the hands of any particular groups.

After careful consideration of all the points made by the SFC, we reached the conclusion that their misgivings about the use of proxy votes by certain members of the SEHK Limited were justified and that changes were needed. However, we felt that the out-right ban recommended was not appropriate having regard to all the circumstances. We felt that there would always be cases in which members of the company should be able to appoint proxies e.g. because of illness or absence from Hong Kong.

Also, on the technical side of the subject, we noted that even if section 114C were to be amended to prohibit appointment of proxies in the case of the SEHK Limited, there would still be the provisions of section 115 of the Companies Ordinance (representation of companies at meetings of other companies and of creditors). This section provides in effect that if company A owns shares in company B, company A may, by resolution of its directors, "authorise such person as it thinks fit to act as its representative at any meeting" of company B and to speak and vote on its behalf. Thus, even if section 114C were to be amended to ban the use of proxies as such, individual members would still be able to become incorporated and appoint representatives under section 115. Groups of them could all appoint the same representative, thus reproducing the original problem.

Since, in our opinion, the problem boiled down to a few individuals being able to turn up at meetings of the SEHK Limited with fistfuls of proxies, we decided that a more practical approach to the problem would be to amend the provisions of sections 114C and 115 to the effect that -

(a) a member of the SEHK Limited should be allowed to appoint a proxy in certain circumstances, such as illness or absence from Hong Kong;

(b) no person could act as proxy for more than one member; and

(c) the only person who could act as a proxy would be someone who was both a director, partner or employee of the member and who was registered with the SFC under Part VI of the Securities Ordinance.

The SFC's legal staff subsequently prepared a draft clause implementing our suggestions, by way of an amendment to the Stock Exchanges Unification Ordinance, Cap. 361, which we considered at our October Meeting. The draft went rather further than our suggestions in that it laid down that an individual member wishing to appoint a proxy would have to -

(i) be unable to attend the company meeting in person due to illness or absence from Hong Kong; and

(ii) make a statutory declaration in which he stated that he was unable to attend and give the reason.

We recommended that (i) should be expanded to allow the use of a proxy "for other good cause" and that (ii) be altered to provide that a statutory declaration would only be necessary if required by the SFC in any particular case.

These recommendations were incorporated in the Stock Exchanges Unification (Amendment) Bill which was Gazetted on 9 Novemebr.

However, when the resulting Stock Exchanges Unification (Amendment) Ordinance, No. 104 of 1991, was enacted on 29 November, it incorporated an amendment to the effect that an individual member could appoint a proxy if he "is unable to attend and vote in person due to any reason which is acceptable to the Committee" i.e. to the Council of the SEHK Limited. We are informed that this amendment was a compromise which had been agreed between the SFC and the SEHK Limited in the first instance and then reported to the Members of Omelco dealing with the Bill, who had accepted it.

With respect, we doubt whether this amendment represents an improvement on the provisions in the Bill. It can be argued, for example, that, under the Bill, the question of whether a particular member had in fact been ill or absent from Hong Kong or whether there had been "other good cause" was a matter of fact which would be reviewable in the courts. Under the amendment incorporated in the Ordinance, the only form of redress would appear to be a judicial review of whether the Council's decision in a particular case was reasonable.

One point which may give rise to discussion in practice is whether a member wishing to appoint a proxy can satisfy the Council of the SEHK Limited that he has an acceptable reason for so doing, after the meeting in question has taken place. For example, if a member suddenly becomes ill only hours before a meeting is to take place, will he be able to appoint a proxy, subject to satisfying the Council as soon as possible after the meeting that the illness was an acceptable reason for not attending personally?

If the answer is in the affirmative, this could give rise to some interesting questions if the Council were ever to decide in a particular case after the meeting that the reason given for appointing the proxy was not in fact acceptable. What would the position be regarding the validity of the votes cast by the proxy at the meeting?

(Our attention was drawn to the fact that there is a standard article in Table A to the Companies Ordinance, article 68, which provides to the effect that objections as to the qualification of a voter can only be raised at the meeting concerned and that the decision of the Chairman of the meeting on the subject is final. However, we were advised on behalf of the SEHK Limited that this particular article is not included in the company's articles of association and is therefore not relevant in the present context.)

8. Purchase by a Company of its own Shares

In our Seventh Annual Report (Subjects considered during 1990), we urged the Administration to enact legislation enabling companies to purchase their own shares and set out our recommendations on the principles of such legislation. These principles were based on the U.K. legislation on this subject i.e., in outline, shareholders should be protected by the need for prior approval of proposed repurchases by a general meeting, creditors should be protected by a requirement for repurchases to be made out of distributable profits and the shares repurchased should be cancelled. However, we noted the need for changes in various aspects of the mechanisms of repurchases.

We also repeated our previous view that the proposed legislation should not be brought into operation before -

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

(b) the legislation on distributable profits previously recommended by us was in operation.

We stated that we would prefer to see the legislation recommended by us in respect of fiduciary duties of directors in operation but confirmed that we did not regard this as a pre-requisite for the legislation on repurchases.

A draft of the proposed Bill allowing repurchases was considered by us in considerable detail at our January meeting. Among the various points raised was the question of the validity of a repurchase which did not comply fully with the statutory provisions.

The draft Bill contained a provision to the effect that any purported repurchase of shares by a company which was not in compliance with the statutory provisions would be void. This was based on the corresponding U.K. legislation (Companies Act 1985, section 143(2)). The representative of the Securities and Futures Commission at the meeting, however, thought that this U.K. provision was not practical in that it did not recognise the reality of the problems involved in attempting to unravel stock market transactions. Mr. Hanson agreed with this view.

At our meeting in February, Mr. Ip, as representative of the Monetary Affairs Branch, advised us that the Administration had decided to delete the provision on voidness in the draft Bill. However, the penalties for a company, and its officers, making a repurchase otherwise then

in accordance with the statutory provisions would be increased considerably in comparison with the corresponding U.K. provision.

Also in the course of our January meeting, we commented on certain aspects of the SFC's proposals for their then forthcoming Share Repurchases Code and the Stock Exchange of Hong Kong Limited's proposals for consequential amendments to the Listing Rules. At Mr. Smith's request, it was recorded that the mere fact that we had done so should not be regarded as meaning that the Standing Committee had approved the terms of the draft Code and amended Rules.

We did not get another opportunity to look at the draft Bill prior to its publication in the Gazette on 22 March. The Bill, the Companies (Amendment)(No. 2) Bill 1991, also incorporated the proposed legislation regarding distributable profits and prohibition of financial assistance by a company for purchase of its own shares which we had previously recommended.

After its publication, we noted with concern at our April meeting that the Bill contained a new Clause 5 which had not appeared in the draft which we had considered at our January meeting.

This clause proposed to introduce a new section 58(1B) in the Companies Ordinance, the effect of which would be that, if a listed company committed a breach of the Share Repurchases Code, it would be committing a criminal offence which would render both it and its officers liable to heavy fines and imprisonment.

To understand this aspect of the subject better, it is necessary to go back to our Seventh Annual Report. Paragraphs 3.19 - 3.27 of the Report read as follows :

"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."

We were advised by our Secretary at our meeting in May that the Administration had decided that the best way to deal with the dilemma was -

(a) to provide in the proposed new section 49B(1) that a listed company could repurchase its own shares in accordance with the Share Repurchases Code; and

(b) to provide in the proposed new section 58(1B) that any repurchase which did not comply with the provisions of the Code would constitute a criminal offence, with liability for heavy penalties.

Under the corresponding U.K. legislation, it is a criminal offence for a company to repurchase its own shares otherwise than in accordance with the statutory provisions (Companies Act 1985, section 143(2)) and any breach makes the company and its officers liable to a fine and imprisonment. To this extent, therefore, the provisions in the draft Bill followed the U.K. precedent. The big difference was that, as already noted in para. 3.20 of our Seventh Annual Report previously quoted, the U.K. legislation only lays down a

comparatively limited number of rules for certain aspects of repurchases and these are, of course, framed in the usual precise language of statutes. The Hong Kong Share Repurchases Code, by contrast, covered all aspects of the repurchase procedure and was framed in the general terms normally used in such Codes. The scope for a company being liable to criminal penalties for a breach of repurchase procedures would therefore be far wider under the Bill than in the U.K.

The Secretary explained that the reasoning behind the approach adopted in the published Bill had been that, as noted in paras. 3.19 - 3.27 of our Seventh Annual Report previously quoted, the experience of share repurchases in the U.S. had shown that they were particularly valuable as a means of providing support for share prices in emergency situations. For example, it seemed to be generally accepted that the large American companies had helped to steady the market in the crash of October 1987 when a number of them had announced large scale programmes of repurchases.

On the other hand, no large scale programmes of repurchases had been announced in the U.K. at the time, although the psychological boost which the programmes had provided in the U.S. had been needed at least as badly in the U.K. It was understood that one of the reasons for the lack of such announcements in the U.K. was that many of the

authorisations which the major companies held for making repurchases were insufficiently flexible to be used effectively in the prevailing circumstances and, of course, there simply had not been the time available to call general meetings to vary the terms of the authorisation.

The Secretary thought that over the next few years there were going to be occasions when it would be highly desirable for Hong Kong companies to be able to support their shares by repurchases, as the Americans had done in October 1987.

The problem was that the more details of the system that were included in the Companies Ordinance, the more difficult it would be to provide the flexibility for companies to act quickly in an emergency situation. One solution would be to include in the Ordinance provisions to allow the normal procedures to be varied, or even waived, in an emergency. However, provisions of this nature were themselves usually difficult and controversial. The Administration had reached the conclusion that it would be more logical to simply provide in the Ordinance for shares to be repurchased by listed companies in accordance with a Code which would provide the necessary flexibility. However, since it was generally accepted that allowing share repurchases opened up opportunities for abuse, which would be particularly serious in the case of listed companies, it was

also decided that it would be necessary to provide realistic penalties for any breach of the provisions in the Code. This was the origin of the proposed new section 58(1B) in the gazetted Bill.

We were advised that the Law Society had objected strongly to this approach. We were told that the Society objected in principle to the proposed new section 58(1B) making a breach of the non-statutory Share Repurchases Code a criminal offence. The Society recommended the following amendments to the Bill :

(a) the insertion of a requirement that listed companies obtain the prior approval of shareholders for share repurchases distinguishing, as appropriate, between on-market and off-market transactions; and

(b) the deletion of all references in the Bill to the Code.

Our Secretary agreed that it was unusual for an ordinance to provide for a breach of a non-statutory code to constitute a criminal offence, but suggested that there were precedents i.e.

(a) The Telecommunication Ordinance, Cap. 106. This Ordinance imposes heavy penalties for engaging in various activities otherwise than in accordance with a sound broadcasting licence and such a licence can, under section 13C(3), require the holder to comply with a Code of Practice issued by the Broadcasting Authority.

(b) The Smoking (Public Health) Ordinance, Cap. 371. Section 13(1) authorises the Broadcasting Authority to issue Codes of Practice relating to cigarette advertising on radio. Section 13(4) provides that no one may broadcast a cigarette advertisement which does not comply with any such Code of Practice. Section 15(1) provides that anyone who contravenes section 13(4) is liable on summary conviction to a fine.

(c) The Electricity Ordinance (No. 16 of 1990) enables the Governor-in-Council to make regulations which can adopt by reference Codes or Standards. Such regulations may themselves prescribe penalties for their breach. There is therefore a basis for criminal sanctions to be attached to breaches of a Code.

However, our Chairman was of the view that these purported precedents for the proposed imposition of criminal sanctions for breaches of the Share Repurchases Code were wholly unsatisfactory and confirmed that, in his opinion, the views of the Law Society were entirely correct. This opinion was strongly supported by solicitor and barrister Members of the Standing Committee.

Mr. Hanson also agreed with the views of the Law Society as did the representative of the SFC present at the meeting. However, they confirmed that they understood and agreed with the Administration's desire to provide flexibility in times of crisis and suggested that the legislation should contain a provision authorising the SFC to grant waivers of the normal provisions.

It was suggested to us by the Administration that an alternative approach to deal with the objections to the Bill would be to retain the basis that a breach of the Share Repurchases Code would be a criminal offence but to insert additional provisions that -

(a) the Attorney General's personal approval in writing would be required for any prosecution; and

(b) the Financial Secretary's consent would be required for any proposed amendment to the Code.

We did not find this proposal satisfactory.

After considerable discussion, we recommended that the Bill be amended along the lines suggested by the Law Society, subject to a power being given to the SFC to grant exemptions from the provisions in respect of authorisation of repurchases by listed companies.

The Bill, as amended, was duly gazetted as the Companies (Amendment) Ordinance, No. 77 of 1991, on 5 July 1991. The power for the SFC to grant exemptions from the provisions of the relevant section 49BA (Requirements for listed company to purchase own shares) is contained in subsections 49BA(11) and (12).

The Ordinance was brought into operation on 1 September 1991.

The related Securities (Disclosure of Interests) Ordinance and the Securities (Insider Dealing) Ordinance were also brought into operation on the same date, as previously recommended by us. However, we noted that the Companies (Amendment)(No. 1) Bill 1991, which incorporated our recommendations in respect of fiduciary duties of directors, was withdrawn by the Administration after meeting strong opposition from the Law Society and the Bar Association.

One outstanding matter in connection with share repurchases is that when the proposals were the subject of a public consultation exercise conducted by the SFC and the SEHK, various members of the public had urged that property companies should be allowed to use unrealised reserves representing increases in the valuation of properties, for the purpose of making repurchases.

This is a controversial proposal with considerable implications and ramifications, as we pointed out in our Seventh Annual Report (paragraphs 3.11 - 3.14). We have therefore appointed a Sub-committee to consider the proposal and expect to have their report for consideration at our meeting in April 1992.

9. Securities (Disclosure of Interests) Ordinance, Cap. 396

The Securities (Disclosure of Interests) Ordinance ("Cap. 396") was enacted in July 1988, but at the beginning of 1991 had still not come into force.

We dealt with a number of topics relating to Cap. 396 in our Sixth Annual Report (subjects considered during 1989). One of these was the question of whether the Ordinance should be applied to overseas companies listed on the Stock Exchange.

We explained in our Sixth Annual Report that Cap. 396, like the U.K. legislation on which it was based, applied only to companies incorporated in Hong Kong. We pointed out that this was consistent with the 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. We noted that the U.K. leaves it to the Stock Exchange Authorities and the Listing Rules to require overseas companies listed there 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.

We also explained in the Sixth Annual Report, however, that the Securities and Futures Commission, strongly supported by the Stock Exchange of Hong Kong, had approached us with a proposal that Cap. 396 should be applied to overseas companies listed in Hong Kong. Paragraphs 6.19 - 6.21 of the Sixth Annual Report read as follows :

"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."

In February 1991, we considered a paper from the Monetary Affairs Branch which set out the detailed proposals for amendments to Cap. 396 required to extend the Ordinance to overseas companies.

The paper explained that the Branch had received legal advice that there was the necessary legislative competence to extend Cap. 396 to overseas companies. However, the paper also stated that the Branch were mindful of the need to ensure, as far as possible, that the provisions of the Ordinance purporting to have extra-territorial effect would be capable of enforcement. For this reason, the Branch, on the SFC's advice, proposed to extend Cap. 396 to all companies listed in Hong Kong regardless of the place of incorporation subject to -

(a) giving the SFC a power to exempt certain companies from the requirements of the Ordinance;

(b) the repeal of the restriction provisions in section 44(1)(b) - (d); and

(c) limiting the scope of the restriction provisions in section 44(1)(a) to shares registered on the Hong Kong share register.

(Note : The restriction in section 44(1)(a) is a prohibition of any transfer of shares which are subject to a freezing order. The restriction in section 44(1)(b) prevents the shares from being voted at a meeting of the company

concerned. The restrictions in section 44(1)(c) and (d) prohibit the issue of any bonus shares or the payment of any dividend in respect of the shares).

The justifications for these proposals advanced by the Branch were, in summary, as follows :

(a) Power to exempt

The Branch accepted that, as a general rule, Cap. 396 should apply to all companies listed in Hong Kong. However, they also believed that relief could be justified in certain cases e.g. a foreign company which had its primary listing elsewhere and which was subject to equivalent disclosure requirements in that place. The Branch envisaged that relief would take the form of an exemption from the requirements of the Ordinance on condition that the regulatory authorities in Hong Kong received copies of the notifications required to be filed under the disclosure legislation in the original jurisdiction. The exemption would thus be designed to ease the administrative burden on the company and relevant directors and substantial shareholders of duplicate filing requirements, without compromising the provision of adequate investor protection in Hong Kong. A breach of the condition would invalidate the exemption and would render the company and relevant persons liable to the penalties under Cap. 396. The Branch also

proposed that, because of the difficulty of laying down rigid rules for exemption, the SFC should be given a general discretion to exempt. The SFC would develop and make available to the public the criteria for exemption.

(b) Repeal of the restriction provisions

The Branch accepted that the freezing order was fundamental to the Ordinance. They pointed out that it was the sanction against obstruction of an investigation by a company or the Financial Secretary into the ownership of the company's shares and therefore upheld the basic purpose of the Ordinance. Moreover, as the criminal sanctions under the Ordinance could only be applied in practice to persons who were in Hong Kong, the only sanction available to Hong Kong regulators against the non-resident officer or substantial shareholder of a listed company, local or overseas, was the freezing order. The Branch accepted that the freezing order provisions must therefore be effective for the Ordinance to achieve its purpose.

The paper explained that the Branch's proposal to repeal the provisions of section 44(1)(b) - (d) was based on three arguments. Firstly, that the provisions could not and should not be applied to overseas companies. Secondly, that the transfer restriction under section 44(1)(a) was

sufficient of itself for all companies. Thirdly, that any disparity of treatment between local and overseas companies would be inequitable and politically unacceptable.

With regard to the first argument, the Branch noted that all concerned within the Administration agreed that the provisions of section 44(1)(b) - (d) could not be enforced directly against overseas companies.

With regard to the second argument, the Branch recognised that a restriction on transfer of shares registered in Hong Kong might not be effective in all cases. They also recognised that evasion would always be possible. However, they believed (on the SFC's advice) that a transfer restriction would be effective in most cases.

With regard to the third argument, the Branch stressed that, above all, they shared the concern of the SFC, and SEHK, on the need to avoid a disparity of treatment between local and overseas companies. Any such disparity would raise very difficult questions. The sanctions would be seen either to be inadequate (for overseas companies) or excessive (for local companies). The Administration's aim must be to provide a level playing field. The Branch could not be sure to what extent any disparity of treatment would provide an added incentive or pretext for companies to shift

their domicile overseas, but there was little point in having greater sanctions for local companies while such emigration remained possible.

In summary, the Branch stated that they believed that repeal of the relevant restrictions in section 44(1)(b) - (d) was the best solution in all the circumstances. They had been convinced by the SFC that the transfer restriction was adequate (though not perfect) and the most acceptable solution. They thought that to retain the existing provisions on restrictions for all companies would be inappropriate and unenforceable and that retaining the provisions for local companies only would not necessarily be more effective because of the option of emigration.

(c) Limiting the scope of transfer restrictions

The Branch accepted that the provisions of section 44(1)(a) could only be enforced in relation to the shares of a company registered in Hong Kong i.e. in the case of an overseas company, those registered in the branch register which the overseas company was required to maintain in Hong Kong under the Stock Exchange Listing Rules. This would be true whether the shareholder was resident in Hong Kong or overseas.

Secretary's paper on the proposals

At the same time as we considered MAB's paper on the proposed amendments to the legislation, we also considered a paper by our Secretary on the proposed deletion of the restrictions imposed by section 44(1)(b) - (d).

The Secretary agreed whole-heartedly with MAB's view that the freezing order is fundamental to the provisions of Cap. 396. He recalled that the freezing order provisions originated in the U.K. in 1948 (section 174 of the Companies Act 1948) and had been an important, and effective, weapon in enforcing the disclosure legislation since then. He therefore proceeded to examine the Branch's arguments, as summarised above, for repealing most of the restrictions which have made the freezing order so useful in the U.K. :

(a) The restrictions in section 44(1)(b) - (d) could not be applied to overseas companies

The Secretary agreed with this view. Indeed, he thought that this was why the U.K. authorities had eschewed the legislative approach to applying the disclosure requirements to overseas companies. What was the point in extending legislation to overseas companies if there was legal advice that most of its provisions could not be enforced against them?

(b) The transfer restriction under section 44(1)(a) was sufficient sanction of itself for all companies

The Secretary observed that only time would tell whether this view was justified. His own view, however, was that while, on its own, the restriction on transfers might be of limited effectiveness in enforcing Cap. 396 as far as local companies were concerned, it would not be much of a deterrent where overseas companies were concerned. He gave a detailed example to illustrate the basis for this view.

(c) The "level playing field" argument

Our Secretary did not agree with this argument either. He disagreed with it because he did not think that Hong Kong companies were "redomiciling" because they thought that company or securities laws here were too strict. He thought that they were redomiciling for political reasons. He was of the view that if Government repealed Cap. 396 and the Insider Dealing legislation overnight, not one redomiciled company would return to Hong Kong nor would one of those intending to redomicile change its plans. He accepted that if there was a disparity between the restrictions which could be imposed by a freezing order on shares of a Hong Kong company and those which could be imposed on shares of an overseas company, some Hong Kong companies might give this as a reason for redomiciling.

However, he was convinced that this would never be the main, or even a major, reason for redomiciling and it would not have any major effect on the decision on whether or not to redomicile, although in some cases it might affect the timing. In short, he did not think that the existence or otherwise of a level playing field in respect of restrictions under section 44(1) would have any ultimate effect on the numbers of companies redomiciling. He accepted that, if a level playing field existed, it might mean that some companies planning to redomicile might not do it so quickly as they would if it did not exist, but he was of the opinion that this effect was only temporary. He posed the question of whether it was worth giving up the ability to apply the legislation effectively in respect of Hong Kong companies for what was, in his opinion, a temporary advantage?

Our recommendation

At our Meeting during which the papers by MAB and the Secretary respectively which are summarised above were considered, Mr. Pascutto who was in attendance on behalf of the SFC, stressed that the basic question which the SFC had to consider was : Which was more effective - having stronger restrictions in freezing orders or maintaining equity between Hong Kong and overseas incorporated companies? The more incentives Government created for listed companies to redomicile, the more power it lost in practice. How

important was it to have the strongest powers in respect of a steadily decreasing category of companies? He thought that the Standing Committee had to look at the general position. Even under the amended version of Cap. 396 proposed by the MAB's paper, there would still be the strongest sanctions available in Hong Kong in respect of securities regulation. No one could be sent to prison for breaches of the Listing Rules or the Insider Dealing legislation. On balance, the SFC were aware of the decrease in sanctions which would result from the proposed amendment to Cap. 396, but were prepared to live with this.

Mr. Hanson supported the views of the MAB and the SFC.

However, Mr. Marvin Cheung thought that if the only sanction under the legislation was the restriction on transfers contained in section 44(1)(a), it would not be very difficult for a transfer of shares to be effected in the home jurisdiction of an overseas company, say Bermuda, and for the shares then to be brought back into Hong Kong and traded here. As far as he was aware, there would be no way in which a member of the public buying the shares in Hong Kong would know that they had been the subject of a freezing order, because shares of listed companies are seldom, if ever, numbered nowadays.

We had a long and thorough discussion of this controversial subject. Eventually, however, we decided that we agreed with the MAB and the SFC that the primary aim should be to retain a level playing field for both locally and overseas incorporated listed companies. Given that there seemed to be common agreement that the restrictions in section 44(1)(b) - (d) could not be enforced against overseas listed companies, we therefore decided that they should not apply in respect of locally incorporated companies either. We therefore agreed to recommend the amendments to Cap. 396 suggested by the MAB and summarised above.

The amendments were duly implemented in the Securities (Disclosure of Interests) (Amendment) Ordinance, No. 68 of 1991, which was Gazetted on 28 June 1991.

Cap. 396, as amended, was brought into operation on 1st September 1991. It is too early at present to judge the effectiveness of the amended Ordinance in practice.

10. Shadow and Nominee Directors

During the year, we considered a paper by the Secretary setting out problems which are alleged to arise for regulators from the common use of corporate directors for private companies in Hong Kong and from what is perceived to

be a common failure to fulfil the statutory obligation under section 158(10)(a) of the Companies Ordinance to name "shadow directors" in every company's register of directors.

We instructed the Secretary to write to the organisations usually consulted on such matters for their views and to submit these to us in due course. We expect to consider the views at our Meeting in March 1992.

11. Stock Exchange : Possible New Listing Status

At our October Meeting, we considered a public consultation paper on a possible new listing status which had been sent to us by the Stock Exchange of Hong Kong Limited with a request for our views.

This was a detailed document (62 pages including appendices) dealing with the possibility of a new listing status, to be known as a "trading listing status". Such a status would be available to a Hong Kong listed company which for a variety of reasons might be seeking to move its lead regulation overseas while the majority of its shareholders and trading would remain in Hong Kong.

The document explained :

"1.1 As part of the recently completed Six Months Review of the Listing Rules, the Exchange proposed to attract suitable overseas listed companies by providing those companies with "Exempt Foreign Company" status. The concept arose out of the Exchange's desire to encourage well-capitalised and well-regulated overseas companies which are listed on recognised overseas exchanges to seek secondary listings in Hong Kong. The Exempt Foreign Company status is essentially a simplified secondary listing."

"1.2 After the concept of "Exempt Foreign Company" status had been proposed, the Jardine Matheson group of companies ("Jardine") put forward a new proposal for a trading listing status for Hong Kong listed companies. Although the Exempt Foreign Company status was proposed for companies with a primary listing overseas and where the majority of trading takes place overseas and is thus not relevant to the Jardine situation, it was decided to defer introduction of the Exempt Foreign Company status to avoid the possibility of confusion while the new listing status is being considered."

"1.3 This paper focuses on the suggestion to introduce a trading listing status and includes a reconsideration of the concepts of primary and secondary listings in the light of the increased globalisation of trading in securities."

At our Meeting, the view was expressed that while some people might think that Hong Kong was going down a unique path in suggesting that there could be primary regulation of a company by another exchange and trading regulation by the SEHK Limited, this was not so. In Europe, stock exchanges were having to face a similar situation. For example, most of the trading in shares in some Scandinavian companies have moved to London for tax reasons while the primary regulation remained in Norway or Sweden. Also, with the proposed harmonisation of listing requirements in the European Community, there might again be situations where the primary regulation of a company would be in one country and trading regulation in another.

On the other hand, it was pointed out to us that the Securities and Futures Commission had considerable reservations about the proposed status because, if it went ahead, the fact was that the lead regulator in, say, London, would be thousands of miles from Hong Kong where most of the trading in shares was going on. This would obviously involve

operational problems of a type which had not been encountered before. Also, what would be the effect on market confidence? Confidence was what drove a stock market.

However, one of our Members expressed the view that the principle of a lead regulator was not unusual. He pointed out that it had been mooted a lot in the banking sphere, particularly in the European Community. There, each country had its own statutory framework but the aim was to give some one country primacy in relation to regulation. This was usually done on the basis of a great deal of cooperation. One of the main problems was the difficulty in reconciling confidentiality of information supplied to the lead regulator on the one hand and the opening up of lines of communication to other regulators and their taking an active part in decision-making on the other. The Member felt that, before any final decision could be made on the proposed listing status, it would be preferable for Members to have more details about how, in practice, there would be cooperation between the regulators so that, if something was perceived to be going wrong in Hong Kong, the Hong Kong regulators could both have their say and participate in any decision to take action. In particular, he was concerned about the complications relating to confidentiality of information already referred to. He thought that experience in the banking field showed that this issue caused the most problems because the separation of the legislature, judiciary

and the administration usually made it quite impossible for the regulator to guarantee confidentiality. It might well mean that there would be a need for statutory changes in both jurisdictions on the subject of confidentiality.

After careful consideration of all aspects of this controversial subject, we reached the conclusion that if the Hong Kong regulators could be satisfied in any particular case that -

(a) the regulations prevailing in the jurisdiction of the proposed lead regulator were comparable to those applying to Hong Kong;

(b) the proposed lead regulator would have a legal right to pass on to the Hong Kong regulators any confidential information which the company had supplied to it; and

(c) the proposed lead regulator would liaise satisfactorily with the Hong Kong regulators and allow them to make a real contribution to the regulation process in the event of the Hong Kong regulators becoming concerned on any material point,

then there was no objection in principle to a new listing status of the type envisaged, in the circumstances described in the consultation paper. However, we would like to emphasize that the decision in any particular application would depend very much on the total circumstances of the case, particularly with regard to the need to ensure effective liaison between the proposed lead regulator and the Hong Kong regulators.

12. Ultra Vires

During the year, we considered a paper by the Secretary on the new legislation on this subject introduced by sections 108-112 of the U.K. Companies Act 1989.

We agreed that, before reaching any conclusions, it was necessary to consult all interested organisations regarding this important and controversial subject. We instructed the Secretary to write accordingly. We expect to be able to consider the views of the organisations in early 1992.

13. Part III of the Companies Ordinance : Registration of Charges

In our Seventh Annual Report (subjects considered during 1990) we explained that we had appointed a Sub-committee to consider the new legislation on registration of charges introduced by the U.K. Companies Act 1989. This legislation introduced a number of important practical changes in the system on registration of charges in the U.K. although it did not bring in the root-and-branch reform which many think necessary.

We also outlined in that Report some of the main recommendations of the Sub-committee's Report to us and explained how, during subsequent consultations with the private sector which had been recommended by the Sub-committee, it had become clear that certain aspects of the Sub-committee's proposals were quite controversial. We concluded by saying that we had asked the Sub-committee to look at the views submitted during the consultation process and to report back to us.

The Sub-committee submitted their Report to us at our Meeting in May 1991. A number of the items dealt with in the Report were of a very technical nature, of interest only

to those specializing in the subject, and we do not propose to list these in this Report. The main items dealt with in the Sub-committee's Report were as follows :

(1) <u>Definition of "charge" (new section 395 of the 1985 Act)</u>

It had been pointed out to the Sub-committee that there has always been some debate as to whether retention of title clauses and, to a lesser extent, express set-off rights constitute a registrable charge and it was suggested that the proposed amendments should include an express provision that these rights do not amount to charges unless there is an express intention to create a security interest. (There is no corresponding provision in the new U.K. legislation.)

However, the Sub-committee felt that the legal position regarding retention of title clauses was still being worked out in the courts and that it was too big a subject to be able to provide a satisfactory definition of such clauses at present. Even if a satisfactory definition had been available, there would still be the policy debate on whether such a charge **<u>should</u>** be registrable.

The Sub-committee therefore decided not to adopt this suggestion.

(2) Charges requiring registration

(a) Definition of "book debt" (new section 396)

(i) Deposit with banks

This has always been a contentious subject. The existing law is not absolutely clear as to whether it is necessary to register a charge granted by a company over a credit balance held by it with a bank.

The Sub-committee in its original Report had recommended that such a charge should not be registrable.

The Sub-committee reported that, during the consultation process, there had been a fairly even division of opinion among the consulted organisations as to whether such charges should be registrable.

During the Sub-committee's discussions, the view had been expressed that, conceptually, there was no good reason to exclude such credit balances from the definition of book debts. It had been suggested that the questions to be considered were :

Whether a charge in favour of a bank holding the credit balance should be registrable; and

Whether a charge in favour of a third party should be registrable.

One point of view was that the originally-recommended exclusion of all charges over credit balances held by banks was perhaps too broad. On the other hand, there was a view that it would be undesirable to have some charges over credit balances with banks which were registrable and others which were not.

Another suggestion was that it should be necessary to register all charges over credit balances with banks except where the charge was in favour of the bank holding the balance.

The Sub-committee eventually agreed, however, that it would be preferable to adhere to their previous recommendation to exclude credit balances with authorised financial institutions from the definition of "book debt" and thus exclude all charges over such balances from registration. They supported the view that, since the very important rights of banks over deposits with them which arise out of the common law right of set-off, were not registrable, it would not be logical to require the registration of charges created by the companies over such balances. Why should this particular type of priority right over the balances be singled out for registration?

(ii) Dividends

The Sub-committee had been asked to clarify whether a charge on dividends from securities was registrable. They formed the opinion that a dividend, once declared, became a debt and possibly a book debt. If it was a book debt then a charge would, of course, be registrable.

The Standing Committee recommended, for the avoidance of doubt, that it would be useful to exclude dividends from the definition of "book debt".

(b) Assignment of rentals

It had been suggested that charges over assignments of rental should be excluded from the category of registrable charges but the Sub-committee concluded that there were in fact good reasons connected with conveyancing practice for requiring such charges to be registered and that they should continue to be registrable.

(c) Charge on a debenture

It had been suggested to the Sub-committee that it would be highly desirable for the proposed legislation to contain a definition of the term "debenture". The Sub-committee, however, noted that it was notoriously difficult to define and that, as far as they were aware, there was no comprehensive definition in any comparable jurisdiction. They decided therefore not to attempt a comprehensive definition in the meantime.

(d) Charge over shares in a subsidiary

The Sub-committee had included in its original Report a recommendation that a charge over shares in a subsidiary of the company creating the charge should be registrable. (There is no such requirement in the new U.K. legislation although its inclusion was recommended as long ago as 1962, in the Jenkins' Committee's Report.)

During the consultation process, a number of organisations suggested that the proposal should be extended to cover a charge over **any** shares. However, the Sub-committee decided that this would be extraordinarily burdensome to comply with in practice, particularly in view of the fact that the "pools" of shares normally used in connection with such charges were subject to constant change.

There was another suggestion that the requirement should be limited to a charge over shares in a listed company. The Sub-committee concluded that this restriction was not really necessary because shares accepted as security were almost always in listed companies any way.

(3) Registrar's certificate (new section 397 of the 1985 Act)

The new law in the U.K. on this subject has quite important practical implications.

At present, the Companies Ordinance in Hong Kong lays down that when a charge is created by a company, a statutory form must be completed giving

basic information about its terms and then presented to the Registrar of Companies for registration. The original charge document must be presented to the Registrar for examination at the same time as the statutory form. When the Registrar has satisfied himself that the information given in the form is correct, he registers it and gives a certificate of registration. Under section 83(2) of the Companies Ordinance, this certificate is "conclusive evidence that the requirements of this Part as to registration had been complied with". There is a large body of case law on how conclusive the certificate actually is and this is too complicated to summarise here. However, it can be said that the certificate is conclusive for many important purposes, but not for all, and that it can be challenged in the courts.

Under the new U.K. legislation, the company creating a charge will still require to register a form setting out the basic information about the charge. However, the original charge document will not be presented for comparison purposes at the same time and the Registrar will not be responsible for the correctness or otherwise of the information

in the form. He will simply give a certificate that the form was filed with him for registration on a particular date.

The view has been expressed that doing away with the conclusive certificate that the charge has been properly registered, will mean that in practice every liquidator will feel obliged to investigate the registration of any charge created by the company and, if there is any doubt, challenge the validity of the registration in the courts.

During the consultation process, the view was expressed that this was how things should be i.e. that the courts were the correct place for any dispute as to the validity of the registration of a charge.

During the Sub-committee's deliberations on this subject, there was support for this view. However, it was also felt that it was possible to imagine difficulties for a chargee in practice under the proposed law. It was not unusual in a liquidation for there to be only one senior employee with detailed knowledge of the circumstances of the creation of the charge, left

in Hong Kong. The employee might be hopeful of being employed by the liquidator and, in his desire to please, might say that the registration of the charge had been dealt with carelessly in some way. In such a case, the liquidator would have to challenge the registration of the charge. How would the chargee prove the circumstances of the registration? The Sub-committee agreed that the onus of proof would lie on the challenger i.e. the liquidator. However, he would be able to produce the last remaining senior employee to back up his challenge. How could the chargee disprove the employee's version? In practice, it might be very difficult. The view was expressed that there had been a very good reason for the existing system under which the Registrar of Companies in effect decides whether the statutory requirements as to registration have been complied with i.e. it provides certainty and gives information which can be relied upon. In an ideal world, the Registrar would continue to give a conclusive certificate. However, was this achievable in practice in Hong Kong? Not if the Registrar could not keep an efficient register because of lack of the necessary resources, which was what was happening. If the ideal could not be achieved, change would have to be considered.

The Sub-committee reported that they had therefore asked themselves what degree of uncertainty would open up in Hong Kong if the new U.K. system was adopted here. They had concluded that this could not be answered with any certainty. Only experience would show. They recognised, however, that the liquidator would be duty-bound to investigate the circumstances of registration of existing charges in each case. They concluded that this would be no bad thing. They pointed out that no-one was really checking on compliance with, say, the time limit for registration under the existing system. In practice, the Registrar of Companies accepted the date on the charge at face value.

The Sub-committee also accepted that it was probably true that the proposed system would lead to some evidential squabbles, which would not have happened under the existing system, but they did not think that this should be regarded as a disaster.

The Sub-committee therefore recommended adoption of the provisions of the new section 397 of the 1985 Act.

(4) Time limit for registration (new section 398)

The Sub-committee had originally recommended that the time limit for registration of charges be reduced from its present 5 weeks to 14 days.

After consideration of objections to this from various consulted organisations, the Standing Committee decided to recommend that the time limit be 21 days, as in the U.K.

(5) Effect of failure to deliver particulars (new section 399) and late delivery of particulars (new section 400)

Under the existing law in Hong Kong, if a charge is not registered within the time limit of 5 weeks, the company can apply to the court under section 86 of the Companies Ordinance. The court, on being satisfied that the omission to register within the time limit was accidental, or due to inadvertence or to some other sufficient cause, or was not of a nature to prejudice the position of creditors or shareholders, or that on other grounds it is just and equitable to grant relief, may, on such terms and conditions as seem to the court just and expedient, order that the time for registration

shall be extended. The same section also provides for making a similar application to the court for rectification of any omission or mis-statement in the particulars of the charge registered in the Companies Registry.

While this remedy means that an application must be made to the court, it does have the important practical benefit that, if the application is approved, the charge is treated as if it had been validly registered i.e. if the failure to meet the time limit for registration was the fault of, say, the company's solicitors, the company and the chargee are not prejudiced by the failure (although, of course, whoever has to pay the expenses of the application to the court is unhappy). The effect of the new U.K. provisions is to split up total non-registration of the charge and late registration. Basically, they make it easier to register late but this involves a penalty which could be serious in some cases. It is easier to register late because all that is required is to lodge the appropriate form with the Registrar of Companies i.e. there is no need to get the court's approval. The penalty is that the late registration is subject to any rights in favour of

third parties which may have accrued between the expiry of the original time limit for registration and the late registration.

After careful consideration, the Sub-committee formed the view that, on balance, it would be better to retain the existing provisions of section 86 of the Companies Ordinance because they allow the failure to register on time to be put right, while the new U.K. provisions cannot do so completely. The Sub-committee recommended accordingly.

(6) Power of sale (new section 406)

This provision has no equivalent in the former U.K. legislation or in our own Ordinance. The only objection raised by the organisations consulted was with regard to subsection 406(2) which sets out how, once the security property has been disposed of by a chargee exercising power of sale, the proceeds of the sale are to be held by the chargee in trust to be applied -

"First, in discharge of any sum effectively secured by prior incumbrances to which the sale is not made subject;

Second, in payments of all costs, charges and expenses properly incurred by him in connection with the sale, or any previous attempted sale, of the property;"

It was suggested during the consultation exercise that it was more reasonable that the costs of exercise of the power of sale should get first priority.

The Sub-committee agreed and recommended accordingly.

(7) Effect of voidness of a charge (new section 407)

This provides that where a charge becomes void the whole of the sum secured becomes payable on demand, whether or not the sum secured is also secured by another security. This has the effect that payment is accelerated not after the filing time limit has expired but upon an insolvency occurring or another person obtaining an interest in the property.

It was recommended during the consultation exercise that acceleration should occur from the date a charge becomes potentially void.

The Sub-committee agreed and recommended that acceleration of payment should occur upon expiry of the 21 days filing period.

(8) Prescribed particulars of charge (new section 415)

The Sub-committee adopted a recommendation by various consulted organisations that the registered particulars should be required to contain information about any negative convenant not to create further charges or to dispose of the property which is the subject of the charge.

(9) Constructive notice (new section 416)

This is a new provision which has no equivalent in the former U.K. legislation or in our existing ordinance.

Under the old U.K., and our present, law, everyone is deemed to have notice of the existence of a registered charge, although not necessarily notice of its contents.

Under the new U.K. section, only a person who is taking a charge over a company's property, will be taken to have notice "of any matter requiring

registration and disclosed on the register at the time the charge is created". Other persons will not be taken to have notice of matters so disclosed.

During the consultation process, the Association of Banks indicated that it was dissatisfied with this reduction in the scope of persons who will be deemed to have constructive notice of a registered charge.

Nevertheless, the Sub-Committee decided to recommend that Hong Kong adopt the new U.K. provision, subject to an amendment as follows.

They were concerned about the possibility of constructive notice affecting the rights of suppliers of goods to the chargor company. The contracts used by some suppliers of goods sometimes contain retention of title clauses which may constitute a charge over the property concerned. Such suppliers might be deemed by virtue of the new provision to have constructive notice of pre-existing registered charges. The Sub-committee thought that, in practice, it should not be necessary for all suppliers of goods to have to check the terms of any pre-existing registered

charges created by the company. The Sub-committee therefore recommended that the Hong Kong version of this section should include a provision that it would not be deemed to be constructive notice to suppliers of goods to a company.

(10) Filing of copy charge in Registry

There is no obligation in the U.K. for a company creating a charge to file a copy of it in the Companies Registry. Instead, there is a requirement for the company itself to keep a copy at its registered office and make this available for public inspection (New sections 411 and 412 of the 1985 Act).

However, the view was expressed by one of the organisations consulted, that there should be a requirement in the proposed new Hong Kong legislation for a company creating a charge to file a copy in the Registry here.

The Sub-committee agreed that such a requirement would be very convenient for members of the public. They noted, however, that it could cause complications in connection with the new provisions on constructive notice contained in

section 416 of the 1985 Act i.e. there would be constructive notice of all the contents of the copy charges.

As indicated previously, the Sub-committee's Report dealt with a number of other matters which we do not think it appropriate to detail in this Report.

When we discussed the Sub-committee's Report, most of our time was taken up with item (3) i.e. the nature of the certificate to be granted by the Registrar of Companies under the new section 397 of the 1985 Act.

Professor Tyler thought that there had been scare-mongering on this aspect of the new U.K. system i.e. in respect of the loss of the "conclusive" Registrar's certificate under section 83(2) of the Companies Ordinance and the uncertainties which this would allegedly introduce. He thought that it was a misconception that, under section 83(2), the Registrar's certificate was conclusive on all matters. In fact, there was a long line of authorities that it was not conclusive on many matters. It was only conclusive as to date. It was not conclusive as to, for example,

the amount of the charge and it was possible to litigate on this point under the existing system. He thought that the new system would not involve any real change.

The question was then raised as to why, if the proposals would not involve any real change, the existing system should be altered.

The Chairman of the Sub-committee, Mr. Wrangham, explained that it was thought that the existing system did in fact enshrine a number of inequities and that, in practice, it could cause a great deal of inconvenience. What happened was that, because of the ever-increasing work load and shortage of resources, the Registrar of Companies usually did not start to examine the filed particulars of a charge until near the expiry of the statutory time limit for registration. If he then found material points which he thought made the particulars unacceptable for registration, by the time he informed the company of this, it was often too late for the company to attempt to correct the errors and resubmit the particulars for registration within the time limit. This meant that, after the company had dealt with the points raised by the Registrar, it was then necessary to

apply to the court under section 86 of the Ordinance for permission for late filing. The Sub-committee felt that this was unfair.

Mr. Gleeson, as Registrar of Companies, confirmed that if the new U.K. provisions on certificates granted by him were to be introduced, it would eliminate the time delays involved in registration of charges.

After careful consideration we agreed -

(a) to approve the recommendations in the Sub-committee's Report, and

(b) to recommend that the new system should include a requirement to file a copy of every charge in the Companies Registry, but that the Hong Kong equivalent of section 416 of the U.K.'s 1985 Act should make it clear that there will only be constructive notice of the information contained in the filed form of prescribed particulars of the charge i.e. that there will not be constructive notice of the additional information in the filed copy of the charge.

14. Section 98 of the Companies Ordinance (Inspection of register of members)

Section 98(1) of the Companies Ordinance provides that the register of members of a company must be kept available for public inspection in the company's registered office. The fee payable for each inspection by a member of the public is $1, or such less sum as the company may prescribe. This fee was last revised in 1984. No fee is payable by a shareholder.

Section 98(2) provides that anyone may require the company to supply a copy of its register, or any part thereof, on payment of a fee of ¢25, or such less sum as the company may prescribe, for every 100 words or part thereof required to be copied. This fee has not been altered since the section was introduced.

At our April Meeting, we considered a paper by Mr. Gleeson, in his capacity of Registrar of Companies, suggesting that the fee payable under subsection 98(2) should be amended to bring it into line with current market rates. He explained that a large listed company had complained to him that the supplying of copies to members of the public was in effect being subsidized by its shareholders because of the very low level of fees payable.

We agreed that the fee payable under section 98(2) was seriously out-of-date and approved the proposed amendment.

15. Section 109 of the Companies Ordinance (General provisions as to annual returns)

Section 109(1) provides that a company's annual return shall be completed within 42 days of the annual general meeting and that the company shall forthwith forward a copy of it to the Registrar of Companies.

At our November Meeting, we considered a paper by Mr. Gleeson, in his capacity as Registrar of Companies, on the practical effect of this provision. Since most companies tend to hold their annual general meetings around the end of the calendar year, the section means that they have to submit their annual returns to the Companies Registry between 1st January and 11th February or thereabouts. This time limit is usually adhered to because late filing means that a company has to pay a higher fee. The scale of fees payable under the Eighth Schedule to the Companies Ordinance is -

> "Annual registration fee (to be paid on delivery of annual return under section 107) -

(i) if delivered within 42 days after
the annual general meeting $50

(ii) if delivered more than 42 days after
but within 3 months after the annual
general meeting $500

(iii) if delivered more than 3 months after
but within 6 months after the annual
general meeting $1000

(iv) if delivered more than 6 months after
the annual general meeting ....$1500"

As a result, the Companies Registry receives more than double the normal monthly total of documents during the months of January and February. This causes not only serious operational problems for the Registry but also a great deal of inconvenience for members of the public using it, due to the resulting queues in the Registry and delays in actually placing the annual returns on the public files.

Mr. Gleeson submitted that in order to solve the problem, the terms of section 109(1) should be amended as a matter of urgency to require companies to submit their annual

returns on the anniversaries of their respective dates of incorporation. This would spread the workload in the Registry much more evenly throughout the year.

He also proposed that the time limit for filing should be reduced to 28 days.

Transitional arrangements would be required for companies incorporated before the enactment of the proposed new legislation as follows :

(a) if the anniversary of the date of incorporation falls within six months of the date from when the last annual return was filed, the next annual return should be filed not later than 28 days after the next anniversary of the date of incorporation;

(b) if the anniversary of the date of incorporation falls within seven to twelve months of the date from when the last annual return was filed, the next annual return should be filed not later than 28 days after the anniversary of the date of incorporation.

With regard to (a) above, Mr. Gleeson explained that, in the case of some companies, there might be a gap of as much as 18 months before the filing of the annual returns. However, this was regarded as unavoidable given that -

(i) companies would not want to submit a second annual return within six months of the date of the previous annual return; and

(ii) the object of the exercise was not to increase the volume of registration and paper work in the Registry but to achieve a more even spread of registration so that relevant corporate information could be made available to the public at a much earlier date than at present.

With regard to (b) above, it was also pointed out that some companies would have to file their annual returns as early as 7 months after the filing of the previous return and that the problems mentioned in the preceeding paragraph were also relevant. However, against this, there were the following mitigating factors -

(i) submitting an annual return within a period of seven to twelve months from the date when the last annual return was filed would be better than submitting an annual return within a period of six months from the date of the last filing;

(ii) from the angle of public disclosure, a gap of up to 23 months between the filing of annual returns would be unacceptable in terms of the disclosure of important corporate information.

We pointed out to Mr. Gleeson that his proposals had serious practical implications for listed companies, for example -

(a) Under the existing system, the date as at which the list of shareholders required for inclusion in a listed company's annual return was prepared, usually coincided with the book-closing date for the final dividend. The cut-off date was clear and the same list could be used for both purposes. Under the proposed new system, it might be necessary to prepare lists for these two purposes as at two separate dates. The cost of the additional list on a separate date could be very high in the case of a really large company.

(b) There were statutory restrictions on the number of days during which a company could close its register of members (section 99 of the Companies Ordinance : register not to be closed for more than 30 days in any year, extendable to 60 days by ordinary resolution of the company). A company might already have needed to close its register for a dividend payment, for a rights issue, etc. Such closures very quickly ate into the permitted maximum. If the legislation were to pick yet another date for the purposes of the list of members to be included in the annual return, the necessary closure of the register for preparation of the list would eat still further into the permitted maximum.

We suggested that the proposals should not be applied to listed companies unless and until there had been consultations with all the usual interested organisations.

Mr. Gleeson explained that the proposed legislation was intended to be introduced as soon as possible to help solve the practical problems being experienced at the Registry. He therefore proposed that they should be amended to apply only to private companies as defined in section 29 of the Companies Ordinance. After all, private companies made up the vast majority of total companies registered

(298,796 out of a total of 304,538, i.e. 98%, as at 31 December 1991) and spreading the filing of their annual returns more evenly throughout the year would effectively attain the object of the exercise.

On that basis, we agreed with Mr. Gleeson's proposals and recommended that section 109 of the Companies Ordinance be amended to require every private company to file its annual return within 28 days of the anniversary of the date of its incorporation. We also recommended the technical amendments consequential upon this main recommendation, as detailed in Mr. Gleeson's paper, which we do not think it necessary to repeat in this Report. (To avoid any possible doubt, we confirm that we consider that the existing time limit of 42 days should be retained for the filing of annual returns by public companies).

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

In our Seventh Annual Report (subjects considered during 1990) we explained the provisions of the above two sections in the following terms :

"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 be 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."

We also explained recent developments in the U.K. as follows :

"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 preceding 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."

In paragraph 8.7, we explained how Mr. Gleeson, Registrar General, who is a Member of the Standing Committee, had submitted a paper to us proposing that our sections 157E and 157F be repealed and replaced by new legislation based closely on the U.K.'s Company Directors Disqualification Act 1986 ("CDDA"). We also explained that we had instructed the Secretary to write to the usual organisations asking for their views.

At our March Meeting, we considered all the views received as a result of the consultation exercise. In general, the organisations were in favour of the proposals for new legislation in principle, subject to various suggestions for amendment, with some exceptions.

The Hong Kong Society of Accountants felt that there was, in fact, not a great deal of substantive difference between the existing provisions of sections 157E and 157F of the Companies Ordinance and the provisions of the CDDA. The Society commented that there appeared to be a problem of enforcement rather than of ineffective legislation. The Society pointed out that, in fact, they were not aware of any application for disqualification having ever been made under either section 157E or section 157F since the introduction of these in 1984. The Society felt that there appeared to be little point in introducing further legislation unless there was a real intention to use it and resources were made available for this purpose. Nevertheless, the Society commented that, since the differences in the existing and proposed legislation were, in their opinion, so few they had no objection to the introduction of the proposed legislation in principle. However, by the same token, they did not understand the need to bring in the new legislation. As the two sets of provisions appeared very similar, disqualification orders could be made using the existing provisions of the Companies Ordinance. (The Chairman and Mr. Gleeson confirmed that, to the best of their knowledge, no application had ever actually been made to the court under either section 157E or section 157F.)

The Institute of Chartered Secretaries and Administrators in Hong Kong welcomed the proposals in so far as they applied to listed companies but felt that further careful consideration was required before they could be applied to private companies.

As already remarked, all the other organisations consulted were basically in favour of the proposed legislation subject to various suggested amendments. These related to such matters as the length of time for which a person could be banned from being a director etc. and the categories of person who should be entitled to apply to the court for a disqualification order. The respective suggestions varied considerably. The Law Society thought that, in considering an application for an order against a person, the court should have regard to -

(a) the conduct of all business dealings generally;

(b) breaches of securities, futures and investors protection legislation generally (including the Securities (Insider Dealing) Ordinance);

(c) culpability under the Prevention of Bribery Ordinance;

(d) administrative or regulatory action having been taken against a person.

In addition, the Society thought that an order should be automatic where fraud is involved.

After careful consideration of all the submissions, we agreed to recommend approval of the Registrar General's proposals for repealing sections 157E and 157F of the Companies Ordinance and replacing these with the new legislation based on the U.K.'s Company Directors Disqualification Act 1986 as detailed by him in the paper considered by us, subject always to the Administration having careful regard to the amendments suggested by the consulted parties.

However, we also thought that the comments made by the Society of Accountants on the ineffectiveness of the existing legislation due to the lack of resources for enforcement of it, were very pertinent and we urge Government, if the recommended legislation is enacted, to ensure that the necessary resources are made available.

Several of the parties consulted suggested that the concept of "wrongful trading" which now exists in the U.K.'s insolvency legislation should be introduced in Hong Kong and that a conviction for such wrongful trading should be a basis

for presentation of an application for disqualification under the proposed legislation. The introduction of this concept will be considered by the Sub-committee of the Law Reform Commission which is considering reform of the law of insolvency generally and, if the Sub-committee does recommend the introduction of the concept, then we will certainly be sympathetic to a proposal that the new legislation now recommended by us should be expanded as suggested by these consulted parties. However, this will, of course, have to await the outcome of the Sub-committee's deliberations.

17. Section 157H of the Companies Ordinance (Prohibition of loans to directors, etc.) Proposed amendments to the Travel Agents Ordinance, Cap. 218

Section 157H of the Companies Ordinance sets out complicated provisions regulating the granting of loans by a company to any of its directors, either directly or indirectly. There is a general prohibition of such loans in subsection (2) but this is subject to a number of important exceptions set out in subsection (3).

In particular, under subsection (3)(b) a private company (other than a private company which is a member of a group of companies of which a listed company is a member) can make a loan to any of its directors provided that this is approved by a general meeting of the company.

At our November Meeting, we considered a detailed paper by the Trade and Industry Branch of the Administration regarding the terms of subsection (3)(b) in relation to the regulation of Travel Agents under the Travel Agents Ordinance, Cap. 218.

In very brief summary, the paper explained that the Administration was concerned about the fact that 243 of the 840-odd companies registered as travel agents under Cap. 218 had used the exception in subsection 157H(3)(b) to make loans of varying amounts to their directors. Of these 243 companies, 80 were lending to their directors sums which were, in total, in excess of net share equity. That is, if such a company had paid-up capital plus profits, it was lending more than the total of these. Alternatively, where such a company had paid-up capital but had incurred a loss, it was lending more than was in the kitty.

Government therefore proposed that Cap. 218 should be amended to provide that a private company registered as a travel agent under the Ordinance should not be able to take advantage of the exception contained in subsection 157H(3)(b) of the Companies Ordinance.

We had an extensive discussion of the situation with the representative of the Trade and Industry Branch who attended our Meeting and explained that, while we shared his Branch's concern over the situation, we did not feel that an amendment of the type suggested would be a satisfactory solution to the problem. We explained that section 157H had been designed to protect minority shareholders against the actions of directors. What was involved in the travel industry, however, was the problem of protecting funds deposited by members of the public with a company. We did not think that simply prohibiting the company from taking advantage of subsection 157H(3)(b) of the Companies Ordinance would be fully effective. We thought that it would be necessary to consider a system for the protection of such funds along the lines of the protection of clients' funds deposited with solicitors or accountants e.g. the system of stakeholders' accounts used in connection with protection of deposits for purchases of flats.

The representative of the Trade and Industry Branch agreed to consider the situation further and to come back to us in due course.

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 1991

Chairman : The Hon. Mr. Justice Jones,

Members : Mr. Malcolm A. Barnett,

Mr. John R. Brewer,

Mr. Ambrose W.S. Cheung,

Mr. Marvin K.T. Cheung,

Mr. D.E. Connolly, JP,

Mr. Stefan M. Gannon, Legal Adviser, Monetary Affairs Branch,

Mr. Mark Hanson,

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

Mr. Raymond P.L. Kwok,

Mrs. Angelina Lee,

Mr. Alan Smith,

H.H. Judge L.G. Edward Tyler,

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. David Carse, Commissioner of Banking,

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

A Representative of the Attorney General's Chambers,

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

Appendix 3

Meetings held during 1991

Seventy-third Meeting	-	5th January
Seventy-fourth Meeting	-	2nd February
Seventy-fifth Meeting	-	2nd March
Seventy-sixth Meeting	-	13th April
Seventy-seventh Meeting	-	4th May
Seventy-eighth Meeting	-	1st June
Seventy-ninth Meeting	-	6th July
Eightieth Meeting	-	14th September
Eighty-first Meeting	-	5th October
Eighty-second Meeting	-	9th November
Eighty-third Meeting	-	7th December