STANDING COMMITTEE ON COMPANY LAW REFORM

NINTH REPORT TO HIS EXCELLENCY THE GOVERNOR IN COUNCIL

Subjects considered by the Standing Committee during 1992

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Audit of Company Accounts

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

We have been considering this subject since 1988. Our 8th Annual Report (subjects considered during 1991) contained the following :

" 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. "

At our October Meeting, we considered a lengthy paper by our Secretary in which he informed us that the Registrar General had taken legal advice from the Attorney General on the subject.

In very brief summary, the Attorney General had not expressed any serious dissatisfaction with the bases of

the existing legislation and practice but had suggested a number of changes in the Companies Ordinance to assist in raising the standard of the financial information in company accounts.

We decided that we would like to have the views of the organisations usually consulted on these matters on a number of the suggestions made by the Attorney General before we reached any conclusions.

We therefore instructed our Secretary to write to the organisations accordingly and we hope to consider their views at a meeting early in 1993.

We will explain the views of the Attorney General in detail, together with our conclusions on his suggestions for changes in the Companies Ordinance, in our next Report.

(2) Inner Reserves of Banks

As with the foregoing item, this item has been under consideration for some considerable time, pending the outcome of various discussions being carried on between the Administration and the banking industry.

We understand that discussions by the Commissioner of Banking with the Hong Kong Society of Accountants and with the Hong Kong Association of Banks are in progress and we look forward to learning the outcome of these as soon as possible.

(3) Proposal to allow Auditors to incorporate

In our 8th Annual Report we referred to a request from the Hong Kong Society of Accountants to the Administration that section 140(2)(c) of the Companies Ordinance, which prohibits a body corporate from acting as an auditor of a company, should be repealed, thus opening up the possibility of incorporated auditors.

We concluded our comments by saying :

" 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. "

We understand that the discussions between the Monetary Affairs Branch and the Society of Accountants continued during 1992 and that the matter will probably be referred back to us for further consideration in the first half of 1993.

The Cadbury Committee Report

Audit Committees

The draft Report of the Committee chaired by Sir Adrian Cadbury entitled "The Financial Aspects of Corporate Governance" was published in the UK in May and at our meeting in June we considered a paper by our Secretary containing summaries of the Report's main recommendations.

The Cadbury Report proposed that the boards of all listed companies should comply with a 19-point code of best practice which was set out in the Report and recommended that as many other companies as possible should aim at meeting this requirement.

It also proposed that within the next two years all listed companies should have established effective audit committees as required by the Code. The Report stressed the importance of having independent non-executive directors on these committees.

There were many other recommendations designed to increase the effectiveness of audit and the prevention of fraud.

However, as the Report itself said, the proposed code reflects existing best practice and very few of the proposals would require legislation.

There seemed to be only two recommendations for substantial changes to company law, viz :

(1) There should be new legislation to extend to the auditors of <u>all</u> companies the statutory protection available to auditors in the regulated sectors (banks, insurance companies, etc.) so that they can report reasonable suspicion of fraud freely to the appropriate investigatory authorities, and

(2) Directors' service contracts should not exceed three years without shareholders' approval.

We are not aware of any public pressure for either of these amendments in Hong Kong but, of course, if evidence of such pressure should appear we will be happy to consider the situation further.

The Cadbury Report recommended that, if the code of best practice and other recommendations in the Report were adopted, there should be another review two years later to see if they had been adequate and effective in practice.

In an interview reported in The Times of 28th May, Sir Adrian Cadbury warned that, if standards of company reporting and conduct did not rise, legislative regulation would follow.

We discussed the views and recommendations of the Cadbury Report at considerable length and we will certainly keep them in mind during our future deliberations on relevant recommendations for amendments to the Companies Ordinance and related legislation. For example, with regard to the recommendations on audit committees, we have in the past reported that there appears to be general agreement among experts in Hong Kong that banks, more than any other category of company, should have audit committees and that we would prefer to wait and see what developments take place in the banking sector on use of audit committees before reaching a conclusion on whether a general statutory requirement for their appointment would be appropriate. We are still keeping a check on the situation with regard to banks where, although the practice of appointing an audit committee is steadily increasing, it is still far from universal and the constitutions and powers of the committees which have been appointed vary considerably. We do not feel able to recommend a statutory requirement for appointment of audit committees by any particular class of companies at this stage.

Central Clearing and Settlement System "CCASS"

In our last Annual Report we explained that, at our meeting in December 1991, we had considered the draft of the Securities (Clearing Houses) Bill and detailed our observations on the draft.

The Bill itself was Gazetted on 24 January 1992. The published version contained a substantial number of amendments to the draft which we had commented on but none of these appeared to affect the Companies Ordinance and we did not think it necessary to enquire further into them.

The Bill was further amended during its progress through the Legislative Council. The resulting Ordinance was Gazetted on 17 July, 1992 and came into operation on 7 October 1992.

We would like to take the opportunity to emphasize a point which we have made previously. One of the basics of the new system is that all shares in the system will be registered in the name of a common nominee. The Hong Kong Securities Clearing Company Limited will have the power under the terms of Section 115 of the Companies Ordinance (representation of companies at meetings of other companies and of creditors) to appoint corporate representatives in respect of these shares in the system who will be able to attend and vote at meetings of the respective listed companies concerned. We have been advised that, in practice, the Hong Kong Securities Clearing Company Limited will appoint the beneficial owners or controllers of the shares in the system to act as such corporate representatives. We feel very strongly that it is of the greatest importance for proper corporate governance of listed companies that the arrangements for appointing the beneficial owners or controllers as corporate representatives in respect of the shares held in the new system, are run fairly and efficiently.

Prospectuses

Public Offers of Securities and Other Investments

At our February meeting we considered a consultation paper issued by the Securities and Futures Commission ("SFC") which asked us for our comments on a Report on the subject of offers of securities and other

investments prepared by a Working Group formed by the SFC. We also considered a paper by our Secretary raising a number of points in connection with the consultation paper, the more important of which were as follows :

(1) Vetting and Lodgement of Offer Documents (paragraphs 3.83 - 3.86 of the consultation paper). Paragraph 3.84 of the consultation document read as follows:

"3.84 We have considered whether the Commission should retain an ultimate right to scrutinize any particular offering document and to give or withhold approval, notwithstanding that it has transferred the vetting function to the Exchange. We do not consider that an effective check could be made unless the Commission were to review in detail all offering documents for securities for which applications for listing are made. Neitheran occasional spot check nor a cursory scrutiny of documents would in our view be satisfactory. A full review would mean a complete duplication of function with serious consequences for manpower requirements in the Commission. We therefore recommend that the Commission should transfer the vetting function to the Exchange, without retaining any residual power to carry out checks itself other than the power conferred by section 47 of the Securities and Futures Commission Ordinance to call for a re-transfer of the function to itself, and except in the case of investments where it retains responsibility as mentioned in paragraph 3.83. We understand that the Registrar General considers that approval to an offer should be capable of being withheld on public interest grounds, for example if the subject of the offer were politically sensitive. The Commission has set up arrangements with the Exchange to ensure that the Exchange will withhold approval to an offer where this is justified on public policy grounds."

Our Secretary referred to the statement in the last sentence of the paragraph that the SFC had set up arrangements with the Stock Exchange of Hong Kong Limited ("SEHK") to ensure that SEHK would withhold approval to an offer where this was justified on public policy grounds. This seemed to him to suggest that the SFC would retain some influence on the decision as to whether or not to approve an offer which involved some aspect of public policy. On the other hand, the Secretary pointed out that the fifth sentence of paragraph 3.84 recommended that the

SFC should transfer the vetting function to the SEHK without retaining any residual power to carry out checks. The Secretary thought that there was some ambiguity involved. He also thought that if the SEHK, a private sector entity, was indeed to have full power to reject an offer document on public policy grounds, this would be an unusual situation. However if, alternatively, the SEHK would in practice follow the SFC's view on whether a particular offer should be rejected on public policy grounds, would this give rise to queries as to whether the SEHK was exercising its discretion properly?

We reached the conclusion that if any question ever arose as to whether the SEHK had exercised its discretion properly in any particular case, the court's decision would be based on all the circumstances and not simply on whether the SEHK had consulted the SFC.

We also felt that the public would find it very useful if guidelines were published on how the SEHK proposed to exercise its power regarding authorisation of offer documents in respect of listed securities.

(2) The Secretary was of the view that (subject to clarification of what he thought to be the ambiguity in paragraph 3.84 relating to rejection of an offer document on public policy grounds, referred to above) the overall affect of the proposals in the consultation document would be that the SEHK would be in full control of approval of public offers in respect of listed securities, for the following reasons :

(a) The contents of offer documents will be those required under the SEHK's Listing Rules and the Exchange will be able to waive any particular requirement (paragraph 3.71, page 37).

(b) The SFC will not retain any residual power to carry out checks on offer documents (paragraph 3.84, page 40).

(c) The Ordinance will provide, simply, that no offer document will be issued without its having been authorised in advance by the SEHK (paragraph 3.87, page 41). This paragraph of the consultation paper also states : "It would not be right for the Ordinance to require the regulator to satisfy itself that the offer document is not misleading,

or that it contains adequate information for an informed assessment to be made. Wording of that sort places too heavy a burden on the regulators and might open them to civil liability".

The Secretary raised two questions :

(i) Will the SEHK be required to state why it has refused to authorise any particular proposed offer document?

(ii) It was not clear to him why the consultation paper reached the conclusion that it would not be right for the proposed legislation to require the regulator to satisfy itself on the information contained in a proposed prospectus. He pointed out that the Registrar General in his capacity as the Registrar of Companies, has, in effect, been under such an obligation under the provisions of the Companies Ordinance since 1972 and he does not have the benefit of a statutory immunity. (The Secretary was assuming that, as in the case of the Securities (Disclosure of Interests) Ordinance, Cap. 396, the SFC and the SEHK would be given statutory immunities in respect of functions preformed under the proposed legislation.)

With regard to point (i), Mr Hanson in his then capacity as Chief Executive of the SEHK, confirmed that it would certainly be his intention that reasons would be given by the SEHK for any refusal to accept a proposed prospectus. He stated that, under the SEHK's existing listing Rules, it was already necessary for the Exchange to give reasons for such a refusal.

With regard to point (ii), the representative of the SFC at our February meeting, Mr Little, thought that there was a difference between the existing provisions under which the Registrar General accepted prospectuses for registration and those in the proposed legislation, i.e. the difference between the Registrar of Companies having the power under the existing 38D(5) of the Companies Ordinance to refuse to register a prospectus where there was evidence that it was misleading and the possibility of imposing on the SEHK, and the SFC in the case of prospectuses in respect of unlisted securities, a positive duty to enquire into whether or not the material set out in the prospectus might be misleading. He pointed out that although the Working Group had recommended that there

should not be any such duty to investigate the accuracy of the information contained in a proposed prospectus, it would still be open to the regulator to refuse to authorise the prospectus when it came to its attention that the prospectus was misleading.

(3) Mr Kotewall raised a point regarding a recommendation in paragraph 3.107 of the consultation paper which read as follows :

"3.107 We recommend that section 3(1) of the Misrepresentation Ordinance (Cap. 284) should be disapplied for purposes of civil claims arising out of misstatements in offering documents. This section enables damages to be awarded for innocent (as contrasted with fraudulent) misrepresentations, a ground which is essentially the same as that covered now by section 40 of the Companies Ordinance. To preserve both statutory remedies side by side would in our view lead to confusion and overlap. Some commentators have taken a similar point on the U.K. legislation - see for example Gore-Browne on Companies 44th ed. section 11.6."

He pointed out that, apart from the passage in Gore-Browne referred to in the paragraph (which itself acknowledges that there may be differences in the operation of the different provisions) none of the other texts which he had had an opportunity to consult took the same unequivocal view.

Mr Kotewall thought that while there might be some overlap and any confusion should be avoided, he was concerned that taking away the remedy provided for by section 3(1) of Cap. 284 might, in some circumstances, deprive an affected person of an additional recourse. He thought that if section 3(1) of Cap. 284 added nothing (and none of the other text books which he had consulted made the same point) then so be it. But if it could in principle cover a situation not covered by the other provisions then it should be retained. The position was not sufficiently clear to justify taking what might be a fairly drastic step.

Mr Kotewall also supplied us with a detailed list of relevant extracts from leading text books which he felt supported his view.

Mr Little promised that the SFC would give careful consideration to the points made by Mr Kotewall.

(4) "Private Placements"

Mr Smith referred to the discussion in paragraphs 19 and 20 of the consultation paper on documents which could reasonably be regarded as not being offers to the public and which could therefore be exempted from the more onerous requirements which would apply to offers to the public. Paragraph 3.29 of the consultation paper read as follows :

"3.29 At present the Commission assists practitioners by indicating informally, and without legal commitment, how invitations may be issued without their being treated as made "to the public" for the purposes of the Protection of Investors Ordinance. We also understand that, until two or three years ago, the Registrar of Companies had been giving similarly informal views about whether an offer of shares or debentures would require registration of a prospectus (that is, would constitute an offer to the public) for the purposes of the Companies Ordinance. The Commission has taken, as a rule of thumb, 50 as the maximum number of persons who may be approached without the invitation or offer being treated as made to the public. But the Commission also indicates that the circumstances in which invitations or offers are made are relevant, and has informally stipulated at least the following :

(a) not more than 50 copies of the offering document or invitation should be issued;

(b) each copy should be serially numbered;

(c) each copy should be individually addressed to a named person;

(d) each copy should make clear that only the named addressee is entitled to take up the offer or invitation, and that he is not entitled to transfer his acceptance to any other person.

Sometimes, additional matters are stipulated, but the primary concern has been that the number receiving the invitation or offer should not exceed 50, and that the circle of investors should not be widened."

Mr Smith urged that there should be greater flexibility in this matter. He reminded Members that there had not been any scandals associated with private placements in the past. In particular, Mr Smith suggested that paragraph 3.29 should be altered to read that there should not be more than 50 placees, rather than offerees.

The consultation paper also suggested that there should be an exemption for an offer with a minimum individual cash subscription or purchase price of HK$2.5 million (paragraph 3.33). Mr Smith thought that this was quite a substantial sum, which would rule out a significant number of bone fide private placements which were not being distributed widely. He thought that if the figure was reduced to HK$0.5 million or HK$1 million, it would still be the sort of offer which would not be going indiscriminately to the public at large.

Mr Hanson thought that the figure of HK$0.1 million would be reasonable.

Mr Smith next referred to paragraph 3.103 of the consultation paper which was in the following terms :

"3.103 By section 40 of the Companies Ordinance, compensation is payable "to all persons who subscribe for any shares or debentures on the faith of the prospectus ...". This appears to preclude claims by anyone except the original subscriber. In principle, it seems that someone who buys in the secondary market should be entitled to compensation if he suffers loss as a result of a misstatement in the prospectus. We recommend that the legislation make this clear. We further recommend, however, that there should be a cut-off date for such claims by reference to purchases up to say, 6 months after the later of the first issue and the date when the misstatement comes to light. This is because after a period the effect on the market of disclosures in a prospectus wears off and the market makes its own assessment of the investment. Any period which is chosen is necessarily arbitrary, but 6 months appears reasonable."

Mr Smith understood the proposal to mean that a person would be able to claim on the basis of a false statement in a prospectus even if he had never read and relied upon it. He did not think that this was a sound basis for civil liability. He agreed that, if there was a false statement in a prospectus, then obviously there should be some criminal sanction. However, if someone did not read a company's prospectus before he bought shares in it, it did not seem right that, if he subsequently decided he did not like his investment, he could then read through the prospectus with a view to finding an untrue statement which would allow him to sue in the civil courts. It seemed to him that the proposal sought to impose a criminal sanction in the guise of a civil remedy.

Mr Hanson supported Mr Smith's views.

Judge Tyler (who had been a Member of the Working Group whose report was included in the consultation paper) doubted whether liability under the legislation recommended in the consultation paper would be as open-ended as Mr Smith feared. Paragraph 3.105 of the consultation paper also recommended that a claimant would have to establish a "causal connection" between the misleading statement and his loss.

Mr Gannon suggested that the only causal connection which could arise in practice would be the fact that the investor had read the prospectus before he invested and made a loss through relying on the untrue statement contained in it.

Judge Tyler explained that the reason for recommending that the proposal should extend to the secondary market had been that, even though the investor in the secondary market would not himself have read the prospectus for a new offering, market consultants and financial writers would have done so and their public comments and advice would have been to a large extent based on the prospectus i.e. the contents of the prospectus would have filtered down to and affected perceptions in the secondary market. He thought that the reference to a causal connection in paragraph 3.105 of the consultation paper was intended to pick this point up, albeit in a rather vague way. There had to be some sort of reliance on the prospectus.

After our Meeting, the Chairman advised the SFC of our comments on the consultation paper.

Subsequently, Government published a Bill under which the SFC would be responsible for authorisation of prospectuses. The Bill is discussed in the separate section of this Report headed "Prospectuses : Authorisation and Registration."

Prospectuses

Authorisation and Registration

We have dealt separately in this Report with a consultation paper dated December 1991 issued by the Securities and Futures Commission ("SFC") on the general subject of public offers of securities and other investments, which we considered at our February Meeting.

We also mentioned in our 8th Annual Report (subjects considered during 1991) that at our meeting in November 1991 we had considered a paper from the Administration setting out detailed proposals for amendments to the existing provisions of the Companies Ordinance regarding registration of prospectuses which would implement the recommendations on this subject contained in the Report of the Securities Review Committee popularly known as the Hay Davison Report. It might be thought rather odd that such proposed drafting instructions should be submitted to us for our comments in November 1991 when their subject matter was to be included in a public consultation exercise starting the following month, but we were advised that, in view of the urgency of the matter, drafting of the legislation was proceeding in anticipation of a favourable public reception to the proposals during the consultation process.

A draft Bill implementing the drafting instructions considered at our meeting in November 1991 was duly presented to us for consideration at our meeting in May.

Basically, the Bill contained all the provisions necessary to amend the Companies Ordinance to give the SFC the power to authorise prospectuses for registration under the Companies Ordinance. It was explained to us that the SFC would delegate the power to authorise prospectuses in respect of shares in listed companies to the Stock Exchange of Hong Kong Limited ("SEHK"). Once a prospectus had been authorised by the SEHK or the SFC, as appropriate, the

formalities of the actual registration process would be carried out by the Registrar General in his capacity as Registrar of Companies.

We raised a number of points regarding the draft Bill. Most of these were of a very technical nature and we do not think it necessary to detail them in this Report. However, there was a point of principle which we think is of some general importance.

The existing section 40A(1) of the Companies Ordinance provides that where a prospectus includes any untrue statement, any person who authorised the issue of the prospectus shall be liable to imprisonment and a fine (on indictment $0.5 million and 3 years; on summary conviction $0.1 million and 12 months) unless he proves either that the statement was immaterial or that he had reasonable grounds to believe and did up to the time of the issue of the prospectus believe the statement to be true. Section 40A(2) provides that a person shall not be deemed for the purposes of this section to have authorised the issue of a prospectus by reason only of his having given his consent to the inclusion in the prospectus of a statement made by him as an expert.

It is clear from the definition of "prospectus" in section 2 of the Companies Ordinance that section 40A only applies to a prospectus issued by a company incorporated in Hong Kong.

At the time we considered the draft Bill, the provisions of the Companies Ordinance relating to prospectuses of companies incorporated overseas were contained in Part XII (sections 342 - 343) of the Ordinance. They did not include an equivalent of section 40A i.e. there was no provision in the Ordinance for prosecution in respect of an untrue statement in a prospectus for shares in an overseas company.

The draft Bill proposed to change this situation by introducing a new section 342F which would apply section 40A to prospectuses offering shares in companies incorporated overseas. The representative of the SFC present at our meeting in May, Mr Gerard McMahon, explained that the purpose of the proposed new section was to ensure equality of treatment so that parties who authorised prospectuses in respect of Hong Kong companies and those who authorised prospectuses in respect of overseas companies would all be equally liable to prosecution for

any untrue statement contained in a prospectus issued in Hong Kong i.e. to provide a level playing field in this respect.

This proposal was discussed at some length at our May Meeting and a number of subsequent meetings.

The views of Members who objected to the proposed new section 342F can be summarised very briefly as follows:

(a) It was wrong in principle for Hong Kong to introduce a criminal sanction in respect of an untrue statement in a prospectus issued here in respect of shares in a company incorporated overseas, say in the UK. Under UK law the company would have to register the same prospectus in the UK and the UK authorities could prosecute in respect of any untrue statement contained in it. If the company could also be prosecuted in Hong Kong in respect of the same offence it would be subject to double jeopardy.

(b) In any event, the provisions of section 40A were unreasonable. A typical modern prospectus contained 40 - 50 pages, full of technical information and detail. It was not unlikely that there would be an error somewhere, possibly of a very minor nature, such as the age of a non-executive director. None of the other directors who signed the prospectus would be aware of the error nor would it really affect the merits of the shares on offer, but, on a strict interpretation of the section, they would all be liable to prosecution and be subject to potentially heavy penalties. Of course, it was unlikely that a prosecution would take place in such circumstances and, if it did, the directors would be able to take advantage of the statutory defence by proving that the error was immaterial. However, the prosecution would inevitably embarrass the directors and they would be involved in considerable time and expense in defending themselves. The law should be amended to remove the possibility of such a situation by providing that there was only an offence where an untrue statement was material and where the party authorising the prospectus made the statement knowingly and wilfully. Furthermore, it was considered that the reverse-onus nature of the offence in section 40A might be in breach of the Bill of Rights Ordinance.

The views of Members who supported the proposal for the then proposed new section 342F can be summarised as follows :

(a) It was right and reasonable for Hong Kong to have the right to prosecute in respect of any untrue statement in a prospectus which was circulated in Hong Kong and might therefore lead to Hong Kong residents investing in the securities on offer. There was no logical justification for perpetuating a situation in which overseas incorporated companies and their directors issuing false or misleading prospectuses in Hong Kong could be immune from prosecution, whilst companies registered in Hong Kong and their directors could be prosecuted for committing the same acts. The distinction was particularly inappropriate given that the majority of companies listed on the Stock Exchange of Hong Kong are incorporated outside Hong Kong.

(b) The SFC's representative on the Standing Committee had expressed the view to Members that it was of the utmost importance that the existing terms of section 40A should be preserved and that the proposed new section 342F in respect of prospectuses relating to shares in overseas companies should be in basically the same terms. It was clearly in the public interest that no prospectus distributed or circulated in Hong Kong be permitted to contain statements which were not true. Accordingly, it must be appropriate for the law to require all prospectuses distributed or circulated in Hong Kong to be truthful and not misleading to the public, and provide an effective criminal deterrent to prevent misleading prospectuses from being issued. Members of the Standing Committee were also advised that the Attorney General had considered the Bill of Rights Ordinance objection and had formed the opinion that neither the existing section 40A nor the proposed new section 342F was in breach of the Ordinance.

The Administration was advised of the views which had been expressed at the various meetings of the Standing Committee.

In the event, when the Companies (Amendment)(No. 2) Bill 1992 was Gazetted on 3 July 1992, it did contain a

proposed new section 342F which in effect applied the terms of the existing section 40A of the Companies Ordinance to prospectuses in respect of shares in companies incorporated overseas. There were several technical amendments to the wording of the proposed new section during its progress through the Legislative Council but this did not affect the basic provision. The Bill was subsequently Gazetted as the Companies (Amendment) Ordinance 1992 on 24 December 1992 and will come into operation on a day to be appointed by the Governor by notice in the Gazette.

Shadow Directors and Nominee Shareholders

In our 8th Annual Report (subjects considered during 1991) we referred to a paper by the Secretary setting out problems which were alleged to arise for regulators from the common use of corporate directors for private companies in Hong Kong and from what was 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 recorded that we had instructed the Secretary to write to the organisations usually consulted on such matters for their views and to submit them to us in due course.

We duly considered a paper by the Secretary on the results of the consultation exercise at our meeting in March. He explained that he had also taken the opportunity to ask the organisations for their comments on connected problems including nominee shareholders. His letter to the various organisations asking for their views had been along the following lines :

(a) It included a brief summary of the main relevant statutory provisions on the subjects of shadow directors, corporate directors and nominee shareholders;

(b) it commented that the net result of the existing legislation on these subjects was that a private company which was not a member of a group of companies which contained a listed company could have all of its shares registered in the names of nominees and all of its directors could be corporations; for the sake of convenience such a company is hereinafter referred to as "an ordinary private company";

(c) it explained that representations had been made to the Standing Committee that, while regulators recognised that this position had many legitimate commercial advantages, it also meant that an ordinary private company could be a very effective vehicle for commercial crime by reason of the fact that the identity of it's real controllers could easily be concealed from parties dealing with the company;

(d) it explained that some regulators considered that they had insufficient legal power to ascertain the ultimate ownership of an ordinary private company when it was involved in a fraud; the procedures for appointment of an inspector by the Financial Secretary under the provisions of the Companies Ordinance were considered to be neither fast enough nor flexible enough to be fully effective in serious cases of fraud;

(e) it explained that the Standing Committee had not reached any conclusions on the representations made to them but had noted several possible amendments to the existing legislation which might assist regulators, as follows :

(A) Shadow Directors

(i) Heavy increases in the penalties for breach of the provisions of sections 158 and 158B of the Companies Ordinance.

(ii) Introduction of a requirement for the form of annual return of every company to contain a positive statement by the director and secretary signing the return that, to the best of their knowledge and belief, there were no shadow directors of the company other than those named in the annual return (if any). Any director or secretary who wilfully made such a statement which was false in any material particular, knowing it to be false, would be liable to the heavy penalties provided for in section 349 of, and the Twelfth Schedule to, the Companies Ordinance.

(B) Corporate Directors

The introduction of a complete ban on corporate directors, as was originally recommended by the Jenkins' Committee in the U.K. and by the Company Law Revision Committee in Hong Kong in their Second Report published in April 1973 (paragraph 7.6, page 211). Corporate directors are not allowed in Singapore - section 145(2) of the Companies Act.

(C) Nominee Shareholders

The introduction of a requirement for directors of all companies to give details in public registers of their beneficial interests in the shares of the companies. This is the existing law in the U.K. - section 324 of the Companies Act 1985. This would still mean that non-director beneficial owners of shares in an ordinary private company held in the name of nominees would not need to disclose their interests;

(f) it explained that the Standing Committee were very conscious of the legitimate advantages which the existing law on ordinary private companies held for the private sector and were also conscious of the fact that, even if the amendments to the law referred to in (e) above were implemented, they could be avoided to a large extent by intending swindlers switching to the use of overseas incorporated companies to which the new requirements would not apply (although it always had to be kept in mind that the Financial Secretary could appoint inspectors in respect of an overseas company which had, or had had, a place of business in Hong Kong - section 146A of the Companies Ordinance); in short, the Standing Committee were cautious about recommending new provisions which would complicate the carrying on of legitimate businesses but which could be avoided without too much trouble by intending swindlers;

(g) it explained that another approach which had been suggested was that Hong Kong should follow a number of other jurisdictions by requiring every private company carrying on business in Hong Kong to give details of the identity of the beneficial

owners of its shares and of the ultimate controllers of any corporate directors, such information to be kept in confidential files for use by regulators only and not to be disclosed publicly; and

(h) it referred to the fact that this was a complicated and controversial subject and explained that, before reaching any conclusions, the Standing Committee would be very grateful for the views of the organisations consulted, including any information about problems which the existing system caused for their Members.

At our March Meeting, the Secretary reported that, of the nine organisations which had submitted comments in reply to his letter, only three had indicated a degree of support for some of the possible measures referred to in his letter and summarised at (e) and (g) above. A number of organisations thought that the suggestions would be unenforceable in practice especially in view of the fact that would-be swindlers could always resort to the use of off-shore companies, which would not be subject to the suggested new requirements.

The following suggestions for alternative approaches were made :

(a) "We believe that the problem, to the extent that it exists, should be dealt with by means of more effective investigatory remedies rather than massive public disclosure of legitimate private interests" - Hong Kong Association of Banks.

(b) "We suggest that a more effective approach to establishing beneficial ownership in cases under investigation would be legislation which enabled the regulator to conduct an enquiry, having obtained the authority of a magistrate" - Hong Kong General Chamber of Commerce.

(c) "The introduction of more information on the annual return with respect to shadow directors would not only eliminate this practice but would also nullify the use of nominee shareholders since it is common for a shadow director to be a major shareholder as well" - Hong Kong Society of Accountants.

(d) "Therefore we propose that what should happen should be an expansion of relevant investigatory powers and not a general change in the pattern of Hong Kong registration" - Law Society of Hong Kong.

(e) "This Chamber suggests that a clear definition be given for "director" and "shareholder". Difficulties are already being encountered by directors and company secretaries in ascertaining whether any "shadow director" exists in their companies because the concept of "shadow director" is not clear owing to a lack of definition" - Chinese General Chamber of Commerce.

(f) "Moreover, there is no clear legal definition or reference in the Ordinance as to who should fall within the category (of shadow director)" - Chinese Manufacturers Association.

After careful consideration of the detailed replies received from the organisations consulted, we agreed that the best way to approach this problem would be to give regulators greater access to inspections, subject to safeguards to ensure that this would not be abused. We agreed that the existing arrangements for appointing inspectors were too inflexible.

Mr Ip, the Member representing Monetary Affairs Branch at our March Meeting, confirmed that the Branch was considering the whole question of statutory provisions for investigations, resources for such investigations and the delegation of power to authorise an inspection and would come back to us on the subject at a future date.

Purchase by a Company of its own Shares

Possible Use of Unrealised Reserves

Sections 49 - 49S of the Companies Ordinance contain provisions under which companies can purchase their own shares. These provisions were introduced in 1991 and are based to a large extent on the corresponding UK legislation. Although the provisions are fairly complicated, one underlying principle is that companies can only repurchase their shares out of realised profits (or the proceeds of a new issue of shares made for that

purpose). However, private companies can, under sections 49 I - 49 O, purchase their own shares out of capital if there are no distributable profits available. The procedures involved are complicated, with provision for public advertisement of the proposed purchase and an opportunity for any member or creditor of the company who objects to the proposal to apply to the court to have the proposed purchase cancelled. The complications are obviously all designed to prevent abuse of what is, after all, a reduction of the purchasing company's capital, something which until a few years ago was regarded as anathema unless specifically authorised by the courts.

We dealt with various aspects of the subject of repurchase of shares in our Annual Report (subjects considered during 1991) and the last two paragraphs of the Report read as follows :-

> " 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."

The Sub-committee's Report was duly submitted to us for consideration at our April Meeting.

The Report started with a detailed review of the background to the subject which we do not think it necessary to reproduce here, but the summary of the Sub-committee's discussions and conclusions read as follows:-

"In discussions the sub-committee considered the following points :-

- Equality of treatment for Hong Kong listed companies and overseas incorporated companies in ability to buy back shares out of capital reserves "

" The sub-committee acknowledged that some overseas incorporated companies with a listing on the Hong Kong Stock Exchange will be able to use capital reserves to buyback their own shares if the company law in the place of incorporation so permits (such as in Bermuda). Such companies will be only subject to the Code and the Listing Rules which allow buybacks to be financed out of permissible reserves, creating an apparent unfair advantage over locally incorporated companies and possibly encouraging companies to change their place of incorporation.

Members of the sub-committee did not consider that this was a valid reason on its own to permit Hong Kong listed companies to use capital reserves for share buybacks."

"- Relevant regulations in other jurisdictions

The sub-committee studied carefully the restrictions placed on the use of funds for financing share repurchases in other jurisdictions. Apart from the UK, the sub-committee considered requirements in Australia, Canada and the US. In the sub-committee's view, nothing in the requirements of those jurisdictions suggested provisions which could helpfully be incorporated into Hong Kong's own requirements.

- Use of a "Solvency test" in capital redistributions

One of the safeguards which is used to protect creditors of private companies which finance share buybacks from capital reserves, is a solvency test on the company. The Members of the sub-committee did not feel that they wished to extend this provision to listed companies.

- Shareholder Approval

On a slightly separate issue, the Members of the sub-committee considered the suggestion that if capital reserves are to be used to finance a share repurchase there should be a requirement for shareholders to approve the use of such funds on each occasion that it was suggested they should be used. This contrasts with the current arrangement under which all share buybacks must be approved by shareholders under the Companies Ordinance, the Code and the Listing Rules. Under the Listing Rules this approval can take the form of a general mandate for the following year. Under the "

suggested arrangement, the shareholders would be able to grant a general mandate to buyback out of distributable profits without being forced at the same time to permit the use of capital reserves.

On occasions when it was suggested that capital reserves should be used, a separate resolution would have to be passed by a special shareholders meeting, stating the terms of the proposed buyback. The terms could also include a warning about the potential consequences e.g. volatility of the reserves, any personal liabilities of the directors and any requirements to issue new shares (possibly in a depressed property market) if the revaluation reserve fell below a certain amount.

- Restriction of use of capital reserves for buybacks to certain types of "property" companies

The sub-committee considered the suggestion that, since there is a large preponderance of property companies in Hong Kong, the distributable profits test should be changed to accommodate the special needs of these companies.

The Members considered the argument that property companies often have large revaluation reserves which they would like to distribute to shareholders in the form of a share repurchase scheme. Many property companies trade at less than net asset value as investors are aware that property prices are not stable and the company may not be able to realise the reserve. This is compounded by the problem that individual shareholders do not have control over the timing and disposal of the property portfolio. In theory, companies trading at a significant discount to net asset value could buy back the shares and realise the revaluation reserve when selling the properties at the revalued price.

Implicit in accepting this argument is a need to define what type of company would qualify as a "property company". The sub-committee identified two main types of property companies - property investment companies and property development companies, though it was noted that there would be difficulties in achieving a clear distinction between the two, as most property companies engage in both activities. Most property development companies will have a reasonably rapid turnover on their property portfolios and be able to realise the "

" difference (profit) between cost and market value as soon as the property is sold. Property investment companies, on the other hand, will not realise this difference so easily and therefore the difference between cost and market value will be unrealised and constitute an undistributable reserve.

After having considered this argument, Members of the sub-committee decided that it did not justify a special case being made for property companies. There were several reasons for this. First, the Members felt that even if it were possible to find a watertight definition of "property companies", other companies with large property holdings might claim that the exemption should extend equally to them. This type of case, however, is very different. A company headquarters or production facilities held for a company's own use may show a large increase in value on the revaluation reserve account but this is unlikely ever to be realised. Permitting use of these reserves for share buybacks, Members felt, would be inappropriate. The second reason for the Members' decision centred around the volatility of the Hong Kong property market. A revaluation, and the reserves it creates in the accounts, cannot be expected to remain constant as the property market fluctuates.

Quite apart from these two reasons, Members were unconvinced about the accuracy of revaluations, especially on properties which had not been sold for a significant period of time. The sub-committee considered a number of ways in which, it had been suggested, the accuracy of such valuations could be improved. These included a requirement for the valuation to be prepared by an independent valuer meeting international standards for consistency and completeness of reports and a requirement for two valuations to be provided with an interval of time between them, to guard against exploitation of sudden, unsustained movements in property values. The Members of the sub-committee remained unconvinced that these measures would be effective.

- <u>Use of fixed assets other than property for distribution through permissible capital payment</u>

Although Members of the sub-committee had concentrated principally on property revaluation reserves, it was noted that other assets can also create a surplus on revaluation. For instance, securities held for investment purposes could be marked to market. A "

" surplus could also arise on the revaluation of plant and machinery. Members considered that even greater problems arose with these types of assets than with property. Share prices can be more volatile than property prices, making reserves raised by their revaluation correspondingly uncertain. Normally plant and machinery depreciate in value over time rather than appreciate. The problem with valuing this type of asset is the difficulty in obtaining an independent valuation with the same developed standards as those applied to property.

- Restriction of use of capital distribution from revaluation reserves to an agreed percentage

Continuing to explore ways of reducing risks to creditors, Members of the sub-committee studied the possible use of imposing restrictions on the percentage of the revaluation reserves that can be used to make the permissible capital payment. It had been suggested that the percentage should be 50%, but that a lower figure might be required if there were to be no additional creditor protection. Banks are allowed to use a 70% figure when calculating capital adequacy ratios, but this figure is not used to calculate permissible distributions to shareholders.

The sub-committee noted the comments of Mr Tony Nicolle, ex-Commissioner of Banking and a member of the Standing Committee, that in his capacity as Commissioner of Banking, he had allowed a proportion (70%) of unrealised reserves in respect of revaluations of property to be used for the purposes of the capital adequacy rules applying to authorised financial institutions. There had been suggestions that this was a precedent for allowing part of such a reserve to be used for share repurchases. Members noted, however, that Mr Nicolle had been at pains to point out the significant differences between the two situations. In particular, the Standing Committee's recommendations relate to distributable profits while the capital adequacy rules relate to assets which will remain in the authorised financial institutions.

Members of the sub-committee were of the opinion, therefore, that in the light of Mr Nicolle's comments, the Banking Commissioner's practice regarding capital adequacy in no way created a precedent for the use of unrealised reserves in share buybacks. "

"- <u>Re-issue of shares to cover subsequent reductions in the revaluation reserve</u>

As has been mentioned previously, Members of the sub-committee had observed that revaluation reserves are not a constant feature and will change as property prices fluctuate and the nature of the property portfolio changes.

To preserve the capital of the company, Members of the sub-committee considered whether the company should be required to re-issue new shares if the revaluation reserve falls by more than either the capital used in the share buyback or by a fixed percentage. This percentage might be the same as that used to restrict the amount available for distribution, as discussed above.

Members considered that this could cause problems if the reduction in revaluation reserve were due to fall in property values rather than a restructuring of the property portfolio. In this case, the lower property value would be reflected by a lower share price, which would mean that the company would be disadvantaged by issuing the shares in a depressed market. The fall in property values would usually affect all the companies in the sector and other companies might also have to issue new shares, thus depressing share prices further.

Members therefore rejected this as a useful mechanism for the protection of creditors.

- <u>Creditor protection aspects of use of revaluation reserves</u>

Members of the sub-committee recalled that the original prohibition on share repurchases had been imposed partly with a view to protecting a company's creditors. In lifting this prohibition, the new provisions in the Companies Ordinance nevertheless attempted to maintain as great a degree of protection as possible by requiring that share repurchases could only be funded out of distributable profits. Members" therefore felt that permitting the use of revaluation reserves to finance share buybacks went directly against the spirit of the legislation by creating a situation in which there could well be a reduction in a company's permanent capital to the detriment of creditors."

"Conclusion

The Members of the sub-committee considered all aspects of the question of whether the financing of share buybacks by the distribution of capital reserves should be extended to listed companies as well as private companies. The matter was considered with particular reference to property companies, since such companies had been most strongly in support of the inclusion of this provision. The sub-committee's principal concern was that permitting listed companies to use capital reserves in share buybacks could act to the detriment of a company's creditors and Members were interested in suggestions which had been made to minimise this risk.

In the event, none of the possible safeguards considered seemed to outweigh the danger of companies using unrealised reserves for share buybacks. It is therefore recommended that no change be made to the Companies Ordinance. In making this recommendation, it is emphasized that section 79D of the Companies Ordinance does give the Financial Secretary the necessary authority to exempt certain companies from the distributable profits test. It seemed to the Members of the sub-committee that this provided adequate opportunity for property companies, for example, to seek permission to use revaluation reserves and for this permission to be given on a case by case basis, after careful examination of the circumstances of each particular case. "

(End of Sub-committee's Report.)

After very careful consideration of the Report, we agreed to adopt the recommendation of the Sub-committee, i.e. that no change be made to the present provisions of the Companies Ordinance which prevent the use of unrealised reserves from revaluations of property for the purpose of purchasing a company's own shares.

Qualifications of Companies' Secretaries

In our 6th Annual Report (subjects considered during 1989) we reviewed the position regarding qualifications of companies' secretaries (pages 34 to 44).

In that Report, we noted that the statutory position is that section 154 of the Companies Ordinance requires every company to have a secretary but does not

require the holder of the post to possess any specified qualification. The position was the same in the UK until section 79 of the Companies Act 1980 was enacted and introduced certain requirements regarding qualifications to be held by the secretaries of public companies. The section required the directors of a public company to secure that the secretary of the company was a person who, firstly, appeared to them to have the requisite knowledge and experience to discharge the functions of the secretary and, secondly, was either an existing company secretary, or possessed certain legal, accountancy or secretarial qualifications or was "a person who, by virtue of his holding or having held any other position or his being a member of any other body, appear(ed) to the directors to be capable of discharging those functions" (section 79(1)(e)). The section is now section 286 of the Companies Act 1985. There is still no statutory requirement in the UK for the secretary of a private company to hold any qualifications.

We recorded that the Association of the Institute of Chartered Secretaries and the Administrators in Hong Kong (now The Institute of Chartered Secretaries and Administrators in Hong Kong Limited and hereinafter referred to as "the Institute") had approached us in 1984 with a proposal for the introduction of a requirement for companies secretaries in Hong Kong to possess qualifications, and that, in a number of respects, their suggested requirements were more strict than those in the UK. At that time we had concluded that it would not be appropriate to recommend that legislation be introduced along the lines of section 79 of the UK Companies Act 1980 but we had undertaken to take up consideration of the matter again at a future date.

We further recorded that the Institute had requested us to resume consideration of the matter in 1989 and we detailed the public consultation exercise which we carried out subsequently.

We also noted that the Stock Exchange of Hong Kong Limited ("SEHK") had introduced new listing rules which in effect implemented the Institute's recommendations in respect of secretaries of listed companies.

We closed our report for 1989 by explaining that we had decided to resume consideration of the subject after we had had an opportunity to see how the listing rules worked in practice. We also decided to consider the position of secretaries of unlisted companies subject to statutory prudential supervision at the same time.

At our meeting in March 1992 we considered a letter from the Institute suggesting that it would be appropriate to take the matter up again.

In their letter, the Institute accepted that the main thrust of their submission in 1989, i.e. that secretaries of listed companies should be suitably qualified, had been overtaken by the new SEHK listing rules requiring this. However, the Institute asked us to reconsider the position regarding companies, both public unlisted and private, which were subject to regulations over and above those contained in the Companies Ordinance i.e. travel agents, securities dealers, banks, insurance companies, etc. They pointed out that these companies often had onerous compliance requirements to discharge in addition to their obligations under the Companies Ordinance. They commented that it had been disappointing to note that, in recent amendments to the Banking Ordinance, the requirement for the Commissioner of Banking to approve the appointment of the secretary of a bank, in the same manner as he had to approve the appointment of directors, had been repealed.

The Institute explained that they did not believe that it would be appropriate to require the secretaries of all companies to be qualified (as was the case in Singapore) or to confine this requirement solely to listed companies. They suggested that protection could best be achieved by providing for the Financial Secretary or the Secretary for Monetary Affairs to be empowered to declare by Regulation which companies would be required to have qualified secretaries, rather than to have amendments to all the relevant Ordinances.

The Institute confirmed that, if the Standing Committee felt that there was merit in developing the proposal further, they would be pleased to provide further assistance upon request.

We instructed the Standing Committee's Secretary to obtain the views of all the organisations normally consulted by the Standing Committee, regarding the proposals in the Institute's letter.

We duly considered a report by the Secretary on the results of this consultation exercise at our meeting in August.

Replies had been received from six organisations.

We noted that the Hong Kong Association of Banks had confirmed the views which they had set out during the previous consultation exercise in 1989. Very briefly, the Association felt that the requirement for statutory qualifications should extend to all companies, as in the UK, and that if the Standing Committee felt that the requirement should be restricted to listed companies, special provision should be made in respect of insurance companies.

The Law Society of Hong Kong had also confirmed the views which they had previously submitted in 1989. The Society supported a statutory requirement for qualifications in respect of secretaries of listed companies and of certain unlisted companies subject to prudential supervision, specifically banks, deposit-taking companies and insurance companies.

Apart from The Association of Banks and The Law Society, there was no support for any alteration to the existing statutory provisions on the subject.

During our discussions on this subject, a few of us felt that, although the SEHK listing rules do require the secretaries of listed companies to hold certain qualifications, the weakness in this situation is that the only sanction for breach of the listing rules is the suspension of a company's listing or delisting. They thought that it was unlikely that a regulator would invoke his sanction in such circumstances. They therefore thought that it would be preferable to have a statutory requirement in the Companies Ordinance which would have the normal sanction of a fine and, possibly, imprisonment.

Other Members, however, felt that it was highly unlikely in practice that a listed company would risk suspension or delisting by insisting on appointing an unqualified secretary. They felt that there was no need for a back-up requirement in the Companies Ordinance unless and until there was evidence that the listing rules were not being complied with in this respect.

There was very limited support among Members for introducing a requirement for secretaries of unlisted companies which are subject to special statutory regulatory provisions, to possess specified qualifications.

After careful consideration of all the circumstances we decided not to recommend any amendments to the existing provisions of section 154 of the Companies Ordinance.

Registration of Charges

We dealt with this subject at pages 67 - 88 of our 8th Annual Report (subjects considered during 1991) and concluded with approving a Report by a Sub-committee which, basically, recommended that Hong Kong adopt, subject to a number of substantial amendments, the new legislation on registration of company charges which was contained in the UK's Companies Act 1989 but which had not yet been brought into operation when we were considering the Sub-committee's Report.

At the time we approved the Sub-committee's Report, we understood that the new UK legislation would be brought into operation in the very near future.

After we submitted our 8th Annual Report to Government, drafting of the legislation implementing our recommendations proceeded quickly.

However, at our Meeting in May our Secretary reported to us that, as a result of liaison with the authorities in the UK, it had been established that a number of unexpected problems had been discovered there in connection with bringing the new legislation into operation and that the commencement date would be delayed until these had been resolved. He indicated the main points which had arisen in the UK which might also affect our recommendations, but we do not think it appropriate to detail these at present pending the outcome of the continuing review of the situation in the UK. Our Secretary explained that the Administration felt that it would be premature to bring the new legislation recommended by us into operation here before it was seen how the problems which had arisen in the UK had been resolved and consideration had been given as to whether any amendments to our recommendations were required as a result.

According to the information available to us at the end of the year under review, the problems in the UK had not yet been fully resolved and the new provisions on registration of charges in the 1989 Act had not yet been brought into operation. They were the only substantial provisions in the 1989 Act which had not been brought into operation by the end of 1992.

We hope that there will be progress in this matter in the first half of 1993 because this is a subject of great practical importance to both businessmen and professionals.

Statutory Provisions regarding Listed Companies

At our April Meeting, the representative of the Securities and Futures Commission, Mr Pascutto, raised the general question of the role of the Companies Ordinance with regard to listed companies.

Generally speaking, the provisions of the Companies Ordinance apply only to companies incorporated in Hong Kong although there are certain relatively limited requirements for registration of an overseas company which has established a place of business here (Part XI) for the registration of offers of shares or debentures in an overseas company to the Hong Kong public (Part XII) and for the registration of a charge granted by an overseas company which has established a place of business in Hong Kong, over its property situated in Hong Kong (section 91). This follows the UK approach. As Professor Gowwer commented at page 743 of his Principles of Modern Company Law (4th Edition, 1979) :

> "The obvious guiding principle, to which, on the whole, the Anglo-Americian countries have subscribed, is to say that, as a corporation is an artificial entity, its existence and powers should be determined by the law of the country to which it claims to owe its existence, the country of its alleged incorporation."

Mr Pascutto, however, pointed out that the stock market in Hong Kong is unique in having so large a proportion of its listed companies incorporated overseas. At the time he addressed us, the proportion was about 40% of all listed companies. He did not doubt that this proportion would continue to increase and we agreed with that view.

Mr Pascutto also pointed out that, in such circumstances the Companies Ordinance is becoming increasingly irrelevant as far as listed companies are concerned because the vast majority of the provisions do not apply to such a large, and increasing, proportion of the companies.

He raised the question of whether it was intended that the Ordinance should be the Companies Ordinance, i.e. applying to Hong Kong-incorporated companies only, or a Companies and Securities Ordinance which would apply to all companies listed on the Stock Exchange of Hong Kong, wherever they were incorporated.

We agreed that this was a subject which justified further study and we asked Mr Pascutto if he would be good enough to let us have a detailed paper on it. He kindly agreed to do so and we look forward to studying it in due course.

Ultra Vires

We should perhaps preface this section of our Report by observing that this is a subject of considerable complexity, the explanation of which invariably takes up a substantial part of any textbook on company law. We cannot within the confines of a Report of this nature give more than a very brief outline of the principles and problems involved and of the discussions which took place at the various meetings where we have considered the subject.

Our Eighth Annual Report (subjects considered during 1991) contained the following on the subject :

> " During the year, we considered a paper by the Secretary on the new legislation on this subject introduced by sections 108-112 of the UK 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. "

Our Secretary duly reported to us at our meeting in April. He explained that he had written to the organisations usually consulted on such matters and that the terms of his letter could be summarised as follows :

(a) It had referred to the two main approaches to the question of defining the powers of a limited company, i.e.

  (i) the first being to give a company the capacity and powers of a natural person, an approach which had been followed in, for example, Canada, Australia and New Zealand; and

(ii) the second being to provide that the company can pursue only those objects which it is expressly authorised to pursue and that it possesses only those powers which are expressly conferred on it, this being the approach which had been followed in the UK and which had given rise to the doctrine of ultra vires and its associated problems.

(b) It explained that the history of the doctrine of ultra vires was rather long and tangled :

(i) Basically, the doctrine in the UK dated from the late 1800s and is to the effect that a company is formed to pursue the objects stated in its memorandum of association and that if it acts outside these objects, the transaction is ultra vires (beyond its powers); implied powers are restricted to those which are reasonably incidental to the accomplishment of the company's authorised objects;

(ii) The purpose of the doctrine was two-fold : firstly to protect current and prospective shareholders by letting them know the objects for which their money was to be used, and secondly to protect creditors by ensuring that the company's funds were not dissipated in unauthorised activities;

(iii) As Professor Gower put it in his Principles of Modern Company Law (4th Edition, 1979) page 161 :

" Hence anyone dealing with a company may have to ask himself not only whether the officers of the company acting in the matter had authority to do so but also whether the company itself had the capacity to enter into the transaction. The two questions overlap because, if the company lacked capacity, the officers would necessarily have exceeded their authority. If, however, the only flaw was absence of authority the matter could, if the company was so minded, be put right by ratification by the competent organ of the company. If the transaction was beyond its capacity, it could not.

Because of the overlapping of capacity and authority it is not possible to treat the two entirely separately.";

(iv) What has happened in practice is that businessmen have covered themselves by specifying in the objects clause of the memorandum of association of a typical company not only the business which the company was initially intended to follow but also all of the other businesses which it might conceivably want to turn to in the future; thus it is not unusual for a modern gold-mining company to include in its memorandum the power to operate a fried-fish shop;

(v) The courts, in their turn, have tried to curb excesses in this practice of specifying all possible objects for a business;

(vi) The end result has been, as Mr David S Glass remarked wryly in an article in the Company Lawyer (Volume II, No. 7), that "English case law developed, analysed, distinguished and ultimately confused the traditional doctrine of 'ultra vires' in many ways and now the legislators are having a go with new provisions contained in sections 108-112 (inclusive) of the Companies Act 1989."

(Section 35 of the Companies Act 1985 had enabled ultra vires transactions to be enforced against, but not by, companies in certain circumstances. However, there was widespread dissatisfaction with the section because it was subject to a number of restrictions which limited its practical effect);

(c) It commented that it might be useful to recall that, at one time, it seemed that the UK might adopt the approach now followed in Canada and Australia;

(d) It explained that the present legislation in the UK took its shape from the UK joining the European Community because the EC approach is basically to restrict a company's capacity while at the same time ensuring that third parties dealing with the company are not prejudiced by the company's lack of capacity, e.g. article 9 of the EC's First Directive on company law required member states to provide that acts done by organs of a company would be binding on the company, even if not

within the company's objects. This obviously presupposed the continued existence of specification of objects in the company's constitution. In implementing the EC's approach to the subject, the UK :

(i) passed section 9(1) of the European Communities Act 1972 which later became section 35 of the Companies Act 1985; and

(ii) has now passed sections 108-112 of the Companies Act 1989.

The letter also enclosed a commentary on the new legislation from a professional journal which explained the new legislation and also commented upon the problems still remaining with regard to the law on ultra vires notwithstanding the new legislation;

(e) It explained the present position in Hong Kong, which is, basically, that we have a number of relevant provisions in the Companies Ordinance (section 5(5), section 8 and the seventh schedule) which are useful but of a relatively minor nature and which have not affected the operation of the ultra vires doctrine to any significant extent (we do not even have an equivalent of section 35 of the Companies Act 1985);

(f) It explained that the Standing Committee were considering what further legislation, if any, was required in Hong Kong and that the Committee would be very grateful for the views of each organisation on the subject of ultra vires generally and, particularly, :

(i) whether Hong Kong should continue to follow the UK precedent, and introduce new legislation along the lines of the provisions introduced by the Companies Act 1989 subject to any amendments which the organisation might think desirable; or

(ii) whether Hong Kong should instead follow the Canadian and Australian precedents by granting companies the capacity and powers of a natural person.

At our April Meeting, the Secretary reported that he had received replies from seven of the organisations consulted, viz : from the Hong Kong Bar Association, the Law Society of Hong Kong, the Hong Kong Society of Accountants, the Hong Kong Association of Banks, the Institute of Chartered Secretaries and Administrators in Hong Kong, the Hong Kong General Chamber of Commerce and the Chinese General Chamber of Commerce. With the exception of the Law Society, all the organisations felt that Hong Kong should abandon the existing British approach and follow the Canadian and Australian models by giving a company all the powers of a natural person.

The Law Society preferred to follow the UK approach since Hong Kong company law already follows English law, both statutory and common law, closely. They therefore proposed legislation that would :

(a) abolish the ultra vires rule; they recommended adoption of amended versions of sections 35, 35A and 35B of the Companies Act 1985 (as amended);

(b) render transactions with directors or connected parties voidable at the instance of the company; they recommended adoption of the amended version of section 322A of the Companies Acts 1985 (as amended); and

(c) safeguard charitable companies.

They provided a very detailed and useful exposition of their proposals.

In our ensuing discussions of the results of the consultation exercise, there was general agreement that anything which would reduce the present burden of having to study carefully the objects clause in a company's memorandum of association would be welcome. It was felt that, provided that the shareholders in a company had adequate protection against the abuse of power by their directors, there was no good reason why third parties should be disadvantaged by technicalities in the company's memorandum of association.

Some of us were very disappointed to note that various expert commentaries on the latest attempts in the UK to produce satisfactory legislation on ultra vires had expressed the view that there were still various aspects

which gave grounds for concern. To take one recent example, Eilis Ferran concluded a two part article in the "Company Lawyer" (Volume 13 No. 9) on the subject by stating :

> "Nevertheless, it is regrettable that new legislation in such an important area of English company law should be so uncertain in its effect that the best advice is simply to ignore it and carry on as if nothing had changed and the ultra vires rule and its relatives, such as the constructive notice rule, retained their full force and effect."

The representative of the Securities and Futures Commission present at our April meeting, Mr Pascutto, who is a Canadian, commented that, coming from a jurisdiction which had had the "natural person" provision for 20 years, he found it astonishing that the rest of the world had not caught up yet. He thought that the drafting of objects clauses was an exercise in futility. He felt that giving a company the powers of a natural person was part of the natural evolution of company law and was of the opinion that doing so in Canada had not given rise to any problems there.

The view was also expressed by Mr Kotewall, however, that many of the problems associated with the long objects clauses under the existing system could be removed if a "shorthand" approach was adopted by using a so-called "Cotman -V- Brougham" objects clause. In that 1918 House of Lords case Lord Wrenbury had criticised the system of setting out numerous objects and powers in a company's memorandum of association and had urged that it should be a short clause confined strictly to setting out the company's authorised business. Mr Kotewall pointed out that such an approach was being used in a few other jurisdictions which followed the UK system of company law.

After careful consideration of all the problems resulting from the existing ultra vires doctrine here and in the UK and of the seeming inability of the UK legislature to produce legislation which dealt with these problems in a wholly satisfactory way, we agreed to recommend that the "powers of a natural person" approach based on the Canadian model should be adopted in Hong Kong and that all necessary amendments to the Companies Ordinance should be made accordingly.

At our Meeting in August we considered detailed comments which had been received at the beginning of July from the Chinese Manufacturers' Association of Hong Kong in

response to the Secretary's original request. Basically, the Association were not in favour of adopting the Canadian/Australian approach and preferred to adhere to the UK model subject to certain amendments. After careful consideration of the Association's views, however, we decided that we still preferred the Canadian approach.

Having reached a decision in principle to follow the Canadian model, we went on at a subsequent meeting to consider a paper on the subject by our Secretary in which he referred to the following statements by Professor Gower in "Modern Company Law" (4th Edition 1979) in the chapter on "Ultra Vires : Reform", pages 179 to 180 :

> " We ought to be able to do better than any of our efforts so far. What seems to be needed is :
>
> (1) total abolition of the ultra vires rule in so far as it affects the capacity of companies;
>
> (2) total abolition of the constructive notice rule relating to any 'public documents';
>
> (3) express provision that except as provided by statute or by its memorandum a company can carry on any business or other activity and exercise any powers to the same extent as a natural person of full capacity;
>
> (4) express provision that any limitation in the memorandum or articles on the objects or powers of the company or any limitation, whether in the memorandum or articles or resulting from a decision of the competent organ of the company, on the authority which an organ or officer of the company would have had in the absence of such
>
> limitation shall not affect a third party unless he actually knows of it and should have realised that it deprived the organ or officer of authority in the relevant transaction.
>
> Perhaps the Commonwealth provisions which come closest to this prescription are those in the Canada Business Corporation Act 1975. We still fall woefully short; how far, will be apparent when the present position regarding the liability of a company for the acts of its organs or officers is analysed in the next Chapter. "

The Secretary also referred to sections 15 - 19 of the Ontario Business Corporations Act 1982 and drew our attention to the following points. (It should be kept in mind that the Canadian 'articles' of a corporation equate to a company's memorandum of association in Hong Kong.) :

(a) section 15 gives a corporation the capacity and the rights and powers of a natural person;

(b) section 17(2) allows the corporation to provide in its articles that it shall not carry on a particular business;

(c) section 17(3) provides that notwithstanding subsection (2) no act of a corporation is invalid by reason only that it is contrary to the articles, etc; this is supplemented by the "Indoor management rule" provisions in section 19; and

(d) section 18 provides that no one is affected by or is deemed to have notice or knowledge of the contents of a document concerning a corporation by reason only that the document has been filed with the Canadian equivalent of our Companies Registry or is available for inspection at an office of the corporation.

The Secretary suggested that, as we had already recommended adoption of the first part of the Canadian approach, i.e. giving a company the powers of a natural person, it would be logical to adopt the other aspects of this approach as set out in sections 17, 18 and 19 of the 1982 Act.

We agreed that the provisions of sections 17 and 19 appeared suitable but asked for a further paper on the subject of constructive notice.

In his further paper, the Secretary compared the respective provisions on constructive notice in the Ontario Business Corporations Act 1982 and the UK's Companies Act 1985, which are in the following terms :

<u>Ontario</u> :

"18. Where notice is not deemed. - No person is

affected by or is deemed to have notice or knowledge of the contents of a document concerning a corporation by reason only that the document has been filed with the Director or is available for inspection at an office of the corporation. "

United Kingdom :

"711A Exclusion of deemed notice

(1) A person shall not be taken to have notice of any matter merely because of its being disclosed in any document kept by the registrar of companies (and thus available for inspection) or made available by the company for inspection.

(2) This does not affect the question whether a person is affected by notice of any matter by reason of a failure to make such inquiries as ought reasonably to be made.

(3) In this section 'document' includes any material which contains information.

(4) Nothing in this section affects the operation of -

(a) section 416 of this Act (under which a person taking a charge over a company's property is deemed to have notice of matters disclosed on the companies charges register), or

(b) section 198 of the Law of Property Act 1925 as it applies by virtue of section 3(7) of the Land Charges Act 1972 (under which the registration of certain land charges under Part XII, or Chapter III of Part XXIII, of this Act is deemed to constitute actual notice for all purposes connected with the land affected). "

As can be seen, the UK's section 711A(1) is very similar to the Canadian section.

Our Secretary explained that his first reaction to the UK's subsection (2) was that it introduced an area of considerable doubt by providing that subsection (1) did not affect the question of whether a person was affected by notice of any matter by reason of failure to make such

enquiries "as ought reasonably to be made". He felt that this was too vague. He had subsequently read a number of articles which also expressed doubt about the subsection and he supplied copies of these for study. For example, an article in the Company Lawyer (Volume 12, No. 5) commented:

> " Secondly, the most obscure exception to the abrogation of the constructive notice rule is in the form of s 711A(2), which provides that as an exception to the abolition of the constructive notice rule :
>
> > 'This does not affect the question whether a person is affected by notice of any matter by reason of a failure to make such inquiries as ought reasonably to be made'.
>
> This subsection begs the question as to what is meant by 'inquiries as ought reasonably to be made'. "

Our Secretary suggested that there was no need for Hong Kong to adopt a subsection which, at best, seemed to be designed to deal with hard cases and which, at worst, might prejudice the effectiveness of abolition of the doctrine of constructive notice. We agreed with this view.

With regard to the exemption set out in subsection 711A(4), our Secretary pointed out that, at present, Hong Kong does not have statutory provisions corresponding to those exempted by the subsection. He also advised us, however, that there was a distinct possibility that there might be corresponding provisions in place by the time the legislation we are now recommending on the subject of ultra vires is enacted and suggested that, if they did come into existence by that time, the new corresponding provisions should be also exempted as in the UK. We agreed.

We therefore recommended that the Companies Ordinance be amended by adopting section 711A(1) and (3) of the UK Companies Act 1985, with an equivalent of subsection 711A(4) if appropriate.

<u>Summary</u>

We recommended that the Companies Ordinance be amended by adopting provisions on the subject of ultra vires and capacity of directors equivalent to those in sections 15, 17 and 19 of the Ontario Business Corporations Act 1982, as amended.

We also recommended that the Ordinance be amended by adopting the provisions with regard to abolition of the doctrine of constructive notice contained in section 711A(1) and (3) of the UK Companies Act 1985, with an equivalent of section 711A(4) if appropriate.

We have instructed our Secretary to prepare for our consideration a detailed list of the amendments to the Companies Ordinance which the above recommendations in principle would entail.

Section 111 of the Companies Ordinance (Annual General Meeting)

Section 111(1) of the Companies Ordinance provides to the effect that every company shall hold an annual general meeting in each calendar year and that not more than 15 months, or such longer period as the Registrar of Companies may in any particular case authorise in writing, shall elapse between the date of one annual general meeting and the next. The proviso to subsection (1) lays down that so long as the company holds its first annual general meeting within 18 months of its incorporation, it need not hold it in the year of its incorporation or in the following year.

Section 111(1) is based very closely on the corresponding section 131(1) of the UK's Companies Act 1948 (now section 366 of the Companies Act 1985) with the exception that the UK provision does not contain the power for the Registrar of Companies to extend the time limit of 15 months between annual general meetings. This power was inserted in our section 111(1) in 1984 in implementation of a recommendation made by the Companies Law Revision Committee in their Second Report.

At our October Meeting, we considered a paper by our Secretary in which he explained that, earlier in the year, the Law Society of Hong Kong had commented on two Bills to the Ad hoc Groups of Legislative Council Members set up to consider these Bills and in each case had added observations which included the following :

" (U)nder section 111, the Registrar of Companies may authorise in writing the extension of the time limit for holding an annual general meeting. This

power relates only to the period between annual general meetings but the Registrar has no power to extend the 18 months period for the holding of the first annual general meeting. The Committee would suggest that the powers of the Registrar under section 111 be widened to cover extensions to the period for holding the first annual general meeting as well as subsequent annual general meetings."

After careful consideration we decided regretfully that we could not support the Law Society's recommendation. We felt that it is important that the first annual general meeting of any company should be held within 18 months of its incorporation and that any deferral of the meeting beyond then would be to the detriment of general shareholders.

We recognised that it is appropriate for the Registrar of Companies to have the power to extend the time limit for subsequent annual general meetings, because there might be routine operational considerations, relating to financial requirements for example, which could justify such extensions. However, we could not see any justification for delaying a company's first annual general meeting beyond 18 months from its incorporation.

Sections 157E and 157F of the Companies Ordinance

Disqualification of Company Directors

We dealt with this topic at pages 96 - 103 of our 8th Annual Report (subjects considered during 1991).

We agreed (page 102) to recommend approval of proposals by the Registrar General, in his capacity as Official Receiver, to repeal the existing sections 157E and 157F of the Companies Ordinance and to replace these with a new Ordinance based on the UK's Company Directors Disqualification Act 1986, subject to the Administration having careful regard to various amendments which had been suggested by the organisations which we had consulted on the Registrar General's proposals.

Under the UK legislation, as under our existing sections 157E and 157F, only the court can impose disqualification orders.

At our meeting in June, our Secretary reported that the Registrar General had submitted for consideration a further proposal that the proposed new legislation should also include an equivalent of section 600 of the Australian Companies Code. In summary, that section applies to a person who has been a director of two or more companies which have gone into insolvent liquidation within 7 years of each other and where the liquidators have reported that the unsecured creditors have received less than a 50% dividend. The Corporate Affairs Commission may serve on such a person a notice requiring him to show cause why he should not be prohibited from being a director or from being in any way (directly or indirectly) concerned in or taking part in the management of a company without the leave of the court. The onus is placed on the person concerned to prove that his conduct has been such that a prohibition should not be placed upon him.

The Registrar General believed that section 600 had achieved a large measure of success in Australia. He also believed that the provision represented a reasonable compromise between automatic disqualification, which some considered too extreme, and the UK's disqualification provisions, which some thought leaned too far in favour of directors. The Registrar General suggested that, if an equivalent of section 600 were to be adopted then he, in his capacity as Official Receiver, should be the enforcement authority.

After considerable discussion of various technical aspects of these proposals, we agreed to recommend that the new Ordinance on Disqualification of Directors should contain an equivalent of section 600 of the Australian Companies Code, with the Official Receiver being the enforcement authority. For the avoidance of doubt, we confirm that this new provision should be supplementary to and not in replacement of, the provisions recommended in our 8th Annual Report.

Section 165 of the Companies Ordinance (Provisions as to liability of officers and auditors)

Section 165 of the Companies Ordinance is in the following terms :

" Subject as hereinafter provided, any provision, whether contained in the articles of a company or in any contract with a company or otherwise, for exempting

any officer of the company, or any person employed by the company as auditor from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty or breach of trust of which he may be guilty in relation to the company shall be void :

Provided that -

(a) (Repealed 6 of 1984 s. 122)

(b) nothing in this section shall operate to deprive any person of any exemption or right to be indemnified in respect of anything done or omitted to be done by him while any such provision was in force; and

(c) notwithstanding anything in this section, a company may, in pursuance of any such provision as aforesaid, indemnify any such officer or auditor against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgement is given in his favour or in which he is acquitted or in connexion with any application under section 358 in which relief is granted to him by the court. "

This section is based on section 152 of the Companies Act 1929. That section in due course became section 205 of the Companies Act 1948 and then section 310 of the Companies Act 1985, with only comparatively minor changes in drafting along the way.

However, section 137 of the Companies Act 1989 introduced an important clarification of the meaning of section 310 of the 1985 Act by introducing the following new subsection (3)(a) :

"(3) This section does not prevent a company -

(a) from purchasing and maintaining for any such officer or auditor insurance against any such liability, or "

At our December Meeting, we considered a paper by our Secretary in which he drew our attention to an article entitled "Directors and Officers Liability" by Mr Malcolm Brown which appeared in the November issue of the "Company

Secretary" published by the Institute of Chartered Secretaries and Administrators in Hong Kong. In the article, Mr Brown suggested that it was desirable for our section 165 to be amended in the same way as the corresponding provision in the UK had been, and thus put the position regarding the ability of a company to purchase directors and officers insurance beyond doubt.

We were generally sympathetic to amending section 165 as suggested but decided that, before making a final decision on the subject, it would be logical to appoint a Sub-committee to review the duties and responsibilities of company directors in Hong Kong.

We therefore appointed a Sub-committee of five members to consider the subject and report back to us as soon as possible.

Section 206 of the Companies Ordinance (Meetings of Creditors and Contributories to Determine Whether Committee of Inspection shall be Appointed)

Section 206 applies in the case of liquidations by the court and is in the following terms :

" (1) When a winding-up order has been made by the court, it shall be the business of the separate meetings of creditors and contributories summoned for the purpose of determining whether or not an application should be made to the court for appointing a liquidator in place of the Official Receiver, to determine further whether or not an application is to be made to the court for the appointment of a committee of inspection to act with the liquidator and who are to be members of the committee if appointed.

(2) The court may make any appointment and order required to give effect to any such determination, and if there is a difference between the determinations of the meetings of the creditors and contributories in respect of the matters aforesaid the court shall decide the difference and make such order thereon as the court may think fit."

At our meeting in April, the Chairman referred to an order which he had recently made in respect of an application under section 206 by the Official Receiver as provisional liquidator for appointment of a committee of

inspection in the highly-publicised liquidations of BCCI Finance International Limited and Bank of Credit and Commerce Hong Kong Limited. The Official Receiver had nominated as members of the proposed committee five individuals together with a firm of solicitors and a very substantial corporate creditor, making a total of seven in member. However, three other individuals had addressed the Chairman with a request that two of them should be added to the list of members.

This was the first time in the Chairman's experience on the bench that an application had been made for additional persons to be appointed to a committee of inspection. Section 206 does not provide for any particular number to be appointed but the Official Receiver had drawn the Chairman's attention to the fact that, in England, Rule 4.152 of the Insolvency Law 1986 provides that a liquidation committee shall consist of a minimum of three and not more than five creditors of the company elected by the meeting of creditors.

The Chairman had decided that it would be undesirable to have too many persons serving on the committee, for it could become unwieldy. Indeed, the number suggested by the Official Receiver already exceeded that prescribed in England.

He had granted an order in terms of the Official Receiver's application but had commented that he would raise in the Standing Committee the question of whether there should be a provision for minimum and maximum membership similar to that existing in England.

During our discussion of the subject, Mr Gleeson, in his capacity as Official Receiver, agreed with the Chairman's view that it was not helpful to have a large committee of inspection because it would tend to bog down the business of the liquidation. The BCCI case had been exceptional in terms of both the amount of money and the number of creditors involved and it had been thought appropriate, as an exceptional measure, to have a committee of seven members. He also agreed with the view expressed by Mr Kotewall that it would be desirable, if Hong Kong was to adopt a provision similar to that existing in the UK, to preserve a degree of flexibility e.g. it should require "not more than five members, unless the court directed otherwise".

As the Law Reform Commission has appointed a Sub-committee to consider the Law on insolvency, i.e. the law on bankruptcy of individuals as well as the law on liquidation of companies, we directed the Secretary to refer this matter, with a note of the views expressed at our meeting, to the Sub-committee for consideration.

Section 265 of the Companies Ordinance (Preferential Payments)

Preferential Payments to Small Depositors on Liquidation of a Bank

Section 265 of the Companies Ordinance sets out detailed rules regarding preferential creditors, in the liquidation of a company.

During 1992 we considered three papers prepared by the Monetary Affairs Branch (MAB) on a suggestion that Section 265 should be amended by adding to the existing categories of preferred creditors, the holders of small deposits in a bank which has gone into liquidation.

It was clear that the proposal had been precipitated by the closure in July 1991 of the Bank of Credit and Commerce Hong Kong Limited ("BCCHK") a locally incorporated subsidiary of the Bank of Credit and Commerce International Limited ("BCCI"). There is no form of statutory deposit protection scheme in Hong Kong so that depositors in BCCHK were in the same legal position as ordinary creditors of the bank.

In their first paper, the MAB explained that there would be a public consultation exercise regarding the merits of a statutory deposit protection scheme but that, as an alternative, they would like our views on the possibility of introducing amendments to the Companies Ordinance to give priority status to small depositors on the liquidation of a bank. Briefly, the proposal was that anyone who was a depositor of a bank and whose deposit was less than a certain figure should be given statutory priority in respect of such deposit, either to rank pari passu with or immediately after the existing preferential debts set out in Section 265 of the Companies Ordinance.

By the time they issued their third paper for consideration, the MAB had refined the proposal as follows:

> Small creditors with claims of HK$100,000 or less would be given priority under Section 265 in the event of liquidation of a locally incorporated bank. Large creditors would have an option to continue to rank for dividends which would be paid throughout the liquidation in the ordinary way, or to elect to accept HK$100,000 and waive the balance of their claims. The election could be made at any time up to, say, one year from the date of the making of the winding-up order. Deposits placed by both residents of Hong Kong and non-residents would receive the same treatment as would depositors in the local branches and foreign branches of a locally incorporated bank.

We should make it clear at this stage that we did not take part in the public consultation exercise on the merits of a statutory deposit protection scheme. For the purposes of our consideration of the proposals to give small depositors preference under Section 265 we were, in effect, asked to assume that a statutory deposit protection scheme would not be acceptable and that the proposal to amend Section 265 was the only option available.

Some of us felt that the proposal to amend Section 265 was objectionable in principle. Judge Tyler, who was, and continues to be, Chairman of a Law Reform Commission Sub-committee considering general reform of the law of insolvency, pointed out that the trend elsewhere in the world was to cut down on the number of preferential creditors and to give equal treatment to the general body of creditors. In Hong Kong, however, the list of preferential creditors was being added to constantly. To take two recent examples, in 1991 various payments from the Employees Compensation Assistance Fund were given preference under section 265(1)(ce) and (ea) and in 1992 various sums in respect of unpaid contributions etc. under the Occupational Retirement Schemes Ordinance (88 of 1992) were given preference under section 265(1)(cf) and (cg). Judge Tyler also thought that depositors were under a duty, like other investors, to take reasonable care in deciding in which banks they should place their deposits. If they chose to deposit in an institution because, for example, it gave a better rate of interest than other banks, they had to accept that the higher reward involved a higher degree of risk. He did not see why depositors in banks should receive better treatment than other investors if their

investment decisions eventually turned out to be unwise. The rule "caveat emptor" should apply. However, his main objection was to the further erosion of the principle of pari passu treatment of creditors which he considers to be a fundamental principle of insolvency law.

Mr Hanson pointed out that, on the liquidation of a bank, shareholders were given no special consideration at all. He thought it would be unfair for the legislature to give preferential treatment to one class of investors in the bank, the small depositors, and to ignore the plight of another class, the small shareholders.

Other Members recognised the force of these objections to the proposals and supported them.

The Chairman commented that the basis for granting any preferential treatment to a class of creditors must surely be the existence of special hardship for that class. He pointed out that, in fact, no evidence had been presented to the Standing Committee showing that, in the case of BCCHK, any small depositors had suffered special hardship as a result of the existing statutory provisions.

In contrast, the view was expressed by Mr Gleeson that the position of small depositors in banks had a number of features which justified special treatment. Such people, he suggested, should be regarded as savers rather than investors. They were not in the same category as people who played the stock market. Mr Gleeson understood that in the case of those who had deposited their money with BCCHK, many of them had not in fact obtained any higher rate of interest than they would have received from other banks. In addition, they had not been qualified to assess the degree of risk involved in depositing with BCCHK rather than with any other authorised institutions. They were small-time savers rather than speculating investors.

Mr Carse thought that there should be special treatment for bank depositors because banks occupied a special place in the financial system. The collapse of a bank would inevitably have more far-reaching consequences than the collapse of any other company. Banks were also unique to the extent to which they geared up. That was the whole essence of banking. They had a small shareholder base and took large amounts of deposits in order to carry on business. For these reasons, depositors deserved special protection.

These views were also supported by a number of other Members. However, the Members who supported the principle of giving some degree of preferential treatment to small depositors pointed out that the papers presented by the MAB only dealt with the principles and that there were many points of technical detail which would have to be dealt with satisfactorily before any final decision could be reached on whether Section 265 should be amended. There were, for example, problems in defining "depositor".

The members in favour of the proposal to amend Section 265 also felt that if the scheme was to be successful in practice it would have to have two basic features - speed and certainty. Small depositors could not be asked to wait for long periods while means-tests were carried out or while it was worked out whether an individual had one account or fifteen accounts with the bank, how preferences were to be applied, why the individual's name was spelt differently in different accounts, the position regarding set-off etc.. Under existing legislation on the conduct of a liquidation, it would be years before the liquidator could make a payment to depositors. Such a situation would defeat the whole purpose of the proposed exercise. If a scheme of the type proposed was to be adopted, the laws on insolvency would have to be changed to allow the liquidator to make the payments to small depositors within six months, with immunity for the liquidator except in the case of gross negligence. The preference would have to be restricted to a narrow range of accounts : say, savings accounts. It would also be necessary to restrict the preference to individuals and to exclude companies, thus avoiding problems of segregation and set-off.

In summary, Members in favour of the proposals considered that preference would have to be restricted to specified types of savings accounts with a specified ceiling limit, i.e. a maximum amount which an individual could claim irrespective of how many accounts he held with the bank. The liquidator would also have to be given power to make payments quickly with an immunity except in case of gross negligence. Members felt that if a scheme along these lines could not be implemented, the proposals should be withdrawn because it is unlikely that they would work in practice.

The MAB have been informed of the Standing Committee's views.

(In their third paper on the subject, considered at our October Meeting, the MAB proposed that the suggested preference for small depositors should be extended to trade creditors, but this proposal was rejected. By way of illustration the Standing Committee could see no reason why a supplier of stationery to a bank in liquidation should be a preferred creditor while a supplier of stationery to, a hotel-owning company in liquidation would not).

Section 292 of the Companies Ordinance

(Property of dissolved company to be bona vacantia)

Section 292 of the Companies Ordinance is in the following terms :

" Where a company is dissolved, all property and rights whatsoever vested in or held on trust for the company immediately before its dissolution (including leasehold property but not including property held by the company on trust for any other person) shall, subject and without prejudice to any order which may at any time be made by the court under sections 290 and 291, be deemed to be bona vacantia and shall accordingly belong to the Crown, and shall vest and may be dealt with in the same manner as other bona vacantia accruing to the Crown. "

It will be noted that the section does not give the Crown any discretion on the matter i.e. all property of a dissolved company vests in the Crown, whether the Crown wants it or not. The position in this respect has always been different in the UK. Under section 354 of the Companies Act 1948 (later section 654 of the Companies Act 1985) the position was the same in so far as all property of a dissolved company was deemed to be bona vacantia and accordingly belonged to the Crown. However, under section 355 of the 1948 Act (later section 656 of the 1985 Act) there were detailed provisions allowing the Crown to disclaim any property which vests in it under section 354, provided that the disclaimer is made within a period of 12 months of the date of which the vesting of the property came to the notice of the Crown's representative.

Under provisions contained in the Companies (Amendment) Bill 1992, which was Gazetted on 3rd July, the Registrar of Companies has the power to strike off a company which has failed for two consecutive years to file

its annual returns. There are also provisions that the company so struck off will be dissolved and all of its property vested in the Crown as bona vacantia but the section gives the Crown the right to disclaim such property, other than immovable property.

The reason why it was still felt that the Crown should not be able to disclaim immovable property was that the position regarding ownership of land in Hong Kong is, of course, basically different from that in the UK. The only freehold property in Hong Kong is the site of the Anglican Cathedral. All other property is held on lease from the Crown. It was felt that the practical results of allowing the Crown to disclaim any bona vacantia consisting of an interest in land would therefore be very odd. If the former owner, the dissolved company, had ceased to exist and the Crown could disclaim it, in whom would the interest in land vest?

It would be in some kind of legal limbo. However, at our December Meeting we considered a paper from our Secretary on a proposal which had been received from the Registrar General, in his capacity as Land Officer, that the provisions on dissolved companies in the Companies Ordinance should be amended to allow the Crown to disclaim any bona vacantia including any interest in land. The paper explained that the Crown wished to have this right to disclaim because sometimes an interest in land can represent a liability e.g. a retaining wall.

As for the problem of what would happen to any interest in land disclaimed by the Crown, the Land Officer's proposal was that the new legislation would provide for it to be vested automatically in all the other owners of shares in the lot concerned. The mechanics would be as follows :

(a) Upon disclaimer by the Crown, the disclaimed right in land would automatically vest in the relevant owner's corporation under the Multi-storey Buildings (Owners of Corporation) Ordinance, Cap. 344, or the existing management company, if any. In the absence of any such owners corporation or management company, the property would automatically vest in all the registered co-owners as joint tenants.

(b) Notice of such vesting following disclaimer by the Crown would be registered in the Land Office against the property in question and sent to the

relevant owners of corporation, the management company or all the other co-owners, as the case might be.

(c) To avoid difficulties with large developments, the multi-storey building management legislation could be amended to include a provision to the effect that it would be mandatory for any development with more than, say, 10 co-owners to form an owners corporation.

Our Secretary suggested that there were two aspects of the proposals which required careful consideration :

(1) Having regard to all aspects of the proposals, he questioned whether it was fair to allow the Crown to "cherry pick" among the interests in land which vested in it as bona vacantia upon dissolution of companies. Why should the Crown be able to keep the assets, such as parking spaces, and sell them (as has happened in the past) but decide that an interest which might represent a liability should vest in the other co-owners of the site concerned. It seemed to our Secretary that, having regard to all the circumstances, it would be more reasonable to provide that <u>all</u> bona vacantia consisting of an interest in land vest in the other co-owners.

(2) However, our Secretary was not aware of any precedent for vesting parts of a property automatically in the other co-owners of the property, whether they liked it or not. When a person is buying a flat in Hong Kong, he relies upon his solicitor to explain to him exactly what part of the development he will have the exclusive rights to, what parts he will have mutual rights in, and what his obligations for up-keep of all these interests will be. Under the new proposals, such an owner could suddenly find himself obliged to maintain a part of a development, such as a retaining wall, for which he had had no responsibility in the past. In fact, he may have gone out of his way when buying his flat to get confirmation from his solicitor that he did not have any responsibility for maintenance of the retaining wall. Of course, our Secretary pointed out that if his suggestion that all bona vacantia should automatically vest in the other co-owners was upheld, individual owners might equally

suddenly find themselves the recipients of an unexpected bonus in the shape of car parks, a previously restricted-use tennis court, etc. This might make the possibility of imposition of unexpected liabilities more acceptable.

After careful consideration of all the circumstances, we decided that we were unable to support the Registrar General's proposal to amend the Companies Ordinance to allow the Crown to disclaim bona vacantia consisting of an interest in land, because, basically, we did not think that the problems caused to the Crown by the existing law, as explained to us by the Registrar General, justified legislation which could place such unusual potential liabilities on the owners of the other interests in the land concerned.

The Registrar General also had proposals to amend the Companies Ordinance to provide a statutory procedure which would prevent, in as far as possible, interests in land becoming bona vacantia in the first place.

Under this procedure, the Registrar of Companies would be required to check on every company which was heading towards dissolution (i.e. either because it was being wound up voluntarily or compulsorily or because it was to be struck off the register under section 291 of the Companies Ordinance or other proposed statutory provisions). Briefly, it was proposed that :

(a) the Registrar of Companies would ask the Land Officer to advise him whether the company in question had any interest in land in Hong Kong registered in its name; and

(b) if the Land Officer confirmed that it had, the Registrar of Companies would try to get the company to dispose of the interest in land before it was dissolved.

After careful consideration of this set of proposals, we concluded that we were unable to support them either, because, again we did not think that the scale of the problems for the Crown as explained by the Registrar General justified the complicated legislation and extensive administrative procedures which would be involved in attempting to regulate them.

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 and Futures Commission in its role of administering those Ordinances.

Appendix 2

Membership of the Standing Committee as at 31st December 1992

Chairman : The Hon Mr Justice Jones

Members :

Mr Malcolm A Barnett

Mr John R Brewer

Mr Dennis G D Cassidy

Mr Ambrose W S Cheung

Mr Marvin K T Cheung

Mr Paul M Y Chow

Mr David W Gairns

Mr Stefan M Gannon, Legal Adviser, Monetary Affairs Branch

Mr Mark Hanson

Mr Robert G Kotewall, Q.C.

Mrs Angelina Lee

Mr Alan Smith

H H Judge L G Edward Tyler

Ex-officio Members :

Mr Tam Wing Pong, Deputy Secretary for Monetary Affairs, as representative of the Secretary for Monetary Affairs

Mr Noel M Gleeson, OBE, JP, Registrar General

Mr David Carse, Commissioner of Banking

A Representative of the 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 1992

Eighty-fourth Meeting	-	15 February
Eighty-fifth Meeting	-	7 March
Eighty-sixth Meeting	-	11 April
Eighty-seventh Meeting	-	2 May
Eighty-eighth Meeting	-	6 June
Eighty-ninth Meeting	-	4 July
Ninetieth Meeting	-	1 August
Ninety-first Meeting	-	31 October
Nineth-second Meeting	-	5 December