Corporate Governance Review
By
The Standing Committee on Company Law Reform

A Consultation Paper
on proposals made
in Phase I of the Review

July 2001

CONTENTS

	Page
Membership of the Standing Committee on Company Law Reform	**i**
Terms of Reference of the Directors Sub-Committee	iii
Terms of Reference of the Shareholders Sub-Committee	v
Terms of Reference of the Corporate Reporting Sub-Committee	vii
Summary of Proposals	ix
Chapter 1 INTRODUCTION	
1. Background	1
Inception of Review	1
Structure of Review	1
Scope of Review	1
Direction of Review	2
Policy Considerations	3
• *Oversea companies*	3
• *Dominant shareholders*	4
• *Lack of shareholder activism*	5
Programme of Review	6

2. Future work 7

The Directors Sub-Committee 7

The Shareholders Sub-Committee 8

The Corporate Reporting Sub-Committee 8

Corporate Regulation 9

3. Other measures which seek to enhance our corporate governance regime 9

4. Consultation 10

Chapter 2 DIRECTORS 11

5. Overview 11

6. Directors' duties 11

Background 11

Position in Hong Kong 12

Other jurisdictions 14

Proposals 15

7. Voting by directors in relation to directors' self-dealing 16

Background 16

Proposals 18

Rationale 20

8. Shareholder approval for connected transactions of significance involving directors 21

Background 21

Other jurisdictions 21

Proposals 26

- *Persons connected with the director* 27
- *Controlling shareholder and persons connected with controlling shareholder* 27
- *Exception in relation to transactions with wholly owned subsidiaries* 27
- *Consequences of breach* 28

Rationale 28

9. Transactions between directors or connected parties with an associated company 29

Background 29

Other jurisdictions 30

Proposals 31

Rationale 31

10. Nomination and election of directors 32

Background 32

Shareholder's right to nominate 34

Cumulative voting 35

The SCCLR's views 37

Proposals 38

11. Role of the independent director 40

Background 40

Proposals 42

Chapter 3 SHAREHOLDERS 44

12. Overview 44

13. Self-dealing by controlling shareholders 45

Background 45

Listing rules 46

Whether the requirement to abstain from voting should be incorporated into the law 47

Other jurisdictions 48

Proposals 50

14. Overview of shareholder remedies 52

Background 52

Types of action 52

Derivative rights 52

Personal rights 52

Intervention by regulator 53

15. Derivative action 53

Background 53

The proper plaintiff rule 54

The majority rule 54

Exceptions under the rule of Foss v. Harbottle 54

Wrongdoings that can be ratified and those that cannot 55

Wrongdoer control 56

Determining standing as a preliminary issue 56

Practical difficulties 56

When should the remedy be available? 57

Directors' duties and conflict of laws 58

Proposals 59

Rationale 60

Views of the public 60

16. Unfair prejudice 61

Background 61

Scope of section 168A 62

"Personal wrongs" 63

Corporate wrongs as a foundation for section 168A actions 64

Breaches of directors' duties 65

Oversea companies 65

Width of available remedies 66

Difficulties in relation to unfair prejudice remedy 66

Proposals 68

17. Personal rights 68

Background 68

Memorandum and articles of association 69

Internal corporate procedure 69

Inconsistent case law 69

Proposals 70

18. Orders for inspection 70

Background 70

Other jurisdictions 71

Proposals 71

19. Other powers of the court 72

Background 72

General power to injunct 72

Orders as to costs 73

Oversea companies 73

20. The role of regulators 74

Background 74

Policy considerations 74

Proposals 75

Chapter 4 CORPORATE REPORTING 76

21. Overview 76

22. Filing of financial statements 77

Background 77

Other jurisdictions 78

Proposals 80

Rationale 80

23. Management discussion and analysis 81

Background 81

United Kingdom Approach 82

The HKSA's Recommendations 82

Proposals 82

Rationale 83

24. Inconsistencies between the audited financial statements and other financial information contained in the directors' report and other sections of the annual report 83

Background 83

United Kingdom Approach 83

Proposals 84

25. Accounting reference date 84

Background 84

United Kingdom Approach 85

Proposals 85

Rationale 85

26. Standards-setting process 86

Background 86

Other jurisdictions 86

Proposals 88

Rationale 89

27. Body to investigate financial statements 90

Background 90

Other jurisdictions 91

Proposals 92

Rationale 93

28. Quality of audit practice and monitoring of audit practice 93

Background 93

Other jurisdictions 95

Proposals 96

Rationale 96

29. Revision of audited financial statements and related matters 97

Background 97

Proposals 99

Rationale 99

Membership of the Standing Committee on Company Law Reform

The Standing Committee on Company Law Reform was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance and other related ordinances.

The members of the Committee for the period from May 2000 to May 2001 were :-

Chairman	The Hon Justice Rogers, JA	
Members	Mr Roger T Best, JP	
	Mr Henry Fan Hung-ling, JP	
	Ms Betty Ho May-foon	
	Mr Gerald Hopkinson	(up to 31.1.2001)
	Mr Edwin Ing	(up to 31.1.2001)
	Mrs Angelina Lee Wong Pui-ling, JP	
	Mr Ian Perkin	
	Mr Winston Poon Chung-fai, SC	
	Mr Alvin Wong Tak-wai	
	Mr Randolph G Sullivan	
	Mr Peter Wong Shiu-hoi	
	Mr Richard Thornhill	
	Mr Michael W Scales	(from 1.2.2001)
	Mr William Tam Sai-ming	(from 1.2.2001)
Ex-Officio Members :	Mrs Alexa Lam, Chief Counsel The Securities & Futures Commission	
	Mr Alec Tsui Yiu-wa, Chief Executive The Stock Exchange of Hong Kong Limited	(up to 31.7.2000)
	Mr Lawrence Fok, Chief Executive The Stock Exchange of Hong Kong Limited	(from 1.8.2000)

Mr Charles Barr
Department of Justice

Mr E T O'Connell
The Official Receiver

Mr Gordon W E Jones, JP
The Registrar of Companies

Mr David T R Carse, JP
Deputy Chief Executive
The Hong Kong Monetary Authority

Miss Susie HO Shuk-yee
Deputy Secretary for Financial Services (2)

Secretary : Mr J S Bush

Corporate Governance Review
Directors Sub-Committee

Terms of Reference

1. In the light of –

   - the predominance of controlling shareholder groups and the rights and interests of controlling shareholders;
   - the lack of shareholder activism as a natural force for improving corporate governance;
   - the domiciling of a significant proportion of listed companies outside Hong Kong,

   to review the current statute law, administrative rules and regulations and codes of practice relevant to the directors and boards of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby further improving corporate governance standards.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

   (a) The structure of the board including the establishment, where appropriate, of audit, executive, nomination and remuneration committees;

   (b) The roles and functions of the Chairman and Chief Executive Officers;

   (c) The roles and functions of the executive directors;

   (d) The roles and functions of the non-executive directors;

   (e) The composition of the board with particular reference to achieving an appropriate balance between executive and non-executive directors;

   (f) The appropriate procedures for the appointment, re-election and resignation of directors, including the establishment of a nomination committee (where appropriate);

   (g) The appropriate procedures for undertaking the business of the board;

   (h) The development of a statutory statement of principles on directors' duties;

   (i) The development of coherent proposals on how to deal with directors' conflicts of interest including –

- the question of self-dealing; and
- the establishment of a register of directors' interests

(j) The development of appropriate training programmes and qualifications for directors;

(k) The development of appropriate principles and procedures regarding setting and approval of the levels and composition of directors' remuneration, including contracts and compensation, the establishment of a remuneration committee (where appropriate), disclosure and shareholder involvement;

(l) The roles and functions of Audit Committees;

(m) The necessary regulatory framework and best practice to ensure that directors and boards are encouraged to comply with their statutory and non-statutory obligations.

3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.

4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

Corporate Governance Review
Shareholders Sub-Committee

Terms of Reference

1. In the light of –

   - the predominance of controlling shareholder groups and the rights and interests of controlling shareholders;
   - the existence of corporate groups;
   - the lack of shareholder activism as a natural force for improving corporate governance;
   - the domiciling of a significant proportion of listed companies outside Hong Kong,

   to review the current statute law, administrative rules and regulations and codes of practice relevant to the shareholders of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby further improving shareholder democracy and communications.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

   (a) The definition, timing, notice, agenda (including resolutions) of, and conduct and voting (including the rights of proxies) at, company general meetings, having regard to the use of audio-visual communication and electronic voting;

   (b) The possible development of institutional investors as a force for promoting shareholder democracy and good corporate governance;

   (c) The development of a proxy system, having regard to the rights of persons other than registered shareholders, particularly given the need to ensure genuine shareholder democracy in the context of the Central Clearing and Systems System (CCASS);

   (d) Restraints on controlling shareholders' voting having regard to the following considerations –

      - transactions in which controlling shareholders have an interest different from that of other shareholders should be subject to approval by shareholders, with the controlling shareholder abstaining from voting;

- adequate exceptions should be made available to accommodate immaterial transactions and bona fide transactions in the ordinary course of business on arm's length terms;
- compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law;
- private companies may include exemptions in their articles;

(e) Improved accessibility to corporate records by shareholders;

(f) The variation of class rights;

(g) The suitability of judicial control, multiplicity of provisions and class votes;

(h) The circumstances in which it would be appropriate for minority shareholders to take action against the company or its directors and officers;

(i) The types of action which can be taken by minority shareholders against the company or its directors and officers.

3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.

4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

Corporate Governance Review
Corporate Reporting Sub-Committee

Terms of Reference

1. In the light of the role of disclosure as one of the key elements in corporate governance to review –

   - the existing level and nature of information, both financial and non-financial, which all companies incorporated or registered in Hong Kong need to disclose to their shareholders; and
   - the existing processes by which this information is prepared, vetted and approved.

   with the objective of enhancing the standard of corporate disclosure, transparency and accountability.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

   (a) Reforming and strengthening the statutory disclosure requirements in Part IV of and the Tenth and Eleventh Schedules to the Companies Ordinance, taking account of –

      - Possible further modification and extension of the simplified disclosure requirements in Part IV of and the Eleventh Schedule to the Companies Ordinance;
      - The possibility of mandatory publication and filing of financial statements by private companies.

   (b) Reforming and strengthening the non-statutory disclosure requirements in respect of listed companies promulgated in the Listing Rules issued by the Stock Exchange of Hong Kong;

   (c) Improving compliance with the accounting standards as promulgated by the Hong Kong Society of Accountants, with particular reference to sanctions;

   (d) The use of information technology to report and distribute, among other things, the annual reports and accounts of companies to enhance timeliness of provision of corporate information;

   (e) Strengthening the internal controls in companies with particular reference to internal audit functions;

   (f) The roles and functions of Audit Committees;

(g) The responsibilities, liabilities and independence of external auditors;

(h) The necessary regulatory framework to ensure efficient and effective monitoring of compliance with reporting requirements.

3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.

4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

SUMMARY OF PROPOSALS

PROPOSALS IN CHAPTER 2 ON DIRECTORS

1. Directors' duties

1.01 The SCCLR reviewed the law on directors' duties in Hong Kong as well as other common law jurisdictions. The SCCLR found the current state of law on fiduciary duties and the standards of care and skill in Hong Kong expected of directors generally acceptable. However, this is on the assumption that it is open for case law to demand higher standards of care and skill from directors, as evidenced in developments internationally.

1.02 In the absence of any great uncertainties in the law with regard to the duties of directors, the SCCLR did not see the need to enact these duties into statute for the following reasons: -

(a) Because the finding of a breach of duty would also depend on the complexities of the facts, it would not be possible for all duties to be properly encapsulated in the law;

(b) As a broad statement of principles would have to be framed in very general terms, it would have to be supplemented by detailed guidelines in non-statutory form;

(c) A broad statement of principles may not necessarily assist directors to clearly identify the extent of their duties nor would it help directors to determine how they should behave in any given set of circumstances;

(d) Statutory enactment would tend to be regarded as exclusive, would be inflexible and would not accommodate judicial developments to take into account changing standards;

(e) A broad statement of principles is unlikely to be of any additional assistance to shareholders;

(f) There is no intention to create criminal penalties for breach of directors' duties generally.

2. Voting by directors in relation to directors' self-dealing

2.01 General law on self dealing by directors does not prohibit an interested director voting on a matter in which he has a material interest if a company's constitution so permits. This position is also reflected in the existence of exceptions to this rule appearing in the default articles of association (Table A) in the Companies Ordinance.

2.02 However, the SCCLR considered that the current provisions under the Companies Ordinance and Table A could be improved in order to give effect to the general principle that a director should abstain from voting on a transaction in which he has an interest.

2.03 The SCCLR proposes the following amendments to the law: -

(a) The law should set out that the general position which is that an interested director should not vote at a board meeting on a matter in which he has an interest. The extent to which the articles of a company should be permitted to allow a director to be exempted from his duty to abstain from voting should be statutorily amended. Exceptions to the general prohibition will be set out in the law;

(b) Subsection 162(2) of the Companies Ordinance should be amended so that the interested director should make a disclosure of his interest on an *ad hoc* basis in addition to the general notice in advance. This is to ensure that directors are reminded of the possible conflict of interest and duty of the interested director at the time the proposal is put forward for consideration;

(c) Contracts, transactions or arrangements in which the director or connected persons have an interest should in any event be disclosed to shareholders. Where these are significant, they should also be referred to the shareholders for their approval;

(d) The law should also be amended to clarify the civil consequences of a breach of the general rule;

(e) The ambit of section 162 of the Companies Ordinance should be widened to cover 'transactions', 'arrangements' and 'connected persons'.

3. Shareholder approval for connected transactions of significance involving directors

3.01 The listing rules of the SEHK include a number of provisions dealing with connected transactions. The SCCLR found, however, that, other than in relation to the payments to directors in connection with the loss of office, the Companies Ordinance does not require that shareholders' approval should be sought for transactions with the company involving directors or persons connected with directors under Hong Kong law. This is in contrast with the position in the other jurisdictions surveyed.

3.02 The SCCLR recommends the adoption of a statutory provision so that the approval of shareholders should be obtained in relation to transactions or arrangements of a requisite value involving directors or persons connected with directors. The relevant arrangement would not be limited to non-cash assets only but would apply to the acquisition or disposition of all assets and other arrangements potentially benefiting the director or connected person.

3.03 The SCCLR seeks the views of the public on: -

(a) Whether the test for determining the requisite value should be by reference to a net asset value test or a value which is the gross value less intangibles and less current liabilities in order to get to a longer view of the invested value of a company or some other appropriate test;
(b) The requisite percentage which would trigger the requirement for shareholders' approval for the purposes of legislation;
(c) Whether there should be a *de minimis* absolute figure which would be excluded from this requirement, and if so, what amount would be appropriate?

3.04 This requirement would extend to the directors of unlisted public companies or persons connected to them as well as to the directors of private companies. In the case of private companies where no quorum of disinterested directors can be constituted, the transaction or arrangement should be referred to shareholders for their unanimous approval.

3.05 The proposal is intended to set out more clearly, the circumstances under which shareholders' approval should be obtained for arrangements involving directors, or in relation to persons connected to directors and the consequences of the breach of such rules.

4. Transactions between directors or connected parties with an associated company

4.01 The SCCLR considered whether the approval of the shareholders be obtained in relation to transactions or arrangements between (i) a director or connected person and (ii) other "associated companies or corporations".

4.02 Currently Chapter 14 of the listing rules regulates "connected transactions". Relevant arrangements and transactions include arrangements and transactions between "connected persons" and the listed company itself or its subsidiary. The SCCLR found, however, that the listing rules do not currently address arrangements and transactions entered into between: -

(a) a director of a listed company (or connected person); and
(b) a company that does not fall within the definition of a "subsidiary" of the listed company, i.e. where the listed company or its subsidiary holds less than 51% of the company in question (referred to, for ease of reference, as an "associated company").

4.03 Since the definition of "subsidiaries" does not extend to such companies, neither the approval of shareholders, nor disclosure or notification to shareholders will be necessary in relation to the transaction in question. Accounting principles, on the other hand, would take into account the possible influence that the company would have in relation to companies in which it has less than 51% share ownership.

4.04 The SCCLR proposes that:-

(a) The listing rules relating to connected party transactions should be extended to an "associated company" and not limited to "subsidiaries". The SCCLR considers that the "associated company" for these purposes, should be defined as one in which the listed company controls the exercise of 20% or more of the voting rights of the equity share capital;

(b) The Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors or connected persons and an associated company;

(c) The proposed provision under the Companies Ordinance (as discussed in section 2 above) would in addition equally apply to arrangements between: -

- the associated company of the company; and
- directors of the company or directors of its holding company or other persons connected with the director.

5. Nomination and election of directors

5.01 The SCCLR considered that the current requirements in relation to nomination and election of directors do not provide all shareholders with a meaningful procedure by which to nominate and elect directors.

5.02 Under common law principles, the right to vote for directors may belong to the shareholders. The SCCLR found that, in practice, even though the shareholder has in theory the right to nominate shareholders, the provisions in articles of association generally mean that:-

(a) the time frame within which a shareholder may leave a notice of nomination can be extremely small; and
(b) details of the nominee may not be circulated among the shareholders as a whole and he may need to bear the costs of circulating the details himself prior to the meeting.

5.03 The SCCLR found also that, in practice, because of the control that management has over the procedure for nomination, it is *management* that would be in the position to determine or influence the composition of the board through the nomination process. In Hong Kong, where in some of the public companies there is generally little separation between the board and the controlling shareholder, it is

the *controlling shareholder* that would in many cases be in the best position to control the ultimate composition of the board.

5.04 The SCCLR makes the following recommendation, subject to the results of the further studies and consultations with the Universities :-

(a) There should be a statutory requirement for the effective circulation of notices relating to a nominee proposed by shareholders in time for the date fixed for election. The existing period during which the shareholders can lodge a proposal for a candidate for the position should also be amended so that shareholders will have a realistic time frame within which to effectively lodge their nominations;

(b) There should be a requirement that the biographical details of a candidate for a directorship must be set out for shareholders' information. Private companies may, however, be able to exclude this requirement by unanimous agreement in writing;

(c) For the time being, the use of formal procedures for the nomination of directors should be encouraged as a matter of best practice. Any such procedures should be fair and disclosed to the shareholders. The manner of selection of nominees should therefore be set out in the notices to shareholders of the proposed AGM;

(d) Companies should be encouraged to adopt the cumulative voting procedure if they wish to, without, however, making such a voting procedure mandatory;

(e) The right of the shareholders to elect directors should be clearly set out in legislation so that it cannot be excluded by the articles of association of the company;

(f) If any director has resigned or declined to stand for re-election since the last annual general meeting and has set out his reasons for disagreement to the company, the company should also set out a summary of this disagreement in its report to shareholders.

6. Role of the independent director

6.01 Should the role of the independent director differ from the role of other directors in law? On the whole, the SCCLR finds that the *duties* of an independent director in law are not different from those of an executive director. The SCCLR concluded that:-

(a) The law sets out the principle of the collective duty of the board of directors and their core obligations;

(b) Jurisdictional studies show that the courts should be able to accommodate the standards expected of directors within the principle of the collective

duties of directors. This is done by reference to various factors including the tasks or functions a person under those circumstances or position is to perform.

6.02 In the Hong Kong context, the SCCLR does not believe, at this stage, that it would be practicable to impose a general statutory duty for the independent director(s) to perform a special monitoring role to represent the interests of minority shareholders. The SCCLR therefore recommends that:-

(a) The role of the non-executive director, independent or otherwise, should not be set out in statute;

(b) Functions of the non-executive directors under specific circumstances may be found in Codes of Best Practices or roles specifically assigned to them. In the case of public listed companies, the functions of the non-executive and independent directors under specific circumstances may be set out in a Code of Best Practices. This may include, for example, the functions of such directors in situations where executive directors or other directors might have conflicts of interest;

(c) Independent directors or advisors could be appointed with specific monitoring roles, for instance, where the existing board has breached its obligations to comply with the listing rules.

PROPOSALS IN CHAPTER 3 ON SHAREHOLDERS

7. Self-dealing by controlling shareholders

7.01 Should shareholders or persons connected to the shareholders be under a duty to abstain from voting in a transaction in which they have an interest, which is an interest that is different from other shareholders?

7.02 In Hong Kong, as in other common law jurisdictions such as the United Kingdom and Singapore, fiduciary principles apply to a *director* so that he may be prohibited from voting in a transaction in which he has an interest. However, unlike the director, there is support for the view that the shareholder, in his capacity as a shareholder, is not subject to the rule that he must avoid conflicts of interest. This applies even where the shareholder is a director of the company.

7.03 Chapter 14 of the listing rules of the SEHK prescribes in considerable detail how connected transactions in Hong Kong are to be dealt with. For significant “connected transactions”, shareholders deemed to be "interested" persons are not permitted to vote.

7.04 The SCCLR found that the issue of whether or not the majority shareholder has the right to vote in his own selfish interest is also relevant to the discussion as to whether or not a transaction can be ratified, and therefore whether a derivative action can be taken.

7.05 Apart from *de minimis* and defined exemptions, the laws of jurisdictions such Australia and the States require disinterested shareholder voting in relation to transactions in which controllers have an interest. Malaysia is also proposing to adopt this approach in the law. While the United Kingdom and Singapore have not incorporated this requirement into the law (to the extent that the controlling shareholder is not connected to the director or a connected person of the director), the requirement nevertheless applies in relation to listed companies and their subsidiary undertakings under their respective listing rules.

7.06 The SCCLR proposes that:-

(a) For commercial certainty, shareholders should be normally be bound by their approval of a self-dealing transaction in which the director or substantial shareholder or other connected person has an interest. However, these should be subject to the exceptions in relation to transactions involving dishonesty, bad faith and "misappropriation of company assets". The exceptions reflect the current position under general law where such transactions cannot be ratified at all, whether by unanimous shareholder resolution or otherwise;

(b) To ensure procedural fairness, connected transactions must be disclosed and subject to a disinterested shareholders' vote, with interested shareholders abstaining from voting;

(c) This rule would be subject to certain exceptions such as transactions entered into by liquidators during the course of compulsory winding up or on a general reduction of capital, and, in the case of listed companies, the limited exemptions allowed under the listing rules. The rule would also be subject to other *de minimis* exceptions, along the lines of any proposal (after the consultation referred to in paragraph 3.03 above) in relation to director-related transactions;

(d) In order to ensure that the views of all disinterested shareholders are properly reflected, voting must, under such circumstances, take place on a poll. This is in contrast to the current position where shareholders must first demand for a poll;

(e) The court's power to determine whether or not the transaction constitutes a waste of corporate assets should be nevertheless specifically preserved;

(f) A failure to follow this rule of procedural fairness, i.e. disclose and obtain the approval of the disinterested shareholders, means that the transaction should be voidable at the instance of the company, provided that *bona fide* third party rights are not affected, or if restitution is not lost. Transactions (not constituting a waste of corporate assets or involving dishonesty or in

bad faith or illegal acts) should remain capable of being ratified by disinterested shareholders within a reasonable time;

(g) The liability of the interested shareholder to compensate the company should arise where the transaction is found by the court to be a waste of corporate assets and the interested shareholder has benefited from the transaction. Certain presumptions will apply :-

(i) If there is no disclosure and approval of the disinterested shareholder has not been obtained, the burden falls on the interested shareholder to show that the transaction is not a waste of corporate assets or a transaction in bad faith from which he has benefited. Otherwise the burden still lies with the plaintiff;

(ii) If the company goes into liquidation within one year from which the transaction was entered into, the burden also falls on the interested shareholder to show that the transaction is not a waste of corporate assets or a transaction in bad faith from which he has benefited. If he fails to discharge this burden, criminal sanctions may be imposed. The extent of his civil and criminal liability will need to be set out under statute.

8. Derivative action

8.01 The SCCLR has found that, particularly in the case of listed companies, where a secondary market exists, there are few incentives and considerable practical difficulties for minority shareholders to take action on behalf of the company. The SCCLR identified practical difficulties with derivative actions in Hong Kong, including the following: -

(a) The shareholder bringing the action is potentially liable for the costs of the action even though he has no corresponding right to the potential damages. The court has a general power to order the company to provide the plaintiff an indemnity as to the costs of the action, although the precise circumstances are not clear;

(b) Damages are attributable to the company and not to the individual minority shareholder;

(c) Shareholders (who are not insiders) are likely to find that they are effectively prevented from taking action because they are unable to access information or the wrongdoers in order to commence a proper action;

(d) Apart from winding up proceedings or actions under section 37A of the Securities and Futures Ordinance, the SCCLR found that it is not entirely clear whether shareholders' remedies for corporate injury to companies incorporated outside the jurisdiction of Hong Kong would be entertained;

8.02 To the extent that the unfair prejudice remedy may not be currently available for corporate injuries, the SCCLR considers that the derivative action procedure should be maintained. It also proposes the introduction of a statutory derivative action to make it clear that: -

(a) There will be no 'trial within a trial' for the purpose of determining the standing of an applicant to commence a derivative action on behalf of the company. Shareholders, at the time the cause of action arose, directors and officers of the company, past or present, may commence the action in the court;

(b) The court's power to ensure that there has been no illegal or fraudulent transactions or those that constitute a waste of corporate assets (non-"ratifiable" transactions) or which affect the personal rights of shareholders should be specifically preserved. Where the approval of disinterested shareholders has not been secured, the burden should fall on the controlling shareholder to show that the transaction was fair and not to the detriment of the company;

(c) Ratification by general meeting would, however, not be a bar to the commencement of the proceedings. Where there is apparent wrongdoer involvement in a "ratifiable" transaction (i.e. where the wrongdoer appears to have profited from the transaction in breach of his duties or a director is also a controlling shareholder or related to a controlling shareholder), only "independent" shareholders can ratify the transaction;

(d) The derivative action is intended to allow shareholders or directors of the company to bring an action on behalf of the company for a wrong done to the company where the company is unwilling or unable to do so. The grounds for such action would include the following :-

- fraud;
- negligence;
- default in relation to any laws or rules;
- breach of any duty, whether fiduciary or statutory.

9. Unfair prejudice

9.01 The SCCLR reviewed and considered the usefulness and adequacy of the unfair prejudice remedy. The SCCLR found that the difficulties faced by a petitioner in relation to the application of the remedy under section 168A of the Companies Ordinance might be as follows: -

(a) In relation to listed companies, it is not clear that the remedies available under this section are necessarily adequate, since it may not be practicable in all circumstances, for instance, for the court to require a buy-out of minority shareholders. It is not clear that the shareholder bringing the action has a right to the damages;

(b) As with the derivative action, it does not appear that legal aid is available to a petitioner seeking an unfair prejudice remedy. The court might grant such an order as to costs, but again the circumstances under which it would do so are not entirely clear;

(c) Apart from section 37A of the Securities and Futures Ordinance, the remedy is not available in relation to shareholders of oversea companies;

(d) As with derivative actions, shareholders (who are not insiders) are likely to find that they are effectively prevented from taking action because they are unable to access information or the wrongdoers in order to commence a proper action;

(e) The SCCLR also concluded that section 168A is inconsistent with section 147(2)(b) in relation to oversea companies and needs to be rectified.

9.02 The SCCLR proposes that: -

(a) The powers in section 168A should be amended to make it clear that the court has the power to award damages by way of a remedy to shareholders or former shareholders (as shareholders at the time the cause of action arose) in circumstances of unfair prejudice. The court should also have the power to award interest on damages on such terms as the court shall think fit;

(b) Subsection 168A(2)(c) should be expanded to allow an order for compensation of costs to be paid to the shareholders undertaking representative actions;

(c) Subsection 168A(2)(c) should be expanded to allow the court to require controlling shareholders to buy out the minority shareholders;

(d) Section 168A of the Companies Ordinance should also be amended to allow members of oversea companies, as well as Hong Kong incorporated companies, to commence an action for unfair prejudice;

10. Personal rights

10.01 The SCCLR has recommended previously that the law should be clarified so an individual member can enforce all rights in the memorandum and articles of association as personal rights. The recommendations are contained in the Companies (Amendment) (No. 2) Bill 2001.

11. Orders for inspection

11.01 If such rights of inspection are not incorporated into the articles of the company, shareholders may find it difficult to sue in the event of breach of their rights or injury to the company. On the other hand, the SCCLR found that the rights of

minority shareholders should be balanced against the possibility of harassment by shareholders seeking access to the company's accounts, books or papers for without proper grounds.

11.02 In line with other jurisdictions, the SCCLR proposes that a statutory method by which shareholders can obtain access to company records should be provided, subject to the prescribed safeguards, on application to the court.

12. Other powers of the court

12.01 The SCCLR also considered whether additional powers of the court might be useful to help address current practical difficulties in enforcing the duties of directors, connected persons or controlling shareholders under statute or case law.

12.02 The SCCLR proposes that :-

(a) The court should have a general power, on application by an affected person or, a relevant authority, to grant an injunction against any contravention of the Companies Ordinance or any breach of fiduciary duties. This should extend to any attempt to contravene such provisions or attempted breach of any of the directors' duties. The court should be entitled on the application of any person whose interests have been, are or would be affected by the conduct, to grant an injunction. This should be on such terms as the court thinks appropriate, restraining the person from engaging in the conduct and, if in the opinion of the court it is desirable to do so, requiring that person to do any act or thing;

(b) The court should at least have a clear general power to grant orders as to costs for shareholders for the purposes of taking action in respect of corporate injury as well as for unfair prejudice actions. This is subject to the requirement that the court will be satisfied that there is no evidence of bad faith on the part of the plaintiff and that the plaintiff has reasonable grounds on which to commence an action;

(c) The powers of the courts to make these orders should be expanded to all companies registered in Hong Kong including companies incorporated outside Hong Kong but registered under Part XI of the Companies Ordinance.

13. The role of regulators

13.01 The SCCLR proposes that it should be made clear that the securities regulator is able, without court approval, to bring derivative actions against wrongdoers in relation to a public company including an oversea company listed on the SEHK for breaches of duty on behalf of the company. This is subject to the proviso that (a) the regulator shall exercise its power in the public interest as well as in the interest of the company, and (b) it shall not be entitled to indemnities as to costs from the company.

13.02 The grounds on which the SFC should be able to commence proceedings should be wide and should include the following: -

- fraud;
- negligence;
- default in relation to any laws or rules;
- breach of any duty, whether fiduciary or statutory; or
- any other misconduct committed in connection with a matter to which any investigation or examination relates, or the recovery of property of any person including the property of the company.

PROPOSALS IN CHAPTER 4 ON CORPORATE REPORTING

14. Filing of financial statements

14.01 The SCCLR proposes that private companies with limited liability should file their financial statements with the Companies Registry (CR) for public inspection. The SCCLR considers that the proposal is conducive to good corporate governance. It would enable parties such as the suppliers and creditors of private companies with limited liability to have better access to financial information on private companies and have a better assessment of the risks inherent in their dealings with these companies.

15. Management discussion and analysis

15.01 The Hong Kong listing rules require listed companies to prepare a Management Discussion and Analysis (MD&A), which comprises a statement containing a discussion and analysis of the group's performance during the financial year and the material factors underlying its results and financial position. It should emphasize trends and identify significant events or transactions during the financial year under review.

15.02 The review includes: -

(a) Comments on segmental information. This may cover changes in the industry segment, developments within the segment and their effect on the results of that segment;
(b) Prospects for new business including new products and services introduced or announced; and
(c) Details of material acquisitions and disposals of subsidiaries and associated companies.

15.03 The MD&A also contains details of the number and remuneration of employees, remuneration policies, bonus and share option schemes and training schemes, information about its major customers, information about its major suppliers, brief biographical details of the directors and senior managers, and information about financial risks.

15.04 In the United Kingdom, it is proposed that each listed company should include an Operating and Financial Review (OFR) in its annual report. The OFR requires disclosure on the following areas :-

(a) A fair review of the development of the company's and/or group's business over the year and position at the end of it, including material post year end events, operating performance and material changes;
(b) The company's purpose, strategy and principal drivers of performance;
(c) An account of the company's key relationships with employees, customers, suppliers and others, on which its success depends;
(d) Corporate governance – values and structures;
(e) Dynamics of the business – i.e. known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes;
(f) Environmental policies and performance, including compliance with relevant laws and regulations;
(g) Policies and performance on community, social, ethical and reputational issues; and
(h) Receipts from, and returns to, shareholders.

15.05 The SCCLR proposes that the listing rules on MD&A should be amended to include more qualitative and forward looking disclosure on areas as shown in paragraph 15.04.

16. Inconsistencies between the audited financial statements and other financial information contained in the directors' report and other sections of the annual report

16.01 The SCCLR proposes that the Companies Ordinance should be amended to enable auditors to report on any inconsistencies between the audited financial statements and financial information contained in the directors' reports. As it is in the public interest for auditors to be tasked with reporting any abnormalities found in directors' reports, it would be unreasonable for auditors to be penalized for doing so. Views are also sought as to whether such qualified privilege should be extended to enable the auditors to report inconsistencies between the audited financial statements and financial information contained in other sections of the annual reports normally distributed by listed companies.

17. Accounting reference date

17.01 The Companies Ordinance does not provide for a company's financial year and accounting reference periods. Section 122 of the Ordinance requires accounts to be made out in every calendar year, to be laid before the company's annual general meeting, and those accounts shall be made up to a date falling not more than certain months before the date of the meeting. Section 111 of the Companies Ordinance requires that not more than 15 months shall elapse between the date of the one annual general meeting and the next. Section 111 indirectly requires accounts to be made up for a period of not more than 15 months, but there are no rules on shorter accounting periods. In addition, there is no provision to regulate the first accounting period, except that the first annual general meeting has to be held within 18 months of incorporation, and accounts are required to be laid at the annual general meeting.

17.02 The SCCLR proposes that the Companies Ordinance should be amended to provide for an accounting reference date, an accounting reference period and financial year. The SCCLR considers that there may be merit in tackling the question of an accounting reference date in the context of a major review of the accounting and auditing provisions in Part IV of the Companies Ordinance. However, the SCCLR is prepared to deal with the question of the accounting reference date ahead of the review if this is supported by public opinion.

18. Standards setting process

18.01 The SCCLR considered the extent to which the accounting and auditing standards setting process may be improved. The SCCLR believes that Hong Kong does not need independent standard setting bodies for accounting and auditing standards, given that they are very closely modeled on IASs and ISAs. The standard setting function should continue to be vested in the HKSA but the composition of the Financial Accounting Standards Committee (FASC) and Accounting Standards Committee (AuSC) of the HKSA should be widened to cater for more involvement of the public.

18.02 The SCCLR proposes that wider representation on the FASC and AuSC would increase the credibility of the standards set by these committees. The SCCLR thus proposes that:-

(a) The FASC should comprise 10 to 15 persons drawn from :-
- the accountancy profession;
- the users of financial statements;
- the preparers of financial statements;
- the business community;
- the regulators of the securities and banking industries;
- academia;
- the investment community;
- members of the public

(b) The AuSC should comprise 10 to 15 persons drawn from :-

- the accountancy profession;
- the preparers of financial statements;
- the regulators of the securities, banking and insurance industries;
- the relevant Government departments;
- the banking industry;
- academia;
- members of the public.

(c) The Chairmen of the FASC and AuSC should be members of the Council of the HKSA;

(d) The HKSA should approach relevant organisations for nominations with regard to their representatives instead of appointing individuals;

(e) Where the appointment of lay members is concerned, the HKSA should adopt the following means –

(i) approaching the Consumer Council for representatives; or
(ii) conducting a public recruitment exercise to select persons with a good public service track record; or
(iii) seeking nominations from the members of the FASC and AuSC;

(f) Alternates of members should be allowed.

19. Body to investigate financial statements

19.01 The SCCLR finds that there is no body in Hong Kong tasked with making enquiries into the accounts of companies on their compliance with the accounting requirements in the Companies Ordinance, accounting standards and the true and fair view requirement. Neither is there a mechanism whereby directors may be required to revise and re-issue accounts.

19.02 The SCCLR seeks the views of the public on the proposal, as a means of strengthening our regulatory framework for financial reporting, to set up a body similar to the Financial Reporting Review Panel (FRRP) in the United Kingdom. Such a body would be is responsible for formulating general policy for the maintenance and improvement of financial reporting practices. The FRRP's function is to examine apparent departures from the accounting requirements of the Companies Act 1985, including applicable accounting standards, and its jurisdiction is confined to the accounts of public listed companies and large private companies. However, the FRRP does not proactively review accounts for non-compliance but reacts to matters that come to its attention, mainly through complaints and press reports.

19.03 The views of the public are also sought on associated issues as follows: –

(a) The functions of the body, i.e. to respond to complaints by enquiring into the financial statements of companies where there may be a failure to comply with the accounting requirements of the Companies Ordinance, including the compliance with applicable accounting standards and the true and fair view requirement, to have the power to apply to the court for an order to require a company to re-issue accounts that do not comply with the requirements in the law;

(b) The jurisdiction of the body; i.e. should the body's work be confined to certain categories of companies, for example, public companies and/or large private companies only?

(c) The mode of establishment for the body, i.e. there are different modes for establishing the body, including an independent body similar to that in the United Kingdom, parking the body with a regulator, or a self-regulating professional body.

20. Quality of audit practice and monitoring of audit practice

20.01 In Hong Kong, the HKSA is the regulator of company auditors. To monitor compliance with auditing standards by auditors, the HKSA has regular programmes such as the Professional Standards Monitoring Committee Programme and the Practice Review Programme under Part IVA of the Professional Accountants Ordinance, which monitors the quality of all audit practices. In addition to the regular monitoring programmes, the HKSA also has the power to conduct formal investigations under Part VA of the Professional Accountants Ordinance into specific complaints on specific acts or omissions of all HKSA members that have attracted public concern. Among these measures, the SCCLR considers that the Practice Review is the key element to monitor compliance with auditing standards and to ensure quality of audit practice. Now that the Practice Review has been in operation for eight years, the SCCLR would like to invite the public's comments on possible further improvements to the Practice Reviews undertaken by the HKSA.

20.02 In 1992, the HKSA introduced the Practice Review under Part IVA of the Professional Accountants Ordinance. The Practice Review empowers the HKSA to perform on-site reviews of the audit procedures and working papers of certified public accountants' practices in order to monitor compliance with auditing standards. The Practice Review goes beyond just the presentation of the financial statements and actually looks at the underlying auditing process regarding the data contained in the financial statements and cover audits of not only listed companies but also private companies.

20.03 The SCCLR would like to ask the public to comment as to whether there are possible improvements to the HKSA's Practice Review and in particular -

(a) Whether the current "one standard fits all" approach is appropriate? Should a higher standard be required for firms auditing public companies ?

(b) Should the frequency of reviews be higher for those audit firms that audit public companies, bearing in mind the additional costs that might be involved and be borne by the audit firms, and eventually, the business community?

(c) Whether audit firms performing audits of listed companies or companies with significant public interest should be subject to additional scrutiny or a separate regulatory regime?

21. Revision of audited financial statements and related matters

21.01 There are no statutory provisions at present for the revision of the financial statements after they have been laid before the company in general meeting or delivered to the registrar. This has created an undesirable uncertainty for companies and their auditors as to the proper legal steps to be taken to correct financial statements when they are found to be defective after they have gone through the due process of being approved at the AGM and filed with the CR. Furthermore, there is no statutory mechanism to allow the company or its auditors to prevent the public from further reliance on the filed financial statements.

21.02 It is, however, not uncommon that information may come to light or become known to the directors or the auditors after the financial statements have been issued that suggest that the financial statements had been incorrectly prepared based on wrong or omitted information unknown at the time.

21.03 The SCCLR proposes that -

(a) Where it comes to the directors' attention that there are material misstatements in the financial statements that have been laid before the company in the general meeting and filed (in case of public companies), they should file a warning document with the CR to prevent further reliance on that set of financial statements at the earliest possible opportunity. In the meantime, the directors should work with the auditors to prepare and file revised financial statements and a revised auditors' report;

(b) If the auditors find that there are material misstatements in the financial statements that have been laid and filed (in case of public companies), they should report this to the directors. The directors should be required to respond to the auditors as to whether the company will file a warning document with the CR to prevent further reliance on the financial statements;

(c) If the directors agree with the auditors, this will trigger the mechanism set out in (a) above. If the directors refuse to file a warning document, the law should allow the auditors to file such a document; and

(d) The Companies Ordinance should be amended so that the directors would be required to work with the auditors with a view to revising the financial statements in question.

CHAPTER 1

INTRODUCTION

1. Background

Inception of Review

1.01 The Financial Secretary announced in his 2000/01 Budget Speech that a comprehensive review of corporate governance should be undertaken to identify and plug any gaps in Hong Kong's corporate governance regime. The Standing Committee on Company Law Reform (SCCLR) has been tasked with the conduct of an overall review of corporate governance (CGR) in Hong Kong.

Structure of Review

1.02 In order to take the CGR forward, the SCCLR agreed that three sub-committees should be established, namely –

- The Directors Sub-Committee (DSC);
- The Shareholders Sub-Committee (SSC); and
- The Corporate Reporting Sub-Committee (CRSC)

Scope of Review

1.03 The CGR is a roots and branch examination of the existing corporate governance regime in Hong Kong. However, in order to do this properly and thoroughly, it is necessary to establish external and internal benchmarks as a framework for reference. Consequently, one of the first tasks of the Review has been to commission two major surveys. The first is a survey and analysis of the attitudes of international institutional investors towards corporate governance standards in Hong Kong. The views of such investors will be of particular importance and value given Hong Kong's importance as a capital-raising centre, with particular reference to China listings, and the need to access international capital at the most advantageous rates. The second is a comparative survey and analysis of the development of corporate governance standards in both competitor jurisdictions in South East Asia and jurisdictions elsewhere in the world. These are Australia, Singapore, Taiwan, the United Kingdom and the United States of America.

1.04 The review will also cover unlisted as well as listed companies. To date, the corporate governance debate has tended to proceed as if listed companies were the

only companies worth considering and, in this respect, two points should be made. *First*, the law does not require a company issuing shares to the public to list on any exchange. However, investors in a publicly-held but not listed company need as much protection as investors in a listed company. Indeed they need more because they do not have the protection of the Securities and Futures Commission (SFC) and the Stock Exchange of Hong Kong (SEHK). *Secondly*, private companies comprise the overwhelming majority of the half a million companies registered in Hong Kong. Together with unincorporated businesses, these companies represent about 99% of all entities both incorporated and unincorporated. They play a very important economic role as they sell a significant proportion of the Special Administrative Region's exports, contribute roughly 40% to GDP and employ about 60% of the work force. However, in the final analysis, if the shareholders in a public company have a grievance which either cannot or will not be remedied, they have an exit as there is usually a market for their shares. By contrast, no such remedy is available to the shareholders in private companies. It is, therefore, very important that the governance issues affecting unlisted companies, both public and private, are addressed fully in the CGR.

Direction of Review

1.05 The primary objectives of having laws and rules are to ensure that *minimum* standards of behaviour are reflected in the law, and are complied with. However, the broader objective of raising standards of corporate behaviour also involves raising the general ethical standards of managers and controlling shareholders, *with a view to maximising return to shareholders*. The SCCLR considers that too many prescriptive rules and regulations will not achieve this objective of maximising returns to shareholders. Corporate governance does not, therefore, merely entail enacting a voluminous body of laws or rules. As each type of company may have different governance needs depending on, for instance, its size and objectives, corporate governance "wisdom" is that it is not practicable to prescribe detailed rules for every type of company. To achieve the right balance, it is crucial that there must also be the right "culture". This involves self-discipline, by the board, management and controlling shareholders as well as market discipline, to help monitor the performance of companies.

1.06 As such, the direction of the review is also 'open' in so much as the SCCLR does not have any pre-determined theoretical balance to be struck between statutory regulation on the one hand and internal best practice on the other. Any recommendations on this 'mix' can evolve only after the review has begun to consider the existing corporate governance regime against external and internal benchmarks, having regard to the results of detailed research projects, and decided where it would be appropriate and reasonable to make adjustments in order to enhance corporate governance standards. However, it should be stressed that, if good corporate governance practice is to take root, it must come from

within rather than being imposed from without. Consequently, it is as much, if not more so, a matter of corporate culture, education and best practice as well as legislation and regulation. On the other hand, it would be foolish and naïve to leave everything to best practice, and one point which has emerged strongly from the review to date is that there must be adequate policing and enforcement of corporate governance standards. In this respect, the major issue of corporate regulation will be considered in the second phase of the CGR.

Policy considerations

1.07 In order to address gaps in the regulatory regime, the SCCLR considers that standards of the regulatory regime in Hong Kong must be at least commensurate with those of jurisdictions of international standing, with adaptations if necessary to take into account the Hong Kong corporate environment. The SCCLR in making its recommendations considered the standards of laws and practices in other jurisdictions to benchmark itself from the perspective of international competitiveness. The SCCLR also referred extensively to the laws and rules of other common law jurisdictions whose origins are closest to those of the laws of Hong Kong.

Oversea companies

1.08 However, the SCCLR also considers that there is a need to ensure that its proposals are appropriate in the context of the Hong Kong corporate environment. Consequently, the Sub-Committees' Terms of Reference have required them to consider three particular issues. The **first** consideration is that a large proportion of companies listed on the SEHK are incorporated outside Hong Kong. As of end April 2001, 75% of the 809 companies listed on the SEHK are companies incorporated outside Hong Kong[1].

1.09 Apart from Part XI of the Companies Ordinance, most provisions of the Companies Ordinance do not apply to companies incorporated outside Hong Kong. Where practicable, however, the SCCLR has considered the position of investors with regard to oversea companies registered under Part XI of the Companies Ordinance listed on the SEHK. To the extent that these companies are operating within Hong Kong and are companies listed on the SEHK, the SCCLR takes the view that it is practical and justifiable to demand certain high standards of conduct from their directors and controlling shareholders.

1.10 Nevertheless, since there are practical[2] and jurisdictional limitations[3] to the extent to which the laws of Hong Kong can apply in relation to such companies, the listing rules of the SEHK remain a significant part of the corporate

[1] Source: The SEHK
[2] From the point of view of practical enforcement
[3] From the point of view of the conflicts of laws

governance regime[4]. Important provisions of the listing rules can also be inserted into the constitution of a company. For those companies incorporated under common law jurisdictions[5] (other than Hong Kong), rights set out under the constitution of a company would normally also constitute personal rights, breaches of which should be actionable by shareholders under common law[6].

Dominant shareholders

1.11 The **second** consideration is that in cases of many companies listed on the SEHK, a single dominant shareholder or single group of persons controls the company. This may be the significant shareholder or a person connected with the "controlling" shareholder. Typically the "controlling" shareholder would appoint persons connected with him onto the board of the listed company, or its subsidiaries. The types of control structures of companies listed on the SEHK include the following: -

(a) Management-controlled companies with dispersed shareholdings where the managers are in the position to direct the company with little or no equity in the company[7];

(b) Shareholder-controlled companies where the controlling shareholder has a direct majority stake, that is to say, 51% or more of the ordinary voting shares. Under such circumstances, his ability to control and direct the company is more closely aligned with the proportion of equity held by him;

(c) Shareholder-controlled companies where the controlling shareholder has direct but substantial minority stake. Under the rules of takeovers and mergers, a person, or persons acting in concert, holding 30% or more of shares in the company is considered to be a person with control. His or their ability to control and direct the company is also aligned with the proportion of equity held by him;

(d) Shareholder-controlled companies where the controlling shareholder has only an indirect stake, either through a pyramid-structure or a cross holding, as a result of which the ability of the indirect owners to effectively control and direct management are well in excess of the proportion of equity held by them.

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[4] In this paper unless expressly stated, all references to listing rules of the SEHK refer to listing rules of the Main Board of the SEHK

[5] 423 companies incorporated in Bermuda and 128 companies incorporated in the Cayman Island as of end April 2001 : Source SEHK

[6] See section 17 below

[7] Typified, for example, by many companies listed in the United Kingdom and the United States

Of these, the types of companies that fall within categories (b) to (d)[8] heavily outweigh the number of companies falling within category (a).

1.12 Particularly in the case of category (d), there is potential for unauthorised transfers or diversions of corporate assets, as the influences wielded by the controlling shareholder may not always be obvious even from disclosures made in accordance with applicable rules. Unauthorised transfers or diversions of corporate assets to managers (and also "controlling" shareholders) raise issues of public interest for the following reasons: -

(a) This is liable to be inefficient, since the transfers would represent misallocation of resources;
(b) The ability to extract funds from the company does not maximise overall returns to the company and therefore returns to shareholders;
(c) Such arrangements undermine investor confidence and therefore the ability of the corporate system to raise capital[9].

Lack of shareholder activism

1.13 The **third** consideration is how the law might address issues of governance given the lack of shareholder activism in Hong Kong. Notwithstanding the current gap in terms of shareholder activism, the SCCLR considers that the ability of investors to avail themselves of protection as well as enforcing the laws within such an environment remain a critical issue that should be addressed. Investor protection mechanisms include the following: -

(a) The law relating to the rights of shareholders;
(b) The protection that shareholders enjoy against abuses and expropriation by insiders;
(c) The quality of disclosure;
(d) The quality of law enforcement (private and public).

1.14 The principal rights that shareholders have in this respect may be specifically provided for, and include rights to vote in relation to the following key matters so as to limit the discretion of insiders: -

(a) The election of directors;
(b) Amendments to the constitution of the company (including changes in the nature of business of the company, transfer to another jurisdictions and change in the nature of the shares);

[8] As of end January 2001, approximately 24% of the entire market capitalisation comprised family-led listed companies. Approximately 30% of the entire market capitalisation comprised Government-led listed companies.

[9] JE Parkinson "Corporate Power & Responsibility (1993), Issues in the Theory of Company Law" (Clarendon Press Oxford), page 201

(c) Pre-emptive rights of the shareholders on further issues of shares;
(d) Key corporate matters such as the sale of substantial or all of the company's assets, and on mergers or liquidation.

1.15 Because of the number of companies in Hong Kong which operate within conglomerate group structures controlled by one large shareholder or group of shareholders[10], this review also necessarily focuses on: -

(a) The need to encourage directors (who may be under the influence of "controlling" shareholders) to consider the interests of shareholders as a whole, as opposed to the interests of any particular shareholder or set of shareholders; and
(b) The need to address the fundamental conflict between the interests of the majority or "controlling" shareholder and the other "outside" investors.

1.16 The SCCLR notes that since the early 1990's, the listing rules of the SEHK have attempted to regulate "connected transactions". However the SCCLR also considers it appropriate to focus on the role of the controlling shareholder within the context of the Companies Ordinance and the law in general. Chapter 3 of this paper also considers the adequacy of available shareholders remedies as a mechanism to provide meaningful redress in the context of corporate injury or infringement of shareholder rights.

Programme of Review

1.17 Essentially, the CGR is proceeding on two major fronts as follows:-

(a) The universities have been or will be commissioned, after a tendering exercise, to undertake various surveys and research projects which have been identified by the three Sub-Committees. These are as follows:-

(i) A comparative survey and analysis of the development of corporate governance standards in other comparable jurisdictions;

(ii) A survey of the attitudes of international institutional investors towards corporate governance standards in Hong Kong;

(iii) The roles and functions of audit, nomination and remuneration committees;

(iv) Company information flow and shareholders' rights of access to such information;

(v) An economic analysis correlating the performance of listed companies with their shareholders' profile.

[10] e.g. in the form of ownership described in paragraph 1.11(d) above

Contracts regarding four of these consultancies have been signed and work is in progress. New tenders will be invited for the consultancy on company information flow in the near future. It is hoped that the results of most of these consultancies will be known by the end of 2001.

(b) Since mid-2000, the Sub-Committees have been considering papers on specific subjects, having regard to their terms of reference, which can be considered in advance of the results of the consultancy projects. It is possible that some of these subjects may have to be reconsidered in the light of the findings of the consultancy projects while a number of issues cannot be considered until the results of the consultancy projects are known.

2. Future work

2.01 While the views of the public are being obtained on the proposals in this paper, the DSC, SSC and CRSC will continue to work on the second phase of the CGR. An indication of the issues that remain to be considered is outlined in the following paragraphs. However it should be stressed that this is not necessarily comprehensive.

The Directors Sub-Committee

2.02 The DSC will be considering and/or taking action on the following issues:-

(a) The structure of the board including the establishment, where appropriate, of audit, executive, nomination and remuneration committees;
(b) The roles and functions of the Chairman and Chief Executive Officer;
(c) The composition of the board with particular reference to achieving an appropriate balance between executive and non-executive directors;
(d) The appropriate procedures for undertaking the business of the board;
(e) The preparation of a non-statutory statement of principles of directors' duties;
(f) The development of appropriate training programmes and qualifications for directors;
(g) The development of appropriate principles and procedures regarding setting and approval of the levels and compositions of directors' remuneration, including contracts and compensation, the establishment of a remuneration committee (where appropriate), disclosure and shareholder involvement; and
(h) The roles and functions of audit committees.

2.03 Work on the issues outlined in (a), (c), (g) and (h) can proceed only after the DSC receives the results of the consultancy on the roles and functions of audit, nomination and remuneration committees which will also cover the major topic of "independent non-executive directors". It is expected that these will not be available until the end of 2001. In the meantime, the DSC will be considering

the issues outlined in (b), (d), (e) and (f), all of which are 'best practice' or administrative issues, not requiring legislative amendments which, once agreed, can be implemented relatively quickly.

The Shareholders Sub-Committee

2.04 The SSC will be considering the following issues: -

(a) The definition, term, notice, agenda (including resolutions) of, and conduct and voting (including the rights of proxies) at, company general meetings, having regard to the use of audio-visual communication and electronic voting;
(b) The possible development of institutional investors as a force for promoting shareholder democracy and good corporate governance;
(c) The development of a proxy system;
(d) Improved accessibility to corporate records by shareholders;
(e) The variation of class rights;
(f) The suitability of judicial control over reduction of capital and schemes of arrangement, the multiplicity of provisions regarding corporate restructuring and class votes.

2.05 Work on the issues outlined in (a), (c) and (d) can proceed only after the SSC receives the results of the consultancy on the company information flow and shareholders' rights of access to such information. It is expected that these will not be available until the end of 2001. There are, however, a number of recommendations regarding (d) in this consultation paper. In the meantime, the SSC will be considering the issues outlined in (b), (e) and (f).

The Corporate Reporting Sub-Committee

2.06 The CRSC will be considering and/or taking action on the following issues: -

(a) Developing a framework setting out the financial reporting standards for different categories of companies e.g. listed, unlisted public, large private and small private companies;
(b) Undertaking a complete review of the accounting and audit provisions in Part IV of and the 10th Schedule to the Companies Ordinance;
(c) Further reform and strengthening of the non-statutory disclosure requirements in respect of listed companies in the SEHK's listing rules including directors' remuneration;
(d) Strengthening the internal controls in companies with particular reference to internal audit functions;
(e) The roles and functions of Audit Committees;
(f) The responsibilities, liabilities and independence of external auditors.

2.07 Work on the issue outlined in (e) can proceed only after the CRSC receives the results of the consultancy on the roles and functions of audit, nomination and remuneration committees. It is expected that these will not be available until the end of 2001. Although the DSC will also be examining the same issue, this will be from the angle of board structure and involvement by independent non-executive directors, and it is important that the CRSC also examines the usefulness (or otherwise) of such committees from the angle of disclosure. Work on the issue outlined in (a) is dependent on the results of a separate public consultation by the HKSA on the recommendations of the HKSA's "Small GAAP" Working Group. Work on the issue outlined in (b) is dependent on the establishment of a new joint Government/HKSA Working Group. In the meantime, the CRSC will be considering the issues outlined in (d) and (f).

Corporate Regulation

2.08 In parallel with the work of the three Sub-Committees, the Financial Services Bureau, in consultation with the CR, the SFC, Commercial Crimes Bureau and Official Receiver's Office, is preparing a paper on an overall review of corporate regulation in Hong Kong with a view to assessing the need, and developing recommendations, for strengthening the existing institutional and enforcement arrangements. It is intended that this will be discussed by the SCCLR later this year with a view to consulting on the results of the review in second phase of the CGR.

2.09 The SCCLR recognizes that a significant number of foreign incorporated companies exist in Hong Kong whose shares are held by Hong Kong persons and which hold Hong Kong assets but which have not established a place of business here. These companies are currently outside the purview of the Companies Ordinance and the SCCLR intends to review this position.

3. Other measures which seek to enhance our corporate governance regime

3.01 The SCCLR notes that measures to enhance Hong Kong's corporate governance regime are not confined to those being considered under the CGR. In the context of listed companies, the SFC and the SEHK are also taking a positive role in this regard.

3.02 At present, because of the share certificate system, a substantial amount of shares are held through the nominee of the Central Clearing and Settlement System (CCASS) and beneficial owners seldom participate directly in the affairs of the relevant listed company. The Steering Committee on Enhancement of Financial Infrastructure (SCEFI) convened by the Chairman of the SFC is examining the introduction of scripless trading. A dematerialized structure would help to enfranchise the beneficial shareholders.

3.03 The SFC is reviewing the legislative provisions in the Companies Ordinance relating to 'offers of investment', with a view to updating the legal and regulatory requirements thereby facilitating subscribers to have more ready access to and greater understanding of the contents of the offer documents.

3.04 The SFC is also examining the comments received during the recent public consultation on proposed amendments to the Takeovers and Share Repurchase Codes. The proposed amendments seek to bring the provisions in the Codes in line with international standards. It is expected that the amendments to the Codes will be in place by the first half of 2002.

3.05 Separately, the SEHK and SFC are reviewing the listing rules of both the Main Board and the Growth Enterprise Market. This review seeks to bring the listing rules for the two boards into one set of rules, to update the provisions in the light of international practice and to introduce measures to improve the corporate governance of listed companies.

4. Consultation

4.01 As corporate governance reform is a very major and continuous process, the SCCLR proposes to deal with the review in phases. This also has the merit of enabling some proposals to be processed and implemented at an earlier stage than others as opposed to including all proposals in a major report whose preparation would take far longer thereby delaying the implementation of certain urgently needed reforms. Consequently, this Consultation Paper contains the first phase of the proposals made by the three Sub-Committees up to the end of April 2001.

4.02 The views of the public are sought on the proposals outlined in Chapters 2, 3 and 4 of the Consultation Paper. Submissions should be made in writing using either hard copy or e-mail not later than 15 October 2001 to :–

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CHAPTER 2

DIRECTORS

5. Overview

5.01 Chapter 2 of this paper discusses the following issues: -

(a) Directors' self-dealing;
(b) Directors' duties;
(c) Connected transactions involving directors;
(d) Transactions between directors or connected parties with an "associated corporation" of a listed company;
(e) Nomination and election of directors;
(f) Role of the independent director.

5.02 The SCCLR has kept in mind the necessity of balancing the need for regulation against the promulgation of laws that could be too onerous on directors. It is not intended to unnecessarily restrict entrepreneurial development with inflexible rules. On the other hand, reform must be appropriate where the laws or rules are either unclear or no longer accommodate the standards expected of modern businesses and international practices.

6. Directors' duties

Background

6.01 Is the law on directors' duties sufficiently comprehensible and accessible?

6.02 The basic duties of directors in Hong Kong are found largely in case law. These are derived from contract, equitable and tortious principles. Each of rule 3.08 of the Main Board listing rules and Rule 5.01 of the GEM listing rules of the SEHK sets out a broad summary of the basic duties of directors as follows: -

> "The board of directors of an issuer is collectively responsible for the management and operations of the issuer. The Exchange expects the directors, both collectively and individually, to fulfil fiduciary duties and duties of skill, care and diligence to a standard at least commensurate with

the standard established by Hong Kong law. This means that every director must, in the performance of his duties as a director: -

(a) act honestly and in good faith in the interests of the company as a whole;
(b) act for proper purposes;
(c) be answerable to the listed issuer for the application or misapplication of its assets;
(d) avoid actual and potential conflicts of interest and duty;
(e) disclose fully and fairly his interests in contracts with the listed issuer; and
(f) apply such degree of skill, care and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the listed issuer."[11]

In addition, directors must comply with specific obligations imposed on them by statute, the articles of association and their relevant contracts with the company. Directors may also be subject to disqualification orders by the court under the Companies Ordinance[12]. In particular, the Companies Ordinance and the listing rules of the SEHK specifically set out certain standards of conduct, for instance, to deal with conflicts of interest[13]. Other than in exceptional circumstances[14], duties of directors are generally owed to the company as a whole, and not to any particular shareholder.

Position in Hong Kong

6.03 The SCCLR reviewed the law on directors' duties in Hong Kong as well as other common law jurisdictions. These are outlined in paragraphs 6.04 to 6.12 below.

6.04 The general law on fiduciary duties of directors requires them to:-

(a) act honestly and in good faith in the interests of the company as whole;
(b) not make improper use of the company's assets;
(c) not make improper use of their position as directors;
(d) avoid conflicts and disclose interests in transactions with the company;
(e) exercise discretionary powers.

Directors would also be responsible for the application or misapplication of assets of the company in breach of these duties[15].

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[11] Query whether this standard will evolve in light of English case law developments
[12] Part IVA of the Companies Ordinance
[13] Section 7, below
[14] e.g. Walker and others v. Stones and Others TLR 26 September 2000, discussed in the Business Law Review December 2000 page 279
[15] Carrian Investments Ltd. v. Wong Chong Po et all [1986] HKLR 945. Man Luen Corporation v. Sun King Electronic Printed Circuit Board Factory Ltd. [1981] HKC 407

6.05 In the past, the statutory duty of care and diligence has been interpreted consistently with the equitable duty and was relatively low. The English case of Re: City Equitable Fire Insurance Co. Ltd.[16] that laid down the traditional standard of care and skill at common law is generally known to have been applied in Hong Kong. This sets out the test that a director must exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take in looking after his own interests in the particular circumstances. However, he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person with his knowledge and experience, although if he does possess a special skill, the court may impose a higher standard of care and skill on him. It is generally considered that this standard, as a whole, is fairly low, so that a director would not be responsible in damages unless he was guilty of gross or culpable negligence[17].

6.06 Subsequently, however, cases in the United Kingdom have since raised the standards expected from a person undertaking the duties of a director. This is particularly evidenced by the standards in the provisions relating to insolvency[18] (since substituted by the Companies Directors Disqualification Act 1986). The test is that, in determining whether or not a director should be disqualified from acting as a director, the courts must be satisfied that the director should meet the standard of care with "(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge skill and experience that the director has." The Court of Appeal in Re: Grayson Building Services Ltd.[19] also takes the view that that Parliament in enacting the Companies Directors Disqualification Act 1986 has provided evidence of its intention to hold directors to higher standards[20]. Certainly, more recent case law in the United Kingdom also supports the proposition that the standard of care expected of non-executive directors is much higher than the standard set under previous case law[21].

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[16] [1925] Ch 407

[17] For example, Gower, Principles of Modern Company Law (1997); See also Overend & Gurney & Co. v. Gibb (1872) LR 56 HL 480

[18] See D'Jan of London Ltd. [1993] BCC 646

[19] [1995] BCC 555 at 557E

[20] Similarly in Australia – see Daniels v. Anderson, [1995] 13 ACLC 614 at page 656, Court of Appeal.

[21] In Dorchester Finance Co Ltd. v. Stebbings (in 1977) but reported in [1989] BCLC 498, non-executive directors were already found to be responsible for losses because of their failure to supervise policies on loans given out by the company, as well as for signing blank checks.

6.07 The provisions of the Companies Directors Disqualification Act 1986 of the United Kingdom were adopted in Hong Kong in 1994[22]. These are found in Part IVA of the Companies Ordinance[23]. Accordingly, it is to be expected that this later line of English case law, raising the standards of directors on the basis of legislation, would be of good persuasive value in the courts of Hong Kong.

6.08 The Companies Ordinance and related statutes also impose specific duties on directors. Some of these provisions include the following: -

(a) Sections 163 and 163A to D of the Companies Ordinance require that directors must make disclosures if payments are to be made to the directors for loss of office in connection with a transfer of the company's undertaking or on a take-over[24];
(b) Directors must also make disclosures regarding their activities such as loans made by the company to officers of the company (section 161C of the Companies Ordinance[25]). Directors must also disclose the aggregate of directors' emoluments, including fees, percentages, and pensions (section 161 of the Companies Ordinance[26]);
(c) Loans by the company to its directors are generally forbidden under section 157H of the Companies Ordinance[27];
(d) Directors also have duties in relation to the accounts and records that must be kept by the company (for example, section 121 of the Companies Ordinance[28]).

6.09 Other sources of duties include those set out under the articles of association of the company and contracts between the directors and the company. These are considered to be supplementary to the common law and equity rules[29].

Other jurisdictions

6.10 In other common law jurisdictions such as Australia, Malaysia and Singapore, some of the general fiduciary duties and the duty of "care and skill" of directors have, for some time, been spelt out in statute law. In Malaysia, the Finance Committee on Corporate Governance also recently proposed a statutory codification of all of the duties of directors. The main reasons for their proposal for statutory codification appears to be in order to facilitate minority shareholders to enforce some of these duties, in particular the duty to avoid conflicts of interest.

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[22] Betty Ho, Public Companies and their Equity Securities, Principles of Regulation under Hong Kong law, page 253
[23] Sections 168C to 168S of the Companies Ordinance
[24] Failure by such director to make the relevant disclosures subjects him to a fine: Subsection 163B(3)
[25] Failure of which subjects him to a fine: subsection 161C(3) of the Companies Ordinance
[26] Wilful failure of which is an offence: subsection 161A(2)(b) of the Companies Ordinance
[27] Sections 157I and J of the Companies Ordinance
[28] failure of which subjects him to a fine or imprisonment – subsection 121(4) of the Companies Ordinance
[29] Man Luen Corporation v. Sun King Electronic Printed Circuit Board Factory Limited [1981] HKC 407

The proposal there was intended also to enable the imposition of criminal sanctions for such breaches[30].

6.11 In Australia, notwithstanding the existence of a statutory provision on the duty of care and skill, the Companies Law and Economic Reform Program Act 2000 nevertheless amended the law to deal with uncertainties created by a decision of the Court of Appeal[31] regarding the standards applicable with respect to the director's duty of care and skill. The Act also enacted the common law "business judgement rule" with the intention of providing greater legal certainty[32].

6.12 In the United Kingdom, the Company Law Review Steering Group has proposed a statutory re-statement of the principles relating to directors' duties. This proposal has been consulted on twice, and there is general support for it to be taken forward. The Group found the law complex and inaccessible in the context of modern circumstances, and was concerned that directors were not aware of the extent of their duties[33]. However, the proposal does not intend to impose any greater duties nor additional sanctions for such breaches.

Proposals

6.13 The SCCLR found the current state of law on fiduciary duties and the standards of care and skill in Hong Kong expected of directors generally acceptable. This is on the assumption that it is open for case law to demand higher standards of care and skill from directors, as evidenced in developments internationally. In the absence of any great uncertainties in the law with regard to the duties of directors, the SCCLR did not see the need to enact these duties into statute for the following reasons: -

(a) Because the finding of a breach of duty would also depend on the complexities of the facts, it would not be possible for all duties to be properly encapsulated in the law;

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[30] Paragraph 2.2.29 Chapter 6, Issue 1 of the Finance Committee Report on Corporate Governance

[31] In the context of discussing directors' liability for a tortious duty of care, the Australian Court of Appeal in the case of AWA Ltd v Daniels (1992) 10 ACLC 933 extended the objective standard beyond the financial sphere by requiring directors to take reasonable steps to place themselves in a position to guide and monitor the company's management and rejected the general defence that the directors had delegated duties to management in relation to the conduct of forex transactions. The case caused uncertainty as to the standard of care expected of directors and legislation was amended to clarify the legal position.

[32] In view of the introduction of the statutory derivative action.

[33] Pages 33 to 52, Modern Company Law For A Competitive Economy- Completing the Structure, a Consultation Document from the Company Law Steering Group (November 2000) with further responses in February 2001. In the context of Hong Kong, see "Company Directors' Perceptions of Their Responsibilities and Duties: A Hong Kong survey." Abdul Majid, Low Chee Keong, Krishnan Arjunan, Vol 29, Part 1 HKLJ 50 (1998)

(b) As a broad statement of principles would have to be framed in very general terms, it would have to be supplemented by detailed guidelines in non-statutory form;
(c) A broad statement of principles may not necessarily assist directors to clearly identify the extent of their duties nor would it help directors to determine how they should behave in any given set of circumstances;
(d) Statutory enactment would tend to be regarded as exclusive, would be inflexible and would not accommodate judicial developments to take into account changing standards;
(e) A broad statement of principles is unlikely to be of any additional assistance to shareholders;
(f) There is no intention to create criminal penalties for breach of directors' duties generally.

6.14 The SCCLR does not therefore recommend that the duties of directors should be set out by way of a statutory enactment, particularly if there is no intention to change the nature of their duties or impose any greater sanctions in relation to such breaches. The SCCLR does not consider it necessary to impose criminal consequences for these general breaches of duties except in the case of misappropriation of company assets or other dishonest acts. In cases of fraud or dishonesty, the SCCLR considered that specific sanctions would apply, or, where necessary, could be set out under legislation.

6.15 The SCCLR considers that a more pragmatic approach should be taken. Consequently, the SCCLR believes that there is merit in having a Code of Best Practice that would serve as a guide to directors as to their duties, which can more readily be amended if necessary to reflect developments in case law. The Hong Kong Institute of Directors has, for instance, issued guidelines of this nature[34]. Action is now being taken by the SFC to draft such a Code of Best Practice. The SCCLR also believes that awareness of directors of their duties could be promoted through educational means.

7. Voting by directors in relation to directors' self-dealing

Background

7.01 Is the current law on self-dealing by directors sufficient?

7.02 Section 162 of the Companies Ordinance attempts to provide for the regulation of self-dealing by directors. In this paper, the term "self-dealing" is given the same

[34] Guidelines for Directors issued by the Hong Kong Institute of Directors in 1995; Guidelines for Independent Directors issued by the Hong Kong Institute of Directors in 2000

meaning as the SCCLR's Report on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance[35]. In other words this relates to "a transaction where a person who participates in decisionmaking on one side of the transaction also has an interest on the other side".

7.03 For the purposes of this discussion, a reference to the director also refers to a "shadow" director.

7.04 The original fiduciary principle would prevent a fiduciary from gaining any benefit from his position, regardless of whether or not the transaction may be fair to the beneficiary. Directors, as fiduciaries, were held to owe a similar duty of loyalty to companies. This "conflict" rule, as applied to directors, means that company directors must not in any matter falling within their scope of service have a personal interest or inconsistent engagement with a third party. The exception is where a director has obtained the company's fully informed consent.

7.05 The law has, however, since evolved so that the constitutions of companies may nevertheless allow directors to profit from contracts despite possible conflicts of interest. This would be subject to certain rules of procedural fairness. Thus, it is common to require that such material interests must be disclosed. The objective of requiring such disclosure is to ensure the efficacy of the decision-making process. The proposition is that, with disclosure, the board would be aware of the conflict of interest. The board can then assess the situation and make decisions knowing that there is a possible influence from directors with personal interests[36].

7.06 The SCCLR views this position as being "probably sound"[37] as there are advantages to a company in having well-connected directors. Such directors might be in a better position to provide the company with corporate opportunities and may help to reduce transaction costs in negotiating and enforcing corporate contracts.

7.07 General law does not prohibit an interested director voting on a matter in which he has a material interest if its constitution so permits. This position is also reflected in the existence of exceptions to this rule appearing in the default articles of association (Table A) in the Companies Ordinance.

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[35] Page 76, paragraph 6.73 Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance (February 2000)

[36] See Betty Ho, page 312, citing Neptune (Vehicle Washing Equipment) Ltd. v. Fitzgerald [1995] 3 WLR 108: Object of statute to (i) Let all directors know or be reminded of the interest declared (ii) give pause to the interested director for reflection on the existence of the conflict and of the duty to prefer the interests of the company over his own, (iii) to record in written form the declaration and to caution interested directors who might otherwise think their interest would escape notice.

[37] Page 77, paragraph 6.73, Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance

7.08 Given these developments, the questions the SCCLR seeks to address are: -

(a) First, to what extent should the law allow an interested director to be present and vote on a transaction in which he has an interest?
(b) Secondly, what are the civil consequences of a breach of this general prohibition?
(c) Thirdly, is the ambit of the current statutory provisions under the Companies Ordinance sufficient?

Proposals

7.09 The SCCLR proposes the following amendments to the law: -

(a) The law should set out the general position which is that an interested director should not vote at a board meeting on a matter in which he has an interest. The extent to which the articles of a company should be permitted to allow a director to be exempted from his duty to abstain from voting should be statutorily amended[38]. In particular the exception in Regulation 86 of Table A that allows the interested director to vote in relation to "(A)ny contract or arrangement with any other company in which he is interested only as an officer or shareholder or holder of securities of the other company"[39] should not be included as one of the exceptions to the general rule[40] that an interested director may vote for a transaction in which he is interested;

(b) The only exceptions to the general prohibition should be as follows: -

- Any interest which is an immaterial interest. An "immaterial interest" might be defined as one which does not give rise to a risk of actual conflict. In the event of dispute, the director should satisfy the court that the interest did not give rise to actual conflict and the rest of the board was aware of his interest[41];
- In the case of a contract relating to a loan to the company, where the director gives a guarantee for repayment of the loan;

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[38] Fourth issue highlighted by the SCCLR, Page 78, Paragraph 6.82 The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance

[39] The fourth exception under regulation 86(2) of Table A. See paragraph 5.03(iv) below.

[40] First issue highlighted by the SCCLR, Page 78, Paragraph 6.79 The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance

[41] See proposal of the English and Scottish Law Commissions "Company Directors : Regulating Conflicts of Interests and Formulating a Statement of Duties" (September 1999): lawcom.gov.uk/misc/company.htm

- Any proposal or arrangement for the benefit of employees of the company or its subsidiaries, under which he may benefit, or the adoption, modification or operation of a pension fund or retirement, death, or disability benefits scheme that relates both to directors and employees, provided that the directors' entitlements are no greater than any privilege or advantage not generally accorded to the class of persons to which such scheme or fund relates. This does not detract from the requirements of the listing rules in relation to listed companies, insofar as they prohibit voting by participants in relation to any such scheme;

(c) Subsection 162(2) of the Companies Ordinance should be amended so that the interested director should make a disclosure of his interest on an *ad hoc* basis, in addition to the general notice in advance[42]. This is to ensure that directors are reminded of the possible conflict of interest and duty of the interested director at the time the proposal is put forward for consideration;

(d) Contracts, transactions or arrangements in which the director or connected persons have an interest should in any event be disclosed to shareholders. Where these are significant, they should also be referred to the shareholders for their approval[43]. When such approval would be necessary is considered below under section 8. The proposal would also need to be referred for shareholders' approval where there are insufficient disinterested directors to form a quorum;

(e) The law will be amended to clarify the civil consequences of a breach of the general rule. If the directors, or, as the case may be, the shareholders' approval is not obtained, the transaction or arrangement will be voidable at the instance of the company. For commercial certainty, the company's right to avoid the transaction or arrangement will, however, be lost if:-

- restitution is no longer possible;
- if rights acquired by a third party in good faith and for value would be affected by the avoidance;
- the arrangement is affirmed (where ratifiable[44]) within a reasonable time by the company in general meeting.

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[42] Second issue highlighted by the SCCLR, Page 78, Paragraph 6.80 The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance

[43] Some of these are already provided for in the listing requirements of the SEHK, namely Chapter 14 of the Main Board listing rules /Chapter 20 of the GEM listing rules.

[44] See paragraphs 15.07 to 15.10 below

It is noted that case law in Hong Kong suggests that the courts will, in any event adopt the position that this would make the contract voidable at the option of the company[45]. The director or the person connected with the director should also be liable to account to the company for any gain that he has made, and to indemnify the company for any loss or damage resulting from the arrangement or transaction[46]. The section will be "without prejudice to any liability imposed otherwise than by that subsection …";

(f) The ambit of section 162 of the Companies Ordinance itself will be widened. The SCCLR proposes that section 162 should be expanded to deal with: -

- "transactions" and "arrangements"[47], as opposed to just "contracts" or "proposed contracts"; and
- "connected persons"[48] including relatives and associates of the director.

7.10 It is noted that similar issues are pertinent where the interested director is also a controlling shareholder, and, in relation to a controlling shareholder that has an interest in a transaction. An interested director who is also a shareholder may be able to vote or influence a vote in favour of ratifying a transaction or arrangement in breach of the general rule. Proposals relating to this matter are discussed further in this consultation paper.[49]

Rationale

7.11 The proposals will continue to allow self-dealing by directors subject, however, to the additional requirement for securing the approval of disinterested directors, and, where applicable, shareholders' approval. The limited exceptions to the requirement to the circumstances needing the approval of disinterested directors only are generally in line with those of other jurisdictions. The proposals to widen the ambit of section 162 of the Companies Ordinance would also bring the provision more into line with those of common law jurisdictions such as the United Kingdom and Australia.

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[45] Man Luen Corporation v. Sun King Electronic Printed Circuit Board Factory Ltd. [1981] HKC 407, Fuad J.

[46] as in the provisions in the subsection 322(2) of the Companies Act 1965 of the United Kingdom

[47] Which would include "dispositions, contracts for a disposition or agreements for a disposition which would not amount to a contract for a disposition": Re: British Basic Slag Ltd.'s Agreement [1963] 1 WLR 727; Re: Duckwari plc [1999] Ch 253

[48] To be defined so that it is consistent with other provisions or proposed provisions in the law. See the definition in paragraph 8.26, below, in the context of such transactions or arrangements which should be approved by shareholders.

[49] Section 13 below

8. Shareholder approval for connected transactions of significance involving directors

Background

8.01 Should the Companies Ordinance require that connected transactions (involving directors) be subject to shareholders' approval? These are transactions between:-

(a) the company or its subsidiaries; and
(b) directors of the company or directors of its holding company or other persons connected with the director.

8.02 The listing rules of the SEHK include a number of provisions dealing with connected transactions[50]. A "connected transaction" is defined as including "… any transaction between a listed issuer or any of its subsidiaries and a connected person". The SEHK will usually require that shareholders' approval be obtained, with the interested person abstaining. In particular, a transaction in this context includes, *inter alia*, an acquisition or realisation of assets by a listed issuer or any of its subsidiaries[51]. Exceptions are made for transactions on normal commercial terms within specified limits[52] that may nevertheless be subject to disclosure requirements.

8.03 The SCCLR found, however, that, other than in relation to the payments to directors in connection with the loss of office[53], the Companies Ordinance does not require that shareholders' approval should be sought for transactions involving directors or persons connected with directors under Hong Kong law[54]. This is in contrast with the position in the other jurisdictions surveyed.

Other jurisdictions

8.04 A review of the laws of other common law jurisdictions reveals that these jurisdictions have common law[55] or statutory[56] law provisions that require

[50] Rule 14.23 of the Main Board listing rules/ rule 20.12 of the GEM listing rules of the SEHK
[51] Rule 14.26 of the Main Board listing rules / rules 20.12 and 20.15 of the GEM listing rules of the SEHK
[52] Rules 14.24 and 14.25 of the Main Board listing rules/ rules 20.23, 20.24, 20.34 and 25.35 of the GEM listing rules of the SEHK
[53] i.e. Payments in connection with the transfer of the company's assets to directors or past directors for loss of office must have the prior approval of the shareholders: section 163A of the Companies Ordinance
[54] Subsection 129D(3)(j) requires that the directors' report should include a statement as to whether or not there subsists (i) a contract with the company or the company's holding company or a subsidiary of the holding company in which the director has, or at any time in that year, had, in any way, whether directly or indirectly, an interest. It must also disclose whether or not at any time of the year, there subsisted a contract in which a director of the company has, directly or indirectly any interest in any contract of significance in relation to the company's business in which the director's interest is or was "material".
[55] United States

shareholders' approval in relation to transactions that involve a benefit to directors, or persons related to the director.

8.05 Under section 320 of the English Companies Act 1985, shareholders' approval must be obtained for certain arrangements between companies and their directors[57] or connected persons[58]. These arrangements relate to the acquisition or disposal of substantial non-cash assets of a requisite value. The relevant "non-cash asset" is defined in section 739(1) of the English Companies Act 1985 as any property or interest in property other than cash. An asset is "of the requisite value" if at the time the arrangement is made its value exceeds £100,000 or 10% of the company's net assets (subject to a *de minimis* in relation to transactions with a value of £2,000 or less). The word "*arrangement*" is used in order to cover transactions where an asset is transferred first to a third party and then on to a director[59]. Specific exceptions to the requirement are set out under the Act[60].

8.06 If the company's approval is not obtained, the transaction or arrangement is voidable at the instance of the company. The company's right to avoid the transaction or arrangement will, however, be lost if[61]: -

(a) restitution is no longer possible;
(b) if rights acquired by a third party in good faith and for value would be affected by the avoidance;
(c) the arrangement is (where ratifiable[62]) within a reasonable period affirmed by the company in general meeting.

8.07 The consequences of a breach of the provision are that the director or the person connected with the director is liable to account to the company for any gain that he has made, and to indemnify the company for any loss or damage resulting from the arrangement or transaction[63]. The section is "without prejudice to any liability imposed otherwise than by that subsection …".

8.08 The rationale behind the English provision has been stated to be as follows: -

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[56] Section 320 of the English Companies Act 1985; Chapter 2E of the Australian Corporations Law, Section 160A of the Singapore Companies Act; section 132F of the Malaysian Companies Act 1965

[57] Sections 320 to 322 of the English Companies Act 1985 came about as a response to the Department of Trade and Industry Inspectors' reports on fraudulent asset stripping by directors in the late 1970s.

[58] as defined under section 346 of the Companies Act 1985. These include the director's minor children, spouse, partners and any company in which the director and his associates control 20% or more of the equity share capital

[59] encompassing "dispositions, contracts for a disposition or agreements for a disposition which would not amount to a contract for a disposition": Re: British Basic Slag Ltd.'s Agreement [1963] 1 WLR 727; Re: Duckwari plc [1999] Ch 253

[60] section 321 of the Companies Act 1985

[61] Section 322 of the Companies Act 1985

[62] See paragraphs 15.07 to 15.10 below

[63] Subsection 322(2) of the Companies Act 1965

"… that if the directors enter into a substantial commercial transaction with one of their number, there is a danger that their judgement may be distorted by conflicts of interests and loyalties, even in cases where there is no actual dishonesty. The section is designed to protect a company against such distortions. It enables the members to provide a check. Of course that does not necessarily mean that the members will exercise better commercial judgment; but it does make it likely that the matter will be more widely ventilated and a more objective decision reached."

8.09 In **Singapore**, proposals for certain arrangements involving directors or persons connected with directors need shareholders' approval or, as the case may be, approval of the shareholders of its holding company. This is where the company proposes to enter into an arrangement under which it either buys from or sells to, relevant persons, non-cash assets worth more than Singapore 100,000/-[64]. The objective is that a company must approve substantial transactions with a director or person connected to the director.

8.10 The relevant persons for the purposes of the Singaporean legislation are: -

(a) A director of the company or its holding company, including (it is thought) a shadow director;
(b) The spouse and children (including step-children) of such a director; or
(c) A body corporate with which such a director is associated.

8.11 A body corporate is associated with such a director if he *and* the person connected with him[65] are interested in more than 20% of the equity share capital of that body corporate or can control the exercise of more than 20% of the votes in a general meeting.

8.12 The consequences of breach are civil. Transactions in contravention of this provision would be voidable at the instance of the company[66] unless the rights to avoid the transaction have otherwise been lost[67].

8.13 In **Australia**, chapter 2E of the Corporations Law specifically requires that a public company and its controlled entities that seek to give a financial benefit to directors or other related parties must obtain the approval of shareholders. The Australian Securities and Investments Commission also makes comments on the

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[64] Section 160A of the Singapore Companies Act
[65] i.e. the persons mentioned in paragraphs 8.10(a) and (b) above
[66] Section 160C of the Singapore Companies Act
[67] by ratification at general meeting within a reasonable time (section 160C(2)(c)), where a rights have been acquired bona fide by a third party (section 160C(2)(b)) or where *restitutio ad integrum* is not possible (section 160C(2)(a))

proposals although it does not make a judgement as to whether the proposed resolution is in the best interests of the company[68].

8.14 This provision is not intended to prevent "full value, commercial transactions" with related parties. However, it is intended to prevent transactions that have the potential to adversely affect the interests of shareholders as a whole[69]. The object of chapter 2E is stated as "being to protect the interests of a public company's members as a whole, by requiring member approval for giving benefits to related parties that could endanger those interests"[70].

8.15 "Related parties" include: -

(a) a controlling entity of the public company;
(b) directors of the public company or its controlling entity and their spouses, and *de facto* spouses, parents and children;
(c) an entity controlled by a related party;
(d) an entity which was a related party during the previous 6 months;
(e) an entity which acts in concert with a related party on the understanding that the related party will receive a financial benefit if the public company gives the entity a financial benefit.

8.16 Approval of the shareholders is not however necessary if the financial benefit is given on terms that: -

(a) would be reasonable in the circumstances if the public company or entity and the related party were dealing at arm's length; or
(b) are less favourable to the related party than the terms referred to in paragraph (a)[71].

8.17 There are also certain exceptions to the rule[72]. These include the following: -

(a) reasonable remuneration as an officer or employee of the public company or an entity which controls or is controlled by the public company;
(b) repayment of expenses incurred by a related party in performing duties as an officer or employee of the public company or a controlling or controlled entity;
(c) payment of reasonable insurance premiums in respect of a liability incurred as an officer of the public company;

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[68] Section 221 of the Australian Corporations Law
[69] Explanatory Memorandum accompanying the Corporate Law Reform Act 1992 that introduced the provision.
[70] Section 207 of the Corporations Law
[71] Section 210 of the Australian Corporations Law
[72] Sections 210-216 of the Australian Corporations Law

(d) payments in respect of legal costs incurred by an officer in defending an action involving a liability incurred as an officer of the public company;
(e) amounts of money given to the director or spouse of less than AUD 2000;
(f) financial benefits to or by a closely-held subsidiary;
(g) benefits given to the related party as a member of the public company and the benefits do not discriminate unfairly against the other members.

8.18 A breach of the provision does not affect the validity of the transaction[73]. However, persons involved in the breach are subject to civil penalties or orders for compensation by the court[74].

8.19 In the **United States**, the American Law Institute recommended that (unless already approved or ratified by disinterested directors) the following elements must exist in order for a transaction involving self-dealing to be upheld: -

(a) the transaction must be fair to the corporation when entered into;
(b) the transaction must be authorised in advance or ratified with disclosure, by disinterested shareholders, and does not constitute a waste of corporate assets[75].

8.20 It would seem that statutes of some states might not necessarily provide that the shareholder approval must be by disinterested shareholders, or that the transactions are subject to review for waste of corporate assets. Nevertheless, the American courts have generally read such limitations into their decisions[76].

8.21 A breach of fiduciary duties in itself does not amount to fraud under American law. However it would appear that such a breach coupled with non-disclosure might amount to a fraud in contravention of rule 10b-5 of the Securities Exchange Act of 1934 if the controlling shareholders have an interest adverse to the company and misrepresent or conceal material facts[77].

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[73] Subsection 209(3) of the Australian Corporations Law
[74] Section 1317E of the Australian Corporations Law
[75] Pages 211 and 222, the American Law Institute's "Principles of Corporate Governance": An analysis and recommendations (1994)
[76] Pages 211 and 222, the American Law Institute's "Principles of Corporate Governance": An analysis and recommendations (1994)
[77] Page 52, paragraph 312, "Responsibilities of Corporate Officers and Directors under Federal Securities Laws" (CCH) Issue No. 1757

Proposals

8.22 The SCCLR proposes the adoption of a statutory provision to address this issue. This would be modeled along the lines of the section 320 of the English Companies Act 1985 with modifications. In particular, the relevant arrangement would not be limited to non-cash assets only but would apply to the acquisition or disposition of all assets and other arrangements.

8.23 The "arrangements" in question would, therefore, include other possible financial advantage to directors or connected persons, for instance, the giving of services, such as: -

(a) leasing an asset from or to the director or connected person;
(b) supplying services e.g. management services to or receiving services from the director or connected person;
(c) issuing securities or granting an option to the director or connected person;
(d) taking up or releasing an obligation of the director or connected person.

Such arrangements could be effected in the following manner: -

(a) giving a financial benefit indirectly, for example, through one or more interposed entities;
(b) giving a financial benefit by making an informal agreement, oral agreement or an agreement that has no binding force;
(c) giving a financial benefit that does not involve paying money (for example, by conferring a financial advantage).

8.24 In the United Kingdom, for the purposes of the companies legislation, the requisite value is in relation only to non-cash assets and amounts to either GBP100,000 or 10% of the company's net assets, on an aggregated basis for each financial year, provided that it is no less than GBP2,000. The value of the company's net assets would be determined by reference to the accounts prepared and laid under the legislation in respect of the latest financial year[78]. For other transactions, the listing rules prescribe the relevant test. Currently, Chapter 14 of the Main Board listing rules of the SEHK and Chapter 20 of the GEM listing rules of the SEHK are being reviewed. The exercise is considering a test by reference to the gross value less intangibles and less current liabilities, in order to get to a longer view of the invested value of a company

8.25 The SCCLR seeks the views of the public on: -

(a) Whether the test for determining the requisite value should be by reference to a net asset value test or a value which is the gross value less intangibles

[78] cf. Subsection 320(2)(a) of the English Companies Act 1985

and less current liabilities in order to get to a longer view of the invested value of a company or some other appropriate test;

(b) The requisite percentage which would trigger the requirement for shareholders' approval for the purposes of legislation;

(c) Whether there should be a *de minimis* absolute figure which would be excluded from this requirement, and if so, what amount would be appropriate?

Persons connected with the director

8.26 Similar to the English provisions, a "connected person" would include the following: -

(a) director's children or step-children;

(b) spouse;

(c) trustee of any trusts in which the director, spouse, children are beneficiaries under the trust;

(d) partners; and

(e) any corporation associated with the director[79]. This would include a body corporate in which the director and his associates[80] control the exercise of 20% or more of the voting rights of the equity share capital (or control the composition of the board or any other company which is its subsidiary or holding company or subsidiary of any holding company)[81].

Controlling shareholder and persons connected with controlling shareholder

8.27 In relation to circumstances where a controlling shareholder has an interest in the arrangement, the controlling shareholder should also abstain from voting on the transaction. This is discussed further under the heading of "Shareholders" in Chapter 3 below. A "connected person" in relation to the controlling shareholder would have to be correspondingly drafted.

Exception in relation to transactions with wholly owned subsidiaries

8.28 The SCCLR is of the view that where there are several companies interposed between the subsidiary and the ultimate holding company, the provision should be applied so that only the approval of the shareholders of the ultimate holding company is necessary. Therefore, the approval of a body corporate which wholly owns the company in question will not be necessary. A company should be a wholly-owned company of another company if it has no members except that other and that other's wholly owned subsidiaries and persons acting on behalf of

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[79] This should include foreign companies

[80] Along the lines of the definition under section 346 of the English Companies Act 1985

[81] cf. Definition of "associate" in rule 1.01 of the Main Board listing rules of the SEHK / rule 1.01 of the GEM listing rules of the SEHK

that other or its wholly owned subsidiaries[82].

Consequences of breach

8.29 In addition, the SCCLR also proposes that a breach of this provision would entail the following consequences: -

(a) The transaction should be voidable at the instance of the company, subject to rights of bona fide third parties for value, the impossibility of restitution or ratification (where permissible[83]) within a reasonable time;
(b) The director or connected person should be liable to account for any profits and to indemnify the company against any loss or damage resulting from the breach of the provision;
(c) The liability of the director or connected person must be without prejudice to any other liability that may be imposed by law. As such, any criminal sanctions applicable to the director or connected person would continue to apply;
(d) In addition, should the company also be liquidated within one year after the entry of the transaction, criminal penalties may be imposed on the officers involved in the breach of this provision. In addition, the burden would fall on the director or connected person to show that the transaction or arrangement is not a misappropriation of the company's assets.

8.30 This requirement would extend to the directors of unlisted public companies or persons connected to them as well as to the directors of private companies. In the case of private companies where no quorum of disinterested directors can be constituted, the transaction or arrangement should be referred to shareholders for their unanimous approval.

Rationale

8.31 These proposals would bring the law into line with jurisdictions such as Singapore, United Kingdom and Australia. The SCCLR considered that the provisions of the laws of the United Kingdom, with adaptations, would be the most appropriate within the context of Hong Kong jurisprudence. The consequences of breaches of the law under the United Kingdom provisions are also likely to be more consistent with the consequences under the laws of Hong Kong. Further, unlike Australia,

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[82] Section 124(4) of the Companies Ordinance provides that, for the purposes of that section, a body corporate shall be deemed to be the wholly owned subsidiary of another if it has no members except that other and that other's wholly owned subsidiaries and its or their nominees. The UK section 736 of the Companies Act 1965 provides that a company is a "wholly owned subsidiary" of another company if it has no members except that other and that other's wholly owned subsidiaries and persons acting on behalf of that other or its wholly owned subsidiaries

[83] see paragraphs 15.07 to 15.10 below

there is no intention for the law to provide that regulators may make comments in relation to such arrangements. In particular, following the provisions of the United Kingdom, it will be immaterial what the proper law of the contract is[84].

8.32 The proposal is intended to set out more clearly, the circumstances under which shareholders' approval should be obtained for arrangements involving directors, or in relation to persons connected to directors.

8.33 The incorporation of this requirement into statute also means that, in relation to all Hong Kong incorporated companies, there would be legal consequences with regard to breaches of these laws, as opposed to the mere breach of the listing rules[85].

8.34 If the requirements are reflected as a matter of a personal right of the shareholder under the articles of oversea companies, in common law jurisdictions arguably breaches of such provisions (subject to any internal management rule in the laws of those jurisdictions) could form the basis of a cause of action for the shareholder.

9. Transactions between directors or connected parties with an associated company

Background

9.01 Should the approval of the shareholders be obtained in relation to transactions or arrangements between (i) a director or connected person and (ii) other "associated companies or corporations"?

9.02 As mentioned earlier, Chapter 14 of the listing rules regulates "connected transactions". For some of these transactions, Chapter 14 requires that all shareholders be furnished with an informational circular, the content of which is first vetted and approved by the SEHK, or be given an opportunity to vote on whether the transaction ought go forward. Relevant arrangements and transactions include arrangements and transactions between "connected persons" and the listed company itself or its subsidiary.

9.03 The listing rules do not currently address arrangements and transactions entered into between: -

[84] Section 347 of the Companies Act 1985
[85] Rule 2A.09 of the Main Board listing rules of the SEHK / Rule 3.10 of the GEM listing rules

(a) a director of a listed company (or connected person); and
(b) a company that does not fall within the definition of a "subsidiary" of the listed company, i.e. where the listed company or its subsidiary holds less than 51% of the company in question (referred to, for ease of reference, as an "associated company").

9.04 Thus since the definition of "subsidiaries" does not extend to such companies, neither the approval of shareholders, nor disclosure or notification to shareholders will be necessary in relation to the transaction in question.

9.05 Accounting principles, on the other hand, would take into account the possible influence that the company would have in relation to companies in which it has less than 51% share ownership. In the Statement of Standard Accounting Practice ("SSAP") 20, paragraph 5, "parties are considered to be related if one party has the ability, directly or indirectly, to control the other party or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence." Significant influence might be gained, *inter alia*, by share ownership. In SSAP 10, paragraph 3, it is provided that, if an investor held, directly or indirectly through subsidiaries, 20% or more of the voting power of the investee, it will be presumed that the investor had significant influence, unless it could be clearly demonstrated that this was not the case.

Other jurisdictions

9.06 The Financial Services Authority Listing Rules[86] deal with "transactions with related parties". These transactions are defined to cover transactions (other than transactions of a revenue nature in the ordinary course of business) between: -

(a) the company or any of its subsidiary undertakings; and
(b) a related party, or any person who, or another entity which, exercises significant influence over the company[87].

9.07 A "subsidiary undertaking"[88] for the purposes of the United Kingdom listing rules is defined to include an enterprise over which a company has "… the right to exercise a dominant influence over the undertaking's memorandum and articles of association, or by virtue of a control contract."[89].

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[86] with effect from 1st May 2001, this is the Financial Services Authority, and no longer the London Stock Exchange under the Official Listing of Securities (Change of Competent Authority) Regulations 2000
[87] The Financial Services Authority Listing Rules paragraph 11.1(a)(iii)
[88] Section 259 of the United Kingdom Companies Act
[89] As defined under section 258 and Schedule 10A of the United Kingdom Companies Act 1985

Proposals

9.08 The SCCLR proposes that: -

(a) The listing rules relating to connected party transactions should be extended to an "associated company" and not limited to "subsidiaries". The SCCLR considers that the "associated company" for these purposes, should be defined as one in which the listed company controls the exercise of 20% or more of the voting rights of the equity share capital[90];

(b) The Companies Ordinance should require the approval of disinterested shareholders in relation to transactions involving directors or connected persons and an associated company;

(c) The proposed provision under the Companies Ordinance (section 8 above) would in addition equally apply to arrangements between: -

- the associated company[91] of the company; and
- directors of the company or directors of its holding company or other persons connected with the director.

Rationale

9.09 This proposal is intended to deal with arrangements where a director or controlling shareholder (or connected persons) might be acting in concert with other parties (perhaps also directors or controlling shareholders of other companies)[92]. The companies controlled by the parties acting in concert could each hold a percentage of the associated company falling short of the definition of "subsidiary".

9.10 Under such circumstances, the parties acting in concert might be able to transfer (without shareholder approval or knowledge) unprofitable assets into the associated company at inflated prices, or acquire profitable assets from the associated company at an undervalue.

9.11 The SCCLR is of the view that there is a strong case in Hong Kong for these proposals and for exceeding the standards in other jurisdictions where the shareholding is dispersed, and where the issue of indirect control through cross-holding or pyramiding is not a significant problem.

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[90] cf. Definition of "associate" in rule 1.01 of the listing rules of the Main Board of the SEHK/ rule 1.01 of the GEM listing rules of the SEHK,;

[91] which would include a foreign company

[92] see www.webb-site.com/articles/outofsight.htm

10. Nomination and election of directors

Background

10.01 Do the current requirements in relation to nomination and election of directors provide all shareholders with a meaningful procedure by which to nominate and elect directors?

10.02 While shareholders should not interfere with management decisions, it is generally accepted that shareholders should have some measure of influence over board decisions and corporate policies of the company through the election of the board. Consequently, directors are accountable to shareholders who have the right to remove the directors from the board. In many jurisdictions, the right to participate in the election of the members of the board is considered a basic shareholder right[93].

10.03 The SCCLR considered the current procedures for the nomination and election of directors. The SCCLR believes that there is a need to improve these procedures so as to provide shareholders with a meaningful right to nominate and elect directors within the current framework.

10.04 Apart from the appointment of the first directors[94], the right of shareholders to elect directors will be derived from the exercise of the inherent power of shareholders to direct the control of the company: Worcester Corsetry Ltd. v. Witting[95]. It has been pointed out in relation to English law, that there are no statutory provisions that provide for the directors to be elected by shareholders at general meeting[96]. In this connection, this right to elect directors might be expressly excluded by the articles or by clear implication: Integrated Medical Technologies Ltd. v. Macel Nominees Pty. Ltd.[97].

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[93] Page 25, OECD Principles of Corporate Governance, Meeting of the OECD Council at Ministerial Level, 1999

[94] In practice, regulation 77 of Table A will usually be adopted so as to provide that the subscribers of the memorandum of association will determine the first directors of the company. The first directors are either named in the articles or are determined in writing by the subscribers of the memorandum or a majority of them

[95] [1936] Ch 640 @ 650

[96] Gower, Principles of Modern Company Law (1997) page 180

[97] [1988] 13 ACLR 110. nb. This position has also been statutorily dealt with in Australia.

10.05 Essentially, the Companies Ordinance requires that there must be a minimum of two directors[98] and separate voting in relation to the appointment of each director[99]. However, apart from those requirements, the Ordinance does not regulate the selection, nomination and election processes for directors. The articles of association essentially govern the manner of electing directors.

10.06 The listing rules prescribe certain provisions that must be included in the articles of a listed company. They provide that directors appointed to fill a casual vacancy, or as an addition to the board, must retire at the next annual general meeting of the company[100]. The rules also require that company's articles should provide that the shareholders in general meeting have the power to remove any director before expiration of his term[101]. In addition, they deal with the time frames during which a shareholder intending to propose a candidate for the position of director can do so[102].

10.07 Apart from these requirements, under the provisions of the Companies Ordinance, a company is generally free through its articles to determine the procedure for the election of its directors. It has been pointed out in relation to English law, that there are no statutory provisions which provide for the directors to be elected by shareholders at general meeting[103].

10.08 In practice, the articles of association of the company will also include the provisions relating to election that are similar to those in the model articles of Table A (First Schedule, Companies Ordinance). The model articles provide that, at the first general meeting, all the directors should retire[104]. At every annual general meeting ("AGM") thereafter, one-third of the directors for the time being should retire[105]. The retirees should be those who have been longest in office since their last election and, as among those of the same seniority, should be chosen by lot[106]. Retiring directors may nevertheless offer themselves for re-election by the shareholders[107].

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[98] Section 153 of the Companies Ordinance

[99] Section 157A of the Companies Ordinance provides that at a general meeting of a company, a motion for the appointment of 2 or more persons directors of the company by a single resolution shall not be made unless a resolution that it shall be so made has first been agreed to by the meeting without any vote being taken against it.

[100] Paragraph 4(2), Appendix 3, Main Board listing rules of the SEHK / Paragraph 4(2), Appendix 3 GEM listing rules of the SEHK

[101] Paragraph 4(3), Appendix 3, Main Board listing rules of the SEHK / Paragraph 4(3), Appendix 3 GEM listing rules of the SEHK

[102] Paragraphs 4(4) and (5), Appendix 3, Main Board listing rules of the SEHK / Paragraphs 4(4) and (5), Appendix 3 GEM listing rules of the SEHK

[103] Gower, Principles of Modern Company Law (Sweet & Maxwell) (1997 Ed.) page 180

[104] Regulation 91

[105] Regulation 91

[106] Regulation 92

[107] Regulation 93

10.09 Shareholders may by ordinary resolution also increase or decrease the number of directors[108]. If the company increases or decreases the size of the board, it may also determine in what rotation the increased or reduced number of directors are to go out of office[109]. The board can also fill casual vacancies[110] (though in the case of public listed companies, such directors can hold office only until the next AGM[111]).

10.10 Typically, the management will put forward a slate of directors in the management information circular that will have been approved by the directors. This will accompany the proxy form sent to shareholders for the AGM. Shareholders will either vote for or withhold their vote from each director in turn and a simple majority at the AGM will allow the director to be voted in.

Shareholder's right to nominate

10.11 Under common law principles, the right to vote for directors may belong to the shareholders. However, in practice, because management has control over the procedure for nomination, it is *management* that would be in the position to determine or influence the composition of the board through the nomination process. In Hong Kong, where in some of the listed companies there is generally little separation between the board and the controlling shareholder, it is the *controlling shareholder* that would in many cases be in the best position to control the ultimate composition of the board.

10.12 Under current practice, the choice of nominees is offered to the shareholders in the notice convening the annual general meeting. Shareholders also have the right to nominate their own candidates but, in order to do so, articles generally require that they must give notice of their intention to propose a candidate as indicated in the following paragraphs.

10.13 The model article in Table A[112] provides:-

"No person other than a director retiring at the meeting shall unless recommended by the directors be eligible for election to the office of director at any general meeting unless not less than 3 nor more than 21 days before the date appointed for the meeting, there shall have been duly left at the registered office of the company notice in writing, signed by a member duly qualified to attend and vote at the meeting for which such notice is given, of the intention to propose such

[108] Regulation 96
[109] Regulation 96
[110] Regulation 97
[111] Paragraph 4(2), Appendix 3 of the Main Board listing rules of the SEHK/ Paragraph 4(2), Appendix 3 GEM listing rules of the SEHK
[112] Regulation 95

person for election, and also notice in writing signed by that person of his willingness to be elected."

10.14 In order for a nomination to be effectively put forward, the shareholder must put in a notice *not more than 21 days and no later than 3 days* before the date appointed for the meeting. The maximum time of notice means that the shareholder's nomination would not be accepted unless it is left during that period of time.

10.15 In the case of public listed companies, the listing rules provide that this notice must be given not less than 7 days before the date fixed for the AGM[113]. It also provides that the length of time during which the notice can be given must be a minimum of 7 days[114]. In other words, if the minimum time frame is adopted, the shareholder can only make his nomination in a window period of 7 days, and in any event, not later than 7 days prior to the date fixed for the AGM.

10.16 In practice, this means that: -

(a) the time frame within which a shareholder may leave a notice of nomination can be extremely small; and
(b) details of the nominee may not be circulated among the shareholders as a whole and he may need to bear the costs of circulating the details himself prior to the meeting.

10.17 The SCCLR considered therefore that any shareholders should be provided with a reasonable opportunity to lodge their nominations with the company for consideration at the AGM and the time frame for lodging nominations should be extended. If a nomination is made prior to the date on which the notice of AGM is circularised, the details of the nominee can also be circulated at the same time without significant or any additional costs to the company.

Cumulative voting

10.18 In Hong Kong and some of the other Asian countries, where management is effectively controlled by a large shareholder or a group of large shareholders, in reality, the constitution of the board will be determined through the influence of these large shareholders. Minority shareholders would find it difficult, even where they are able to put up their own nominees as candidates for the position, to ensure that their nominee is voted in.

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[113]Paragraph 4(5), Appendix 3, of the Main Board listing rules of the SEHK/ Paragraph 4(5), Appendix 3 GEM listing rules of the SEHK

[114] Paragraph 4(4), Appendix 3, subparagraph 4(4) of the Main Board listing rules of the SEHK/ Paragraph 4(4), Appendix 3 GEM listing rules of the SEHK

10.19 This particular problem might be addressed by adopting the cumulative voting procedure. This procedure can, under the proper set of circumstances, increase the chances of minority shareholders voting in their candidate.

10.20 The cumulative voting procedures would allow a shareholder to cast all his votes for one candidate standing for election on the board of directors, thus increasing his chances of voting in his preferred candidate. This is instead of casting one vote for each candidate standing for election as is currently the case. Under this procedure all votes for the directors would be cast all at once.

10.21 The number of votes of each shareholder is calculated by multiplying the shareholder's total number of shares by the number of candidates standing for the election as director. Thus, for example, if a shareholder has 2,000 shares, and there are 3 candidates, the total number of votes that he can cast will be [2,000 x 3] = 6,000 votes. He may then cast all his 6,000 votes for one candidate, and none for the other two candidates. Alternatively he can choose to split his votes among the candidates, e.g. 1,000 votes for one candidate, 5,000 votes for the other and none for the remaining candidate.

10.22 The rationale for cumulative voting is to increase the chances of minority shareholders securing representation on the board. However, it does not guarantee that minority shareholders will be able to get their preferred candidate elected if the minority is not sufficiently large or sufficiently cohesive. Although such procedures may not directly help the retail investor, however, it is thought that it may be of assistance where there are "large" minority shareholders, who might be able to effectively monitor management and prevent abuse by directors and controlling shareholders.

10.23 The chances of success for minority shareholders to vote in an independent director might thus be increased. Consequently, such a procedure would be likely to be most effective where there are shareholder watchdog groups or corporate monitoring firms or institutional shareholder with sufficiently significant shareholding or proxies to vote in independent shareholders.

10.24 In **Australia**, the Companies & Securities Advisory Committee (CASAC) consulted on this issue and decided that cumulative voting is not prohibited under their laws though to do so may require the approval of the Exchange. The Companies & Securities Advisory Committee did not, however, support any legislative provisions for cumulative voting[115]. Jurisdictions such as **Malaysia** are considering the possibility of introducing cumulative voting procedure into the

[115] Paragraph 4.207 of the CASAC's 'Shareholder Participation in the Modern Public Listed Corporation' Final Report (June 2000)

law in order to strengthen the presence of independent directors on the board[116]. This is in light of concerns over abuse of minorities by controlling shareholders that would normally appoint directors onto the board. In the **United States**, the cumulative voting procedure is mandatory in some States, while others allow but do not mandate a corporation to have cumulative voting procedures in relation to the election of directors[117]. The Securities and Exchange Commission has also considered whether or not to make it mandatory but has not done so.

10.25 The arguments in favour of cumulative voting are that it may help to ensure that directors will pay more attention to the interests and views of minority shareholders. Furthermore, if independent directors are to take the lead in management oversight and highlight abuses such as self-dealing by controlling shareholders, the process for voting in directors supported by minority shareholders would be useful[118].

10.26 The argument against cumulative voting is that the inclusion of representatives of minority shareholders may operate against the best interests of the company. It is argued that it could lead to divided boards and could create opposition groups that may use it as a tool in a long-term fight for control of the company. This is the traditional view in the United Kingdom that generally prefers to support the concept of a unitary and co-operative board.

The SCCLR's views

10.27 The SCCLR believes that the effectiveness of mandating the cumulative voting procedure depends on, first, the availability of qualified candidates to undertake the role of the independent director. Secondly, as will be discussed below[119], the role of the independent director in the context of a unitary board structure would need to be clarified. At this stage, the SCCLR does not recommend that this procedure should be adopted as a matter of law, although it believes that it could be encouraged as a matter of best practice.

10.28 However, should the procedure be adopted, whether voluntarily or otherwise, it is important that investors should be aware of its other limitations. In the United States, for instance, companies have employed devices such as staggering the number of candidates who are put up for election at each meeting so as to reduce the total number of votes of the minority. In the States, formulae have been developed to determine the minimum number of shares necessary to elect a

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[116] The Report on Corporate Governance (March 1999), paragraph 2.1.28, Reform of Laws, Regulations and Rules, issue 5.

[117] Kluwer Law International "Protecting Minority Interests", page 620

[118] The Malaysian Finance Committee in considering particular concerns with controlling shareholders in Malaysian companies, found persuasion in this argument, paragraph 2.1.28 Chapter 6, Reform of Laws Regulations and Rules, Issue 5, "Cumulative voting for directors".

[119] Section 11

director if the shares are "cumulated" in favour of one candidate[120]. In addition, it is noted that the laws of jurisdictions outside Hong Kong where many listed companies have been incorporated would also need to support the cumulative voting procedure[121].

Proposals

10.29 In view of the above, the SCCLR makes the following proposals. However, some of these may need to be reassessed after the results of the studies and consultations with the universities have been published:-

(a) There should be a statutory requirement for the effective circulation of notices relating to a nominee proposed by shareholders in time for the date fixed for election. The existing period during which the shareholders can lodge a proposal for a candidate for the position should also be amended so that shareholders will have a realistic time frame within which to effectively lodge their nominations;

(b) There should be a requirement that the biographical details of a candidate for a directorship must be set out for shareholders' information. These details should be normally sent together with the notices to shareholders of the AGM. This requirement may be effected either through the rules of the SEHK or by statute. Some of the matters that might be disclosed (in keeping with practices in other jurisdictions) include the following: -

(i) a brief description of the individuals concerned, including their ages;
(ii) their qualifications and relevant experience;
(iii) the date they were first appointed onto the board, the details of any board committee to which each belong;
(iv) shareholdings in the company or the subsidiaries of the company exceeding 5% or more of the share capital of the company;
(v) family relationship with directors or substantial shareholders;

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[120] The minimum percentage of minority shareholding needed to succeed in electing the preferred director depends on the number of candidates standing for election. Where there are *n* numbers of candidates, the minority shareholders as a group would need to hold an aggregate of 1/(n+1) percentage of all voting shares, plus 1 share.

[121] Under such circumstances, to ensure that the cumulative voting procedure is effective, where adopted, the following will need to be dealt with:

- the minimum number of candidates standing for election is important;
- as such the requirements to rotate a proportion of the board at each annual general meeting and the size of the board is important;
- the educational process for investors as to the manner in which they can vote for directors. In particular this might entail implementing additional procedures for beneficial owners under the Central Clearing and Settlement System.

(vi) directorships in any other company which might give rise to a conflict or potential conflict of interest.

Private companies may, however, be able to exclude this requirement by unanimous agreement in writing;

(c) For the time being, the use of formal procedures for the nomination of directors should be encouraged as a matter of best practice. The use of nomination committees or other formal procedures should be encouraged. Examples of other procedures include allowing only independent directors to choose candidates or the use of specialist external consultants may also be accepted. Any such procedures should be fair and disclosed to the shareholders. The manner of selection of nominees should therefore be set out in the notices to shareholders of the proposed AGM. This proposal may however need to be reconsidered after the research project by the consultants on this matter has been completed;

(d) At this stage, the law should not prescribe any one single voting procedure for listed companies. However, in addition to the procedures by which candidates are selected (above), procedures for voting in all candidates should also be transparent and fair. Every candidate should have an equal opportunity to be voted in. The form of voting procedure adopted by the company should also be set out in the notices to shareholders of the proposed annual general meeting. This should explain clearly how the shareholders can properly exercise their rights to elect directors. The SCCLR's proposal is that companies should be allowed to adopt the cumulative voting procedure if they wish to, without, however, making such a voting procedure mandatory. The listing rules will also need to be amended to support the cumulative voting procedure, where necessary. It should be noted that the SCCLR considers that the question of mandatory cumulative voting could, however, be revisited should the role of the independent director be re-defined with a specific duty to represent minority shareholders or with an emphasis on the monitoring role of such directors;

(e) The right of the shareholders to elect directors should be clearly set out in legislation so that it cannot be excluded by the articles of association of the company;

(f) If any director has resigned or declined to stand for re-election since the last annual general meeting and has set out his reasons for disagreement to the company, the company should also set out a summary of this disagreement in its report to shareholders.

11. Role of the independent director

Background

11.01 Should the role of the independent director differ from the role of other directors in law?

11.02 Non-executive directors are appointed for various reasons. These include making positive contributions as equal board members to the development of the company's strategy, as well as giving the board the benefit of skills and expertise from diverse backgrounds. Non-executive directors also provide a balanced and independent view to the board. This role is increasingly being construed as a duty of the non-executives to monitor the activities of the executives on the board.

11.03 Under traditional case law, a non-executive director would not normally be under any obligation to supervise his co-directors or to acquaint himself with all the details of the running of the company. However various Codes of Best Practice in corporate governance have raised the profile of the non-executive director, particularly the independent non-executive director. Independent non-executive directors are said to provide a monitoring mechanism of the executive directors' management practices, because of the fear that an executive director's decisions on the board may be influenced by his role in management. The Codes on corporate governance have highlighted the need for some independent element on the board. They generally look to non-executive directors to provide this independence[20]. The Cadbury Code of Best Practice, for example, requires a majority of non-executives to be independent of management.

11.04 On the whole, however, the SCCLR finds that the *duties* of an independent director in law are not different from those of an executive director.

11.05 A distinction could, however, be made between the *functions* of a director, as opposed to his *duties*. In determining whether or not the director has fulfilled his duties, the courts may have regard to the functions or position assigned to the particular director. Thus the courts may take into account the functions attributed to the director in question, in deciding whether or not he has fulfilled the standards expected of a director in his position. This may include taking into account the position of the director as executive or independent director.

11.06 The position or tasks of the director as an executive director, or an independent director is therefore relevant as one of the factors that may be considered in determining whether the director has met the relevant standard of care, skill and diligence. For instance, as one of these factors, it has been said that the responsibilities of a person in the position of an independent director may not, under certain circumstances, be considered as heavy as those of an executive

director[122]. Other factors will also go towards determining whether the director has fulfilled the duties of a person in the position and circumstances of the director. This is evident, for example, where he sits on a committee charged with a particular task (such as a nomination or remuneration committee), or has been appointed on the understanding that he possesses a particular skill.

11.07 As illustrated by the Australian case of Duke Group Ltd. v. Palmer[123], there will be occasions where the independent director may be called upon specifically to protect the interests of minority shareholders[124]. This may be where there is the possibility of conflicts of interests in relation to some of the directors. In these circumstances, a committee comprising independent directors may be set up to avoid such conflicts. As such, the independent directors on the committee may be charged with functions that should not be performed by directors with a conflict. In determining whether the independent director has discharged his duty of care, skill and diligence under these circumstances, the court may consider that his function includes ensuring that the interests of the minority shareholders are not compromised.

11.08 The allocation of tasks or responsibilities of independent directors may be also referred to in the codes relating to take-overs and mergers, as well as listing rules or Codes of Best Practice. In the case of Codes of Best Practice, generally, the independent directors are expected to undertake the role of providing a balanced and independent view to the board. This may take into account the fact that, on occasion, executive directors may not be in a position to be truly objective in the performance of their functions. However, this does not mean that the independent director owes a *different* duty from the rest of the board.

11.09 Similarly, it has been said that Codes of Best Practice may state or imply that the role of the independent director includes monitoring the activities of the company. However this role should be regarded as being encapsulated within the intrinsic duty of *all* directors to act in the best interests of the company, regardless of whether he is an independent non-executive, non-executive or executive director[125].

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[122]The American Legal Institute, American Legal Institute's "Principles of Corporate Governance – Analysis and Recommendations" (1994), page 148.

[123] (1998) 16 ACLC 567

[124] See also the Guide for Independent Non-Executive Directors, pages 3 and 4.

[125] In particular circumstances, however, such a role could be more significant than on other occasions. For instance, Stock Exchange might exercise its powers to require that a company that has breached the listing rules to appoint more independent directors, because there have been breaches of the listing rules in relation to director's duties.

11.10 In summary, the SCCLR's conclusions are as follows: -

(a) The law sets out the principle of the collective duty of the board of directors and their core obligations;

(b) Jurisdictional studies show that the courts should be able to accommodate the standards expected of directors within the principle of the collective duties of directors. This is done by reference to various factors including the tasks or functions a person under those circumstances or in that position is to perform.

Proposals

11.11 In the Hong Kong context, the SCCLR does not believe, at this stage, that it would be practicable to impose a general statutory duty on the independent director(s) to perform a special monitoring role to represent the interests of minority shareholders for the following reasons:-

(a) The law requires that the entire board should have regard to the interests of the company as a whole, and this includes, in the case of directors with a conflict, the responsibility not to act so as to prejudice the interests of minority shareholders;

(b) To impose such a duty at this stage may be onerous especially if independent directors do not have ready access to information, and given the current inadequate incentives in most companies for the non-executive directors to assume this role. To impose such a duty in law might thus dissuade persons from taking on non-executive directorships;

(c) Standards set out in Codes are aspirational and could be a useful method of changing expectations in the context of listed companies;

(d) Other means of encouraging qualified persons to perform as independent directors through having a minimum shareholding qualification[126], education, and cumulative voting, should be considered. Should controlling shareholders or directors be in breach of requirements of the listing rules in relation to connected party transactions, for instance, the SEHK could consider using its ability to require the appointment of an independent advisor in the interests of minority shareholders. It could also make such other order as it thinks fit, such as requiring that the company should appoint additional non-executive independent directors onto the board[127].

[126] Currently for listed companies, the *maximum* shareholding permissible in order to be considered an independent director is 1%

[127] Rule 2A.09 of the Main Board listing rules / Rule 3.10 of the GEM listing rules

11.12 The SCCLR therefore proposes that: -

(a) The role of the non-executive director, independent or otherwise, should not be set out in statute;

(b) Functions of the non-executive directors under specific circumstances may be found in Codes of Best Practices or roles specifically assigned to them. In the case of public listed companies, the functions of the non-executive and independent directors under specific circumstances may be set out in a Code of Best Practices. This may include, for example, the functions of such directors in situations where executive directors or other directors might have conflicts of interest;

(c) Independent directors or advisers could be appointed with specific monitoring roles, for instance, where the existing board has breached its obligations to comply with the listing rules.

CHAPTER 3

SHAREHOLDERS

12. Overview

12.01 Chapter 3 of this paper discusses the following issues:-

(a) Voting by controlling shareholders and persons connected to controlling shareholders in situations where they have an interest in the proposal or transaction;
(b) The statutory derivative action;
(c) Remedies under section 168A of the Companies Ordinance;
(d) Powers of the court to order inspection of books of the company;
(e) Other powers of the court;
(f) The role of the securities regulator.

12.02 As mentioned at the beginning of the paper[128], the SCCLR has taken the view that strong investor protection is a critical issue. This is particularly the case where there are concerns over the potential for undisclosed or unauthorised diversions of assets of the company to the detriment of minority shareholders.

12.03 Specific rights of shareholders (e.g. specific statutory rights in relation to certain major issues, or class rights) and the manner in which voting rights in general may be exercised are still subject to further review and study by the SCCLR.

12.04 In this Chapter, the investor protection mechanisms that are the subjects of discussion are (a) protection that shareholders enjoy against abuses and expropriation by insiders on a general basis, and (b) the quality of shareholder remedies and law enforcement (private and public).

12.05 The regulation of particular types of conduct by management and controlling shareholders is an important aspect of the corporate governance exercise. Thus, the law might regulate conflicts of interests, for instance, by requiring disinterested shareholders' approval. This is discussed under section 13 below, in relation to controlling shareholders. The law might also set limitations on directors' discretion, in order to help control management. It might also attempt to improve efficiency, by requiring proper decision-making procedures to be put in place.

[128] Paragraphs 1.13 to 1.16 above

12.06 However, the SCCLR considers the enforcement of the laws to be as important as the adequacy of the laws themselves. In order for these legal standards to be upheld, there must be a realistic prospect of enforcing these legal standards.

12.07 It is generally accepted that there are currently insufficient incentives and, in fact, considerable obstacles for minority shareholders who wish to take legal action to enforce breaches of these standards. In sections 15 to 19, the SCCLR has reviewed the laws relating to shareholders' remedies and identified possible technical or other obstacles that might impede shareholder actions.

12.08 The degree of intervention necessary by public regulators would also depend on the effectiveness of the private enforcement mechanism. Section 20 discusses the possible role of the securities regulators in this context.

12.09 In Hong Kong, there is also the need to take into account the fact that approximately 75% of the companies listed on the SEHK are corporations incorporated outside Hong Kong[129]. As such, as far as practicable, the SCCLR has made recommendations keeping in mind the rights of minority shareholders in relation to oversea companies that are listed in Hong Kong.

13. Self-dealing by controlling shareholders

Background

13.01 Should majority shareholders or persons connected to the majority shareholders be under a duty to abstain from voting in a transaction in which they have an interest, which is an interest that is different from other shareholders?

13.02 In Hong Kong, as in other common law jurisdictions such as the United Kingdom and Singapore, fiduciary principles apply to a *director* so that he may be prohibited from voting in a transaction in which he has an interest. However, unlike the director, there is support for the view that the shareholder, in his capacity as a shareholder, is not subject to the rule that he must avoid conflicts of interest. This applies even where the shareholder is a director of the company.

13.03 The case of North-West Transportation Co. Ltd. v. Beatty[130] and other cases[131] support the principle that *a member can vote on a resolution even where he has an interest in the subject matter of the resolution*. In this case, the director who was also an important shareholder of the company, cast his votes in favour of the

[129] as of end December 2000: Source: SEHK
[130] (1887) 12 App Cases 589
[131] Burland v. Earle [1902] AC 83; Goodfellow v. Nelson Line [1912] 2 Ch 324

purchase by a company of a large item of his own property. In doing so, he ratified a sale that would otherwise have been challenged as an abuse of the director's duty to avoid a conflict of interest. The basis for decisions such as these is that a director as a shareholder is entitled to vote in his own interests as a shareholder. Courts have in the past been reluctant to disenfranchise the shareholder from what they consider his property right, i.e. his right to vote.

13.04 It appears that this right of majority shareholders to vote in favour of transactions is not, however, unlimited. In the context of alteration of articles, it has been stated that the majority's powers to vote must also be exercisable subject to the general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. This power, it is said, must be exercised not only in the manner required by law, but also *bona fide* for the benefit of the company as a whole, and it must not be exceeded[132]. Also there is case law indicating that there is an obligation, in a class meeting, to act in the interest of a class of shareholders as a whole[133]. As a whole, it is clear that controlling members do owe a duty not to commit fraud on the minority. However, apart from these situations, the precise limits of the duties of majority shareholders are not well defined[134] and cases are hard to reconcile[135].

13.05 As a matter of procedure, however, it would seem that in Hong Kong and the United Kingdom, the law[136] does not require that shareholders should abstain from voting in relation to all types of transactions in which they have an interest[137]. The courts have, however, indicated in substantive law their willingness to intervene where majority shareholders have attempted to act in a manner that constitutes "fraud on the minority".

Listing rules

13.06 In Hong Kong (as in many other East Asian countries), few companies evidence a separation of management from ownership control[138]. Thus, the extent to which a

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[132] Allen v. Gold Reefs of West Africa Ltd. [1900] 1 Ch 656 at 671, Megarry VC in Estmanco (Kilner House); Ltd. v. Greater London Council [1982] 1 All ER 437 at 444; Greenhalgh v. Arderne Cinemas Ltd. [1951] Ch 286, CA

[133] Re: Holders Investment Trust Ltd. [1971] 2 All ER 289

[134] "Limitations on a Shareholder's Right to Vote – Effective Ratification Revisited", Brenda Hannigan, Professor of Corporate Law, Faculty of Law, University of Southampton

[135] Clemens v. Clemens Bros Ltd. [1976] 2 All ER 268, cf. Re Swindon Town Football Club Ltd. [1990] BCLC 467

[136] Although listing rules may so require: Chapter 14 of the Main Board listing rules of the SEHK/ Chapter 20 of the GEM listing rules of the SEHK.

[137] Pender v. Lushington (1877) 6 Ch D 70; Menier v. Hooper's Telegraph Works (1874) 9 Ch App 350, Northern Counties Securities Ltd. v. Jackson Steeple Ltd. [1974] 2 All ER 625; Multinational Gas and Petrochemical Services Ltd. [1983] 2 All ER 563.

[138] The Separation of Ownership and Control in East Asian Corporations, Stijn Classens, Simeon Djankov, Larry H.P Lang

director in his capacity as a shareholder, or a controlling shareholder, can vote in relation to a transaction in which he as an interest, is particularly relevant.

13.07 Chapter 14 of the listing rules of the SEHK prescribes in considerable detail how connected transactions in Hong Kong are to be dealt with. For significant "connected transactions", chapter 14 requires that all shareholders be furnished with an informational circular, the content of which is first vetted and approved by the Exchange, and be given an opportunity to vote on whether the transaction ought go forward. Shareholders deemed to be "interested" persons are not permitted to vote[139]. Moreover, in major transactions, independent financial advisors must be retained to provide written advice to shareholders about whether the proposed transaction is both "fair and reasonable".

Whether the requirement to abstain from voting should be incorporated into the law

13.08 Whether or not an interested person (a substantial shareholder or connected person) should be required to abstain from voting in circumstances under which he has an interest is related to the issue of derivative actions below. For a derivative action to take place, the court must be of the view that the majority shareholders cannot "ratify" the wrong in question. If it is found that the majority shareholders can legitimately "ratify" the wrong that is done to the company, the minority shareholder will have no redress.

13.09 As such, whether or not the majority shareholder has the right to vote in his own selfish interest is also relevant to the discussion as to whether or not a transaction can be ratified, and therefore whether a derivative action can be taken.

13.10 It also seems clear that majority shareholders cannot ratify wrongdoings that would amount to misappropriation of company assets and from which the wrongdoers have benefited. The determination of whether there has been misappropriation often involves the determinations of questions of complex facts. As such, decisions under case law are regarded as providing an uncertain guide as to what types of conduct constitute misappropriation of company assets and what types of conduct might not[140].

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[139] Rule 14.26, Chapter 14, Main Board listing rules of the SEHK/ Rule 20.15 of the GEM listing rules of the SEHK. This includes directors, substantial shareholders (defined under rule 1.01 of the Main Board listing rules and rule 1.01 of the GEM listing rules as persons entitled to exercise 10% or more of the voting rights at general meeting) and connected persons (defined under rule 14.03(2) of the Main Board listing rules/rule 20.10 of the GEM listing rules of the SEHK)

[140] This is discussed further in paragraphs 15.07 to 15.10 below

Other jurisdictions

13.11 In the **United Kingdom**, the listing rules[141] apply to require shareholders' approval in relation to "transactions with a related party". These are transactions (other than a transaction of a revenue nature in the ordinary course of business) between (a) a listed company or any of its subsidiary undertakings and (b) a related party or, any person or entity who exercises significant influence over the company. They also include arrangements where the listed company or a subsidiary undertaking, and a related party each invests in, or provides finance to, another undertaking or asset[142]. The related party includes a substantial shareholder[143], a director or shadow director[144], or an associate[145] of either. Subject to limited exceptions[146], the related party must abstain and take reasonable steps to require its associates to abstain from voting on the resolution[147].

13.12 The Company Law Review Steering Group did not make recommendations with regard to whether or not, as a matter of law, majority shareholders should have a duty to abstain from voting in situations where they may have an interest in the transaction. The Group only considered the votes of interested parties in the context of an attempted *ratification* of a wrongdoing. In considering whether a board or shareholders had validly ratified a breach of directors' duties or a decision by members of the board or the company not to pursue such wrongdoing, the suggestion is that the court should consider whether the necessary majority had been reached without the need to rely on the votes of the wrongdoers or those who were substantially under the influence, or, a person who had a personal interest in the condoning of the wrongdoing[148]. The Group also proposes that there would be general limitations on the powers of the majority to ratify a wrong where there is a threat of insolvency and where the company could not in the first place lawfully carry out that wrongful act.

13.13 In **Malaysia,** amendments to the law have been proposed because of blatant abuses by substantial shareholders in connected party transactions in Malaysia. The Malaysian Finance Committee in its review of company law, also took the

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[141] Chapter 11, listing rules of the Financial Services Authority

[142] Chapter 11, rule 11.1; listing rules of the Financial Services Authority

[143] person entitled to exercise or control the exercise of 10% or more of the votes at general meeting (or was so entitled 12 months preceding the date of the transaction)

[144] or was so within 12 months preceding the date of the transaction

[145] Chapter 11, rule 11.1(d) and (e) in relation to substantial shareholders who are individuals and substantial shareholders who are companies; listing rules of the Financial Services Authority

[146] Chapter 11, rule 11.7; listing rules of the Financial Services Authority, with exceptions including employee share option schemes and long term incentive schemes, granting of credit on normal commercial terms, underwriting, small transactions.

[147] Chapter 11, rule 11.4(d); listing rules of the Financial Services Authority

[148] Modern Company Law For a Competitive Economy Completing the Structure, A Consultation Documents from the Company Law Steering Group (November 2000), page 99, paragraph 5.85

view that statutory enactment was necessary to clearly give companies the power to exclude interested shareholders from voting under such circumstances[149].

13.14 In **Australia**, Chapter 2E of the Corporations Law, which applies in relation to directors of a public company, also applies in relation to "related parties"[150] of a public company. This requires that a public company and its controlled entities which seek to financially benefit related parties must obtain the approval of shareholders[151]. Voting by or on behalf of a related party interested in a proposed resolution at the general meeting, or by an associate of such a party is prohibited[152]. "Control" for the purpose of these provisions arises if one entity has the capacity to "determine the outcome of decisions about the second entity's financial and operating policies"[153].

13.15 In the **United States,** it is generally accepted that, in a situation where the *controlling shareholder* has an interest in the transaction in question, *he must abstain from voting*. As described earlier[154], the American Law Institute has recommended that (unless already approved or ratified by disinterested directors) the following elements must exist in order for such a transaction to be upheld:-

(a) The transaction must be fair to the corporation when entered into; and
(b) the transaction must be authorised in advance or ratified with disclosure, by disinterested shareholders, and must not constitute a waste of corporate assets[155].

13.16 The American courts have generally taken the view that shareholders' approval for such transactions must be by disinterested shareholders[156]. In addition, in reviewing whether a transaction that has already been entered into is a waste of corporate assets, the American courts have also considered whether such transactions are approved by disinterested shareholders.

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[149] Section 148 of the Malaysia Companies Act 1965 also provides for the right of each shareholder (other than preference shareholders) to vote. This cannot be excluded by the constitution of the company.
[150] "Related parties" is defined under section 228 of the Corporations Law; see paragraph 8.15, above
[151] This provision is not intended to prevent "full value, commercial transactions" with related parties. However, it is intended to prevent transactions that have a potential to adversely affect the interests of shareholders as a whole. The objective of Chapter 2E is stated as "being to protect the interests of a public company's members as a whole, by requiring member approval for giving benefits to related parties that could endanger those interests: Section 207 of the Corporations Law
[152] Section 224 of the Corporations Law
[153] Section 50AA of the Corporations Law
[154] Paragraphs 8.19 to 8.20 above
[155] Pages 211 and 222, the American Law Institute's "Principles of Corporate Governance": An analysis and recommendations (1994)
[156] Pages 211 and 222, the American Law Institute's "Principles of Corporate Governance": An analysis and recommendations (1994)

13.17 In summary, therefore, apart from *de minimis* and defined exemptions, the law of jurisdictions such Australia and the States require disinterested shareholder voting in relation to transactions in which controllers have an interest. Malaysia is also proposing to adopt this approach in the law. While the United Kingdom and Singapore have not incorporated this requirement into the law (to the extent that the controlling shareholder is not connected to the director or a connected person of the director), the requirement nevertheless applies in relation to listed companies and their subsidiary undertakings under their respective listing rules.

Proposals

13.18 The SCCLR proposes that: -

(a) For commercial certainty, shareholders should normally be bound by their approval of a self-dealing transaction in which the director or substantial shareholder[157] or other connected person has an interest. However, these should be subject to the exceptions in relation to transactions involving dishonesty, bad faith and "misappropriation of company assets". The exceptions reflect the current position under general law where such transactions cannot be ratified at all, whether by unanimous shareholder resolution or otherwise[158];

(b) To ensure procedural fairness, connected transactions must be disclosed and subject to a disinterested shareholders' vote, with interested shareholders abstaining from voting. The principle reflected in the rules of the SEHK concerning disinterested voting in relation to connected transactions should apply, thus extending the principle of disinterested shareholder voting to unlisted public companies and private companies. For the purposes of these other types of companies, the definition of the "connected persons" should be set out in the law[159]. This would be identical to that outlined in paragraph 8.26 above;

(c) This rule would be subject to certain exceptions such as transactions entered into by liquidators during the course of compulsory winding up or on a general reduction of capital[160], and, in the case of listed companies, the limited exemptions allowed under the listing rules[161]. The rule would

[157] As defined under rule 1.01 of the Main Board listing rules of the SEHK/ rule 1.01 of the GEM listing rules of the SEHK

[158] Shareholders may unanimously resolve not to proceed with an action for such wrongdoing and thus be bound by this decision, but no majority of shareholders can ratify the transaction itself.

[159] Under the SEHK listing rules, this may involve the discretion of the SEHK: rule 14.03(2)(a)(i) of the Main Board listing rules of the SEHK / rule 20.10(4) Footnote 3(a) of the GEM listing rules of the SEHK

[160] c.f. section 321 of the English Companies Act 1985, applicable with regard to directors

[161] See rules 14.24 and 14.25 of the Main Board listing rules of the SEHK / rules 20.23, 20.24, 20.43 and 20.35 of the GEM listing rules of the SEHK.

also be subject to other *de minimis* exceptions, along the lines of those adopted, if any, after the consultation referred to in paragraph 8.25 above in respect of director-related transactions;

(d) In order to ensure that the views of all disinterested shareholders are properly reflected, voting must under such circumstances take place on a poll. This is in contrast to the current position where shareholders must first demand for a poll;

(e) The court's power to determine whether or not the transaction constitutes a waste of corporate assets should be nevertheless specifically preserved. As such, notwithstanding that the disinterested shareholders have cast their votes in an attempt to approve the misappropriation of companies' assets, if it transpires later that such transactions constitute misappropriation they should nevertheless be subject to challenge (because in law they cannot in any event be approved even unanimously);

(f) A failure to follow this rule of procedural fairness[162], i.e. disclose and obtain the approval of the disinterested shareholders, means that the transaction should be voidable at the instance of the company, provided that *bona fide* third party rights are not affected, or restitution is not lost[163]. Transactions (not constituting a waste of corporate assets or involving dishonesty or in bad faith or illegal acts) should remain capable of being ratified by disinterested shareholders within a reasonable time;

(g) The liability of the interested shareholder to compensate the company should arise where the transaction is found by the court to be a waste of corporate assets and the interested shareholder has benefited from the transaction. The following presumptions will apply: -

(i) If there is no disclosure and approval of the disinterested shareholder has not been obtained, the burden falls on the interested shareholder to show that the transaction is not a waste of corporate assets or a transaction in bad faith from which he has benefited. Otherwise the burden still lies with the plaintiff;

(ii) If the company falls into liquidation within one year from which the transaction was entered into, the burden also falls on the interested shareholder to show that the transaction is not a waste of corporate assets or a transaction in bad faith from which he has benefitted. If he fails to discharge this burden, criminal sanctions

[162] Which would apply regardless of the law applicable to the contract, in relation to Hong Kong incorporated companies c.f. English Section 347 of the Companies Act 1985

[163] As for directors, in paragraph 8.06 above.

may be imposed. The extent of his civil and criminal liability will need to be set out under statute.

14. Overview of shareholder remedies

Background

14.01 Sections 15 to 17 of this paper provide a review of: -

(a) The circumstances under which minority shareholders or an individual shareholder would be able to intervene to enforce wrongdoings by means of litigation; and
(b) Whether the available remedies are adequate as a means to encourage good corporate behaviour.

Types of action

14.02 The law in Hong Kong recognises the following broad types of actions where the individual shareholder can intervene by means of litigation[164]. These are: -

(a) The "unfair prejudice" remedy under section 168A of the Companies Ordinance;
(b) The winding up remedy under section 171 of the Companies Ordinance[165];
(c) Other personal actions to enforce shareholders' personal rights;
(d) The **"**derivative action".

These types of action may be founded on remedies available under statute or under common law.

Derivative rights

14.03 In contrast to personal actions, these are actions in respect of wrongs done to the company as a whole as opposed to the wrongs done to any particular shareholder or set of shareholders. This is based on the principle that, if the wrong is carried out against the company, only the company may sue. Common law, however, under limited circumstances allows minority shareholders to sue for injury to the company, on behalf of the company. This is the "*derivative action*".

Personal rights

14.04 The laws on *personal rights* of shareholders are found both under common and statute law. There are circumstances under which a shareholder should be

[164] Legislation also provides specific remedies for minorities to challenge majority decisions in particular cases, such as changes to class rights and invocation of the "squeeze out" procedure, enabling a 90 per cent majority to remove the minority in certain cases. This is not however discussed here.
[165] This is not discussed in this Paper as the SCCLR finds this remedy generally adequate

recognised as having a "personal right" that he can enforce as an individual because of his special interest in the subject matter, as distinct from the interests of the company as a whole. These are rights in contract, by statute or in common law or equity, and include circumstances under which the individual shareholder may challenge the validity of a majority decision as being unfair to the shareholder or beyond the powers of the shareholders.

14.05 Hong Kong laws on shareholders' remedies may have inherited some of the problems under English laws. The English and Scottish Law Commissions[166] have identified two main problems with the existing shareholders' remedies in the United Kingdom. These include the following: -

(a) the obscurity and complexity of the law relating to the ability of the shareholder to bring proceedings on behalf of his company; and
(b) the efficiency of the unfair prejudice remedy in the event of the breach of directors' duties or of other unsatisfactory conduct.

Intervention by regulator

14.06 The SFC is also empowered to take such actions for the public interest, including actions for unfair prejudice[167]. The Financial Secretary also has certain powers to appoint inspectors to investigate the affairs of a company and to make a report, on application of a minimum number of members[168]. Subsection 147(2)(b) of the Companies Ordinance also allows the Financial Secretary to present a petition for unfair prejudice instead of, or in addition to, a petition for winding up on the basis of the inspector's report or any information or document obtained under the Companies Ordinance[169].

15. Derivative action

Background

15.01 This section considers whether the derivative action enables minority shareholders to effectively enforce the rights of the company in relation to wrongs inflicted by insiders.

15.02 The types of conduct which constitute a corporate wrong include the following:-

(a) breaches of director's duties of loyalty;
(b) negligence on the part of the director;

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166 "Shareholders Remedies – A Consultation Paper" (Law Commission Consultation Paper No. 142)
167 Section 37A of the Securities and Futures Ordinance
168 Either of not less than 100 members or of members holding not less than one-tenth of the shares issued.
169 Page 2,553 Tomasic and ELG Tyler, Hong Kong Company Law, Volume 1

(c) exercise of the powers of directors for an improper purpose.

Subject to certain limitations (below), shareholders may by agreement ratify such wrongs. However, shareholders cannot forgive certain types of conduct such as the following:-

(a) a transaction which is illegal, such as theft of company assets;
(b) financial assistance in contravention of the Companies Ordinance;
(c) distributions out of capital in contravention of the Companies Ordinance;
(d) the misappropriation of company assets so as to constitute fraud on the company's creditors[170];
(e) misappropriation of corporate assets by shareholders or directors

The proper plaintiff rule

15.03 If a wrong has been inflicted on a company, the proper plaintiff is the company itself. This is the rule in Foss v. Harbottle[171]. In particular, since directors' duties are owed to the company (and not to any individual shareholder), the company is the appropriate complainant. This is the "proper plaintiff" rule. It is a rule evolved by the courts in order to avoid a multiplicity of suits.

15.04 In reality, the right to determine whether or not the proceedings should be brought lies with the directors, or where applicable, the majority shareholders. This would mean that, if the directors resolved against taking legal action, there is little likelihood of the shareholders receiving redress.

The majority rule

15.05 This "majority rule" supports the principle that the will of the members of the company should, in general, prevail. The rationale is that, if the majority is ultimately able to do something which the minority complains of, the court will not allow the company to be subject to long and expensive litigation, unless the minority shareholders are able to show that the facts fall within the exception to the rule of Foss v. Harbottle[172].

Exceptions under the rule of Foss v. Harbottle

15.06 Obviously, under circumstances where the wrongdoers are the directors or the controlling shareholders, minority shareholders could be severely disadvantaged. The courts have therefore evolved exceptions to the rule in Foss v. Harbottle. The major exceptions to the rule are: -

(a) where there has been "fraud on the minority"; and

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[170] Re Halt Garage (1964) Ltd. [1982] 3 All ER 1016
[171] (1843) 67 ER 189
[172] MacDougall v. Gardiner (1875) 1 Ch D 13, CA at 25

(b) the wrongdoers are in control of the company in general meeting ("wrongdoer control").

Wrongdoings that can be ratified and those that cannot

15.07 The difficulty lies in discerning from the case law clear principles under which a wrongdoing may be "ratified" by majority shareholders and circumstances where they may not.

15.08 It is clear that the consequences of certain types of misconduct cannot be waived, whether or not the shareholders agree so to do. These are misappropriation of company assets from which the wrongdoer benefits[173], abuse of powers by directors to benefit themselves[174], self-serving negligence where the directors benefit themselves to the detriment of the company[175]. Consequently, where the substance of the transaction was damaging to the company, and to the personal benefit of the wrongdoers, the courts will not uphold such transactions. Thus where transactions involve misappropriation of corporate assets or abuse of these powers and where the wrongdoers have benefited themselves from such transactions, the courts will not allow shareholders to ratify such a transaction (even unanimously). Neither will the courts allow shareholders to unanimously agree to transactions where there is a threat of insolvency since these would affect the rights of creditors in the event of insolvency[176], or an act that cannot lawfully be done by the company.

15.09 There are other examples of wrongdoings that have on the other hand been held to be capable of ratification by the majority of shareholders. Mere negligence of directors (without bad faith or fraud) is capable of ratification[177]. Directors who are in breach of their duties may, as shareholders, even cast their votes to ratify such breaches[178]. A company in general meeting has also been allowed to waive a breach by a director of his duty not to make secret profits[179]. Matters of internal management not constituting personal rights of any shareholders are also capable of being ratified. However, other case law also indicates that, in situations where the directors have profited from his wrongdoing, the courts have held that the transaction cannot be ratified[180].

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[173] Burland v. Earle [1902] AC 83; Cook v. Deeks [1916] 1 AC 554

[174] Alexander v. Automatic Telephone Company [1900] 2 Ch 56 (Court of Appeal)

[175] Daniels. v. Daniels [1978] Ch 406

[176] Chingtung Futures Ltd. (In liquidation) v. Lai Cheuk Kwan Arthur et al [1992] 2 HKC 637 (Hong Kong High Court)

[177] Ibid, acts of negligence on the part of directors which result in insolvency however is not ratifiable

[178] Gower's Principles of Modern Company Law, (1997) 6th Edition, page 646, citing in addition Northern Counties Securities Ltd. v. Jackson & Steeple Ltd. [1974] 1 WLR 1133

[179] Regal (Hastings) Ltd. v. Gulliver [1942] 1 All ER 378 House of Lords

[180] Daniels v. Daniels [1978] Ch 406

15.10 Apart from clear cases of misappropriation of company assets or abuse, the difficulty lies in discerning from the case law when the court will hold that a misconduct may be ratified by the majority shareholders and when they cannot. This might also be attributed to the difficulty of drawing a fine line in cases of self-dealing between cases of abuse to the detriment of the company, and acceptable self-dealing. Thus, the decision as to whether or not a transaction is capable of ratification might, under such circumstances, depend on the findings of fact by the court.

Wrongdoer control

15.11 Furthermore, the concept of "wrongdoer control" described above may be difficult to apply. While the concept extends to *de facto* control e.g. where shares are held by nominees of the wrongdoers, in practice, it would normally be difficult to show that there are controlling or ill-motivated shareholders who are preventing litigation from taking place.

Determining standing as a preliminary issue

15.12 In England, the court must, at a preliminary stage, determine whether or not the derivative action is justifiable[181]. Thus, the plaintiff must establish a prima facie case that (a) the company is entitled to the relief claimed, and (b) the action falls within the boundaries of the exceptions to the rule in Foss v. Harbottle. As a result, such proceedings have become protracted and expensive.

15.13 The SCCLR submits that that the courts in Hong Kong do not hold preliminary hearings to determine the standing of the plaintiff[182]. In other words, the courts do not consider, at a preliminary stage, whether the case is one that falls within the exceptions to the rule in Foss v. Harbottle.

Practical difficulties

15.14 However, the SCCLR identified other difficulties with, and disincentives to shareholders commencing, derivative actions in Hong Kong as follows: -

(a) The shareholder bringing the action is potentially liable for the costs of the action even though he has no corresponding right to the potential damages. Like unfair prejudice claims, legal aid is not available, and in addition, the defendant (the wrongdoers) could be fighting the litigation with company's funds. Also, the costs of the proceedings are not shared with other shareholders. The court has a general power to order the company to

[181] Prudential Assurance Co. Ltd. v. Newman Industries Ltd. [1981] Ch 229

[182] there being no equivalent rules as the rules of the Supreme Court in England and Wales on this point; note however comments of Godfrey JA, in Tan Eng Guan and Chan Wing Chong v. Southland Co Ltd. & Ors [1996] 2 HKC 100 (Hong Kong Court of Appeal)

provide the plaintiff an indemnity as to the costs of the action, although the precise circumstances are not clear[183];

(b) Damages are attributable to the company and not to the individual minority shareholder[184];

(c) Shareholders (who are not insiders) are likely to find that they are effectively prevented from taking action because they are unable to access information or the wrongdoers in order to commence a proper action.

In conclusion, the SCCLR has found that, particularly in the case of listed companies, where a secondary market exists, there are few incentives and considerable practical difficulties for minority shareholders to take action on behalf of the company.

When should the remedy be available?

15.15 It is clear that minority shareholders should be entitled to take action and claim redress on behalf of the company where there has been a misappropriation of corporate assets[185]. These situations are always subject to remedy, whether or not the shareholders purport to sanction such conduct[186].

15.16 The issue is whether the minority shareholder should be entitled to take action where there have been the following breaches, and whether the majority rule should continue to apply in relation to the following: -

(a) breaches of director's duties of loyalty;
(b) negligence on the part of the director;
(c) exercise of powers by directors for an improper purpose.

15.17 The SCCLR considers that, in order to avoid difficult determinations with regard to the motives of the majority of the shareholders, where such wrongs appear to involve the majority shareholder[187], such wrongs can be ratified only with the agreement of the majority of "independent" shareholders.

15.18 In other words, where the court finds that a majority of "independent" shareholders agree not to take action in relation to the circumstances under paragraph 15.17, the court will be justified in finding that the minority

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[183] Jaybrid Group Ltd. v. Greenwood [1986] BCLC 319, cf. Smith v. Croft [1986] 1 WLR 580
[184] Prudential Assurance v. Newman (No. 2) [1982] 2 WLR 31 (Court of Appeal)
[185] Paragraph 15.08 above.
[186] Although if shareholders unanimously agree not to take legal proceedings, the shareholders that made the agreement would be bound by the agreement. This does not however mean that other shareholders not party to the agreement could not subsequently take proceedings.
[187] "wrongdoer control"

shareholders will be bound by this decision[188]. "Independent" shareholders would under such circumstances exclude the alleged wrongdoers, persons under their influence, and persons who had a personal interest in condoning the action[189]. In the absence of such an agreement, redress will be available if the injury to the company can be established.

Directors' duties and conflict of laws

15.19 The SCCLR also considered the issue of the substantive law which would be applicable in relation to the standards expected of directors of companies incorporated outside the jurisdiction, and whether the courts of Hong Kong would accept jurisdiction in cases where breaches have been committed by directors of oversea companies.

15.20 Conflict of laws issues arise in relation to directors' fiduciary duties where, for instance, the director of an oversea company breaches his duties in Hong Kong, or where the director of the oversea company breaches his duty abroad.

15.21 In relation to the tortious duty of care, the laws which could be applicable to determine whether or not the director has breached his duty will either be (i) the law of the country of incorporation or (ii) the laws of the country in which the wrong is committed. If the wrong is actionable both in the country of incorporation and in the country where the wrong was committed, then in Hong Kong the court will generally accept jurisdiction over the matter[190]. The applicable law would be the law of the country in which the tort was committed.

15.22 In relation to the fiduciary duties of the directors, generally it would be expected that the applicable law would be the law of the place of incorporation[191]. The court in which the proceeding is brought may also refuse to hear the matter on the basis that there is a more appropriate forum, in the country of incorporation[192].

15.23 In many cases, however, the applicability of laws of the country of incorporation would be fortuitous, especially where central management and control of the company is ultimately within Hong Kong. It would appear that, in certain other jurisdictions[193], the courts have taken a pragmatic approach and will declare a breach of duty on the part of directors of foreign companies[194]. In the case of

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[188] Some practical difficulties still lie in the determination of the "disinterested" status of the shareholders. This is probably inevitable.

[189] cf. Paragraph 5.85 Page 99, "Modern Company Law for a Competitive Economy - Completing the Structure. A Consultation Document from the Company Law Review Steering Group, November 2009

[190] Chaplin v. Boys [1971] AC 356 House of Lords

[191] Hong Kong Company Law Cases and Materials, Phillip Smart, Katherine Lynch, Anna Tam (Sweet & Maxwell 1997 Ed), page 524

[192] English case of Bill v. Sierra Nevada Lake, Water & Mining Co. (1860) LT 256

[193] Singapore: Sumitomo Bank Ltd. v. Kartika Ratna Thahir [1993] 1 SLR 725, High Court, Singapore

[194] Company Law, Walter Woon, Sweet & Maxwell, (2000 Ed), page 302

unjust enrichment, therefore, there have been decisions that the applicable law was the law of the country in which the unjust enrichment took place[195].

15.24 Under the current circumstances in Hong Kong, however, (apart from winding up proceedings[196] or actions under section 37A of the Securities and Futures Ordinance[197]), it is not entirely clear whether shareholders' remedies for corporate injury to companies incorporated outside the jurisdiction within Hong Kong would be entertained[198].

Proposals

15.25 To the extent that the unfair prejudice remedy is not currently available for corporate injuries, the SCCLR considers that the derivative action procedure should be maintained. It also proposes the introduction of a statutory derivative action to make it clear that: -

(a) There will be no "trial within a trial" for the purpose of determining the standing of an applicant to commence a derivative action on behalf of the company. Shareholders, directors and officers of the company, past or present, may commence the action in the court. Past shareholders may, however, only take action insofar as the act complained of arose while they held shares in the company.

(b) The proposals in section 13 above make it clear that transactions that involve self-dealing must be approved by disinterested shareholders. In other words, controlling shareholders have a duty to abstain from voting where they have an interest in the transaction. However, notwithstanding the fact that such procedures are followed, the court's power to ensure that there has been no illegal or fraudulent transactions or those that constitute a waste of corporate assets (non-"ratifiable" transactions) or which affect the personal rights of shareholders should be specifically preserved. Where the approval of disinterested shareholders has not been secured, the burden should fall on the controlling shareholder to show that the transaction was fair and not to the detriment of the company.

(c) Ratification by general meeting would however not be a bar to the commencement of the proceedings. Where there is apparent wrongdoer involvement in a "ratifiable" transaction (i.e. where the wrongdoer appears

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[195] Kartika Ratna Thahir v. PT Pertambangan Minyak dan Gas Bumi Negara (Pertamina) [1992] 3 SLR 725, Court of Appeal, Singapore

[196] Section 326 of the Companies Ordinance; Re China Tianjin International Economic and Technical Cooperative Corp [1995] 1 HKC 720 (Hong Kong High Court)

[197] On which, see proposals in paragraphs 16.27 and 20.09 below

[198] Hong Kong Company Law Cases and Materials, Phillip Smart, Katherine Lynch, Anna Tam (Sweet & Maxwell 1997 Ed), page 523

to have profited from the transaction in breach of his duties or a director is also a controlling shareholder or related to a controlling shareholder), only "independent" shareholders can ratify the transaction. These would be only one of the considerations of the court in determining whether or not the company should have redress.

Rationale

15.26 The derivative action is intended to allow shareholders or directors of the company to bring an action on behalf of the company for a wrong done to the company where the company is unwilling or unable to do so. The grounds for such action would include the following:

- fraud;
- negligence;
- default in relation to any laws or rules;
- breach of any duty, whether fiduciary or statutory.

15.27 The SCCLR considers that statutory clarification would not impose new forms of liability on directors. However, it would remove uncertainties and provide a more effective means of enforcing directors' duties and other wrongdoing committed in relation to the company. It is intended to provide an effective mechanism by which shareholders can protect themselves. In addition, clarifying the derivative action in statute could create a valuable tool to enhance corporate governance and maintain investor confidence.

15.28 The derivative action is originally a rule of procedure. Under the conflict of laws, procedure is governed by the law of the jurisdiction in which the action is taken. These rules would appear to also apply in respect of oversea companies, provided that action is taken against such companies in the Hong Kong courts.

Views of the public

15.29 These proposals (taken together with the proposals with regard to the unfair prejudice remedy, below) are intended to remove any uncertainties or procedural obstacles and facilitate derivative actions. In addition, under section 18, below, the SCCLR also proposes amendments to help facilitate access by shareholders to information. Nevertheless, the SCCLR is conscious that the public may have had experience with regard to the practical disincentives identified in paragraph 15.14, above, and welcomes the views of the public on this matter.

16. Unfair prejudice

Background

16.01 The SCCLR reviewed and considered the usefulness and adequacy of the unfair prejudice remedy.

16.02 The Companies Ordinance provides statutory remedies for shareholders with regard to acts of the company. Section 168A provides for a statutory remedy (short of liquidation) against unfair prejudice. Its underlying premise is the member's personal right to be treated fairly[199].

16.03 This remedy entitles a member to make an application to the court for appropriate orders where the member is unfairly prejudiced. Subsection (2) of section 168A provides for a wide range of remedies as follows: -

> *"(2) If on a petition under this section the court is of the opinion that the company's affairs are being or have been conducted in a manner unfairly prejudicial to the interests of its members generally or of some part of the members, whether or not the conduct consists of an isolated act or a series of acts, the court may, with a view to bringing to an end the matters complained of-*
>
> *(a) make an order restraining the commission of the act or conduct;*
> *(b) order that such proceedings as it may think fit shall be brought in the name of the company against the persons, and on the terms, that it orders;*
> *(c) appoint a receiver or manager of the whole or a part of the company's property or business and may specify the powers and duties of the receiver or manager and fix his remuneration;*
> *(d) make any other order it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise."*

16.04 Subparagraph (d) allows the court to order any remedy it thinks fit to remedy the matters complained of by the aggrieved member[200]. "Member", for the purposes of this section, extends to persons beneficially interested in the shares by virtue of a will or intestacy[201] but is limited to such beneficial owners[202].

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[199] Page 118, The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance (February 2000)

[200] For breadth of these remedies, see for example, Re: Bondwood Development Ltd. [1990] 1 HKLR 200 Hong Kong High Court

[201] Subsection (5) of section 168A

[202] So that investors holding under the Central Clearing and Settlement System do not qualify. However, note the limitations of this remedy in relation to shareholders of public companies, below.

16.05 The court has a discretion to choose from a wide range of remedies, which include the following: -

(a) prohibiting, cancelling or varying a transaction or resolution;
(b) providing for the purchase of the shares of the company by other members of the company or the company (buyouts);
(c) receivership;
(d) winding-up the company.

It is noted that subparagraph (b) of section 168A(2) of the Companies Ordinance also allows for the court to make an order for a derivative action[203]. Additionally, it appears that claims for restitutionary relief may not necessarily be restricted under this provision[204].

16.06 The SCCLR considered the adequacy of the remedy from the perspectives of:-

(a) the scope of the unfair prejudice remedy including its availability in respect of oversea companies;
(b) the breadth of the remedies that may be awarded by the court including the availability of damages.

Scope of section 168A

16.07 To qualify for this remedy, the conduct complained of must be both unfair and prejudicial to members' interests: Re: Taiwa Land Investment Co Ltd.[205]. Conduct may also be unfairly prejudicial even where it has been taken in good faith, although the intention of the oppressor may be of relevance in determining whether the act is unfair and prejudicial: Re: HR Farmer Ltd.[206].

16.08 Examples of conduct that might be caught under section 168A include the following: -

(a) exercise of powers for an improper purpose;
(b) self-interested transactions by controllers generally;
(c) corporate opportunities;
(d) secret profits;
(e) misapplication and misappropriation of the company's assets;
(f) excessive remuneration;

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[203] For a discussion of the implications of this provision, see below
[204] Prime Aim International Ltd. v. Cosmos Parvis International Ltd [1994] 2 HKC 540
[205] [1981] HKLR 297
[206] [1958] 3 All ER 689.

(g) allotment of shares, dilution of equity stake or voting rights;
(h) enforcement of statutory rights[207];
(i) alteration of articles of association;
(j) unjustifiable failure to pay dividends or fair dividends;
(k) mismanagement, directors' neglect of the duty of care, skill and diligence and inefficiency *where it affects the shareholder personally*;
(l) illiquidity of investment;
(m) exclusion from management.

These matters might at the same time also give rise to other common law or statutory remedies.

16.09 A Hong Kong case has applied the general test that there must have been "objective unfairness" that is based on external standards of fair dealing. The test is whether "… a reasonable bystander observing the consequences of the respondent's conduct would regard it as having unfairly prejudiced the petitioner's interests."[208]. Unlike the derivative action, there is no need for the petitioner to show lack of probity or bad faith towards him, on the part of those in control[209]. This applies to both public and private companies. For public companies cases, there is also likely to be an overlapping action in common law for interference with the complainant's personal rights, or a breach of director's duties or breach of statute[210].

"Personal wrongs"

16.10 Examples of "personal wrongs" that may also initiate an action for unfair prejudice include: -

(a) allotments and issues of shares so as to deny the minority shareholder the equal opportunity to subscribe;
(b) allotments where the issuer knows that the complaining member would be unable to take up the offer;
(c) unfair restructurings;
(d) unfair takeovers.

16.11 Whether the infringement also involves the infringement of personal rights of the shareholders, in some cases the courts have refused remedies on the grounds that the shareholder has sufficient recourse to other means of exiting the company[211].

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[207] Re: Hailey Group Ltd. [1993] BCLC 459
[208] Re Taiwa Land Investments Co Ltd. at 307, Re RA Noble & Sons (Clothing) Ltd [1983] BCLC 273 at 290
[209] Re Noble RA & Sons (Clothing) Ltd. [1983] BCLC 273
[210] Page 2,455 Hong Kong Company Law, Volume 1, paragraph 8301
[211] Page 663 Betty Ho, Public Companies and their Equity Securities, Principles of Regulation under Hong Kong law; Chu Li-kai, Ronald v. Chiu Te-ken, Deacon [1991] HKC 362, [1991] 2 HKLR 572

Corporate wrongs as a foundation for section 168A actions

16.12 There are a few examples of "corporate wrongs" that have been held to constitute unfair prejudice. These include the following:-

(a) payment of excessive remuneration to directors[212],
(b) diversions of businesses of the company[213];
(c) use of corporate assets to subsidise businesses of related persons[214];
(d) use of moneys belonging to the company[215].

16.13 The section might apply where the conduct complained of affects all shareholders but impacts more negatively on some of the members because of their different interests[216]. However, the courts will ordinarily be reluctant to accept that the managerial conduct e.g. in relation to declaration of dividends, will amount to unfairly prejudicial conduct[217] although clear mismanagement might be so regarded[218].

16.14 As noted earlier[219], an order for a derivative action is itself a remedy under subsection (b) of section 168A(2). There have been cases where the court has considered the possibility of a derivative claim under this section[220]. This would avoid the difficulties of having to fulfil or satisfy the requirements in relation to the rule in Foss v Harbottle. On the other hand it has also been stated (obiter) that where the matter complained of was no more than unlawful conduct, then the derivative action might be more appropriate[221]. As a whole it is not clear under what circumstances the court would order a derivative action to be taken under section 168A of the Companies Ordinance.

16.15 The advantage of the action over derivative actions is that it is procedurally simpler and there are wide range of remedies[222]. In addition, ratification of the wrongdoing will not deprive the applicant of a remedy.

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[212] Re Halt Garage (1964) Ltd [1982] 3 All ER 814
[213] Scottish Co-operative Wholesale Society Ltd. v. Meyer Ltd. [1959] AC 324 (HL)
[214] Re Tai Lap Investment Co Ltd. [1999] 1 HKLRD 384
[215] Yun Jip Auto Services Ltd. v. Yuen Su Fai [1990] 1 HKC 20 (CA)
[216] Page 2,454, Tomasic and ELF Tyler, Hong Kong Company Law, Vol 1; and Re Sam Weller & Sons Ltd. [1990] Ch 682; Re Little Olympian Each-Ways Ltd (No. 3) [1995] 1 BLCL 636 at 684
[217] Re Elgindata [1991] BCLC 959
[218] Re Macro (Ipswich) Ltd [1994] 2 BCLC 354
[219] Paragraph 16.05 above
[220] Lowe v. Fahey [1996] 1 BCLC 262
[221] Re Charnley Davis Ltd [1990] BCC 605 at 625
[222] Page 2,853, Hong Kong Company Law, Roman Tomasic and EG Tyler, Volume 2

Breaches of directors' duties

16.16 It is clear that this remedy will be available where the conduct complained of is outside the provisions of the articles, and if the board acts in breach of their fiduciary duties by using its powers for an ulterior purpose[223]. Under English law, the courts will also intervene under the unfair prejudice action for the breach of directors' duties which constitute serious mismanagement or diversion of corporate assets[224].

16.17 Under English law, there have been cases which indicate that not all breaches of fiduciary duty would suffice to justify the unfair prejudice action under English statute law[225]. However, other cases indicate that it would be possible for action to be taken in relation to breaches of fiduciary duties other than improper purpose or abuse of power i.e. if the directors acted otherwise than for the benefit of the company[226].

16.18 The fact that a "ratifiable transaction or arrangement" is capable of ratification will not deprive the minority from taking an action under section 168A of the Companies Ordinance, if such acts have been unduly prejudicial. However, it still remains unclear in Hong Kong to what extent the remedy may be available in relation to simply bad managerial decisions, any other breach of fiduciary duties short of abuse of power or use of power for an ulterior motive[227]. It would seem that the serious mismanagement must be considered to be unfairly prejudicial in the first place and this would depend on the circumstances of the case.

16.19 The SCCLR considered whether it should be made clear whether the unfair prejudice remedy should be available to shareholders for breach of directors' duties generally. On the whole, the SCCLR believes that the courts should determine whether on the facts available to them mismanagement in breach of duties is unfair to the minority shareholder. Aside from that, the SCCLR concludes that the courts need not interfere in managerial decisions which are not commercially appropriate or merely incompetent.

Oversea companies

16.20 Section 168A of the Companies Ordinance refers to "any member of a company …". The "company" is defined under section 2 of the Companies

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[223] Re Saul D Harrison Ltd. [1995] 1 BCLC 14, CA

[224] In Re: Elgindata Ltd. it was said that serious mismanagement causing economic harm to the business could be unfairly prejudicial conduct but that in most cases simple mismanagement would not suffice. Also Re Macro Ipswich Ltd. (No. 1) allowed a petition based on serious management which had caused economic loss to the company.

[225] Re Blackwood Hodge Plc. [1997] 2 BCLC 650

[226] Re BSB Holdings Ltd (No. 2) [1996] 1 BCLC 155

[227] Page 2,502, Roman Tomasic and ELG Tyler, Hong Kong Company Law, Volume 1; Prime Aim International Ltd. v. Cosmos Parvis International Ltd [1994] 2 HKC 540

Ordinance to mean a company formed and registered in Hong Kong. As such, section 168A of the Companies Ordinance does not appear to extend to oversea companies.

16.21 In Hong Kong, the SFC additionally has the power under section 37A of the Securities and Futures Ordinance to take action for unfair prejudice in the public interest.

16.22 This remedy is important in particular where the wrongs have been carried out in respect of oversea companies falling within the meaning of section 332 of the Companies Ordinance. Unlike the Companies Ordinance, section 2 of the Securities and Futures Ordinance defines a company to include "… any company within the meaning of the Companies Ordinance (Cap 32) and … an oversea company within the meaning of that Ordinance …". As such, the unfair prejudice remedy under section 37A of the Securities and Futures Ordinance can be taken in respect also of oversea companies.

16.23 It is also noted that section 168A of the Companies Ordinance is not available to beneficial owners under the Central Clearing and Settlement System, or former members. However: -

(a) this remedy might also be limited to the extent that section 168A of the Companies Ordinance is limited[228]; and
(b) it applies only in relation to public *listed* companies and does not extend to other public companies.

Width of available remedies

16.24 Subsection (d) of section 168A(2) of the Companies Ordinance allows the court to "… make any other order it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise". The SCCLR considers that, despite the width of this section, it is not clear if this would allow the court to make an order for damages to be awarded to members.

Difficulties in relation to unfair prejudice remedy

16.25 In summary, the difficulties faced by a petitioner in relation to the application of the section 168A remedy are as follows: -

(a) In relation to listed companies, it is not clear that the remedies available under this section are necessarily adequate, since it may not be practicable

[228] See paragraph 16.18 above

in all circumstances, for instance, for the court to require a buy-out of minority shareholders. It is not clear whether the shareholder bringing the action has a right to any damages;

(b) As with the derivative action, it does not appear that legal aid is available to a petitioner seeking an unfair prejudice remedy[229]. However, it has been held that in the case of a claim for a wrong done to a shareholder as an individual shareholder, rather than on behalf of the company, the court would not allow an indemnification as to costs[230]. On the other hand, it has also been held that where the result of the case is such that it would be beneficial to members generally, an order for costs might be made on a common fund basis[231]. Thus, the court might grant such an order as to costs, but again the circumstances under which it would do so is not entirely clear;

(c) Apart from section 37A of the Securities and Futures Ordinance, the remedy is not available in relation to shareholders of oversea companies;

(d) As with derivative actions, shareholders (who are not insiders) are likely to find that they are effectively prevented from taking action because they are unable to access information or the wrongdoers in order to commence a proper action.

16.26 The SCCLR has also noted that section 168A of the Companies Ordinance allows shareholders to seek remedies only in respect of Hong Kong incorporated companies in terms of the remedies in section 168A(2). However, section 147(2)(b) of the Companies Ordinance allows the Financial Secretary to petition under section 168A for the unfair prejudice remedy under section 168A(2)[232]. This sub-section allows an application for a section 168A remedy by the Financial Secretary, also in relation to a "body corporate"[233]. As such, the SCCLR concluded that section 168A is inconsistent with section 147(2)(b) and needs to be rectified.

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[229] Section 5 of the Legal Aid Ordinance Cap 91, Schedule 2, Part II, paragraph 11(c)

[230] In Re a Company [No. 005136 of 1986) [1987] BCLC 82

[231] Marx v. Estates & General Investments Ltd. [1987] BCLC 82, 85e

[232] if it appears to the Financial Secretary that "… that the business of such body corporate is being or has been conducted in a manner unfairly prejudicial to the interests of the members generally or of any part of its members, he may (in addition to, or instead of, presenting a petition under paragraph (a)) present a petition for an order under section 168A."

[233] defined under subsection 2(3) as including a company incorporated outside the jurisdiction

Proposals

16.27 The SCCLR proposes that: -

(a) The powers in section 168A should be amended to make it clear that the court has the power to award damages by way of a remedy to shareholders in circumstances of unfair prejudice. The court should also have the power to award interest on damages on such terms as the court shall think fit;

(b) Subsection 168A(2)(c) should be expanded to allow an order for compensation of costs to be paid to the shareholders and past shareholders undertaking representative actions. Past shareholders may, however, only take action insofar as the act complained of arose while they held shares in the company;

(c) Subsection 168A(2)(c) should be expanded to allow the court to require controlling shareholders to buy out the minority shareholders;

(d) Section 168A of the Companies Ordinance should also be amended to allow members of oversea companies, as well as Hong Kong incorporated companies, to commence an action for unfair prejudice.

17 Personal rights

Background

17.01 A shareholder has a right to bring an action where wrongs affect his interests in his personal capacity. The four main sources of this personal right include the memorandum and articles of association, the provisions of statute law, personal contracts and the law.

17.02 Personal rights *short of*, or not necessarily amounting to, unfair prejudice would include the rights to have the constitution of the company observed, to restrain *ultra vires* and illegal acts, to have access to records and information and to attend and vote at meetings. Failure to comply with statutory provisions may give rise to offences on the part of the director or company or specific rights to restrain the prohibited conduct or to cause the transactions in contravention of statute to be voidable. There is, however, some uncertainty under case law as to the extent to which the rights of shareholders under the constitution of the company can be personally enforced by shareholders[234].

[234] The SCCLR has recommended that this be statutorily provided for.

Memorandum and articles of association

17.03 Subsection (1) of Section 23 of the Companies Ordinance provides that, "… subject to the provisions of this Ordinance the memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles." The rights in the model articles for companies in Schedule 1 of the Companies Ordinance (insofar as not excluded) comprise the right to receive notice[235] and to attend and vote[236] at meetings and the right to transfer shares[237]. If provided for by the directors, shareholders might have the right to inspect balance sheets and other documents of the company[238].

17.04 Generally, since the memorandum and articles would appear to confer contractual rights on the members, it would follow therefore that a member should have standing to sue whenever there has been a breach of the provisions of the memorandum or articles.

Internal corporate procedure

17.05 However, some courts have indicated that a shareholder does not have an unqualified right to seek relief in court. The cases, adhering to a statement in the rule in Foss v. Harbottle, hold that a member can only sue on rights in his capacity as a member and not those involving internal corporate procedure. This is because a shareholder may not sue in respect of a wrong that can be ratified by a simple majority.

17.06 Thus in the case of Bamford v. Bamford[239], the court held that an improper allotment is an injury to a company and the conditions for a derivative action must be fulfilled. In MacDougall v. Gardiner[240], the court held that it is *not* the individual who is entitled to ensure that all articles of the company are adhered to.

Inconsistent case law

17.07 On the other hand, this approach is not consistent with a line of decisions where the Foss v. Harbottle rule was not even considered[241]. It is also inconsistent with the provisions in section 23 of the Companies Ordinance which provide that the memorandum and articles of association are binding as between members and the

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[235] Regulation 52
[236] Regulation 64
[237] Regulation 23
[238] Regulation 126
[239] [1970] 1 Ch 212, at 238, 242
[240] (1875-76) 1 Ch D 13
[241] See Page 634, Betty Ho, Public Companies and their Equity Securities, Principles of Regulation under Hong Kong law

company. In decisions such as Pender v. Lushington[242], the court held that rights under the constitution are personal rights in respect of which the shareholder can sue regardless of the rule in Foss v. Harbottle. In Edwards v. Halliwell[243], the court made the same distinction.

17.08 In sum, it is difficult to find a principle which distinguishes when the courts should classify a matter in question as an internal corporate procedure from circumstances under which the shareholder would be considered to be enforcing a personal right[244]. In the first case, a shareholder is subject to the rule in Foss v. Harbottle so that he cannot institute a personal action, nor, where the wrong is ratifiable by a majority, a derivative action on behalf of the company.

Proposals

17.09 The SCCLR has recommended previously that the law should be clarified so an individual member can enforce all rights in the memorandum and articles of association as personal rights. The recommendations are contained in the Companies (Amendment) (No. 2) Bill 2001.

18. Orders for inspection

Background

18.01 The Companies Ordinance grants members the right to inspect the register of debenture holders (section 74A), register of charges (section 83), register of directors and secretaries (section 158(7)), minute books of general meetings (section 120), register of members (section 95) and management contracts at general meetings (section 162A). By virtue of section 129G, the profit and loss statement, balance sheet and auditor's report are sent to members before the general meeting at which those documents are to be laid before the shareholders. Section 16 of the Securities (Disclosure of Interests) Ordinance provides for the keeping of a register of interests in shares by public listed companies, which must by section 27 be open to inspection by members of the public. Section 26 of the Companies Ordinance also requires that the company send a copy of its memorandum and articles of association upon the request of the member subject to payment of a nominal sum.

18.02 It is noted that Regulation 126 of the model articles in Schedule 1, Table A, states that the other accounts, books or papers of the company can be inspected by a member (if not already authorised by statute) only if authorised by the directors or by the company in general meeting. This disadvantages the minority shareholders

[242] [1877) 6 CH D 70
[243] [1950] 2 All ER 1064
[244] Page 632 Betty Ho, Public Companies and their Equity Securities, Principles of Regulation under Hong Kong law

if such rights of inspection are not incorporated into the articles of the company and especially where information is needed to help pursue their action.

18.03 On the other hand, the rights of minority shareholders should be balanced against the possibility of harassment by shareholders seeking access to the company's accounts, books or papers without proper grounds. Furthermore, should the members be allowed to inspect such documents, they may not necessarily have the expertise to secure relevant information.

Other jurisdictions

18.04 In **Australia**, section 247A of the Australian Corporations Law 1989 provides a statutory right for members to inspect records of the company or for members to authorise persons to inspect the documents on their behalf but only upon application to the court. Under this provision, the court must also be satisfied that the member is acting in good faith and that the inspection is made for a proper purpose. This allows the court to protect against unscrupulous shareholders from accessing company records for frivolous reasons, harassment or for industrial espionage as well as to minimise disruptions to business operations. The Ontario High Court had also recognised the difficulty of complainants to access company records and has therefore interpreted the equivalent provisions flexibly to allow affidavits based in part upon information and belief[245]. If there is an arguable case, it must be shown that it is in the interests of the company that the case be pursued. In Singapore, the court has the ability to impose conditions on the bringing of a derivative action[246] so that it is able to tailor the order to the justice of the case. This may include an order giving the complainant access to company records to enable him to gather evidence for the action.

Proposals

18.05 The SCCLR proposes that a statutory method by which shareholders can obtain access to company records should be provided, subject to the following conditions:-

(a) The procedure should be by application to court;
(b) The applicant must satisfy the court that he is acting in good faith and the inspection is for a proper purpose;
(c) Generally only authorised persons as the court may order (e.g. solicitors and auditors of the applicant at the applicant's expense) should be able to inspect the documents and to make copies under this court order; and
(d) A person who inspects books on behalf of an applicant must not disclose information obtained during the inspection unless the disclosure is made to relevant authorities.

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[245] Armstrong v Gardner (1978) 20 OR (2d) 648, 652
[246] Subsection 216A(5) of the Singapore Companies Act

19. Other powers of the court

Background

19.01 The SCCLR also considered whether additional powers of the court might be useful to help address current practical difficulties in enforcing the duties of directors, connected persons or controlling shareholders under statute or case law. The SCCLR thus considered whether the courts should have general powers:-

(a) to grant injunctions,
(b) to grant orders as to costs.

General power to injunct

19.02 The SCCLR proposes that the court should have a general power, on application by an affected person or a relevant authority[247], to grant an injunction against any contravention of the Companies Ordinance or any breach of fiduciary duties. This should extend to any attempt to contravene such provisions or attempted breach of any of the directors' duties. The court should be entitled on the application of any person, in respect of whose interests have been, are or would be affected by the conduct, to grant an injunction. This should be on such terms as the court thinks appropriate, restraining the person from engaging in the conduct and, if in the opinion of the court it is desirable to do so, requiring that person to do any act or thing. The power of the court to grant an injunction restraining a person from engaging in conduct should be exercisable: -

(a) whether or not it appears to the court that the person intends to engage again, or to continue to engage, in conduct of that kind;
(b) whether or not the person has previously engaged in conduct of that kind; and
(c) whether or not there is an imminent danger of substantial damage to any person if the first-mentioned person engages in conduct of that kind.

[247] Such as the Financial Secretary, the Registrar of Companies or the Securities and Futures Commission

The court should, either in addition to or in substitution for the grant of the injunction, also have the power to order that person to pay damages to any other person[248].

19.03 The SCCLR considered that the availability of general powers to award injunctions (without needing to come under the unfair prejudice provisions) could help to prevent potential breaches of the law. Such cases would not involve the need for considerable evidence and costs. The SCCLR proposes that the courts should be given a wider power to restrain directors or other persons from entering into transactions in breach of the law under the Companies Ordinance or in relation to breaches or potential breaches of fiduciary duties.

Orders as to costs

19.04 The SCCLR recognises that one of the most difficult obstacles for shareholders to litigate is the tremendous cost involved in litigation, as described above. The practical difficulties for shareholders proposing to litigate to enforce their rights as well as the rights of the company were discussed earlier.

19.05 As such, the SCCLR recommends that the court should at least have a clear general power to grant orders as to costs for shareholders for the purposes of taking action in respect of corporate injury as well as for unfair prejudice actions. This is subject to the requirement that the court will be satisfied that there is no evidence of bad faith on the part of the plaintiff and that the plaintiff has reasonable grounds on which to commence an action.

Oversea companies

19.06 The SCCLR recommends that the powers of the courts to make these orders should be expanded to all companies registered in Hong Kong including companies incorporated outside Hong Kong but registered under Part XI of the Companies Ordinance. The court will however, have, the discretion not to accept jurisdiction on the basis of *forum non conveniens*, where the action is not one which the court considers should be properly considered in the courts of Hong Kong. This could arise, for instance, where the Part XI body corporate is listed outside Hong Kong and has significantly all its businesses and assets outside Hong Kong.

[248] cf. The Australian section 1324 of the Corporations Law

20. The role of regulators

Background

20.01 What should be the powers of the regulators to enforce standards of corporate behaviour?

20.02 As mentioned earlier, the issue of corporate regulation will be the subject of the second phase of the CGR.

20.03 Nevertheless the SCCLR considered that in light of the review in respect of private remedies above, it made sense also to consider current related powers of the securities regulator.

20.04 First, as highlighted earlier[249], the SFC has certain powers to take action, in relation to public listed companies, under section 37A of the Securities and Futures Ordinance. The remedies available to the SFC reflect the remedies under section 168A of the Companies Ordinance.

20.05 These, however, are likely to be subject to similar limitations which exist in section 168A of the Companies Ordinance. As such, while the SFC might in principle seek an order from the court for a derivative action to be instituted against wrongdoers in relation to a public listed company[250], the circumstances under which the court would order a derivative action to be instituted on behalf of the company remain unclear[251].

20.06 The SCCLR thus considered that the clarification of the powers of the regulators as well as an extension of such powers, to take in the public interest would be useful. This is especially so in the light of shareholder apathy in taking action, as well as the difficulties in finding shareholders who would be willing to fund such litigation. It is noted that in jurisdictions such as Australia, the roles of regulators to take action on behalf of shareholders have been enhanced.

Policy considerations

20.07 Nevertheless, the SCCLR notes that the exercise of the powers of the regulator will entail costs to the public and, as such, in bringing actions the regulator will still need to balance the cost-benefits of utilising such powers. Consequently, the regulator would have to make choices as to which cases to pursue. The SCCLR found that these actions are likely to be exemplary cases aimed at deterring blatant abuses and infringements of the law.

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[249] Paragraph 16.21 above
[250] Section 37A(2)(b) of the Securities and Futures Ordinance
[251] Paragraph 16.14 above

20.08 The SCCLR also notes that, while enhancing the powers of the regulator where necessary might be useful, regulatory enforcement should not be the only means of ensuring compliance with the laws and creating a culture of good governance. The SCCLR believes that ensuring that there are available remedies for shareholders to take legal action for themselves must also be an important aspect in developing corporate governance standards.

Proposals

20.09 The SCCLR proposes that it should be made clear that the *securities regulator* is able, without court approval, to bring derivative actions against wrongdoers in relation to a company, including an oversea company listed on the SEHK, for breaches of duty on behalf of the company. This is subject to the proviso that (a) the regulator shall exercise its power in the public interest as well as in the interest of the company, and (b) it shall not be entitled to indemnities as to costs from the company[252].

20.10 The SFC would be allowed to conduct civil proceedings on behalf of any public company or individual in the following circumstances: -

(a) in matters arising out of investigation or examination by any regulatory body;
(b) on a request by any person.

20.11 The grounds on which the SFC should be able to commence proceedings should be wide and, as in Australia, should include the following:-

- fraud;
- negligence;
- default in relation to any laws or rules;
- breach of any duty, whether fiduciary or statutory; or
- any other misconduct committed in connection with a matter to which any investigation or examination relates, or the recovery of property of any person including the property of the company.

[252] Page 141, Paragraph 4 of the Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance (February 2000)

CHAPTER 4

CORPORATE REPORTING

21. Overview

21.01 Chapter 4 of this paper discusses the following issues: -

(a) Private companies with limited liability should file their financial statements with the Companies Registry (CR) for public inspection;
(b) The listing rules governing the Management Discussion and Analysis (MD&A) section of the Annual Reports of listed companies should be amended to include the provision of qualitative and forward-looking corporate information in additional to the current requirement for financial review;
(c) The Companies Ordinance should be amended to enable auditors to include in their reports on the financial statements any inconsistencies between the audited financial statements and financial information contained in other sections of the annual report ;
(d) The need and urgency to provide for an accounting reference date in the Companies Ordinance;
(e) The possible expansion of the composition of the Financial Accounting Standards Committee and Auditing Standards Committee of the Hong Kong Society of Accountants (HKSA);
(f) The setting up of a body with authority to investigate financial statements and enforce compliance;
(g) Possible improvements to the mechanism for monitoring the quality of audit practice; and
(h) Provision for the revision of the audited financial statements after they have been laid at a company's general meeting or filed with the CR and for the filing of a document with the CR to prevent further reliance on the audited financial statements already filed with the CR that require revisions.

21.02 The SCCLR considers that adequate, timely and relevant corporate disclosure is one of the key elements in good corporate governance. In Hong Kong, at present, the laws and rules governing corporate disclosure of companies incorporated in Hong Kong are principally set out in the following ordinances, rules and standards -

(a) The Companies Ordinance which applies to all companies registered in Hong Kong;

(b) The Securities (Disclosure of Interests) Ordinance;
(c) The SEHK listing rules and the Growth Enterprise Market listing rules which cover disclosure on, for instance, director's remuneration, connected transactions;
(d) The Code on Takeover and Mergers and Share Repurchases; and
(e) The Hong Kong Statements of Standard Accounting Practice.

Items (a) and (e) above apply to all companies. In addition, items (b), (c), and (d) apply to companies listed on the SEHK.

21.03 Disclosure of information is a continuous process which starts from the incorporation of a company leading to annual disclosure in the form of the annual directors' report, profit and loss account etc. and disclosures upon changes in directors and secretary, location of registered office and registers, and share capital. Where companies are listed on the SEHK, more comprehensive disclosure requirements apply, including the announcement of interim and final results, new issues of securities under certain circumstances, results of offers, rights issues and placings, and notifiable transactions such as acquisitions, disposals and transactions between listed companies and their directors.

21.04 Oversea companies which establish a place of business in Hong Kong are required under the Companies Ordinance to register with the Registrar of Companies. Oversea companies are also required to submit information including a certified copy of the latest financial statements (and the auditor's report, if any) in the form required by the law of the place of incorporation initially and thereafter at intervals not more than 15 months. If the oversea company is not required in its place of incorporation to prepare financial statements, the company is required to deliver to the Registrar such financial statements as in the form required for Hong Kong companies. For oversea companies listed in Hong Kong, the disclosure requirements of the SEHK identical to those for local listed companies, will apply.

22. Filing of financial statements

Background

22.01 Should private companies with limited liability be required to file their financial statements with the CR for public inspection?

22.02 At present, the Companies Ordinance provides for the preparation and distribution of a company's financial statements. It requires every company incorporated in Hong Kong to prepare a set of financial statements including a balance sheet, a profit and loss account (section 123(2)), a directors' report (section 129D) and an

auditors' report (section 141). Companies shall distribute a set of these financial statements to every member and debenture holder of the company (section 129G).

22.03 In addition, every 'public company' (i.e. a company which is not a private company) is required to file with the CR an annual return, which contains certain basic company information such as the registered office address and directors' particulars, together with –

(a) a balance sheet of the company;
(b) a profit and loss account of the company;
(c) an auditors' report; and
(d) a directors' report.

(sections 109(3), 129C and 129D of the Companies Ordinance)

Copies of the relevant documents are available (in the format of microfiches) for public inspection at the CR upon payment of certain fees (sections 304(1) and 305).

22.04 Under the present regime, private companies are not required to file any company financial statements at the CR. Concerns have been raised in this regard as to whether public interests have been served. It has been argued that, given the lack of sources of private corporate credit information in Hong Kong, creditors would find filing of financial statements by private companies helpful. Furthermore, although their shares are not publicly traded, many private companies are sizable. Given their significant role in the economy of Hong Kong, disclosure of their financial statements would be in line with the cardinal principles of accountability and transparency.

Other jurisdictions

22.05 In other jurisdictions such as the United Kingdom, Canada, Singapore, and the United States, the filing requirements for company financial statements vary.

22.06 In the **United Kingdom**, since 1967, all limited companies (public or private) must file copies of their financial statements at Companies House (the equivalent to the CR in Hong Kong). However, small and medium sized companies may file abbreviated financial statements. These statements are a shorter form of financial statements which exclude key financial information and do not purport to give a true and fair view. Their main purpose is to enable smaller companies to keep key financial information confidential from, for instance, competitors. In the case of medium sized companies, they may omit details of turnover and cost of sales in their abbreviated financial statements. Small companies do not need to file a profit and loss account and a directors' report. They can also file an abbreviated

balance sheet. In the United Kingdom, 55% of companies eligible to file abbreviated financial statements are doing so.

22.07 There has been criticism of the usefulness of abbreviated financial statements despite their popularity. Both the business and professional communities questioned their value to users such as creditors. In view of such criticism, the United Kingdom Steering Group on Company Law Review[253] proposed that they should be abolished. If implemented, all companies would be required to file at Companies House and distribute to shareholders the same set of financial statements. This proposal has wide public support.

22.08 In **Canada**, the Canada Business Corporations Act (Chapter C-44) (CBCA) and the Canada Business Corporations Regulations (CBCR) are the federal legislation governing business corporations that carry on business in Canada[254]. The CBCA (section 155) and the CBCR (section 46) require every company to prepare a set of the following documents -

(a) a balance sheet;
(b) a statement of retained earnings;
(c) an income statement;
(d) a statement of changes in financial position; and
(e) an auditor's report.

A copy of the above documents must be sent to each shareholder at least 21 days before an annual general meeting (section 159 of the CBCA).

22.09 However, the CBCA requires only public (or distributing) companies[255] to file these documents with the Director (section 160)[256] who makes these documents available to the public. If a public company considers that the disclosure of such statements or any items in them would be detrimental to its competitive position, it may apply to the Director for an order to omit any item in its financial statements or to dispense with the publication of them (section 156 of the CBCA).

22.10 The filing requirements under the CBCA have changed in recent years. Before 1994, the CBCA required public and private companies with economic

[253] It was commissioned by the United Kingdom Government in 1998 to review United Kingdom company law. The relevant proposal of abbreviated financial statements is in its consultation document "Developing the Framework", which was issued in March 2000.
[254] Companies may also be incorporated at a provincial level and carry on business in one province only. The respective provincial legislation would govern these companies.
[255] In the Canadian context, distributing or public companies refer to companies having securities that were part of a distribution to the public. These securities must be held by more than one person.
[256] The Director is the head of the Corporations Directorate, and is equivalent to the Registrar of Companies in Hong Kong.

significance [257] to file their financial statements with the Director. This requirement was repealed on 23 June 1994. Since then, only public companies have been required to file financial statements.

22.11 In **Singapore**, the Companies Act (CA), provides for three main types of companies, namely the private limited companies, public companies and branches of foreign companies[258]. The CA requires each of these types of companies to file an annual return together with audited financial statements with the Registry of Companies and Business (RCB), which is the equivalent to the CR in Hong Kong.

22.12 The RCB will make the filed financial statements available to the public at a cost through its microfilm or computer search services.

22.13 In the **United States**, two pieces of federal legislation govern the filing of annual financial statements of publicly traded companies, namely the Securities Act and the Securities Exchange Act. They require publicly traded companies to file annual financial statements with the Securities and Exchange Commission (SEC), which is a federal government agency overseeing publicly traded companies.

22.14 Filings from public companies, including the financial statements, are available to the public through the SEC's EDGAR database online. They are usually also available at the websites of the public companies. Access to the financial statements through the SEC's database or the companies' websites are usually free of charge.

22.15 The federal legislation does not, however require private companies to file any financial statements. Some States (such as Illinois) require private companies to file annual or biannual returns. However, these returns contain only basic company information, such as the names of officers, and do not contain any accounting or financial information of the company.

Proposals

22.16 The SCCLR proposes that private companies with limited liability should file their financial statements with the CR for public inspection.

Rationale

22.17 The SCCLR considers that the proposal is conducive to enhancing corporate transparency, disclosure and accountability. The SCCLR also considers that the duty to file financial statements by private companies with limited liability may be regarded as a quid pro quo imposed in return for the privilege of limited

[257] That is assets more than $5 million or revenues more than $10 million Canadian dollars.

[258] These are companies whose places of incorporation are outside Singapore and who wish to set up a branch in Singapore. These companies are registered but not incorporated under the Companies Act.

liability. Limited liability presents an inherent risk for those, such as suppliers and creditors, who deal with the companies. The filing of financial statements for public inspection would enable parties such as the suppliers and creditors of private companies with limited liability to have better access to financial information on such companies and thereby attain a better assessment of the risks inherent in their dealings with them.

22.18 The cost of the proposed filing is unlikely to be significant as private companies with limited liability are already required under the Companies Ordinance to prepare audited financial statements. In the longer term, the cost is likely to come down further with the introduction of an electronic filing system in the CR.

23. Management discussion and analysis

Background

23.01 The SCCLR reviewed the adequacy and quality of information in Hong Kong listed companies' MD&A disclosure.

23.02 The Hong Kong listing rules require listed companies to prepare a MD&A, which comprises a statement containing a discussion and analysis of the group's performance during the financial year and the material factors underlying its results and financial position. It should emphasize trends and identify significant events or transactions during the financial year under review.

23.03 The review includes: -

(a) Comments on segmental information. This may cover changes in the industry segment, developments within the segment and their effect on the results of that segment;
(b) Prospects for new business including new products and services introduced or announced; and
(c) Details of material acquisitions and disposals of subsidiaries and associated companies.

23.04 The MD&A also contains details of the number and remuneration of employees, remuneration policies, bonus and share option schemes and training schemes, information about its major customers, information about its major suppliers, brief biographical details of the directors and senior managers, and information about financial risks.

United Kingdom Approach

23.05 As recommended in the consultation document entitled "Modern Company Law for a Competitive Economy : Developing the Framework" issued in March 2000, each listed company should include an Operating and Financial Review (OFR) in its annual report. The objective of this recommendation is to provide lay shareholders with qualitative and forward-looking information.

23.06 The OFR requires disclosure on the following areas: -

(a) A fair review of the development of the company's and/or group's business over the year and position at the end of it, including material post year end events, operating performance and material changes;
(b) The company's purpose, strategy and principal drivers of performance;
(c) An account of the company's key relationships with employees, customers, suppliers and others, on which its success depends;
(d) Corporate governance – values and structures;
(e) Dynamics of the business – i.e. known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes;
(f) Environmental policies and performance, including compliance with relevant laws and regulations;
(g) Policies and performance on community, social, ethical and reputational issues; and
(h) Receipts from, and returns to, shareholders.

The HKSA's Recommendations

23.07 The HKSA, as the sole local professional body for accountants and auditors in Hong Kong, has been advocating for qualitative non-financial disclosures in the annual report to increase transparency since 1995 when it launched its first publication on the subject "Performance Measurement that Matters – Using non-financial indicators for corporate success in Hong Kong". In its subsequent Corporate Governance publication issued in 1998 entitled "A Guide for Directors' Business Review in the Annual Report", the HKSA proposed a comprehensive set of principles and criteria for the preparation of the MD&A section in the annual report which advocated all the above elements of the OFR as benchmarks for adoption by listed companies in Hong Kong.

Proposals

23.08 The SCCLR proposes that the listing rules on MD&A should be amended to include more qualitative and forward looking disclosure on areas as shown in paragraph 23.06.

Rationale

23.09 The SCCLR notes the recommendations contained in the HKSA's Guide and the United Kingdom's Modern Company Law Consultation Paper and agrees that there is merit in providing lay shareholders of listed companies with qualitative and forward-looking corporate information, in addition to a discussion and analysis of the group's performance during the financial year.

24. Inconsistencies between the audited financial statements and other financial information contained in the directors' report and other sections of the annual report

Background

24.01 Should the auditors' report be extended to cover inconsistencies found between the audited financial statements and the directors' report and other financial information contained in other sections of the annual report?

24.02 Section 141 of the Companies Ordinance confines the scope of the statutory audit to the financial statements of a company consisting the balance sheet, profits and loss accounts and notes. Auditors have no statutory responsibility in respect of financial information in other documents such as directors' reports. Furthermore, Appendix 16 "Disclosure of Financial Information" of the listing rules (Main Board) and Chapter 18 "Financial Information" of the listing rules (GEM) of the SEHK stipulates the information to be contained in the annual reports of listed companies. However, auditors have no statutory responsibilities in respect of the financial information contained therein.

24.03 The auditor may refer to the inconsistent information in his report. However, the qualified privilege (i.e. the defence to an action for defamation) which an audit report normally enjoys may not extend to comments on items of other financial information which appear to be inconsistent with the audited financial statements. Similarly, no qualified privilege may attach to statements made by him on such matters at a general meeting pursuant to his right under section 141(7) of the Companies Ordinance.

United Kingdom Approach

24.04 The 1985 Companies Act introduced an additional requirement for an auditor to consider where the information given in the directors' report for the financial year in respect of which the annual financial statements are prepared is consistent with those financial statements; and if he is of the opinion that it is not, he shall state that fact in his report. Under the Companies Act, the contents of the director's report covers a wide range of issues including:-

(a) A fair review of the development of the business of the company and its subsidiary undertakings during the financial year and of their position at the end of it;
(b) Particulars of any important events affecting the company or any of its subsidiary undertakings which have occurred since the end of the financial year;
(c) An indication of likely future developments in the business of the company and of its subsidiary undertakings; and
(d) An indication of the activities (if any) of the company and its subsidiary undertakings in the field of research and development.

The matters covered in the directors' report are more extensive than those in the directors' report under the Hong Kong Companies Ordinance and are similar to some of the items in the listing rules of the SEHK.

Proposals

24.05 The SCCLR proposes that the Companies Ordinance should be amended to enable auditors to report on any inconsistencies between the audited financial statements and financial information contained in the directors' report.

24.06 Views are also sought as to whether such qualified privilege should be extended to enable the auditors to report inconsistencies between the audited financial statements and financial information contained in other sections of the annual reports normally distributed by listed companies. At present, the term "annual report" is not defined in the Companies Ordinance. Annual reports of listed companies required by the listing rules contain much more information than those reports required by the Companies Ordinance. If the proposed extension were to be pursued, it would be necessary to consider how this would be provided for in the legislation, e.g. whether the Companies Ordinance needs to be amended to refer to the annual reports.

25. Accounting reference date

Background

25.01 Should the Companies Ordinance provide for an accounting reference date?

25.02 At present, the Companies Ordinance does not provide for a company's financial year and accounting reference periods. Section 122 of the Ordinance requires financial statements to be made out in every calendar year, to be laid before the company's annual general meeting, and those financial statements shall be made up to a date falling not more than certain months before the date of the meeting.

Section 111 of the Ordinance requires that not more than 15 months shall elapse between the date of the one annual general meeting and the next.

25.03 Section 111 indirectly requires financial statements to be made up for a period of not more than 15 months, but there are no rules on shorter accounting periods. In addition, there is no provision to regulate the first accounting period, except that the first annual general meeting has to be held within 18 months of incorporation, and financial statements are required to be laid at the annual general meeting.

25.04 This indirect way of prescribing the accounting reference period is considered to be ambiguous and unsatisfactory.

United Kingdom Approach

25.05 Section 224 of the Companies Act 1985 stipulates a company's accounting reference periods and accounting reference dates. Section 224 (3A) states that the accounting reference date of a company is the last day of the month in which the anniversary of its incorporation falls. Section 224 (4) states that a company's first accounting period is the period of more than six months, but not more than 18 months, beginning with the date of its incorporation and ending with its accounting reference date. Section 224(5) states that the company's subsequent accounting reference periods are successive periods of twelve months beginning immediately after the end of the previous accounting reference period and ending with its accounting reference date.

25.06 Section 223 stipulates a company's financial year. Section 223(2) states that a company's first financial year begins with the first day of its first accounting reference period and ends with the last day of that period or such other date, not more than seven days before or after the end of that period, as the directors may determine. Section 223 (3) states that subsequent financial years begin with the day immediately following the end of the company's previous financial year and end with the last day of its next accounting reference period or such other date, not more than seven days before or after the end of that period, as the directors may determine.

Proposals

25.07 The SCCLR proposes that the Companies Ordinance should be amended to provide for an accounting reference date, an accounting reference period and financial year.

Rationale

25.08 The SCCLR considers that there may be merit in tackling the question in the context of a major review of the accounting and auditing provisions in Part IV of the Companies Ordinance. However, the SCCLR is prepared to deal with the question ahead of the review if this is supported by public opinion.

26. Standards-setting process

Background

26.01 To what extent should the accounting and auditing standards setting process be improved?

26.02 The HKSA is responsible for promulgating accounting and auditing standards in Hong Kong. Under the HKSA, there are two committees, the Financial Accounting Standards Committee (FASC) and Auditing Standards Committee (AuSC) which are respectively responsible for accounting and auditing standards setting. The current membership of the Committees comprises practising accountants, non-practising accountants in commerce/industry/banks, and representatives from the SEHK and the SFC. It has been the HKSA's policy to have a wide representation of interests on both FASC and AuSC, and as a matter of policy, nomination is open to interested parties including the regulators, the investment community, academia and the accounting industry. Nevertheless, it is noted that HKSA has been experiencing difficulty in attracting individuals from the relevant sectors such as the investment industry, financial analysts and academics to join and contribute in the FASC and AuSC.

26.03 Since 1993, it has been the HKSA's policy to harmonise its accounting and auditing standards respectively with International Accounting Standards (IAS) and the International Standards on Auditing (ISA). These are two sets of well-recognized international standards developed by the International Accounting Standards Committee (IASC) and the International Federation of Accountants (IFAC) respectively. It is only under rare circumstances, such as conflicts with local legal requirements, that departures from IASs and ISAs would be accommodated. Although the HKSA's standards do not have any statutory backing, the HKSA requires its members to comply with these standards.

Other jurisdictions

26.04 A review of the accounting and auditing standards-setting processes in the United Kingdom, the United States and Australia suggests a trend of opening up the membership of the standards-setting bodies and the importance of having independent elements on these bodies.

26.05 In the **United Kingdom**, the Accounting Standards Board (ASB), which has been set up under the Companies Act 1985, is responsible for issuing accounting standards. The ASB acts independently and on its own authority in making accounting standards. It is, however, the policy of the ASB to consult widely on its proposals and to give thorough consideration to comments received on them. The ASB can have up to a maximum of ten members, of whom two (the

Chairman and the Technical Director) are full-time, and the remainder, who represent a variety of interests, are part-time.

26.06 On auditing standards, the standards-setting and enforcement processes are undergoing significant changes. Since late 2000, a new system has been put into place with a view to regulating the accountancy profession. The new system is headed by a new independent body called the Accountancy Foundation. Under the Accountancy Foundation, there are several boards with different functions. Amongst these is the New Auditing Practices Board (new APB). The new APB has taken over the functions carried out by the old Auditing Practices Board which operated under the aegis of the accountancy bodies and is principally responsible for establishing and publishing statements of the principles and procedures with which auditors are required to comply in the conduct of audits. The new APB comprises 15 members who are appointed by the Accountancy Foundation after consultation with the relevant accountancy bodies. Under the constitution of the new APB, no more than 40% of its membership can be accountants who are eligible for appointment as company auditors. The remaining 60% of its membership can, at the Accountancy Foundation's discretion, include accountants not eligible for appointment as company auditors provided that they are not involved in the governance of one or other accountancy body.

26.07 In the **United States**, standards on financial accounting and reporting are set by the private sector organization named the Financial Accounting Standards Board (FSAB). The FASB's standards are officially recognized as authoritative by the American Institute of Certified Public Accountants (AICPA) and the SEC. Despite the fact that the SEC has the statutory authority to set reporting standards for publicly held companies under the Securities Exchange Act 1934, it has been the SEC's policy to rely on the private sector, that is the FASB, for the standards-setting function.

26.08 All members of the FASB serve full-time and are required to sever all connections with the firms or institutions they served prior to joining the board. The members have diverse backgrounds but must possess knowledge of accounting, finance and business, and a concern for the public interest in matters of financial accounting and reporting. Traditionally, the FASB comprises the following -

- Two non-practising accountants from the commercial field;
- One academic;
- Three practising accountants from the public accounting sector; and
- One financial analyst.

26.09 Regarding auditing standards, the Auditing Standards Board, which is a body within the AICPA, is responsible for the promulgation of auditing and attestation standards. The Auditing Standards Board comprises 15 members, including

representatives from international, national, regional, and local firms, as well as representatives from accounting education and state government.

26.10 In **Australia**, the Australian Accounting Standards Board (AASB) is responsible for the formulation of accounting standards for private companies and for the public and not-for-profit sectors. The AASB has been established under section 226 of the Australian Securities and Investments Commission Act (ASIC Act).

26.11 All the AASB's members are appointed by a body named Financial Reporting Council which comprises a wide representation from accounting bodies to users and regulators. The Chairperson of the AASB is appointed by the government. According to the ASIC Act, a person must not be appointed as a member of the AASB unless his/her knowledge of, or experience in business, accounting, law or government qualifies him/her for the appointment.

26.12 On the auditing side, the Auditing & Assurance Standards Board is responsible for the development and maintenance of standards and statements on auditing and audit related services. The power for final approval of auditing standards proposed by the Auditing and Assurance Standards Board is vested in the councils of the Australian accounting bodies. The Auditing and Assurance Standards Board consists of members nominated by the accounting bodies.

Proposals

26.13 The SCCLR proposes that –

(a) Hong Kong does not need independent standard setting bodies for accounting and auditing standards, given that they are very closely modeled on IASs and ISAs. The standard setting function should continue to be vested in the HKSA but the composition of the FASC and AuSC of the HKSA should be widened to cater for more involvement of the public;

(b) The FASC should comprise 10 to 15 persons drawn from –

- the accountancy profession;
- the users of financial statements;
- the preparers of financial statements;
- the business community;
- the regulators of the securities and banking industries;
- academia;
- the investment community;
- members of the public;

(c) The AuSC should comprise 10 to 15 persons drawn from–

- the accountancy profession;
- the preparers of financial statements;
- the regulators of the securities banking and insurance industries;
- the relevant government departments;
- the banking industry;
- academia;
- members of the public.

(d) The Chairmen of the FASC and AuSC should be members of the Council of the HKSA;

(e) The HKSA should approach relevant organisations for nominations with regard to their representatives instead of appointing individuals;

(f) Where the appointment of lay members is concerned, the HKSA should adopt the following means –

(i) approaching the Consumer Council for representatives; or
(ii) conducting a public recruitment exercise to select persons with a good public service track record; or
(iii) seeking nominations from the members of the FASC and AuSC;

(g) Alternates of members should be allowed.

Rationale

26.14 Given that the HKSA adopts a policy of benchmarking local standards against IASs and ISAs, which already provided a substantial element of independence and objectivity in the standard setting process, the SCCLR considers that there is no need for Hong Kong to emulate other jurisdictions in having an independent standards setting body.

26.15 Nevertheless, the SCCLR considers that a widened representation on the auditing and accounting standards-setting committees would improve the credibility of the accounting and auditing standards issued by the HKSA. To address the problem in finding and maintaining the right people, the SCCLR considers that nominations should be invited from institutions representing the targeted sector rather than appointing individuals on a personal basis. The SCCLR also considers that the suggested composition will enhance the involvement of members of the community who prepare and/or use financial statements in the standards-setting processes.

27. Body to investigate financial statements

Background

27.01 How can the compliance with accounting standards be better enforced? Should there be a body with authority to investigate financial statements and enforce compliance?

27.02 At present, there is no mechanism in the Hong Kong regulatory regime to provide for the making of enquiries into the financial statements of companies on their compliance with the accounting requirements in the Companies Ordinance, including the accounting standards and the true and fair view requirement. Neither is there any mechanism whereby directors may be required to revise and re-issue financial statements. Auditors of a company may at best issue a qualified audit opinion if they find that the company's financial statements do not comply with the accounting requirements either in the Companies Ordinance or in the accounting standards.

27.03 The Listing Division of the SEHK has established an accounts review team which reviews on a timely basis financial information disclosed by listed issuers. Annual and interim reports, interim and preliminary announcements are selected on a pre-determined basis. The objective of the review is to ensure that the financial information disclosed is in compliance with the listing rules, all relevant statutory requirements and the appropriate accounting standards adopted by the reporting entity. The team exercises its professional judgement in discharging its responsibilities and usually sends letters of enquiry to the listed issuers to obtain further information and explanations and holds meetings with listed issuers. The SEHK may also require listed issuers to make clarification announcements where necessary. However, the SEHK has no statutory authority to enforce listed issuers to amend and to re-issue their financial statements.

27.04 A Financial Reporting Advisory Panel (FRAP) has also been established under the SEHK consisting of Listing Committee and HKSA's FASC representatives, to act in an advisory capacity to the SEHK on accounting and accounts disclosure matters where necessary.

27.05 Under the HKSA's regulatory regime, there is a Professional Standards Monitoring Committee (PSMC) programme which monitors the quality of audited financial statements of listed companies for compliance with accounting and reporting requirements. However, the PSMC has no enforcement power over companies.

Other jurisdictions

27.06 Other jurisdictions (such as the United Kingdom, the United States and Australia) have established bodies to look at cases of non-compliance with standards. Singapore is also considering setting up a similar body.

27.07 In the **United Kingdom**, there is a body called the Financial Reporting Review Panel (FRRP) which is authorised under the Companies Act 1985 to examine apparent departures from the Companies Act. The FRRP has power to apply to the court to require directors to re-issue financial statements. In the United Kingdom, no such order has been sought so far as directors have voluntarily agreed to remedy the defects identified by the FRRP. When voluntary agreement has been reached, the FRRP issues a press notice giving the name of the company, details of the defect and the remedial action agreed. The jurisdiction of the FRRP is confined to the financial statements of public listed companies and large private companies as well as the contents of audited financial statements i.e. profit and loss account, cash-flow, balance sheet and notes. It has no jurisdiction over other material in an annual report. The FRRP does not proactively review financial statements for non-compliance but reacts to matters that come to its attention, mainly through complaints and press reports.

27.08 The FRRP is an independent body and a company limited by guarantee. Members of the FRRP are appointed by the Appointment Committee of the Financial Reporting Council (FRC)[259] in the United Kingdom. The FRRP's members are drawn from a wide spectrum of the financial reporting community and include bankers, company directors and company secretaries, as well as accountants. In considering an individual case, the Panel operates through groups of five or more members drawn from the overall FRRP membership, and there is no collective involvement by the other FRRP members. To secure a consistent approach, all groups are normally chaired by the FRRP Chairman. The FRRP carries out its functions autonomously and needs neither outside approval for its actions nor approval from the company's directors.

27.09 In the **United States**, the SEC is the front-line regulator in ensuring compliance with the US Generally Accepted Accounting Principles (US GAAP) by listed companies in preparing their financial statements. Section 13 of the Securities Act 1934 provides that securities issuers have to file such annual and quarterly reports as the SEC may prescribe and in conformity with such rules (that is the US GAAP) as the SEC may promulgate. Section 21 of the Securities Act 1934 gives the SEC the power to make such investigation as it deems necessary to determine whether

[259] The FRC is responsible for formulating general policy for maintenance and improvement of financial reporting practices in the United Kingdom. The Chairman and the three Deputy Chairmen of the FRC are jointly appointed by the government and the Governor of the Bank of England.

any person has violated any provision of the Securities Act 1934. In addition, the SEC may under section 21C of the same Act request a court order requiring a person to cease and desist from committing or causing a violation of the provisions in the Act and any future violation.

27.10 In **Australia**, the Australian Securities & Investments Commission (ASIC), a body established by the ASIC Act to monitor listed companies and certified public accountants, is responsible for enforcing companies' compliance with reporting and disclosure standards. The ASIC actively reviews companies' financial statements to ensure that they comply with the accounting standards issued by the AASB and other reporting requirements of the Corporations Laws. Where the ASIC is of the view that a company does not comply with the accounting standards or other reporting requirements in preparing the financial statements, the company is required to make necessary amendments and re-submit the amended financial statements to the ASIC. If companies refuse to co-operate, the ASIC may apply to the court requiring revisions.

27.11 In **Singapore**, the reporting requirements monitoring function is undertaken by various parties such as the Singapore Exchange Limited (SGX) and the Institute of Certified Public Accountants of Singapore (ICPAS). Amongst others, the scope of ICPAS' review is confined to the financial statements and offering documents issued by listed companies. Consideration is now being given to delegating the task of monitoring and enforcement of compliance with reporting and disclosure standards to the securities regulator.

Proposals

27.12 The SCCLR proposes that a body with authority to investigate financial statements and enforce any necessary changes to the companies' financial statements should be set up. The SCCLR envisages that the body will operate in a way similar to the FRRP in the United Kingdom. The SCCLR would like to seek public's views on this proposal and associated issues as follows: –

(a) The functions of the body, i.e. to respond to complaints by inquiring into the financial statements of companies where there may be a failure to comply with the accounting requirements of the Companies Ordinance, including the compliance with applicable accounting standards and the true and fair view requirement, to have the power to apply to the court for an order to require a company to re-issue financial statements that do not comply with the requirements in the law;

(b) The jurisdiction of the body; i.e. should the body's work be confined to certain categories of companies, for example, public companies and/or large private companies only?

(c) The mode of establishment for the body, i.e. there are different modes for establishing the body, including an independent body similar to that in the

United Kingdom, parking the body with a regulator, or a self-regulating professional body.

Rationale

27.13 The SCCLR considers that, in principle, there is merit in setting up a body, similar to the United Kingdom's FRRP, as a means of strengthening our regulatory framework for financial reporting. The SCCLR considers that, in the light of experience in the United Kingdom, a FRRP type of body will be a cost-effective set-up to monitor compliance of accounting and reporting standards.

27.14 The SCCLR is aware that there are other existing mechanisms, such as the SEHK's accounts review team under the Listing Division and the FRAP as well as the HKSA's PSMC, which serve as on-going standards monitoring devices. However, none of these devices provide for a power to order companies to revise financial statements. The SCCLR is of the view that, while these existing mechanisms may continue their operation, the establishment of a dedicated body with an authority to order companies to revise financial statements would be desirable.

28. Quality of audit practice and monitoring of audit practice

Background

28.01 In Hong Kong, the HKSA is the regulator of company auditors. To monitor compliance with auditing standards by auditors, the HKSA has regular programmes such as the PSMC programme (as mentioned in paragraph 27.05 above) and the Practice Review Programme under Part IVA of the Professional Accountants Ordinance, which monitors the quality of all audit practices. In addition to the regular monitoring programmes, the HKSA also has the power to conduct formal investigations under Part VA of the Professional Accountants Ordinance into specific complaints on specific acts or omissions of all HKSA members that have attracted public concern. Among these measures, the SCCLR considers that the Practice Review is the key element to monitor compliance with auditing standards and to ensure quality of audit practice. Now that the Practice Review has been in operation for eight years, the SCCLR would like to invite the public's comments on possible further improvements to the Practice Reviews undertaken by the HKSA.

28.02 In 1992, the HKSA introduced the Practice Review under Part IVA of the Professional Accountants Ordinance. The Practice Review empowers the HKSA to perform on-site reviews of the audit procedures and working papers of certified public accountants' practices in order to monitor compliance with auditing standards. The Audit Practice Review goes beyond just the presentation of the

financial statements and actually looks at the underlying auditing process regarding the data contained in the financial statements and covers audits of not only listed companies but also private companies.

28.03 All members of the HKSA engaged in public practice (i.e. holders of a current practising certificate) are required to adhere to the standards prescribed by the HKSA's Members' Handbook. All members, whether in full or part-time practice, must submit to a practice review, subject to exemption as approved by the Practice Review Committee mentioned in paragraph 28.04 below. The Registrar of the HKSA will select practice units for review randomly and will determine the order of review. Practice units will not be selected until after they have completed 12 months in practice. The annual review target is about 100 new cases. The HKSA has just completed it first review cycle of 1000 cases in the year 2000.

28.04 The establishment and composition of the Practice Review Committee is governed by section 32A of the Professional Accountants Ordinance. The principal provisions include –

(a) The Committee shall consist of such number of members, being not less than 5, as the Council of the HKSA shall fix and of whom not more than 2 may also be members of the Council;
(b) Of the members of the Committee not less than two-thirds shall each hold a practising certificate;
(c) A person shall not be a member of the Committee and the Disciplinary Committee at the same time;
(d) The quorum for any meeting of the Committee shall be not less than half of the members of the Committee for the time being; and
(e) The Committee may appoint sub-committees of its members and may delegate to any such sub-committee any of its functions or powers except the powers conferred on it by section 32D(5) of the Ordinance, i.e. make a complaint against a member.

28.05 Under the provisions of sections 18A and 32B(1)(a) of the Professional Accountants Ordinance, the Council has specified that the professional standards which are to be examined under a practice review are the accounting, auditing and ethical standards issued by the HKSA. The Council has also issued directions to the Practice Review Committee under section 32B(1)(b) to conduct practice reviews to determine that the professional standards are observed, maintained or applied by all practice units.

28.06 Essentially, a practice review entails a review of current audit engagement files and related financial statements to ascertain that the practice unit is adhering to professional standards. Where a practice unit is not following professional standards in certain situations, suggestions and recommendations for

improvement may be made, and possibly followed by a further review, in keeping with the educational thrust of practice reviews.

28.07 The Registrar will assign a reviewer to each practice unit selected. The identity of the practice unit will be kept confidential from the Practice Review Committee and those staff of the HKSA not directly involved in practice review.

28.08 At the conclusion of his practice review, a reviewer is required by section 32C(3) of the Professional Accountants Ordinance to make a report to the Practice Review Committee. The Practice Review Committee, on receiving a report from a reviewer, may make recommendations to the practice unit concerned regarding its application of professional standards, issue an instruction to a reviewer to carry out a further practice review, within one to two years, or make a complaint to the Registrar of the HKSA regarding a partner of a firm or other professional accountant concerned, as the case may be, in the event that professional standards have failed to be observed, maintained or applied.

Other jurisdictions

28.09 Similar "practice reviews" of company auditors can also be found in the United Kingdom, the United States and Singapore.

28.10 In the **United Kingdom**, the Institute of Chartered Accountants in England and Wales (ICAEW), the Institute of Chartered Accountants in Scotland (ICAS) and the Institute of Chartered Accountants in Ireland (ICAI) have jointly set up a limited liability company named "the Joint Monitoring Unit" to monitor compliance by member audit firms with audit regulations and investment business regulations. In conducting monitoring, the Joint Monitoring Unit's main objectives are to -

(a) achieve the annual visit targets agreed with the government;
(b) provide helpful and constructive advice to member firms; and
(c) reporting the results of visits to a joint committee of the three institutes to consider if regulatory action is needed.

28.11 In the **United States**, audit firms are divided into two tiers. If an audit firm would like to audit SEC clients, it has to be a member of the SEC Practice Section. The SEC Practice Section is a voluntary membership organization within the AICPA. The SEC Practice Section operates a peer review program among member firms with a view to improving the quality of its members' practices. A peer review of member firms is required every three years.

28.12 A peer review involves an independent, rigorous examination of a member firm's system of quality control with respect to its accounting and auditing practice. It also encompasses reviewing reports, financial statements, and relevant working

papers for a representative sample of accounting and auditing engagements. A written opinion and a letter of comments reporting on findings will be issued where there is a possibility that the member firm does not conform to professional standards. The results of every member firm's most recent peer review are available to the public.

28.13 In **Singapore**, the ICPAS introduced in November 2000 the Practice Monitoring Program. The objective of the program is to ensure that all practising members maintain, observe and apply an appropriate level of professional standards at work. All practising members in Singapore are required to adhere to the standards prescribed by the ICPAS.

28.14 The program runs on a five-year cycle which requires practising members to be monitored once every five years. The selection of practising members for practice monitoring is made randomly on an ongoing cyclical basis.

28.15 A Practice Monitoring Committee (PMC), established by the ICPAS, reviews the report of the monitoring findings together with recommendations for improvement and practising members' input and comments. Where the conclusion of a practice monitoring review is other than a satisfactory recommendation, the PMC may decide either to revisit the practising member in approximately 18 months or to refer the case to the ICPAS for further action.

Proposals

28.16 The SCCLR would like to seek public comment on possible improvements to the HKSA's Practice Review and in particular -

(a) Whether the current "one standard fits all" approach is appropriate? Should a higher standard be required for firms auditing public companies ?

(b) Should the frequency of reviews be higher for those audit firms that audit public companies, bearing in mind the additional costs that might be involved and be borne by the audit firms, and eventually, the business community?

(c) Whether audit firms performing audits of listed companies or companies with significant public interest should be subject to additional scrutiny or a separate regulatory regime?

Rationale

28.17 The SCCLR is of the view that, with the introduction of the Practice Review in 1992, the HKSA is in a leading position in the Asia region in this regard. The

SCCLR is aware that the HKSA is now reviewing and developing the approach for the second review cycle. Nonetheless, the SCCLR considers that it is an opportune time to review the Practice Review mechanism to see whether there are possible improvements.

29. Revision of audited financial statements and related matters

Background

29.01 Should audited financial statements which have been laid before the company in the general meeting and, in case of a public company, filed with the CR, be allowed to be revised?

29.02 Under the Companies Ordinance, the directors of a company are responsible for ensuring that a company's financial statements give a "true and fair" view of the state of affairs and profit and loss of the company at the end of its financial year, as well as complying with the other accounting provisions of the Companies Ordinance (section 123(6)).

29.03 Auditors of a company, on the other hand, are required to report to the members of the company on the financial statements examined by them and on every balance sheet, every profit and loss account and all group financial statements laid before the company in general meeting during their tenure of office (section 141(1)). If the company is a non-private company (i.e. "public company"), the company needs to file with the CR a certified copy of the balance sheet laid before the company in general meeting, including any document required to be attached to the balance sheet; and a certified copy of the auditors' report and the directors' report accompany each balance sheet (section 109). These documents are open for inspection by the public upon the payment of a fee (section 305).

29.04 There are no statutory provisions at present for the revision of the financial statements after they have been laid before the company in general meeting or delivered to the Registrar. This has created an undesirable uncertainty for companies and their auditors as to the proper legal steps to be taken to correct financial statements when they are found to be defective after they have gone through the due process of being approved at the AGM and filed with the CR. Furthermore, there is no statutory mechanism to allow the company or its auditors to prevent the public from further reliance on the filed financial statements.

29.05 It is, however, not uncommon that information may come to light or become known to the directors or the auditors after the financial statements have been issued that suggest that the financial statements had been incorrectly prepared based on wrong or omitted information unknown at the time.

29.06 The directors have fiduciary duties to take corrective actions to prevent continuing reliance being placed on those financial statements. The auditors also have a professional duty to do the same.

29.07 In this regard, the Statement of Auditing Standard (SAS) 150 issued by the HKSA provides guidance to auditors on dealing with facts which may materially affect the financial statements -

(a) before the date of the auditor's report; or
(b) after the date of the auditors' report but before the financial statements are issued; or
(c) after the financial statements have been issued but before they have been laid before the shareholders; or
(d) after the general meeting.

In the event of (a) to (c), the auditors would normally have sufficient time and means to consider the matter with the directors. Depending on the directors' action as to whether they are prepared to revise the financial statements, the auditors may re-issue a new auditors' report on the revised financial statements or bring to the attention of the shareholders that the financial statements require revision.

29.08 However, in the event of (d), after the general meeting, the auditors' appointment expires. Under SAS 150, the auditors are required to first determine whether the information is reliable and, if so, they should take action to prevent further reliance on the auditors' report. However, as mentioned above, the Companies Ordinance does not contain any provision to deal with such situations. This issue was highlighted in a recent case in which the audited financial statements for a company, which had been tabled at the general meeting, remained filed with the CR even though the auditor involved had resigned and made a public press statement that the auditor was withdrawing its audit opinion on the financial statements.

29.09 In the light of the above, the issue is how the directors and, if the directors decide not to take action to revise the accounts, the auditors may disclose those facts which materially affect the financial statements, after the financial statements have been laid at the general meeting and perhaps also after having been filed with the CR.

Proposals

29.10 The SCCLR proposes that -

(a) Where it comes to the directors' attention that there are material misstatements in the financial statements that have been laid before the company in the general meeting and filed (in case of public companies), they should file a warning document with the CR to prevent further reliance on that set of financial statements at the earliest possible opportunity. In the meantime, the directors should work with the auditors to prepare and file revised financial statements and a revised auditors' report;

(b) If the auditors find that there are material misstatements in the financial statements that have been laid and filed (in case of public companies), they should report this to the directors. The directors should be required to respond to the auditors as to whether the company will file a warning document with the CR to prevent further reliance on the financial statements;

(c) If the directors agree with the auditors, this will trigger the mechanism set out in (a) above. If the directors refuse to file a warning document, the law should allow the auditors to file such a document; and

(d) The Companies Ordinance should be amended so that the directors would be required to work with the auditors with a view to revising the financial statements in question.

Rationale

29.11 The SCCLR considers that the proposal should help to prevent further reliance on misstated financial statements particularly in the case where financial statements have been laid before the company in the general meeting and, in the case of a public company, filed with the CR. By imposing a duty on directors to respond to the auditors, the proposal reflects the responsibility of directors to prepare financial statements which give a true and fair view as required by the Companies Ordinance.