

**Bills Committee on
Companies (Amendment) Bill 2002**

**Recommendations arising from
Review of Companies Ordinance and
Corporate Governance Review**

Introduction

This paper informs Members of the latest position on the implementation of the recommendations in –

- (a) the Report of the Standing Committee on Company Law Reform (SCCLR) on the Recommendations of a Consultancy Report on the Review of the Hong Kong Companies Ordinance¹ (SCCLR Report); and
- (b) the Consultation Paper on Proposals made in Phase I of the Corporate Governance Review.

SCCLR Report

2. On the basis of the recommendations in the SCCLR Report, we have identified a total of 62 items for legislative amendments or further study. These items are divided into the following four phases -

- (a) Phase I: The 17 Items in this phase involve amendments to specific sections of the Companies Ordinance. A list of these items is at Annex A;
- (b) Phase II: This phase includes 19 items, such as reviewing the need for a statutory statement of directors' duties and the provision of a statutory right of derivative action, which have been included in the Corporate Governance Review. A list of the items is at Annex B;
- (c) Phase III: This phase includes 8 items requiring further study which are either not related to corporate governance or where a high degree of professional specialty is involved, such as the recommendation of permitting no-par value shares for all companies on an optional basis. We intend to appoint a

¹ The cost of employing consultants to review the Companies Ordinance is about \$14.9 million.

consultant to conduct research on the recommendation relating to the no-par value shares. A list of these items is at [Annex C](#);

- (d) [Phase IV](#): This phase includes 18 items regarding restructuring and rewriting the Ordinance. These include revising a number of definitions; removing the winding-up provisions to a new Insolvency Ordinance; and creating a separate part of the Ordinance dedicated to matters dealing with shareholders' rights and remedies. A list of these items is at [Annex D](#).

Consultation Paper on Proposals made in Phase I of the Corporate Governance Review

3. In 2000, the SCCLR was tasked by the Financial Secretary to conduct a comprehensive corporate governance review. The SCCLR set up three Sub-committees on Directors, Shareholders and Corporate Reporting respectively to take forward the review. A Consultation Paper containing 21 proposals in respect of directors' duties, shareholders' rights and corporate reporting enhancement was issued in July 2001. A summary of the major proposals is at [Annex E](#).

4. The comments received from the professional bodies, trade associations, academia and individuals during the consultation period indicated general support for most of the proposals. The SCCLR has completed its scrutiny of the comments, and recommended that these proposals be implemented with the exception of the proposal relating to the filing of financial statements by private companies which will not be pursued in the light of considerable objections received during the public consultation.

5. The Administration is following up the recommendations in parallel. For those recommendations which do not require legislative amendments, follow-up action is underway. For example, a non-statutory code on directors' duties is being prepared for public consultation. Some of the recommendations require further consideration, particularly to take account of new developments. For those recommendations (such as provision of a statutory right of derivative action, amending the statutory unfair prejudice remedy, giving shareholders a statutory method of securing access to company records, and giving the court to grant an injunction) requiring legislative changes, the intention is to include them in a Companies (Amendment) Bill, planned to be introduced into the Legislative Council in 2003.

6. Under the Corporate Governance Review, we commissioned consultants to conduct the following studies at the respective fees -

- (a) the roles and functions of audit, nomination and remuneration committees (about \$1.07 million);
- (b) an economic analysis co-relating the performance of listed companies with their shareholders' profile (about \$1.14 million);
- (c) a survey on international institutional investors' attitudes towards corporate governance standards in Hong Kong (about \$0.98 million); and
- (d) a survey on the corporate governance regimes in other jurisdictions (about \$1.22 million).

**Financial Services Branch
Financial Services and the Treasury Bureau
October 2002**

Phase I

| <u>Item</u> | <u>Subject</u> |
|-------------|---|
| 1 | One member companies. |
| 2 | One director companies. |
| 3 | Incorporation of a company limited by guarantee with share capital be prohibited in the future. |
| 4 | Regulation 82 of Table A be amended along the lines of the U.K. Table A. |
| 5 | Removal of directors by ordinary resolution notwithstanding any provision in the company's constitution. |
| 6 | Subject to contrary provision in the articles, a director be vicariously liable for the acts and omissions of his alternate. |
| 7 | The statutory provisions be extended to cover in generic terms the provision of financial assistance to directors. |
| 8 | A statutory definition of shadow directors be provided. |
| 9 | A shadow director be defined to include someone who can influence less than the whole board of directors. |
| 10 | The definition of manager be clarified to indicate a rank immediately below and reporting to the board. |
| 11 | The Ordinance should confirm that indemnities may be given to directors for liability incurred by them to others in the course of performing their duties and that the permissible scope of such indemnities should be studied further. |
| 12 | Companies be permitted to insure directors and officers except in certain specified circumstances. |

Item**Subject**

- 13 The threshold for shareholders' proposals be reduced to 2½% of voting rights or 50 shareholders.
- 14 A strict time limit (10 business days) be stipulated for completion of transfers of shares of public companies.
- 15 Giving every shareholder a personal right to sue to enforce the terms of the Memorandum and Articles of Association.
- 16 The right to resort to the court under section 8 (Statutory procedure for amending the objects clauses of a company's memorandum) be repealed as regards public companies.
- 17 Court approval for reduction of capital should not be required for the redesignation of par-value to a lower amount provided that the company has only one class of shares; the issued shares are fully paid-up; the reduction is distributed equally to all shares; and the reduction is credited to the share premium account.

Phase II

| <u>Item</u> | <u>Subject</u> |
|--------------------|--|
| 1 | Further study be made of the appropriate board structure for public companies as part of the programme to improve corporate governance. |
| 2 | The question of appointment of directors be reviewed. |
| 3 | The question of a statutory statement of directors' duties and whether directors be able to rely in good faith on reports prepared by officers and professional advisers be kept under review in the light of international developments. |
| 4 | The question of self-dealing be further studied. |
| 5 | The dispersed notice provisions be consolidated into one general criterion : the notice must provide a full explanation (including conflict of interests) of a proposed transaction to enable shareholders to form a judgement. |
| 6 | Provisions for a proxy system be further studied. |
| 7 | The impact on the right of shareholders to vote when shares are registered in the name of Central Clearing and Settlements System (CCASS) be further studied after the completion of the market restructuring. |
| 8 | The following principles be studied further : transactions in which controlling shareholders have an interest different from that of other shareholders is proposed to be subject to approval by shareholders, with the controlling shareholder abstaining from voting; adequate exceptions is proposed to 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 is proposed to be deemed to be compliance with the law; it is |

Item**Subject**

proposed that private companies may include exemptions in their articles.

- 9 The issue of access to corporate records be further studied.
- 10 A statutory right of derivative action to be considered.
- 11 Section 155A be repealed and its contents moved to Table A with the following amendments: the requirement for approval should be triggered by dispositions of the same percentage of net assets of the company; the provision should apply to all companies, provided that transactions between parents and wholly-owned subsidiaries and between wholly-owned subsidiaries of the same holding company shall be exempt.
- 12 The question of class rights and variation be further studied.
- 13 The suitability of judicial control, multiplicity of provisions and class votes be further studied.
- 14 Section 141D of the Ordinance be amended to refer to a 'true and fair' view.
- 15 A study be undertaken as to whether, and if so to what extent, section 141D (regarding simplified accounts for private companies) should be modified and extended.
- 16 Further study and consultation be conducted on exempting private companies from publication of financial statements.
- 17 The Tenth Schedule be updated, and the HKSA's offer of assistance in this respect be accepted.
- 18 The concept of a register of directors interests be studied further.
- 19 Directors' minimum qualifications including requirement that all directors must be natural persons i.e. abolition of corporate directors.

Phase III

| <u>Item</u> | <u>Subject</u> |
|--------------------|---|
| 1 | No-par value shares to be permitted for all companies on an optional basis. |
| 2 | Section 341 (Interpretation of Part XI – Companies incorporated outside Hong Kong) be redrafted. |
| 3 | The filing requirements for registration as a foreign company should be simplified. |
| 4 | The filing requirements applicable to foreign companies under the new Ordinance should be co-ordinated with those of the Business Registration Ordinance. |
| 5 | The offences and punishment provisions in the Ordinance be further studied. |
| 6 | The investigation provisions in the Ordinance be further studied. |
| 7 | The study of the issue of the status of shares as negotiable instruments be deferred until the completion of the securities and futures market reforms. |
| 8 | The issue of scripless securities to be studied after the completion of the securities and futures market reforms. |

Phase IV

| <u>Item</u> | <u>Subject</u> |
|--------------------|--|
| 1 | The new Ordinance should cover solvent liquidations and dissolutions but insolvent liquidations and dissolutions should be left to a comprehensive Insolvency Ordinance. |
| 2 | The provisions in the Ordinance applicable to listed companies be applicable to Public Companies. |
| 3 | Removal of Prospectus provisions from the Ordinance. |
| 4 | Review of the “Charges” provisions under Part III with a view to introducing a separate, comprehensive regime governing security interests in personal property. |
| 5 | The Ordinance to be written in plain language so as to be accessible to users like business people, lawyers and accountants etc. |
| 6 | Public Companies to be defined to mean companies limited by shares that are not private companies. |
| 7 | Companies limited by guarantee be referred to as ‘Guarantee Companies’. |
| 8 | Memorandum and Articles of Association be retitled the constitution. |
| 9 | The drafting of the provisions regarding financial assistance to directors be simplified. |
| 10 | A separate part of the Ordinance be dedicated to matters dealing with shareholders’ rights and remedies. |

Item**Subject**

- 11 Improve the overall organization of provisions regarding the fundamental changes of a company, such as changing the scope of the business or restructuring the share capital, to make the legislation more user-friendly.
- 12 Reform of section 47A (financial assistance by a company for acquisition of its own shares) be further studied.
- 13 Further study be made of restraints on issuance of shares for consideration in kind.
- 14 The application of section 79C (regarding restrictions on the distribution of a company's assets) to private companies should be further studied.
- 15 The issue of liability of controllers of companies for employees' wages be referred to the Administration for further consideration.
- 16 The provisions of Parts VII and XIII regarding the administration of the Ordinance be consolidated and updated.
- 17 Enabling provisions be inserted in Table A to permit electronic communications.
- 18 Provisions be made for the concept of 'record dates' for the payment of dividends, issue of notices of meetings and voting purposes.

Major proposals in "A Consultation Paper on Proposals made in Phase I of the Corporate Governance Review"

(1) Proposals relating to Directors' Duties and Responsibilities

- * A director should be required to abstain from voting at a board meeting on a transaction in which he has an interest, with exceptions for immaterial transactions.
- * For transactions or arrangements above a certain threshold value involving directors or persons connected with directors, the approval of disinterested shareholders voting on a poll should be obtained. The views of the public are being sought with regard to the definition of this threshold value.
- * Requirements for disinterested shareholders' approval for connected party transactions should be extended to transactions between a company and an "associated company" and not limited to transactions between the company and "subsidiaries". An "associated company" should be defined as "one in which the company in question controls the exercise of 20% or more of the voting rights of the equity share capital", to be consistent with accounting practice.
- * Procedures for the nomination and election of directors should be improved so that shareholders have a meaningful right to nominate and elect directors.
- * Directors' fiduciary duties and the standards of care and skill should be set out in a "Code of Best Practice" by way of guidance to directors.

(2) Proposals relating to Shareholders' Rights

- * Connected transactions involving controlling shareholders should be subject to voting (on a poll) by disinterested shareholders only, with defined exceptions.
- * The common law derivative action should be complemented by a statutory derivative action which would allow shareholders and directors, past or present, to bring an action on behalf of the company for a wrong done to the company.

- * The Securities and Futures Commission should, without having to first obtain court approval, be allowed to bring derivative actions, on behalf of a listed public company including an oversea company listed on the Stock Exchange of Hong Kong.
- * The statutory unfair prejudice remedy should be amended so that the court has clear powers to award damages and interest on damages. The statutory remedy should be extended to shareholders of oversea companies.
- * Shareholders should have a statutory method of securing access to company records subject to court approval and other safeguards.
- * The court should have, in relation to companies including oversea companies: -
 - (a) a general power, on application by an affected person or a relevant authority, to grant an injunction in relation to any proposed contravention of the Companies Ordinance or breach of fiduciary duties;
 - (b) a clear power to grant orders as to costs for shareholders taking action, subject to good faith and reasonable grounds requirements.

(3) Proposals relating to Corporate Reporting

- * A body with authority to investigate financial statements and enforce any necessary changes to companies' financial statements should be set up, subject to the public comments on the functions, the jurisdiction and the mode of establishment of the body.
- * The accounting and auditing standards setting function should continue to be vested in the Hong Kong Society of Accountants, subject to greater involvement of the public in the standards setting process.
- * Directors and auditors should be allowed to prepare and file revised financial statements and a revised auditors' report, in the event that material misstatements in the financial statements are found after the financial statements being laid before the company in the general meeting and (in case of public companies) filed.
- * Directors should be required to file a warning document with the

Companies Registry to prevent further reliance on misstated financial statements at the earliest possible opportunity. If directors refuse to do so, the law should allow the auditors to file such a document.

- * Private companies with limited liability should be required to file their financial statements with the Companies Registry for public inspection.
- * Auditors should be allowed to report on any inconsistencies between the audited financial statements and financial information contained in the directors' reports.
- * The Listing Rules should be amended to require management discussion and analysis (MD&A) to include more qualitative and forward looking disclosure.