For discussion
on 7 April 2003

Legislative Council Panel on Financial Affairs

Enhancement of Regulation of Listed Companies and Corporate Governance of Companies

PURPOSE

This is a joint paper from the Financial Services and the Treasury Bureau, the Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx), outlining the major measures taken by regulators of overseas jurisdictions in the area of corporate governance. For Members' easy reference, it also briefly recapitulates our recent submissions to Members on our efforts to enhance the regulation of listed companies and corporate governance of companies in Hong Kong.

INTRODUCTION

2. Good corporate governance is a key factor in building and sustaining any successful financial market. At the micro level, corporate governance ensures the management conducts company affairs in a trustworthy and credible manner to return shareholder value. At the macro level, corporate governance holds the key to the reputation of a financial market and is a competitive necessity. The global community has in recent years focussed on standards of corporate governance, especially in light of increasing globalization of financial services and financial markets.

RECAPITULATING INITIATIVES TO ENHANCING CORPORATE GOVERNANCE OF COMPANIES IN HONG KONG

3. We have been keeping Members in the picture of our efforts in enhancing corporate governance. These are set out in the Corporate Governance Action Plan, which was presented to Members in January 2003 (copy at Enclosure A). Our plan is to keep Members informed of the development of the initiatives in the Action Plan. In this regard, we submitted in March 2003 a paper to Members (copy at Enclosure B) on relevant proposals to amend the Companies Ordinance. The Securities and Futures Ordinance, which contains provisions that would contribute towards better corporate governance, including provisions to enhance the transparency of listed companies and measures to combat market

misconduct, has become effective from 1 April 2003. HKEx would by June this year introduce amendments to the Listing Rules to implement various corporate governance measures consulted since January 2002. HKEx and SFC will also issue a joint consultation paper on the regulation of IPO intermediaries towards the end of April/early May this year. On corporate reporting, we are committed to finalising and taking forward by the end of 2003, in consultation with the listed sector and the accountancy profession, the proposal to establish a Financial Reporting Review Panel to investigate financial statements of companies and enforce changes thereto. Our position in relation to the regulation of the accountancy profession is set out in the reply to a written Legislative Council question raised on 12.2.2003 (copy at Enclosure C).

CORPORATE GOVERNANCE REGIME IN OTHER COUNTRIES

4. Enhancement of corporate governance involves many aspects and on-going efforts. Recent initiatives adopted in the United States (US), United Kingdom (UK), Australia and Singapore in the following key areas are outlined in this paper –

(a) regulation of initial public offering (IPO) intermediaries;

(b) listing regime;

(c) board of directors, derivative action and corporate reporting; and

(d) regulation of the accountancy profession.

Regulation of IPO intermediaries

The United States

5. The Securities and Exchange Commission (SEC) does not seek directly to regulate the conduct of firms lead managing IPOs. The bulk of US regulation of intermediaries is aimed at those who deal in securities. In primary market matters, the SEC relies largely on the requirement established by the Securities Act of 1933 and subsequent interpretations, that all material facts must be disclosed in any prospectus.

6. Lead underwriters take formal legal responsibility for the accuracy and completeness of statements made by issuers they are advising. Adequate due diligence is the only effective defence in the event of civil action by aggrieved shareholders or the SEC. In the US, with a disclosure-

based system, the primary purpose of the due diligence process is to produce a prospectus which contains full, true and plain disclosure. Since the fear of punitive damages is a very real one in the US, this system has generally been sufficient to maintain high standards of due diligence. The SEC (which has no powers of criminal prosecution) can, in addition to filing normal civil suit, take "administrative action", which involves bringing a case to a specialist judge, called an Administrative Law Judge.

The United Kingdom and Singapore

7. The regulatory system of IPO intermediaries in the UK and Singapore are similar. Companies seeking to list on the London Stock Exchange (LSE) and the Singapore Stock Exchange (SGX) must appoint a sponsor or lead manager to -

(a) manage the listing application procedure;

(b) advise the company on its listing preparation and interpretation of the listing rules; and

(c) represent the company in its listing application submissions to the relevant listing authority, i.e. the United Kingdom Listing Authority (UKLA) in the UK and the SGX in Singapore.

8. In the UK, these sponsors or lead managers must be approved by the UKLA. A sponsor firm must meet certain requirements and have a minimum number of eligible experienced staff. In Singapore, sponsors must be licensed by the Monetary Authority of Singapore (MAS) authorizing them to give corporate finance advice.

9. The UK Listing Rules and the SGX Listing Rules set out a list of duties and responsibilities the sponsor is expected to perform in respect of listing applications. For example, sponsors are required to provide UKLA with a written confirmation of due diligence work they undertook in relation to the listing document (the equivalent of a prospectus) and certain types of circulars published by a listed company. When a sponsor is found to be in breach of his duties and obligations under the UK Listing Rules, the UKLA can issue a public censure.

Australia

10. The role of sponsor does not exist in Australia. Intermediaries who deal in securities or who provide financial product advice (which include statements intended to influence person in relation to investment

decisions) require a licence from the Australian Securities and Investments Commission (ASIC). This includes not only promoters and underwriters but may also include reporting accountants and other professionals who express opinions which are included in disclosure documents and which may be relied on by investors. ASIC may bring disciplinary action to suspend or revoke a licence for breaches of the Corporations Act or for not performing duties efficiently, honestly and fairly.

11. Any intermediary or professional who participates in the preparation of a prospectus or whose opinion is included in the prospectus may be liable for misstatements subject to a due diligence defence. While Australian investors have not traditionally been as active as US investors in bringing class actions in relation to the contents of disclosure documents, in recent years such actions have been brought against companies, their directors and their advisers including corporate finance advisers, accountants and lawyers (either directly or after being joined by the company and its directors).

Regulatory regime concerning listing matters

The United States

12. In the US, the securities market is regulated by SEC which has broad authority over all aspects of the industry, including the power to register, regulate and oversee stock exchanges. The exchanges are self-regulators overseen by SEC. Rules made by the exchanges are subject to SEC's review and approval. Before securities may be admitted to trading on an exchange, they must be authorised for listing by the exchange and must be registered with SEC, which is responsible for enforcing laws relating to, inter alia, disclosure of information by the issuers.

The United Kingdom

13. In the UK, the UKLA under the Financial Services Authority (FSA), the single statutory regulator directly responsible for the regulation of deposit-taking, insurance and investment businesses, took over all of the listing regulatory functions formerly performed by LSE when the latter become a public limited company in 2000. The UKLA is the competent authority responsible for admission of securities to the official list. There is a distinction between "admission to listing" and "admission to trading". The former process is to ensure that minimum standards for the protection of investors are met and to provide for mutual recognition of the listing status across the European Union. The latter process is for a stock

exchange to decide whether trading of a security should be permitted on its trading board.

Australia

14. The supervision of securities exchanges in Australia is the responsibility of three parties, namely the Minister for Financial Services and Regulation, ASIC and the exchanges. The exchanges are responsible for setting their own standards for listed entities through the listing rules. The listing rules govern, amongst others, the admission of entities to and removal of entities from the official list, suspension of securities from quotation, and disclosure and some aspects of a listed entity's conduct. The listing rules are enforceable against listed entities and their associates under the Corporations Act, which provides the legal foundation for securities industry regulation, exchanges, clearing houses, industry participants and their conduct, etc.

15. The Australian Stock Exchange (ASX), Australia's only significant stock exchange, demutualised and listed its shares on the exchange in October 1998. To resolve the conflicts of interests between commercial and supervisory responsibilities after its demutualisation and listing, it established a subsidiary company, ASX Supervisory Review, which is an internal review mechanism (with external participation) to provide assurance that the ASX is directing appropriate resources to supervisory functions and maintaining standards.

Singapore

16. In Singapore, MAS established under the Monetary Authority of Singapore Act of 1970 supervises the capital market and administers the Securities and Futures Act of 2001. The SGX is a publicly listed company that operates the securities and futures markets, and is overseen by MAS. The SGX is responsible for approving listing applications in accordance with the rules set out in the Listing Manual and may suspend trading of the listed securities or remove an issuer from the official list. The Listing Manual is issued by SGX whereas its underlying principles are subject to MAS' approval to ensure that issuers shall have minimum standards of quality, operation, management experience and expertise.

17. The MAS has the power to issue "stop orders" to halt an offering if there are problems. It also has the statutory authority to require SGX to enter into arrangements for dealing with possible conflicts of interests that may arise from listing and quotation of SGX on a stock exchange, and for the purpose of ensuring the integrity of trading of the

securities of the transferee holding company. SGX's compliance with the listing rules established by its own exchange is supervised by MAS.

Board of directors, derivative action and corporate reporting

Board of directors

The United States

18. In the United States, there is no mandatory requirement that the roles of the Chairman and Chief Executive Officer be separated. Such separation is recommended as a best practice. A listed company is required to have an audit committee that consists of at least three members who are independent directors. It is not required to have a remuneration committee nor nomination committee.

The United Kingdom

19. In the United Kingdom, there is no mandatory requirement that the roles of the Chairman and Chief Executive Officer be separated. Such separation is recommended as a best practice. A listed company should have an audit committee that consists of at least three members most of whom are independent non-executive directors. It is not required to have a remuneration committee. The setting up of a nomination committee is recommended.

Australia

20. In Australia, there is no mandatory requirement that the roles of the Chairman and Chief Executive Officer be separated. Such separation is recommended as a best practice. A listed company should have an audit committee that has a majority of non-executive directors, preferably independent. It is not required to have a remuneration committee nor nomination committee.

Singapore

21. In Singapore, there is no mandatory requirement that the roles of the Chairman and Chief Executive Officer to be separated. Such separation is recommended as a best practice. A listed company is required to have an audit committee that consists of at least three members a majority of whom cannot be executive directors. It is not required to have a remuneration committee nor nomination committee. The setting up of such committees is recommended.

Derivative Actions

22. A derivative action is an action brought by minority shareholder(s) in his own name, in which he seeks a remedy (usually damages) on behalf of and for the benefit of the company in respect of a wrong done to the company (usually) by those controlling it. Generally any damages awarded by the court would go to the company, instead of the shareholder(s) initiating the derivative action (except in the US (see paragraphs 24-26 below)).

23. In all other comparable jurisdictions, the law provides for minority shareholders to exercise self-help by instituting a derivative action.

The United States

24. Shareholders in the US can bring class action suits with contingency fees.

25. The general concept of derivative action in the US is similar to the common law derivative action in the UK (see paragraph 27 below), in that a defendant has failed to perform his duties as an officer of the corporation and that injury is caused to the corporation.

26. Important elements of the laws in the US include –

(a) criteria for determining whether or not derivative actions should be permitted is a general criterion of "justice"; and

(b) the plaintiff can seek damages for a class of shareholders, rather than for the corporation under a derivative action.

(b) above is very significant and together with the contingency fee system, distinguishes the US position from other common law jurisdictions.

The United Kingdom

27. In the UK, reliance is placed on shareholders exercising their common law rights to institute derivative actions before the courts together with a statutory right to seek legal remedies for unfair prejudice. However, the UK plans to codify the common law right in a new comprehensive Companies Bill to be introduced to Parliament within the next legislative session.

Australia and Singapore

28. In Singapore, the right for shareholders to institute a derivative action is provided for in statute. There is no statutory right for a regulator to initiate derivative action.

29. In Australia, the right for shareholders to institute a derivative action is also provided for in statute. Of the four jurisdictions (the US, UK, Australia and Singapore), ASIC is the only securities regulator which has been conferred an analogous derivative action power to bring civil proceedings to recover damages or property either in the name of a person or a company (with their consent). ASIC has stated that as a matter of policy it is reluctant to undertake civil proceedings where there is a potential plaintiff with sufficient funds to bring those proceedings, but who is not prepared to do so.

Corporate Reporting

The United States

30. In the US, SEC is the front-line regulator in ensuring compliance with the US Generally Accepted Accounting Principles by listed companies in preparing their financial statements. The SEC has the power to make such investigation as it deems necessary.

The United Kingdom

31. In the UK, the Financial Reporting Review Panel is responsible for examining apparent departures from the Companies Act. The body has power to apply to the court to require directors to re-issue financial statements. Its jurisdiction is confined to the financial statements of public listed companies and large private companies as well as the contents of audited financial statements.

Australia

32. In Australia, ASIC is responsible for enforcing companies' compliance with reporting and disclosure standards. It actively reviews companies' financial statements to ensure that they comply with the accounting standards and other reporting requirements of the Corporations Laws.

Singapore

33. In Singapore, the reporting requirements monitoring function is undertaken by various parties such as the Singapore Exchange Limited and the Institute of Certified Public Accountants of Singapore. We understand that consideration is being given to delegating the task to the securities regulator.

Regulation of the accountancy profession

The United States

34. In the US, the American Institute of Certified Public Accountants is the national professional organisation for all Certified Public Accountants (CPAs). It provides certification and licensing to public accountants in the US. It has launched a Peer Review Program, which is dedicated to enhancing the quality of accounting, auditing and attestation services by its members in public practice. Under the Sarbanes-Oxley Act 2002, an independent Public Company Accounting Oversight Board is set up to oversee audits of public companies. It has the power to conduct investigations and impose sanctions.

The United Kingdom

35. In the UK, there are six chartered accountancy bodies, which are responsible for the registration and discipline of auditors. They have provided funding for the setting up of the Accountancy Foundation, which is an independent body. The Investigation and Discipline Board of the Accountancy Foundation is set up to make regulation of auditors more independent of the accountancy profession. It will investigate and take any appropriate action in disciplinary cases that are of significant public interest. It should be noted that in late 2002, the regulatory regime of the accountancy profession in the UK was reviewed. A number of recommendations on possible changes were published in January 2003.

Australia and Singapore

36. In Australia, ASIC is responsible for the registration of auditors. The Companies Auditors and Liquidators Disciplinary Board is responsible for the discipline of auditors. Three largest professional bodies have in place rules and professional codes of ethics that govern their members' professional conduct.

37. In Singapore, the Public Accountants Board is a statutory board and the regulatory body for public accountants, whereas the Institute of Certified Public Accountants of Singapore is the professional accountancy body. The Public Accountants Board is responsible for the registration of public accountants. It may appoint an inquiry committee to investigate complaints about the conduct of public accountants.

CONCLUSION

38. Hong Kong, same as other international financial centres, is committed to the enhancement of corporate governance. As mentioned above, the Government has, together with SFC and HKEx, drawn up a Corporate Governance Action Plan for 2003 with a view to bringing our corporate governance standards in line with international ones. In the course of implementation, we will, where appropriate, make reference to relevant practices of other countries.

39. However, it should be noted that comparison of the corporate governance practices and the reforms of such practices in different countries must not be done in isolation. Regulatory regimes have to be viewed in the context of the broader environment such as past economic policies and business practices which help to shape and condition them. They are closely related to, and heavily influenced by, the legal, institutional, social and cultural regime of their own countries.

Financial Services and the Treasury Bureau
Securities and Futures Commission
Hong Kong Exchanges and Clearing Limited
April 2003

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Enclosure A

Enhancing Corporate Governance

The Mission

Maintaining and enhancing our competitiveness as a leading international financial centre and the premier capital formation centre for our country.

Objective

To upgrade the quality of our market by bringing our corporate governance standards in line with international standards, and to be the preferred support base for Hong Kong and Mainland companies by providing quality international financial and other professional services.

The Corporate Governance Action Plan for 2003

The Administration has, together with the Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx), reviewed the measures proposed by concerned parties to improve corporate governance; and taken the lead in drawing up an Action Plan for 2003 to identify priority areas, assign ownership and devise a timeframe for implementation.

The Administration, SFC and HKEx are fully committed to this Action Plan. Together we shall review progress regularly; and coordinate efforts to close any gaps and remove inconsistencies in implementation.

The Action Plan in no way pre-empts the findings of the Expert Group, and will be amended and adapted as necessary to meet any structural or procedural changes flowing from those recommendations.

Five Priority Areas

Priority I: Upgrading the Listing Rules and Listing Functions

- By Q2 2003: HKEx to introduce amendments to the Listing Rules and promulgate a revised Code on Best Practice to implement various corporate governance measures consulted since Jan 2002.

- By Q1 2003: HKEx to complete streamlining of the listing process in order to improve quality control at the point of entry by focussing on critical matters.

- By phases, starting from Q2 to Q4 2003: HKEx to amend the Listing Rules to improve the initial and continuing listing requirements and delisting procedures, following consultation started in July and November 2002.

- By Q4 2003: The Administration to follow up recommendations of the FS-appointed Expert Group scheduled for publication in March 2003 with a view to improving Listing Functions; and delineating roles of FSTB, SFC and HKEx under the tiered regulatory structure.

Priority II: Tightening the regulation of IPO intermediaries

- By Q1 2003: HKEx to consult the market on amendments to the Listing Rules to tighten regulation of IPO intermediaries, in particular sponsors and financial advisors. Target is implementation in H2, 2003.

- By Q1 2003: SFC to put forward proposals to the Standing Committee on Company Law Reform (SCCLR) on amendments to the Companies Ordinance to extend the prospectus-related liability to IPO sponsors, and possibly, other IPO intermediaries, for ensuring quality disclosure to investors.

- By Q3 2003: FSTB, in consultation with the Hong Kong Society of Accountants, to finalise legislative proposals to enhance the regulation of the accountancy profession.

Priority III: Effective Roll Out of the Securities and Futures Ordinance

- By 1 April 2003: SFC to formulate an effective strategy in enforcing the Securities and Futures Ordinance (SFO), in particular with regard to execution of "dual filing", inquiries into corporate misconduct, regulation of licensed IPO sponsors, cooperation with HKEx in combating pre-IPO market manipulation, etc. SFC to adopt a case specific approach as a corporate regulator under SFO and 'dual filing'.

Priority IV: Successful completion of SCCLR Phase II Corporate Governance Review

- By Q1 2003: The Administration, SFC and HKEx to render full support to the SCCLR for completion of its Phase II Review, with SFC and HKEx putting forward further proposals to SCCLR, including amendments to the Companies Ordinance on related party transactions, shareholders' rights, disclosure requirements, liability of professional advisers relating to misstatements in listing documents etc.

Priority V: Early implementation of SCCLR Recommendations from its Phase I Corporate Governance Review

- By Q1 2003: FSTB and SFC to release a joint consultation paper on the concept to empower SFC to conduct derivative actions for minority shareholders of a listed company, including legal issues, scope and effectiveness of remedies, and possible implementation arrangements.

- By Q2 2003: FSTB to introduce to LegCo a Companies (Amendment) Bill to enhance corporate governance by implementing SCCLR Phase I recommendations relating to shareholders' remedies.

- By Q4 2003: FSTB, in consultation with the listed sector and the accountancy profession, to finalise and take forward a proposal to establish a Financial Reporting Review Panel to investigate financial statements of companies and enforce changes thereto.

Enclosure B

For information
on 20 March 2003

The Legislative Council
Panel on Financial Affairs

Legislative Proposals
in the Companies (Amendment) Bill 2003

PURPOSE

This paper informs Members of the legislative proposals to the Companies Ordinance (CO) which are intended to be included in the Companies (Amendment) Bill 2003.

BACKGROUND

2. We intend to seek amendments to the CO to facilitate offers of shares and debentures; enhance shareholder remedies as proposed by the Standing Committee on Company Law Reform (SCCLR); define "subsidiary" for the purposes of group accounts; and enable electronic incorporation and to update the provision on partner limit.

(A) Amendments facilitating offers of shares and debentures

3. The Financial Secretary highlighted in his Budget Speech in 2002 the importance of increasing liquidity through attracting more financial product issuers to Hong Kong, as well as capital and investors from the Mainland and overseas. In his Budget Speech in 2003, he said that in order to foster the development of retail bonds and other financial products, we would like to amend the CO to simplify the procedures for the registration and issue of prospectuses. This is Phase II of a three-phase approach[1] to modernize the prospectus regime. We are drafting the

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[1] Measures under the first phase are made in response to specific requests from market participants and do not involve amendments to the CO. They involve the issue by the SFC in February 2003 of various guidelines permitting awareness advertisements and an alternative "dual prospectus" structure, and allowing faxed copies and bulk print proofs for the purposes of registration. They also involve the issue of two class exemptions by the SFC relating to prospectuses for offers of debentures. Measures under the second phase are intended to be included in the

proposed amendments to the CO in close consultation with the industry. Together with the Securities and Futures Commission (SFC), we have published a joint consultation document to invite public comments on the proposals until end March 2003.

4. The major proposals are highlighted below –

Enhanced clarity of the application of the prospectus regime

5. Under the CO, any document falling within the definition of "prospectus" is required to comply with the prospectus-related requirements. In response to market views, we propose to amend the CO to provide greater clarity as to the types of offers and invitations that can be made without triggering the prospectus regime by excluding expressly from the definition of "prospectus" documents containing or relating to offers and invitations that fall within specified descriptions.

Flexible implementation of the prospectus regime

6. We propose to expand the existing exemption power of the SFC under sections 38A and 342A of the CO by providing the SFC with an additional ground of exemption: that the exemption would not be prejudicial to the interest of the investing public; and increasing the number of provisions in respect of which exemptions may be granted. Such enhanced flexibility in administering the prospectus regime is essential in a market which demonstrates and supports ongoing innovation in the form of new offering structures, offering methods and financial products.

Facilitative marketing permitted

7. We propose to make clear in the CO that subject to necessary investor protection safeguards, it is permissible for issuers to issue "awareness advertisements" setting out basic factual and procedural information concerning offers of shares and debentures. We intend that such advertisements will not constitute prospectuses (or extracts or abridged versions of a prospectus) nor fall within the prohibition in section 103 of the Securities and Futures Ordinance. The purposes are to enhance investors'

Companies (Amendment) Bill 2003. In the third phase, the SFC will conduct a comprehensive review of all local laws and procedures governing public offers of securities as well as regulatory reforms introduced in other leading jurisdictions, with a view to putting in place a framework that provides the most efficient, competitive and fair environment for issuers and investors alike. The SFC has started this review and aims to put forward proposals for public consultation within 18 months.

awareness of an offer and allow them more time to arrange their financial and other affairs in anticipation of a public offer.

Alternative prospectus regime for programme offerings

8. The standalone prospectus contemplated under the CO is not conducive to the conduct of programme offers (i.e. offers made on a repeat or continuous basis or through successive tranches) as each time an offer in a series is made, authorization and registration of a full prospectus is required. The associated administrative burden hinders the making of timely offers responsive to market conditions and results in increased compliance cost that serves little regulatory purpose. We therefore propose to include in the CO an alternative "dual prospectus" structure whereby a prospectus may consist of (a) a "programme prospectus", (b) an "issue prospectus", and (c) an "addendum", if necessary, updating the information in the "programme prospectus" or "issue prospectus". Safeguards to ensure that investors are given access to all relevant information and other safeguards applicable to a full prospectus will be included as appropriate.

Level playing field and other miscellaneous revisions

9. A number of other amendments are proposed to remove the discrepancies in certain regulatory requirements applicable to offers made by companies incorporated locally and overseas; and for clarifying the application of and the requirements under certain provisions.

Prospectus liability provisions

10. Under section 40 of the CO, directors, promoters and persons who authorize the issue of a prospectus are liable to pay compensation to all persons who subscribe for any shares in or debentures of a company on the faith of the relevant prospectus, for the loss or damage they have sustained by reason of any untrue statement (deemed to include a statement that is misleading) in the prospectus. We propose to make clear that (a) investors who acquire shares or debentures in a public offering (whether it is an offer for subscription or offer for sale) through or via an agent shall be regarded as persons who subscribe for the shares or debentures; and (b) omission of material information in a prospectus would also give rise to liability.

(B) Legislative amendments to enhance shareholder remedies

11. We propose a number of amendments to the CO to enhance shareholder remedies. These proposals were contained in the SCCLR's Consultation Paper on Proposals made in Phase I of the Corporate

Governance Review published in July 2001, and the comments received indicated support for such proposals.

Statutory derivative action

12. Generally, directors' duties are owed to a company rather than individual shareholders. If a wrong has been inflicted on a company, the proper plaintiff is the company itself. Under the common law, minority shareholders of a company may take derivative action on behalf of the company against the wrongdoers. To facilitate minority shareholders to take derivative action on behalf of the company against the wrongdoer, we propose to introduce a statutory derivative action along the following lines -

(a) there will be no need for an applicant to obtain prior leave of the court before commencing the action;

(b) the court should have a general power to grant orders as to costs for a shareholder taking a derivative action provided that there is no evidence of bad faith on the part of the shareholder and there are reasonable grounds on which to commence the action; and

(c) ratification of the conduct that is the subject matter of the proceedings would however not be a bar to the commencement of the proceedings. Where there is an apparent wrongdoer involvement in a "ratifiable" transaction (i.e. where the wrongdoer appears to have profited from the transaction in breach of his duties), only "independent" shareholders can ratify the transaction. This would be only one of the considerations of the court in determining whether or not the company should have redress.

Unfair Prejudice Remedies

13. Section 168A of the CO provides for a statutory remedy (short of liquidation) against unfair prejudice. Its underlying premise is that the member's personal right should be treated fairly. A wide range of remedies is available under this section such as providing for the purchase of the shares of the company by other members of the company or the company.

14. This notwithstanding, we propose that

(a) the powers in section 168A should be amended to make it clear that the court has the power to award damages 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 the action; and

(c) section 168A should be amended to allow members of oversea companies, as well as Hong Kong incorporated companies, to commence an action for unfair prejudice.

Orders for inspection

15. To facilitate shareholders to exercise their rights, we propose to provide a statutory method whereby the court, on application by a shareholder, may make an order to allow the shareholder to obtain access to company records if the court is satisfied that the applicant is acting in good faith and the inspection is for a proper purpose.

Injunction orders

16. To help address any breach of the CO or any breach in relation to directors' duties, we propose that the court should have a general power, on application by an affected person or the Financial Secretary to grant an injunction order restraining the concerned person from engaging in the conduct or requiring that person to do any act or thing.

(C) Definition of "Subsidiary" for the Purposes of Group Accounts

17. Section 124 requires a company having subsidiaries to lay before the company in general meeting, accounts dealing with the state of affairs and the profit and loss of the company itself and its subsidiaries. These accounts are known as group accounts. The term "subsidiary" is defined in section 2(4), which deems the relationship between a holding company and its subsidiary to be one of the control of the board of directors of the subsidiary, control of more than half of the voting power of the

subsidiary or the holding of more than half of the issued share capital of the subsidiary.

18. The Hong Kong Society of Accountants (HKSA) is responsible for issuing the Hong Kong Statements of Standard Accounting Practice (SSAPs), which govern the preparation and presentation of accounts (including group accounts). Since 1993, it has been the HKSA's policy to harmonise SSAPs with the International Accounting Standards (IASs), which are the internationally recognised set of accounting standards.

19. The HKSA issued SSAP 32 "Consolidated Financial Statements and Accounting for Investments in Subsidiaries" in January 2001 to apply in the preparation and presentation of group accounts for accounting periods beginning on or after 1 January 2001. SSAP 32 is based on, and generally consistent with IAS 27 "Consolidated Financial Statements and Accounting for Investments in Subsidiaries" except that SSAP 32 currently accommodates the CO's definition of "subsidiary" for statutory reporting purposes. In both IAS27 and SSAP 32, a subsidiary is defined as "an enterprise that is controlled by another enterprise", where the control is the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

20. Compared with the IAS and SSAP's definition of a subsidiary, the definition of a subsidiary under section 2(4) is narrower. We consider it necessary to amend the statutory definition to more closely align with the IAS and SSAP's definition. We do not consider it appropriate to adopt the definition of "subsidiary" in SSAP 32 in the CO as the definition is based on the concept of "control", which is imprecise, and involves a high degree of accounting judgement. After consultation with the SCCLR, we have formulated our legislative amendments on the basis of the relevant provisions of the UK Companies Act 1985 (as amended in 1989), as follows -

(a) to introduce new terms of "subsidiary undertaking", "parent company" and "parent undertaking" for the purpose of group accounts. These terms will not replace the existing terms "subsidiary" and "holding company" used in section 2(4) to 2(7);

(b) to define the term "undertaking" to include body corporates, partnerships and other unincorporated associations. This is in contrast to the existing provision under which a subsidiary or a holding company must be a body corporate. Without this amendment, assets and liabilities of partnerships and

unincorporated associations within a group can be kept out of the group accounts, even when substantially all the risks and rewards are retained in the group;

(c) to add the "right to exercise a dominant influence over another undertaking" to the existing tests of determining the existence of a parent/subsidiary relationship;

(d) to define the right to exercise a dominant influence over another undertaking as the right to give directions with respect to the operating and financial policies of that other undertaking which its directors will be obliged to comply with; and

(e) to introduce "true and fair override" provisions to the effect that if compliance with the requirements of the Ordinance does not result in a true and fair view of the state of affairs of the company or the group, the directors should depart from these requirements to the extent necessary to give a true and fair view. Additional information in order to present a true and fair view should be given in the accounts or in a note to them. Particulars of any such departure, the reasons for it and its effect should be given in a note to the accounts. The "true and fair override" provisions will cater for the evolving nature of accounting reporting requirements. They would negate attempts to find ways around the standards or the law to avoid inclusion of vehicles, such as special purpose entities and other off-balance sheet non-subsidiaries, into the group accounts;

(D) Miscellaneous Amendments

Amendments to enable electronic incorporation of a company

21. In order to simplify the application procedures for the incorporation of a company and to pave the way for electronic submission and processing of applications, we propose to amend the CO to introduce new procedures for the incorporation of a company. The present requirement for the witnessing of the signatures of the subscribers (to be renamed as founder members) under the CO will be dispensed with if the memorandum and articles of association of the company are submitted to the Registrar of Companies electronically. A specified form containing vital information about a company will be introduced as the application form to incorporate a company. We also propose to amend the CO to state the purposes for which the documents kept by the Registrar of Companies under the CO are made available for public inspection. This is in the

interest of protection of personal data in the documents.

Repeal of the 20 Partner Limit in Section 345

22. Section 345 of the CO and section 3 of the Limited Partnerships Ordinance contain a restriction of the 20 partner limit. The reasons for the restriction are historical and no longer appropriate. The restriction places an unnecessary burden on business by preventing the expansion of business by the introduction of new partners. The limit has also been removed in the United Kingdom. For these reasons, we propose to repeal the limit.

Way Forward

23. We are drafting the above legislative amendments with a view to including them in the Companies (Amendment) Bill 2003.

Financial Services Branch
Financial Services and the Treasury Bureau
March 2003

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Enclosure C

LegCo Question No. 9
(Written Reply)

Date of Meeting : 12 February 2003
Asked By : Hon CHAN Kam-lam

Replied by :
Secretary for Financial Services and the Treasury

Question:

The Hong Kong Society of Accountants ("HKSA") may, at its discretion, form Investigation Committees and Disciplinary Committees to deal with complaints about the professional misconduct of professional accountants. It has been reported that the authorities suggested to HKSA in December last year that, to enhance the credibility of these committees, the number of lay members should be more than half of their respective membership. In response, HKSA accepted the suggestion and further proposed to set up an Independent Investigation Board to investigate cases involving alleged substandard audit work performed for listed and regulated companies. In this connection, will the Government inform this Council:

(a) of the content and progress of the discussions between the authorities and HKSA;

(b) whether it has estimated when the new arrangements can be implemented; and

(c) whether it plans to have the self-regulation arrangement for the accountancy profession eventually replaced?

Reply:

Madam President,

(a) Accountants have a duty to safeguard the accuracy and integrity of financial reporting. Conscious of the need for an effective, transparent and accountable regulatory regime that is in line with international developments, I met with representatives of the accounting profession in December 2002 to discuss ways to improve the existing regime set out in the Professional Accountants Ordinance (Cap. 50). In response to the Administration's request for enhancing the independence element in the present regulatory regime, the Hong

Kong Society of Accountants (the Society) submitted detailed proposals to the Administration on 22 January 2003. The proposals are summarised as follows –

(i) increase the lay members in the Society's Council (i.e., the governing body);

(ii) expand the membership of any Investigation Committee instigated by the Society's Council from three to five, and alter the composition of the Investigation Committee, with the majority of members (including the chairman) being lay persons;

(iii) alter the composition of the 5-member Disciplinary Committee instigated by the Society's Council, with the majority of members (including the chairman) being lay persons; and

(iv) establish an Independent Investigation Board to deal with alleged accounting, auditing and/or ethics irregularities related to companies listed on the Stock Exchange of Hong Kong.

HKSA's proposals are a move in the right direction. We intend to take forward the proposals to enhance the independence and transparency of the Society's Council and two Committees in the first instance. Implementing such proposals would require amendments to the Professional Accountants Ordinance. The proposal for an Independent Investigation Board warrants more detailed examination, in particular in the light of international developments on the oversight of the auditing profession. We will continue our dialogue with HKSA in this regard.

(b) As mentioned in our Corporate Governance Action Plan for 2003 (presented to the Legislative Council Panel on Financial Affairs on 13 January 2003), we aim to finalize the legislative proposals to enhance the regulation of the accounting profession in the third quarter of 2003, in consultation with the Society.

(c) In considering the development of the regulatory regime of the accounting profession, our objective is to ensure that the relevant regulatory regime is effective and transparent, inspires confidence in investors, serves the needs of Hong Kong and is in line with international trends. The nature of such regulatory regime is not a primary concern.