

**BY HAND**

17 May 2004

Mr Frederick Ma  
 Secretary for Financial Services and the Treasury  
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**Re: Consultation Paper on Statutory Derivative Action in the Company (Amendment) Bill 2003**  
**Ref.: C2/1/57/3(04) Pt.7**

Dear Mr Ma,

I write on behalf of CPA Australia Hong Kong China Division in response to your invitation of April 22, 2004 to comment on the proposed introduction of Statutory Derivative Action (SDA) by way of amendment of Hong Kong's Company Ordinance. The following comments are in reference to the above Consultation Paper.

**1. Need to modernize derivative action**

Derivative action is one of the many tools that jurisdictions with modern legal systems offer to rectify cases of abuse against shareholders. At present, in Hong Kong, the only type of derivative action available is antiquated and ineffectual common law derivative actions (CDA).

The proposed SDA will bring Hong Kong's derivative action in line with modern company law. The proposed SDA offers three advantages over current CDA:

First, SDA will apply a more formal process of acceptance of cases, ie, by grant of leave of the court.

Second, the narrow criteria of *Foss vs. Harbottle* which will continue to apply to CDA, will not apply to SDA. The operative criteria for acceptance of cases will be whether the "wrong" is suffered by the company, whether the wrong is of the nature of a fraud, negligence, default, or breach of duty on the part of company officers and directors, and whether the claimant can be established, at a preliminary level, the "good faith" of the claim (i) as to the probability that the company will not bring the case itself and (ii) as to the seriousness of the question to be tried.

Third, if the claimant has met the preliminary test of acceptance of his case and he has prevailed on the merit of the case, one important difference between the SDA and the CDA will be that the claimant will be able to recoup his legal costs. What is unchanged is that the proposed SDA remains a derivative action, that is an action instituted on behalf of a company and therefore, compensation awards still will go back to the company.

The proposed SDA is an improvement on the ineffectual and uneconomical CDA, and, from this perspective, we are generally supportive of the proposed SDA.

**2. Critique and concerns over the wording of the proposed SDA**

We understand the need to maintain a balance of interests and to prevent the institution of frivolous actions. However, we note that the test for granting leave of the court will be very subjective (ref. "good faith", "best interest of the company") and that this test will be applied to a number of criteria which may be difficult to establish by claimants (ref. "probability that the company will not bring proceedings itself", "seriousness of the question to be tried").

In short, it is unlikely that the proposed SDA will open a floodgate of cases. To the contrary, given the significant legal costs and evidentiary difficulties related to qualifying corporate abuse cases for trial under the proposed SDA, we wonder if the proposed wording might be insufficiently "investor-friendly" to encourage *bona fide* and serious cases of corporate abuse to be instituted.

### 3. Other important limitations of derivative action and the proposed SDA

The proposed SDA has two important limitations:

(1)	<p>The proposed SDA does not solve the key criticism that such shareholder suits take a long time and are costly. The proposed SDA may allow the prevailing party his legal costs (to the extent that they are permitted by the courts), but given the need to finance the suit until the matter is finally decided (that is until the case is appealed barred), there are still few new incentives for claimants to take action under the proposed SDA.</p> <p>Also on the issue of cost, as stated above, the SDA remains a derivative action. Derivative actions are, by their nature, of limited use to shareholders. They are proceedings of exception, instituted NOT for the benefit of minority shareholders, but on behalf and for the benefit of companies. This means that the proposed SDA will not be a remedy for minority shareholders seeking direct compensation. It will not solve the bulk of the needs for legal protection of minority shareholders in Hong Kong (eg, does not allow the sharing the risk of litigation with other aggrieved parties, does not expedite legal proceedings, does not ease the proof of shareholder cases).</p>
(2)	<p>The proposed SDA is a change to Hong Kong's company law. This means that the proposed SDA will <u>not</u> apply to companies incorporate outside of Hong Kong. This is a serious limitation given the number of private and listed companies operating in Hong Kong which are incorporate in the BVI and other such jurisdictions where there is no SDA.</p>

### 4. Conclusion

SDA is one of the many protection mechanisms that is offered in markets with developed legal systems. All major international markets and most major financial jurisdictions in Asia have SDA<sup>1</sup>. The introduction of a SDA in Hong Kong is long overdue. However, one should not over-estimate the value of this proposal. The proposed SDA is limited in scope and it will not solve the problems of lack of effective and fair protection for minority shareholders in Hong Kong.

The proposed SDA should be supported, but this proposal is only a small step towards an adequate level of protection for minority shareholders in Hong Kong.

Your sincerely



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<sup>1</sup> SDA jurisdictions in Asia include India, Malaysia, The Philippines, Singapore, S. Korea, Taipei, Thailand, Vietnam.