Submission from Linklaters

Companies (Amendment) Bill 2003

This memorandum sets out Linklaters' comments on the Companies (Amendment) Bill 2003 (the "Bill"), which was introduced into the Legislative Council on 25 June 2003.

In general, we are supportive of the proposals contained in the Bill. We note that many of the proposals have been the subjects of previous consultation and we have provided detailed comments on some of the proposals before. Accordingly, we wish to only focus on those areas where we think may cause concerns. Our comments are set out below in four main parts corresponding to the four Schedules to the Bill.

A. Comments on Schedule 1 relating to Prospectuses

1. In general, we welcome the proposals in Schedule 1 which we believe will be beneficial in clarifying the existing legislative framework, in particular in relation to exemptions from the prospectus regime.

Resale Restrictions

2. We have a number of concerns relating to the resale restriction set out in Sections 38AA and 342AB:

   - This provision overlaps with Section 41(2) of the Companies Ordinance that provides the current anti-avoidance provisions. We are not aware of any pressing mischief which needs to be addressed by the new provision, nor any misconduct that is not already caught by Section 41(2).

   - We are also not aware of any similar provisions in the legislation of other common law jurisdictions that seeks to regulate the secondary market in this way, presumably as it is felt that there is no significant mischief to address.

   - We are concerned that this provision is somewhat novel imposing restrictions, punishable by a fine, on a purchaser of securities. Hong Kong law has up to this point in common with other jurisdictions, regulated offers of investments through issuers and intermediaries; end purchasers are not generally within the regulatory regime.

   - In particular, we are unclear as to what the intended scope of this provision is. Its application to the use of 'any document …. [to] sell or offer to sell the shares or debentures to the public' may mean, for example, that a purchaser that issues a term sheet to a group of potential investors would have to consider whether such investors constituted the 'public'. It is also unclear how this restriction interacts with the Schedule Seventeen exemptions that are available with respect to a primary offer.

Legending Requirements in Prospectuses

3. We have a number of concerns relating to the requirement that all but one of the Schedule Seventeen exemptions can only be relied on to the extent that the legending requirements are met.

   - We would question the extent to which the legends really provide any degree of investor protection, in particular in the context of the exempted offers. We appreciate the concern to highlight certain risks in the context of public offers. However, if for example an offer falls within the high denomination exemption, we would question whether the legend serves a useful purpose.

   - The concern is that this requirement may result in certain offers losing the right to rely on one of the exemptions as a result of the omission of the legend. This is of particular concern in the context of international offerings not necessarily focused on Hong Kong, where the issuer and its counsel may not be familiar with Hong Kong laws. For example, for a Eurobond issued by a company in Europe, a decision to offer to a limited group of Hong Kong investors may only be taken after printing of the documentation. In such context the requirement will create administrative difficulties without materially adding to investor protection.

   - We are not aware of any other common law jurisdiction that specifically requires a legend to be used in order to benefit from such exemptions. Presumably because such jurisdictions do not consider that investors falling within exemptions from public offer requirements need such protection. Such provision may indeed be considered by the international capital market as excessive and unnecessary regulation of the market.

Dual Prospectus Provisions

4. In relation to the dual prospectus provisions in Schedule 20 to the Companies Ordinance, we have one detailed point in relation to Part 1 paragraph 8. The requirement that the programme prospectus be updated every 12 months is desirable, but this requirement should be sufficiently flexible to cater for the fact that there may be a period of 13 or 14 months between the dates on which a company's annual reports are published.

B. Comments on Schedule 2 relating to Group Accounts

Impact on the Hong Kong asset-back securitisation market

1. Our principal comment in relation to Schedule 2 is that the proposed amendments, as they now stand, would likely have a negative effect on the development of the Hong Kong asset-back securitisation market as the consolidation of special purpose entities brought about by the extended definition of "subsidiary" would undermine the incentive for asset securitisation.

2. We note that this concern has already been raised by the Hong Kong Mortgage Corporation Limited and the Hong Kong Capital Markets Association when the proposed amendments to the definition of "subsidiary" under the Companies Ordinance were first exposed in April 2003. We also note that the Financial Services and the Treasury Bureau has indicated in the Legislative Council Brief attached to the Companies (Amendment) Bill 2003[1] that the Government would keep a close watch on international developments, particularly, in relation to the International Accounting Standards, and that, where necessary, refinements would be introduced into the Bill before its enactment to ensure, amongst others, that Hong Kong development needs are adequately catered for.

3. In light of the current state of flux in relation to the accounts consolidation treatment of special purpose entities formed for the purpose of securitisation, it does not appear that the development of a set of internationally accepted principles dealing with the related issues would be a speedy process. Therefore, we believe that the better alternative at this stage is to provide a clear "carve out" in the Schedule 2 amendments to exclude their application to securitisation transactions and special purpose entities specifically. If this is spelt out in the Bill, securitisation transactions would not be subjected to the uncertainty brought about by the potential application of the extended definition of "subsidiary" in the meantime; and the breathing space provided by the "carve out" would give the market sufficient time and opportunity to consider the implications of any proposed amendments that may be introduced to govern securitisation transactions and special purpose entities after taking into account international developments and experiences.

Section 17 of Schedule 2 – New Twenty-Third Schedule to the Companies Ordinance

4. Sections 2(1)(c) and (4) of the Twenty-Third Schedule propose to introduce the concept of determining parent/subsidiary relationship through the rights to exercise a "dominant influence" over another undertaking by virtue of the provisions contained in the undertaking's constitutional documents or a "control contract". Although these provisions track the legislative amendments made by the UK Companies Act 1989 to the definition of "subsidiary", it would be important to clarify whether more than one entity can exercise a "dominant influence" over another undertaking in the Hong Kong context, e.g. through joint control. (We note that the Twenty-Third Schedule does not include provisions equivalent to Sections 258(4) and 260 of the UK Companies Act 1985 regarding "participating interest"). Further "control contracts" (as defined in Section 2(4) of the Twenty-Third Schedule) are not common in relation to UK companies in practice. They are more relevant to European companies (e.g. German company) where entering into control contracts with subsidiaries are prevalent. Hence, it seems that the meaning of "control contract" under the Hong Kong provisions may need to be more specifically considered.

[1] Paragraph 8 of the Legislative Council Brief dated 12 June 2003.

Sections 2 and 4 of Schedule 2 - "True and fair view override"

5. We note that Sections 2 and 4 of Schedule 2 introduce the "true and fair view override" provisions to ensure that the Companies Ordinance could better cater for the evolving nature of accounting reporting requirements. Whilst we have no objection to the introduction of such provisions, we are concerned that the discretion for directors to exercise the "true and fair view override" under the new Sections 124(4A) and 126(5) without more specific guidance or without the reference to "special circumstances" as in the case of their UK equivalents[2] may create problems or uncertainties on how the discretion should be exercised.

6. Accordingly, we suggest that the Hong Kong Society of Accountants should provide practical guidelines on the application of the override provisions, and that the proposed amendments in Sections 2 and 4 of Schedule 2 should not become effective until such guidelines have been developed.

C. Comments on Schedule 3 relating to Overseas Companies and Incorporation Procedures

Sections 1(2) and 42 of Schedule 3 - "Place of business"

1. The proposals set out in Schedule 3 to the Bill aim to simplify the registration requirements of Part XI "oversea companies" (to be renamed non-Hong Kong companies) and enhance the disclosure requirements relating to such companies. We support these proposals in general and note that most of the proposals, if implemented, would not significantly increase the compliance cost and burden for Part XI companies.

2. However, we believe that the new definition of "place of business" would create problems or uncertainties in determining whether a non-Hong Kong company should be required to register under Part XI of the Companies Ordinance.

3. Section 322 of the Companies Ordinance provides that Part XI of the Ordinance shall apply to all companies incorporated outside Hong Kong which establish a "place of business" in Hong Kong. Currently, Section 341(1) defines "place of business" to include "a share transfer or share registration office and any place used for the manufacture or warehousing of any goods but does not include a place not used by the company to transact any business which creates legal obligations".

4. The new definition of "place of business", as set out in Sections 1(2) and 42 of Schedule 3 to the Bill, only provides that it does not include a local representative office established or maintained with the approval of the Hong Kong Monetary Authority ("HKMA") by a bank. No other guidance is given on the circumstances under which a "non-Hong Kong" company would be considered as having a "place of business" in Hong Kong.

[2] Sections 226(5) and 227(5) UK Companies Act 1985 respectively.

5. At present, whether a representative office of an overseas-incorporated company is regarded to have a “place of business” in Hong Kong is to be determined based on the facts of the case, having regard to the existing definition of the term as set out in Section 341(1) of the Companies Ordinance and case law.

6. It is not clear whether the intention of the proposed amendment to the definition of “place of business” is to widen the scope of the Part XI registration regime to catch all representative offices of overseas-incorporated companies except those maintained by duly licensed banks as approved by the HKMA. If this is the intention, we believe that more consideration should be given to the cost and business implications arising as a result of the implementation of the proposal.

7. Further, we think that the removal of the reference to “share transfer or share registration office” in the definition of “place of business” may give rise to difficulty or confusion on whether or not an H-share company listed on the Hong Kong Stock Exchange which does not have any operations in Hong Kong except for the maintenance of a branch share register as required by the Stock Exchange Listing Rules would be regarded as having a place of business in Hong Kong, hence, required to maintain a registration under Part XI. We understand that currently, nearly all H-share companies are oversea companies registered under Part XI based on the existing definition of the term “place of business”, and some of them may not have any real business operations in Hong Kong.

8. For the purpose of better understanding the scope of application of Part XI, we believe that it would be important to more clearly spell out the reasons for amending the definition of “place of business” as proposed. By way of contrast, it is worth noting that Section 744 of the UK Companies Act 1985 defines a "place of business" as including "a share transfer or share registration office".

Section 38 of Schedule 3 – Notices to be sent when non-Hong Kong companies cease to have places of business in Hong Kong

9. We note that the requirement for any non-Hong Kong company ceasing to have a place of business in Hong Kong “forthwith” to give notice to the Registrar of Companies is now specified under Section 38 of Schedule 3 to be seven days after the company ceases to have a place of business in Hong Kong. We find this requirement onerous and recommend that the notification period be extended to 14 days after the company ceases to have a place of business in Hong Kong.

D. Comments on Schedule 4 relating to Shareholders’ Remedies

Overview

1. The Explanatory Memorandum to the Bill states that the principal purpose of the amendments introduced by Schedule 4 is to enhance shareholders’ remedies available under the Companies Ordinance in relation to derivative action, actions for unfair prejudice, orders for inspection of records of companies incorporated in Hong Kong and non-Hong Kong companies and injunction orders.

2. The amendments proposed in Schedule 4 of the Bill will, in general terms, materially improve the remedies that are available to shareholders in Hong Kong and from a corporate governance perspective should be welcomed. In particular, the amendment giving shareholders a statutory right to initiate derivative actions brings the companies legislation in Hong Kong in line with common law jurisdictions such as Australia and Singapore.

3. A material change that the Bill will introduce is to extend the unfair prejudice remedies and the statutory right to bring a derivative action to shareholders of a non-Hong Kong company (ie. an "overseas company" as presently defined in Section 332 of the Companies Ordinance, namely, companies incorporated outside of Hong Kong but which have established a place of business in Hong Kong under Part XI of the Ordinance).

4. From a corporate governance perspective, extending the enhanced remedies available under the Companies Ordinance to shareholders in non-Hong Kong companies ought to be welcomed. In particular, given the number of non-Hong Kong companies which are effectively managed or have their place of business in Hong Kong, these amendments might be considered long overdue. However, the extra-territorial nature of these amendments might be susceptible to objection in circumstances where the law of the place of incorporation of a non-Hong Kong company does not recognise or provide for similar shareholder rights/remedies. In addition, a judgment or order obtained by a shareholder in a non-Hong Kong company pursuant to these amendments might encounter difficulties if enforcement of such judgment/order by a foreign court against the relevant non-Hong Kong company may be required.

5. Subject to our comments in paragraph 4 above, we set out in paragraphs 6 to 15 below our specific comments in relation to the amendments proposed in Schedule 4 to the Bill.

Sections 1 to 3 of Schedule 4 – Inspection of Records

6. Section 152FA, if introduced, would significantly enhance the rights of a shareholder to inspect the books and records of both a Hong Kong and non-Hong Kong company. This amendment will be of material importance to shareholders in non-Hong Kong companies which are incorporated in jurisdictions (for example, the British Virgin Islands) where a shareholder's right to information is limited or non-existent under the law of the place of incorporation. However, Section 152FA may be criticised for having gone too far in terms of the "records" which a shareholder may seek to inspect counterbalanced only by the court's determination of whether the inspection is for a proper purpose having regard to the interests of both the relevant specified corporation and the applicant (see also our comments in paragraph 8 below in this regard).

7. The definition of "record" for the purposes of Sections 152FA, 152FB and 152FD, as introduced by Section 2 of Schedule 4, would mean that potentially every document within the company's possession is liable to inspection by a member pursuant to a court order. The non-exhaustive definition of "record" would also leave open the door to an order allowing for inspection of electronic records such as emails as well as other documents containing information of a confidential or

price-sensitive nature not only pertaining to the relevant specified corporation but potentially other third parties.

8. In deciding whether to order inspection of records, the test prescribed by Section 152FA(2) will involve the court ascertaining whether the application has been made in good faith and "for a proper purpose having regard to the interests of both the relevant specified corporation and the applicant." Whilst the court may be more accustomed to determining whether an application is or is not being made in good faith, the second requirement could potentially present difficulties for the court since the interests of the specified corporation and the application will inevitably be divergent in most, if not all, applications for inspection. Section 152FA(2)(b) would impose on the court the unenviable task of balancing the diverging interests in order to ascertain whether the inspection applied for is for a "proper purpose".

9. The test under Section 152FA(2) might be contrasted with its Australian equivalent where a "proper purpose" is limited to a purpose connected with an application for leave to initiate a derivative action on behalf of the company or to bring or intervene in such proceedings with leave of the court. In enhancing the effectiveness of the amendments being introduced in connection with the inspection of records, we wonder whether it might be preferable to better define the ambit of what constitutes a "proper purpose" under Section 152FA along the lines of the equivalent provision under the Australian Corporations Act 2001 (see Section 247A).

10. The amendments proposed by Section 3 of Schedule 4 also include Section 152FC which specifies the circumstances in which the applicant may disclose the information or document obtained through a court ordered inspection under Section 152FA. The current exceptions are all relatively straightforward. However, we would suggest that a further provision should be introduced to Section 152FC(1) to allow for the information or document to be disclosed to the applicant's solicitors or barristers for the purposes of seeking legal advice. We also wonder whether the exception contained in Section 152FC(1)(a) should include civil proceedings in addition to criminal proceedings.

Section 4 of Schedule 4 – Unfair Prejudice Remedies

11. The amendments introduced by Section 4 of Schedule 4 of the Bill should now remove any doubts as to the court's power to award damages to a member in respect of any loss suffered as a result of unfairly prejudicial conduct. The amendments also cure the lacuna under the existing provisions in the Companies Ordinance where a former member did not have locus standi to seek such relief when, in fact, the conduct complained of resulted in his ceasing to be a shareholder. In this respect, we do not have any material comments on the proposed amendments.

Section 5 of Schedule 4 – Derivative Actions

12. The amendments introduced by Section 5 of Schedule 4 of the Bill should achieve the objectives and recommendations of the Standing Committee on Company Law Reform ("SCCLR") in Phase 1 of their Review. The provisions

which Section 5 will introduce ought, in theory, to remove the procedural impediment which hitherto discouraged a minority shareholder from initiating a derivative action in respect of wrongs committed against the company.

13. Whilst we generally agree with the provision set out in Section 168BE regarding the effect and relevance which a court should give to any purported ratification by members of the specified corporation, we wonder whether Section 168BE(2)(c) is necessary. Sub-sections (a) and (b) of Section 168BE(2) ought to be sufficient for the purposes of enabling the court to decide whether and what significance ought to be attributed to a purported ratification by members of the specified corporation of the conduct that is the subject of the derivative action. Our concern is that Sub-section (c) is potentially liable to be construed as imposing on shareholders a statutory duty to act in the best interests of the company when exercising their voting rights as shareholders. This would involve a radical development in the law of companies and given that Sub-sections (a) and (b) would enable a court to determine whether ratification were achieved by the votes of disinterested members, we do not see the need for Sub-section (c).

14. We also agree with the provisions contained in Section 168BH in requiring the leave of court to discontinue or settle a derivative action brought or intervened in under Section 168BB(1).

Section 6 of Schedule 4 – Injunctions

15. The introduction of Section 350B should bolster the remedies available to a shareholder or an affected person to seek injunctive relief against corporate misconduct and should be welcomed. If, as appears from the recommendations of the SCCLR in Phase 1 of their Review, the amendments should extend also to companies incorporated outside of Hong Kong but with a place of business within the jurisdiction, the reference to “company” in Section 350B(1)(g) should be amended to “specified corporation”.

Linklaters

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