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 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,

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

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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.

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

(d) 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
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