Companies (Amendment) Bill 2004
Administration's Responses to the Submissions from

(1) The Law Society of Hong Kong

	Summary of Comments[1]	Responses
1	**Proposed section 2B(4) of the Ordinance *(Clause 2)*:** Under the proposed section 2B(4), the Secretary for Financial Services and the Treasury is given the power to amend the proposed section 2B(3) by gazette notice. Adoption of the extended meaning of "subsidiary" for other areas of our company law could have significant consequences. Clearly any such change should require legislative oversight and should not be left to the Administration.	The "notice published in the Gazette" referred to in the proposed section 2B(4), for the purpose of any proposed amendments to section 2B(3) by the Secretary for Financial Services and the Treasury, is subsidiary legislation, hence subject to the legislative scrutiny (including vetting by the Legislative Council).
2	**Section 3(3) of the proposed Twenty-third Schedule *(Clause 18)*:** The objective or intended effect of Section 3(3) is not apparent.	This section is modelled on section 10 of Schedule 10A of the United Kingdom (UK) Companies Act 1985. It is intended to cater for a situation where a subsidiary undertaking, vis-à-vis other right holders, acquires voting rights in itself. This can be the case when the subsidiary undertaking holds certain voting rights in the parent undertaking (e.g. through

[1] For details of the comments, please refer to the original submissions from the relevant organizations.

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		owning shares of the parent undertaking or a control contract), hence indirectly holding voting rights in itself. In such a situation, the "rights held by the undertaking itself" shall be reduced to reflect the proportion of the rights actually owned by other rights holders for the purpose of determining whether an undertaking is a parent undertaking for the purpose of preparing group accounts.
3	**Section 5(b) of the proposed Twenty-third Schedule *(Clause 18)*:** The proposed section defines "control contract" as a contract in writing conferring a right which is "permitted by the law under which that undertaking is established". In this connection – (i) There may not be a readily identifiable jurisdiction in which the undertaking is considered to have been established. Take partnership as an example: It is formed by a contract and does not require registration to come into existence. A partnership may have a presence in one or more jurisdiction in which it carries on business, but it cannot be said that in every case the partnership is established in the jurisdiction where is operates. (ii) The law under which the undertaking is established may be silent on whether a control	The definition of "control contract" in section 5(b) of the proposed Twenty-third Schedule is modelled on section 4(2) of Schedule 10A to UK Companies Act 1985. Although it is possible that an unincorporated body or a partnership may not be invariably established in the place where it operates, it should be noted that section 5(b)(ii) refers to the "the law ***under which*** that undertaking is established *(italics and emphasis added)*" but <u>not</u> "the law ***of the place where*** that undertaking is established *(italics and emphasis added)*". Therefore, the crux of the issue is how we ascertain the governing law of the constitutional document in relation to the establishment of the undertaking (for example, a partnership agreement). Usually, such a document will contain a governing law clause. If so, "the law ***under which*** that undertaking is established" will be the governing law as expressly provided in the document. If there is no express governing law clause, there will be legal rules governing the law that should apply. For example, in the case of a partnership, where the partners are all domiciled in Hong

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	contract is permissible; on the other hand, the law does not prohibit the entering into of such contracts. The use of the word "recognized" could perhaps clarify the intention of the provision.	Kong, it is likely that the partnership agreement will be governed by the laws of Hong Kong. Where the partners are domiciled in different jurisdictions, there are rules in private international law to determine the governing law of the partnership agreement. The Law Society suggested using the word "recognized", instead of "permitted", in the phrase "(a contract in writing conferring a right which is) permitted by the law under which that undertaking is established" in section 5(b)(ii) of the proposed Twenty-third Schedule. We consider that the original wording "permitted" has sufficiently reflected our intent, i.e. that which is not prohibited by law is permitted. If it is considered that the clarity of the current drafting should be enhanced, substituting the word "recognized" will not help clarify the uncertainty, if any. Therefore, we are of the view that there is no need to change the original wording which is modelled on the UK Companies Act 1985.
4	**Proposed section 124(2A)(a)** ***(Clause 4)***: Under the proposed section 124(2A)(a), a subsidiary may be excluded from the group accounts if severe long-term restrictions substantially hinder the exercise of the rights of the holding company over the assets or management of the subsidiary. The provision fails to identify who the decision-maker should be if such a circumstance arises. Directors are given the right to form an opinion in	The proposed section 124(2A)(a) is modelled on section 229(3)(a) of the UK Companies Act 1985. We note that the International Accounting Standards Board had decided to remove this condition from the latest IAS 27 "Consolidated and Separate Financial Statements" which was promulgated in December 2003. In the light of the latest development, we would consider proposing a Committee Stage Amendment (CSA) to repeal this proposed provision from the Bill.

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	relation to the exclusions listed in the existing section 124(2). It would be clearer for the operation of section 124(2A)(a) to give a similar right to directors.	
5	**Proposed amendments to section 128(1) of the Ordinance *(Clause 7)*:** Under the amended section 128(1), particulars to be shown in the group accounts in respect of a subsidiary include the country in which it is incorporated or established. Again there may not be a readily identifiable jurisdiction in which an undertaking is considered to have been established. It would be more meaningful to require the disclosure of the country in which the undertaking carries on business. Sections 128(c) and (d) require information on the nature and quantity of shares held in the subsidiary to be disclosed. The term "share" is given an extended meaning in section 1(1) of the proposed Twenty-third Schedule to catch unincorporated bodies. Even if the extended definition of "share" is applied to section 128(1)(c) and (d), it is still not clear on the extent and nature of information that is required to be disclosed in respect of an unincorporated body in terms of ownership.	With respect to the proposed amendment to section 128(1)(b), we note the Law Society's suggestion that there may be difficulties to identify the place where the incorporated undertaking is established and that it is more meaningful to require the disclosure of the place in which the undertaking carries on business. In this regard, we will consider proposing a CSA to require, by modelling on paragraphs 1(3) and 15(3) of Schedule 5 to the UK Companies Act 1985, the disclosure of the "**address of its principal place of business**", instead of the "country in which it is established", if the subsidiary is unincorporated. In relation to sections 128(c) and (d) of the Ordinance, the reference to "shares" shall, pursuant to the proposed section 2B of the Ordinance, be construed in accordance with the proposed the Twenty-third Schedule. The definition of "shares" in section 1 to the Twenty-third Schedule, modelled on section 259(2) of the UK Companies Act 1985, has provided guidance on how the term "shares" should be interpreted in relation to an undertaking with a share capital, with capital in the form other than share capital, or without any capital. We also note that the same disclosure requirement as applied to both an incorporated and

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		unincorporated body is stipulated in paragraphs 2 and 16 of Schedule 5 to UK Companies Act 1985.
6	**Proposed amendments to section 360(5) of the Ordinance *(Clause 13)*:** Under the proposed amendments to section 360(5), the Financial Secretary will be empowered to amend the proposed Twenty-third Schedule. The Schedule basically defines how wide that net is cast on unincorporated bodies for financial reporting purposes. It is a substantive part of the CO and is of no less importance than the main body of the Ordinance. Any change to the Twenty-third Schedule should require legislative oversight.	The "order published in the Gazette" referred to in section 360(5), for the purpose of any proposed amendments to the Twenty-third Schedule by the Financial Secretary, is subsidiary legislation, hence subject to the legislative scrutiny (including vetting by the Legislative Council).

(2) Linklaters

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1	We are supportive of the proposals contained in the Bill.	Noted.
2	**Sections 2(1)(c) and 5 of the proposed Twenty-third Schedule *(Clause 18)* –** 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 "dominant influence" over another undertaking in the Hong Kong context, e.g. through joint control.	Only one undertaking can have dominant influence or control over another undertaking under IAS / HKAS 27. It is a question of fact to determine which undertaking ultimately has a dominant influence over another. If two undertakings concurrently but independently exert influence or control over another undertaking but each fails to demonstrate that it is a parent undertaking under the test for the "parent-subsidiary" relationship under the CO or IAS / HKAS 27, the two undertakings will be regarded as having a joint control over what the financial reporting standards call the "jointly controlled entity" (i.e. not "subsidiary"). An undertaking having a joint control together with others over a "jointly controlled entity" does not need to prepare group accounts, as the undertaking cannot satisfy any of the tests (including the "dominant influence" test) which determines "parent-subsidiary" relationship under the CO **and** IAS / HKAS 27.
3	**Sections 2(1)(c)(ii) and 5(b) of the proposed Twenty-third Schedule *(Clause 18)*:** One of the	In determining whether or not an undertaking is a subsidiary undertaking in relation to another undertaking under the

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	tests to determine a "parent-subsidiary" relationship is to look to the right to exercise a dominant influence over the subsidiary undertaking by virtue of a control contract. "Control contracts" do not appear to be common in Hong Kong. We understand that they are more relevant to European companies (e.g. German company) where entering into control contracts with subsidiaries is prevalent. Hence, it seems that the meaning of a "control contract" under the Hong Kong provisions may need to be specifically considered.	existing provisions of the CO and the proposed Twenty Third Schedule, the subsidiary undertaking's place of incorporation, formation or registration is not relevant. Even though "control contracts" may not appear to be very common in Hong Kong, it can still be relevant in certain cases to identify the source document providing for the right to exercise a dominant influence over the subsidiary undertaking. We consider that sections 2(1)(c)(ii) and 5(b) of the proposed Twenty-third Schedule, modelled on section 258(2)(c) of the UK Companies Act 1985 and section 4(2) of Schedule 10A to the same Act, adequately reflect our policy intent.
4	**Proposed sections 123(4), 123(4A), 126(4) and 126(5) *(Clauses 3 and 5)*:** Whilst we support the introduction of the "true and fair view override" provisions, the discretion for directors to exercise the provisions without more specific guidance may create problems or uncertainties on how such discretion should be exercised. It would be helpful if the Hong Kong Institute of Certified Public Accountants (HKICPA) could provide practical guidelines on the application of the "true and fair view override" provisions.	We envisage that the "true and fair view override" provisions will be used only in an exceptionally rare occasion to cater for the unforeseen circumstances of a company. If necessary, the HKICPA will promulgate guidelines and interpretations as to the application to the "true and fair view override" provisions, taking into account the experience in the application of the provisions and the development of the International Financial Reporting Standards.

Financial Services and the Treasury Bureau
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