Bills Committee on
Companies (Amendment) Bill 2004

Follow-up Actions Arising
from the Discussion at the Meeting on 3 February 2005

PURPOSE

At the fourth Bills Committee meeting held on 3 February 2005, Members requested the Administration to provide additional information on and clarify a number of matters relating to the Companies (Amendment) Bill 2004 (the Bill). We have consulted the Department of Justice (D of J) and the Hong Kong Institute of Certified Public Accountants (HKICPA), and set out the relevant information in the ensuing paragraphs.

DETERMINATION OF PARENT AND SUBSIDIARY RELATIONSHIP BETWEEN ENTITIES

(a) A Committee Stage Amendment (CSA) to the definition of "undertaking" in section 1(1) of the proposed Twenty-third Schedule to the Companies Ordinance (Cap. 32, CO) to reflect the policy intent that the definition does not cover "an individual";

(b) A CSA to recast the drafting of section 2(3) of the proposed Twenty-third Schedule to reflect the policy intent that the subsection is to cater for a "grandparent, parent and subsidiary" situation.

2. The frameworks of the proposed CSAs in these two aspects have been set out in paragraphs 9 and 11 of the Administration's paper entitled "Follow-up Actions Arising from the Discussion at the Meeting on 13 January 2005 - LC Paper No. CB(1)825/04-05(02)". The draft provisions would be presented during the clause-by-clause examination.

(c) (i) The obligations of parent undertakings under the situation

whereby more than one undertaking satisfy the various criteria under which an undertaking is defined to be a parent undertaking in relation to a subsidiary undertaking;

(ii) The need for setting out in the Bill provisions dealing with the occurrence of the above possibility, and to provide information on whether similar provisions are contained in relevant legislation of other jurisdictions.

3. The existing section 2(4)(a) of the CO already contains a hypothetical possibility whereby more than one company could be the parent company of a subsidiary. In this circumstance, all the companies satisfying the criteria as set out in section 2(4)(a) as parent companies would have to prepare group accounts under section 124(1) of the CO. The Bill does not intend to, and would not, alter this position.

4. We do not consider it necessary for the Bill to contain express provisions to deal with the situation referred to in paragraph 3 above. Our considerations are as follows -

(a) We are not aware of any difficulties in the application of the existing section 2(4)(a) of the CO. We have not come across or been advised of any case whereby two companies claim to be the parent company of a subsidiary under this existing provision;

(b) Having said this, there is one more usual situation, i.e. the "grandparent, parent and subsidiary" situation, where two companies prepare group accounts consolidating the accounts of a single subsidiary. This scenario is covered under section 2(4)(b) of the existing CO and section 2(3) of the proposed Twenty-third Schedule; and

(c) We are not aware of any company law provisions in the common law jurisdictions expressly setting out how the above situation is to be dealt with.

(d) Section 3(3) of the proposed Twenty-third Schedule.

5. In communications with the Department of Trade and Industry of the United Kingdom (UK), we have noted the observation that it is generally considered that paragraph 10 of Schedule 10A to the UK Companies Act 1985 (the UK Act)[1], on which section 3(3) of the proposed Twenty-third Schedule[2] is modelled, should be read as applying to voting rights in an undertaking held by the same undertaking itself. Further research has thus been undertaken to survey the UK's position, and our understanding thereof is set out in paragraph 6 below.

6. According to our legal adviser's understanding of the UK's position, where a UK public company acquires its own shares under certain circumstances, section 146 of the UK Act provides that the company is entitled to hold those shares for three years (or one year in certain circumstances) after which such shares must be cancelled. During this period, the company cannot exercise any voting rights in respect of such shares. Furthermore, section 162C of the UK Act permits certain companies to hold under certain circumstances their own shares, which are termed "treasury shares", but prohibits them against exercising any right in respect of those shares. In view of the above, it seems that paragraph 10 of Schedule 10A of the UK Act applies to such a company with the result that rights held by the company itself shall be reduced for the purpose of determining the "parent and subsidiary" relationship.

7. In Hong Kong, a company cannot be a member of itself[3], except where statute otherwise provides. Sections 49A and 49B of the CO permit a company to redeem or purchase its own shares. However, according to section 49A(4) of the CO, shares redeemed by a company under section 49A shall be cancelled on redemption. By virtue of section 49B(3), the same applies to the purchase by the company of its own shares under section 49B. Consequently, voting rights in respect of these shares would be extinguished altogether. Furthermore, there is no equivalent of sections 146 and 162C of the UK Act in the CO whereby a

---

[1] Paragraph 10 of Schedule 10A of the UK Companies Act 1985 reads –
"The voting rights in an undertaking shall be reduced by any rights held by the undertaking itself."

[2] Section 3(3) of the proposed Twenty-third Schedule reads –
"The voting rights in an undertaking referred to in subsection (1) shall be reduced by any rights held by the undertaking itself."

[3] *Trevor v Whitworth* [1887] 12 App Cas 409; *Kirby v Wilkins* [1929] 2 Ch 444.

company is allowed to hold its own shares under those circumstances. In any case, the existing tests of determining "parent and subsidiary" relationship of two companies under sections 2(4) to (7) of the CO do not contain a reduction rule of voting rights equivalent to section 3(3) of the proposed Twenty-third Schedule. We are not aware of any difficulties in applying sections 2(4) to (7) of the CO in this aspect. In view of the above considerations, we do not see the need to introduce a reduction rule equivalent to section 3(3) of the proposed Twenty-third Schedule into the CO for determining whether a body corporate is the subsidiary of another body corporate.

8. Moreover, we have further consulted the HKICPA and the D of J and are advised that section 3(3) of the proposed Twenty-third Schedule appears to have little relevance in Hong Kong. We are not aware of any real life situation where a subsidiary undertaking which is not a body corporate holds voting rights in the same undertaking itself. Even where such a situation exists, since the undertaking is not prohibited to exercise such rights, we do not see the need for a reduction rule to discount such voting rights, for the purpose of determining the "parent and subsidiary" relationship. Accordingly, we would consider proposing a CSA to remove section 3(3) of the proposed Twenty-third Schedule from the Bill[4].

PROPOSED "TRUE AND FAIR VIEW OVERRIDE" PROVISIONS

(e) The proposed "true and fair view override" provisions and the liability provision relating to non-compliance with the requirement to give a "true and fair view" of the state of affairs and profit and loss of the company in the accounts or group accounts.

9. According to the existing section 124(3) of the CO, the primary duty of preparing group accounts rests with company directors. The **existing** sections 125 and 126 of the CO further govern the forms and contents of such group accounts. In particular, the existing section 126(1) prescribes that the group accounts shall give a "true and fair view"

[4] This position supersedes what were set out in the Administration's previous reply letter dated 23 November 2004 to the Assistant Legal Adviser (LC Paper No. CB(1)453/04-05(17)) and responses to the submission of the Law Society (LC Paper No. CB(1)681/04-05(02)).

of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole. Failure to take all reasonable steps to secure compliance in this respect is an offence under the **existing** section 123(6).

10. The express "true and fair view override" provisions under proposed sections 126(4) and (5) are modelled on what are now sections 227A(4) to (6) of the UK Companies Act 1985. The proposed section 126(4) is intended to *expressly* require directors to give additional information in the group accounts as may be necessary to give a true and fair view, as and when compliance with the Tenth Schedule and other requirements of the CO as to the matters to be included in a company's group accounts would not be sufficient to give a true and fair view. The proposed section 126(5) goes further in requiring directors to depart from the requirements of the Tenth Schedule and other requirements of the CO as to the matters to be included in the group accounts where compliance therewith is inconsistent with the requirement to give a true and fair view.

11. We have consulted the Prosecutions Division of the D of J and are advised that, subject to there being sufficiency of evidence, there should not be any particular difficulty in prosecuting an offence for breach of the proposed sections 126(4) and (5), in the light of the **existing "true and fair view" requirement**. Comparable "true and fair view override" provisions are also found in the UK and Australian company laws (see the comparison table attached to the Administration's paper entitled "Impact of the Bill on the Asset-Securitization Market in Hong Kong" - LC Paper No. CB(1)938/04-05(09)).

The Financial Services and the Treasury Bureau
March 2005