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Panel on Financial Affairs

Meeting on 7 June 2010

Background brief on the Companies Ordinance rewrite

Purpose

This paper provides background information on the rewrite exercise of the Companies Ordinance (Cap. 32) (CO) and summarizes the main concerns and views expressed by members when the subject was discussed by the Panel on Financial Affairs (the Panel). The paper also outlines other initiatives being pursued outside the rewrite exercise but involving amendments to the CO.

Background

2. The CO is one of the largest and most complex pieces of legislation in Hong Kong with over 600 sections and subsections and 20 schedules. The last major review of the CO took place in 1984. Since then, there have been amendments from time to time to keep the CO attuned to business needs. The Standing Committee on Company Law Reform (SCCLR)[1] was formed in January 1984 to advise the Financial Secretary on necessary amendments to the CO as and when experience shows such amendments are required.

3. In February 2000, SCCLR published "The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance". Initiatives to implement the recommendations in the Report have been taken in the context of a series of amendment bills, most notably the Companies (Amendment) Bill 2003

[1] Members of SCCLR include representatives of Securities and Futures Commission, the Hong Kong Exchanges and Clearing Limited and relevant government departments, as well as personalities from the relevant sectors or professions such as accountancy, legal and company secretarial.

and the Companies (Amendment) Bill 2004[2]. At the Panel meeting on 5 July 2004, the Administration advised that a complete rewrite and restructuring of CO was necessary to modernize Hong Kong's company law in light of the experiences of comparable common law jurisdictions and to enhance Hong Kong's competitiveness and attractiveness as a major international business and financial centre.

Organizational framework for the rewrite exercise

4. According to the Administration, in addition to a Joint Working Group between the Government and the Hong Kong Institute of Certified Public Accountants (JWG) which was tasked with reviewing the accounting and auditing provisions in the CO, four dedicated Advisory Groups[3] commenced work in phases since October 2006 to review and advise on specific areas of the CO. Recommendations made by the JWG and the Advisory Groups were then considered by the SCCLR, which is the principal body advising the Administration on matters relating to the CO rewrite.

5. A Steering Committee formed within the Administration, chaired by the Permanent Secretary for Financial Services and the Treasury (Financial Services), is responsible for supervising and steering the entire rewrite exercise, examining all major proposals discussed at the SCCLR, the JWG and the Advisory Groups. A dedicated Companies Bill Team (CBT), led by a Deputy Secretary (Financial Services) and comprising both policy and legal staff, was also set up within the Financial Services and the Treasury Bureau in mid-2006 to take forward the CO rewrite.

6. The Administration has also commissioned an external legal consultant to study and formulate proposals on certain complex areas of the CO, including share capital and debentures, distribution of profits and assets and registration of charges.

The CO rewrite exercise

7. Given the extensive nature of the rewrite exercise, the Administration has adopted a phased approach by tackling the core company provisions which affect the daily operation of live companies in Hong Kong in Phase One. The

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[2] The Companies (Amendment) Bill 2003 was introduced to LegCo on 13 June 2003 and was passed on 9 July 2004. The Companies (Amendment) Bill 2004 was introduced to LegCo on 8 October 2004 and was passed on 29 June 2005.

[3] The Advisory Groups comprise members nominated by the relevant professional bodies (including Hong Kong Institute of Certified Public Accountants, Law Society of Hong Kong, Hong Kong Institute of Chartered Secretaries, Hong Kong Bar Association, Hong Kong Institute of Directors and Hong Kong Association of Banks) and business organizations (including the Hong Kong General Chamber of Commerce and the Chinese General Chamber of Commerce), company law academics, Standing Committee on Company Law Reform members and representatives from relevant Government departments/agencies.

winding-up and insolvency-related provisions, which are mainly administered by the Official Receiver's Office, will be reviewed in Phase Two of the rewrite exercise[4], which according to the Administration is scheduled to be launched after the Companies Bill (CB) has been acted by LegCo.

8. The Administration conducted three public consultations in 2007 and 2008 to gauge views on the more complex subjects, including -

(a) accounting and auditing provisions;

(b) company names, directors' duties, corporate directorship and registration of charges; and

(c) share capital, capital maintenance regime and court-free merger procedure.

9. The Administration has issued the consultation conclusions for public information and consideration by the SCCLR. The Panel was briefed on the consultation conclusions at its meeting on 26 February 2009.

10. Taking into account the views received, the Administration has prepared draft clauses of the CB for further consultation in two phases. On 17 December 2009, the Administration published a consultation document entitled "Draft Companies Bill First Phase Consultation" for a three-month public consultation on 10 parts of the draft CB, focusing on issues relating to corporate governance. The Administration has received 140 submissions from companies, chambers of commerce, business associations, professional bodies, financial regulators and individuals, and plans to issue the consultation conclusions in mid-2010.

11. On 7 May 2010, the Administration published another consultation document entitled "Draft Companies Bill Second Phase Consultation" to consult the public on the remaining 10 parts of the draft CB. The proposals in the second phase consultation focused more on technical and operational issues, including accounting and auditing provisions, share capital, capital maintenance rules, registration of charges and company formation. The consultation lasts for three months until 6 August 2010. The Administration aims to introduce the CB into the Legislative Council (LegCo) by the end of 2010.

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[4] As mentioned in the consultation document "Draft Companies Bill Second Phase Consultation" issued by the Administration on 7 May 2010, pending the Phase Two rewrite, a number of Parts in the current CO will remain in Cap. 32, which will be given a provisional title, viz. the Companies (Winding-up Provisions) Ordinance.

Legislative amendments involving the CO but dealt with outside the rewrite exercise

Companies (Amendment) Bill 2010

12. The Administration has separately worked on legislative amendments to the CO ahead of the introduction of the CB to provide for electronic incorporation of companies and filing of company documents, so as to tie in with the development of the Phase II of Companies Registry's Integrated Companies Registry Information System. In this connection, the Administration has proposed to improve the company name registration system with a view to expediting the company incorporation process and empowering the Registrar of Companies to tackle "shadow companies"[5]. The legislative proposals also include the technical amendments to remove, or provide exceptions to the limitations arising from the provisions on scrip-based shares and debentures presently found in the CO. These technical amendments will lay the foundation for implementing a scripless securities market in Hong Kong. The Administration introduced these amendments into LegCo on 3 February 2010. A Bill Committee on Companies (Amendment) Bill 2010 and Business Registration (Amendment) Bill 2010 has been set up to scrutinize the two Bills.

Review of legislative proposals on corporate rescue procedure

13. The corporate rescue and insolvent trading proposals were originally scheduled to be reviewed as part of the Phase Two CO rewrite. With the onset of the global financial crisis and the likely increase in companies facing financial difficulties, the Administration announced in January 2009 that it would adopt the recommendation of the Task Force on Economic Challenges to re-consider the introduction of a corporate rescue procedure, ahead of the schedule of the Phase Two CO rewrite. On 29 October 2009, the Administration launched a public consultation on the subject. The consultation lasted for three months and ended on 28 January 2010. Subject to the outcome of the consultation, the Administration plans to issue consultation conclusions in mid-2010.

Possible reforms to the Prospectus Regime in the CO and the Offers of Investment Regime in the SFO

14. SFC submitted a report to the Financial Secretary in December 2008 recommending various measures to restore investor confidence in the financial market, including the need to reconsider whether Hong Kong should retain two public offering regimes in CO and the Securities and Futures Ordinance (Cap. 571) (SFO). On 30 October 2009, SFC published a consultation paper on "Possible

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[5] "Shadow companies" refer to those companies incorporated in Hong Kong with names which are very similar to existing and established trademarks or trade names of other companies and which pose themselves as representatives of the owners of such trademarks or trade names to produce counterfeit products in Mainland China bearing such trademarks or trade names.

Reforms to the Prospectus Regime in CO and the Offers of Investment Regime in SFO" for a two-month consultation to solicit public views on the proposals to align the two regimes by transferring the regulation of public offers of structured products in the form of debentures from the CO prospectus regime[6] to the regulatory regime under the SFO. SFC published the consultation conclusions on 22 April 2010 and briefed the Panel on the relevant legislative proposals[7] at the meeting on 3 May 2010. The Administration plans to introduce relevant legislative amendments into the Legislative Council within 2010.

15. As regards the remaining reform proposals, including transferring the whole prospectus regime from the CO to the SFO; changing the regulatory focus of the prospectus regime from the documents containing the offer to the act of offering; and other measures to modernize the regime, SFC aims to issue a consultation paper in the first half of 2011.

Deliberations of the Panel

Discussions in 2004 to 2009

16. The Panel the Administration's proposals to rewrite CO at the meetings on 5 July 2004, 4 July 2005, 7 November 2005, 16 October 2006, 7 May 2007 and 26 February 2009. The major views and suggestions given by members include the following -

(a) the CO rewrite exercise should leverage on the experiences of other common law jurisdictions in company law reforms or reviews, while the unique circumstances of Hong Kong should be fully considered;

(b) the rewrite exercise should cover issues of wide public concern, such as review of the provisions governing privatization of listed companies, and enhancement of corporate governance of companies through codifying directors' general duties;

(c) the rewrite exercise should aim at keeping the CO up-to-date to meet present-day circumstances and to improve Hong Kong's business environment; and

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[6] As mentioned in the "Draft Companies Bill Second Phase Consultation" published by the Administration on 7 May 2010, the CO rewrite exercise does not cover provisions concerning prospectus in the CO, namely sections 37 to 44B, section 48A, sections 342 to 343, the Third and Fourth Schedules as well as the Seventeenth to the Twenty-second Schedules as the prospectus regime in the CO is under separate review by the SFC.

[7] SFC proposes that the prospectus provisions in the CO including the safe harbours in the Seventeenth Schedule to the CO will no longer apply to structured products. Regulation of public offers of structured products will be explicitly specified under the offers of investment regime in the SFO. SFC will be empowered to authorize structured products and the authorization process will depend on compliance with codes and guidelines to be published by SFC. The regulatory requirements on securities in the SFO will apply to structured products offered to the public.

(d) since CO rewrite exercise involves complex legal and technical issues, the Administration should expedite the exercise to allow sufficient time for LegCo to complete scrutiny of the CB before the end of the LegCo term in July 2012.

Discussion on the reform proposals in 2010

17. Following the launch on 17 December 2009 of the first phase public consultation covering 10 Parts or roughly half of the draft CB, the Administration briefed the Panel on the reform proposals contained in the draft CB on 4 January 2010. The major objectives of the reform proposals are: enhancing corporate governance; ensuring better regulation; business facilitation; and modernizing the law. A list of the proposed legislative changes is given in **Appendix I**.

18. The Administration also highlighted the following issues on which the Administration would like to seek more views before deciding on the way forward -

(a) whether the headcount test[8] for approving a members' scheme of arrangement or compromise for listed companies, non-listed companies and creditors' schemes should be abolished, retained, or retained but allowed the court to have discretion to dispense with the test;

(b) whether the disclosure of residential addresses of directors and identification numbers of directors and company secretaries on the public register should continue;

(c) whether a private company associated with a listed or public company, such as a private company that is a member of a group of companies which include a listed company, should be subject to more stringent regulations similar to public companies for the purposes of the provisions on fair dealings by directors; and

(d) whether the common law derivative action should be abolished once the CO has been extended to cover multiple derivative actions[9].

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[8] The "headcount test" refers to the requirement under section 166 of the CO which provides that, for a compromise or arrangement between a company and its members or creditors to be approved, a majority in number of those who cast votes in person or by proxy at the meeting must have voted in favour of the compromise or arrangement.

[9] Multiple derivative action allows a member of an associated company of the specified corporation (i.e. the specified corporation's subsidiary or holding company, or a subsidiary of that specified corporation's holding company) to take a statutory derivative action on behalf of the specified corporation.

19. On 8 April 2010, the Administration consulted the Panel on the proposal to retain three directorate posts for the CBT[10] and briefed the Panel on the progress of the public consultation on the draft CB.

20. During the discussions on 4 January 2010 and 8 April 2010, Panel members expressed various concerns including the guiding principles for the rewrite exercise, the scope and timeframe of the rewrite exercise and how far the reform proposals could enhance corporate governance of companies. These concerns are summaried in the following paragraphs.

Objectives of and guiding principles for the rewrite exercise

21. A member expressed concern that the objectives of enhancing corporate governance and business facilitation might be in conflict with one another. The member also highlighted the need to strengthen protection of investors' interest, and pointed out that many investors had asked for enhancement of the disclosure requirements for listed companies and the legal backing for investors to seek remedies for damages arising from the misconduct of company directors. Investors were also concerned that the senior executives/managing directors of some listed companies were receiving excessive remuneration.

22. The Administration advised that the rewrite exercise aimed at updating and modernizing the legal framework for companies in Hong Kong, so as to facilitate the conduct of business on the one hand and enhance corporate governance on the other. In analysing the views of the public on the proposals, it would take into account the need for facilitating the conduct of business and protecting investors.

23. On the assessment of views collected during the consultation exercise, a Panel member considered that the following principles should be adopted –

(a) the CO should be in tandem with the corresponding legislation in other international business and financial centres;

(b) the CO should be able to cater for the needs of the future development of Hong Kong as a business and financial centre; and

(c) where changes to the CO would be conducive to attaining the objectives, the Administration should actively pursue such changes notwithstanding that technical difficulties in implementation were envisaged.

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[10] The three supernumerary posts are one Administrative Officer Staff Grade B and one Administrative Officer Staff Grade C in the Financial Services Branch and one Deputy Principal Solicitor / non-civil service position at DL2-equivalent in the Companies Registry. On 14 May 2010, the Finance Committee approved the extension of the three posts from 1 April 2011 to 31 July 2012, from 9 October 2010 to 30 June 2013 and from 16 October 2010 to 30 June 2013 respectively.

Timeframe of the rewrite exercise

24. Panel members were concerned whether there would be sufficient time for LegCo to complete the scrutiny of the future CB within the current LegCo term, and whether consensus could be arrived at in respect of the proposed legislative amendments before they were introduced into LegCo.

25. The Administration advised that the broad framework for the CB had been formulated based on the outcome of the three topical consultation exercises conducted in 2007 and 2008. The draft provisions of the CB were put forward for public consultation in two phases, with a view to attaining a general consensus on the major proposed provisions and facilitating LegCo to complete scrutinizing the Bill before the end of the current legislative term in July 2012. The relevant subsidiary legislation would be introduced after the enactment of the Bill, and was expected to be enacted by June 2013.

Corporate governance

26. A member expressed concern about the governance of charitable organizations, and pointed out that many charitable organizations were incorporated as guarantee companies and some operated as a trust fund. The Administration explained that under the current proposals, guarantee companies would be required to comply with more stringent disclosure requirements regarding their financial situation and submit their financial reports to the Companies Registry for scrutiny. The Law Reform Commission was also conducting a review of the legislation relevant to the regulation of charitable organizations.[11]

27. On the concern as to how the CB would codify the standard of directors' duty of care, skill and diligence and the sanctions to be imposed, the Administration advised that only general principles were stated in the proposed provisions. Such principles were based on the reasonable expectations of the public and shareholders on the performance of directors of listed and private companies. Similar to the existing arrangement under the common law, any company director who had breached the provisions, if enacted, would be liable to civil litigation actions.

28. On a member's suggestion of safeguarding the interest of small shareholders by allowing them to appoint non-executive directors of companies, the Administration advised that the CO rewrite exercise was not the appropriate forum for dealing with issues purely related to listed companies. The Administration undertook to relay the proposal to SFC for consideration in the review of the SFO.

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[11] According to the Administration's reply to an oral question raised by Hon Paul CHAN at the Council meeting on 12 May 2010, the relevant sub-committee of the Law Reform Commission expects to release a consultation paper on its findings within this year.

Business facilitation

29. Regarding the legislative proposals to enable private and guarantee companies to take advantage of the simplified accounting and reporting requirements to save their compliance and business costs, a member expressed concern on whether the public would be adequately consulted and the public interest well protected. The Administration responded that it would liaise closely with the relevant professional bodies to work out the requirements and draw up appropriate provisions in the draft CB for public consultation.[12]

Headcount test

30. Some members expressed concern about the impact on protection of the interest of small investors if the headcount test was abolished. They urged the Administration to work with SFC in reviewing the headcount test arrangements and measures for prevention of vote splitting, making reference to relevant arrangements in other major financial centres. The Administration advised that the SCCLR and the Administration had yet to finalize their stance on the issue. At the Panel's request, the Administration provided supplementary information (**Appendix II**) on the legislative amendments enacted in Australia in 2007 regarding the headcount test arrangements and the latest development.

Disclosure of information on public register

31. Panel members expressed diverse views on whether the disclosure of residential addresses of directors and identification numbers of directors and company secretaries on the public register should continue. Some members opined that the Administration should follow the practices in the United Kingdom to discontinue the disclosure arrangement so that personal data privacy could be protected. However, a member opined that the disclosure arrangement should continue in order to protect public interest.

Consultancy study

32. Regarding the concern about the need of commissioning a consultant for the CO rewrite and the expenditure involved, the Administration explained that the consultant was engaged to provide expert advice on more complicated issues, such as share capital, debenture, capital maintenance rules and registration of charges, for which there was a lack of in-house expertise in the Government. The consultant team had almost completed its work. The consultancy fee was about $14 million and no further consultancy study would be required.

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[12] The draft provisions are contained in Part 9 of the draft CB published by the Administration on 7 May 2010.

Latest development

33. The Administration will update the Panel on the progress of CO rewrite exercise at the meeting on 7 June 2010.

Relevant papers

34. The relevant papers are available at the following links:

http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa_c1.htm

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Legislative Council Secretariat
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Appendix I

Main legislative changes in the draft Companies Bill

1. Enhancing Corporate Governance

   (a) codify the standard of directors' duty of care, skill and diligence;

   (b) restrict the appointment of corporate directors by requiring every company to have at least one director who is an individual for the purpose of improving the accountability and transparency of company operations and the enforceability of directors' obligations;

   (c) improve disclosure of company information by requiring public companies and larger private companies to furnish a more analytical and forward-looking business review as part of the directors' report;

   (d) strengthen auditors' rights to obtain information for performing their duties;

   (e) enhance shareholders' engagement in the decision-making process and facilitate their participation through the use of information technology, e.g. introduction of rules to allow electronic communications between a company and its members and permit companies to hold general meetings at two or more places using audio-visual technology; and

   (f) foster shareholder protection by strengthening rules on directors' self-dealing and connected transactions, providing for multiple derivative actions and extending the scope of the unfair prejudice remedy.

2. Ensuring Better Regulations

   (a) introduce electronic incorporation and expedited company name approval process to enable companies to be incorporated within one day[13];

   (b) empower the Registrar of Companies ("Registrar") to tackle "shadow companies", including acting on court orders to direct such companies to change their names and substituting a company's name by its registration number if it fails to comply with the direction to change its name[14] ;

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[13] The proposal has been included in the Companies (Amendment) Bill 2010.

[14] The proposal has been included in the Companies (Amendment) Bill 2010.

(c) enhance the Registrar's powers to help ensure that the information on the public register is accurate and up-to-date and to obtain necessary information for enforcement;

(d) streamline those regulations which are outdated and no longer serve any purpose (e.g. removing the share qualification requirement for directors);

(e) streamline and update the regime of registration of charges; and

(f) improve the enforcement regime by updating the provisions on company investigations, offences and penalties.

3. Business Facilitation

(a) allow small private and guarantee companies to take advantage of simplified accounting and reporting requirements so as to save their compliance and business costs;

(b) allow companies to dispense with AGMs by unanimous members' consent;

(c) introduce cheaper and less time-consuming court-free procedures for the reduction of share capital and intra-group amalgamation; and

(d) streamline the buy-back rules for all companies subject to a solvency test.

4. Modernising the Law

(a) abolish the par value regime and adopt a mandatory system of no-par for all companies with a share capital;

(b) remove the requirement for authorised capital;

(c) enable scripless holding and trading of shares and debentures to tie in with the scripless securities market reform (details of which were included in a separate public consultation exercise launched in late 2009);

(d) allow electronic communications between a company and its members; and

(e) modernise the language and re-draft the statutory provisions in a more logical and user-friendly order.

Information on the Implementation of the Headcount Test for Approving a Scheme of Arrangement or Compromise in Australia

Background

In Australia, in order to tackle the problem of share splitting by parties opposing a scheme, section 411(4) of the Australia Corporations Act 2001 (ACA) was amended in December 2007 to give the court a discretion to approve a members' scheme if it was approved by a 75 percent majority in value even though approval by a majority in number of those members present and voting at the scheme meeting was not obtained. The reasons for the amendment, as stated in the Explanatory Statement to the Exposure Draft of the Corporations Amendment (Insolvency) Bill 2007, were that:

> *"A members' scheme could be defeated by parties opposed to the scheme engaging in 'share splitting', which involves one or more members transferring small parcels of shares to a large number of other persons who are willing to attend the meeting and vote in accordance with the wishes of the transferor. By splitting shares to increase the number of members voting against the scheme, an individual or small group opposed to the scheme may cause the scheme to be defeated. This may occur even though a special majority is achieved in terms of voting rights attaching to share capital, and if the*

share split had not occurred, the majority of members were in favour of the scheme."

2. Prior to the amendment, the court's discretion was limited to either approving or rejecting a scheme that had met both the headcount test and the share value test. The amendment retains the headcount test "unless the Court orders otherwise" and thereby gives the court a discretion to dispense with the headcount test or disregard the outcome of the test. The share value test and the court's general discretion to reject or amend a scheme approved by shareholders remain intact.[1]

3. The ACA does not qualify the discretion given to the court to dispense with the headcount test. However, the Explanatory Memorandum on the amendment indicated that the principal concern is the increase of influence of certain persons under the headcount test by share splitting. The Explanatory Memorandum stated that —

"It is intended that the court would only exercise the discretion to disregard the majority vote under [the headcount test] in circumstances where there is evidence that the result of the vote has been unfairly influenced by activities such as share splitting, however the court's discretion has not been limited to allow for unforeseen extraordinary circumstances."

[1] The amendment to section 411(4)(a)(ii)(A) of the ACA added the words "unless the Court orders otherwise" at the beginning of sub-paragraph (A) so that sub-paragraph (A) reads as follows :-

"(A) unless the Court orders otherwise − passed by a majority in number of the members, or members in that class, present and voting (either in person or by proxy)".

Latest development

4. Our research does not reveal any Australian cases ruling directly on or having elaborate discussion of the court's discretion in dispensing with the headcount test pursuant to the amended section 411(4) of the ACA. However, in making an enquiry with the Australian Corporations and Markets Advisory Committee (CAMAC), we note one possible case for the exercise of the judicial discretion as mentioned in the case *pSivida Limited v New pSividia, Inc* ([2008] FCA 627 at [11] – [12]) where a single shareholder held 53 percent of the total issued share capital on behalf of a very large number of beneficial owners and that shareholder could have been outvoted under the headcount test. The court observed that in such situation, the plaintiff, being the applicant for the court's approval of the scheme, may wish to ask the court to exercise discretion under the amended section 411(4) of the ACA to dispense with the headcount test.

5. In June 2008, a discussion paper on "Members' Schemes of Arrangement" was issued by CAMAC to invite public views on the review of various matters relating to members' schemes of arrangement including whether the headcount test should be amended or repealed. According to the Discussion Paper, there is no known instance where a proponent has succeeded under share value test, but failed to obtain a majority under the headcount test. However, there is anecdotal evidence that in some cases a decision was taken not to embark upon a scheme because of the possibility of an adverse headcount vote. The consultation period for the Discussion Paper ended by the end of September 2008. We understand from CAMAC that the report of the consultation conclusion will be published at around end of January 2010.