CB(1)1864/10-11(01)

Issued on: 9 April 2011

Submission of the Hong Kong Institute of Directors on the Companies Bill for the Legislative Council Bills Committee Meeting on 9 April 2011

We at HKIoD have pleasure in submitting views to the Bills Committee on the Companies Bill. We look forward to working closely with the Bills Committee, the Administration and other stakeholders to achieve the intended benefits of the Bill.

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Better quality company directors means better corporate governance

Rewriting Hong Kong's company law lends a perfect opportunity to enhance corporate governance. Company directors are ultimately responsible for corporate governance. Better quality company directors should mean better corporate governance.

<u>If we want more from directors,
then give them tools to perform and shields to protect</u>

If we are to make directors more accountable and to have higher expectation or how directors are to perform, there should also be in place complementary measures and mechanisms to work in tandem. Directors need rules that will protect them when they make good faith business judgment and decisions. They need adequate indemnification, insurance or other risk coverage to shield their exposure. They should be required to have a proper level of qualification before taking office. They should be expected to continually upgrade and improve their skills and knowledge. There should also be widely-accepted and recognized reference guides to their conduct and behavior. We will discuss these aspects in more detail.

<u>We want directors of good quality, not just in quantity</u>

For as long as Hong Kong remains a place to do business in, investors and businessmen will want to set up companies and all sorts of business associations here. There will be many director seats to be filled. Naturally, we want to think about the effect of the statutory statement on how directors are to perform when they sit on the board of business associations. And within this larger context, there is an interest in how we can draw more people of better quality to want to take up director positions of publicly listed companies.

There is a strong interest in strengthening the accountability of directors. That is a very noble purpose. The tools to achieve that purpose ought to be ones that invite and encourage capable persons to step up to the fray of company directorship while at the same time appropriately shield them from liabilities for their actions and decisions.

The Bill now writes into the statute the general duty of care, skill and diligence. Those duties have always existed under law. Whether under common law or under a statutory statement, if the extent of liabilities flowing from such duties is not clear, that uncertainty will make many directors feel they are exposed and unprotected. They will be reluctant to become directors themselves.

One potential outcome is businessmen or investors who are capable and well-qualified to be directors, who ought to have become directors themselves, simply decide to remain behind the scene and let someone else fill those roles. Those who become directors may be in that role only because they are paid to be so. They may be "dummy directors", dummies who may not be exactly ready or prepared to meet the tasks of being a director beyond the bare minimum requirements.

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If we are not able to find sufficient capable individuals willing to serve as company directors, the prospect of Hong Kong as an international financial market will also suffer. The impact may be more particularly felt in the realm of non-executive directors for listed companies, especially the independent "outside" directors. Too stringent a statutory standard may drive capable persons away from being nominated to serve as "outside" directors of listed companies.

As an international business and financial centre, Hong Kong should want capable persons to direct company affairs. Hong Kong needs directors of good quality, not just in quantity. There is a strong policy reason for institutionalizing a legal and regulatory regime that is conducive to the effective functioning of companies. HKIoD believes a sufficient supply of quality directors is vitally important towards that end.

<u>Directors ought to exercise reasonable care, skill and diligence</u>

The Companies Bill does not go down the route of comprehensive codification of directors' duties. This we think is the right decision. What the Bill does is to introduce a general statutory statement on the duty of care, skill and diligence for directors that predicates on a "mixed objective/subjective standard".

We note that the objective standard is a minimum standard. It can be adjusted upwards to reflect any special skill, knowledge and experience possessed by a particular director by virtue of the subjective test, but cannot be adjusted downwards to accommodate someone who is incapable of attaining the basic standard of what can reasonably be expected of the reasonably diligent person carrying out the same function.

HKIoD believes in professionalism in company directorships. Company directors should demonstrate core competence to meet the corporate governance demands of today. We agree with the objective standard.

On the subjective standard, there is a strong argument, in line with the value of professionalism in directorship that we advocate, that a director is and should be expected to serve their companies with their personal skills. This is consistent with the values embodied in the *HKIoD Code of Conduct*.

However, the proposed subjective standard may be problematic when put into practice; for example, when a director with professional qualification has chosen to leave formal professional practice to go into business, and becomes a company director. Under what standard of knowledge, skill and experience should this director be judged? That of an "ordinary" director, or that expected of someone with equivalent tenure and seniority in his professional field? How will "the general knowledge, skill and experience that the director has" be measured?

These are some practical problems.

The First Phase Consultation Paper reasoned that adoption of the statutory statement is to "clarify the law and provide guidance to directors". However, the First Phase Consultation Paper also admitted that there is "some uncertainty as to how far the 'mixed objective/subjective test' will be applied by the Hong Kong courts".

The uncertainty is there.

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<u>s456(4) creates more uncertainty</u>

The Companies Bill may be making that uncertainty even worse. Companies Bill s456(4) provides that the statutory statement of general duty in s456(1) "has effect in place of the corresponding common law rules and equitable principles". The reason for this, found in the First Phase Consultation Paper, was that "the retention of the common law rules and equitable principles may result in dual standards and hinder the development of the statutory provision".

If all existing Hong Kong case law on point or relating to the issue, however scant, are to be superseded by virtue of the statutory enactment, it may result in even less guidance to directors. Until a new body of case law emerges or develops, directors will be left in a void, with so much uncertainty as to what duty they owe, how they are expected to fulfill that duty, and what will make them in breach.

Directors have good justifications to want to know how that statement of general duty will be interpreted and applied.

<u>Should have regard to the old common law and equitable principles and keep that continuing relevance</u>

If the statutory statement is to become law, it should be to underpin the existing common law and equitable principles, and to permit that body of case law to evolve and develop. The Companies Bill should go on to make clear that the duties which are set out in s456(1) are to be interpreted and applied in the same way as common law rules or equitable principles and that regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties of care, skill and diligence.

The Companies Bill ought to recognize the continuing relevance of the old common law principles and equitable principles on directors' duties, and give full license to Hong Kong courts to draw on the accumulated (and still evolving) jurisprudence on directors' duties to guide its further development. We should have confidence that our courts, when asked to interpret the statutory statement by giving regard to the corresponding common law rule and equitable principles on directors' duties, will be able to keep up with modern expectations and demands on the norm of directors' duties and appropriately apply them to facts and circumstances of a particular case.

Directors should conscientiously equip themselves to perform but they should also have proper shields to liability

HKIoD has long advocated that, while directors must have core competence to perform and must act with diligence to discharge duties, they must also be properly shielded from liability.

<u>Directors deserve the protection of a business judgment rule</u>

There should be a business judgment rule to work in conjunction with a statutory statement of duty of care, skill and diligence.

The Administration's position is there is no compelling reason for a statutory formulation business judgment rule. The Administration takes the view that the existing common law on review of management decisions was sound and therefore there is no obvious need for a statutory formulation of a business judgment rule. The Administration also seems to take the view that Companies Bill s891 (and quite possibly s892 also) is sufficient protection. The application of s891 (and s892), however, is not mandatory.

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We submit that, the Companies Bill should go beyond s891 (and s892) to include a formal, mandatory business judgment rule. The business judgment rule is needed to complement the statutory statement of duty of care, skill and diligence. The duty of care, skill and diligence has thus far been a matter of case law. Common law courts have evolved a sound judicial doctrine that leads to a deference and reticence in second-guessing directors' business judgment, for the very reason that the sound doctrine has been integrated into common law courts' formulation of the standard care that govern directors' conduct.

If the Administration finds the common law duty of care, skill and diligence worthy of a place in Hong Kong's statute book (there remains the objection to the Administration's erroneous conclusion to not have regard to the corresponding common law and equitable principles), the very sound doctrine that is an integral part of common law courts' formulation of that standard of care, an integral part of the formulation that might have been not obvious, must now deserve equal statutory prominence.

We respectfully submit that the Bills Committee should consider committee stage amendments to include a formal "business judgment rule" to shield company directors from liabilities for their decisions and actions, when such decisions or actions were made on an informed basis, in good faith, in absence of conflict of interest and in the honest belief that the action was in the best interests of the company.

Without such protection, we run a major risk that few individuals with the intellect and integrity may want to become company directors, especially to serve as (independent) non-executive directors.

In formulating Hong Kong's business judgment rule, one issue to be considered is whether it is more appropriate for Hong Kong's business judgment rule to be one following a presumptive formulation with burden on the plaintiff shareholder to rebut, or a safe-harbour formulation for company directors to usher proof to justify the protection.

In formulating Hong Kong's business judgment rule, we should be mindful that it ought to be for the board of directors to manage and supervise a company, and courts are not suited to such a role. In this regard, a formulation that is objective-based and not requiring courts to delve into the merits of business decisions should be preferred.

Permit indemnity to directors against liabilities to third parties
and buy them insurance coverage

The Companies Bill provides for the ability of companies to provide indemnities for liabilities incurred by directors to third parties in the course of performing their duties.

We welcome the change. The uncertainty over the right to be indemnified against liabilities to third parties may deter competent persons from accepting directorships and is therefore undesirable. For good policy reasons, there are some instances where indemnity to directors is not permitted under the Companies Bill.

To cover situations where indemnity from a company is not permissible, or where an indemnity from a company may become worthless, such as when the company is insolvent, it is crucial that company directors have available to them proper insurance coverage to protect themselves from liabilities. HKIoD advocates insurance coverage for all board members.

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<u>Directors should acquire and continue to improve on their skills, knowledge and qualities to meet corporate governance demands of today</u>
The Companies Bill includes some bare minimum qualifications of directors (such as age).

We think there is more to director qualifications. HKIoD has long supported the promotion of corporate governance training. Corporate governance is crucial to the development of companies and the economy at large, and directors are ultimately responsible for corporate governance.

HKIoD believes all company directors, when they first assume their posts, should have a firm measure of competence to perform. Over time, they should strive to remain up-to-date with best corporate governance practices.

The Bills Committee may want to take note that the Stock Exchange of Hong Kong is proposing a Code of Corporate Governance Practices provision to heighten the expectation on directors of companies listing in Hong Kong to participate in continuous professional development of a certain minimum number of hours. This is in addition to the already existing Code provision on induction. There is evidence of an ever stronger appreciation that company directors must have and must continue to improve on their skills, knowledge and qualities required to meet the corporate governance demands of today.

The benefit of proper initial training and continuous professional development for directors will flow not only for big corporations but also small companies, and not only for profit-making ventures but also social enterprises and charitable organizations.

We seriously invite the Bills Committee to consider stipulating in the Companies Bill or otherwise to require:-

- all new appointees to the boards of listed companies to attend one or more mandatory initial training courses of specified length and content;
- by a certain date to be determined, all directors of all Hong Kong companies and all listed companies to have gone through mandatory initial training courses of specified length and content; and
- all directors of all Hong Kong companies and all listed companies to fulfill certain specified number of accredited hours in continuing professional development training over annual or other appropriate periodic cycles.

HKIoD has a continuing professional development requirement for its members, and HKIoD offers its members a variety of training courses and events with opportunities for learning. HKIoD also recognizes self-directed learning. We also grant reciprocal credits to appropriate course offerings or learning activities organized or offered by other institutions or professional bodies. We submit that the mandatory initial training and continuing professional development requirements are not onerous on company directors.

We are aware of some perceived difficulties in determining how to “accredit” or “recognize” training programs. It can be quite difficult to draw the line for suitable content or syllabus for “directorship” training. Obviously, too loose or too broad a standard could mean training activities with no real effect at improving skills.
We believe in allowing a broad range of learning activities to qualify as accredited training activities. The emphasis should be on substance rather than form, that “continuing

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professional development" may be attained not only from class-room activities but also in a variety of other ways, some incurring tuition costs and some incurring service given, and some involving interactions with others and some involving self-study.

Have available reference guides to directors' conduct and behaviour
The Bills Committee may want to take note that the Stock Exchange of Hong Kong is proposing rule changes to clarify the duties the Exchange expects of a director. As part of the rule change and to improve listed company directors' understanding of their duties, the Exchange will stipulate in the Listing Rules to refer to the Companies Registry's *A Guide on Directors' Duties* and HKIoD's *Guidelines for Directors* and *Guide for Independent Non-executive Directors*.

The Companies Registry's guidebook should be of use and benefit to all company directors, not just those of listed companies.

The *Guide for Independent Non-executive Directors* has a focus on independent non-executive directors in the listed company context. The *Guidelines for Directors*, however, is more of a general nature.

We respectfully submit that the Bills Committee should, in addition to the Companies Registry's guidebook, also consider giving full and firm recognition of the HKIoD *Guidelines for Directors* and *Code of Conduct* as a framework of common reference for the conduct of directors in fulfilling their responsibilities.

SMEs will benefit from corporate governance training
Corporate governance training is another necessary ingredient in the support of SMEs. Many SMEs are not able to take full advantage of the government's loan guarantee schemes. There are a number of reasons for this, but one common impediment is that many SMEs could not demonstrate proper internal control and are ill-prepared to submit sound loan proposals. A better corporate governance scorecard will make it more likely for a business to obtain credit and financing.

Good corporate governance is also something for non-profits
Our belief in "good corporate governance" does not rest only with profit making ventures, but with public organizations and social enterprises as well. We need good capable person to be company directors; we also need good capable people to direct and run social enterprises.

We agree with introducing statutory protection for persons dealing with a company, in addition to the common law indoor management rule (otherwise known as the rule in *Turquand*'s case).

We agree *Turquand* should remain good law. Boards/directors should be vigilant in managing the powers and authority they delegate and in ensuring that proper internal management and control procedures are established and followed.

The form of protection embodied in s112 is appropriate. We think the exception embodied in s113 is reasonable. On the exception presented in s114, we have some thoughts and comments.

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Why treat section 98 companies differently?
s114 provides that the form of statutory protection under s112 shall not apply in certain circumstances to a transaction or act of company permitted to be registered by name without "Limited" (i.e., those "section 21 companies" as they are now known, and which will continue to be formed or be in existence under s98). The exception in s114 instead provides a slightly mollified form of protection for outside parties in that it prevents the section 98 company from being bound by a transaction or act if the outside person "knows" about the nature of the company and that the transaction or act exceeds the limitations on the powers of the company or its directors.

It is government policy to encourage social enterprises. Some of them may well be section 98 companies in form but their operation and outward appearance may appear to outsiders as just like any other commercial profit-making entities. There may actually be good and just arguments for vendors and customers of these social enterprises to be afforded nothing less than s112 and *Turquand* protection.

We submit that the *Turquand* and s112 protection should better be viewed by parties to a transaction as a necessary safety net. Notwithstanding the common law and statutory protection, any person dealing with any counterparty company should conduct such due diligence and obtain such evidence or assurance to be satisfied that the counterparty company has duly authorized the company act in question. For those outside parties who follow good practice and conduct proper due diligence when dealing with counterparty companies, whether or not section 98 companies, the exception in s114 may not make a big difference.

The concern for us is the exception under s114 must not slip to become a let-off for section 98 companies to condone poor in-house management and improper internal control.

Section 98 companies are often formed for charitable purposes. As such there may be an interest in ensuring that the precious monies or assets of these companies are properly applied to achieve the avowed charitable objectives and not be wasted or plundered by careless, irresponsible, even unscrupulous persons occupying directorships or similar positions in these organizations.

Not applying in full the rule in s112 as against section 98 companies might have a beneficial effect in helping protect the precious monies and assets of charitable organizations. HKIoD asserts that, in so doing, we should not be sending out a wrong message that society can or should tolerate less vigilant and less competent directors or lesser corporate governance in charitable organizations.

Organizers and members of charitable organizations have as good reasons as profit-making organizations to want capable persons who can meet corporate governance demands of today to take up directorships. These directors have as much duties and necessity as their counterparts in business enterprises to set up proper in-house management and internal control procedures.

Restrict the appointment of corporate directors
because company directorship is a matter of personal performance
The Companies Bill will restrict corporate directorship in private companies by requiring a private company (other than one within the same group of a listed company) to have at least one director who is a natural person.

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The Companies Bill will retain the current prohibition for a public company and a private company within the same group of a listed company from appointing corporate directors.

HKIoD had in the past expressed its support for the abolishment altogether of corporate directorship, subject to a reasonable grace period. We continue to believe that corporate directorships should be abolished altogether. For us, company directorship is a matter of personal performance.

We recognise that company groups may need the flexibility of corporate directorship for entirely legitimate business and commercial purpose. We think the "at least one natural person" requirement will add some safeguard for enforcing directors' obligations and to hold company actions accountable. The natural person(s) serving as director(s) must demonstrate a firm grounding of skills, knowledge and qualities required to meet the corporate governance demands of today.

The First Phase Consultation Paper included the notion of a "six month grace period". The Bills Committee may want to consider whether a grace period is still necessary or desirable.

Subject to the foregoing, HKIoD will support the position taken in the Companies Bill.

Disinterested shareholders' approval is a proper check on directors' fair dealings involving "relevant private companies"

The Companies Bill will modify the concept of "relevant private company" to cover only private companies which are subsidiaries of a public company.

We continue to believe there is a valid reason for the concept of "relevant private companies" to be extended to cover private companies associated with public companies, listed or unlisted.

The "disinterested shareholders' approval" is already a significant relaxation of the current regime. If the purpose is to put a check on directors' fair dealings, the job is only half-done if we only look at "subsidiaries" of public companies.

Although the number of non-listed public companies is currently small, the Companies Bill should provide a legal framework that is ready to address all forms of business associations permitted or contemplated thereunder. Non-listed public companies could carry significant commercial significance and invoke as much issue of "public accountability" as listed public companies. We respectfully submit that the Bills Committee should give this aspect some further thought.

For private companies associated with a listed company, we continue to think the relevant prohibitions should appear in the Listing Rules (or other securities laws and/or regulations such as the SFO) rather than the Companies Bill.

Directors ought to provide reasons to explain refusal to register a transfer of shares

The Companies Bill now requires directors to give reasons for refusal to register a transfer of shares "on request".

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We had argued that a company should be obligated to give reasons for refusal to register a transfer of shares. We had also argued that the obligation to give reason should be mandatory whenever there is a refusal.

We can support the position taken in the Companies Bill, but we have some thoughts to share with the Bills Committee.

Commercial practice when followed should help avoid disputes

Share transfer restrictions are usually embodied in charter documents and/or shareholder agreements. It is not difficult for directors to determine if transfer restrictions apply and, if so, offer that as the reason for refusal. It would seem to us that, even if the directors cannot for one reason or another make a conclusive determination, raising a request to the transferee to provide further evidence could itself amount to a very acceptable reason to refuse the registration for the time being, and that practice should be considered more commercially reasonable than a blanket refusal without giving reason. A prudent transferee in a share transfer transaction would have ascertained through due diligence that the transfer is not subject to any prohibitions. A prudent transferee would also have procured the reasonable assurance and assistance of the share transferor to effectuate the registration of the share transfer. It should not be difficult for evidentiary proof, if so needed, to reach the directors. Prudent companies would also make effort to ensure that proper share transfer restriction legends conspicuously appear on share instruments;

The director's hat and the shareholder's hat, which hat are you wearing?

A person's capacity as director and shareholder, even of the same company, should not be confused. Directors in a private company are often themselves shareholders of the entity. Empowering directors of a private company to refuse to register a transfer without giving a reason might be seen as incidental to the director-shareholders' prerogative to maintain some degree of control over the identity of the co-owners of the business.

On the basis that share transfer restriction is more a matter of who should be co-owners of a business, the law should be changed to require directors to give reasons when they consider that a shareholder's wish to transfer share ownership should not be honored. On this point, the Bills Committee would also notice that the share qualification requirement was proposed to be abolished. Dubious registration requests should also be much fewer in number when bearer warrants are prohibited.

Restricting access to directors' residential address is the right choice

The Companies Bill will restrict access to directors' residential addresses following essentially the "UK approach". Existing records will be purged upon application and payment of a fee. That is the right choice. The service address of directors will have better utility from the standpoint of contacting the directors or for service of documents. It will be a policy mistake not to put up protection but to wait for abuse of personal data to happen.

Masking certain digits of directors' and company secretaries' identification numbers will not affect the identification of individual persons

The Companies Bill will mask certain digits of the identification numbers of directors and company secretaries in the public register. Existing records will be purged upon application and payment of a fee. That is the right choice. The remaining digits together with the name should be sufficient to identify the individual persons. It will be a policy mistake not to put up protection but to wait for abuse of personal data to happen.

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Directors' personal data need further protection
The issues surrounding directors' residential address and identification number have a farther reach. Many company directors by profession or other reasons are required to file personal data with authorities/agencies knowing that such data will be public records available for inspection. As more and more authorities/agencies post their records online, and as internet searches are becoming more common and easy, there is substantial risk that the full profile of a company director's personal data, even if those filed with the Companies Registry is masked or hidden, can still be revealed by cross-checks of just a few public registers. A fuller examination of the issues relating to public availability of personal data of company directors is in order.

Court discretion to dispense with "headcount test" has merit
The Companies Bill will retain the headcount test for members' scheme while giving the court discretion to dispense with the test so as to tackle the problem of share splitting by parties opposing a scheme.

HKIoD took a different view in our submission in response to the draft CB consultation. There, we argued a preference for the abolishment of the headcount test for members' scheme whether for listed or non-listed companies. A "majority in number" requirement embodied in the headcount test encourages manipulation by majority as well as minority shareholders. Many Hong Kong investors hold only beneficial interests in shares of listed companies within CCASS. With many shares in listed companies being held by nominees and custodians, a headcount test is not necessarily indicative of the decisions of the beneficial owners of the shares. Minority shareholders of listed companies are already afforded substantial protection under the Takeovers Code. A court still has discretion not to sanction members' scheme even without a headcount test requirement. On this basis, we think the removal of the headcount test requirement is appropriate.

We stood by the principle in those views we presented. There being sufficient means to protect minority shareholders has always been a key part in our considerations.

The Bills Committee may want to condition the retention of the headcount test (as to listed companies) on timely introduction and implementation of a scripless market in Hong Kong.

For creditors' schemes
The Companies Bill will retain the headcount test for creditors' scheme, but will not extend court discretion to dispense with the test.

HKIoD took a different view in our submission in response to the draft CB consultation. We continue to believe that voting by value of debt and not by headcount will result in outcomes that are fairer.

Streamlining the restrictions on financial assistance is the right idea
The Companies Bill will have restrictions on financial assistance to be equally applicable to public and private companies.

We agree listed companies and unlisted public companies should continue be subject to some form of restrictions, because there is a real issue of "public accountability" in play.

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For listed companies:

- we believe the better place to set out the restrictions is in the Listing Rules (and/or securities laws and regulations such as the SFO) since a large number of companies listing on the Hong Kong market are not incorporated in Hong Kong;
- we prefer a move towards as much streamlining as possible, although we can support the provisions now embodied in the Companies Bill.

For unlisted public companies:

- we prefer a move towards as much streamlining as possible, although we can support the provisions now embodied in the Companies Bill.

For private companies, the law should not stand in the way

The Companies Bill will retain the financial assistance restrictions for private companies but streamline it in the manner now embodied in the Companies Bill.

For private companies, we still think there is no reason for the law to stand in the way. The Administration has indeed made the observation that the abolition of financial assistance restrictions in the long run is supported in principle.

One practical difficulty in applying the rules has been in identifying what is "financial assistance" that should be banned and what should be permissible. Commercial reality has been making calls for myriads of exceptions. Over the years, various case decisions attempted to shed light but in the end they may have compounded the complexity and clouded the issues even more. It has for a long while been a case of the tail wagging the dog! Simplification is long overdue.

The current prohibition has in theory some use at protecting creditors but we submit it has not much effect in real. Financial assistance for purpose of acquiring a company's own shares is certainly not the only risk for creditors of a company, and among the risks that company creditors face, probably the less imminent. If the sinister purpose is to deprive creditors, there already exist plenty of otherwise innocuous corporate finance tools and devices that can be deployed to put them at a disadvantage.

Removing the prohibition on private companies does not mean there will forever be no restraints. Proper exercise of directors' duties comes into question. Insolvent trading provisions, when enacted, will provide another check. Minority interests (and creditors) will still have recourse through other provisions in the Companies Bill or elsewhere.

If it is felt that the prohibition on private companies still serves some useful purpose not addressed by the other regulatory mechanisms mentioned above, we think the logical step is to clearly identify the villainous conduct that ought to be outlawed and make new law to address that head on. We will be making better law that way;

If it is decided that some form of prohibitions on private companies shall remain, the Bills Committee can consider an alternative proposal to require only that all members of a private company give consent to the subject transaction (i.e., akin to s280, but no solvency test required). Given that there is unanimous shareholder approval, the ceiling requiring financial assistance not to exceed 5% of shareholder's funds (see s279) need not be imposed.

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Preserve common law derivative action
and let litigants select the appropriate route that suits their case
The Companies Bill agrees with us that there is no need to outright abolish the common law derivative action, or CDA, currently preserved in section 168BC(4).

Hong Kong is an international business and financial centre. As noted in the First Phase Consultation Paper, there are likely a large number of foreign companies with resident Hong Kong shareholders but which are not within the definition of "specified corporation" eligible to bring a statutory derivative action, or SDA. As also noted in the First Phase Consultation Paper, a CDA may also be necessary as a "fall back" for non-Hong Kong companies which for one reason or another cannot meet the requirements of section 168BB of the CO.

Non-Hong Kong companies should be given the freedom to choose how to initiate or defend litigation in Hong Kong under all possible legal theories and utilizing all possible procedural mechanisms, whether these are based on statutory provisions, common law or court procedural rules. Hong Kong is and should strive to continue to be a major hub of cross-border legal services. Many law firms and practices with capability in the laws of foreign jurisdictions already have a presence in Hong Kong. These law firms and practices, together with Hong Kong's own law firms and practices, shall be able to advise their respective clients on the best way to proceed. Hong Kong courts shall have the readiness and sophistication to deal with derivative actions as they arise, and make appropriate rulings, whether substantive or procedural, that are appropriate for a particular case and yet consistent from case to case. We think this is more true to the function and spirit a legal system that makes Hong Kong proud. And therefore, we do not believe it is necessary to abolish the CDA outright.

Improving transparency and disclosure of company information
is one key to better corporate governance
<u>Directors should ensure properly prepared financial statements</u>
The Companies Bill will not introduce provisions requiring directors' declaration regarding financial statements. The existing requirement under section 129B of the CO will be preserved.

We support the decision. HKIoD remains of the view that company directors should strive to understand and be familiar with the financial affairs of the company. Since s129B of the CO will be preserved, there remains a duty for directors to prepare financial statements that give a true and fair view or are properly prepared in accordance with applicable accounting standards. In this regard, the Companies Bill has also taken the views and observations we and others have made, that auditors are not permitted to express a "true and fair" opinion on financial statements prepared under a compliance framework such as the SME-FRS. Financial statements of those companies are exempted from the "true and fair view" requirement.

<u>If directors are to prepare meaningful business review,</u>
<u>they should be protected from liability for making forward-looking statements</u>
The Companies Bill now embodied some modifications in the "business review" proposal. Most notably:-

- there are now more opt-outs and exemptions that will relieve smaller, private companies from the requirement;
- the clause requiring a business review to be a "comprehensive analysis" has been deleted (but the business review must still contain "a fair review of the company's

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business", and "to the extent necessary for an understanding of the development, performance or position of the company's business, … must include … an analysis using financial key performance indicators";
- a "safe harbour" along the lines of UKCA 2006 has been included

HKIoD supports the modifications now embodied in the Companies Bill.

Requiring (public) companies to prepare analytical and forward-looking business review as part of the directors' report may provide more information to shareholders (and the investing public). Since there is now a wider set of possibilities to opt-out or be exempt from the requirement, we think this will not impose a heavy burden on too many small, private companies.

Absent proper guidance or constraints, companies may be overly-aggressive in their forward-looking business review. This can breed many litigation from disgruntled shareholders, in the form of class actions (if such a regime is introduced to Hong Kong) or otherwise.

The inclusion of a "safe harbour" along the lines of UKCA 2006 s463 is appropriate because it will mean that directors are shielded from civil liability to third parties, but remain liable for a loss suffered by the company if statements in the directors report are deliberately or recklessly made to be untrue or misleading or to have omissions or concealment of material facts.

We submit HKIoD is well-suited to work with the Administration and other parties to prepare authoritative guidance on the type of information to be included in the business review.

Use of non-GAAP measures can be misleading
Among the various items that should be included in a business review is "an analysis using financial key performance indicators".

To the extent that financial key performance indicators can provide more useful information to shareholders and investors, we want to encourage their use. Numerical measures are quite a common form of financial performance indicators, but these numerical measures do not necessarily all comport with generally accepted accounting principles. Such non-GAAP measures can still serve useful purposes and be valuable to shareholders and investors. For instance, there may be a need to make period-to-period, and in some cases entity-to-entity, performance comparisons with numerical measures that exclude the effects of unusual events (e.g., mergers, restructuring).

But the use of non-GAAP measures can also cause much confusion and even be a tool to mislead so as to become a fraud on shareholders and investors.

Any use of non-GAAP measures to mislead or to sustain a fraud should be outright prohibited. Where use of non-GAAP measures is permissible, there should be a requirement to present such measures together with the most directly comparable GAAP measure, a reconciliation of the differences between the two measures and a statement of the reasons why the company believes the non-GAAP measures are useful or necessary.

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Auditors need access to information and assistance,
but their rights to such should be reasonably constrained

The Companies Bill will clarify and narrow the scope of application of the provisions on auditors' right to information.

We are pleased the Administration has taken the views and observations we and others have made. We agree that reliable financial reporting predicates on auditors having access to information and assistance in the proper performance of their work. But the scope must be constrained to a level that is reasonably necessary for that performance, and the wording must have that level of specificity and objectivity that can lend practicable application in the field.

Directors' remuneration report

The Companies Bill will not introduce the requirement of separate directors' remuneration report.

We support the decision. Shareholders should have reason to be sure that company resources are not expended inappropriately to enrich directors. However, we note the following:-

- for listed companies, the better place for setting out the requirement is in the Listing Rules (and/or securities laws and regulations such as the SFO);
- for non-listed companies, new disclosure requirements on directors' compensation have already been included under s378. Organizers of new companies and members of existing companies are free to stipulate further suitable requirements in their charter documents to suit particular needs.

Shareholders have as much reason to be sure that company resources are not expended to reward non-performing management executives. This can especially be an issue for larger private companies and public companies. The Bills Committee may want to take note that the Stock Exchange of Hong Kong is proposing to introduce changes to Code of Corporate Governance Practices provisions on the structure and disclosure of remuneration of chief executive officers and senior management (in addition to directors).

Respect freedom in business association is to facilitate business

The Companies Bill will enhance Hong Kong's business environment the most if provisions could modernize the framework that regulates the establishment and conduct of company affairs, yet accommodates as much freedom of those who form business associations under it to design their company characteristics. If the Companies Bill can do so, it has that much better effect and advantage in making Hong Kong the choice location in the region to incorporate a business.

Hong Kong should make itself a jurisdiction where companies incorporating here have much freedom to design their company characteristics unless there is a compelling public policy reason or interest to restrict freedom. Permitting such freedom is not to create confusion, but to accommodate the many different needs and wants of business associations that want to incorporate in Hong Kong.

Companies should have the option to choose "early adoption" of Part 9

The Companies Bill stipulates that the financial year of a company that begins before or straddles the commencement date of Part 9 to be governed by the existing CO.

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We think a company should have the option to elect "early adoption" of Part 9 (as enacted) for the financial year that ends after the commencement date of Part 9. The Administration rejected our views, citing the reason 'to avoid confusion". We respectfully submit that permitting early adoption in the way described above will not add confusion anymore than the transition contemplated by the Companies Bill would. It could actually bring more companies into the purview of Part 9 faster.

Companies should have the freedom to opt for par value or no par as they see fit
The Companies Bill will enable "no par" capital but will also impose a mandatory "no par" system for Hong Kong.

We support the introduction of legislation that enables "no par" share capital. But rather than a mandatory system of no par, a wholly plausible option would have been to respect the freedom of individual Hong Kong companies to opt for par value or no par as they see fit. Though the world trend may be towards "no par", we see no reason to not let people choose par value shares. A large number of companies listing in Hong Kong are not incorporated locally. They may have chosen or be required to have share capital with par value. Hong Kong businesses may be setting up associate companies in other jurisdictions. These may have or may be required to have par value shares or some other form of "stated capital". The introduction of a mandatory no par system for Hong Kong incorporated companies does not necessarily equate "simplicity", since the Hong Kong business community and investors will necessarily have to deal with companies that may or may not have par value shares.

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