CB(1)2066/10-11(01)

Bills Committee on Companies Bill

Part 4 and Part 5 of the Companies Bill

PURPOSE

This paper explains the major proposals and policy issues in Part 4 (Share Capital) and Part 5 (Transactions in relation to Share Capital) of the Companies Bill. It also outlines relevant overseas experience, public views received during earlier public consultations on the major proposals and our responses.

DETAILS

2. Details for each Part are contained in the Annexes:-

Annex A - Part 4 (Share Capital)

Annex B - Part 5 (Transactions in relation to Share Capital)

ADVICE SOUGHT

3. Members are invited to note the contents of the paper and provide their views.

Financial Services and the Treasury Bureau
Companies Registry
28 April 2011

<u>Annex A</u>

Bills Committee on Companies Bill

Part 4 – Share Capital

INTRODUCTION

Part 4 (Share Capital) of the Companies Bill (CB) contains provisions relating to the core concept of "share capital" and its creation, transfer and alteration.

POLICY OBJECTIVES AND MAJOR PROPOSALS

2. Part 4 contains initiatives that aim at modernising the law (subparagraphs (a) and (b) below), enhancing corporate governance (subparagraphs (c) and (d)), ensuring better regulation (subparagraph (e)), and facilitating business operation (subparagraphs (f) and (g)), namely:-

(a) Adopting a mandatory system of no-par for all companies with a share capital (paragraphs 4 to 12 below);

(b) Removing the power of companies to issue share warrants to bearer (paragraphs 13 to 17);

(c) Extending the requirement of shareholders' consent for allotments of shares to the grants of rights to subscribe for, or to convert securities into, shares (paragraphs 18 to 21);

(d) Requiring a company to give reasons explaining its refusal to register a transfer of shares upon request (paragraphs 22 to 25);

(e) Requiring a company to deliver to the Companies Registry (CR) a return or notification, including a statement of capital whenever there is a change to its capital structure (paragraphs 26 to 30);

(f) Clarifying and simplifing the requirements relating to class rights (paragraphs 31 to 36); and

(g) Simplifying the publication procedures for replacement of lost share certificate of a listed company (paragraphs 37 to 40).

3. The details of the above major proposals in Part 4 are set out in paragraphs 4 to 40 below.

Adopting a mandatory system of no-par for all companies with a share capital (Clause 130 and Division 2 of Part 4 of Schedule 10)

<u>Current position</u>

4. Par value (also known as "nominal value") is the minimum price at which shares can generally be issued. Currently, companies incorporated in Hong Kong and having a share capital are required to have a par value ascribed to their shares.

<u>Proposal</u>

5. The par value does not serve the original purpose of protecting creditors and shareholders, and in fact may even be misleading because the par value does not necessarily give an indication of the real value of the shares. We legislate for the migration to mandatory no-par. Relevant concepts such as nominal value, share premium, and requirement for authorised capital will no longer be necessary and will be abolished. We introduce deeming provisions to ensure that contractual rights defined by reference to par value and related concepts will not be affected by the abolition of par (see paragraph 9 below). The deeming provisions will save considerable work, expense and time for companies and reduce the possibility of disputes. It will not prevent individual companies from reviewing their documents and introducing more specific

changes having regard to their own circumstances before the Bill comes into force.

Key provisions in the Bill

6. **Clause 130** abolishes the concept of nominal value. Upon the commencement of that clause, a company's shares will have no nominal value. This will apply to all shares, including shares issued before that day. The commencement date is expected to be at least 18 months after the enactment of the CB, to allow time for companies to review and amend their articles of association and other documents where necessary (please also see the deeming provisions in paragraph 9 below).

7. **Clause 165**, modified from section 53 of the Companies Ordinance (CO), empowers a company to alter its share capital in a number of ways under a no-par environment, e.g. to allow a company to capitalise its profits without issuing new shares and to allot and issue bonus shares without increasing share capital.

8. With the abolition of nominal value, "share premium" will no longer exist. Provisions based on this concept will be modified. **Section 38 of Schedule 10 (Transitional and Saving Provisions)** is a legislative deeming provision for the amalgamation of the existing share capital amount with the amount in the company's share premium account (and also capital redemption reserve) immediately before the migration to no-par. **Section 39 of Schedule 10** is to preserve substantially the currently permitted uses of the share premium for the amount standing to the credit of the share premium account before the migration to no-par. As for the position after the migration to no-par, **clause 144** provides that a company may apply its capital in writing off the preliminary expenses of the company, commission paid or any other expenses of any issue of shares. **Clauses 189 to 194** modify the merger and group reconstruction relief under sections 48C to 48E of the CO, so that the two types of relief may operate in a no-par environment.

9. **Sections 36 to 42 of Schedule 10** contain transitional provisions relating to migration from shares having nominal value to shares having

no nominal value. The provisions (particularly the statutory deeming provision in **section 41**) are intended to provide legislative safeguards to ensure that contractual rights defined by reference to par or nominal value and related concepts will not be affected by the migration to no-par.

Overseas experience

10. In other comparable common law jurisdictions, there is also growing acceptance of no-par value shares. There is general acceptance that retiring the concept of par would create an environment with greater clarity and simplicity that would be desirable for the business community generally.

11. Jurisdictions that have adopted no-par shares include Australia, New Zealand and Singapore[1]. They have adopted mandatory no-par systems without any apparent difficulties. A mandatory system is preferred because it would be simpler for all concerned.

Public consultation

12. We consulted the public on this issue in a topical consultation in 2008[2], and during the second phase consultation of the draft CB[3]. In both consultations, there was majority support for the proposal to adopt a mandatory no-par sytem, with some of those comments suggesting that instead of a mandatory no-par system, companies should be allowed to opt in or out. However, an optional no-par system requires legislating for and administering two parallel legal system which would involve added costs and complexity. In view of overseas experiences and

[1] For example, Singapore implemented a no-par system for all companies simultaneously on the commencement of the Companies (Amendment) Act 2005 from 30 January 2006. It has been suggested that the United Kingdom (UK) is likely to migrate to a no-par system if restrictions in European legislation are removed.

[2] Financial Services and the Treasure Bureau (FSTB), *Consultation Conclusions on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (February 2009), paragraphs 5 to 10 (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/cmrsap_conclusion _e.pdf).

[3] FSTB, *Consultation Conclusions on Second Phase Consultation on the Draft Companies Bill* (October 2010) (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccsp_conclusion_e.pdf).

majority support in the consultations, we propose to adopt mandatory no-par.

Removing the power of companies to issue share warrants to bearer (Clause 134 and section 14 of Schedule 10)

Current position

13. Under section 73 of the CO, a non-private company limited by shares is allowed to issue "share warrants to bearer" (i.e. a warrant stating that the bearer of the warrant is entitled to the shares specified in it, also known as bearer shares)[4]. It is possible for legal title to shares to be transferred merely by physical delivery of the warrant.

Proposal

14. Share warrants are rarely issued nowadays and are undesirable from the perspective of anti-money laundering because of the lack of transparency in the recording of their ownership and the manner by which they are transferred. In the CB, we propose to remove the power of companies to issue share warrants to bearer.

Key provisions in the Bill

15. **Clause 134** repeals a company's power to issue "share warrants to bearer" while providing that share warrants issued prior to the commencement of that clause would be grandfathered, so that upon the surrender of such existing share warrants, the bearer's name will be registered in the company's register of members. The clause partially restates section 97 of the CO, to provide for the surrender of share

[4] "Share warrants to bearer" are different from "warrants" listed on the stock exchange. "Share warrants to bearer" are an alternative form of title document evidencing the ownership of shares. "Warrants" listed on the stock exchange, on the other hand, are instruments which only give an investor the right to buy or sell the underlying shares. Moreover, "share warrants to bearer" enable the shares specified in it to be transferred by delivery of the warrant. "Warrants" listed on the stock exchange may be traded, but their transfer simply gives the transferee a right to buy or sell the underlying shares and does not make him or her a member until the option is exercised.

warrants. **Section 14 of Schedule 10** provides that the records in the register of members in respect of existing share warrants would be preserved until the share warrants are surrendered.

Overseas experience

16. This proposal is based on the Singaporean approach[5]. The UK retains the right to issue share warrants to bearer[6]. In Australia, a company is not allowed to issue bearer shares[7].

Public consultation

17. We consulted the public on the issue during the second phase consultation of the draft CB. Most of those who responded to this issue agreed to the proposal. Some suggested that the Government should consider a registration and approved custodian depositary requirement to handle bearer certificates, such as that in the British Virgin Islands, as a half-way alternative. We consider that it would be more desirable to completely repeal the power to issue "share warrants to bearer" from the anti-money laundering perspective.

Extending the requirement of shareholders' consent for allotments of shares to the grants of rights to subscribe for, or to convert securities into, shares (Clauses 135 and 136)

Current position

18. The allotment of shares is generally carried out by directors. Under section 57B of the CO, directors are only entitled to do that with prior approval of the company in a general meeting. The requirement of shareholders' approval is mandatory and notwithstanding any provision in the company's articles to the contrary. There are only two exceptions

[5] Section 66 of the Singapore Companies Act (SCA).

[6] Section 779 of the UK Companies Act 2006 (UKCA 2006).

[7] Section 254F of the Australia Corporations Act (ACA).

to this rule, namely, (a) a rights issue; and (b) an allotment to the founder members (section 57B(1) and (7) of the CO). However, section 57B only requires shareholders' approval for the allotment of shares, but not the grant of an option to subscribe for shares or a right to convert any security into shares. It is only the subsequent exercise of the option or the right of conversion that would result in an allotment which would require shareholders' approval.

<u>Proposal and key provisions in the Bill</u>

19. To enhance protection of minority shareholders against dilution, **clauses 135 and 136** extend the requirement of shareholders' approval for allotments of shares to the grants of rights to subscribe for, or to convert securities into, shares. If approval is given for the grant of an option, there would not be a need to obtain further approval of the allotment of shares pursuant to that option.

<u>Overseas experience</u>

20. This proposal accords with the position in the UK[8]. The Singapore Companies Act (SCA) also requires prior approval of shareholders but only for the issue of shares, and applies it without exceptions[9]. The Australia Corporations Act (ACA) has no enacted requirement for shareholders approval and appears to leave this to the company's constitution, which may or may not give the shareholders a role in the decision-making process.

<u>Public consultation</u>

21. We consulted the public on the issue during the second phase consultation of the draft CB. Some suggested that shareholders' approval for allotements of shares or grant of rights should not be required for private companies. To protect shareholders' interest, we

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[8] Section 549 of the UKCA 2006.

[9] Section 161 of the SCA.

consider it prudent to continue to require shareholder's approval for private companies.

Requiring a company to give reasons explaining its refusal to register a transfer of shares upon request (Clause 146(3) and (4))

Current position

22. Section 69(1) of the CO requires a company which refuses to register transfer of shares or debentures to send a notice of such refusal to the transferor and transferee within two months after the transfer was lodged with the company.

Proposal and key provisions in the Bill

23. Currently, there is no requirement for the notice to be accompanied by the reasons for the refusal. We propose in **clause 146(3) and (4)** to require companies to give reasons explaining their refusal to register a transfer of shares upon request 28 days after receiving the request, so as to enhance transparency and to ensure that directors only exercise their powers for proper purposes.

Overseas experience

24. This proposal accords with the position in the UK except that in the UK, the giving of reason is mandatory[10]. Australia does not have similar requirement.

Public consultation

25. We consulted the public on the issue during the second phase consultation of the draft CB. A minority of respondents disagreed with the proposal. They considered that under common law, directors were permitted not to give reasons for acceptance or rejection and there are

[10] Section 771 of the UKCA 2006.

currently sufficient grounds (e.g. breach of fiduciary duties, etc.) to sanction against wrongful refusals. In view of the majority support, we will proceed with the proposal. The approach is similar to the case of transmission of shares by operation of law under section 69(1A) of the CO.

Requiring a company to deliver to the CR a return or notification including a statement of capital whenever there is a change to its capital structure (Clause 196)

Current position

26. A statement of capital is in essence a "snapshot" of a company's total subscribed capital at a particular point in time. Under the current CO, the capital structure of the company can only be ascertained by searching through a number of documents on the register, e.g. the annual return, any return of allotment filed since the annual return, any documents filed in relation to, e.g. a permitted reduction of capital. It is therefore not easy to ascertain the capital structure at a specific moment in time without a thorough check of the register.

Proposal and key provisions in the Bill

27. Under the existing provisions, information on a company's share capital structure in the public register may not be up-to-date. The Bill requires a company to deliver to the CR such a statement to be contained in a return or notification, whenever there is a change to its capital, e.g. where there is an allotment of shares (**clause 137**) or a permitted alteration of share capital (**clause 166**). A statement of capital will show the company's share capital information as at the time the company has so changed its share capital.

28. **Clause 196** sets out the information to be contained in a statement of capital. This new requirement enhances the existing requirements for notification to the CR of changes of a company's share

capital. This will ensure that the public register contains up-to-date information on a company's share capital structure.

Overseas experience

29. A similar requirement for a company to submit a "statement of capital" when there is a change to its capital structure has been introduced in the UK[11]. Australia also has a similar requirement[12], but not Singapore.

Public consultation

30. We consulted the public on the issue during the second phase consultation of the draft CB. We did not receive any objection.

Clarifying and simplifying the requirements relating to class rights (Clauses 171 to 188)

Current position

31. Sections 63A and 64 of the CO set out the requirements for a variation of class rights of shareholders. The CO does not define the concept of class rights, which gives rise to some uncertainties. Section 63A is also complicated in relation to the procedures for variation, which differ depending on where the class rights are provided for, and whether the articles contain a procedure for variation. Under section 63A, variation of class rights needs to follow any requirements set out in the articles. If the articles do not contain the requirements, then section 63A requires different types of approvals (e.g. approved by members holding 75% of the shares or approval by all members) depending on whether the rights are set out in the memorandum. The CO is silent in the case of companies without a share capital.

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[11] Sections 644(2) and 649(2) of the UKCA 2006.

[12] Section 178C of the ACA.

Proposal and key provisions in the Bill

32. For companies with share capital, the provisions on class rights under **clauses 171 to 179** refer to "rights attached to shares in a class of shares". This clarifies that the concept of class rights is restricted to rights attached to shares. Also, **clause 172**[13] clarifies that class rights are the rights conferred on the holder of a share as a member of the company. To provide further guidance on the meaning of a class of shares, **clause 173**[14] provides that shares are in a class if the rights attached to them are in all respects uniform, and are not regarded as different only because the shares do not carry the same rights to dividends in the first 12 months immediately after allotment.

33. **Clause 175**[15] sets out the procedural requirements for the variation of the rights of a class of members of a company having a share capital, i.e. the rights may be varied in accordance with the articles or with 75% consent or special resolution of the class members. This simplifies the CO procedures mentioned in paragraph 31 above. **Clause 176**[16] requires the company to notify each class member if the rights of the class are varied. **Clause 177**[17] allows members holding at least 10% of the total voting rights of the class to apply to the Court of First Instance to have a variation disallowed. **Clause 179**[18] requires the company to notify the CR with a specified form (including a "statement of capital") of a variation within one month after the variation takes effect.

34. **Clauses 180 to 187,** mirroring the corresponding provisions in **clauses 171 to 179**, provide for variation of class rights for companies

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[13] A new provision with reference to section 246B(1)(a) and (2)(a) of the ACA.

[14] A new provision based on section 629 of the UKCA 2006.

[15] A new provision based on sections 630(2) to (5) and 632 of the UKCA 2006, and section 246D(3) of the ACA regarding clause 175(4).

[16] A new provision based on section 246B(3) of the ACA.

[17] A new provision based on section 246D(1), (2), (4) and (5) of the ACA.

[18] Existing provision modified with reference to section 637 of the UKCA 2006.

without a share capital. This fills the gap in the CO which is silent in the case of companies without a share capital.

Overseas experience

35. Our proposal is partially existing law with some new provisions mainly based on the UK Companies Act 2006 and the ACA. Details are set out in footnotes 13 to 18.

Public consultation

36. We consulted the public on the issue during the second phase consultation of the draft CB. No objection was received.

Simplifying the publication requirements relating to the replacement of lost share certificate of a listed company (Clauses 157 to 164)

Current position

37. Section 71A of the CO provides that where a person applies to the company for replacement of a lost certificate, the company has to publish a notice before issusing the new certificate. If the value of the shares does not exceed the threshold amount of $20,000, the notice shall be publicshed once in an English and Chinese newspaper respectively; if it exceeds $20,000, the notice shall be published in the Gazette once in each of three consecutive months.

Proposal and key provisions in the Bill

38. Given the cost involved in publishing a notice, some consider that the threshold amount should be raised and the publication requirements streamlined. **Clauses 157 to 164** based on section 71A of the CO simplify the publication requirements, taking account of developments in information technology (e.g. website publication). Under **clause 159**, for cases where the value of the shares is below $200,000 (instead of $20,000 in the CO), the notice will be published on

the listed company's website for one month (instead of newspapers in the CO). For cases where the value of shares is at or above $200,000, the notice will be published on the listed company's website for three months and once in the Gazette within one month after the company has first published the notice on its own website (instead of publishing the notice in the Gazette once in each of three consecutive months under the CO).

Overseas experience

39. The above changes are proposed taking into account the prevailing local circumstances of Hong Kong and the views collected from the second phase consultation of the draft CB (see paragraph 40 below).

Public consultation

40. We consulted the public on the issue during the second phase consultation of the draft CB. Some considered that the current publication requirements should be abolished altogether by only requiring notice to be published on the website of the Hong Kong Stock Exchange. However, to ensure sufficient protection for shareholders, we consider it necessary to keep the gazettal requirements for lost certificates with the value of the shares exceeding the threshold amount, while reducing the number of notices to be gazetted from three to one to make it less cumbersome. Some considered that the new threshold amount of $50,000 proposed in the second phase consultation too low and should instead be $200,000. We agreed and accordingly amended the draft CB.

PUBLIC COMMENTS

41. We consulted the public on the major reform proposals to the share capital provisions of the CO in June to September 2008[19]. We have consulted the public on the draft Bill in two phases in December

[19] FSTB, *Consultation Conclusions on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (February 2009) (available at http://www.fstb.gov.hk /fsb/co_rewrite/ eng/pub-press/doc/cmrsap_conclusion_e.pdf).

2009 to March 2010 and May to August 2010 respectively. Part 4 was covered by the second phase consultation. The public comments on our major proposals are discussed above. For other comments on Part 4 and our response, they are set out in Appendix III to the consultation conclusions issued on 25 October 2010[20].

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[20] FSTB, *Consultation Conclusions on Second Phase Consultation on the Draft Companies Bill* (October 2010) (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccsp_conclusion_e.pdf).

<u>Annex B</u>

Bills Committee on Companies Bill

Part 5 – Transactions in relation to Share Capital

INTRODUCTION

Part 5 (Transactions in relation to Share Capital) of the Companies Bill (CB) contains provisions concerning "capital maintenance" (reduction of capital and purchase of own shares (buy-backs)) and related rules (financial assistance by a company for the purpose of acquiring shares in the company or its holding company).

POLICY OBJECTIVES AND MAJOR PROPOSALS

2. Part 5 contains initiatives that aim at facilitating business operation, namely:-

(a) Adopting a uniform solvency test based on cash-flow for different types of transactions under this Part (paragraphs 4 to 11 below);

(b) Introducing an alternative court-free procedure for reduction of capital based on a solvency test (paragraphs 12 to 16);

(c) Allowing all companies to purchase their own shares out of capital, subject to a solvency test (paragraphs 17 to 22); and

(d) Allowing all types of companies (listed or unlisted) to provide financial assistance for acquisitions of the company's shares, subject to satisfaction of the solvency test and certain specified procedures (paragraphs 23 to 29); and

(e) Relaxing the rules on giving of financial assistance for the case of employee share schemes (paragraphs 30 to 33).

3. The details of the above major proposals in Part 5 are set out in paragraphs 4 to 33 below.

Adopting a uniform solvency test based on cash-flow for different types of transactions under this Part (Clauses 199 to 203)

Current position

4. Under Part II of the CO, a solvency test is provided for in respect of:-

(a) buy-backs of its own shares out of capital by a private company (requirements of the solvency test are set out in section 49K(3), (4) and (5)); and

(b) financial assistance by an unlisted company for the purpose of an acquisition of shares in the company or its holding company (requirements of the solvency test are set out in section 47F(1)(d) and (2)).

5. Both solvency tests are based on cash flow alone, but there are minor differences between them, as follows:-

(a) for buy-backs, under section 49K(5), the solvency statement has to be accompanied by an auditors' report; and

(b) for financial assistance, section 47F(1)(d)(i) has an additional requirement for the solvency statement which provides for the situation where the company intends to commence winding up within 12 months of the date of the proposed financial assistance.

Proposal

6. There is currently discrepancy in the solvency tests applicable to buy-backs and financial assistance. We consider it to be desirable to adopt a uniform solvency test for buy-backs and financial assistance, and extend its application to the court-free procedure for reduction of capital, for consistency in the law. In the CB, we propose to adopt the approach for financial assistance set out in section 47(F)(1)(d) (see paragraph 5(b) above), as it can give clarity and certainty on how the solvency test may apply in the different scenarios.

7. We consider that there is no need to impose the requirement of attaching the auditors' report to the solvency statement. Auditors would not be in a better position than the directors in ascertaining the company's solvency which involves forward-looking business judgments. Directors should be expected to have reasonable grounds in forming their opinion as to the company's solvency and judgement in deciding whether professional assistance is needed. Requiring an auditors' report in every case would add expense and cause delay for relatively little gain.

Key provisions in the Bill

8. **Clause 199** provides that a uniform solvency test will be applicable to all three categories of transactions, namely reduction of capital, buy-backs and financial assistance. **Clause 200** sets out the content of the uniform solvency test, which in substance, re-enacts section 47F(1)(d) of the CO. **Clause 201** provides for the making of a solvency statement by the directors who have formed the opinion that the company satisfies the solvency test in relation to the transaction concerned. In forming his or her opinion, a director must inquire into the company's state of affairs and prospects and take into account contingent and prospective liabilities of the company. The solvency statement must be made and signed by all directors for buy-backs and reductions of capital, and made and signed by a majority of directors for financial assistance.

Overseas experience

9. The proposed solvency test is derived from the existing section 47F of the CO applicable to financial assistance. The United Kingdom (UK) has two types of solvency tests, one of which applies to buy-backs out of capital by a private company[1] and is similar to the solvency test under section 49K of the CO, while the other one applies to a non-court procedure for reduction of capital[2], which is similar to the solvency test under section 47F of the CO (also see paragraph 4 above). In Singapore, the solvency tests include a "balance sheet" test (i.e. the assets of the company should exceed the value of its liabilities after the relevant transaction has taken place)[3]. In Australia, a different test is used, which requires that the relevant transaction must not materially prejudice the company's ability to pay its creditors[4].

Public consultation

10. We consulted the public on this issue in the topical consultation on the capital maintenance regime (among other subjects) conducted in 2008[5], and during the second phase consultation of the draft CB[6]. In both consultations, some suggested that the solvency test currently used should be modified by including a balance sheet test as this would provide a more comprehensive and objective approach to the assessment of solvency and thus a better safeguard for creditors. However, adding

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1 Section 714 of the UK Companies Act 2006 (UKCA 2006).

2 Section 643 of the UKCA 2006.

3 Section 7A and 76F(4) of the Singapore Companies Act (SCA).

4 See e.g. section 256B(1)(b) (regarding reduction of capital), section 257A(a) (regarding buy-backs) and section 260A(1)(b) (regarding financial assistance) of the Australia Corporations Act (ACA).

5 Financial Services and the Treasure Bureau (FSTB), *Consultation Conclusions on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (February 2009), paragraphs 41, 44 and 51 (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/cmrsap_conclusion_e.pdf).

6 FSTB, *Consultation Conclusions on Second Phase Consultation on the Draft Companies Bill* (October 2010) (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccsp_conclusion_e.pdf).

the balance sheet test as a second limb to the solvency test may cause undue burden to companies and is not particularly useful, especially in an economic climate where the values of assets and liabilities are highly volatile.

11. In the second phase consultation of the draft CB, some considered that the requirement for all directors to make and sign the solvency statement for buy-backs and reductions of capital would mean few companies would be able to benefit from the simplified procedures, for any one director may refuse to provide certification, whether out of groundless fear or educated caution. Such a requirement follows the existing requirement in section 49K of the CO and we propose to retain the requirement so as to provide sufficient safeguard.

Introducing an alternative court-free procedure for reduction of capital based on a solvency test (Clauses 210 to 220)

<u>Current position</u>

12. At present, the CO only allows a reduction of share capital if there is approval by the shareholders via a special resolution and if the reduction is approved by the court (sections 58 to 63 of the CO). In determining whether to approve the reduction, the court would consider various factors, including whether the reduction is equitable between shareholders and whether creditors' interests are safeguarded. Court approval is not required if the sole purpose of the reduction is to re-designate the nominal value of shares to a lower amount (section 58(3)).

<u>Proposal</u>

13. In the CB, we introduce, as an alternative procedure, a general court-free procedure based on the solvency test which would be faster and cheaper and can be utilised by all companies.

Key provisions in the Bill

14. **Clauses 210 to 220** provide for the said court-free procedure, subject to compliance with the solvency test. The key features of the procedure include:-

(a) all the directors need to sign the solvency statement in support of the proposed reduction (**clause 211**);

(b) the company needs to obtain members' approval by a special resolution (**clauses 210 and 212**);

(c) the company must publish notices with relevant information in the Gazette and newspapers and must register the solvency statement with the Companies Registry (CR) (**clause 213**);

(d) any creditor or non-approving member of the company may, within five weeks after the resolution is passed, apply to the court for cancellation of the resolution (**clauses 215 to 217**). During this five-week period, the company must make available the special resolution and solvency statement for members' and creditors' inspection (**clause 214**); and

(e) the company must deliver after the five-week period (but no later than seven weeks) to the CR a return in specified form if there is no court application (**clause 219**), or within 14 days after the court makes the order confirming the special resolution or the proceedings are ended without determination by the court (**clause 220**). The reduction takes effect when the return is registered by the CR.

Overseas experience

15. For reduction of capital, Singapore[7] and the UK[8] have introduced an alternative court-free procedure based on solvency, which

[7] See Division 3A of Part IV (sections 78A to 78K) of the SCA.

requires a solvency declaration to be made by all directors and approval of shareholders. In the UK, the alternative procedure is confined to private companies. In Australia, court sanction for capital reduction was removed and capital can be reduced with the approval of shareholders provided that creditors are not prejudiced[9].

Public consultation

16. There was majority support amongst the respondents for the introduction of such a procedure in the 2008 topical public consultation[10].

Allowing all companies to purchase their own shares out of capital, subject to a solvency test (Clauses 252 to 261)

Current position

17. Under the CO, the general rule is that a company can only buy back its shares using distributable profits or using the proceeds of a fresh issue of shares (sections 49A and 49B of the CO). This rule is derived from the capital maintenance doctrine. There is an exception for private companies which may fund a buy-back by payment out of capital based on a solvency test (sections 49I to 49N of the CO).

Proposal

18. In the CB, all companies are allowed to fund buy-backs out of capital, subject to a solvency requirement.

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8 See Chapter 10 of Part 17 (sections 641 to 653) of the UKCA 2006.

9 See Division 1 of Part 2J.1 (sections 256A to 256E) of the ACA.

10 See footnote 5, paragraphs 39 and 40.

Key provisions in the Bill

19. **Clauses 253 to 261** retain most of the current CO requirements and procedures applicable to buy-backs by a private company out of capital, and extend them to all companies. The requirements and procedures are similar to the new court-free procedure for reduction of capital as set out in paragraph 14 above[11]. The redemption or buy-back must be made no earlier than five weeks and no later than seven weeks after the special resolution is passed, unless otherwise ordered by the court.

20. **Clause 252** prohibits listed companies from making a payment out of capital in respect of a buy-back of its own shares on a recognised stock market or on an approved stock market because it would be impractical for them to follow all the procedural requirements.

Overseas experience

21. Singapore allows buy-backs for all companies from whatever source of funds subject to the making of a solvency statement[12] and approval by shareholders.[13] Australia similarly allows buy-backs for all companies with the approval of shareholders provided that creditors are not prejudiced[14]. In the UK, the rules are similar to those under the CO as discussed in paragraph 17 above.

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11 There are some differences though, to align the registration requirements with those for buy-backs out of profits. For example, instead of requiring the company to deliver to the CR a return in specified form after the five-week period (paragraph 14(e) above), the company will instead be required, under clause 266, to deliver a similar return, which is applicable to all types of redemption/buy-back of shares (i.e. not limiting to those financed out of capital), within 14 days after the redeemed or bought back shares are delivered to the company.

12 See section 76F of the SCA.

13 See sections 76C, 76D, 76DA and 76E of the SCA.

14 See Division 2 of Part 2J.1 (sections 257A to 257J) of the ACA.

Public consultation

22. In the topical public consultation conducted in 2008, the majority of respondents considered that the current provisions should be amended as they are fairly complex and restrictive. A large number of them supported amendments allowing all companies to fund buy-backs (regardless of the source of funds) subject to a solvency requirement in a manner similar to that of the Singapore Companies Act[15].

Allowing all types of companies (listed or unlisted) to provide financial assistance, subject to satisfaction of the solvency test and certain specified procedures (Clauses 279 to 285)

Current position

23. Section 47A of the CO prohibits a company and its subsidiaries from giving financial assistance for the purpose of acquiring shares in the company. The broad prohibition is subject to certain exceptions.

Proposal and key provisions in the Bill

24. The rules on financial assistance and the exemptions available are fairly complex and there has been general support for reform[16]. **Clause 270** retains the current definition of financial assistance. **Clauses 273 to 278** largely retain the current exceptions to the prohibition in section 47C of the CO and the special restrictions for listed companies in section 47D of the CO. The main change from the current law is to allow all types of companies (listed or unlisted) to provide financial assistance, subject to satisfaction of the solvency test and one of the three procedures set out in **clauses 279 to 285**.

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[15] See footnote 5, paragraph 43.

[16] See footnote 5, paragraphs 49 and 50.

25. The first procedure, set out in **clause 279**, provides that a company may give financial assistance if the assistance, and all other financial assistance previously given and not repaid, is in aggregate less than 5% of the shareholders' funds. The giving of the assistance must be supported by a solvency statement and a resolution of the directors in favour of giving the assistance. The assistance must be given not more than 12 months after the solvency statement is made. Within 15 days after giving the assistance, the company must notify its members of the details of the assistance.

26. The second procedure, set out in **clause 280**, provides that a company may give financial assistance if it is approved by written resolution of all members of the company. The giving of the assistance must be supported by a solvency statement and a resolution of the directors in favour of giving the assistance. The assistance must be given not more than 12 months after the solvency statement is made.

27. The third procedure, set out in **clause 281**, provides that a company may give financial assistance if it is approved by an ordinary resolution. The giving of the assistance must be supported by a solvency statement and the board must resolve that giving the assistance is in the interests of the company. The company must send to each member at least 14 days before the resolution a notice which contains all information necessary for the members to understand the nature of the assistance and the implications of giving it for the company. The assistance may only be given not less than 28 days after the resolution is passed and not more than 12 months after the day on which the solvency statement is made. **Clauses 282 to 284** provide that shareholders holding at least 10% of the total voting rights or members representing at least 10% of the total members of the company may, within the 28-day period, apply to the court to restrain the giving of the assistance. A similar threshold is present in section 47G of the CO, mainly to minimise frivolous claims.

Overseas experience

28. Restriction against private companies providing financial assistance has been abolished in the UK under the UK Companies Act 2006 (UKCA 2006)[17]. Singapore retains the general prohibition, but has introduced two additional exceptions premised upon solvency for all companies[18]. In Australia, financial assistance is allowed if the giving of the assistance does not materially prejudice the interests of the company or its shareholders, or the company's ability to pay its creditors[19]. In New Zealand, financial assistance with a solvency certification by the directors is allowed, provided that (a) there is unanimous shareholders' approval; or (b) the board discloses information to each shareholder and certifies that the giving of financial assistance is of benefit to those shareholders not receiving the benefit (any member may apply to the court to restrain the giving of the assistance) or (c) it does not exceed 5% of shareholders funds[20].

Public consultation

29. In the 2008 topical consultation and the second phase consultation on the draft CB, many respondents supported the proposal to abolish the restrictions on financial assistance for private companies, with some taking this position on the condition that a statutory duty for

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17 See paragraph 987 of the Explanatory Notes of the UKCA 2006.

18 The two new exceptions are, namely, first, the financial assistance may not exceed 10% of the total paid-up capital and reserves of the company (section 76(9A) of the SCA), or second, there is an unanimous shareholders resolution for the giving of the financial assistance (section 76(9B) of the SCA).

Both exceptions require that all directors make a solvency statement in relation to the giving of the financial assistance, and that they resolve to support the giving of the financial assistance.

The old exception (section 76(10) to (12) of the SCA) requires shareholders' approval and that the creditors would not be prejudiced. The company is also required to publish a notice in the newspaper and a member or creditor may object to the court for the giving of the assistance.

19 See section 260A(1)(a) of the ACA. A company may also give financial assistance with the approval of the shareholders or under specific exemptions (see section 260A(1)(b) and (c)).

20 The board also has to resolve that the company should give the assistance, that it is in the best interest of the company, and that the terms are fair and reasonable to the company. See sections 76 to 81 of the New Zealand Companies Act 1993.

directors to prevent insolvent trading will be introduced. On the other hand, other respondents had grave concerns over outright abolition from the viewpoint of protection of minority shareholders and creditors[21]. On balance, we consider it prudent to retain some restrictions on financial assistance for private companies, pending the introduction of insolvent trading provisions[22]. Meanwhile, we propose to streamline the financial assistance provisions, taking into account the reforms in other jurisdictions such as New Zealand (see paragraph 28 above).

Relaxing the rules on giving of financial assistance for the case of employee share schemes (Clause 276)

<u>Current provision</u>

30. The existing section 47C(4)(b) of the CO provides that the prohibition on financial assistance does not apply to employee share schemes, provided that the financial assistance is restricted to the provision of money for the purchase or subscription of fully paid shares.

<u>Proposal and key provision in the Bill</u>

31. **Clause 276** allows financial assistance for all types of employees share schemes if the assistance is given in good faith in the interest of the company for the purposes of an employee share scheme or the giving of the assistance is for the purposes of enabling or facilitating transactions to acquire the beneficial ownership of shares for the employees.

<u>Overseas experience</u>

32. This is a more flexible approach adapted from the UKCA 2006.

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[21] See footnote 6, paragraphs 11 to 22.

[22] Insolvent trading provisions will be further studied in Phase II of the CO Rewrite.

Public consultation

33. We consulted the public on the issue during the second phase consultation of the draft CB. No objection was received.

PUBLIC COMMENTS

34. We consulted the public on the capital maintenance regime and financial assistance provisions under the CO in June to September 2008[23]. We have consulted the public on the draft Bill in two phases in December 2009 to March 2010 and May to August 2010 respectively. Part 5 was covered by the second phase consultation. The public comments on our major proposals are discussed above. For other comments on Part 5 and our response, they are set out in Appendix III to the consultation conclusions issued on 25 October 2010[24].

Financial Services and the Treasury Bureau
Companies Registry
28 April 2011

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[23] FSTB, *Consultation Conclusions on Share Capital, the Capital Maintenance Regime, Statutory Amalgamation Procedure* (February 2009) (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/cmrsap_conclusion _e.pdf).

[24] FSTB, *Consultation Conclusions on Second Consultation on the Draft Companies Bill* (October 2010) (available at http://www.fstb.gov.hk/fsb/co_rewrite/eng/pub-press/doc/ccsp_conclusion _e.pdf).