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Panel on Financial Affairs

Meeting on 1 November 2010

Background brief on the Companies Ordinance rewrite

Purpose

This paper provides background information on the rewrite exercise of the Companies Ordinance (Cap. 32) (CO) and summarizes the main concerns and views expressed by members when the subject was discussed by the Panel on Financial Affairs (the Panel).

Background

2. The CO provides the legal framework which enables the business community to form and operate companies. It also sets out the parameters within which companies must operate, so as to safeguard the interests of those parties who have dealings with them, such as shareholders and creditors. The CO is one of the largest and most complex pieces of legislation in Hong Kong with over 600 sections and 20 schedules. The last major review of the CO took place in 1984. Since then, there have been amendments from time to time to keep the CO attuned to business needs. The Standing Committee on Company Law Reform (SCCLR)[1] was formed in January 1984 to advise the Financial Secretary on necessary amendments to the CO as and when experience shows such amendments are required.

3. In February 2000, SCCLR published "The Report of the Standing Committee on Company Law Reform on the Recommendations of a Consultancy Report of the Review of the Hong Kong Companies Ordinance". Initiatives to

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

implement the recommendations in the Report have been taken in the context of a series of amendment bills, most notably the Companies (Amendment) Bill 2003 and the Companies (Amendment) Bill 2004[2]. At the Panel meeting on 5 July 2004, the Administration advised that a complete rewrite and restructuring of CO was necessary to modernize Hong Kong's company law in light of the experiences of comparable common law jurisdictions and to enhance Hong Kong's competitiveness and attractiveness as a major international business and financial centre.

Organizational framework for the rewrite exercise

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

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

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

The CO rewrite exercise

7. Given the extensive nature of the rewrite exercise, the Administration has adopted a phased approach by tackling the core company provisions which affect

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

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

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

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

(a) accounting and auditing provisions;

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

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

9. Taking into account the views received, the Administration has prepared draft clauses of the CB for further consultation in two phases. The consultation documents for the first and second phases of consultation were issued on 17 December 2009 and 7 May 2010 respectively. The framework of the draft CB is given in **Appendix I**.

Deliberations of the Panel

Discussions in 2004 to 2009

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

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

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

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

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

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

Discussions on the reform proposals in 2010

11. The Administration briefed the Panel on the reform proposals contained in the draft CB on 4 January 2010 and 7 June 2010. The major objectives of the reform proposals are: enhancing corporate governance; ensuring better regulation; business facilitation; and modernizing the law. The key proposed legislative changes in the draft CB are given in **Appendix II**.

12. In both the first and second phase consultation, apart from the draft clauses of the CB, the Administration also highlighted the following issues for consultation -

Issues highlighted in the first phase consultation

(a) whether the headcount test[5] for approving a members' scheme of arrangement or compromise for listed companies, non-listed companies and creditors' schemes should be abolished, retained, or retained but allowed the court to have discretion to dispense with the test;

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

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

(d) whether the common law derivative action should be abolished once the CO has been extended to cover multiple derivative actions[6].

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

[6] Multiple derivative action allows a member of an associated company of the specified corporation (i.e. the specified corporation's subsidiary or holding company, or a subsidiary of that specified

Issues highlighted in the second phase consultation

(a) whether the restrictions on giving financial assistance by a private company for the purpose of acquiring its own shares should be abolished;

(b) whether the proposal for the CB to provide for the preparation of a directors' remuneration report in addition to the annual accounts should be dropped;

(c) proposed changes to the provisions concerning the Financial Secretary's powers to investigate or enquire into a company's affairs, as well as new provisions empowering the Registrar to obtain documents, records and information in certain circumstances; and

(d) whether a company should be required to give reasons explaining its refusal to register a transfer of shares.

13. During the discussions, Panel members expressed various concerns including the guiding principles and timeframe for the rewrite exercise, how far the reform proposals could enhance corporate governance of companies, and how a reasonable balance could be struck between the concern of imposing onerous requirements/restrictions on company activities and the need to provide adequate protection for small investors. The issues raised are summarized in the following paragraphs.

Objectives of and guiding principles for the rewrite exercise

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

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

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

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

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corporation's holding company) to take a statutory derivative action on behalf of the specified corporation.

15. Some members highlighted the need to strengthen protection of investors' interest, and pointed out that many investors had asked for enhancement of the disclosure requirements for listed companies and the legal backing for investors to seek remedies for damages arising from the misconduct of company directors. A member expressed concern that the objective of business facilitation would be pursued at the expense of the need to enhance corporate governance of companies.

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

Timeframe of the rewrite exercise

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

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

Corporate governance

19. A member expressed concern about the governance of charitable organizations, and pointed out that many charitable organizations were incorporated as guarantee companies and some operated as a trust fund. The Administration explained that under the current proposals, guarantee companies would be required to comply with more stringent disclosure requirements regarding their financial situation and submit their financial reports to the Companies Registry for scrutiny. The Law Reform Commission was also conducting a review of the legislation relevant to the regulation of charitable organizations.[7]

20. On the concern as to how the CB would codify the standard of directors' duty of care, skill and diligence and the sanctions to be imposed, the Administration advised that only general principles were stated in the proposed provisions. Such

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

principles were based on the reasonable expectations of the public and shareholders on the performance of directors of listed and private companies. Similar to the existing arrangement under the common law, any company director who had breached the provisions, if enacted, would be liable to civil litigation actions.

21. On a member's suggestion of safeguarding the interest of small shareholders by allowing them to appoint non-executive directors of companies, the Administration advised that the CO rewrite exercise was not the appropriate forum for dealing with issues purely related to listed companies. The Administration undertook to relay the proposal to the Securities and Futures Commission (SFC) for consideration in the review of the Securities and Futures Ordinance (Cap. 571) (SFO).

Headcount test

22. Some members expressed concern about the impact on protection of the interest of small investors if the headcount test was abolished. They pointed out that despite its possible loopholes/shortcomings, the headcount test served the function of safeguarding minority shareholders' interests. Members urged the Administration to work with SFC in reviewing the headcount test arrangements and measures for prevention of vote splitting, making reference to relevant arrangements in other major financial centres.

23. The Administration advised that the majority of the respondents to the first phase consultation were supportive of the abolition of the headcount test, and they included not only listed companies but also a certain number of professional associations and trade associations. The Administration would consult the views of SCCLR before deciding whether the headcount test should be abolished or other arrangements should be adopted.

Disclosure of information on public register

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

Consultancy study

25. Regarding the concern about the need of commissioning a consultant for the CO rewrite and the expenditure involved, the Administration explained that the consultant was engaged to provide expert advice on more complicated issues, such as share capital, debenture, capital maintenance rules and registration of charges,

for which there was a lack of in-house expertise in the Government. The consultant team had almost completed its work. The consultancy fee was about $14 million and no further consultancy study would be required.

Restrictions on financial assistance for acquisition of shares

26. On the proposal to abolish restrictions on private companies giving financial assistance to a party for the purpose of acquiring its own shares, a member expressed concern that the proposal would facilitate takeovers that were in favour of substantial shareholders only and were not in the interest of minority shareholders.

27. The Administration advised that some jurisdictions such as the United Kingdom had opted for the abolition of financial assistance restrictions on private companies and retained the restrictions on public companies. One major consideration was that despite the abolition of the restrictions, other means were available to protect the interests of small shareholders. In Hong Kong, there were provisions in the CO based on which small shareholders could initiate litigation to safeguard their interests. Improvements to the provisions in the CB such as codification of directors' duty of care, skills and diligence were proposed as well. The Administration was open to comments on whether the restrictions should be retained.

Directors' remuneration report

28. On the Administration's proposal of not introducing any requirement in the CO for listed or unlisted companies to prepare separate directors' remuneration reports, some members were concerned whether the proposal would be a setback and sought clarification on the Administration's stance on the requirement for listed companies to prepare separate directors' remuneration reports and whether it would seek to incorporate this requirement into the Listing Rules and / or the SFO.

29. The Administration advised that it had yet to propose amendments to the Listing Rules or SFO to include the requirement. At present, all listed companies in Hong Kong were already required to disclose in their financial statements detailed information concerning the remuneration of individual directors and past directors under the Listing Rules. No significant non-compliance with this requirement had been identified by the Stock Exchange of Hong Kong. Since the Listing Rules were non-statutory in nature, the Administration was open to further discussions on whether the requirement should be codified into statutory rules. Taking into account that most listed companies were incorporated outside Hong Kong, any initiative to legislate the requirement should be better pursued through amendments to the SFO rather than the CO.

Latest development

30. The Administration will update the Panel on the progress of CO rewrite exercise at the meeting on 1 November 2010.

Relevant papers

31. The relevant papers are available at the following link:

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

Council Business Division 1
Legislative Council Secretariat
28 October 2010

Framework of Draft Companies Bill

Part*		First Phase	Second Phase
1	Preliminary	✓	✓
2	Registrar of Companies and Register	✓	
3	Company Formation and Related Matters, and Re-registration of Company		✓
4	Share Capital		✓
5	Transactions in relation to Share Capital		✓
6	Distribution of Profits and Assets		✓
7	Debentures		✓
8	Registration of Charges		✓
9	Accounts and Audit		✓
10	Directors and Secretaries	✓	
11	Fair Dealing by Directors	✓	
12	Company Administration and Procedure	✓	
13	Arrangements, Amalgamation, and Compulsory Share Acquisition in Takeover and Share Buy-Back		✓
14	Remedies for Protection of Companies' or Members' Interests	✓	
15	Dissolution by Striking Off or Deregistration	✓	

* The titles of some Parts have been revised since the first phase consultation. The titles of Parts are provisional and subject to change.

16	Non-Hong Kong Companies	✓	
17	Companies not Formed, but Registrable, under this Ordinance	✓	
18	Communications To and By Companies	✓	
19	Investigations and Enquiries		✓
20	Miscellaneous		✓

Appendix II

Main legislative changes in the draft Companies Bill

1. Enhancing Corporate Governance

   (a) codify the standard of directors' duty of care, skill and diligence (Part 10);

   (b) restrict the appointment of corporate directors by requiring every company to have at least one director who is an individual for the purpose of improving the accountability and transparency of company operations and the enforceability of directors' obligations (Part 10);

   (c) improve disclosure of company information by requiring public companies and larger private companies to furnish a more analytical and forward-looking business review as part of the directors' report (Part 9);

   (d) strengthen auditors' rights to obtain information for performing their duties (Part 9);

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

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

2. Ensuring Better Regulations

   (a) introduce electronic incorporation and expedited company name approval process to enable companies to be incorporated within one day (Part 3)[8];

[8] The proposal has been included in the Companies (Amendment) Bill 2010, which was passed by the Legislative Council on 7 July 2010.

(b) empower the Registrar of Companies to tackle "shadow companies", including acting on court orders to direct such companies to change their names and substituting a company's name by its registration number if it fails to comply with the direction to change its name[9] (Part 3);

(c) give the Registrar powers to obtain documents, records and information for enhancing the enforcement of certain provisions (Part 19);

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

(e) streamline and update the regime of registration of charges (Part 8);

(f) remove disclosure requirements in the Tenth and Eleventh Schedules of the CO that duplicate with financial reporting standards (Part 9);

(g) update the provisions on company investigations (Part 19); and

(h) empower the Registrar to compound specified offences (Part 20).

3. Business Facilitation

(a) allow companies to dispense with AGMs by unanimous members' consent (Part 12);

(b) expedite the company name registration process so that a company can be incorporated within one day (Part 3);

(c) abolish the memorandum of association so that information contained in the memorandum of association of existing companies, such as object clauses (if any), capital statement and members' liability will be deemed to be regarded as provisions of the company's articles of association (Part 3);

(d) make the keeping and the use of a common seal optional and relax the requirement for a company to have an official seal for use abroad (Part 3);

(e) introduce an alternative court-free procedure for the reduction of share capital based on a solvency test (Part 5);

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[9] The proposal has been included in the Companies (Amendment) Bill 2010, which was passed by the Legislative Council on 7 July 2010.

(f) allow all companies to purchase their own shares out of capital subject to a solvency test (Part 5);

(g) streamline the financial assistance provisions (Part 5);

(h) allow more private companies and small guarantee companies (including those in a group) to take advantage of simplified accounting and reporting requirements so as to save their compliance and business costs (Part 9); and

(i) introduce a court-free statutory amalgamation procedure for wholly-owned intra-group companies (Part 13).

4. Modernising the Law

(a) abolish the par value regime and adopt a mandatory system of no-par for all companies with a share capital (Part 4);

(b) remove the requirement for authorised capital (Part 4);

(c) enable scripless holding and trading of shares and debentures to tie in with the scripless securities market reform (Part 4);

(d) allow electronic communications between a company and its members (Part 18); and

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