

Speech

Speech by PSFS at Hong Kong Securities Institute's Professional Development Seminar (English only)
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Following is the speech by the Permanent Secretary for Financial Services and the Treasury (Financial Services), Miss Au King-chi, at the Hong Kong Securities Institute (HKSI)'s Professional Development Seminar Meeting Your Regulators and Government Officials (MYGO) Series today (January 15):

Headcount, Company Names, Directors' Duties and Addresses... - Challenges in Rewriting the Companies Ordinance

(Barbara), (SF), distinguished guests, ladies and gentlemen,

Let me first thank the HKSI for inviting me to speak in the MYGO Series. I am delighted to have a chance to share with you a major legislative reform being pursued by the Financial Services Branch, that is the exercise to rewrite the Companies Ordinance, or CO for short. After my presentation, I would like to hear from you your comments and views on some of the topical issues raised in the rewrite, which I will talk about shortly.

Background on the CO Rewrite

The CO is the cornerstone of business operation in Hong Kong. It 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.

As one of the oldest pieces of legislation in Hong Kong, the CO has been reviewed and amended from time to time. In the late 1990s and early 2000s, the Government conducted several major reviews with a view to modernising the CO and upgrading the corporate governance regime. They resulted in

recommendations to amend various sections of the CO. Earlier last decade, we implemented some of those recommendations by means of several amendment bills. However, such a piecemeal approach to amending the CO has its limitations. A comprehensive rewrite is needed to modernise the language and concepts, improve the structure and keep us abreast with international developments. Indeed, over the past decade, some major common law jurisdictions, including the UK, Australia and Singapore, have conducted comprehensive reforms of their company laws.

The Government launched the current CO rewrite exercise in mid-2006. We hope that through the rewrite, the legal framework for regulating companies can keep pace with the times, facilitate business operation, and enhance corporate governance for the better protection of stakeholders like minority shareholders and creditors. This will in turn bring substantial economic benefits to Hong Kong, and consolidate our position as an international financial and business centre.

Attaching importance to public engagement

The CO is one of the longest and most complex pieces of legislation in Hong Kong. It has more than 600 sections and 20 schedules, even longer than the Securities and Futures Ordinance (SFO) with which you are familiar. The CO contains provisions on company formation and registration, share capital, distribution of profits and assets, accounts and audit, directors and secretaries, communications to and by companies, etc. Given the length and the scope of the CO, the rewrite is a massive exercise. To ensure that the future CO can meet the needs of the business community and public aspirations, we consider it important to gauge the views of stakeholders and the general public in the process of the rewrite. In this connection, we have benefited from the advice of the Standing Committee on Company Law Reform as well as that of our dedicated Advisory Groups, which draw members from relevant professional and business organisations, government departments, regulatory bodies and the academia. Just to share with you some figures on the consultation process: the Standing Committee has met 18 times and the five advisory groups have convened almost a hundred meetings over the past few years to discuss and consider the reform proposals. We also conducted three public consultations in 2007 and 2008 to gauge views on the more complex policy concepts. Based on

the findings of these engagement efforts, we have prepared a draft Companies Bill for a final round of consultation in two phases. Phase one commenced on December 17, 2009; whereas phase two will be launched in March.

Highlight of key changes to the CO

Many of you are directors, shareholders or senior management of your company. You will have an interest in the major changes proposed to the CO, and how these changes may affect the performance of your professional duties. Just to highlight a few of these changes. For directors, we will clarify your duties in relation to the standard of care, skill and diligence by codifying them in the new CO. We will also review the existing requirements of disclosing directors' residential addresses and personal identity numbers on the public register in view of privacy concerns.

For shareholders, the new CO will enable you to communicate more effectively and conveniently with your company through electronic means, and allow you to participate in company meetings at different places through the use of information technologies.

For the SMEs, we will allow more companies to enjoy simplified accounting and reporting requirements so as to save their compliance and business costs. You may also wish to know that we will introduce company incorporation and filing of documents on-line. Together with an expedited company name approval process, a company can be formed on-line within a day.

Of course, the rewrite exercise is not without challenges. For a number of issues, there is divergence of views among the public on how the CO should be reformed. The differences are often the result of conflicting interests. For example, while some directors may be concerned about disclosing their residential addresses on the public register, creditors and other stakeholders like employees of a company would be concerned as to how to contact the directors when a company is being wound up. Our job is to strike a reasonable balance among the diverging interests, and this is indeed the key challenge in the CO rewrite exercise. Today, I would like to focus on a few of these issues.

Discussion on a few topical issues

Headcount test

The first issue which I would like to talk about is the headcount test. Last year the PCCW case drew public attention to the current requirement under section 166 of the CO that, for a scheme of arrangement to be approved, a majority in number of shareholders must have voted in person or by proxy in favour of the scheme at the meeting. The original intention of having this headcount test is to protect the minority interests, so that the possibility of a scheme being oppressive to minority shareholders will be reduced. This case has given rise to public debates over the effectiveness and appropriateness of the headcount test. First, as a very large proportion of shares in listed companies are held by nominees and custodians, some would argue that the headcount test is not indicative of the decisions of the beneficial owners of the shares. Second, the headcount test is easily subject to manipulation by share splitting, either by the majority shareholder or offeror of the proposal, or by minority shareholders who support or oppose the scheme. Third, some may argue that Securities and Futures Commission (SFC)'s Takeovers Code already renders safeguard for minority shareholders beyond that in comparable jurisdictions. The code specifically requires that the number of votes cast against a proposal shall not be more than 10% of the voting rights attached to all disinterested shares. On the other hand, others may think that the headcount test should be preserved to give minority shareholders an effective say.

In view of these concerns, we have put forward three options for public consultation, namely, Option One - no change to the status quo; Option Two - to retain the headcount test but give the court discretion to disregard the outcome of the test; or Option Three - to abolish the headcount test.

Option Two (i.e. to retain the headcount test but give the court discretion to disregard the headcounts) needs some explanation. This is based on a legislative amendment introduced in Australia in 2007. Currently, the court may disapprove a scheme should there be evidence of vote manipulation, even if the headcount test and other voting requirements are met. However, there is no recourse to the court in the event where the headcount test is not passed

because of share splitting by parties opposing the scheme, i.e. the company is not in a position to present any scheme to the court. On the face of it, giving the court a discretion to disregard the headcounts in certain special circumstances (e.g. when there is evidence of vote manipulation) may seem to be a viable compromise. However, there may be doubt as to whether we are leaving too much to the court to decide; and also there may be concern over the uncertainty as to whether, and if so, how the court would exercise its discretion. Companies may still be deterred from proposing a members' scheme, given the time, cost and uncertainty involved.

Ladies and gentlemen, there is no obvious solution for this matter. I look forward to hearing your views during the Q and A session following my presentation for insight on how to protect the minority shareholders without unduly interfering with corporate decisions.

Company names

The second issue that I would like to talk about is company names. In recent years, we have received many complaints from owners of trademarks or trade names regarding "shadow companies". "Shadow companies" are companies incorporated with names similar to the trademarks or brand names of established local or overseas companies. These companies may pose as representatives of such trademarks or brand names, and serve as covers for manufacturers producing counterfeit products in the Mainland. The name of a shadow company may not be "too like" the name of an existing company incorporated in Hong Kong (e.g. France Crocodile Group (HK) Industry Limited, Hong Kong Mei Xin International Food Limited, etc.) In these cases, the Registrar of Companies would not be able to take enforcement action under the name registration procedure in the CO. Even if an owner of a trademark or trade name takes a passing off action against the "shadow company" and obtains a court order to direct the latter to change its name, the Registrar of Companies has no authority under the current law to take any enforcement action. As a result, the complainant often faces difficulty in enforcing the court order.

In this regard, there are calls for us to take more drastic measures to tackle the problem of "shadow companies". For example, some proposed that

the Registrar should strike off from the register a company which did not comply with a direction to change name issued by the Registrar. However, as a company will be dissolved upon being struck off the register, it may adversely affect the interests of third parties, such as employees and other creditors, and may create uncertainties over the liabilities and obligations of the company and its officers.

Having considered views received from different stakeholders, we propose to empower the Registrar to act on a court order requiring a "shadow company" to change its name, by directing the "shadow company" to do the same, or substituting its name with the company registration number if the company fails to comply with the direction.

We believe that the proposal represents a balance of stakeholders' interests. As our key trading partners like the US, the European Union, Japan and the Mainland all wish to see early implementation of this proposal, it will be included in an amendment bill to be introduced to the Legislative Council next month, ahead of the CO rewrite exercise.

On a related note, we shall also expedite the company name approval process. Currently it takes four working days for incorporating a company in Hong Kong, with more than half of the time spent by the Registrar on vetting the company names. We intend to expedite the company name approval process. A company name will be accepted for registration almost instantaneously if it satisfies certain preliminary requirements, namely, that it is not identical to another name on the register, and does not contain certain specified words or expressions that need prior official approval, e.g. trust, chamber of commerce, etc. Thereafter, if the company name is found to be objectionable, the Registrar of Companies will be empowered to direct the company in question to change its name within a specified period. The revised procedures will shorten the processing time for company incorporation from four working days to one day. This will put Hong Kong on a par with comparable jurisdictions like the UK and Singapore.

Codifying Directors' Duties

The third issue is about directors' duties. In recent years, the public has been increasingly concerned about the economic, social and environmental impact of corporate operation. It has become an international trend that business enterprises are required to take on more social responsibilities. At present, the Registrar of Companies issues general guidelines on directors' duties, whereas the Hong Kong Institute of Directors publishes guidelines which provide a detailed account on the powers, roles and duties of directors. There are views that the Government should take the opportunity of rewriting the CO to introduce statutory provisions to promote corporate social responsibility. Some have suggested that we should follow the UK Companies Act 2006 and introduce the principle of "enlightened shareholders value" through, for example, a new duty for directors to have regard to a wide list of factors, such as the interests of employees, the impact of the company's operations on the community and the environment, etc., in their decision-making.

The proposal was fairly controversial in the consultation and legislative process in the UK. We specifically highlighted the issue of "enlightened shareholders value" for public consultation in 2008. Many of the respondents expressed strong reservation, citing such reasons like heavy burden on directors, unclear requirement and compliance difficulties, and the concept of "enlightened shareholders value" not being widely accepted in Hong Kong. Noting such strong reservations, we believe that we should allow opportunities for the community to further debate the concept of "enlightened shareholders value", and keep in view overseas developments, including the UK's experience in implementing this principle.

This notwithstanding, we will seek to enhance corporate governance without placing excessive burdens on SMEs. First, we propose that public companies and large private companies should be required to prepare a more analytical and forward-looking business review as part of the directors' report. Such review may cover a discussion on the company's environmental policies and performance, including compliance with the relevant laws and regulations, and an account of the company's key relationships with employees, customers, suppliers and others. This is in line with international trends and will indirectly promote corporate social responsibility. Second, we will clarify and enhance the directors' standard of care, skill and diligence through codifying the common law rules, based on similar provisions in the UK Companies Act

2006. Third, we propose to enhance the transparency of company operations and accountability of directors through various means, such as to restrict the appointment of corporate directors by requiring every company to have at least one director who is an individual, and to strengthen auditors' rights to obtain information from a wider range of persons for the purpose of performing their duties. We will also enhance a company's engagement with its shareholders in the decision-making process by say, lowering the threshold for members to demand a poll from 10% to 5% of the total voting rights and providing members with the right to propose a resolution to be moved at a meeting.

Disclosing Directors' Residential Addresses on Public Register

The fourth issue which I would like to share with you concerns the disclosure of directors' residential addresses on the public register. Currently, for transparency purposes, such information is available for public inspection on the public register. Although we are not aware of major problems arising from the disclosure so far, we understand that people nowadays are more concerned about protecting personal data and we therefore see the need to review the existing disclosure arrangement.

It seems very logical to many people that personal information like residential addresses should not be disclosed to the public. Yet, the issues involved are not as simple and straightforward as they appear. We are facing a dilemma on whether, and if so, how such disclosure should be restricted.

On the one hand, we are mindful to protect and respect personal privacy. On the other, there is a need to maintain sufficient transparency on the identity of companies and their directors. In fact, information like directors' residential addresses is considered important for regulatory authorities or relevant stakeholders such as shareholders, creditors and liquidators to locate directors, especially in cases when a company is in trouble such as winding up, given that directors bear fiduciary obligations to their companies. On this, there is no surprise that representatives of some labour unions have expressed concern over the proposal to restrict inspection of directors' information. In fact, when we consulted the Panel on Financial Affairs of the Legislative Council last week, some Legislative Council members expressed similar concern over possible restriction.

We have studied similar reviews in other comparable jurisdictions like the UK and Australia. Their experience however shows that there are practical difficulties in implementing any system to restrict the disclosure of residential addresses of directors. Just to pose a few questions for thought --- who should have the right to access the restricted information? Should we restrict general access but exempt public authorities, creditors, and/or liquidators? How about other stakeholders such as employees? If directors are allowed to apply to the Registrar for withholding their residential addresses from the public register, what should be the criteria for the Registrar to accept such applications? How about the pre-existing information already on the register? Our register now contains more than 760,000 companies and more than a million documents are filed with the Registry each year.

We really need to think through the issues before deciding the way forward. Many of you here are directors of companies. I look forward to hearing your views for devising an acceptable solution.

Scripless

Now let me touch on the fifth issue - scripless - very briefly. Over the years, we have devoted a lot of effort in debating the need, and the best model, for pursuing a scripless securities market in Hong Kong. I am pleased to note that the SFC, Hong Kong Exchanges and Clearing Limited (HKEx) and the Federation of Share Registrars have just published a Joint Consultation Paper last month on a proposed operational model for scripless securities. This represents a renewed, and more importantly, a concerted effort among the three parties in pressing ahead this important initiative.

In brief, the proposed scripless model will allow investors to hold and transfer securities electronically, in their own names, as an alternative to scrip securities. It will be implemented gradually, allowing investors to switch from physical certificates to paperless securities at their own pace. Issuers of initial public offerings will be able to offer a scripless option.

In considering the merits of a scripless market, we should not just focus on our need today, or our need tomorrow, but the longer term need of Hong

Kong as an international financial centre, and as Mainland China's preferred testing ground for pilot schemes of new financial services as the RMB goes regional and international. We should prepare our market infrastructure for, say, the listing of RMB-denominated products on our exchanges and the participation of more diverse issuers and investors.

At present, the CO does not allow the holding and transfer of securities in a scripless mode. We shall make use of the CO rewrite exercise to remove obstacles to the introduction of paperless holdings and transfers of securities, as a clear indication of Government support for the development of a scripless market. We hope that this important, albeit small, step in the legislative process would help focus market discussions on a scripless securities market.

Structured products

Last but not the least, I would like to draw your attention to another important legislative proposal to enhance the transparency of structured products, which is relevant to the CO rewrite. The proposal is an initiative from the SFC. It involves transferring the authorisation for structured products in a debenture form from the Companies Ordinance to the Securities and Futures Ordinance. As such, the SFC will have greater flexibility to regulate unlisted structured products by setting out appropriate standards in its code, including requirements on pre-sale disclosure, ongoing disclosure, issuer eligibility and collaterals. The SFC has completed a public consultation exercise last December and we are considering the legislative proposals together with the SFC. We plan to introduce amendments to both the CO and SFO later this year to improve the current regime and enhance the transparency of structured products, ahead of the CO rewrite.

Concluding Remarks

Ladies and gentlemen, it has been a rather lengthy presentation. Given the extensive scope of the CO rewrite, I have not been able to cover each and every proposal here today. We have deposited copies of the consultation document at the door, and I would like to invite you to pick up a copy as you leave and let us have your feedback before March 16.

Our plan is to introduce the Companies Bill into the Legislative Council by December this year. Your views are valuable and would definitely help us in meeting this challenge.

In closing, I wish you a fabulous Year of the Tiger, blessed with success and good health. As I said at the beginning, I look forward to listening to your views and taking questions on the topical issues that I have raised in my presentation in the remaining time. To facilitate this process, we have distributed a short questionnaire to you for feedback.

Thank you once again for giving me a platform to share with you our latest reform initiatives.