CHAPTER 8

REGULATING DIRECTORS' FAIR DEALINGS OF PRIVATE COMPANIES ASSOCIATED WITH A LISTED OR PUBLIC COMPANY

8.1 Currently, a private company that is a member of a group of companies which includes a listed company (a "relevant private company"[99]) is in essence treated in the same manner as a public or listed company in the CO in respect of prohibitions on loans, quasi-loans and credit transactions in favour of directors or directors of its holding company or another company controlled by one or more of its directors.[100] The relevant private companies are thereby subject to more stringent restrictions than other private companies. In Part 11 of the CB, we propose relaxing the prohibitions on public companies in respect of these transactions. A new exemption will be introduced to enable public companies to make a loan, a quasi-loan or enter into a credit transaction in favour of a director or connected entity subject to disinterested members' approval.[101] Private companies will generally continue to be subject to less stringent regulations. There are, however, different views as to whether private companies associated with a public or listed company should be subject to more stringent restrictions similar to a public company. We would like to hear the public's views on this matter, before taking a final view.

Background

8.2 Sections 157H and 157HA of the CO deal with prohibitions on loans, quasi-loans and credit transactions in favour of directors, directors of a holding company and certain connected persons and exceptions to these prohibitions. Public companies and relevant private companies are subject to more stringent restrictions than other private companies in the following aspects:

(a) they are subject to additional prohibitions relating to quasi-loans and credit transactions[102];

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99 See section 157H(10) of the CO.

100 The prohibitions are extended to cover certain connected persons (e.g. spouse, child and step-child) of the directors in the case of listed companies and relevant private companies.

101 See paragraphs 24 to 27 of Explanatory Note on Part 11.

102 Sections 157H(3) and (4), which was introduced in 2003 to include more modern forms of credit, prohibits public companies and relevant private companies from making quasi-loans or entering into credit transactions in favour of their directors or other persons specified in the section.

(b) the prohibitions are extended to making loans, quasi-loans to or entering into credit transactions with persons connected with a director[103]; and

(c) they are not eligible for the members' approval exception in section 157HA(2) under which other private companies may be exempted from the prohibitions on making loans to a director etc. if the transaction is approved by members at a general meeting.

8.3 A relevant private company may be a subsidiary, holding company or fellow subsidiary of a listed company. This can include a private company owned by a holding company of a listed company although the private company falls outside the listed group under the Listing Rules.[104]

8.4 The SCCLR has recommended that the general exception of members' approval to the prohibitions on loans and similar transactions currently applicable to private companies other than "relevant private companies" should be extended to all companies (see paragraphs 7 to 9 of the Explanatory Notes on Part 11 for details). Nevertheless, as a safeguard against possible abuse by those in control, public companies will be subject to the requirement of disinterested members' approval, i.e. the resolution of a public company is passed only if every vote in favour of the resolution by the specified interested members is disregarded (see paragraphs 24 to 27 of the Explanatory Notes on Part 11). We have to consider whether "relevant private companies" should be subject to the same disinterested members' approval requirement as well as the additional restrictions stated in paragraph 8.2(a) and 8.2(b) above. Other than abolishing the concept of "relevant private company" and treating all private companies in the same manner, four possible options are set out below for consideration.

Options

Option 1: Retaining the concept of "relevant private company"

8.5 It may be argued that a private company associated with a listed company should continue to be subject to tighter regulation, given that a more stringent regulation of such private companies is desirable to further protect the interests of the shareholders, particularly minority shareholders of the

[103] It should be noted that the additional prohibitions do not apply to a public non-listed company unless it is a member of a group of companies which includes a listed company, see section 157H(8) of the CO.

[104] c.f. the terms "group" and "subsidiaries" as defined in Chapter 1 of the Main Board Listing Rules. A "group" means the issuer or guarantor and its subsidiaries, if any, and "subsidiaries" includes the meaning attributed to it in section 2 of the CO and any entity which is or will be accounted for and consolidated in the audited consolidated accounts of another entity as a subsidiary pursuant to the applicable financial reporting standards.

listed companies. It is also noted that there is similar concept of "relevant private companies" in the UK CA 2006 where "companies are associated if one is a subsidiary of the other or both are subsidiaries of the same body corporate".[105] The concept of "companies associated with a public company" in the UK is therefore similar to that of "relevant private companies" in Hong Kong. The only difference between Hong Kong and the UK approaches is that the Hong Kong provisions refer to a group of companies in which a member is a "listed" company whereas the UK model refers to companies which are in the same group as a "public" company. Notwithstanding the disinterested members' voting requirement, the extension of the members' approval exception to "relevant private companies" is already a relaxation of the existing law.

Option 2: Extending the concept of "relevant private company" to cover companies associated with non-listed public companies

8.6 As an alternative to Option 1, instead of covering private companies which are in the same group as a "listed company", we can consider following the UK approach which covers companies associated with a "public company" instead. This would extend the extra protection of shareholders of listed companies to shareholders of non-listed public companies. Nevertheless, the impact is likely to be insignificant as the number of non-listed public companies is relatively small in Hong Kong.

Option 3: Modifying the concept of "relevant private company" by disapplying it to private companies having a common holding company with a listed/public company

8.7 The current definition of "relevant private company" does not only cover private companies which are subsidiaries or holding companies of a listed company, but also any private company which has a common holding company with a listed company. This means that tighter restrictions are imposed on a private company whose holding company happens to be a majority shareholder of a listed company. There is some doubt as to whether this is justified because the listed company and its public investors have no interests in such a private company although the two companies happen to have a common majority shareholder which is a company. It can be argued that such a private company should be excluded from the concept of "relevant private company".

8.8 On the other hand, we note that any loss suffered by the sibling private company may indirectly impact on the listed company depending on the

[105] Section 256(b) of UKCA 2006.

circumstances. For instance, where the listed company had provided security for the private company's liabilities under other transactions, the damage to the financial position of the private company can trigger the listed company's liabilities. It may therefore be argued that more stringent regulation of any private company in a group containing a listed company seems justified.

Option 4: Modifying the concept of "relevant private company" to cover only private companies which are subsidiaries of a listed/public company

8.9 Another alternative is to modify the concept of "relevant private company" to cover only the subsidiaries of a public company, whether listed or unlisted. The rationale is that the shareholders of all types of public companies should be given the same level of protection and it is fair and justified to include subsidiaries of all public companies in view of the number of shareholders that may be involved.[106] Where the private company is the subsidiary, then any loss suffered by the private company (as a result of the quasi-loans, etc.) impacts on the shareholders of the listed/public holding company since the subsidiary is an asset of the holding company and there would be a diminution in the holding company's assets, with flow-on effects for the shareholders of the holding company. On the other hand, if the holding company is a private company, any loss suffered by the holding company would not have the same type of impact on the position of the minority shareholders of the listed/public company subsidiaries. Meanwhile, targeting only subsidiaries will avoid casting the net too wide to cover private companies whose holding company happens to be a majority shareholder of a listed company. As noted in paragraph 8.7 above, there is some doubt as to whether such private companies should be subject to tighter restrictions.

Question 6

On the assumption that a new disinterested members' approval exception to prohibitions on loan and similar transactions in favour of directors and their connected persons will be introduced in respect of public companies, which of the following options do you prefer?

Option 1: "relevant private companies" as defined in section 157H(10) of the CO should continue to be subject to more stringent regulations similar to public companies (including restrictions relating to quasi-loans and credit transactions, restrictions

[106] It is noted that private companies associated with a public company are subject to tighter regulation under the UKCA 2006. See sections 198(1), 200(1) and 201(1) of the UKCA 2006.

relating to connected persons and disinterested members' approval requirement);

<u>Option 2</u>: extending the concept of "relevant private company" to cover companies associated with non-listed public companies;

<u>Option 3</u>: modifying the concept of "relevant private company" by disapplying it to private companies having a common holding company with a listed/public company;

<u>Option 4</u>: modifying the concept of "relevant private company" to cover only private companies which are subsidiaries of a listed/public company; or

<u>Option 5</u>: abolishing the concept of "relevant private companies", i.e. all private companies should be subject to the same treatment.

Any other option (please elaborate)?