

Standing Committee on Company Law Reform

The Twenty-Sixth Annual Report

2009/2010

**Standing Committee on Company Law Reform (SCCLR)
Twenty-Sixth Report
Subjects considered by the
Standing Committee during 2009/2010**

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PREFACE

(i)

Terms of Reference of the Standing Committee on Company Law Reform

- (1) To advise the Financial Secretary on amendments to the Companies Ordinance as and when experience shows them to be necessary.
- (2) To report annually to the Financial Secretary on those amendments to the Companies Ordinance that are under consideration from time to time by the Standing Committee.
- (3) To advise the Financial Secretary on amendments required to the Securities and Futures Ordinance on matters relating to corporate governance and shareholders' protection.¹

(ii)

Membership of the Standing Committee for 2009/2010

Chairman : Mr Benjamin YU, S.B.S., S.C., J.P.

Members : Mr Stephen BIRKETT (from 1.2.2010)
Mrs Anne CARVER
Mr Rock C.N. CHEN, J.P. (from 1.2.2010)
Mr CHEW Fook-aun
Mr Vincent FAN Chor-wah
Mr GOO Say-hak
Mr Peter W GREENWOOD
Mr Stephen HUI Chiu-chung, J.P. (up to 31.1.2010)
Ms Teresa KO Yuk-yin, J.P.
Mr Johnson KONG Chi-how
Mr Godfrey LAM Wan-ho, S.C.

¹ The Terms of Reference have been revised following the consolidation of the Securities Ordinance and the Protection of Investors Ordinance into the Securities and Futures Ordinance and the change in the annual reporting procedure.

Mrs Catherine MORLEY
Ms Edith SHIH
Mr David P R STANNARD (up to 31.1.2010)
Mr Paul F WINKELMANN
Mr Patrick WONG Chi-kwong
Dr Kelvin T.Y. WONG (from 1.2.2010)

Ex-Officio

Members :

Mr Andrew YOUNG
Chief Counsel, Legal Services Division
The Securities & Futures Commission

Mr Paul CHOW, S.B.S. J.P. (up to 15.1.2010)
Chief Executive
Hong Kong Exchanges and Clearing Limited

Mr Mark DICKENS, J.P. (from 16.1.2010)
Head of Listing Division
Hong Kong Exchanges and Clearing Limited

Professor Edward L G TYLER
Department of Justice

Mr E T O'CONNELL, J.P.
The Official Receiver

Ms Ada CHUNG, J.P.
The Registrar of Companies

Mr Stefan GANNON, J.P.
General Counsel/Executive Director
The Hong Kong Monetary Authority

Mr John LEUNG, J.P.
Deputy Secretary for Financial Services and the Treasury

Secretary : Mrs Karen HO

(iii)

Meetings held during 2009/2010

Two Hundred and thirteenth Meeting	-	11.7.2009
Two Hundred and fourteenth Meeting	-	31.10.2009
Two Hundred and fifteenth Meeting	-	19.12.2009

EXECUTIVE SUMMARY

The Standing Committee on Company Law Reform (“SCCLR”) was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance (“CO”) and other related ordinances. In the past the SCCLR reported annually to the Chief Executive in Council through the Secretary for Financial Services and the Treasury (“FSTB”) on amendments that are under consideration.²

The main focus of the SCCLR in the past few years was on the CO Rewrite exercise that commenced formally in mid-2006 following the setting up of the Companies Bill Team (“CBT”). As consultation on the more important proposed legislative amendments had been completed, the SCCLR spent the majority of the year on two main areas. These were the consideration of a proposed corporate rescue procedure based on the framework in the Companies (Corporate Rescue) Bill 2001 and the review of the “majority in number” requirement for the approval of a compromise or arrangement in section 166 of the Companies Ordinance.

From 1 April 2009 to 31 March 2010, the SCCLR held three meetings and considered altogether 4 discussion papers and 5 papers by way of circulation, covering proposals on specific topics including the revision of the solvency test in different provisions throughout the CO and the revised proposals on company inspection and preliminary enquiry.

A summary of the recommendations/remarks made by the SCCLR is set out below :-

(I) Statutory Corporate Rescue Procedure (Chapter 1)

- The public should be consulted on a corporate rescue procedure based on the framework set out in the Companies (Corporate Rescue) Bill 2001 with modifications to some key elements.
- A majority of the members was of the view that employees’ entitlements should be exempt from the moratorium and their rights to petition to the court to wind up the company should be preserved.

² As from the year 2010/2011, the SCCLR will report to the Financial Secretary annually.

- The requirement to have a majority in number for a creditor's resolution to approve a voluntary arrangement should be highlighted in the consultation.

(II) The “Headcount” Test for Members’ or Creditors’ Sanction of a Scheme in Section 166 of the CO (Chapter 2)

- Members agreed that the public should be consulted on the proposed options for dealing with the headcount test.
- A majority of the members considered the value of shares a representation of a person's financial stake and the provisions of the Takeovers Code afforded sufficient protection to minority shareholders in the case of a takeover or privatization of a listed company.
- The implementation of a scripless securities market would not solve the problem posed by the Central Clearing and Settlement System (“CCASS”).
- A number of members expressed the view that the headcount test placed disproportionate veto power in the hands of a small number of minority shareholders.
- As for creditor's schemes, some members considered the right to petition for winding-up sufficient protection for creditors.

(III) Pre-Consultation on the Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong (Chapter 3)

- Members were generally in support of the proposal to implement a scripless securities market in Hong Kong.
- It was observed that different types of accounts had their own advantages and disadvantages.
- Some members had reservation on the benefits of the proposed operational model on shareholder transparency.

CHAPTER 1

Statutory Corporate Rescue Procedure

Background

- 1.1 In 1996, the Law Reform Commission (“LRC”) recommended the introduction of a statutory corporate rescue procedure to provide for a moratorium³ on legal action to a company in financial difficulty and to enable the company to appoint an independent professional third party to be the provisional supervisor to formulate a voluntary arrangement proposal for creditors.
- 1.2 At the 117th meeting held on 7 December 1996, the SCCLR endorsed the proposals of the LRC to introduce legislation to provide for corporate rescue and insolvent trading in Hong Kong. Bills were introduced into the Legislative Council (“LegCo”) twice in 2000 and 2001, but due to the complexity of the legislative proposals and the diverse views among the stakeholders, the proposals were not enacted.⁴
- 1.3 The corporate rescue and insolvent trading proposals were originally scheduled to be reviewed as part of Phase II of the rewrite of the CO. In January 2009, the Chief Executive’s Task Force on Economic Challenges decided to advance the review as part of the Administration’s response to the financial tsunami.
- 1.4 At the 213th meeting held on 11 July 2009, the SCCLR considered a paper prepared by the FSTB in conjunction with the Official Receiver’s Office on the review of the proposal to introduce a statutory corporate rescue procedure in Hong Kong. The proposal outlined in the paper was that the corporate rescue framework in the Companies (Corporate Rescue) Bill 2001⁵ should be put out

³ Companies that are in financial difficulties may propose an arrangement with their creditors under section 166 of the CO. The lack of a moratorium that can bind creditors while an arrangement plan is being formulated, except when a company is already in provisional liquidation, is the major deficiency with a proposed arrangement under section 166.

⁴ The LRC’s proposals were introduced as part of the Companies (Amendment) Bill 2000 but were subsequently removed from the Bill because of insufficient time to resolve the complex issues. A slightly modified version of the proposals was introduced as the Companies (Corporate Rescue) Bill 2001. The Bill was allowed to lapse in 2004 as it was not possible to complete the scrutiny of the Bill by the end of the LegCo term.

⁵ The basic framework is that there will be a moratorium period starting with the appointment of a provisional supervisor. During the moratorium there will be a stay of all civil proceedings against the company. The provisional supervisor will decide whether a proposal will be made for a

for public consultation with adjustments to the following key elements :-

(I) Employees' outstanding wages and entitlements

The following three options to deal with employees' outstanding entitlements would be set out for consideration –

- A company would be required to set up a trust account capped at the equivalent of the limits of the Protection of Wages on Insolvency Fund (“PWIF”) prior to initiating corporate rescue. (“2003 Proposal”)
- Employees who were owed arrears of wages or other statutory entitlements would be exempt from the moratorium and their rights to petition to the court to wind up the company would be preserved. (“Alternative A”)
- The arrears of wages and other entitlements subject to the PWIF limits would be treated as protected debts to be paid upon a voluntary arrangement coming into effect, with the remaining amount paid within 12 months. (“Alternative B”)

(II) Insolvent trading

- There should be an insolvent trading provision to complement the corporate rescue procedure which should apply to directors only. Senior management would be excluded from being liable under insolvent trading.
- Directors would be liable if they knew or ought reasonably to have known the company was insolvent or that there was no reasonable prospect that the company could avoid becoming insolvent.

(III) Qualifications, appointment and remuneration of provisional supervisor

- All solicitors holding a practicing certificate and certified public accountants would be eligible to be appointed provisional

voluntary arrangement with creditors which requires creditors' approval in a meeting called to consider the proposal. If approved, the provisional supervision will cease and the voluntary arrangement will take effect.

supervisors.

- The creditors would have the power to approve the appointment of provisional supervisor as well as his remuneration at the first creditors' meeting.
- A provisional supervisor would be personally liable for any contracts he entered into when performing his functions, but he could apply to the court to seek relief from personal liability if directors provided false information to him. The provisional supervisor would have 14 working days to decide whether to accept pre-existing employment contracts.
- The issue of whether to exempt the company, directors and the provisional supervisor from criminal liability under the Employment Ordinance for not fully repaying employees' outstanding entitlements until the voluntary arrangement finishes would be flagged up for consultation.

(IV) Procedural matters

- A notice of appointment of provisional supervisor would be required to be filed with the Registrar of Companies.
- The question of whether the initial moratorium period of 30 days should be extended would be highlighted for comments.
- Any extension of moratorium beyond the initial moratorium period would have to be approved at a creditors' meeting. The whole moratorium period should not be longer than 6 months.
- The provisional supervisor would be required to give notice to major secured creditors⁶ within 1 working day after the commencement of the corporate rescue procedure.

⁶ A major secured creditor is defined in the Companies (Corporate Rescue) Bill 2001 as –

- (a) the holder of a charge, whether fixed or otherwise, over the whole or substantially the whole of the company's property;
- (b) the holder of 2 or more charges, whether fixed or otherwise, on the company's property where the property subject to those charges constitutes the whole or substantially the whole of the company's property.

Recommendation

1.5 The SCCLR endorsed the recommendation that the public should be consulted on the corporate rescue procedure outlined in the paper with the following modifications :-

- The notice of appointment of a provisional supervisor should be advertised on the relevant date i.e. the last filing of notices and affidavits for the appointment of the provisional supervisor.⁷
- The period within which the provisional supervisor was required to give notice to major secured creditors should be 3 working days after the commencement of the corporate rescue procedure.⁸
- The public should also be consulted on the requirement to have a majority in number for a creditor's resolution.⁹

1.6 On the length of the moratorium, some members were of the view that the timeframe was too tight and suggested that the initial period should be 45 days and that the court should be given the power to extend the period if more time was needed.¹⁰

⁷ Under the proposed corporate rescue procedure, the moratorium will commence on the relevant date and the notice of appointment of the provisional supervisor should be published in the gazette and one English and one Chinese newspaper.

⁸ The major secured creditors will be given the power to veto a voluntary arrangement proposal within 3 working days after the receipt of the notice of appointment of provisional supervisor, or 7 days after the commencement of the corporate rescue, whichever is the earlier.

⁹ One of the key elements in the Companies (Corporate Rescue) Bill 2001 is that the provisional supervisor will call a meeting of creditors to consider whether a proposal should be made for a voluntary arrangement. To approve a proposal, there should be a majority in number and in excess of two thirds in value of the creditors present in person or by proxy and voting on the resolution. A resolution will be invalid if more than 50% in value of those creditors who are not connected with the company have voted against it.

¹⁰ The question of whether there should be extension of the moratorium beyond six months upon court approval is included in the consultation paper "Review of Corporate Rescue Procedure Legislative Proposals" issued by the FSTB in October 2009. It is also proposed that the initial moratorium period should be 45 days. The Consultation Paper is available at www.fstb.gov.hk/fsb.

CHAPTER 2

The “Headcount” Test for Members’ or Creditors’ Sanction of a Scheme in Section 166 of the Companies Ordinance

Background

- 2.1 At the 212th meeting held on 7 March 2009, discussion on a paper prepared by the CBT on the question of whether the headcount test under section 166(1) of the CO¹¹ should be abolished was deferred because of an impending court case. The case¹² was concluded in May 2009 and a second paper on review of the headcount test was prepared to seek members’ comments on a draft section to be included in a consultation paper on the draft Companies Bill.¹³
- 2.2 At the 214th meeting held on 31 October 2009, the SCCLR considered the following options put forward by the CBT in the draft consultation paper in respect of a compromise or arrangement under section 166 –
- No change to the headcount test
 - Retaining the headcount test but giving the court discretion to dispense with the test in circumstances where there was evidence that the result of the vote had been unfairly influenced by activities such as share splitting
 - Abolishing the headcount test but to consider if additional protection for minority shareholders should be provided under the CO or the Takeovers Code.¹⁴
- 2.3 Other common law jurisdictions such as the UK, Australia, Singapore, Bermuda

¹¹ The “headcount” test refers to the requirement that for a compromise or arrangement between a company and its members or creditors to be approved at a meeting ordered by the court under section 166(1) of the CO, 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.

¹² *In the Matter of PCCW Limited* (HCMP 2382/2008 and CACV 85/2009)

¹³ The consultation paper on draft Companies Bill First Phase Consultation is issued on 17 December 2009 and is available at www.fstb.gov.hk/fsb. Please see Chapter 6 “Headcount” Test for Approving a Scheme of Compromise or Arrangement.

¹⁴ Under Rule 2.10 of the Hong Kong Code of Takeovers and Mergers, a takeover or privatization scheme is considered approved if it is approved by at least 75% of the votes attaching to the disinterested shares that are cast in person or by proxy and the number of votes cast against the resolution for the approval of the scheme is not more than 10% of the votes attaching to all disinterested shares.

and Cayman Islands, all had legislative provisions similar to section 166, including the headcount test. In Australia, in order to tackle the problem of share splitting, the legislative provision¹⁵ was amended in December 2007 to give the court a discretion to approve a members' scheme if it was approved by a 75 percent majority in value even though approval by a majority in number of those members present and voting was not obtained.

2.4 The argument for retaining the headcount test was that it gave minority shareholders an opportunity to have a significant say in the future nature and structure of a company under a scheme and would reduce the possibility of schemes being oppressive to, or ignoring the interests of, minority shareholders, particularly under a provision like section 166, whereby a sanctioned scheme has the capacity to bind all members or creditors including the dissenting or apathetic ones. It would also place Hong Kong out of line with most other common law jurisdictions (e.g. Australia, Bermuda, the Cayman Islands, Singapore and the UK) if the headcount test was abolished.

2.5 The arguments for abolishing the headcount test were –

- The headcount test was inconsistent with the “one share, one vote” principle in other provisions in the CO dealing with shareholder meetings.
- As a very large proportion of shares in listed companies were held by nominees, the headcount test was not indicative of the decisions of the beneficial owners of the shares.
- The headcount test attracted attempts to manipulate the outcome of the vote by share splitting.
- The court already had a general discretionary power to reject a scheme that improperly prejudiced the interests of the minority.

2.6 Members were also asked to consider the options to deal with the headcount test for members' schemes of non-listed companies and for creditor's schemes. The factors applying to members' scheme of a non-listed company were different from those for a listed company as the use of nominees to hold shares

¹⁵ Section 411(4) of Australian Corporations Act 2001. The discretion applies to members' schemes of both listed and non listed companies, but not creditors' schemes.

was much less common in non-listed companies and the risk of manipulation by share splitting was low in view of the restrictions in the company's articles on the transfer of its shares.

- 2.7 In the case of creditors' schemes, it was less likely for small creditors who opposed a proposed scheme to manipulate the outcome of voting by assigning part of their debts to others because of the difficulty in finding assignees who were willing to take on the debts, especially as the chance of recovery as small creditors was relatively slim. Further, creditors stood in a better position than minority shareholders as they could always petition to the court to wind up the company.
- 2.8 Members noted that the headcount test posed a considerable problem in the case of listed companies because the vast majority of shares were registered in the name of HKSCC Nominees Limited ("HKSCC") under the CCASS.¹⁶ HKSCC would only cast one vote, depending on whether there were more instructions to vote "for" or "against" a motion. While beneficial owners of shares could request HKSCC to authorize themselves or another person to act as a representative so as to attend and vote at a meeting, many owners were not aware of such rights. As an alternative, a beneficial owner could choose to withdraw his shareholdings in CCASS and become a registered shareholder, but this would involve some processing time and cost.
- 2.9 Members also noted that a consultation would soon be conducted on the proposed operational model for implementing a scripless securities market in Hong Kong which could enable investors to hold their shares in their names much more easily and hence to attend and vote at a meeting of the listed company.

Recommendation/Remarks

- 2.10 A majority of the members were of the view that the value of shares was already a representation of a person's financial stake in a company and that the provisions of the Takeovers Code afforded sufficient protection to minority shareholders in the case of a takeover or privatization of a listed company. The

¹⁶ CCASS provides a computerized book entry settlement system among its participants. Shares in CCASS are registered in the name of HKSCC which is a nominee of Hong Kong Securities and Clearing Limited, which in turn is a recognized clearing house under the Securities and Futures Ordinance. Beneficial shareholders may hold their shares directly as investor participants or through their brokers/banks that are CCASS participants.

representative of SFC expressed the view that the non-statutory Takeovers Code was not a substitute for the headcount test.

- 2.11 In advance of a presentation and detailed discussion of the proposal for implementing a scripless securities market (see Chapter 3) some members expressed the view that it would not solve the problem posed by CCASS as most investors would still prefer to hold shares in the name of a nominee, primarily for ease of trading. The representative of SFC expressed the view that the scripless proposal, if implemented, would make it much easier for investors to hold their shares in their own names and exercise their voting rights accordingly.
- 2.12 A number of members expressed the view that the headcount test placed significant veto power in the hands of a small number of minority shareholders, out of proportion to their financial involvement in the company. It could result in a group of persons who together had contributed only a very small proportion of the company's equity capital having the capacity to block a scheme that was supported by the shareholders who owned substantially all of the company's shares and had a substantial amount of money at stake.
- 2.13 Some members were of the view that retaining the headcount test but giving the court discretion to dispense with the test in appropriate circumstances would create uncertainty and that would be a significant adverse factor in any proposed arrangement.
- 2.14 As for creditors' schemes, members noted that there was a difference between members' and creditors' schemes. Some members were of the view that the requirements in section 166 posed a significant obstacle in a proposed creditors' scheme. Further, as a small creditor had sufficient protection in that he could petition to the court to wind up the company if he was unhappy with a proposed scheme, the majority creditor in value should have the say in a section 166 meeting of creditors.
- 2.15 Members agreed that the proposed options to deal with the headcount test should be put out for consultation by setting it out in a separate section in the draft consultation paper. The pros and cons of each option should be set out. There should be more discussion in the paper on the implications or consequences of scripless trading.

CHAPTER 3

Pre-Consultation on the Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong

Background

- 3.1 At the 215th meeting held on 19 December 2009, the Working Group on Scripless Securities Market (“the Working Group”) comprising representatives from the Securities and Futures Commission (“SFC”), the Federation of Shares Registrars Limited and Hong Kong Exchanges and Clearing Limited (“HKEx”) conducted a pre-consultation with the SCCLR on its proposed operational model for implementing a scripless securities market in Hong Kong before the issue of its consultation paper on 30 December 2009.¹⁷
- 3.2 The Working Group proposed a dual system and a phased approach that would allow investors to choose whether to hold securities in certificated form or in uncertificated form and to convert from one form to the other. Under the proposed model, the share register would comprise two parts with all uncertificated securities held in CCASS and all certificated securities held outside CCASS. Shares held in paper form would be recorded in the certificated sub-register whereas scripless shares would be recorded in the uncertificated sub-register.
- 3.3 It was proposed that there would be different account types for an investor to hold his securities either in his own name or in the name of a nominee, including a broker/bank/custodian nominee. An investor who wished to hold his shares inside CCASS could choose from the following account types:
- CCASS Participant Account (“CPA”): The investor would hold his shares through a nominee account with his broker, bank or custodian. He would hold the beneficial interest only.
 - CCASS Participant Sponsored Account (“PSA”): The shares would be held through a segregated account with a broker, bank or custodian and the investor would be the registered holder.

¹⁷ A joint consultation paper on “A Proposed Operational Model for Implementing a Scripless Securities Market in Hong Kong” is issued on 30 December 2009 and is available on the SFC’s website www.sfc.hk.

- Investor Participant Account (“IPA”): The investor would be the registered holder.
- Issuer Sponsored Account (“ISA”): The investor would be the registered holder.

3.4 According to the Working Group, the implementation of a scripless market would bring the following benefits -

- Enhance corporate governance: By enabling investors to hold and transfer securities within CCASS and in their own names, shareholder transparency could be enhanced. Moreover, as legal owners of securities, investors would enjoy a direct relationship with issuers.
- Provide investor choice: Investors would be able to choose whether to hold their securities in paper form or in scripless form. There would also be a range of account types to choose from. The investor had the choice of holding the legal title or only a beneficial interest in the securities. He could either administer his account directly or by his broker/bank/custodian.
- Enhance market efficiency: The proposed model would increase opportunities for straight-through-processing and help improve turnaround time for corporate actions.
- In line with the global trend: A number of leading markets around the world had already implemented a scripless securities market (i.e. dematerialization) including the UK, Australia and Mainland China. It would be in Hong Kong’s interest to keep in line with this trend. Adopting dematerialization could also provide greater opportunity for future linkages with other scripless markets.
- Promote environmental friendliness: Apart from reducing the need for paper, the proposal was also in line with other similar environmental friendly initiatives such as permitting listed companies to make announcements in electronic form, and permitting corporate communications to be sent electronically.

3.5 There were four areas that the Working Group was still working on but these areas should not be an obstacle to proceeding with consulting the market on the proposal. The four areas were:

- How work should be divided between the HKEx and the share registrars in terms of providing corporate action services to market participants.
- Fees and costs: Implementation of the new model would entail cost reallocation and fee changes, but the SFC and market operators would ensure that any new fees would be reasonable.
- Multiple corporate representatives: When HKSCC no longer acted as the nominee, CCASS participants (i.e. brokers) would need to attend meetings of listed companies on behalf of their customers and some customers might want to attend the meetings in person. At present, under the CO, CCASS could appoint multiple corporate representatives. After the implementation of the new model, the law should provide similar arrangements to the CCASS participants.
- Overseas incorporated companies: The Working Group was reviewing the laws of other jurisdictions, including Bermuda, Cayman Islands, Mainland China and the UK to see whether their laws could accommodate the implementation of a scripless model. If not, an appropriate solution would have to be found to address the problem.

Recommendations/Remarks

3.6 The SCCLR considered the proposed model with the assistance of the representatives from the Working Group. Members noted the benefits that the proposal aimed to achieve and were generally in support of the proposal to implement a scripless securities market in Hong Kong. Members also noted that more study had to be carried out on some areas and agreed that this should not be an obstacle to proceeding with the consultation at this stage.

3.7 In respect of the advantages of the different types of accounts, members observed that for ease of trading, PSA should be used. In terms of anonymity, there was no difference in holding shares through IPA, PSA, or ISA. In terms of risk, PSA would have higher risks because the nominee (broker) could steal

the shares and sell them before the investor knew about it. There was in effect a trade-off between the ease of trading and security.

- 3.8 Some members expressed reservation on the benefits of the proposed model on shareholder transparency, as most investors would prefer to hold their securities in the name of a nominee for ease of trading and anonymity.