香港董事學會
The Hong Kong Institute of Directors



20 July 2010

Mr John C Y Leung JP
Deputy Secretary for Financial Services and the Treasury (Financial Services) 3
Financial Services and the Treasury Bureau
15th Floor, Queensway Government Offices
66 Queensway
Hong Kong

Dear John

Consultation Paper on the Draft Companies Bill (First Phase Consultation)

The Hong Kong Institute of Directors ("HKIoD") is pleased to submit our further views and comments on the captioned consultation paper to supplement the views and comments presented in our submission on 26 March 2010.

HKIoD is Hong Kong's premier body representing professional directors working together to promote good corporate governance. We are committed to contributing towards the formulation of public policies that are conducive to the advancement of Hong Kong's international status.

In developing the response, we have consulted our members and organised focused discussions.

Should you require further information regarding our response, please do not hesitate to contact me on tel no. 2889 9986.

With best regards

Yours sincerely
The Hong Kong Institute of Directors

Dr Carlye Tsui
Chief Executive Officer

Enc

cc: Dr Kelvin Wong, Chairman of Council, HKIoD
Mr Henry Lai, Council Member, HKIoD & Chairman,
Corporate Governance Committee

香港董事學會
The Hong Kong Institute of Directors

Issued on: 20 July 2010

**CO Rewrite - Consultation Paper on the Draft Companies Bill (First Phase Consultation) (the "Consultation Paper")**

In connection with the Consultation Paper, The Hong Kong Institute of Directors ("HKIoD") is pleased to present its further views and comments to supplement the views and comments presented in our 26 March 2010 submission.

Capitalized terms used herein but are not otherwise defined shall have the meanings ascribed to them in the Consultation Paper.

We set out our comments along the organization of issues and topics in the Consultation Paper and relevant parts of the Explanatory Note on the Draft Parts. Where appropriate, we have included our views and comments on other subject matters closely related to those issues and topics.

In making our comments herein, we have focused on the principles underlying the draft clauses in the CB.

**CHAPTER 1 INTRODUCTION**

We agree with the guiding principles of the rewrite and we look forward to working closely with the Administration and other stakeholders to achieve the intended benefits.

**CHAPTER 2 ENHANCING CORPORATE GOVERNANCE**

**Strengthening accountability of directors**

Codifying directors' duty of care, skill and diligence, and related issues
(Explanatory Notes on Part 10, para 10-20)

The HKIoD had in the past expressed its reservations over codifying directors' duties. We agree with the conclusion as stated in the Consultation Paper, that it would be premature to go down the route of comprehensive codification at this stage.

We continue to believe that one potential effect of the codification of directors' duties we need to take into consideration is the impact on the supply of quality directors. There is a strong interest in strengthening the accountability of directors on the one hand. The measures to be taken to achieve that purpose, however, must be ones that invite and encourage capable persons to step up to the fray of company directorship while at the same time appropriately shield them from liabilities for their actions and decisions.

For as long as Hong Kong remains a place to do business in, investors and businessmen will want to set up companies and all sorts of business organizations here, and there will be many director seats to be filled. If directors' duties are to be codified but the extent of liabilities flowing from such duties is not clear, that uncertainty will make many feel they are exposed and unprotected. They will be reluctant to become directors themselves. One



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

potential outcome is businessmen or investors who are capable and well-qualified to be directors, who ought to have become directors themselves, simply decide to remain behind the scene and let someone else fill those roles. Those who become directors may be in that role only because they are paid to be so, and they may not be exactly ready or prepared to meet the tasks of being a director beyond the bare minimum requirements.

If we are not able to find sufficient capable individuals willing to serve as company directors, the prospect of Hong Kong as an international financial market will also suffer. The impact may be more particularly felt in the realm of (independent) non-executive directors for listed companies. Too stringent a statutory standard may drive capable persons away from being nominated to serve as (independent) non-executive directors of listed companies.

As an international business and financial centre, Hong Kong should want capable persons to direct company affairs. Hong Kong needs directors of good quality, not just in quantity. There is a strong policy reason for institutionalizing a legal and regulatory regime that is conducive to the effective functioning of companies. The HKIoD believes a sufficient supply of quality directors is vitally important towards that end.

The current proposal is to introduce a general statutory statement on the duty of care, skill and diligence for directors that predicates on a "mixed objective/subjective standard".

We note that the objective standard is a minimum standard. It can be adjusted upwards to reflect any special skill, knowledge and experience possessed by a particular director by virtue of the subjective test, but cannot be adjusted downwards to accommodate someone who is incapable of attaining the basic standard of what can reasonably be expected of the reasonably diligent person carrying out the same function.

The HKIoD believes in professionalism in company directorships. Company directors should demonstrate core competence to meet the corporate governance demands of today. We agree with the objective standard.

On the subjective standard, there is a strong argument, in line with the value of professionalism in directorship that we advocate, that a director is and should be expected to serve their companies with their personal skills. However, the proposed subjective standard may be problematic when put into practice; for example, when a director with professional qualification has chosen to leave formal professional practice to go into business, and becomes a company director. Under what standard of knowledge, skill and experience should this director be judged? That of an "ordinary" director, or that expected of someone with equivalent tenure and seniority in his professional field? How will "the general knowledge, skill and experience that the director has" be measured?

The Consultation Paper reasons that adoption of the statutory statement is to "clarify the law and provide appropriate guidance to directors". However, the Consultation Paper also admits there is "some uncertainty as to how far the 'mixed objective/subjective test' will be applied by the Hong Kong courts".



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

Under the current proposal, the statutory statement will replace the corresponding common law rules and equitable principles, for the reason that retention of the latter may result in differing standards and hinder the development of the statutory provision. If all existing Hong Kong case law on point or relating to the issue, however scant, are to be superseded by virtue of the statutory enactment, it may result in even less guidance to directors. Until a new body of case law emerges or develops, directors will be left in a void, with so much uncertainty as to what duty they owe, how they are expected to fulfill that duty, and what will make them in breach.

Directors have good justifications to know how that statement of duty, especially the subjective standard, will be interpreted and applied. If the statutory statement is to become law, we think there should be clear guidelines on the scope and limits of the subjective test. The Administration should invite further comments from stakeholders and other interested parties on this aspect.

If the statutory statement is to become law, there should also be in place complementary measures and mechanisms to work in tandem. Directors need statutory rules or judicial doctrines that will protect them when they make good faith business judgment and decisions. They need adequate indemnification, insurance or other risk coverage to shield their exposure. They should be required to have a proper level of qualification before taking office. They should be expected to continually upgrade and improve their skills and knowledge. There should also be a widely-accepted and recognized reference to guide their conduct and behavior. We will discuss these aspects in more detail elsewhere in this document.

Business judgment rule

There should be a business judgment rule to work in conjunction with a statutory statement of duty of care, skill and diligence.

We recommend further study on whether and how to develop a formal “business judgment rule” to shield company directors from liabilities for their decisions and actions, when such decisions or actions were made on an informed basis, in good faith, in absence of conflict of interest and in the honest belief that the action was in the best interests of the company.

Without such protection, we run a major risk that few individuals with the intellect and integrity may want to become company directors, especially to serve as (independent) non-executive directors.

Among the issues to be considered is whether it is more appropriate for Hong Kong’s business judgment rule, if one is to be adopted, to be one following a presumptive formulation with burden on the plaintiff shareholder to rebut, or a safe-harbour formulation for company directors to usher proof to justify the protection.

In formulating Hong Kong’s business judgment rule, we should be mindful that it ought to be for the board of directors to manage and supervise a company, and courts are not suited to



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
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such a role. In this regard, a formulation that is objective-based and not requiring courts to delve into the merits of business decisions should be preferred.

Indemnification of directors
(Explanatory Notes on Part 10, para 21-25)

Imposing a general duty of care for directors will have an implication on directors' liabilities. As noted in the Explanatory Notes on Part 10, the uncertainty over the right to be indemnified against liabilities to third parties may deter competent persons from accepting directorships and is therefore undesirable. The HKIoD supports the proposal to set out clear statutory provisions confirming the ability of companies to provide indemnities for liabilities incurred by directors to others in the course of performing their duties.

We do recognise that an indemnity from a company may in some cases, such as when the company is insolvent, become worthless. We think it is crucial that company directors have available to them proper insurance coverage to protect themselves from liabilities. The HKIoD advocates insurance coverage for all board members.

The standard of care, skill and diligence as applied to "shadow directors"
(Explanatory Notes on Part 10, para 16-19)

Subject to our comments above, we agree with the proposal to subject "shadow directors" to the same statutory duty of care, skill and diligence as a duly appointed director. We believe every board of directors, and every individual members of a board, should be vigilant in clearly setting out the scope and limit of authority that they delegate to others.

Qualification of directors
We had in the past stated our views that the Companies Bill should also take into account the qualification of directors.

The HKIoD has long supported the promotion of corporate governance training. Corporate governance is crucial to the development of companies and the economy at large, and directors are ultimately responsible for corporate governance. The HKIoD believes all company directors, when they first assume their posts, should have a firm grounding of the skills, knowledge and qualities required to meet the corporate governance demands of today. Over time, they should strive to remain up-to-date with best corporate governance practices.

We recommend the Administration to seriously consider stipulating in the Companies Bill or otherwise to require:-

- all new appointees to the boards of listed companies to attend one or more mandatory initial training courses of specified length and content;
- by a certain date to be determined, all directors of all Hong Kong companies and all listed companies to have gone through mandatory initial training courses of specified length and content; and



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

- all directors of all Hong Kong companies and all listed companies to fulfill certain specified number of accredited hours in continuing professional development training over an annual or other appropriate periodic cycles.

The HKIoD has a continuing professional development requirement for its members. The HKIoD has been organizing and providing courses on initial directors training and for continuing professional development. We also grant reciprocal credits to appropriate course offerings or learning activities organized or offered by other institutions or professional bodies. We submit that the mandatory initial training and continuing professional development requirements are not onerous on company directors.

We also recommend the Administration to seriously consider stipulating in the Companies Bill or otherwise to give full and firm recognition of the HKIoD Code of Conduct as a framework of common reference for the conduct of directors in fulfilling their responsibilities. The HKIoD Code of Conduct is available on its official website www.hkiod.com.

Ratification of conduct of directors by disinterested shareholders' approval
(Explanatory Notes on Part 10, para 26-28)

We agree with the proposal to require "disinterested shareholders' approval" to ratify conduct of directors.

Minimum age requirement for appointment as director
(Explanatory Notes on Part 10, para 29)

We have no objection to restating the minimum age requirement. We agree that the fact of being "underage" should not operate to exempt the underage director from liability.

We, however, would like to draw your attention to our other comments on the qualifications of directors found elsewhere in this document.

Validity of acts of directors (and managers) despite defects in appointment or qualifications
(Explanatory Notes on Part 10, para 30)

We do not object to leaving out the provision regarding the validity of acts of managers. Boards should be vigilant in overseeing the management of the company, including the due appointment of its officers.

**Restricting the appointment of corporate directors**
(Explanatory Notes on Part 10, para 2-4)

The HKIoD had in the past expressed its support for the abolishment altogether of corporate directorship, subject to a reasonable grace period. We continue to believe that corporate directorships should be abolished altogether.



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

The current proposal is to restrict corporate directorship in private companies by requiring a private company (other than one within the same group of a listed company) to have at least one director who is a natural person, such to take effect after a six-month grace period. We recognise that company groups may need the flexibility of corporate directorship for entirely legitimate business and commercial purpose. We think the "at least one natural person" requirement will add some safeguard for enforcing directors' obligations and to hold company actions accountable. The natural person(s) serving as director(s) must demonstrate a firm grounding of skills, knowledge and qualities required to meet the corporate governance demands of today. Subject to the foregoing, the HKIoD will support the current proposal.

We agree with the retention of the current prohibition for a public company and a private company within the same group of a listed company from appointing corporate directors.

**Improving Transparency and disclosure of company information**

Directors' remuneration report

We note that the detailed provisions on this subject are included in the second phase consultation. We will address the issues at that stage.

Business review (forward-looking statements; safe harbors)

We note that the detailed provisions on this subject are included in the second phase consultation. We may have further comments at that stage. However, we note the following:

We are of the view that requiring (public) companies to prepare analytical and forward-looking business review as part of the directors' report may provide more information to shareholders and the investing public. However, we note that, absent proper guidance or constraints, companies may be overly-aggressive in their forward-looking business review. This can breed many litigation from disgruntled shareholders, in the form of class actions (if such a regime is introduced to Hong Kong) or otherwise. The Administration may want to consider appropriate safe harbour provisions to protect (and guide) companies as they make forward-looking statements.

**Strengthening auditor's rights**

We note that the detailed provisions on this subject are included in the second phase consultation. We will address the issues at that stage.

**Enhancing shareholders' engagement in decision-making process**

Procedures concerning written resolutions

(Explanatory Notes on Part 12, para 4-7)

We agree that an established set of rules to facilitate the use of written resolutions will enable companies and their boards of directors to reach business decisions more expeditiously and at lower costs.



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

Enhancing members' rights to require directors to circulate members' resolutions
(Explanatory Notes on Part 12, para 8-9)

We agree. Directors of a company should have the duty and responsibility to inform shareholders of the status of affairs of the company.

Company to bear expenses of circulating members' statements and proposed resolutions
(Explanatory Notes on Part 12, para 10-13)

We agree. This is in line with the proposal on enhancing members' rights to require directors to circulate members' resolutions for consideration in a general meeting being convened.

Using audio-visual technology to facilitate general meeting
(Explanatory Notes on Part 12, para 14-15)

We agree. This is in line with the aim to promote the use of information technology to facilitate communications between companies and their shareholders as well as members of the public.

Threshold requirement for the right to demand a poll
(Explanatory Notes on Part 12, para 16-18)

We agree with the proposal to lower the threshold requirement for members to demand a poll from 10% to 5% of the total voting rights. We think the change is reasonable, since it will be in line with the threshold (also at 5% of total voting rights) for shareholders to requisition an extraordinary general meeting.

Members' right to inspect voting documents
(Explanatory Notes on Part 12, para 19-20)

We agree with the introduction of statutory provisions to improve the transparency of the voting process.

Rights and obligations of a proxy
(Explanatory Notes on Part 12, para 21-24, para 40-41)

We agree with the proposal to clarify the rights and obligations of a proxy. We in particular think it is important to require the proxy to vote the way specified in the appointment of the proxy. This is necessary to avoid the disenfranchisement of shareholders by a person who is put forward as proxy deliberately failing to vote that proxy in accordance with the instructions.

Dispense with holding AGMs by unanimous members' consent
(Explanatory Notes on Part 12, para 25-27)



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

We agree with the proposal. We note that listed companies are less likely to be able to dispense with holding AGMs, but the provision will reduce the burden of many private companies (many of which are SMEs).

Request for inspection or a copy of the register of members, directors and secretaries
(Explanatory Notes on Part 12, para 28-32)

We agree with giving the court discretion not to compel compliance with a request for inspection or a copy of the register of members, directors or secretaries if the right is being abused.

Display of company name, and related matters
(Explanatory Notes on Part 12, para 33-35)

We think the proposal to empower the Financial Secretary to make the relevant regulations after the enactment of the CB is appropriate. The Administration can also consider whether that power could be given to another appropriate Principal Official instead of the FS. Rules for electronic display of company names do involve technical details and will change with developments in technology. We ask the Administration to work with experts in the field and other stakeholders when coming up with the rules initially and over time to monitor the need for changes and enhancements. At this time, it appears appropriate for the initial rules and subsequent amendments to be subject to "negative vetting". We ask the Administration to re-visit the issue in due course to see if "negative vetting" remains appropriate.

Electronic communications between the company and members
(Explanatory Notes on Part 12, para 36-37; Explanatory Notes on Part 18, para 7-16)
We fully support the introduction of rules regarding the use of new information technology to facilitate the communications between a company and its members.

Where appropriate, we encourage company boards and committees to make use of advance technology to hold meetings or to facilitate communications.

**Fostering shareholder protection - Fair dealing by directors**
Prohibitions on transactions on persons connected with a director
(Explanatory Notes on Part 11, para 3-5)

We agree with the proposal to expand the application of the relevant prohibition provisions to a wider category of persons connected with a director. We think the broadening of categories of persons to be classified as "connected entity" is appropriate.

Exemptions from prohibitions on transactions in favour of directors and connected entities
(Explanatory Notes on Part 11, para 6-9)

We agree with the proposal to extend the application of "members' approval exception" to public companies and "relevant private companies", subject to the safeguard that the



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

transactions must be approved by disinterested members. See also our response to Question 6 in our 26 March 2010 submission.

We think the two new exceptions to the prohibition (and accompanying conditions) are appropriate.

Decriminalise the prohibitions on transactions in favour of directors and connected entities
(Explanatory Notes on Part 11, para 10-12)

We agree that enforcement on the prohibition in favour of directors and connected entities need only be a civil matter.

Prohibitions on payments for loss of office
(Explanatory Notes on Part 11, para 13-16)

We agree with the extension of application of the prohibitions on payments for loss of office to prevent end-runs effectuated by payments made via other parties previously not subject to the rule.

Members' approval of a director's term of employment; Members' right to inspect records
(Explanatory Notes on Part 11, para 17-19)

We agree with the proposal to require members' approval of a director's term of employment and to require a company to keep directors' service contracts (or written memorandum of terms) available for members' inspection. We think members' approval should be required for a term of employment that exceed or may exceed three years (as proposed).

Members' approval for substantial property transaction
(Explanatory Notes on Part 11, para 20-23)

We agree with the proposal to require members' approval for a company to enter into a transaction for the purchase of a major asset from (or conversely, the sale of such an asset to) a director.

We note that there is a provision for "conditional arrangement", which allows such a transaction to be entered into conditional on members' approval being obtained but which relieves the company from liability by reason of a failure to obtain the approval (presumably after a good faith showing of reasonable commercial efforts). We think the provision on "conditional arrangement" is appropriate.

Thresholds based on percentage of a company's asset value are appropriate. But we think the dollar thresholds for triggering the operation of the substantial property transaction provisions in the case of a private company ($1,500,000) and of a public company ($10,000,000) are each too low when applied to the larger companies in the respective categories.



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

Members' approval in the case of public companies
(Explanatory Notes on Part 11, para 24-27)

We agree with requiring "disinterested members' approval" for public companies.

Widening the ambit of disclosure of material interest
(Explanatory Notes on Part 11, para 28-29)

We agree with the proposal to widen the ambit of disclosure of the nature and extent of material interest in or relating to transactions or arrangements by a director (including a shadow director).

**Fostering shareholder protection - Shareholder remedies**
(Explanatory Notes on Part 14)

Extending the scope of unfair prejudice remedy
(Explanatory Notes on Part 14, para 4-5)

We agree with the proposal to extend the scope of unfair prejudice remedy to cover "proposed acts and omissions".

Enhancing court's discretion in granting relief in cases of unfair prejudice
(Explanatory Notes on Part 14, para 6-8)

We agree with the proposal to enhance the court's discretion in granting relief in cases of unfair prejudice.

Multiple derivate action
(Explanatory Notes on Part 14, para 9-15)

We do not object to the proposal to extend the scope of the SDA provisions to allow a member of "associated companies" to bring or to intervene in an action on behalf of the company.

In our view, however, the need for the change (or the specific policy objective that the proposal intends to achieve) could have been better articulated. There is also a legitimate concern whether such proposal, if enacted, will result in a multitude of litigation that may not have a justifiable ground to proceed.

The legislative proposal was incorporated into the Companies (Amendment) Bill 2010, which has recently been passed into law by the Legislative Council. Still, it would have been more helpful to the public if the Administration had given fuller and better explanations to address the concerns mentioned above.

Please see our response to Question 7 in our 26 March 2010 submission for our views on preserving the CDA.



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

**CHAPTER 3 ENSURING BETTER REGULATION**

**Incorporation and name registration**
We support the introduction of new rules and mechanisms to make incorporation and name approval faster and more efficient. We support the introduction of new rules and mechanisms to encourage e-communication.

**Enforcement against shadow companies**
The HKIoD fully supports measures intended to empower the Registrar of Companies to tackle "shadow companies".

**Ensuring accuracy of information on the public register**
We do not express views on this subject matter at this time.

**Streamlining regulation**
We do not express views on this subject matter at this time, except as to the following:-

Removing the share qualification requirement for directors
We support the proposal to remove the share qualification requirement.

**Registration of charges**
We note that detailed provisions are included in the second phase consultation. We do not express views on this subject matter at this time.

**Improving the enforcement regime**
We generally support the measures intended to improve the enforcement regime.

Empowering the Registrar to compound specified offences
We note that the Registrar will be given a new power to compound specified offences. We understand that one rationale is to give opportunities to rectify minor non-compliance. This can help ensure SMEs meet compliance requirements without making the punishment too onerous. Nonetheless, we believe all company directors should strive to be in compliance with requirements in all aspects. In this regard, we think it would not be unreasonable for the compounding fee to be on an escalating schedule for repeated or habitual offences.

Replacing the phrase "officer who is in default" with "responsible person" and refining the definition to strengthen the enforcement regime
(Explanatory Notes on Part 1, para 7-12)

We agree with the proposal to replace the phrase "officer who is in default" with "responsible person".

We also agree with the proposal to extend the scope of "responsible person" to cover an officer or shadow director of a body corporate that is a corporate officer or shadow director of the company in breach. We recognise that company groups may need the flexibility of corporate officer or corporate directorship for entirely legitimate business and commercial



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
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purpose. We believe that the statutory regime must have sufficient safeguard for enforcing officers' and directors' obligations and to hold company actions accountable. See also our comments on corporate directorship elsewhere in this document.

Although we believe directors and corporate officers should be vigilant in meeting compliance requirements, we have reservations about the proposal that would effectively lower the triggering threshold for a breach to a "negligence" standard. We think the Administration should give further reasons to support this change before it is enacted into law.

If lower the triggering threshold for breach is deemed desirable, we recommend that the Administration consider the possibility of an alternative formulation that would have the effect of requiring a level of guilty mind beyond mere negligence, but not as high as the current "knowingly and willful" standard.

**Registration regime for non-Hong Kong companies**
(Explanatory Notes on Part 16)

We welcome the proposals to clarify the provisions on registration (and restoration) of non-Hong Kong companies, which we understand are not meant to introduce substantive amendments.

**Companies not formed but registrable under the CO**
(Explanatory Notes on Part 17)

We welcome the proposals to remove the rules on registration of joint stock companies, on the basis that no incorporated joint stock company exists and the chance of an unincorporated joint stock companies existing is remote.

**CHATER 4 BUSINESS FACILITATION**
We note that detailed provisions for issues covered in this chapter are included in the second phase consultation. We will address the issues at that stage. However, we note the following:

**Saving costs**
Simplified reporting requirements
We generally agree with the proposal to allow more private companies and small guarantee companies to prepare simplified financial reports and directors' reports. We note that detailed provisions are included in the second phase consultation. We may have further comments at that stage.

Dispense with AGMs by unanimous members' consent
(Explanatory Notes on Part 12, para 25-27)

See our comments on this topic elsewhere in this document.



香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com

**Facilitating business operations**

Statutory amalgamation procedure for wholly-owned intra-group companies

We look forward to reviewing the detailed provisions regarding the statements that are required to be made by the board of directors of each amalgamating company to verify the solvency of the amalgamating company as well as the amalgamated company.

**CHAPTER 5 MODERNISING THE LAW**

We note that detailed provisions for issues covered in this chapter are included in the second phase consultation. We will address the issues at that stage.

**CHAPTER 6 "HEADCOUNT" TEST**

Please see our response to Question 1, Question 2 and Question 3 in our 26 March 2010 submission.

**CHAPTER 7 DISCLOSURE OF DIRECTORS' RESIDENTIAL ADDRESS AND ID CARD NUMBERS**

Please see our response to Question 4 and Question 5 in our 26 March 2010 submission.

**CHAPTER 8 REGULATING DIRECTORS' FAIR DEALINGS**

Please see our response to Question 6 in our 26 March 2010 submission.

**CHAPTER 9 COMMON LAW DERIVATIVE ACTION**

Please see our response to Question 7 in our 26 March 2010 submission.

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香港德輔道中 19 號環球大廈 1008 ● 1008 World-wide House, 19 Des Voeux Road Central, Hong Kong
電話 Tel: (852) 2889 9986 傳真 Fax: (852) 2889 9982 電郵 E-mail: executive@hkiod.com 網頁 Web-site: www.hkiod.com