香港董事學會
The Hong Kong Institute of Directors

27 August 2010

Companies Bill Team
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong

Dear Sirs

Consultation Paper on Draft Companies Bill (Second Phase Consultation)

The Hong Kong Institute of Directors ("HKIoD") is pleased to forward our response to the captioned consultation paper.

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: 27 August 2010

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

In connection with the Second Phase Consultation Paper, the Hong Kong Institute of Directors ("HKIoD") is pleased to present its views and comments.

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

We set out our comments along the organization of issues and topics in the Second Phase Consultation Paper and relevant parts of the Explanatory Notes 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. We may have further comments on the drafting details at a later stage.

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 FINANCIAL ASSISTANCE BY A COMPANY FOR ACQUISITION OF ITS OWN SHARES

See our response to Question 1.

CHAPTER 3 DIRECTORS' REMUNERATION REPORT

See our response to Question 2.

CHAPTER 4 INVESTIGATIONS AND ENQUIRIES

Please see our response to Question 3 and Question 4.

CHAPTER 5 NOTICE OF REFUSAL TO REGISTER A TRANSFER OF SHARES

Please see our response to Question 5.

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Responses to specific questions

Our responses to specific questions as set out in the Second Phase Consultation Paper are as follows:-

Question 1

(a) Do you agree that the restrictions on financial assistance should be abolished for private companies?

(b) If you answer to (a) is positive, which of the following options concerning regulation of listed and unlisted public companies would you prefer –

(i) existing rules for listed and unlisted public companies in the CO be retained (i.e. listed companies cannot give financial assistance except for certain exceptions as set out in sections 47C and 47D of the CO while unlisted public companies may give financial assistance subject to solvency test and a special resolution of the shareholders (section 47E of the CO));

(ii) the rules for both listed and unlisted public companies to be streamlined using a solvency test as set out in the draft clauses in Division 5 of Part 5; or

(iii) any other option (please elaborate), having regard to the need to protect small investors of public companies?

(c) If your answer to (a) is negative (i.e. you believe that private companies should still be subject to certain restrictions on financial assistance), do you have any specific comments on the draft clauses in Division 5 of Part 5? Please elaborate.

HKIoD Response:

- As to 1(a) and 1(c):-
  - for private companies, we do not think there is strong reason for the law to stand in the way and we welcome the move to abolish the prohibition on private companies;
  - one practical difficulty in applying the rules has been in identifying what is "financial assistance" that should be banned and what should be permissible. Commercial reality has been making calls for myriads of exceptions. Over the years, various case decisions attempted to shed light but in the end they may have compounded the complexity and clouded the issues even more. It has for a long while been a case of the tail wagging the dog! Simplification is long overdue;
  - the current prohibition has in theory some use at protecting creditors but we submit it has not much effect in real. Financial assistance for purpose of acquiring a company's own shares is certainly not the only risk for creditors of a company, and among the risks that company creditors face, probably the less imminent. If the sinister purpose is to deprive creditors, there already exist plenty of otherwise innocuous corporate finance tools and devices that can be deployed to put them at a disadvantage;
  - removing the prohibition on private companies does not mean there will forever be no restraints. Proper exercise of directors' duties comes into question. Insolvent trading provisions, if enacted, will provide another check. Minority interests (and creditors) will still have recourse through other provisions in the draft CB or elsewhere;

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- if it is felt that the prohibition on private companies still serves some useful purpose not addressed by the other regulatory mechanisms mentioned above, we think the logical step is to clearly identify the villainous conduct that ought to be outlawed and make new law to address that head on. We will be making better law that way;
- if it is decided that some form of prohibitions on private companies shall remain, we can support an alternative proposal to require only that all members of a private company give consent to the subject transaction (i.e., akin to draft CB Clause 5.80, but no solvency test required). Given that there is unanimous shareholder approval, the ceiling requiring financial assistance not to exceed 5% of shareholder's funds (see draft CB Clause 5.79) need not be imposed.

➢ As to 1(b):-
- we agree listed companies and unlisted public companies should continue be subject to some form of restrictions, because there is a real issue of "public accountability" in play;
- for listed companies, we believe the better place to set out the restrictions is in the Listing Rules (and/or securities laws and regulations such as the SFO) since a large number of companies listing on the Hong Kong market are not incorporated in Hong Kong. We prefer a move towards as much streamlining as possible, although we can support the streamlined approach along the NZCA that is now being proposed;
- for unlisted public companies, we prefer a move towards as much streamlining as possible, although we can support the streamlined approach along the NZCA that is now being proposed.

➢ Additional note:-
- see also our comments on relevant parts of Explanatory Notes on Part 5

Question 2

Do you agree that there is no need to impose a statutory requirement in the CB for all listed companies incorporated in Hong Kong and unlisted companies incorporated in Hong Kong where members holding not less than 5% of voting rights have so requested to prepare separate directors' remuneration reports?

HKIoD Response:

➢ The concept behind the legislative proposal for separate directors' remuneration reports has merits. However, we note the following:-
- for listed companies, the better place for setting out the requirement is in the Listing Rules (and/or securities laws and regulations such as the SFO);
- for non-listed companies, there should be no need to impose a statutory requirement. New disclosure requirements on directors' compensation have already been included under draft CB Clause 9.27 and those should be sufficient. Organizers of new companies and members of existing companies are free to stipulate suitable requirements in their charter documents to suit particular needs.

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Question 3

Do you have any comments on the proposed changes to the provisions concerning the investigation of a company's affairs and enquiry into company's affairs that may be exercised by the FS described in paragraphs 4.6 to 4.13, the Explanatory Notes on Part 19 and Divisions 1 to 3 and 5 in Part 19 of the CB?

HKIoD Response:

- See our comments on Explanatory Notes on Part 19

Question 4

Do you have any comments on the proposed new powers for the Registrar to obtain documents, records and information as described in paragraphs 4.14 to 4.17, the Explanatory Notes on Part 19 and Divisions 1, 4 and 5 in Part 19 of the CB?

HKIoD Response:

- See our comments on Explanatory Notes on Part 19

Question 5

(a) Do you think the CB should make it obligatory for a company to give reasons explaining its refusal to register a transfer of shares?

(b) If your answer to (a) is in the affirmative, should the company be required to provide reasons with the refusal:
  (i) in the manner of the UKCA 2006 (i.e. mandatory whenever there is a refusal); or
  (ii) upon request, as in the case of transmissions by operation of law under section 69(1A) of the CO?

HKIoD Response:

- As to 5(a), we think "yes", a company should be obligated to give reasons for refusal to register a transfer of shares.
- As to 5(b):-
  - we think the obligation to give reason should be mandatory whenever there is a refusal. Share transfer restrictions are usually embodied in charter documents and/or shareholder agreements. It is not difficult for directors to determine if transfer restrictions apply and, if so, offer that as the reason for refusal. It would seem to us that, even if the directors cannot for one reason or another make a conclusive determination, raising a request to the transferee to provide further evidence could itself amount to a very acceptable reason to refuse the registration for the time being, and that practice should be considered more commercially reasonable than a blanket refusal without giving reason. A prudent transferee in a share transfer transaction would have ascertained through due diligence that the transfer is not subject to any prohibitions. A prudent transferee would also have procured the reasonable assurance and assistance of

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the share transferor to effectuate the registration of the share transfer. It should not be difficult for evidentiary proof, if so needed, to reach the directors. Prudent companies would also make effort to ensure that proper share transfer restriction legends conspicuously appear on share instruments;

- directors in a private company are often themselves shareholders of the entity. Empowering directors of a private company to refuse to register a transfer without giving a reason might be seen as incidental to the director-shareholders' prerogative to maintain some degree of control over the identity of the co-owners of the business. On the basis that share transfer restriction is more a matter of who should be co-owners of a business, we think the law should be changed to require directors to give reasons when they consider that a shareholder's wish to transfer share ownership should not be honored;
- we note that the share qualification requirement is proposed to be abolished under the draft CB. See CO Rewrite Consultation Paper, Draft Companies Bill First Phase Consultation (May 2010), Chapter 3, para 3.9-3.10;
- we also note that dubious registration requests may be much fewer in number when bearer warrants are prohibited as proposed in the draft CB.

Question 6

Do you have any comments on the draft provisions in the CB Consultation Draft – Parts 1, 3 to 9, 13 and 19 to 20? If so, please elaborate.

HKIoD Response:

- See our comments on the Explanatory Notes on the Draft Parts.

EXPLANATORY NOTES ON THE DRAFT PARTS

Preliminary

(Explanatory Notes on Part 1)

We agree with the proposed changes in this Part.

Company formation; Registration of company

(Explanatory Notes on Part 3)

Company name registration process; Shadow companies

(Explanatory Notes on Part 3, para 2-4)

We fully support measures to simplify and quicken the company incorporation process.

We fully support measures to tackle the problem of "shadow companies".

We note that the Companies (Amendment) Bill 2010 has been passed into law.

Abolishing the memorandum of association

(Explanatory Notes on Part 3, para 5-14)

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We agree there is no longer a practical need to retain the memorandum of association.

Official seal; execution of documents by a company
(Explanatory Notes on Part 3, para 15-20)

We agree with the proposal to make the keeping and use of common seal optional.

Regarding execution of documents by a company, we are of the view that to continue to place too much emphasis on the seal as sign of certainty and solemnity is to fall into the trap of form over substance.

Directors (and members) of a company should be vigilant in setting out the scope and limit of authorities that they delegate to others, and in ensuring that internal management and control procedures have been established and followed.

Company re-registration
(Explanatory Notes on Part 3, para 21-24)

Alterations affecting status of private companies
We agree that the documentary requirement under the Second Schedule of the current CO is unnecessarily complicated and we support the proposal to simplify.

The annual financial statement now required under Clause 3.33 shall be one that conforms to draft CB Clause 9.24; we think this is appropriate.

Unlimited companies registering as limited
Under the draft CB, an unlimited company may only register as a "company limited by shares". The plausible option to re-register an unlimited company into the draft CB category "company limited by guarantee without share capital" is not part of the draft CB. The reason has not been expressly stated in the Second Phase Consultation Paper, and we think there may be a need for the Administration to further explain the rationale.

We note, nonetheless, that the categories of "private/non-private unlimited companies without share capital" now provided for in the current CO are proposed to be abolished in the draft CB, because currently there are no such companies and it is felt unlikely that such companies will be formed in future. See CO Rewrite Consultation Paper, Draft Companies Bill First Phase Consultation (May 2010), Explanatory Notes on Part 1, para 2-6.

Statutory protection for persons dealing with a company
(Explanatory Notes on Part 3, para 25)

We agree with introducing statutory protection for persons dealing with a company, in addition to the common law indoor management rule (otherwise known as the rule in *Turquand's* case).

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We agree *Turquand* should remain good law. Boards/directors should be vigilant in managing the powers and authority they delegate and in ensuring that proper internal management and control procedures are established and followed.

The form of protection embodied in draft CB Clause 3.56 is appropriate.

We think the exception embodied in draft CB Clause 3.57 is reasonable.

On the exception presented in draft CB Clause 3.58, we have some thoughts and comments.

Why treat section 21 companies differently?
Draft CB Clause 3.58 provides that the form of statutory protection under draft CB Clause 3.56 shall not apply in certain circumstances to a transaction or act of company permitted to be registered by name without "Limited" (i.e., those "section 21 companies" as they are now known, and which will continue to be formed or be in existence under draft CB Clause 3.42). The exception in 3.58 instead provides a slightly mollified form of protection for outside parties in that it prevents the section 21 company from being bound by a transaction or act if the outside person "knows" about the nature of the company and that the transaction or act exceeds the limitations on the powers of the company or its directors.

It is government policy to encourage social enterprises. Some of them may well be section 21 companies in form but their operation and outward appearance may appear to outsiders as just like any other commercial profit-making entities. There may actually be good and just arguments for vendors and customers of these social enterprises to be afforded nothing less than Clause 3.56 and *Turquand* protection.

We submit that the *Turquand* and Clause 3.56 protection should better be viewed by parties to a transaction as a necessary safety net. Notwithstanding the common law and statutory protection, any person dealing with any counterparty company should conduct such due diligence and obtain such evidence or assurance to be satisfied that the counterparty company has duly authorized the company act in question. For those outside parties who follow good practice and conduct proper due diligence when dealing with counterparty companies, whether or not section 21 companies, the exception in draft CB Clause 3.58 may not make a big difference.

The concern for us is the exception under draft CB Clause 3.58 must not slip to become a let-off for section 21 companies to condone poor in-house management and improper internal control.

Section 21 companies are often formed for charitable purposes. As such there may be an interest in ensuring that the precious monies or assets of these companies are properly applied to achieve the avowed charitable objectives and not be wasted or plundered by careless, irresponsible, even unscrupulous persons occupying directorships or similar positions in these organizations.

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Not applying in full the rule in 3.56 as against section 21 companies might have a beneficial effect in helping protect the precious monies and assets of charitable organizations. The HKIoD asserts that, in so doing, we should not be sending out a wrong message that society can or should tolerate less vigilant, less competent directors or lesser corporate governance in charitable organizations.

Organizers and members of charitable organizations have as good reasons as profit-making organizations to want capable persons who can meet corporate governance demands of the day to take up directorships. These directors have as much duties and necessity as their counterparts in business enterprises to set up proper in-house management and internal control procedures.

Attorneys to execute documents in Hong Kong or elsewhere
(Explanatory Notes on Part 3, para 26-27)

We agree with the widening of the application of the current CO s34 to allow companies to empower attorneys to execute documents in Hong Kong or elsewhere.

Share capital
(Explanatory Notes on Part 4)

No par shares
(Explanatory Notes on Part 4, para 3-13)

We strongly agree with the introduction of legislation enabling "no par" share capital. The proposal to effect mandatory conversion on an appointed day no less than 24 months after the enactment of the CB is reasonable.

Rather than a mandatory system of no par, however, another plausible option would have been to respect the freedom of individual Hong Kong companies to opt for par value or no par as they see fit. Though the world trend may be towards "no par", we see no strong reason to not accommodate par value shares. Hong Kong should make itself a jurisdiction where companies incorporating here have much freedom to design their company characteristics, including capital structure, unless there is a compelling public policy reason or interest to restrict freedom.

A large number of companies listing in Hong Kong are not incorporated locally. They may have chosen or be required to have share capital with par value. Hong Kong businesses may be setting up associate companies in other jurisdictions. These may have or may be required to have par value shares. The introduction of a mandatory no par system for Hong Kong incorporated companies will not necessarily achieve the purpose of "greater clarity and simplicity", since the Hong Kong business community and investors will necessarily have to deal with companies that may or may not have par value shares.

Repealing company's power to issue share warrants to bearer
(Explanatory Notes on Part 4, para 14-15)

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The Second Phase Consultation Paper cites anti-money laundering as one rationale for removing a company's power to issue share warrants to bearer. We agree this is one rational basis and very strong reason for repeal.

We also believe that banning bearer warrants has another benefit in not attracting unwanted suspicion that Hong Kong is a tax haven.

It appears to us that some jurisdictions (such as the British Virgin Islands) have a registration and approved custodian depositary requirement to handle bearer certificates. This could be an acceptable half-way alternative that the Administration can consider.

Shareholders' consent for grant of rights to subscribe for shares or securities convertible into shares
(Explanatory Notes on Part 4, para 16-19)

We recognize the directors' power to allot shares or securities convertible into shares is and should generally be subject to shareholders' consent. We agree with the general principle that shareholders should have given prior approval to such allotment.

The current proposal preserves the two existing exceptions relating to rights issue and allotment to founder members, respectively. We agree.

The one additional exception relating to bonus issue of shares is also appropriate.

We agree that, once there is shareholder approval for the grant of the right, there is no need for further approval of the allotment of shares pursuant to that option or right.

The provision for the expiry for the shareholder approval to accommodate companies holding AGMs and those who choose to dispense with AGMs is appropriate.

Class rights
(Explanatory Notes on Part 4, para 20-22)

We agree with the general principle that class rights should mean those rights of holders of shares in a class of shares as members of the company (draft CB Clause 4.45), and that shares are in a class if the rights attached to them are "uniform" in material respects (draft CB Clause 4.46).

We agree with the proposal to exclude the second and third categories of rights referred to in paragraph 20 from the concept of class rights for companies with share capital.

We agree with the provisions in Clause 4.54 and 4.55 regarding class rights for companies without a share capital.

Variation of class rights for companies without share capital
(Explanatory Notes on Part 4, para 23-25)

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The draft CB contemplates companies without share capital. It is essential to extend statutory provisions for variations of class rights to cover companies without share capital.

Requirement to deliver statement of capital upon change to capital structure
(Explanatory Notes on Part 4, para 26-27)

We agree with the requirement for a company to deliver to the Registrar a statement of capital whenever there is a change to its capital structure.

Express power to re-denominate share capital currency
(Explanatory Notes on Part 4, para 28-32)

We agree there is a practical benefit to provide for redenomination of share capital.

Repeal company's power to convert shares into stock
(Explanatory Notes on Part 4, para 33-35)

We agree there is no practical need to retain the concept of "stock" in the CB. We believe abolishing "stock" does not materially affect companies' freedom to design their own capital structure.

Requirement to register an allotment in register of members within specified period
(Explanatory Notes on Part 4, para 36-37)

We agree.

Refusal of registration of shares transmitted by operation of law
(Explanatory Notes on Part 4, para 38)

We agree with the new requirement for a company to send a notice of refusal of registration to a person to whom shares are transmitted by operation of law.

See also our response to Question 5.

Replacement of lost share certificate in respect of listed companies
(Explanatory Notes on Part 4, para 39-41)

We agree with the heightened threshold amount and the requirement to make a website announcement in a form and manner that is compliant with Listing Rule requirements.

Transactions in relation to share capital
Uniform solvency test for different transactions under this Part
(Explanatory Notes on Part 5, para 4-7)

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Subject to our response to Question 1, we agree with the introduction of a uniform solvency test for the three categories of transactions under this Part: reduction of capital; buy-backs; and financial assistance (in the event a "solvency test" approach is adopted or applicable).

For the content of the solvency test, draft CB Clause 5.3 essentially follows the approach of current CO s47F(1). The requirement of an auditor report under current CO s49K(5) will be replaced by a solvency statement.

We note that the solvency test currently used in Hong Kong is essentially a "cash flow test". We can see some merits in modifying the test to include a balance sheet test, but we also know that there were objections. We ask the Administration to give further explanations to justify its conclusion not to include a balance sheet test.

We note the heightened requirement under draft CB Clause 5.4 that each company director (versus a majority under the current CO) will have a responsibility (with accompanying liability) to determine and affirm the company's solvency and each will have to sign a solvency statement. Directors individually and collectively should seek to understand the financial affairs of their companies. Directors individually and collectively can seek professional assistance (and place reliance on such to the extent appropriate or permissible) when making the determination. Nonetheless, a "full board certification" requirement may instead be counterproductive. It may result in few companies being able to take advantage of the simplified procedures because just one director, whether out of groundless fear or out of educated caution, refuses to provide the certification. We are of the view that less than full board certification is sufficient. Shareholders will have to decide and that is certainly a suitable level for such decisions to be made. Minority interests (and creditors) will still have recourse through other provisions in the draft CB or elsewhere.

Alternative court-free procedure for reduction of capital based on solvency test
(Explanatory Notes on Part 5, para 8-11)

We agree with the introduction of a court-free procedure for reduction of capital based on solvency test, as an alternative to the current court-sanctioned procedure.

Share buy-back for all companies out of capital
(Explanatory Notes on Part 5, para 12-14)

We welcome the proposal to extend to all companies the application of provisions (which are based on a solvency test) now only applicable to private companies to fund buy-backs out of capital. We note that listed companies will not be allowed to make a payment out of capital in respect of a purchase of its own shares on the stock exchange.

We note that companies will continue be able to redeem or purchase its own shares out of distributable profits or out of the proceeds of a fresh issue of share.

Financial assistance to a company for purpose of acquiring its own shares
(Explanatory Notes on Part 5, para 15-20)

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See our response to Question 1.

Share scheme exception to giving financial assistance
(Explanatory Notes on Part 5, para 21)

We agree with the change.

Standardising definition of net assets in financial assistance
(Explanatory Notes on Part 5, para 22)

We agree, for purpose of Division 5 of Part 5, with the proposal to adopt the definition set out in s47D(2) but not the definition set out in s47B(2) (which cross references s157HA(15)).

Distribution of profits and assets
(Explanatory Notes on Part 6)

We support the conclusion not to adopt a general solvency test in place of the capital maintenance doctrine. We note that, by virtue of other provisions in Part 5 of the draft CB, the solvency test rather than the provision in Part 6 will govern certain forms of "distributions" to shareholders.

We note the technical amendments under this Part 6 and think they are appropriate.

Debentures
(Explanatory Notes on Part 7)

We agree with the scheme to group all substantive provisions on debentures together.

We also agree with the scheme to align the provisions on debentures with the corresponding provisions for shares.

The new requirement to register new allotment of debentures is appropriate.

The proposal to allow holders of 10% of the value of debentures belonging to the same series to apply to the court to order a meeting and give directions to the trustee is appropriate. (Under the proposal, a particular trust deed may exclude or require a higher percentage. This should give companies sufficient freedom and leeway to set up debenture programs that suit their needs.)

We note that current CO s75A and s79 will not be re-enacted but will be considered during Phase II of the CO Rewrite to take place after the enactment of CB. We think this is appropriate.

Registration of charges
(Explanatory Notes on Part 8)

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We do not express views on this subject matter at this time.

Accounts and audits
(Explanatory Notes on Part 9)

We generally support changes that will reduce the compliance burden on more number of private companies (many of them small and medium sized enterprises) and smaller guarantee companies.

Why not an option for early adoption?
(Explanatory Notes on Part 9, para 2)

The current proposal is for the financial year of a company that begins before or straddles the commencement date of Part 9 to be governed by the existing CO. We think a company should have the option to elect "early adoption" of Part 9 (as enacted) for the financial year that ends after the commencement date of Part 9.

Accounting reference period
(Explanatory Notes on Part 9, para 3-8)

We agree with the proposal to stipulate a first accounting reference period of not more than 18 months for companies incorporated on or after the commencement of the new companies ordinance.

We agree with the proposals relating to "first accounting reference periods" and "subsequent accounting reference periods" for existing companies.

We agree with the proposal relating to a company's "financial year".

Simplified financial reports; Simplified directors' reports
(Explanatory Notes on Part 9, para 9-18)

Private companies
We agree with the proposal to relax the qualifying criteria for private companies to prepare simplified financial reports and simplified directors' reports.

We agree with the thresholds for "small private company" automatic qualification.

We note that the current prohibition preventing a company that owns and operates ships or aircraft engaged in the carriage of cargo between Hong Kong and a place outside Hong Kong from relying on current CO section 141D will be removed. We welcome the move.

We agree with the retention of the general requirement that companies seeking simplified reporting must be entities that do not have "public accountability".

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The current proposal states that private companies that do not qualify as a "small private company" can take advantage of simplified reports if members holding at least 75% of the voting rights so resolve and no other member objects. The 75% super-majority and "no other member objects" requirement is mirrored in situations where a group of companies that do not qualify as a "small group" seeks to take advantage of simplified reports. A super-majority of 75% is already a high threshold and we ask if the "no other member objects" provision would translate into an unnecessarily high veto power even if the aim is to protect minority interest. One possibility is to eliminate the "no other member objects" provision but set the super-majority to a level higher than 75%.

Companies limited by guarantees

We agree with the proposal to relax the qualifying criteria for guarantee companies to prepare simplified financial reports and simplified directors' reports. Guarantee companies are required to file annual return but to require all these companies to follow HKFRS could be too burdensome on many of the smaller entities.

We agree with the HK$25 million annual revenue bright line test for guarantee companies.

Companies not incorporated in Hong Kong

So long as not inconsistent with specific requirements imposed by the law of the entity's place of incorporation, or the Listing Rules or securities laws and regulations (to the extent applicable), we believe companies not incorporated in Hong Kong should be permitted to adopt SME-FRF in the same way as companies incorporated in Hong Kong.

Three-tier accounting system

The HKFRS for Private Entities is intended to be applicable to all companies and businesses that do not have public accountability but do not or cannot apply SME-FRF&FRS. We agree with the three-tier accounting system comprising full HKFRS for publicly quoted companies, simplified HKFRS for private entities with no public accountability, and SME-FRF&FRS for SMEs meeting threshold requirements.

<u>Aligning statutory accounting requirements with accounting standards</u>

(Explanatory Notes on Part 9, para 19-26)

We agree with the principle of aligning statutory accounting requirements with accounting standards. We agree the statutory accounting requirements can "incorporate by reference" applicable accounting standards prescribed by regulation. We support the proposal to repeal the Tenth and Eleventh Schedule but only retain those public interest disclosure requirements not specifically covered by prescribed accounting standards.

The proposal to align the requirement for financial statements to show "true and fair view" deserves further thought and consideration. We understand that the SME-FRF&FRS is intended to be a compliance framework, and that it requires less detailed disclosure. For these reasons, financial statements so prepared may not be able to show a "true and fair" view. We also understand that current standard on auditing would only permit auditors to express whether financial statements are prepared in all material respects in accordance

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with the SME-FRF&FRS framework. These may be real and present obstacles to the proposal embodied in para 25. We suggest that the Administration engage in further discussions with auditing practitioners to find the way forward.

Comprehensive directors' reports with analytical and forward-looking business review
(Explanatory Notes on Part 9, para 27-32)

Generally
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). Since there is the possibility to opt for simplified reports in accordance with other provisions of the draft CB, we think this will not impose a heavy burden on too many small, private companies.

Guidance, constraints and safe harbor?
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 harbor provisions to protect (and guide) companies as they make forward-looking statements.

Use of non-GAAP measures
Among the various items that should be included in a business review is "analysis using financial key performance indicators" for purpose of "a balanced and comprehensive analysis of the development, performance or position of the business of the company".

To the extent that financial key performance indicators can provide more useful information to shareholders and investors, we want to encourage their use. Numerical measures are quite a common form of financial performance indicators, but these numerical measures do not necessarily all comport with generally accepted accounting principles. Such non-GAAP measures can still serve useful purposes and be valuable to shareholders and investors. For instance, there may be a need to make period-to-period, and in some cases entity-to-entity, performance comparisons with numerical measures that exclude the effects of unusual events (e.g., mergers, restructuring).

But the use of non-GAAP measures can also cause much confusion and even be a tool to mislead so as to become a fraud on shareholders and investors.

Any use of non-GAAP measures to mislead or to sustain a fraud should be outright prohibited. Where use of non-GAAP measures is permissible, there should be a requirement to present such measures together with the most directly comparable GAAP measure, a reconciliation of the differences between the two measures and a statement of the reasons why the company believes the non-GAAP measures are useful or necessary.

Business review to include environmental and employee matters

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We agree that the inclusion of environmental and employee matters can provide more useful information to shareholders. Inclusion of such items is required (or expected) if "having a significant impact" on the company. But how should the significance of impact be measured?

Enhancing auditors' rights
(Explanatory Notes on Part 9, para 33-37)

We generally agree that reliable financial reporting predicates on auditors having access to information and assistance in the proper performance of their work. However, the proposal to require a wider range of persons to provide them with "information, explanations or assistance as they think necessary" could be seen as too broad and open-ended. The scope of application may have to be narrowed, the wording in the draft CB clauses may have to be made more specific. At the least some guidance on interpretation is in order.

We can support a proposal to make it an offence for a failure to comply with the obligation to respond to the auditor's request for information that is reasonably necessary for the performance of an auditor's duties in like circumstances. It might be an over-reach to subject all employees to potential criminal sanctions regardless of their level of seniority, specific job duties, or knowledge of facts/circumstances in relation to the issue for which information is being sought by the auditor. We recognize that an ex-employee could have information that is essential to the performance of an auditor's duties. But again, whether any ex-employee should be subjected to potential criminal sanctions must be considered in light of whether the ex-employee reasonably has any close connection or any specific knowledge/circumstance in relation to the issue for which information is being sought by the auditor.

Many Hong Kong companies have subsidiaries incorporated and operating in other jurisdictions. It is conceivable that the laws and regulations of those jurisdictions would prevent information, no matter how reasonably required by the Hong Kong parent company's auditor, from being provided. But this could still cause the Hong Kong parent company to be in breach of the requirement to provide information.

We agree it is important to ensure effective and continuous oversight of a company despite a change in auditor. To provide that an outgoing auditor does not contravene any duty just because he gives "work-related information" to an incoming auditor is appropriate.

Cessation of office of auditor
(Explanatory Notes on Part 9, para 38-41)

We agree with the proposal to expand the auditor's right to make and request for circulation of a "cessation statement", and the mandatory requirement to make "statements of circumstances".

We agree that auditors should be given the "qualified privilege" for statements made in the course of their duties as auditors, including "cessation statements" and "statements of

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circumstances". We note that an auditor's qualified privilege can be vitiated by malice on the auditor's part.

Appointment and re-appointment of auditor
(Explanatory Notes on Part 9, para 42-45)

We agree with the introduction of provisions for an "appointment period" and "deemed re-appointment" to deal with situations where the AGM is dispensed with.

Summary financial reports
(Explanatory Notes on Part 9, para 46-48)

We support the proposal. We note that the form and contents of summary financial reports will be prescribed. We may have further comments at that stage.

Directors to make declaration re financial statements
(Explanatory Notes on Part 9, para 49-50)

We agree. Company directors should strive to understand and be familiar with the financial affairs of the company.

New offences relating to contents of auditor's report
(Explanatory Notes on Part 9, para 51-53)

We ask how the new offences introduced under Clause 9.52(1) will operate alongside the sanctions that may be imposed under the Professional Accountants Ordinance.

We think it may not be appropriate to hold employees who are not licensed professionals criminally accountable for errors and omissions that should be the responsibility of licensed professionals.

Arrangements, amalgamation, and compulsory share acquisition in takeover and share buy-back

Schemes of arrangements, takeovers and share buy-backs
(Explanatory Notes on Part 13, para 4-5)

We agree with the proposal to extend scope of current CO s167 to cover all companies liable to be wound up under the current CO.

Revising the definition of "property" and "liabilities" under current CO s167(4)
(Explanatory Notes on Part 13, para 6-8)

We agree with the proposal to revise the definition of "property" and "liabilities" so to enable the transfer or assignment of personal rights and duties pursuant to a current CO s167 transfer order.

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Clarifying meanings of "offer" and "shares to which the offer relates" in situation of a "takeover"
(Explanatory Notes on Part 13, para 9-13)

We agree with the proposal.

Petition to court for authorization to issue "squeeze out" notices
(Explanatory Notes on Part 13, para 14-16)

We support the proposal. We agree with the "unable to trace after due inquiry" and the "fair and reasonable consideration offered" preconditions, and the general requirement that such authorization only be given if "just and equitable".

Situations where revised offer can be treated as original offer
(Explanatory Notes on Part 13, para 17-19)

We agree with the proposal to enable a revised offer, each in the context of a buy-back and a takeover, to be treated as the original offer if such revision is contemplated in the original offer.

Court-free statutory amalgamation procedure
(Explanatory Notes on Part 13, para 20-23)

We agree generally the proposal regarding the court-free statutory amalgamation procedure. It is appropriate to limit the court-free procedure to amalgamations of wholly-owned intra-group companies.

We think it is appropriate to exclude companies with floating charges subsisting over their respective assets from applying the court-free statutory amalgamation procedure.

We agree with the requirement of a solvency statement from the board of each amalgamating company confirming the absence of floating charges and to verify solvency.

We agree with the requirement that each amalgamating company obtain its shareholder approval by special resolution.

Investigation and enquiries
FS power to appoint inspector
(Second Phase Consultation Paper Chapter 4)

We agree to retain a power to appoint an inspector along the lines of current CO s142 and s143. We note that under the draft CB the appointment shall only be made if "significant or great public interest" is involved.

The FS is a suitable candidate, but we also think the Administration can consider vesting the power in another appropriate Principal Official.

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Threshold for application to FS for appointment of an inspector
(Second Phase Consultation Paper Chapter 4, para 4.12-4.13)

The threshold for members to make application for appointment of inspectors (100 or one-tenth) under current CO s142 will be retained with no change. We agree.

Enhancing investigatory powers of an inspector
(Explanatory Notes on Part 19, para 4-9)

We agree with the new power and sanctions proposed to be introduced.

Extending categories of companies that may be subject to investigation
(Explanatory Notes on Part 19, para 10-13)

We agree there is good reason to extend a broader coverage of companies that may be subject to investigations by an inspector to include companies incorporated elsewhere that are doing business in Hong Kong (whether or not registered or having a place of business in Hong Kong) and any other companies within a group comprising such companies, wherever incorporated.

We agree the appointment of inspectors on application of members should be extended to cover non-Hong Kong companies registered under Part 16.

Better safeguards for confidentiality of information
(Explanatory Notes on Part 19, para 14-17)

We welcome the proposed provisions to enhance confidentiality of matters or information obtained pursuant to an investigation or enquiry into a company's affairs. The introduction of a statutory "gateway" provisions along the lines of SFO s378, FRCO s51 and Banking Ordinance s120 is appropriate.

Protection of informer in the form of immunity from liability for disclosure is a useful tool in appropriate circumstances. We can also support further protection for informers by keeping their identity anonymous in appropriate cases. The discretion to employ these devices must be used with great caution, however, to prevent abuse and unjust results.

New but limited power for Registrar to make enquiries
(Explanatory Notes on Part 19, para 18-21)

We agree with the introduction of a new but limited power for the Registrar to obtain documents, records and information for the purposes of ascertaining if an offence has been committed in respect of false information in documents delivered to CR.

Minor improvements of the law
(Explanatory Notes on Part 19, para 22-31)

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We generally agree with the proposed changes.

Miscellaneous
(Explanatory Notes on Part 20)

Widening the scope of offence for false statement
(Explanatory Notes on Part 20, para 2-6)

We agree with the extended scope of offence under draft CB Clause 20.1.

Empowering the Registrar to compound certain offences
(Explanatory Notes on Part 20, para 7-17)

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. The Registrar can be further empowered to exercise discretion to reduce the escalated penalty as justice and circumstance might warrant.

Widening the categories of companies that may be required to give security for costs
(Explanatory Notes on Part 20, para 18-22)

We do not offer our views on this subject matter at this time.

Power of Registrar to require defaulting company or officer to make good the default
(Explanatory Notes on Part 20, para 23-25)

We think the proposal is reasonable.

Applications of time limitation provisions
(Explanatory Notes on Part 20, para 26)

We do not offer our views on these subject matters at this time.

Power to District Court to direct the application of any fine imposed
(Explanatory Notes on Part 20, para 27)

We do not offer our views on this subject matter at this time.

Empowering the FS to make regulations
(Explanatory Notes on Part 20, para 28)

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We think the Administration can consider vesting the power in another appropriate Principal Official.

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