THE LAW SOCIETY OF HONG KONG 香港律師會

The FSTB and Companies Registry Consultation Paper

Subsidiary Legislation for Implementation of the new Companies Ordinance – Phase One

Law Society's submissions

1. Companies (Summary Financial Reports) Regulation

General observation

Generally, subject to our comments below, we agree with the proposal to clarify and explain in more detail the forms and contents of summary financial report and various notices (i.e. notice of intent, notice of revocation and notice of cessation of statutory election) in the subsidiary legislation.

Regulation 2

We suggest the expression "*reporting documents*" (defined in clause 2(2)) be moved into the definitions section (clause 2(1)). It is not easy to find it in its current location.

Regulation 2(1)

The definition of "*potential member*" is vague and it would be difficult to clearly determine whether a person is a potential member or not. Also, a company may have difficulties in practice to ascertain whether a person is a potential member or not as the person's name may not appear in its register of members and the company may not be notified of the existence of the potential member (e.g. a person may become a potential member because he/she has entered into a private arrangement with a shareholder to acquire shares of the company and the company may not be informed of such private arrangement).

Regulation 2(2)

Please add the word "*and*" at the end of subsection (b) as follows:

"*the directors' report for the financial year; **and***"

Regulation 4(1)

We would suggest adding the phrase "*to the effect*" as follows:

"*If the auditor's report of a company contains a statement **to the effect** that, in the auditor's opinion, the financial statements for a financial year of the company have not been properly prepared in compliance with the Ordinance ....*"

Regulation 4(2)

We would suggest adding the phrase "*to the effect*" as follows:

"*If the auditor's report of a company contains a statement **to the effect** that, in the auditor's opinion, the information in a directors' report for a financial year...*"

Regulations 4(3)(a), (b) and (c)

We would suggest adding the phrase "*to the effect*" and the word "*or*" as follows:

(a) "*a statement **to the effect** that, in the auditor's opinion ---*"

(b) "*a statement **to the effect** that the auditor has failed to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit*; ***or***"

(c) "*(if the financial statements of the company do not comply with section 383(1) of the Ordinance or the Companies (Disclosure of Information about Benefits of Directors) Regulation (L.N. of 2012)) a statement **to the effect** that giving the particulars that are required to be, ...*"

Regulation 5(1)

We would suggest changing the wording from "important events" to "*material events*" to be consistent with the wording used in other parts of the subsidiary legislation and other CO subsidiary legislation.

Regulations 7(3)(a)(ii), 7(3)(b)(ii):

We suggest the words are amended to read "*if the company has decided to give an option to receive the copy in electronic form...*" as the company has only actually "given" the option when it sends out the notification.

Regulation 7(3)(b)

We suggest the words "*specified in paragraph (a)*" are not required.

Regulation 7(3)(c)

We suggest the words are amended to read "*the person does not wish to receive a copy of the reporting documents or the summary financial report at all.*"

Regulation 7(4)

The use of the words *"may be"* is confusing when read in light of regulation 10 as it is unclear whether the notice of intent must be given by completing and returning the card or document - or whether other forms are possible. In addition, the words *"that is"* in regulation 7(4) are not in our view, required.

Regulations 8(1)(c)(i), 8(2)(c)(i)

We would suggest adding the word *"and"* at the end of the sentences.

Regulation 8(2)

We would suggest an explanation be provided on a *"notice of cessation of statutory election"* together with the purpose it serves in the subsidiary legislation.

2. Companies (Directors' Report) Regulation

General observation

Generally, subject to our comments below, we agree with the proposal to clarify and explain in more detail the information to be contained in the directors' report in the subsidiary legislation.

Regulations 3(1)(b) and 3(2)(b)

The current proposal confining the directors' interests required to be reported on to those arrangements with the object of enabling directors to acquire benefits is narrow - we would suggest also including those arrangements which actually result in any directors acquiring benefits.

We would suggest clarifying that disclosure is required if any one or more directors are acquiring benefits. Also, we would suggest more guidance is given as to what are meant by benefits.

We would suggest amendments to be made to regulation 3(1)(b) as follows:

"whose objects are, or one of whose objects is, to enable directors ***or any one or more directors*** *of the company to acquire* ***benefits or such arrangements resulting in directors or any one or more directors of the company acquiring benefits*** *by means of the acquisition of shares in the company or any other body corporate*"

Similar amendments should be made to regulation 3(2)(b).

Regulations 4(1)(b) and 4(2)(b)

We would suggest including the phrase "*(or equivalent amount in other available currencies)*" after $10,000.

Regulation 6

Given the purpose of disclosure under regulation 5 and regulation 6 are essentially the same, disclosure under regulations 6(1)(a), (b)(iii), (c) and (d), which already covered those information required under regulation 5, should be adequate. On the other hand, the requirement for public disclosure of the terms of equity-linked agreements under 6(1)(b) could be harmful to the interest of the company where commercially sensitive, confidential information of the company is involved. To ensure the company's interest is not otherwise jeopardized, a qualification similar to that provided under section 390(2)(b) of the new Ordinance ("*the disclosure of which will not, in the directors' opinion, be harmful to the business of the company*") could be added to 6(1)(b).

Regulation 6(3)(c)

Please consider replacing the sentence in 6(3)(c)(i) with: "*an agreement relating to the company's offer of shares to the public that will or may result in an issuance of shares in the company*", and replacing the sentence in 6(3)(c)(ii) with "*an agreement relating to the company's offer of shares to its members in proportion to their shareholdings that will or may result in an issuance of shares in the company*". Such agreements would have been disclosed in the company's prospectus.

3. Companies (Specification of Names) Order

We have no comments on the "List of Words and Expressions for the Proposed Companies (Specification of Names) Order".

4. Companies (Non-Hong Kong Companies) Regulation

General observation

Generally, subject to our comments below, we agree with the proposal to prescribe the detailed requirements and matters in relation to non-Hong Kong companies in the subsidiary legislation.

Regulation 3

Please consider whether to add a requirement for an email address of the directors / company secretary / authorized representative to facilitate electronic communications with the parties.

For comprehensiveness, we suggest adding the words "*of the director*" at the end of 3(1)(d)(ii)(A) and (B) and adding the words "*of the company secretary*" at the end of 3(1)(e)(ii)(A) and (B).

Clarification is required on whether the "address" required under 3(2)(a) is correspondence address and please add "*in Hong Kong*" after the word "address" in 3(2)(a).

Regulation 4(1)(d)

For clarity, we would suggest changing the words "that comply with any of the laws or rules that may be chosen by the company" to:

"***that complies with any of the law or rules referred to in subparagraph (ii) as may be chosen by the company***".

Regulations 4(1)(d)(ii), 4(1)(e)(ii)

For clarity, we would suggest including the phrase "*which the company is subject to*" in the two sub-sections as follows:

"*the law of any other jurisdiction where the company is registered as a company, or the rules of any stock exchange or similar regulatory bodies* ***which the company is subject to*** *in that jurisdiction...*"

Regulations 4(1)(e)(i), 9(1)(a)

Please include the word "*and*" at the end of the sentences.

Regulation 5(2)(a)

Please replace "names" with "*name*".

Regulation 9(3)

The supplementary note should specify what material revisions have been made to the original accounts.

Regulation 9(4)

We remain concerned that "*every agent*" of a non-Hong Kong company could potentially be punished for a technical "permission" of contravention, even though an agent cannot control or compel the actions of the company/its directors to comply with the Ordinance (e.g. the director's notification to the agent that the company's accounts have been revised under section 790; the company's provision of the required revised accounts in time will be necessary for complying with regulation 9).

As it is the company's directors and officers who should be primarily responsible for ensuring the company's compliance (and who will already be caught as "*responsible person*" under the lowered offence threshold in the new Ordinance), it seems excessive to

punish an agent especially where it has not knowingly / willfully permitted the breach. It also seems unfair to impose such onerous punishment and obligations on *"every agent"* (which is not specifically defined and could be broadly interpreted) of non-Hong Kong companies when agents of Hong Kong companies are not punished under the Ordinance.

It is noted that sections 352(4) and 353(5) of the new Ordinance state that an officer of a Hong Kong company / a non-Hong Kong company will commit an offence if the officer *"knowingly and wilfully authorizes or permits"* the omission of an entry required to be made under section 352(2) / section 353(2). A similar threshold should also apply in determining the liability of the agents of non-Hong Kong companies, given that the agents will not be in a position to comply with the Ordinance without the assistance of the company/its directors (the co-operation of which cannot be compelled); it would be unfair to punish the agents if they have not *"knowingly and willfully authorized or permitted"* the breach - clarification in this regard would be appreciated.

5. Company Records (Inspection and Provision of Copies) Regulation (CR(IPC)R)

General observation

Members' right to inspect the records of a Hong Kong company (with ancillary matters such as timing of inspection and taking of copies) is an often-litigated area of Hong Kong corporate law. We agree with the Government's proposal to spell out the relevant provisions in the new subsidiary legislation.

Interpretation

Definition of "company records"

(a) Incorrect Citation of the Companies Ordinance

We note that reference should be made to section 645 rather than section 654 of the CO;

(b) Accounting Records

The definition of "company records" specifically excludes accounting records. Access, inspection and making copy of accounting records has frequently been a problematic area, and perhaps it should also be dealt with in the subsidiary legislation.

In particular, under the current regime, directors have the right to inspect books of accounts of the company (section 121(3) of the CO) and they often do so prior to approving accounts presented to the board to ensure that the accounts present a true and fair view of the state of the company's affairs. In this regard, directors may engage accountants and auditors to access accounting records who may inspect and make copy of documents and raise questions. This could possibly strain the financial personnel/management of the relevant company (in particular, in periods close to the financial year-end when such access rights are often requested).

Under the Companies Bill, courts will be delegated powers to order the manner in which directors could inspect accounting records, but there is no regulation which provides guidance on the extent and manner in which directors may access accounting records. Individual directors who disagree with the board could possibly abuse its power of access, justified by their fiduciary duty towards the company and shareholders as a whole to ensure that the accounts are absolutely accurate

(c) Agreement and Memorandum

The definition also includes agreement and memorandum. We note:

(i) access to these items do not seem to be covered in the existing CO

(ii) depending on the nature of operations of the company, this would permit members and others requesting inspection the right to access documents which may be highly confidential (or subject to confidentiality undertaking with agreement counterparties)

(iii) it is not clear whether this would only cover entered agreements or it would also cover (as memorandums) tender/bid documents, term sheets, etc.

(iv) further, the interests of shareholders of a company may not be aligned with the interests of the company as a whole - while the directors have a fiduciary duty to act in the interest of the company and all its shareholders as a whole (and are permitted to act for individual shareholder nominating them where there is no competing interest) in examining commercial documents, the shareholders could be self-interested and could use documents accessed for its own interests adverse to those of the company

Regulation 5(1)

For clarity, the regulation should also state that the inspection notice may be served on a company pursuant to section 827 of the CO or a registered non-Hong Kong company pursuant to section 803 of the CO.

Regulation 5(2)

The inspection notice should also identify the person making the request, the capacity under which the request is made, the person (if different) to carry out the inspection, his contact phone number and communication details. Such information can establish the requester's right to inspect and facilitate the giving of response by the company to the requester.

Regulation 5(3)

The notice of inspection must specify a date which is not a "general holiday".

We suggest including provisions to deal with consequences if a date which is a general holiday is specified in the notice (i.e. would the notice by invalidated or would the next non-working date be deemed to be the date for inspection?);

Similarly, provisions to deal with situations where the specified time is not within the 9-5 p.m. prescribed time should be included.

Finally, could the company and party requesting access have flexibility as to when they wish to inspect documents other than those prescribed in the regulation for practical reasons?

Regulation 5(5)

The definition of "request for inspection" seems to have a number of incorrect cross-references

Regulation 6(1)

Both working days and calendar days are used in prescribing the notice period. This is inconsistent and unless there is justification the regulation should be amended as there should be consistency in how days are counted.

Regulation 7(1)

The company's obligation to notify place of inspection arises only after payment of the HK$50 inspection fee, but the company's notice must reach the requester within a specified deadline. There could be a time gap between making of the inspection request and fee payment. The deadline for the company's response does not take account of such time gap. A possible solution is to allow fee payment on the date of, but before the time of, inspection.

We repeat our observations on Regulation 691 on the notice period.

Regulation 7(5)

Section 657(4) of the CO contemplates the subsidiary legislation will provide for empowering provisions for the making of ancillary directions by the court, as to the time, duration and manner of inspection.

Regulation 8(1)

The company must inform the requester of the most recent date (if any) on which "alterations" were made to the company records. The word "alterations" does not necessarily include entries (i.e. information added) if literally construed.

For clarity, we suggest adding the word "***entries or***" before the word "alterations".

Regulation 9(5)

Section 657(4) of the CO contemplates the subsidiary legislation will provide empowering provisions for the making of ancillary directions by the court regarding the circumstances in which and the extent to which copying is permitted. We note the absence of such empowering provisions for ancillary directions in the regulations.

Regulation 13(2)

The company must inform the requester of the most recent date (if any) on which "alterations" were made to the company records.

We repeat our comments on Regulation 8(1) above.

Regulations 14(2) & (4)

(a) When the company keeps its records in electronic format only, it should be permitted to give to the requester copy of records in such format and it will be up to the requester to generate hard copies.

(b) If electronic copies are requested and given, then should the obtaining of such copies be subject to the same costs as obtaining hard copies?

(c) Counting number of words in documents and number of entries for charging purposes seem impractical – count pages instead?

Regulation 14(3)

We suggest that this provision be clarified to the effect that if the company keeps the relevant records in hard copy form only and the person requests an electronic copy, the company is not obliged to (but may) provide an electronic copy, *failing which* it must provide a hard copy. The current drafting suggests that nothing needs to be provided at all in this situation, which is not the legislative intent.

Regulation 16

Persons requesting copies are liable also for any "reasonable costs" incurred by the company – does this include staff costs? Should this require receipts of expenses or records of time spent?

Provisions dealing with contraventions of provisions of the regulation

We note contraventions of the provision would cause "every responsible person" to be liable where "responsible person" do not appear to be a defined term and seems to cover employees and other persons who may be conversant with the CO

6. Companies (Model Articles) Notice (C(MA)N)

Schedule 1 – Model Articles for Public Companies Limited by Shares

Interpretation

Article 1(1)

Definition of "partly paid". The definition says: *partly paid*, in relation to a share, means that no part of the price at which the share was issued remains unpaid;

The word "no" should be deleted.

Article 3

We have reservations about vesting in the members a power to direct the directors to take, or refrain from taking specified action. This power is too extensive and runs counter to the principle that the affairs of the company are managed by the directors, each of whom owes a duty of care to the company to exercise their directors' powers in good faith. Shareholders do not owe a duty of care to the company.

Article 10(2)

This is identical to Article 11(2) in Schedule 3 to the UK Companies (Model Articles) Regulation 2008 (the "UK Model Articles"). However, we are concerned that this article permitting the sole director (or any number of directors, being a number lower than that specified in the quorum provisions) of a public company to appoint other persons as directors to make up a quorum. The appointment of persons to the board of a company is a significant matter and should not normally be taken as a purely "procedural" to satisfy the quorum requirement. It is also doubtful whether additional directors so appointed can be removed with ease afterwards (at least until such additional directors are specifically removed by shareholders' resolution, or are required to step down at the next following annual general meeting under Article 22(5)(a)).

While allowing directors to appoint further directors to make up a quorum would not be unreasonable as a matter of expediency for private companies, we query whether it may be an appropriate default article for Hong Kong public companies. We note in this connection that in Hong Kong, a substantial number, if not majority, of locally-incorporated public companies are listed companies or companies that have issued securities to the public or otherwise have a "public" element in their corporate profile.

That said, we see no problem allowing a sole director to call a general meeting for the purpose of appointing additional directors either to make up a quorum or for any other purpose.

We request clarification on whether a director, having an interest in the matter to be discussed at the board meeting, can be counted towards the quorum of that meeting. Article 18(2) seems to suggest that directors having an interest in a transaction cannot constitute a quorum.

Article 15(2)

We refer to paragraph 6.10(c)(ii) (see page 24 of the Consultation Paper), and do not see any compelling reason to preclude a director from voting on a transaction between the subject company and another entity in which the director is "connected" only to the extent that he takes part in the management of that entity (but does not own any interest in it). In

particular, in the case of a person holding multiple independent non-executive directorships, allowing him to vote on a transaction for one of the companies of which he is a director would not necessarily give rise to any conflict issues. Indeed, precluding him from voting (even against the proposal) may be counter-productive from a shareholders' protection perspective.

We appreciate that this provision is only a "default" article and can be disapplied or modified. However, in this instance we believe it is more appropriate for the default position to be permissive rather than prohibitive.

Article 15(3)

From the list of matters on which directors are by default allowed to vote regardless of conflict of interests issues, the Government proposes to remove "the subscription or agreement to subscribe for shares or other securities of the company or to underwrite any such securities". This proposal as highlighted in paragraph 6.10(c)(ii) (see page 24 of the Consultation Paper), fails to provide any explanation.

We note that an equivalent to this exists in Article 16(4)(b) of the UK Model Articles and believe this would be helpful for Hong Kong public companies, particularly those conducting (a) a top-up placing where the substantial shareholder whose shares are being placed out is also a director, or (b) a rights issue solely or partly underwritten by a substantial shareholder who is also a director.

We propose that subscription of securities of the company should be retained as a default matter in this article.

Article 16

Formal procedures are prescribed for the making of a proposal for the passing of directors' written resolutions, which include the giving of written notice with prescribed contents. Full compliance with such formal procedures should not be a condition for valid passing of directors' written resolutions. In practice, directors' written resolutions are drafted and then circulated for approval and signing by the directors, without going through the notice formalities.

Article 17(4)

Section 657(a)(i) contemplates the making of subsidiary legislation to regulate the keeping of company records. The obligation to maintain written records of directors' written resolutions for specified period should be imposed under subsidiary legislation, not the articles.

We note the draft subsidiary legislations under consultation does not cover record keeping.

Article 20

We repeat our observations on Article 17(4) above.

This article speaks of "every decision taken by the directors". If "decision" is literally construed, the obligation imposed is not capable of full compliance because in reality, not every decision made by the directors collectively is reduced into written. To avoid compliance difficulty, "decision" should be defined in Article 1 to mean a decision taken in accordance with Article 6.

Article 25(e)

A director who has been absent from board meetings without permission for more than 6 months will have his office terminated automatically. We disagree. The termination should not be automatic and should require a resolution of the board to that effect.

Article 26(3)

We propose adding contractual flexibility by providing "unless otherwise specified in the appointment", a directors' remuneration accrues from day to day.

Article 27

We propose adding "***or any of its subsidiaries***" at the end of this provision, which would be of practical benefit to a public company.

Article 36(2) and (3)

These are superfluous. The relevant matters are provided for in ss.565 and 567(1) of the revised Ordinance.

Article 44(2)

It would be useful to specify "the member or members present is a quorum", rather than "members" in the plural. For a company (including a technically "public" company) that is very closely held (e.g. by two persons), problems have arisen in practice that the company could be permanently deadlocked if one or more members persistently absent themselves from general meetings and only one of them is willing to attend. If, exceptionally, the possibility of deadlock is actually foreseen and intended by the parties, this default position can be amended with ease.

Our proposal has recent judicial support in the Court of First Instance decision of *Koo Shing Sun v Hung Wing San, Tony [2012] HKCU 1959*, where Harris J. said, in paragraphs 7 and 12, that the word "*members*" in the existing equivalent provision (Article 56 of Table A) is "*infelicitous drafting*" and that "*the Regulation should refer to member singular rather than plural and the Regulation should have been drafted generally in a way which was consistent with business being conduct by only 1 member, or his proxy, of a company*".

Article 89

We suggest inserting an equivalent of Article 70(4) of the UK Model Articles, namely, "unless the members 'resolution to declare or directors' decision to pay a dividend, or the

terms on which shares are issued, specify otherwise, it must be paid by reference to each member's holding of shares on the date of the resolution or decision to declare to pay it".

This would help clarify (i) that the company technically has the power and discretion to pay dividends on a non-pro-rata basis; (ii) that notwithstanding this, the circumstances of such distribution are restricted to those specified; and (iii) the cut-off date for determining members' entitlement.

Without this provision, Article 90 suggests that the only possibility of a non-pro-rata dividend is if the relevant share carry special rights to dividend, and the record date for dividend entitlement would remain an open question.

Schedule 2 – Model Articles for Private Companies Limited by Shares

Article 2(3)

Under article 2(1)(b), the number of members of a private company is limited to 50.

Employee shareholders are not counted towards the limit of 50. There is provision for this in Article 2(3) but the reference there to "paragraph (1)(a)" is incorrect. It should be "paragraph (1)(b)".

Article 4

We have reservations about vesting in the members a power to direct the directors to take, or refrain from taking specified action. This power is too extensive and runs counter to the principle that the affairs of the company are managed by the directors, each of whom owes a duty of care to the company to exercise their directors' powers in good faith. Shareholders do not owe a duty of care to the company.

Article 9(2)(c)

We suggest removing this from the notice requirement. Under this provision, omitting to anticipate or make an inaccurate anticipation of whether the directors would be in the same place could be used as a ground to establish deficient / insufficient notice and potentially jeopardise the validity of board decisions. This would be very inconvenient for private companies and we believe the shareholders' protection benefits afforded by this provision are not proportionate to the potential adverse consequences.

Article 17

As noted above, obligation to maintain written records of decisions for specified period should be imposed under subsidiary legislation, not the articles.

This article speaks of "every unanimous or majority decision taken by the directors". If "decision" is literally construed, the obligation imposed is not capable of full compliance. To avoid compliance difficulty, "decision" should be defined in Article 1 to mean a decision taken at a meeting of the directors or a decision taken in accordance with Article 8.

Article 18(2)

As noted above, obligation to maintain written records of decisions for specified period should be imposed under subsidiary legislation, not the articles.

Article 20(2)

For clarity, there should be added at the end "until terminated pursuant to the articles or the Ordinance".

Article 22(e)

A director who has been absent from board meetings without board permission for more than 6 months will have his office terminated automatically. The termination should not be automatic and should require a resolution of the board to that effect.

Article 23(3)

Our observation on Article 26(3) above is repeated.

Article 67

Our observation on Article 89 above is repeated.

Schedule 3 – Model Articles for Companies Limited by Guarantee

Article 2(3)

Under article 2(1)(b), number of members of a private company is limited to 50.

Employee shareholders are not counted towards the limit of 50. This is provided for in Article 2(3) but the reference there to "paragraph (1)(a)" is incorrect. It should be "paragraph (1)(b)".

Article 3

We have reservations about vesting in the members a power to direct the directors to take, or refrain from taking specified action. This power is too extensive and runs counter to the principle that the affairs of the company are managed by the directors, each of whom owes a duty of care to the company to exercise their directors' powers in good faith. Shareholders do not owe a duty of care to the company.

Article 8(2)(c)

Our observation on Article 9(2)(c) above is repeated.

Article 17

As noted above, obligation to maintain written records of decisions for specified period should be imposed under subsidiary legislation, not the articles.

As noted in the above, to avoid compliance difficulty, "decision" should be defined in Article 1 to mean a majority decision taken at a meeting of the directors or a decision taken in accordance with Article 7.

Article 18

We suggest inserting an equivalent to Article 20(2) of Schedule 2 (a provision that unless otherwise specified in the appointment, a directors appointed by members' resolution is to hold office for an unlimited period of time).

Articles 20(e) & (f)

A director, who has been absent from board meetings without board permission for more than 6 months or has failed to disclose existence of conflicting interest of material significance, will have his office terminated automatically. The termination should not be automatic and should require a resolution of the board to that effect.

Article 21(3)

We propose adding contractual flexibility by providing "unless otherwise specified in the appointment", a directors' remuneration accrues from day to day.

7. Companies (Accounting Standards (Prescribed Body)) Regulation

We have no comments.

The Law Society of Hong Kong
13 November 2012
1060099