I. MEANING OF CAPITAL

Introduction

The word "capital" has a wide variety of meanings, depending on the context in which it is used. So, for example, it may mean assets when used in the context of "capital assets", or money or principal as compared to interest. In the company law context the word is used in the context of share capital. That expression is not defined in the Companies Ordinance (Cap.622), but it refers to the money which the company has raised or intends to raise by the issue of its shares or, stated in another way, as the amount contributed by the shareholders on the issue of shares to them.[1] Note that the (new) Companies Ordinance is hereafter referred to as either "Cap.622"or the "CO". **2.001**

In the context of corporate finance, share capital is sometimes described as equity capital or "Equity", and contrasted with borrowing or loan capital or "Debt". Equity and Debt are both means for raising funds, but are different in that in the case of Equity the investor is a shareholder, whereas in Debt the lender is a creditor.[2]

In the case of a company having a share capital, the CO requires that the articles of a company with a share capital must state certain information as to capital and initial shareholdings set out in Schedule 2 Part 5 s.8 of the CO.[3]

These and other provisions of the CO reflect the abolition of the memorandum of association, authorized or nominal share capital and nominal or par value of shares.

The articles of a company with a share capital may state the maximum number of shares that the company may issue.[4]

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[1] The expression "contributory" is used in the retitled Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32), s.171 in the context of liquidation to mean past and present members of the company who are liable to contribute to the assets of the company in the event of it being wound up, eg, where the full price has not been paid for shares (uncalled capital). Cap.32 s.171 is unaffected by the CO (Cap.622).

[2] Debt has to be repaid and interest and repayments of a loan will usually be deductible for tax purposes. A company is not obliged to pay a dividend, but a shareholder would hope to make a capital gain. For the differences between Debt and Equity, see McGuinness, *A Guide to the Equity Markets of Hong Kong* (OUP Hong Kong 1999) pp 5–8.

[3] CO, s.85(1). This is, subject to an exception, the same as the information as to capital and initial shareholdings required to be stated in the company's incorporation form, namely: (a) the total number of shares that the company proposes to issue on the company's formation; (b) the total amount of share capital to be subscribed by the company's founder members on that formation; (c) the amount to be paid up or regarded as paid up, and the amount to remain unpaid or to be regarded as remaining unpaid, on the total number of shares that the company proposes to issue on that formation; (d) if the share capital is to be divided into different classes of shares on that formation, the classes and, for each class – (i) the total number of shares in that class that the company proposes to issue on that formation; (ii) the total amount of share capital in that class to be subscribed by the company's founder members on that formation; (iii) the amount to be paid up or to be regarded as paid up, and the amount to remain unpaid or to be regarded as remaining unpaid, on the total number of shares in that class that the company proposes to issue on that formation; and (e) in respect of each founder member the number of shares that the company proposes to issue to the member and the total amount of share capital to be subscribed by the member on that formation or, if the shares belong to 2 or more classes, such information in respect of each class. For existing companies, i.e. companies formed and registered under a former CO (CO, s.2(1)), the conditions of the memorandum of association of such company are to be regarded as provisions of the company's articles; see CO, s.98(1). But if such condition states the amount of share capital with which the existing company proposes to be registered or is registered or the division of the share capital of the company into shares of a fixed amount, the condition is to be regarded as deleted and not to be regarded as a provision of the company's articles; see CO, s.98(4).

[4] *Ibid.*, s.85(2). Any alteration to the maximum number may be made by ordinary resolution; see CO, s.88(3).

The share capital may be denominated in a foreign currency,[5] e.g. US dollars, or a number of different currencies, e.g., a certain amount in Hong Kong dollars and the balance in pounds sterling.

Abolition of Nominal or Authorised Capital and Par Value

2.002 Until the commencement of the new CO (Cap.622),[6] the Companies Ordinances had required a company having a share capital, unless the company was an unlimited company, to state in its memorandum of association the amount of share capital with which the company proposed to be registered and the division thereof into shares of a fixed amount.[7]

On incorporation the founder members needed to consider how much money they would need for the start up of the business of the company. They might be taking over an existing business from a sole trader or a partnership, in which case, particularly if they were not intending to borrow immediately, the buy out price for the business plus a sum for immediate cash needs may be the appropriate amount to take as the nominal or authorised capital of the company. But for many companies, particularly those incorporated to hold a flat or other single asset already acquired and not intending to trade actively, the nominal / authorised capital might indeed be nominal, eg, HK$2.[8] The nominal capital of a company represented the amount of share capital which might be issued without an alteration to the capital clause in the memorandum of association of a company. But it was easy enough to increase the capital.[9] When a company has been trading for some time its nominal capital, even if fully paid-up, might bear little relation to the assets or value of the company. The CO 1932, based on the companies legislation developed in the United Kingdom in the latter part of the nineteenth century, was premised on a public company[10] making a public offering to raise funds which would be expended in some substantial development, such as, in the UK nineteenth century context, a railway, canal or factory. In those circumstances, it was understandable that the law should require that some sum should be put forward as the capital required for the initial project, so that investors would have some idea of what they were investing in. But, as will be shown below, that sum may not accurately reflect the amount actually invested in the company.

Originally, under the early companies legislation, companies were required to have a minimum authorised capital.[11] A stated amount of authorised capital was seen as a protection for shareholders and creditors, and even today in Europe and elsewhere

[5] See *Re Scandinavian Bank Group plc* [1988] Ch 87. Approximately 0.5 per cent of Hong Kong incorporated companies have capital in other than HK dollars, the most common currencies being the UK pound sterling, US dollars, euro and yen.

[6] Back on 3 March 2014; see Companies Ordinance (Commencement) Notice 2013, LN 163 of 2013.

[7] See predecessor Companies Ordinance, s.5(4) and First Schedule Table B.

[8] About a quarter of Hong Kong incorporated companies had a nominal capital of HK$2 or less.

[9] See Companies Ordinance 1865, s.12; CO 1932, s.53(a) para 2.013.

[10] That was, a company which was not a private company within the predecessor CO s.29. The new Companies Ordinance (Cap.622) s.12 has a definition of a public company, as a company that (a) is not a private company; and (b) is not a company limited by guarantee.

[11] The UK Limited Liability Act 1855 required that not less than three quarters of the authorised capital had been subscribed and a company was required to be wound up if it lost three quarters of its capital. These requirements did not survive the Joint Stock Companies Act 1856.

a compulsory minimum capital is still a requirement, at least for public companies. There is no requirement for a minimum authorised capital in the companies legislation in Hong Kong, but the Stock Exchange Listing Rules require a minimum capitalisation for listing, unless the issuer satisfies the profit test.[12]

A remaining relic of a minimum capital can be found in the provision in the companies legislation,[13] which prohibits an allotment of shares which have been offered to the public for subscription unless the amount specified in the prospectus as the minimum subscription is achieved.

As we have seen above, the company's nominal share capital had to divided into shares of a fixed amount. This fixed amount was the nominal or par value of the shares. Generally, the company could not issue its shares for less than the par value.[14]

If it transpired at a later date that the par value was too high, e.g., in the case of a listed company, its shares was trading at less than the par value, then this might be an appropriate time to consider a reduction of capital by re-designating the nominal value of the shares at a lower amount.[15]

The rationale of requiring a nominal capital amount and par value for shares was to protect shareholders and creditors. Nominal capital was said to provide protection to prospective subscribers and creditors by indicating the amount of the capital of the company. In the past, the nominal capital was often stated at a high amount in order to impress prospective investors and creditors, but it was the amount of the shares that had been issued (rather than the maximum amount that might be issued without an increase in capital) that more accurately reflected the amount invested by subscribers. However, even that could be misleading. In the past it was common for shares to be issued only partly paid-up, the balance to be "called up" later. It was the paid-up share capital which most accurately reflected what subscribers had invested. In more recent times nominal capital usually bore some relation to the likely needs of the company[16] and shares were generally payable in full on issue. Since 1972 the false impression that might be caused by partly paid shares was dealt with by the provision in the predecessor CO whereby, if a company made a statement as to its authorised or issued capital in any document of the company issued in Hong Kong, it had to also issue a statement in the document of the paid-up capital of the company no less prominently.[17] In reality, nominal/authorised capital was not usually relied upon by

[12] For a main board listing a capitalization of at least HK$4,000,000,000, subject to waiver under r 8.05A (under the market capitalisation / revenue test: see r 8.05(3)(d)).

[13] Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32), s.42, as amended by Sch 9 s.13(3) of Cap.622, but otherwise unaffected by Cap.622.

[14] See *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (HL). There were some exceptions in s.50(1), (2) of the predecessor CO (Cap.32).

[15] For reduction of capital see para 2.016 et seq.

[16] Formerly a so-called "capital duty", in effect a charge, was payable upon incorporation of a company at the rate of HK$1 for every HK$1,000 or part of HK$1,000 of the nominal share capital of the company, subject to a maximum of HK$30,000; see predecessor CO, 8th Schedule, Part I, para (a). But this charge seems to have had little influence on the choice of the amount of nominal capital. It was abolished as from 1 April 2012 by the Companies Ordinance (Amendment of Eight Schedule) Order 2012, LN 39 of 2012.

[17] Predecessor CO, s.350A; see now Cap.622, s.202. As stated by Betty M. Ho in *Public Companies and their Equity Securities: Principles of Regulation under Hong Kong Law* (The Hague: Kluwer Law International, 1998) p 39 "To those unfamiliar with Anglo-Hong Kong law, a statement of the share capital of the company other than of paid-up capital is extremely misleading".

investors, creditors or others when making decisions concerning companies. Since companies often did not issue shares up to the amount of the authorised capital limit and, in any event, loss of capital may result from trading, prudent creditors did not place much, if any, reliance on the amount of the authorised capital.

Par value was said to protect existing shareholders by preventing companies from issuing shares for less than par value and thus diluting the proportions of the respective shareholders, but it is easy enough for a company to increase its capital and thereby dilute the shareholding proportions. In any event, par values were arbitrary and misleading. A real value of a share, market or otherwise, might be worth more or less than the par value, depending on how the company's business was doing. A share is simply a proportionate interest in the net worth of a business. Par values obscured this reality.[18]

Many Common Law jurisdictions had migrated to a no par system in the last decade or so. In some cases the change has been mandatory (e.g., Australia, New Zealand and Singapore); in other cases optional (e.g., some Channel Islands (Jersey and Guernsey), the British Virgin Islands, the Cayman Islands and British Columbia). Under no par systems authorised capital, in the sense of a stated monetary value, can no longer exist, but it is possible to retain a form of authorised capital stated in a number of shares.[19] It is also possible to retain partly paid shares under a mandatory no par system. The United Kingdom abolished authorised share capital in the Companies Act 2006,[20] but retained the nominal value of shares.[21] The Companies Ordinance Rewrite conducted by the Hong Kong Government commenced work in the latter part of 2006 and authorised capital and par value shares were amongst the items considered in the first year. Recommendations as to the migration to a no par system, the abolition of authorised share capital and retention of partly paid shares were published in a Consultation Paper in June 2008 and the provisions in the White Bill were explained in a Consultation Paper published in May 2010 and were set out in Part 4 Share Capital of the Blue Bill published on 14 January 2011. The provisions were not controversial and are now to be found in Part 4 of the Companies Ordinance 2012 (No 28 of 2012) (Cap.622).[22]

Issued and Unissued Capital

2.003 The issued share capital of a company is the amount of the total price paid for shares which a company has issued.

Unissued share capital is the value of the shares of the company which have yet to be paid for or agreed to be taken. The share capital of a company is upon incorporation unissued capital, with the exception of the shares subscribed for by the founder members.[23]

[18] See the extract from the Canadian Dickerson Report 1971 referred to in Ho (n 17 above), p 39, n 58.
[19] See CO (Cap.622) s.85(2).
[20] It is now concerned mostly with called-up share capital, see Companies Act 2006 s.547.
[21] See Companies Act 2006 s.542 (as it was required to do by the Second European Company Law Directive).
[22] The Consultation Papers and Conclusions, the Consultation Study by Freshfields Final Report and the Blue Bill can be found on the CO Rewrite website (fstb.gov.hk/fsb/co_rewrite/).
[23] A founder member: (a) in relation to a company formed and registered under the CO (Cap.622), means a person who signs on the company's articles for the purposes of the formation of the company; or (b) in relation to a company formed and registered under a former Companies Ordinance, means a person who subscribed to or signed on the company's memorandum of association; CO, s.2(1). A founder number is to be regarded as having agreed to become a member of the company; CO, s.112(1). On the registration of a company, a founder member of the company must be entered, as a member, in the company's register of members: CO, s.112. Hong Kong has permitted one person companies since the Companies (Amendment) Ordinance 2003 came into force on 13 February 2004; CO, s.4(1).

Issue and Allotment

Neither "issue" nor "allotment" is defined in the CO. They are not the same thing. 2.004
Allotment is when a person acquires the unconditional right to be included in the company's register of members in respect of the shares he or she has agreed to take from the company.[24] Issue imports some subsequent act has been done whereby the title of the allottee has been completed. The shares are issued when an application to the company for shares has resulted in allotment and notification thereof to the purchaser and completed by entry on the register of members.[25]

Paid-up Capital and other Types of Capital

The price of shares is nowadays usually paid up in full upon the allotment of the 2.005
shares.[26] Often in the past shares would be only partially paid up and the company might subsequently make a call for the balance or part of the balance.[27] This is not the same as payment of shares by instalments, which is not uncommon nowadays.[28] For partly-paid shares nothing further is due from the purchaser until a call has been made. In the case of purchase of shares payable by instalments the instalments are due on the agreed dates.[29]

In both cases of partially paid shares and shares being paid for by instalments, the shares will have been issued and registered in the name of the purchaser. In default of payment on a call or of an instalment the company may exercise its lien over the shares[30] or start the process of forfeiture of the shares.[31]

Paid-up capital is the amount of capital contributed to the company for its issued shares, where the shares are fully paid up. Shares can be issued as fully paid for a consideration other than cash.[32]

Partly paid capital is the amount contributed where the shares are partly paid.

Uncalled capital is the amount unpaid on shares where a balance is due on the shares issued before a call has been made for the payment of the whole or part of the balance.[33]

[24] See UK Companies Act 2006, s.558. There was no equivalent section under the predecessor CO nor is there under Cap.622.
[25] *National Westminster Bank plc v IRC* [1995] 1 AC 119 (HL).
[26] The Model Articles for private companies provide that no share is to be issued unless the share is fully paid; See Companies (Model Articles) Notice (Cap.622H) Sch 2 art.56.
[27] See para 2.002. For articles on calls see Companies (Model Articles) Notice (Cap.622H) Sch 1 arts. 70 to 79 (public company). For private company see Sch 2 art.56: All shares to be fully paid up; see n 26 above.
[28] Instalments due, but not paid, on the issue price of shares, may now be the subject of a registrable charge: see CO, s.334(1)(f); and para 12.023.
[29] See Companies (Model Articles) Notice (Cap.622H) Sch 1 art. 73(1) A call notice need not be issued in respect of sums that are specified, in the terms on which a share is issued, as being payable to the company in respect of that share — (a) on allotment; (b) on the occurrence of a particular event; or (c) on a date fixed by or in accordance with the terms of the issue; (2) But if the due date for payment of such sum has passed and it has not been paid, the holder of the share concerned is — (a) treated in all respects as having failed to comply with a call notice in respect of that sum; and (b) liable to the same consequences as regards the payment of interest and forfeiture.
[30] For lien, see Companies (Model Articles) Notice (Cap.622H) Sch 1 arts. 68, 69.
[31] For forfeiture, see Companies (Model Articles) Notice (Cap.622H) Sch 1 arts. 75 to 78.
[32] See para 2.008.
[33] For charges on uncalled capital, see Part 12, para 12.023.

Called-up capital is the amount actually contributed to the share capital of a company, including what is presently due to be paid or provided by members, i.e. the amounts called for or other consideration due from the members.

Classes of Shares

2.006 Shares may be issued with different rights attached. Any share in the company may be issued with such preferred, deferred or other special rights or such restrictions, whether in regard to dividend, voting, return of capital or otherwise as the company may from time to time determine. Classes of shares are discussed in Part 3.

II. PAYMENT FOR SHARES

Introduction

2.007 It will be shown later[34] that the doctrine of capital maintenance was a fundamental principle of company law from the early days. A company's capital was sacrosanct and not allowed to be returned to shareholders. The capital was a source to which creditors could resort in the event of the liquidation of the company. The fact that the capital might have been lost through trading did not deter the courts nor the legislature from establishing detailed rules as to maintenance of capital and one aspect of that doctrine was that the company must receive at least the nominal value of the shares. This rule does not survive the abolition of nominal value. But it is still necessary that a proper price be paid for shares (otherwise the directors may be liable for breach of fiduciary duty) and the prohibition against issuing shares at a discount still applies.[35]

Payment in Cash or Non-cash Consideration

2.008 Shares may be issued at any price which the directors decide may be obtained for them.[36] With the abolition of par value, the concept of issuing shares at a premium is no longer applicable. If the company receives less than the price fixed for shares, then it has issued shares at a discount, which is prohibited.

Cash means actual cash or a cheque or the release of a liability of the company for a liquidated sum.[37]

The payment for the shares must be cash or non-cash consideration. Non-cash consideration means consideration in strict contract principles, so past services is not good consideration for the allotment of shares.[38] An allotment of shares on consideration of the debt due to the founding members for pre-incorporation expenses

[34] See para 2.029.
[35] See para 2.012.
[36] See *Hilder v Dexter* [1902] AC 474 (HL); See also *Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd* [1904] AC 648 (HL). In determining the price the directors must act in the best interests of the company. The issue of undervaluing the shares sometimes arises in the context of initial public offering, where the over subscription may suggest that the price was too low. But it is difficult to prove.
[37] See *Re Jones Lloyd & Co Ltd* (1889) 41 Ch D 159; See also *Park Business Interiors Ltd v Park* [1992] BCLC 1034. There was no equivalent in the former CO nor is there in the new CO of the definition of "cash consideration" in the UK legislation (See CA 1985 s.738(2); CA 2006 s.583(3)).
[38] *Re Eddystone Marine Insurance Co* [1893] 3 Ch 9 (CA Eng).

is good consideration,[39] as is allotment of shares in consideration of a retainer of the allottee for future services at a fixed sum.[40]

Valuation of Non-cash Consideration

2.009 Where the company accepts non-cash consideration, such as a factory and equipment of a business formerly run as a partnership, it may not be easy to determine whether a proper price has been paid for the shares.

Fortunately, the courts rarely interfere. They will not inquire into the value of the non-cash consideration so long as the company honestly regards the consideration given as fairly representing the price of the shares.[41] However, it sometimes may be apparent from the terms of a contract that the value put on the non-cash consideration is extravagant, in which case the court will treat the transaction as an issue of shares at a discount[42] and require the shareholders to pay the balance of the full price of the shares[43] or treat the shares as only partly paid.

Return of Allotment

2.010 When a company limited by shares makes any allotment of shares, it must within one month thereafter deliver to the Registrar of Companies a return of allotment in the specified form,[44] i.e. Form NSC1. Where shares are allotted for a non-cash consideration, the return must state the particulars of the contract for sale or for services or other consideration for the allotment.[45] On default in complying with these requirements the company and every responsible person of the company who is in default will be liable to a default fine and, for continued default, to a daily default fine.[46]

Registration of Allotment

2.011 A company must register an allotment of shares as soon as practicable and in any event within 2 months after the date of the allotment, by entering in the register of its members the information referred to in ss.672(2) and 672(3) of the CO.[47]

Shares Issued at a Discount

2.012 At common law, issuing shares at a discount, i.e. at less than their nominal value, was prohibited.[48] The predecessor Companies Ordinance permitted issue at a discount subject to certain restrictions and with the sanction of the court where shares of the

[39] *Park Business Interiors Ltd v Park* [1992] BCLC 1034.
[40] *Gardner v Iredale* [1912] 1 Ch 700.
[41] See *Re Ooregum Gold Mining Co of India v Roper* [1892] AC 125, 137 (HL); See also *Re Wragg Ltd* [1897] 1 Ch 796, 830–831 (CA Eng); *Re Innes & Co Ltd* [1903] 2 Ch 254 (CA Eng); *Re White Star Line Ltd* [1938] Ch 458 (CA Eng).
[42] For issue of shares at a discount, see para 2.012. Issue of shares at a discount is still generally prohibited under CO, s.147.
[43] *Hong Kong and China Gas Co Ltd v Glen* [1914] 1 Ch 527.
[44] CO, s.142(2)(a) and the return must include a statement of capital (CO, s.201) as at the date of the allotment.
[45] CO, s.142(2)(b). See also ss.142(2)(c), (d) and (e). For extension of time see s.142(4) to (7).
[46] CO, s.142(3). For responsible person see CO, s.3 and n 47 below.
[47] CO, s.143(1). For contravention see s.143(2). Section 3 (Responsible person) makes an officer and shadow director liable if he or she authorizes or permits or participates in a contravention or failure.
[48] *Ooregum Gold Mining Co of India v Roper* [1892] AC 125 (HL).

same class have already been issued and the company was entitled to commence business at least one year before the issue.[49]

Cap.622 has a general prohibition of commissions, discounts and allowances.[50] Section 148 provides for permitted commissions and s.149 of this Cap.622 allows capital to be applied in writing off certain expenses and commissions.

III. INCREASE OF CAPITAL

Power of Company to Alter Share Capital

2.013 A limited company may alter its share capital in any one or more of the following ways.[51]

The company may: (a) increase its share capital by allotting and issuing new shares in accordance with Part 4; (b) increase its share capital without allotting and issuing new shares, if the funds or other assets for the increase are provided by the members of the company; (c) capitalize its profits, with or without allotting and issuing new shares; (d) allot and issue bonus shares with or without increasing its share capital; (e) convert all or any of its shares into a larger or smaller number of shares; and (f) cancel shares – (i) that, at the date the resolution for cancellation is passed, have not been taken or agreed to be taken by any person; or (ii) that have been forfeited.[52]

A limited company may alter its share capital as referred to in paras (e) or (f) only by resolution of the company.[53] Such resolution may authorize the company to exercise the power: (a) on more than one occasion; and (b) at a specified time or in specified circumstances.[54] If shares are cancelled under para (f), the company must reduce its share capital by the amount of the shares cancelled.[55] For the purposes of Part 5 (Transactions in relation to Share Capital) a cancellation of shares under s.170 of the CO is not a reduction of share capital.[56] A limited company's articles may exclude or restrict the exercise of a power as conferred by s.170 of this Cap.622.[57]

Exercise of the Power

2.014 These powers may be exercised in general meetings[58] or, where appropriate, using the written resolution procedure.[59] Generally, under express regulations the appropriate resolution is an ordinary resolution.[60] If the articles do not provide for increase of capital, it will be necessary to amend the articles to so provide.[61] The notice convening

[49] CO, s.50(1), (2).
[50] *Ibid.*, s.147.
[51] *Ibid.*, s.170(1).
[52] *Ibid.*, s.170(2).
[53] *Ibid.*, s.170(3). CO, ss.140 and 141 contain provisions requiring a resolution of the company for an allotment of shares. Those sections may be relevant to an alteration of share capital referred to in paras (a), (c), (d), above. In any conversion under s.170(2)(e) the proportion between the amount paid and the amount, if any, unpaid on each reduced share must be the same as it was in the case of the share from which the reduced share is derived; CO, s.170(5).
[54] CO, s.170(4).
[55] *Ibid.*, s.170(6).
[56] *Ibid.*, s.170(7). For reduction of capital see s.2.016 et seq.
[57] *Ibid.*, s.170(8).
[58] See Part 5 paras 5.019 et seq.
[59] See CO, s.548 set seq.
[60] And for Model Articles, see Companies (Model Articles) Notice (Cap.622H), Sch 1 art. 87, Sch 2 art. 69.
[61] See CO, s.87. For amendment of articles see Part 1, para 1.011 *et seq.*

a meeting to consider a resolution to increase the capital should state the amount of the proposed increase.[62] The currency of the increase need not be the same as that of the original capital.[63]

Where the articles provide for increase of capital etc those provisions must be observed if the increase is to be valid and effective.[64]

Notice of the alteration of capital (other than for an increase of capital) must be given to the Registrar of Companies in the specified form NSC11 within one month of the alteration.[65]

Fettering the Company's Power to Increase the Capital

The power to increase capital can be abused. In private companies where there is conflict between members, capital is often increased and an issue of new shares made, in order to cause a dilution in the shareholding of the opposition. Dilution is a common complaint in unfair prejudice cases.[66] 2.015

So it is not uncommon in private companies, and joint venture companies in particular, for the articles or a separate shareholder agreement to provide for unanimous approval for an increase of capital.[67] A company cannot fetter its statutory powers, so if such a restriction appears in the articles[68] or in a separate shareholder agreement to which the company is a party, the restriction will not be binding on the company. However, the restriction may be binding on those shareholders party to the agreement (but not shareholders not party to the agreement, unless they adhere to the agreement in some manner),[69] so that, for example, it might be possible to obtain an injunction against a shareholder who was intending to vote contrary to what had been agreed or even damages for breach of contract, if loss could be proved. The Hong Kong courts seem to have gone further in deciding that not only can the company not fetter its statutory rights, but neither can members fetter their statutory powers.[70]

IV. REDUCTION OF CAPITAL

Maintenance of Capital Doctrine

This doctrine of the maintenance of the capital of a company has already been mentioned[71] and more will be said about it later.[72] A company's capital was sacrosanct and not allowed to be returned to members. The reduction of the capital of a company 2.016

[62] CO, s.171(2)(b); *MacConnell v E Prill & Co Ltd* [1916] 2 Ch 57.
[63] *Ibid.*, s.172(1); *Re Scandinavian Bank Group plc* [1988] Ch 87; see also 2.001.
[64] See *Tsao Chin Lan v Tin Ka Kung* [1995] 2 HKC 671 (CA).
[65] CO, s.171(1). The notice must include a statement of capital; see s.171(2)(c) and s.201. For non-compliance under ss.171 and 171(4).
[66] See *Tseng Yueh Lee Irene v Metrobilt Enterprise Ltd* [1994] 2 HKC 684; see also *Ng Yat Chi v Max Share Ltd* [2001] 1 HKLRD 561 (CA), affirmed [2001] 3 HKLRD 299 (CFA); and see Part 8 para 8.092.
[67] *Russell v Northern Bank Development Corp Ltd* [1992] 1 WLR 588 (HL).
[68] For the contractual effect of the articles, see CO, s.86 and Part 8 para 8.064.
[69] *Russell v Northern Bank Development Corp Ltd*, n 68 above.
[70] See *Re Greater Beijing Region Expressways Ltd* [1999] 4 HKC 807; see also *Muir v Lampl* [2005] 1 HKLRD 338. See also Part 8 para 8.071.
[71] See para 2.007.
[72] See para 2.029.

I. DIRECTORS

Scope of Chapter

6.001 This chapter outlines the concept of a "director" and covers: the statutory requirements relating to directors (appointment, qualification, vacation of office, and disqualification of directors); the statutory prohibitions on companies giving loans to, and entering into certain other transactions with, directors; the statutory duty of care of directors; and certain other obligations imposed on directors and officers under the (new) Companies Ordinance (Cap.622) and the retitled Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32).The fiduciary duties of directors under the general law are discussed in Part 7 below.

II. CLASSIFICATION OF DIRECTORS

6.002 Black's Law Dictionary defines "director" as "[a] person appointed or elected to sit on a board that manages the affairs of a corporation or other organisation by electing and exercising control over its officers".[1] For our purposes, this definition is somewhat too narrow, as under the Companies Ordinance as well as at common law a person who has not been appointed or elected to sit on the board can be treated as a director, as will be seen in the discussion below.

De Jure, De Facto and Shadow Directors

6.003 In terms of the ways in which a person becomes (to be treated as) a director by law, directors can be classified into appointed directors (or "*de jure* directors"), *de facto* directors and shadow directors. The need for treating a person who is not a *de jure* director as director lies in the necessity for ensuring that persons who exercise the functions of directors do not escape their legal responsibilities by not being formally appointed as director.[2]

A person who is appointed or elected to sit on a board of directors becomes a *de jure* director upon the appointment or election. Cap.622, s.2 states that "director" includes any person occupying the position of director by whatever name called. That definition is wider than the one quoted at para.6.002, as a person can occupy the position of director even if he or she has never been appointed to sit on the board. The statutory definition of "director" covers *de facto* directors but not shadow directors. As will be seen below, the meaning of "shadow director" is defined separately under Cap.622, s. 2.

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[1] *Black's Law Dictionary* (8th edn, West Publishing, St Paul, Min, 2004) 492.

[2] See *Re Hydrodan (Corby) Ltd* [1994] BCC 161; see also *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1; *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565; *Securities and Futures Commission v Mandarin Resources Corp Ltd* (unrep., HCCW 348/1996, [1999] HKEC 688); *Re Paycheck Services 3 Ltd* [2010] 1 WLR 2793 (SC(E)); *Lisa Alford, Neil Money (as Joint Liquidators of Snelling House Limited) v Sally Ann Barton, Philip Barton, Sarah Barton, Solipetit SL* [2012] EWHC 440 (Ch).

De Facto Directors

6.004 The term "*de facto* directors" refers to persons who act as directors of the company, even though they have not been properly appointed as directors.[3]

In *Re Paycheck Services 3 Ltd; Holland v Revenue and Customs Commissioners*,[4] Lord Hope endorsed the definition that Millett J formulated in *Re Hydrodan (Corby) Ltd*:[5]

> "A *de facto* director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person was a *de facto* director of a company it is necessary to plead and prove that he undertook functions in relation to the company which could properly be discharged only by a director. It is not sufficient to show that he was concerned in the management of the company's affairs or undertook tasks in relation to its business which can properly be performed by a manager below board level".

This idea of "*de facto* directors" is covered by the Cap.622, s.2 definition of "director" (which defines a director as including any person occupying the position of director by whatever name called), although the common law concept of *de facto* directors predates the current statutory definition.[6] Whether a person would be regarded as a *de facto* director would depend on the duties performed by the person in the context of the operations and circumstances of the particular company.[7] Where a person takes on an active role in top-level management functions, and is reasonably perceived by outsiders dealing with the company as a director, then the person may well be treated as a *de facto* director.[8] All the circumstances of the case must be examined, but it is relevant to look at factors such as whether there was a holding out by the company of the person as a director, whether the person used the title, whether the person had to make major decisions and whether the person had proper information (such as management accounts) on which to base decisions.[9]

In *Deputy Commissioner of Taxation v Austin*,[10] Madgwick J held the defendant to be a *de facto* director of the company for the purpose of determining his liability for an unfair preference given in favour of Australia's tax authority. In that case, the

[3] *Aktieselskabet Dansk Skibsfi nansiering v Wheelock Marden & Co Ltd* (unrep., Court of Appeal, 17 November 1994); *Re Hydrodan (Corby) Ltd (in liq)* [1994] BCC 161, 163, cited in *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* [2009] 3 HKLRD 265, 293 (CFI) (reversed by the Court of Appeal on other grounds). See also Susan Watson and Chris Noonan, "Defining Directorship" http://ssrn.com/abstract=1695796.

[4] [2010] 1 WLR 2793, [2010] UKSC 51, [29].

[5] *Re Hydrodan (Corby) Ltd* [1994] BCC 161, 163; cited in *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* [2009] 3 HKLRD 265, 293, CFI (reversed by the Court of Appeal on other grounds).

[6] The definition was first introduced in the Companies Act 1900 (UK) s.30; and in Hong Kong see Companies Ordinance (No 58 of 1911) s.261. On the historical background to the definition, see *Corporate Affairs Commission v Drysdale* (1978) 141 CLR 236. However, for some provisions in the Companies Ordinance, the context may indicate that the reference to "director" does not include *de facto* directors (for example, the provisions on the minimum number of directors): *Re Lo-Line Electric Motors Ltd* (1988) 4 BCC 415, 421–2.

[7] *Deputy Commissioner of Taxation v Austin* (1998) 28 ACSR 565.

[8] *Ibid.*

[9] *Re Kaytech Intl plc, Secretary of State for Trade and Industry v Kaczer* [1999] 2 BCLC 351, 423. See further *Re Red Label Fashions Ltd* [1999] BCC 308; *Secretary of State for Trade and Industry v Jones* [1999] BCC 336; *Standard Chartered Bank of Australia Ltd v Antico* (1995) 18 ACSR 1.

[10] (1998) 28 ACSR 565.

defendant had resigned as a director but continued to perform directorial duties such as conducting negotiations with creditors (including the tax commissioner) on behalf of the company, countersigning and affixing of the company's seal, as well as signing company cheques.

In a fairly recent UK case, *Alford v Barton*,[11] Moss QC ruled that the second defendant, who was not an appointed director, was a *de facto* director on the basis that he was the person at the company in a position to prevent damage to creditors by taking proper steps to protect their interests. The things that the defendant did included the handling of VAT issues following the sale of the company's only property, and withdrawing of the company's monies (for the benefit of himself, and/or his family and/or his family company). The factors that Moss QC had taken into consideration in reaching His Lordship's conclusion on the second defendant's role as a *de facto* director include: (i) that the second defendant had been involved in the company's day-to-day running; (ii) that he dealt with the company's financial and VAT affairs; (iii) that he was in a position to give instructions to the company's accountants; (iv) dealt with the company's receivers as if he were solely in charge; and (v) that he was a signatory on the company's bank account and that he had full power to act under the bank mandate to act in all material respects, including withdrawing the company's money without any limit.[12]

One of the situations where a person's liability as a *de facto* director can arise is where a corporate director is interposed between the defendant, who is a *de jure* director of that corporate director, and the subject company. The issue in such a situation is often whether the defendant can be characterised as a *de facto* director where his or her actions can be attributed entirely to the position which he or she occupied *de jure* as a director of that corporate director. Lord Hope answered this question in the negative in *Re Paycheck Services 3 Ltd; Holland v Revenue and Customs Commissioners*,[13] holding that it was impossible to overcome the distinction between a company (the corporate director here) and its directors simply by pointing to the quality of the acts done by the director and asking whether he was the guiding spirit of the subject company. His Lordship agreed with Millett J in *Re Hydrodan (Corby) Ltd*[14] that "for a creditor of the subject company to obtain those remedies (for the defendant's breach of fiduciary duties) the individual must be shown to have been a director, *not just of the corporate director but of the subject company too* (emphasis added)".[15] In *Re Paycheck Services 3 Ltd, above*, a 3:2 majority of the UK Supreme Court held that as long as the relevant acts are done by the individual entirely within the ambit of the discharge of his duties and responsibilities as a director of the corporate director, then the individual would not be regarded as a *de facto* or shadow director of the company in which the corporate director is director.[16]

[11] [2012] EWHC 440 (Ch).

[12] *Alford v Barton* [2012] EWHC 440 (Ch) at [27] – [30].

[13] [2010] 1 WLR 2793, [2010] UKSC 51.

[14] [1994] BCC 161.

[15] [2010] 1 WLR 2793, [2010] UKSC 51, [43].

[16] [2010] 1 WLR 2793, [2010] UKSC 51, [42], [53]–[54], [96] (sole director of a corporate director of another company held not to be *de facto* director of the latter company for the purposes of liable for misfeasance).

Shadow Directors

6.005 Section 2 of Cap.622 defines shadow director as a person in accordance with whose direction or instructions the directors or a majority of directors of the company are accustomed to act.[17] In *Re Hydrodan (Corby) Ltd*,[18] Millett J held that to establish that the defendant is a shadow director, the plaintiff must allege and prove:

> "(1) Who are the directors of the company, whether *de facto* or *de jure*; (2) that the defendant directed those directors how to act in relation to the company or that he was one of the persons who did so; (3) that those directors acted in accordance with such directions; and (4) that they were accustomed so to act".

The concept of a shadow director is different from that of *de facto* director, although in some situations there could be an overlap.[19] The purpose of the notion of shadow director is to identify those with real influence in the corporate affairs of the company, although it is not necessary that such influence should be exercised over the whole field of its corporate activities.[20] A shadow director has been described as like a "puppet master who controls the actions of the board".[21] The influence or control exercised by a shadow director may be strategic in character, defining the context in which, or conditions upon which, the company operates, or else contriving the transactions of significance to the company.[22] For a person to be a shadow director, his or her influence over the board must occur over a period of time and so the mere fact that the directors acted in accordance with the person's instructions on a single occasion would not be sufficient.[23]

[17] However, a person is not to be considered as a shadow director by reason only that the directors or a majority of them act on advice given by the person in a professional capacity: Cap.622 s.2 definition of "shadow director".

[18] [1994] BCC 161,163.

[19] *Aktieselskabet Dansk Skibsfi nansiering v Wheelock Marden & Co Ltd* [1994] 2 HKC 264; *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340.

[20] *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340.

[21] *Re Unisoft Group Ltd (No 2)* [1994] BCC 766, 775, cited in *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* [2009] 3 HKLRD 265, 293, CFI (reversed by the Court of Appeal on other grounds). In *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340, Morritt LJ in the English Court of Appeal qualified this by stating that the requirement that the directors are accustomed to act in accordance with the putative shadow director's directions or instructions does not necessarily mean that the directors must have surrendered their own discretion and were simply subservient to the putative shadow director. Morritt LJ considered that if the board were accustomed to act on the directions or instructions of the putative shadow director, it is not necessary to demonstrate that their action was mechanical rather than considered. But for a critique of this approach, see Chris Noonan and Susan Watson, "The Nature of Shadow Directorship: Ad Hoc Statutory Intervention or Core Company Law Principle?" [2006] *Journal of Business Law* 763. Morritt LJ's approach was accepted by Lewison J in *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 but Lewison J also accepted the correctness of earlier case law that held that creditors are entitled to protect their own interests by making demands on the debtor company and that creditors will not be regarded as shadow directors merely because the directors agree to requirements imposed by the creditors. On the latter point; see also *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd* (2011) 81 NSWLR 47.

[22] *Australian Securities Commission v A S Nominees Ltd* (1995) 133 ALR 1, 52–53.

[23] *Re Unisoft Group Ltd (No 2)* [1994] BCC 766, 775, cited in *Moulin Global Eyecare Holdings Ltd v Lee Sin Mei Olivia* [2009] 3 HKLRD 265, 293, CFI. In the latter case, a claim that a non-executive director and member of the audit committee of a company was a shadow director of the subsidiary companies was struck out where there was no evidence that she exercised real influence over the affairs of the subsidiaries which were, on the evidence, controlled by the majority family owners of the companies. The CFI decision was reversed by the Court of Appeal on other grounds: [2010] 2 HKLRD 1096.

A parent company can be held to be a shadow director where its directors give directions to the board of a subsidiary entity and the directors of that entity were accustomed to act in accordance with such directions.[24] In *Standard Chartered Bank of Australia Ltd v Antico*,[25] Hodgson J held the parent entity of a company to be the latter's shadow director where the former imposed reporting requirements on the latter, exercised controls over the composition of the board of the latter and had played a decisive role in relation to a number of significant transactions entered into by the subsidiary entity. The board of the child entity in that case simply accepted the decisions of the parent entity in relation to those significant transactions as something necessary or as a *fait accompli*.[26]

Types of Directors According to Functions

Managing Director or Chief Executive Officer

6.006 The managing director is a director who is appointed by the board as the company's chief executive officer. A managing director is both a director and a company employee[27] who is conferred, by the directors, with any of the powers exercisable by the directors.[28] During his tenure, a director so appointed is often not subject to retirement by rotation or taken into account in determining the rotation of retirement of directors.[29] A typical function of the managing director is to oversee the day-to-day running of the company's business and to supervise other senior executives. The precise role of a managing director is, however, not fixed by law but determined by the terms of his engagement.[30]

The term "chief executive officer" (CEO) is often used nowadays instead of "managing director". The functions of a director appointed as CEO are usually similar to those of managing directors.

Executive Directors and Non-Executive Directors

6.007 Executive directors are full-time employees of the company. Non-executive directors (NEDs) do not have full-time involvement with the company. They are also known as part-time, outside or independent directors. NEDs are often able to provide a perspective that is wider than executive directors in corporate decision-making, and they are likely to be more objective and more balanced in thinking.[31] NEDs may also be able to protect certain interests within the company or the interests of stakeholders who do not have a voice on the board, such as small shareholders and creditors.[32]

[24] *Re Hydrodan (Corby) Ltd* [1994] BCC 161. See also *Ho v Akai Pty Ltd (in liq)* (2006) 24 ACLC 1526; *Buzzle Operations Pty Ltd (in liq) v Apple Computer Australia Pty Ltd (2011) 81 NSWLR 47.*

[25] (1995) 18 ACSR 1.

[26] *Ibid*., [63].

[27] *Anderson v James Sutherland (Peterhead) Ltd* 1941 SC 203.

[28] Model Articles (public companies) art.33; predecessor CO, Table A, reg.111.

[29] Model Articles (public companies) art.33(2); predecessor CO, Table A, reg.109.

[30] *Harold Holdsworth & Co (Wakefield) Ltd v Caddies* [1955] 1 WLR 352, Eng HL.

[31] E J Jacobs, "Non-executive directors" [1987] *JBL* 269.

[32] *Ibid*.; Saleem Sheikh, "Non-executive Directors: Self-regulation or Codification?" (2002) 23(10) *Comp Law* 269–270.

Another important function of NEDs is that they serve as a check on the executive directors' control of company management.[33]

Listed companies, under the Listing Rules, are to appoint at least three independent non-executive directors who represent at least one-third of the board.[34] The meaning of independent non-executive directors is defined in Listing Rules (Main Board) r.3.13 and Listing Rules (GEM) r.5.09. There is little doubt that NEDs are subject to the same fiduciary obligations as executive directors.[35] NEDs are also subject to the duty of care, skill and diligence.[36]

Alternate Directors

6.008 An alternate director is a person appointed to act in the place of a director when the latter is unable to attend meetings or otherwise function as a director. The appointment of an alternate director is possible if the articles of the company authorise a director to do so.[37]

Under Cap.622 s.478(1), unless the company's articles provide otherwise, whether expressly or impliedly, an alternate director is deemed to be the agent of the director who appoints him or her and the director who appoints the alternate director is vicariously liable for any tort committed by the alternate director during his or her office. The alternate director, however, remains personally liable for any act or omission.[38] Section 478 of Cap.622 alters the common law position which is illustrated by the Australian decision in *Anaray Pty Ltd v Sydney Futures Exchange Ltd*.[39] In that case, the alternate appointed by a director attended a board meeting and voted for a resolution on a matter on which the appointor director had a personal interest. A number of the articles of the company prohibited directors from voting on proposed resolutions on matters where they had a personal interest. The validity of the resolution that the alternate director voted for was challenged on the basis that the alternate director was disqualified from voting as he was his appointor's agent. The Supreme Court of New South Wales rejected the contention that an alternate director was an agent of his appointor. The basis of the court's decision on this point was that there were no provisions in the articles making an alternate director an agent of his appointor, nor was there any suggestion of any collusion between the alternate and his appointor. In Australia, there is no equivalent of Cap.622, s.478, which deems the alternate the agent of the appointing director.

Generally speaking, an alternate director is treated as being in the same position as any other director and is consequently subject to the normal duties that a director owes to his or her company.[40] An alternate director is, however, not subject to directorial duties unless and until he or she has assumed directorial authority. Thus, a person

[33] See E J Jacobs, "Non-executive directors" [1987] *JBL* 269, 270.
[34] Listing Rules (Main Board), rr.3.10, 3.10A; Listing Rules (GEM), rr.5.05, 5.05A.
[35] *ASIC v Adler* (2002) 168 FLR 253 (affirmed on appeal *Adler v ASIC* (2003) 179 FLR 1); *ASIC v Vizard* (2005) 145 FCR 57).
[36] *Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498; *Law Wai Duen v Boldwin Construction Co Ltd* [2001] 4 HKC 403 (CA).
[37] See, e.g., Model Articles (private companies) art.28; Model Articles (public companies) art.30. The former Table A articles in Cap.32 do not have provisions for alternate directors.
[38] Cap.622, s.478(2).
[39] (1988) 6 ACLC 271.
[40] *Markwell Bros Pty Ltd v CPN Diesels Queensland Pty Ltd* [1983] 2 Qd R 508, 519, *per* Thomas J.

who has been appointed as an alternate director but who has never been called upon to fulfil this role cannot be held liable for breaching of a directorial duty, if under the company's articles an alternate does not have any duty to exercise power until he or she is called upon to fulfil the role.[41] Also, an alternate has no status as a director when his or her appointor is present at the meeting.[42]

Nominee Directors

At a general level, the term "nominee director" can be used to refer to "persons who, 6.009 independently of the method of their appointment, but in relation to their office, are expected to act in accordance with some understanding or arrangement which creates an obligation or mutual expectation of loyalty to some person or persons other than the company as a whole".[43] In practice, a nominee director can be appointed to represent the interests of a particular stakeholder, such as a party to a corporate joint venture, the holding company,[44] a creditor,[45] or even employees or a government body.[46]

Reserve Directors

Under Cap.622, s.455, a private company with one member, who is the sole director, 6.010 may, in general meeting, notwithstanding anything in the company's articles of association, nominate a person (other than the company itself) of 18 years or above to be a reserve director of the company to act in the place of the sole director in the event of his or her death. The nominee will cease to be the reserve director where: (i) he or she has resigned from this post; (ii) the company in general meeting has revoked his or her nomination; or (iii) the director in respect of whom the reserve director was nominated has ceased to be the sole director.[47]

III. QUALIFICATIONS

Generally speaking, the law does not prescribe any minimum professional or 6.011 educational requirements before persons can act as director. Historically, in the 19th century, directors were not necessarily appointed for their business acumen. For example, well-known figures might be appointed to the board in order to attract investors to the company on the basis of their reputation. Greater managerial abilities are expected of directors of commercial enterprises today,[48] but the law only provides for certain minimal qualifications for persons to be appointed as directors.

[41] *Playcorp Pty Ltd v Shaw* (1993) 10 ACSR 212.
[42] *Markwell Bros v CPN Diesels (Qld) Pty Ltd* [1983] 2 Qd R 508; *Playcorp Pty Ltd v Shaw* (1993) 10 ACSR 212.
[43] Companies and Securities Law Review Committee (Australia), "Nominee Directors and Alternate Directors" (Report No 8, 1989) 8.
[44] *Scottish Co-operative Wholesale Soc Ltd v Meyer* [1958] 3 All ER 66.
[45] *Levin v Clark* [1962] NSWR 686.
[46] Phillip Lipton, et al., *Understanding Company Law* (17th edn, LBC, Pyrmount, NSW 2014), [13.2.55].
[47] Cap.622 s.455(2).
[48] See Standing Committee on Company Law Reform, "Corporate Governance Review: Consultation Paper on Proposals in Phase I of the Review" (Hong Kong July 2001) paras.6.06–6.07, 6.13; Companies Registry, *A Guide on Directors' Duties* (Hong Kong July 2009); Stock Exchange Listing Rules r.3.08(f), App.14 (Code on Corporate Governance Practices).

A natural person can be appointed as director only if the person is of 18 years of age or above.[49] There is no maximum age limit unless provided for in the articles.

An undischarged bankrupt is prohibited from acting as a director or taking part in the management of a company, either directly or indirectly, without the leave of the court. See Cap.622, s.480. A person who contravenes this prohibition commits an offence[50] and also becomes personally liable for the debts and liabilities of the company incurred at a time when the person was involved in the management of the company in contravention of s.480 of this Cap.622.[51] A person against whom a disqualification order has been made is also banned from acting as a company director.[52] The articles of companies also commonly provide that a director must not be of unsound mind.[53]

Previously, the predecessor CO, s.155 (repealed) provided that where the articles of association of the company impose a share qualification upon the company's directors, the directors who are not so qualified are under an obligation to obtain such qualification within two months with their appointments unless the articles provide a shorter period.[54] This provision was not reproduced in Cap.622.

The (new) Companies Ordinance now imposes restrictions on the possibility of appointing a body corporate as director.[55]

IV. APPOINTMENT

6.012 A public company must have at least two directors.[56] A company limited by guarantee is also required to have at least two directors.[57] A private company, on the other hand, is required to have at least one director.[58] As mentioned previously, where a private company has only one director who is the sole member, the company may nominate a reserve director who would act in case of the death of the director.[59]

The Registrar has power under Cap.622, s.458 to direct a company to appoint a director or directors to comply with the statutory requirements where the number of directors of the company has fallen below the statutory minimum. If the company fails to comply with the direction within the time period specified by the Registrar (which must be not less than one month or more than three months after the date on which the direction is given), the company and every responsible person[60] commits an offence.[61]

[49] Cap.622 s.459(1). See also para.6.016 below.
[50] Cap.622, s. 480(2).
[51] Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32), s.168O(1)(a) and (3)(a). A person who is involved in the management of the company and acts or is willing to act on instructions given by a person who is an undischarged bankrupt will also be personally liable to the extent set out in s.168O(1)(b) and (3)(b).
[52] Cap.32, Pt.IVA. See Part VI below for further discussion on disqualification.
[53] E.g. Model Articles (private companies) art.25(c); Model Articles (public companies) art.27(c); predecessor CO, Table A reg.90(d).
[54] See also predecessor CO, Table A regs.79 and 90(a).
[55] See para 6.017 below.
[56] Cap.622, s.453(1)(a) and 453(2).
[57] Cap.622, s.453(1)(b) and 453(2).
[58] Cap.622 s.454(1).
[59] See para.6.022.
[60] See Cap.622, s.3.
[61] Cap.622, s.458(6).

Initial Directors

6.013 The first directors of a company are those named in the incorporation form submitted to the Registrar.[62] The appointment of initial directors is subject to the written consent of the appointees.[63]

Subsequent Directors

6.014 Under the Model Articles for public companies,[64] all of the first directors are required to retire from office at the first annual general meeting ("AGM"). At the AGM of every subsequent year, one third of the directors, or if the number of directors is not three or a multiple of three, the number nearest one-third, are to retire from office, although a retiring director is eligible for election.[65] Vacancies created by retirement of directors are to be filled through an election to be conducted at the same meeting at which a director retires and in default, a director who has offered himself or herself for election is regarded as having been reappointed.[66] Directors are elected by ordinary resolution in accordance with the relevant stipulations in the articles.[67] No provisions are made for the rotation of directors in the Model Articles for private companies, but the general meeting has power to appoint new directors by ordinary resolution.[68]

Where the company is a public company or a company limited by guarantee, no motion for the appointment of two or more persons as directors by a single resolution can be made, unless a resolution that such an appointment can be so made has first been passed at the meeting without any vote against it.[69] The rationale behind this prohibition on composite motions is to preserve the member's ability to refuse the appointment of a director without having to reject others.[70]

The power to appoint directors to fill casual vacancies or as an addition to existing directors can be vested in the board or the general meeting exclusively or granted concurrently to both corporate organs. The latter approach is adopted in the Model Articles[71] (as well as under the former Table A). However, any director appointed by the board only holds office until the next AGM.[72] If he or she is to continue in office after the AGM, it would be necessary for reappointment by the general meeting.

Where a new director is appointed, the company must send notice to the Registrar of the appointment, with particulars specified in its register of directors (name, identification number and residential address) together with a statement signed by the director stating that he or she has accepted the appointment, and a statement that

[62] Cap.622, ss.453(2) and 454(2).
[63] Cap.622, s.74.
[64] Model Articles art.24 (public companies): Companies (Model Articles) Notice Sch.1. This provision is similar to those in the predecessor CO Table A regs.91, 94 (repealed).
[65] Model Articles art.25 (public companies).
[66] Model Articles art.24(8). However, the retiring director is not regarded as having been reappointed if (a) at the meeting at which the director retires, it is expressly resolved not to fill the vacated office, or (b) a resolution for the reappointment of the director has been put to the meeting and lost: art.24(9).
[67] For examples, see former Table A regs.96 and 99.
[68] Model Articles art.22 (private companies): Companies (Model Articles) Notice Sch.2.
[69] Cap.622, s.460.
[70] Clive M Schmitthoff (ed.), *Palmer's Company Law* (Vol 1, 24th edn, Stevens & Sons Edinburgh 1987) 878.
[71] Model Articles (private companies) art.22; Model Articles (public companies) art.23.
[72] Model Articles (private companies) art.22(4); Model Articles (public companies) art.23(4).

the appointee has attained the age of 18, if that person is a natural person, within 15 days from the appointment.[73] The company must also enter the details of its directors in its own register of directors.[74]

The managing director is appointed by the board of directors for such period and on such terms as they think fit.[75] Where articles so provide, a director may appoint an alternate director to act in his absence.[76]

Appointment by Outsiders

6.015 It is possible for an outsider to acquire a right to appoint a director pursuant to contractual arrangements. The supplier of either capital or debt finance, for example, may be granted the right of appointing a director pursuant to a term in the company's articles[77] or of a contract.[78] Where the right to nominate is conferred under a contract, however, this may not be specifically enforceable, as the court may be reluctant to compel the company to appoint the nominee where, for example, the nominee is unsuited for the office.[79] Directors may also delegate[80] their powers to appoint directors to enable the supplier of debt finance to nominate a director to protect the lender's interest.[81] Where the company is an incorporated joint venture, joint venturers may appoint nominee directors where such power is conferred under the terms of the shareholders' agreement.[82]

Liabilities of Under-Age Directors

6.016 A natural person director must be at least 18 years of age at the time of appointment.[83] An appointment made in contravention of the statutory provision is void,[84] but an under-age person who purports to act as director or shadow director can still be liable under any provision of Cap.622 or the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32) notwithstanding that the person could not be appointed director. See Cap.622, s.459(3). This provision is modelled on s.157(5) of the Companies Act 2006 (UK). In the United Kingdom, the provision was introduced to deal with concerns that, notwithstanding the statutory provision, child directors were sometimes appointed in order to exploit their immunity from prosecution or the reluctance of enforcement authorities to pursue young persons.[85]

[73] Cap.622, s.645. The new requirement for notification of a correspondence address under ss.643(1)(a)(ii) and 645 is not yet in operation at the time of writing.
[74] Cap.622, ss.641 and 643.
[75] Model Articles (public companies) art.33; predecessor CO, Table A reg.109.
[76] Model Articles (private companies) art.28; Model Articles (public companies) art.30. Alternate directors would be within the s.2 definition of "director", and so notification of their appointment to the Registrar is required pursuant to Cap.622, s.645.
[77] *British Murac Syndicate Ltd v Alperton Rubber Co Ltd* [1915] 2 Ch 186.
[78] *Plantations Trust Ltd v Bila (Sumatra) Rubber Lands Ltd* (1915) 85 LJ Ch 801.
[79] *Ibid.*, 802, *per* Eve J.
[80] Pursuant to the directors' power of delegation as conferred under the articles: Model Articles (private companies) art.5; Model Articles (public companies) art.4; predecessor CO Table A reg.83.
[81] Robert R Pennington, *Company Law* (8th edn, OUP, 2001) 651.
[82] *Re Broadcasting Station 2GB Pty Ltd* [1964–1965] NSWR 1648.
[83] Cap.622, s.459(1).
[84] Cap.622, s.459(2).
[85] *Hansard*, HL GC Day 2, Vol 678 col 167 (1 February 2006).

Corporate Directors

6.017 There is an outright prohibition on public companies appointing a body corporate as director.[86] Corporate directors also cannot be appointed for companies limited by guarantee.[87] For private companies, there is an absolute prohibition on corporate directors for such companies which are members of a group of companies of which a listed company is member.[88] Other private companies can appoint corporate directors, but there is a requirement that the private company must have at least one director who is a natural person.[89]

The issue of corporate directorships had been the subject of public consultation in 2008,[90] with a suggestion being made that the prohibition on public companies having body corporate directors be extended to private companies as well. This was on the basis of ensuring transparency and accountability, as the interposing of a corporate director between individuals and the subject company can mean that the individuals escape personal responsibility for compliance with directors' legal obligations.[91] The lack of transparency also caused concerns on the possibility of the use (abuse) of corporate directors to facilitate money-laundering (as control of the company by individuals can be concealed).[92] On the other hand, there is the argument that corporate directors can serve legitimate purposes: signing of documents etc. can be facilitated by the use of a corporate director where individual directors are often out of Hong Kong; and corporate service providers can provide professional directorial services more conveniently and efficiently through the use of corporate directors rather than natural persons. In the event, Cap.622, s.457 aims to strike a balance by requiring at least one director of private companies to be a natural person.[93]

V. VACATION OF OFFICE

Retirement by Rotation

6.018 As mentioned above, after the first AGM, under Model Articles (public companies) art.24, one-third, or the number nearest to one-third of the directors, are to retire from office by rotation every year. Those who are to retire shall be those who have been the longest in office since their last election. As between persons who became directors on the same day, who to retire, unless they agree among themselves, is to be determined by lot.[94] Where the company has adopted Model Articles (public companies) art.24, and the number of directors is reduced to two, neither needs to retire.[95] The Model

[86] Cap.622, s.456(1)(a).
[87] Cap.622, s.456(1)(c).
[88] Cap.622, s.456(1)(b).
[89] Cap.622, s.457.
[90] FSTB, *CO Rewrite - Company Names, Directors Duties, Corporate Directorship, Registration of Charges: Consultation Paper* (April 2008), [4.1]–[4.7], and *Consultation Conclusions* (December 2008), [25]–[30].
[91] See para.6.010 above as to whether the individuals would be *de facto* directors of the subject company.
[92] Financial Action Task Force, *The Misuse of Corporate Vehicles, Including Trust and Company Service Providers* (13 October 2006).
[93] The provision follows the UK approach in Companies Act 2006 (UK) s.155.
[94] Model Articles (public companies) art.24(6); predecessor CO Table A reg.92.
[95] *Re Moreley & Sons Ltd* [1939] Ch 719.

I. INTRODUCTION

10.001 In this chapter, attention will be turned from the internal governance of the company to the external dimension of the company. Raising public finance gives a company its external dimension *vis-à-vis* the public. Nevertheless, the public faces information asymmetry regarding the company and finds it difficult to make an informed decision as to whether or not to invest in a particular company. This external dimension is largely regulated by measures of investor protection, the objective of which is to provide the public with transparent and sufficient information. Apart from the investor protection measures that are promulgated on primary as well as secondary markets, the potential agency problems are also addressed in order to prevent abuse by those financial intermediaries and market professionals who supply investment advice and execute investment decisions. Most advanced financial jurisdictions have adopted regulation to different extents and Hong Kong is no exception. Investor protection in capital markets is at the heart of the new Securities and Futures Ordinance which provides for various means of investor protection.

This chapter will discuss the regulatory and quasi-regulatory bodies responsible for investor protection in Hong Kong. The line of discussion, however, is organised more in accordance with various regulatory methodologies, that is, regulation of issuers, regulation of intermediaries and regulation of markets.

Part II briefly introduces the regulatory bodies responsible for investor protection and their relationships. Part III discusses the regulation of issuers through the disclosure regime. Parts IV and V mainly deal with the regulation of intermediaries. Such regulation includes the approval of operations, conduct of business rules and rules against unethical forms of solicitation and selling of financial products. Part V discusses the investor compensation schemes when intermediaries default. The focus of Part VI is on the regulation of markets and deals elaborately with the issue of market misconduct as provided in the Securities and Futures Ordinance (Cap.571) (SFO). Parts VII and VIII move onto *ex ante* regulation of market-places such as the market-places owned by the Hong Kong Exchange and Clearing Limited (HKEx) and Approved Trading Services (ATS). A general assessment of investor protection in Hong Kong is made in Part IX, with reference to comparative surveys with international standards. A brief conclusion to this chapter follows in Part X.

II. INVESTOR PROTECTION AND REGULATORY REGIME IN HONG KONG

Who is the Investor?

10.002 The financial marketplace is not only a place for long term investments and savings but also for short term gains and hedges. Hence there are many types and profiles of investors such as individuals, businesses and investment professionals in the market, with different levels of sophistication and needs. Investor protection is thus a very general term and is queried as to whether the regulation providing investor protection has taken account of the vast landscape of its application. Insight into the composition of investors in financial markets will improve the efficiency and fairness of regulatory

choices as regulatory needs differ between the unsophisticated individuals and the sophisticated, resourceful and financially robust financial institutions.

Forces of Change in Capital Markets

10.003 An eminent commentator[1] has observed that the Wall Street has been transformed over the last 50 years. Retail investing was the mainstay in securities markets for a long time, and the individual would be majority holders of stocks and bonds. One of the most profound developments in the markets in the second half of the twentieth century has been the shift in the stock ownership from individuals to institutions.[2] More and more businesses and corporations invest and use sophisticated intermediaries to manage a wide range of investments.

Institutionalisation is a result of a set of technological, economic, social and even political forces.[3] The complexity of investment instruments increased as investments need to be hedged, and derivative instruments have become important financial products in the market. Further, technology makes many types of hybrid financial instruments technically feasible. These hybrid financial instruments combined traditional features of stocks or bonds with special contractual features by which the instrument's return or maturity value can be linked to some exogenous standard such as a stock market index.[4] The market has an ever-growing appetite for new products and other financing and hedging tools and corporations design more and more sophisticated and complicated products such as real estate investment trusts and securitised assets which are then used to back issues of bonds or securities. Technology has also contributed mightily to the globalisation of capital markets, which in turn would affect the investing decisions of powerful and resourceful companies in developed markets to seek less rigid but more profitable investment opportunities. Overall, the integration[5] of different financial product corporations such as banks, securities and insurance would result in greater innovation in products and greater complexity for the investor to grapple with. Therefore, even individual investors are more willing to seek professional diversification to construct their own investment portfolio so that the transaction and opportunity costs can be decreased. With complexity in the financial product innovations, many retail investors have taken a back seat from direct involvement in financial markets to participants in collective investment funds such as pension funds and unit trusts.[6] Financial institutions and market professionals have

[1] The changing landscape of the modern market in the US is described in Joel D. Seligman, "The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation" (1995) 93 *Mich L Rev* 649.

[2] J. Markam, "Protecting the Institutional Investor — Jungle Predator and Shorn Lamb?" (1945) 12 *Yale J on Reg* 345, 347–348.

[3] See generally R. Clark, "The Four Stages of Capitalism" (1981) 94 *Harvard Law Review* 561.

[4] It is often recognised that derivatives are more knowledge-based financial products, which require the derivative investors have a higher education level and work status compared to ordinary stock investors. See HKEx's Retail Investor Survey 2004, January 2005 at 7.

[5] Jerry W. Markham, "Super-Regulator: A Comparative Analysis of the Securities and Derivatives Regulation in the US, UK and Japan" (2003) 28 *Brooklyn Journal of International Law* 319 which discusses the phenomenon of the financial super-market, which is the explosion of innovative financial products in modern times.

[6] Hansmann and Kraakman argue that as we are all shareholders now, the corporate governance structure of management serving shareholders is the most effective one: H. Hansmann and R. Kraakman, "The End of History for Corporate Law" (2001) 89 *Georgetown Law Journal* 439. See however Paddy Ireland, "Shareholder

become much more important in a modern economy. Socially, the industrialised society has come to expect a more constructive employer–employee relationship and more socially responsible employers.[7] This requires the companies to diversify their capital profiles by investing funds in the capital markets to raise funds for the employees' retirement, social insurance and benefits. Thus, corporations are participating directly in secondary markets as well and are not just issuers of primary investment products.

Regulatory challenges are shaped by the changing landscape of the regulated products and participants in the markets. With globalisation, markets are much more accessible with technological and communications improvements and capital has become more mobile. For more interconnected, interdependent and competitive markets, the challenge for regulation would be to facilitate the growth of capital markets, to attract foreign capital and to address cross-border issues. On the one hand, developing an easy regulatory regime may attract capital. On the other hand, there is contradictory evidence to show that both issuers and investors prefer higher standards of investor protection in a market.[8]

Historical Laissez-Faire *of the Hong Kong Regulatory Regime*

10.004 Hong Kong is a leading financial centre in the world.[9] Hong Kong's growing importance as an international equity capital market is reflected in the fact that during 2004 it was Asia's largest (and the world's fifth largest) market for new issue of equity securities, raising US$42 billion and surpassing the levels of equity capital raised on the London and Tokyo stock exchanges.[10] In terms of total market capitalisation it is the second largest capital market in Asia and the 8th largest in the world.[11] The waves of change in financial innovation[12] and the institutionalisation of the financial markets have definitely affected Hong Kong. Hong Kong used to provide only minimal regulation in the self-regulatory efforts of the Stock Exchange of Hong Kong (SEHK)

Primacy and the Distribution of Wealth" (2005) 68 *Modern Law Review* 49, which argues that at least in the UK, shareholders are the elite top few percent of the population and thus, shareholder primacy in corporate governance may not be the most effective if the perspective is taken from the point of view of social benefit.

[7] See generally Craig L. Jackson, "Social Policy Harmonization and Worker Rights in the European Union: A Model for North America?" (1995) 21 *North Carolina Journal of International Law & Commercial Regulation* 1; Simon Deakin, "Regulatory Competition versus Harmonization in European Company Law", March 2000, a research paper of ESRC Centre for Business Research, University of Cambridge at http://www.cbr.cam.ac.uk; and Mark J. Roe, "Some Differences in Corporate Structure in Germany, Japan and United States", (1993) *Yale Law Journal* 1927.

[8] See generally Gerard Hertig, "Regulatory Competition for EU Financial Services", (2000) 13 *Journal of International Economic Law* 348, and John C. Coffee, Jr., "Racing towards the Top?: The Impact of Cross-listings and Stock Market Competition on International Corporate Governance", (2002) 102 *Columbia Law Review* 1757.

[9] Hong Kong has a long established track record as Asia's premier center for cross-border financial transactions. See Howard Curtis Reed, The Preeminence of International Financial Centers (New York: Praeger 1981).

[10] This made Hong Kong the second largest IPO fund-raiser worldwide. See Henry Tang, "Hong Kong as a Global Financial Centre," a speech delivered at a discussion forum on strengthening Hong Kong as China's international capital-formation centre by Hong Kong Exchanges and Clearing Limited on May 31, 2007 (available at http://sc.info.gov.hk/gb/www.news.gov.hk/en/category/ontherecord/070531/html/070531en11001.htm).

[11] *Ibid.*

[12] For example, 1.3% (or 75,000 individuals) of the Hong Kong adult population were derivatives investors in 2009, compared to 1.4% in 2004 and 1.7% in 2006. The median number of derivatives transactions by derivatives investors during the 12-month period was 10 in 2009, similar to that in 2007. 53.4% of male and 46.6% of female stock investors were online stock traders who had traded stocks via online media in 2009. See HKEx's Retail Investor Survey 2009, March 2010, at 2.

in maintaining orderly market conduct and supervising financial intermediaries. The (new) Companies Ordinance (Cap.622) as well as the retitled Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap.32) required mandatory disclosure of company information in prospectuses should an initial public offer be made,[13] but any mandatory continuing disclosure obligation by a publicly traded corporation was almost non-existent. The historical position was that, whether it was an individual retail investor or a sophisticated investor, *caveat emptor* ruled the day and required investors to be responsible for their investing decisions. The October 1987 crisis triggered regulatory responses to the collapse of the stock market and a regulatory framework of investor protection. From 1989 to date, the embryonic investor protection framework in Hong Kong has developed in increasing sophistication and the standards of investor protection today would be quite comparable with other leading financial jurisdictions.

Investor Population in Hong Kong

10.005 It has been reported that 35.1 percent of the Hong Kong adult population[14] (or 2,069,000 individuals) in 2009, the highest record level, were retail investors in stocks (ie securities market products) and/or derivatives (i.e. futures and options) traded on HKEx.[15] The median stock or derivatives investor is a 45 or 40 year old white collar worker, with upper secondary or above education, a monthly household income of about HKD$35,000 or HKD45,000 respectively.[16] This median shows that stock investing is prevalent and popular among especially the educated sector of the population.

Historically, local investors over the past decades contributed more than half of the total market turnover. For instance, the majority of market trading in value terms in 2006/07 came from local investors, among which retail investors contributed 27.5 percent and local institutional investors at 25.2 percent. This landscape however has recently changed. The contribution of local investors to total market turnover decreased from 50% in 2008/09 to 44% in 2009/10.[17] By contrast, the contribution of overseas investors climbed to 46% in 2009/10 from 42% in 2008/09 and for the first time surpassed local investors' contribution.[18] The contribution of overseas investors, mainly institutional investors, was 42 percent in 2009/10, up from 38 percent in 2008/09, and became the largest contributor to total market turnover.[19] During the same period, among overseas investors, UK, US and European investors ranked among the first three and contributed 29 percent, 24 percent and 16 percent of the total overseas investor trading respectively. Mainland China (11%, the fourth largest origin of overseas investors), Singapore (9%), and Japan (2.6%) were the largest contributors

[13] Sections 38B and 38D of the retitled Companies (Widing-Up and Miscellaneous Provisions) Ordinance (Cap.32).
[14] The definition of "adults" refers to individuals aged 18 or above.
[15] See HKEx's Retail Investor Survey 2009, March 2010, at 5. The definition of "stocks" refers to shares, warrants, and Exchange Traded Funds listed or traded on HKEx. The "derivatives" refer to futures and options traded on HKEx.
[16] HKEx's Retail Investor Survey 2009, March 2010, at 9.
[17] HKEx's Cash Market Transaction Survey 2009/10, February 2011, at 2.
[18] See HKEx Research & Corporate Development Department, "Overseas Participation in HKEx's Securities Market Reaches Historical High," April 2011, at 1. Overseas investors' cumulative contribution to total market turnover in the past decade was 42%. See HKEx's Cash Market Transaction Survey 2009/10, February 2011, at 2.
[19] *Ibid*.

in Asia. The aggregate contribution from Asian investors (excluding Hong Kong) was 27 percent of overseas investor trading in 2009/10, compared with 26 percent in 2008/09 and 21 percent in 2005/06.[20]

Therefore, it is imperative that the investor protection laws in Hong Kong cater to this significant percentage of retail investors, even if more sophisticated investors may be able to protect their investments by strategic or contractual measures. It is also important for Hong Kong to adopt regulatory standards at an international level to satisfy the expectations of overseas investors. According to the investor survey conducted by the HKEx for 2009, 51 percent of retail investors, 51 percent of stock investors and 46 percent of derivatives investors opined that HKEx had given priority to the public interest,[21] compared to 63 percent of retail investors and 60 percent of derivatives investors holding the same view in 2007/2008.[22] The level of satisfaction among the investing public with the HKEx purportedly improved gradually from 2005 to 2008 but has recently deteriorated since the financial crisis.[23] Overall, investors are positive on the fairness and orderliness of the market, effectiveness of the regulation of listed companies, good disclosure of information by listed companies, brokers and investors protection.[24]

Regulatory Bodies Responsible for Investor Protection

Creation of the Securities and Futures Commission

10.006 From 1989, the Securities and Futures Commission (SFC) became the principal regulatory body responsible for administering the laws governing the securities and futures markets in Hong Kong including investor protection. The maintenance and promotion of fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry and the promotion of protection for members of the public investing in or holding financial products are the major objectives of the SFC in the Securities and Futures Ordinance (Cap.571) (SFO), which came into force on 1 April 2003.[25] Prior to the creation of the SFC, there was minimal regulation in respect of investor protection. In 1972, mandatory disclosure for corporations making initial public offers was imposed under the Companies Ordinance and in 1973, the Stock Exchanges Control Ordinance was passed in order to concentrate trading on four recognised exchanges and to prevent investors from being defrauded in unrecognised markets. Increased regulation was brought in after the financial crisis of 1973. In 1974, the Securities Ordinance was enacted to license financial intermediaries and advisers, deal with insider dealing, and set up investor compensation for defrauded investors. Also, the Protection of Investors Ordinance was passed to prevent investors from being given recklessly untrue or fraudulent information regarding purchase of financial products. The Stock Exchanges Unification Ordinance then came into force in 1980 in order to further concentrate trading on the SEHK. Investors therefore relied

[20] *Ibid*., 28.
[21] HKEx's Retail Investor Survey 2009, March 2010, at 50.
[22] See HKEx's Retail Investor Survey 2007, January 2008 at 44.
[23] *Ibid*., at 41.
[24] *Ibid*., at 43–49.
[25] SFO, s.4(c).

on the self-regulation of the SEHK to provide an orderly market by regulating financial intermediaries and listing particulars disclosure for listed entities on the exchange. After the financial crisis of 1987 when the stock market had to be shut for four working days, it was recognised that a dedicated body to maintain investor protection and market confidence had to be established. In 1989, the SFC was established and became the main initiator of reform of investor protection laws in Hong Kong. However, the SFC is not the only regulatory and statutory body responsible for investor protection as the SEHK still maintains a certain amount of regulatory power and is responsible for investor protection as well. Finally, the government still wields a considerable amount of residual regulatory power and may intervene to provide investor protection.

The Securities and Futures Commission

Introduction to the SFC

10.007 After its creation in 1989, the SFC was responsible for instituting a range of regulatory tools for investor protection. In 1991, the SFC led the enactment of the Securities (Disclosure of Interests) Ordinance that compelled major shareholdings and transactions to be disclosed so that the public may be aware of important transactions and who may be in control of the company they were investing in. The SFC also led the enactment of the Securities (Insider Dealing) Ordinance that introduced a novel concept of administrative penalties for insider dealers. Although it has been commented that neither of these measures were up to international standards,[26] they were beginning steps that would eventually result in the improvements made in the new Securities and Futures Ordinance.

The SFC now consists of five operational divisions. The Corporate Finance Division is responsible for the dual filing functions in relation to listing matters, administering the Takeovers and Mergers Code and Share Repurchases Code, overseeing the SEHK's listing-related functions and responsibilities, and administering securities and company legislation relating to listed and unlisted companies. The Intermediaries and Investment Products Division is responsible for devising and administering licensing requirements for securities and futures, and leveraged foreign exchange trading intermediaries, supervising and monitoring intermediaries' conduct and financial resources, and regulating the public marketing of investment products. The Supervision of Markets Division is responsible for the supervision and monitoring of activities of the exchanges and clearing houses, encouraging development of the securities and futures markets and promoting self-regulation by market bodies. The Enforcement Division's responsibilities include conducting market surveillance to identify market misconduct for further investigation, undertaking inquiry into alleged breaches of relevant ordinances and codes, including insider dealing and market manipulation, and instituting disciplinary procedures for misconduct by licensed intermediaries. In response to the increasing availability of mainland Chinese securities and investment products on Hong Kong securities markets, the SFC has also dedicated an operation division to Policy, China and Investment Products Division.

[26] Katherine Lynch, "Stock Market Crises and Insider Dealing in Hong Kong: The Need for Regulatory Reform" in Raymond Wacks, *New Legal Order in Hong Kong* (Hong Kong: Hong Kong University Press 1999) at 237.

Regulatory Ambit of the SFC

10.008 The SFC's principal objective is to maintain and promote fairness, efficiency, competitiveness, transparency and orderliness in the securities and future markets and to reduce systemic risks in the securities and futures industry in Hong Kong. The SFC is involved in all areas of regulation, ie, regulation of investment products, regulation of intermediaries and regulation of markets and shares its regulatory competence with other public or quasi-public bodies. The responsibility to regulate primary investment products such as offers of shares or debentures is shared between the SFC and the HKEx, as discussed in Part III. The SFC's regulatory role with respect to the markets is not exclusive. The government is directly involved in certain regulatory aspects especially with respect to market misconduct as will be discussed in Part IV. As for the regulation of intermediaries, the SFC is responsible for recognising exchange companies,[27] exchange controllers,[28] clearing houses[29] and investor compensation companies,[30] as well as approving intermediaries in respect of specified regulated activities,[31] and automated trading services.[32] The responsibility for recognition in respect of exchange companies, exchange controllers, clearing houses and investor compensation companies is different in nature from the authority to approve. These entities are currently monopolies in Hong Kong. For instance, the only exchange controller is the HKEx, that is the holding company of the securities and futures exchanges as well as the clearing house. Other than automated trading services, Hong Kong has not allowed other market-players to operate and all trading in financial instruments is concentrated and under the control of the HKEx. It is intended that the HKEx should have a self-regulatory role. Although the HKEx has been demutualised and has become a for-profit corporation, it is still expected to continue to maintain a certain extent of self-regulation.[33]

The SFO provides for the SFC to have residual powers where the HKEx is exercising primary powers in the interest of investor protection. The SFC could, with consultation with the Financial Secretary, withdraw recognition of the abovementioned entities, or resume any of the functions it transferred to any of these entities, with the blessing of the Chief Executive of Hong Kong.[34] The SFC is also expressly provided with the powers to prescribe listing rules and admission of exchange participants. Although these areas are at the moment within the self-regulatory purview of the SEHK, the residual powers of regulation would vest in the SFC for the purposes of investor protection. The rationale for any exercise of residual powers is not spelt out clearly in section 36 of the SFO, but this assumption of residual powers cannot be

[27] SFO, s.19(2).
[28] Section 59(1), as subject to section 62 of the SFO that allows the Financial Secretary to exempt any person from having to be recognized by the SFC.
[29] SFO, s.37(1).
[30] *Ibid.*, s.79(1).
[31] *Ibid.*, ss.116–122, including approvals of representatives, and of authorised financial institutions already under the supervision of the Monetary Authority of Hong Kong.
[32] *Ibid.*, ss.95–97.
[33] This has been criticised in Betty M. Ho, "Demutualisation of Organised Securities Exchanges in Hong Kong — The Great Leap Forward" (2002) 33 *Law and Policy of International Business* 283.
[34] Sections 25(6) and 28 in respect of an exchange company, s.43 in respect of a clearing house, ss.68(6) and 72 in respect of exchange controllers, and ss.80(6) and 85 of an investor compensation company.

carried out unless with the approval of the Financial Secretary and upon consultation with the affected exchange company. Only in areas of revoking any authorisation granted to automated trading services under section 95 of the SFO, or intermediaries under section 116 of the SFO would the SFC have autonomous discretion.

Relationship with the HKEx

10.009 The HKEx owns and operates the only stock exchange and futures exchange in Hong Kong and three related clearing houses, that is, Hong Kong Securities Clearing Company Limited (HKSCC), HKFE Clearing Corporation Limited (HKCC) and the SEHK Options Clearing House Limited (SEOCH).

HKEx is a recognised exchange controller under the SFO and is a frontline regulator of the primary market in approving the listing of issuers. The *ex ante* vetting function of the SFC in screening market participants is delegated to the HKEx, which shall monitor issuers' compliance with the Listing Rules on a continuing basis. In respect of the regulation of intermediaries, the SFC has taken over the role from the HKEx and has become the main regulator of the HKEx's broker participants. HKEx merely plays a supplementary role in the surveillance of trading on its markets and in ensuring the investing and market participants' compliance with the trading and clearing rules.[35] Although the Listing Rules are largely contractual in nature, SEHK and its Disciplinary Committee are judicially deemed to derive their source of power to impose sanctions by statute and are "under a duty to act judicially" and "in a judicial manner".[36] It has been held by some judges in Hong Kong in some cases that SEHK's Disciplinary Committee constitutes a "court" and performs the functions of a "court".[37]

HKEx, as a listed company on its own stock market, is regulated by the SFC to avoid any conflict of interest and to ensure a level playing field between HKEx and other listed companies. Regulation by the SFC is imposed through Chapter 38 of the Main Listing Rules and Chapter 36 of the GEM Listing Rules, both of which contain certain provisions relating specifically to the listing of HKEx and set out the requirements that must be satisfied for the securities of HKEx to be listed on the SEHK as well as the powers and functions of the SFC in the event of a conflict of interest.[38]

Relationship with the SEHK

10.010 The Stock Exchange of Hong Kong Limited, a wholly-owned subsidiary of HKEx, is a recognised exchange company under the SFO and operates and maintains the

[35] HKEx has a Disciplinary Committee to review any cases brought by the surveillance function for breach of the rules.

[36] *New World Development Co Ltd v Stock Exchange of Hong Kong Ltd (2005)* CACV 170 of 2004, at 34, available at http://legalref.judiciary.gov.hk.

[37] *Ibid*. However, this view upheld by Reyes J. was rejected by the Court of Final Appeal of Hong Kong.

[38] A Memorandum of Understanding dated 22 August 2001 among the SFC, HKEx and the Stock Exchange. This document sets out the way the parties to it will relate to each other in relation to HKEx's and other applicants and issuers' compliance with the Listing Rules; the Stock Exchange's enforcement of its rules in relation to HKEx's securities and those of other applicants and issuers; the SFC's supervision and regulation of HKEx as a listed issuer and, where a conflict of interest arises, other applicants and issuers; conflicts of interest which may arise between the interests of HKEx as a listed company and companies of which it is the controller, and the interests of the proper performance of regulatory functions by such companies; and market integrity.

only listed stock market in Hong Kong. The SFC has delegated its power to regulate the issue of securities on the public markets to the SEHK. Therefore, SEHK is the primary regulator of investors and market players with respect to listing rules and trading matters of companies listed on the Main Board and Growth Enterprise Market of the SEHK. The main function of SEHK is to ensure compliance by issuers with the rules and regulations relating to the listing of securities on the SEHK and continuing obligations of such issues. While the SEHK is empowered to establish and implement rules, SFC still has the power to approve these rules before they come into effect.[39] Since prospective new issuers are required to file draft prospectuses with both the SEHK and the SFC, the SFC maintains its residual role in regulating listing matters. In addition, SEHK rules would be negatively vetted by the Legislative Council.[40]

Relationship with the Government

10.011 The ultimate responsibility for overseeing and ensuring the stability and integrity of the securities markets in Hong Kong rests with the Financial Services and Treasury Bureau, which delegates much of its responsibility to the SFC. Therefore, one of the objectives of the SFC is to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate measures in relation to the securities and futures industry.[41] The SFC is an independent body outside the civil service but answers to the Financial Secretary on a regular basis. The SFC is also guided and advised by an Advisory Committee that meets every 3 months, and the Committee consists of the Chairman of the Commission and a majority of members appointed by the Chief Executive of Hong Kong, after consultation with the Chairman.[42] The Chief Executive may also upon consultation with the Chairman, from time to time give written directions to the SFC to take specific measures,[43] and hence, the SFC would be subject to significant government input and control in its regulatory role.

Pursuant to section 5(1)(c) of the SFO, the SFC also has to encourage and promote an appropriate degree of self-regulation in the markets and this would continue the SFC's delegation to the SEHK of regulatory powers over the day-to-day operation of the listed markets, and the regulation of listed companies,[44] as well as delegation to the entities under the HKEx monopoly of relevant regulatory powers. Therefore, it is widely recognized that the SFC "acts independently in performing its regulatory functions".[45]

[39] SFO, s.24.

[40] *Ibid*., s.24(8).

[41] On the other hand, the Hong Kong Monetary Authority oversees an Exchange Fund to support the stability of the Hong Kong dollar. The total assets of the fund stood at HK$ 2.49 trillion as at the end of 2011, up from HK$2.35 trillion in 2010. The global stock market downturn and Europe's sovereign debt crisis have forced the Hong Kong Monetary Authority to diversify its investments including investing in emerging market equities and bonds, yuan products and overseas property to enhance the fund's long-term performance. Enoch Yiu, "Exchange Fund Hit By Global Turmoil," South China Morning Post, 20 January 2012, B1.

[42] SFO, s.7 and Schedule 2, Part 1.

[43] SFO, s.11.

[44] Pursuant to the Memorandum of Understanding Governing Listing Matters, November 1991.

[45] See CK Low, "A Framework for the Delisting of Penny Stocks in Hong Kong" (2004) 30 North Carolina Journal of International Law and Commercial Regulation 75; and R.G. Kotewall and C.K. Kwong, "Report of the Panel of Inquiry on the Penny Stocks Incident" (2002) para 3.18 available from www.info.gov.hk.

HKEx

HKEx, its Subsidiaries and its Regulatory Role

10.012 The HKEx is a holding company that consists of the SEHK, the Hong Kong Futures Exchange Limited and three clearing houses, namely, HKSCC, HKCC and SEOCH, that serve the securities, futures and options markets. HKEx plays a unique role in the regulatory process in that it is a commercial enterprise,[46] a public body[47] and a regulator[48] with public responsibilities, even though the SFC is the statutory regulator of the market. Under the SFO, the SEHK and the Futures Exchange, being recognised exchange companies, are charged with duties to maintain orderly and fair trading of the securities and derivatives markets, and to monitor the risks of trading as may be incurred by the participants in its markets.[49] To this end, they are allowed to prescribe rules for market conduct, regulation of market participants, listing criteria and conditions for withdrawal or suspension of listing, compensation arrangements and penalties for breach of its rules.[50] Nevertheless, these rules are not purely statutory and are by their nature contractual, private and consensual.[51] As required under the SFO, HKEx established a Risk Management Committee to formulate policies on risk management matters relating to the activities of HKEx, and to submit such policies to HKEx for its consideration.[52]

HKSCC, SEOCH and HKCC, wholly-owned subsidiaries of HKEx, are recognised clearing houses for the purposes of the SFO. HKSCC and SEOCH provide services for the clearing and settlement of securities and stock option transactions respectively, including trades and transactions effected on, or subject to the rules of, the HKEx. HKSCC provides services for the clearing and settlement of transactions on the Futures Exchange.[53] The three clearing houses are also charged with the duties of maintaining expeditious and fair clearing systems and may prescribe rules for the procedures of

[46] The commercial role of the exchange is quite common. An increasing number of exchanges such as the Australian Stock Exchange, the Chicago Mercantile Exchange, the London Stock Exchange, the New Zealand Exchange, the Singapore Exchange, and the Osaka Securities Exchange, have cemented their commercial role by listing on their own markets. As a company whose business is the operation of securities and derivatives markets, the HKEx provides information services to support investors' trading decisions, order-routing services via its networks, the execution services to match the orders. The HKEx also provides depository services, including participant shareholding records, withdrawal and deposit of physical scip, and electronic voting and corporate action services. HKEx's commercial role is still subject to the regulation by SFC. For example, HKEx is required to obtain approval for any changes in its fees and charges from the SFC.

[47] The HKEx is the sole operator of the securities and futures markets in Hong Kong. Given the importance of the securities market to the economy of Hong Kong, it is natural that the government wants to ensure that the public interest is observed. Section 63(2)(b) of the SFO states that HKEx shall ensure that the interests of the public prevails where it conflicts with its own interest. Half of the directors, including the Chairman, are appointed by the government in the public interest.

[48] Almost all exchanges have a regulatory role of some sort. However, with demutualisation and the corporatisation of exchanges pursuing profit, many exchanges such as the London Stock Exchange have surrendered their regulatory roles.

[49] SFO, s.21.

[50] *Ibid.*, s.23.

[51] There have been some constitutional law and private law arguments in support of such view. See *Stock Exchange of Hong Kong v New World Development Co Ltd* (2006) FACV 22 of 2005 available at http://legalref.judiciary.gov.hk and Chee Keong Low, "A Brave New World: The Stock Exchange of Hong Kong Holds Court," [2006] J.I.B.L.R., Issue 8, 464.

[52] The Chairman of HKEx is the chairman of the Risk Management Committee.

[53] See generally http://www.hkex.com.hk.

clearing, compensation arrangements and regulation of clearing participants.[54] The regulatory roles of the exchanges and clearing houses are buttressed by immunity provisions against civil liability for the functions discharged.[55] In this shared regulatory framework between the SFC and the self-regulating exchange and clearing entities, the SFO provides for information exchange in order for efficient and effective supervision of the financial market.[56]

Regulation by the SFC and Government

10.013 Besides the residual powers vested in the SFC earlier described, the SFC has the power to approve the exchange rules and the appointment of Chief Executives of the exchanges.[57] The SFC also has the power to examine and inspect the exchanges' records[58] and to monitor the control of HKEx in the exchanges companies and clearing houses.[59] It could be envisaged that any changes in corporate control of the exchanges and clearing houses may result in conflicts of interest between profit-making for the corporate exchanges and clearing houses and the regulatory roles they undertake. It seems that one way to mute any conflict of interest from arising is by regulatory control of the SFC over the internal corporate control of the exchanges and clearing houses. The SFC may also give directions to the HKEx to deal with conflicts of interest if they should arise,[60] and to serve restriction notices on the HKEx or any of the self-regulating subsidiaries, on any of the rules or actions undertaken by any one of them. The restriction notice may be envisaged for emergency situations in the interests of investor protection.[61] The SFC may, upon consultation with the Financial Secretary, issue suspension orders against any officer of the HKEx or its subsidiaries in the interests of investor protection.[62]

However, there is another layer of control over the regulatory roles of the exchanges and clearing houses, and that is the government itself. A person may not become a minority shareholder in the exchange controller, ie, the HKEx without approval of the SFC upon consultation with the Financial Secretary.[63] The HKEx is also compelled to set up a Risk Management Committee to formulate policies on risk management for all of its subsidiaries, and the Financial Secretary may appoint not less than three or more than five of the five to eight members of the Committee.[64] The Chairman of the HKEx has to be approved by the Chief Executive of Hong Kong,[65] and the Chief Executive or Chief Operating Officer of the HKEx has to be approved by the SFC upon consultation with the Financial Secretary.[66] If it is necessary for investor

[54] SFO, ss.38 and 40.

[55] *Ibid.*, ss.22, 39 and 81.

[56] *Ibid.*, s.91.

[57] *Ibid.*, ss.24, 26 and 42. Section 29 of the SFO also allows the SFC to give emergency directions to the exchanges.

[58] *Ibid.*, ss.27, 42 and 84.

[59] *Ibid.*, s.60.

[60] *Ibid.*, s.75.

[61] *Ibid.*, s.92.

[62] *Ibid.*, s.93.

[63] *Ibid.*, s.61. The consequences include criminal penalties and the statutory invalidation of votes cast in general meeting.

[64] *Ibid.*, s.65.

[65] *Ibid.*, s.69.

[66] *Ibid.*, s.70.

I. INTRODUCTION

The People's Republic of China (the PRC or China)[1] did not have its own Company Law until 29 December 1993 when the Standing Committee of the National People's Congress (the NPC) promulgated the Company Law. The Company Law was further amended on 27 October 2005. The amended Company Law came into force on 1 January 2006. In the intervening period, the PRC economy had become increasingly open and market-oriented, and needed a further reshuffle of China's corporate law so as to boost the operational efficiency and productivity of Chinese companies and serve the structural needs of China's capital market. Although the time was ripe for an overhaul, the Chinese government did not undertake a wholesale reform of existing company law. Rather, in recognition of the need for a more business-friendly corporate law, China has adopted a piecemeal or step-by-step approach by, among others, easing certain restrictions on capital rules, enhancing existing corporate governance and introducing more shareholder protection provisions. The amended Company Law therefore represents a staging post or stepping stone in its quest for what is thought to be an eventual consolidation of one corporate regime, applicable to domestic entities, as well as foreign-invested enterprises (FIEs). 13.001

The Company Law has been recently amended by the Standing Committee of the National People's Congress on its sixth meeting on 28 December 2013. The amendments made to the Company Law came into effect on 1 March 2014. This new round of amendments was made to reflect the instruction made by Premier Li Keqiang in a State Council executive meeting[2] held on 25 October 2013. In that meeting, Li proposed to reform the existing registered capital filing system so as to promote entrepreneurship and commercial freedom. The amendments made to the Company Law in 2013 mainly focus on corporate finance rules abolishing the paid-in capital, minimum of registered capital, instalment of registered capital contribution, restriction on the percentage of contribution in cash, and capital verification. The newly amended Company Law revamps the company incorporation system with the purposes of streamlining the registration formalities and relaxing the threshold for setting up a company in China. These changes are put in place to facilitate and simplify the procedure to incorporate companies in China, thereby encouraging innovation and entrepreneurship.

Before Chinese Company Law came into force in 1994, the companies in China were largely regulated by State-owned enterprise regulations and FIE laws. Of all the legal institutions that were rebuilt or created in the past three decades, those related to foreign direct investment (FDI) have developed the fastest. The urgency of attracting FDI and satisfying foreign investors' needs to have their investments well protected triggered the tremendous effort to create and grow an FDI regime. Against this background, it is not surprising to see the first piece of legislation enacted right after the adoption of the "opening door" policy was the PRC Sino-Foreign Equity Joint

[1] For the purpose of this chapter, the PRC or China does not include the Hong Kong Special Administrative Region, the Macao Special Administrative Region and the territory of Taiwan. Also note that all references to "Company Law" in this chapter refer to the PRC's Company Law.

[2] The purpose of the State Council's Executive Meeting was to reform the registered capital system.

Venture Law (the EJV Law),[3] which was intended to encourage foreign participation in China's modernization program. Other primary legislation and secondary implementing regulations in subsequent years allowed foreign companies to set up representative offices,[4] wholly foreign owned enterprises (WFOEs)[5] and contractual joint ventures (CJVs)[6] in China. The fourth Constitution revised in 1982 contains a critical provision offering the promise to protect "the lawful rights and interests of foreign investors".[7] These laws hit a roadblock on the ideology underpinning the practices of China's first thirty years when China often condemned foreign investment as expropriation of developing countries. A large body of laws centering on the encouragement and protection of FDI were promulgated later on. Tax rules, foreign exchange controls, customs regulations and intellectual property laws were drafted and promulgated. Nonetheless, the foreign investment policy at the early stage was primitive and inconsistent, moving between two extremes of openness and restriction. A widespread lack of uniformity, inconsistency and self-contradiction occasionally endangered the foreign investment community's confidence on China. No denial can be made of the economic and societal contribution legal institutions and infrastructure hastily rebuilt in the wake of the Cultural Revolution have made, though they proved to be far less than otherwise anticipated.

II. COMPANY LAW AND FIE LAWS

13.002 Chinese company law, as a notion, entails both the Company Law and those FIE-related laws and regulations (collectively, the FIE Laws) governing FIEs such as EJVs, CJVs and WFOEs.

As a general rule, the Company Law applies to FIEs to the extent that the *sui generis* laws applicable to those entities are silent and inconsistent. Put differently, the Company Law applies as a background law to the EJV Law,[8] the CJV Law,[9] and WFOE Law[10] in that the Company Law does not apply to the areas in which there are direct conflicts or discrepancies between the Company Law and FIE Laws.[11]

FIE Laws are "special laws" outlining different corporate structure and governance rules in respect to FIEs. Therefore, the relationship between FIE Laws and the Company Law is per *generalia specialibus non derogant*, i.e. the general does not detract from the specific and in practice, the FIE Laws may take precedence over the Company Law largely because the approval authority, the Ministry of Commerce

[3] Promulgated by the NPC and effective as of 1 July 1979, amended on 4 April 1990 and 15 March 2001.
[4] Interim Regulations concerning the Control of Resident Offices of Foreign Enterprises (promulgated on 30 October 1980).
[5] The Law on Enterprises with Sole Foreign Investment (adopted on 11 April 1986).
[6] The Law on Sino-Foreign Co-operative Enterprises (adopted on 13 April 1988).
[7] PRC Constitution 1982, Art.18 (adopted on 4 December 1982).
[8] Promulgated by the NPC and effective as of 1 July 1979, amended on 4 April 1990 and 15 March 2001.
[9] Promulgated by the Standing Committee of the NPC and effective as of 13 April 1988, amended on 31 October 2000.
[10] Promulgated by the Standing Committee of the NPC and effective as of 31 October 2000.
[11] Art.218 of the amended Company Law states that "… where the laws relevant to foreign investment make other provisions, such other provisions shall be applied". Unless otherwise indicated, the Company Law cited in the footnotes refers to the amended Company Law in 2005.

(MOFCOM) and its local branches, have been used to apply more specific FIE Laws (including various Implementing Rules respectively applicable to EJVs, CJVs and WFOEs)[12] and may continue to apply their own historical practices to FIEs. Therefore, the application of governing law needs to be confirmed on a case-by-case, project-by-project and location-by-location basis.

Given the existence of two parallel corporate law regimes, many benefits of the amended Company Law may not flow through to the FIEs and foreign investors.

III. THE NOTION OF COMPANY

Concept of "Legal Person"

13.003 Under the PRC General Principles of Civil Law, a "company" is a "legal person," a type of "social organization legal person" which equals to an "association of persons organized for certain purposes". A legal person "possesses both the capacity for civil rights and civil acts and enjoys civil rights and assumes civil obligations independently according to law".[13] The opposite concept is a "property-based legal person" meaning a legal person based upon trust and confidence.

Classification of "Companies"

13.004 The types of companies that can be established under the Company Law are the "limited liability company" and the "company limited by shares".

Depending on the place of incorporation of the shareholders, companies can be classified as FIEs or domestic companies, with one having foreign shareholders and the other having only Chinese shareholders, whom can be individuals or enterprises, respectively. FIEs can take up different forms, with EJVs and CJVs on the one hand having Chinese investors, and WFOEs on the other, having foreign investors as shareholders only.

Piercing the Corporate Veil

13.005 The concept of limited liability now appears to be both settled and respected in China and conforms substantially to international custom and practice. PRC law respects the doctrine of corporate personality and the amended Company Law affirms it. The general rule is that a shareholder is only liable to a company up to the amount of his capital contributions or, if those contributions have not been made, his agreed contributions.

The amended Company Law has provided that the corporate veil can be pierced in certain instances. The statutory examples are:

[12] E.g., PRC Sino-Foreign Equity Joint Venture Law Implementing Regulations, promulgated by the State Council on 20 September 1983 and amended by the State Council on 15 January 1986, 21 December 1987 and 22 July 2002; PRC Sino-Foreign Co-operative Joint Venture Law Implementing Rules, approved by the State Council on 7 August 1995 and promulgated by MOFTEC on 4 September 1995; and PRC Wholly Foreign-owned Enterprises Law Implementing Rules.
[13] General Principles of Civil Law, Art.36.

- where a shareholder abuses his privileges of incorporation as a shareholder and causes loss to the company or other shareholders, he may be liable in damages;[14]
- where a shareholder abuses the company's independent legal person status or his limited liability as a shareholder to evade and repudiate debts harming the interests of the company's creditors, he may be liable in damages;[15] or
- where a controlling shareholder, *de facto* controller, director, supervisor or senior officer uses his relationship to damage the interests of the company causing it loss, he may be liable in damages to the company.[16]

It is the shareholder that is held liable, although such liability is owed to the company and the other shareholders, or to creditors in the first two cases. In the second case, only persons specified are liable, but only to the company.

Codifying the doctrine of piercing the corporate veil into the Company Law may assist the stakeholders, such as injured creditors or victims in tortious cases, in having recourse to the assets of shareholders who abuse the corporate form.

The corporate veil may be pierced in other scenarios. For instance, where the company's loss of assets, books and other important documents or its inability to perform the liquidation work is attributable to an investor's non-performance of obligations, the court may support a creditor's assertion for such investor to be held responsible.[17]

The corporate veil may be also pierced so that the liability can be chased up to some foreign investors who have committed irresponsible conducts such as abnormally withdrawing capital out of China. Chinese authorities including the MOFCOM, the Ministry of Foreign Affairs, the Ministry of Public Security and the Ministry of Justice may offer their judicial and coordinated assistance to adversely affected Chinese parties in recovering the economic losses and pursuing the errant foreign investors according to domestic laws and international treaties concluded between China and relevant countries on judicial assistance on civil, commercial and/or criminal matters.[18]

Nonetheless, a clear enunciation of these circumstances needs to be carefully considered by the investors, i.e., private equity investors, as piercing of the corporate veil may expose their funds to liability. Intermediate offshore holding companies should be used where possible to insulate liability. Any further piercing of the corporate veil would be determined under the law of the place where the intermediate holding company is incorporated. Transactions that are more likely to give rise to a piercing of the corporate veil include those that are carried on by a company when it is insolvent.

[14] Company Law, Art.20, first paragraph.
[15] *Ibid.*, Art.20, second paragraph.
[16] *Ibid.*, Art.21.
[17] PRC Supreme People's Court, Provisions on Some Issues Concerning the Application of the Company Law of the People's Republic of China (I) (promulgated on 12 May 2008 and effective as of 19 May 2008), Art.18.
[18] The Circular on the Guidelines for Cross-border Pursuit of Liability and Initiation of Legal Actions by Relevant Interested Parties in Connection with Abnormal Withdrawal from China of Foreign Investors, promulgated by the General Offices of the Ministry of Commerce, Ministry of Foreign Affairs, Ministry of Public Security and Ministry of Justice, effective as of 19 November 2008.

Corporate Social Responsibility

13.006 The Company Law codifies a new concept of "corporate social responsibility" and the relevant provision in the Company Law reads:

> "When engaging in business activities, a company must abide by laws and administrative regulations, observe social morals and business ethics, act in good faith, accept supervision by the government and the public, and bear social responsibility".[19]

However, the Company Law fails to provide detailed guidelines on how to apply this concept. Unless the Supreme People's Court offers a concrete definition and effective enforcement mechanism, the concept only imposes a moral, rather legal, obligation. It will be difficult to implement this concept in practice even though the codification of this concept seems consistent with the trendy practice of corporate law worldwide. In common law, especially in English common law, corporate does not bear social responsibility though it has a separate legal personality. The adoption of this concept seems to affirm an artificial linkage between China and its Europe-orientated civil law tradition, as French law has acknowledged the notion of "corporate social responsibility".

IV. PRC COMPANY LAW'S RELEVANCE TO HONG KONG

13.007 The practice of the PRC Company Law is closely relevant to Hong Kong, or vice versa. The reason is multiple-faceted.

From "Piggybacking" to Competition

13.008 There have been many PRC-domiciled companies seeking "overseas" listings and Hong Kong is the major destination apart from New York. This is and will be the case in the foreseeable future. The popular H shares are actually issued by PRC-incorporated companies but traded in the Stock Exchange of Hong Kong (SEHK). These listing companies are subject to two sets of corporate law, the Hong Kong Companies Ordinance, dealing with corporate governance and finance, and the PRC Company Law, which governs the formation, operation and termination of these companies.

Also, Chinese companies and investors often conduct a re-structuring process through a so-called "round-trip investment" model. An intermediary holding company is incorporated in an offshore jurisdiction, typically in Hong Kong, Cayman Islands, British Virgin Islands or Bermuda. The offshore holding company, owned or controlled by Chinese shareholders, controls the operating assets either through direct acquisition or contractual arrangement. In direct acquisition, the offshore holding company acquires and owns the equity capital in the onshore operating company,

[19] Company Law, Art.5.

which retains ownership and operates existing business assets. Thus, the original Chinese shareholders are moved up to the offshore level.

This is called a "round-trip investment" model for several reasons. This model involves the transfer of equity — or assets — of Chinese residents being routed to another jurisdiction, typically a tax heaven. Next, the equity is re-invested back to the operating company in China through an offshore holding company. Lastly, the ownership or control of the operating assets remains with the Chinese shareholders.[20]

The "round-trip investment" model reflects the local business community's preference to be "packaged" as foreign investment,[21] and the concern that the government may impose exchange restrictions on residents,[22] even though the Chinese government has gradually relaxed foreign exchange quotas for outbound investment since 2006.[23] It has been estimated that a share of one-third of all inbound investment to China may be the round-tripping investment.[24] Bilateral FDI stocks from Hong Kong to China in the world were the second largest (in the amount of US$241,573 million) against the eighth largest stocks from China to Hong Kong (in the amount of US$164,063 million) in 2005.[25] The "round-trip investment" model shows investors and market players' attempts to "piggyback" on the corporate law regime in other jurisdictions.

The development of corporate law and corporate governance in China has also been heavily influenced by Hong Kong law in the past three decades when Hong Kong and China are interacted with each other in the economic sphere. As early as in 1993, the then PRC Commission on the Restructuring of the Economic System, a now defunct ministry-level commission in charge of the corporatization scheme, in order to support the listing of PRC-domiciled SOEs on the SEHK, assured the Hong Kong Securities and Futures Commission (the SFC) by sending a reply letter to the SFC to confirm that: "… the duty of good faith recited in Article 62 of the Standard Opinion has the same type of meaning as fiduciary duty under Hong Kong law".[26] This was

[20] The "round-tripping investment" also appears in other jurisdictions, and is a highly litigated or arbitrated issue. See *Tokios Tokeles v. Ukraine*, ICSID Case No. ARB/02/18, Decision on Jurisdiction (April 29, 2004).

[21] Terry Sicular, "Capital Flight and Foreign Investment: Two Tales from China and Russia" (1998) 21 *World Economy* 589–602.

[22] Frank R. Gunter, "Capital Flight from the People's Republic of China: 1984–94" (1996) 7(1) *China Economic Review* 77–96.

[23] Wei Shen, "Is SAFE Safe Now? – Foreign Exchange Regulatory Control over Chinese Outbound and Inbound Investments and a Political Economy Analysis of Policies" (2010) 11(2) *Journal of World Investment and Trade* 227, 229–236.

[24] The World Bank estimated that the "round-trip" investment is at least 25% of China's total FDI while others may claim a higher percentage. See respectively, World Bank, "Private Capital Flows to Emerging Markets" in *Global Development Finance* (New York: World Bank Publication 2002) 41 (Box 2.3: Round-tripping of Capital Flows between China and Hong Kong), available at http://siteresources.worldbank.org/INTGDF2002/Resources/chapter2.pdf; Geng Xiao, "People's Republic of China's Round Tipping FDI: Scale, Causes and Implications" (July 2004) Asian Development Bank Institute Discussion Paper (Tokyo) No.7, available at http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1137.pdf (claiming that the "round-trip" investment constitutes 30% to 50% of the total FDI); David Dollar and Aart Kraay, "Neither a Borrower Nor a Lender: Does China's Zero Net Foreign Asset Position Make Economic Sense?" (2006) 53(5) Journal of Monetary Economics 943–971 (estimating that round-tripping represents as much as 1/3 of China's FDI).

[25] See United Nations Conference on Trade and Development, World Investment Report 2007, pp.44–45; available at http://www.unctad.org/en/docs/wir2007_en.pdf.

[26] CRES Letter to the Hong Kong Stock Exchange Regarding the Opinion on Standards for Companies Limited by Shares and the Addendum Regarding Implementation of the Standard Opinion for Companies Listing in Hong Kong, 10 June 1993.

subsequently incorporated into the Mandatory Articles of Association for Overseas Listing Companies in 1994, well prior to the promulgation of the Company Law in 1994. This is a vivid example of "functional convergence," opposite to a formal one, of corporate law.[27] The strong force of the regional or global capital markets pushes for, or even dictates, more general corporate governance norms, and a harmonizing power of company law in China and Hong Kong. One of the pre-condition to secure a portion of, or a position in, the global capital market is that China is supposed to transplant certain commonly accepted and applied norms, doctrines and principles to promote rights and protections to investors. China's FIE laws and rules are good examples showing the necessity of a full menu of these protective rights to attract foreign investors.

Along with this legislative or regulatory convergence, there is also an apparent move where Hong Kong competes for better and quality companies from mainland China against Shanghai or Shenzhen while all are trying to develop their respective stock markets and enhance their competing edge. This competing force is even more apparent in light of the financial crisis and the increasing growth of the Asian market.

Hong Kong's special relationship with the mainland China is one of the key drivers of Hong Kong's growth as an international financial center in the near future. This should also be the major factor Hong Kong authorities need to consider in designing the development strategy for transcending Hong Kong into a truly international financial center in a long run. Hong Kong has to rely on overseas capital investment in its capital market and on mainland Chinese companies wanting to be listed on SEHK. Hong Kong expects the China Securities Regulatory Commission (CSRC), China's watchdog in the securities sector, to open the door wider for small and medium enterprises to list in Hong Kong.[28] Given the close relationship between Hong Kong and mainland China, the SEHK is planning to allow companies to launch initial public offerings (IPOs) denominated in the Chinese currency in the future which will open a fresh channel for international investors to buy the Renminbi assets.[29] HKEx at the same time plans to move beyond its traditional focus on stocks and IPOs by spending HK$2 billion to upgrade its system and introduce Renminbi-denominated commodities and derivatives trading,[30] which will not only allow investors to trade and hedge their risks in both Renminbi and commodities but also give the HKEx a competitive edge. For the first time, the HKEx managed to host one Renminbi IPO in 2011.[31]

Meanwhile, both Shenzhen and Shanghai are also making great efforts to attract domestic and foreign companies to list there. Shenzhen launched its long-awaited Nasdaq-style stock market in 2009, and Shanghai has been planning to have its own

[27] Ronald J. Gilson, "Globalizing Corporate Governance: Convergence of Form or Function," (2001) 49(2) *American Journal of Comparative Law*, 329–357.

[28] Henny Sender, "China's Regulator Pledges Market Reforms with Eye to Hong Kong," *Financial Times*, 17 January 2012, p.15.

[29] Robert Cookson, "Hong Kong Exchange Presses for IPOs Denominated in Renminbi", *Financial Times*, 6 October 2010, p.1.

[30] Enoch Yiu, "Revamp for HK Stock Exchange," *South China Morning Post*, 20 January 2012, B1.

[31] *Ibid.*

international board so that foreign companies may list on the mainland soon.[32] In order to secure a strong pipeline of China-backed IPOs, Hong Kong may consider a potential merger with the Shanghai and Shenzhen stock exchanges, which were identified in a market survey as preferred targets for such a merger.[33]

Based on the theory of "race to the top," stock exchanges are competing for better firms for listing by offering more stringent listing rules and corporate governance rules. The reality has also forced Hong Kong to "race to the top" by developing an internationally comparable framework that eventually can attract companies of higher quality to list on its stock market. The survey conducted by HKEx in January 2005 also shows that overseas investors require the local regulatory regime to live up to international standards. In order to maintain the status as a regional financial hub and secure the future of the local market, it is not surprising to see that Hong Kong keeps recruiting top overseas experts to steer the SFC and/or HKEx.

It is submitted that Chinese listing rules are somehow stricter than those in Hong Kong. For instance, the Shanghai Stock Exchange requires a mandatory quarterly reporting, which does not exist in Hong Kong. Gradually, we have witnessed more amendments made to the Companies Ordinance and listing rules in Hong Kong in order to ensure its advantageous position over Shanghai. Hong Kong is under the pressure from the mainland China, i.e., potentially competing with Shanghai and fearing losing out to Shanghai as a centre for investment in China,[34] and has to show potential listing applicants and investors that the quality of its markets is higher and more transparent than those in mainland China[35] or other Asian countries.

Use of Special Purpose Vehicle in China Context

13.009 The other dimension of relevance is more related to the cross-border corporate practice between Hong Kong and China. Most merger and acquisition transactions in China take place in a cross-border context with a holding company, usually termed as a special purpose vehicle (SPV), formed in Hong Kong and a target located in China. This cross-border dimension requires practitioners to be familiar with laws, rules, restrictions and features in corporate law in both jurisdictions. In connection with this cross-border dimension, the choice and use of the SPV is probably the most relevant issue.

Foreign investors may need to give serious consideration to make its investment through an SPV or other affiliate in order to further limit the liability of the investing

[32] See respectively, Patti Waldmeir, "China Launches own 'Nasdaq'", *Financial Times*, 19 October 2009, p.19; Enoch Yiu, "Companies Favour HK Arena over Shanghai", *South China Morning Post*, 26 September 2011, B2.

[33] Paggie Leung, "Shanghai, Shenzhen Top Choices if HKEx Seeks Merger, Survey Finds", *South China Morning Post*, 6 May 2011, B3.

[34] Chinese stock exchanges, including the Hong Kong bourse, have raised almost triple the amount of money secured by IPOs across the US in 2010. Robert Cookson, "Chinese Offerings Outpace Value of US IPOs", Financial Times, 13 December 2010, *Financial Times*, p.18; Henny Sender, "China's Regulator Pledges Market Reforms with Eye to Hong Kong," *Financial Times*, 17 January 2012, p.15.

[35] It has been widely agreed that the Shanghai bourse may be less attractive than Hong Kong for the listing purposes (ie for yuan-denominated stock issues) as certain mainland regulations, inter alia, capital controls, asset and earnings requirements, limit market access to overseas firms, which means that only big-name global corporate giants would qualify for listing. Besides Chinese companies are prohibited from bringing back to the mainland yuan accumulated offshore which makes issuing yuan issues less attractive. Enoch Yiu, "Companies Favour HK Arena over Shanghai", *South China Morning Post*, 26 September 2011, B2.

entity[36] and to provide flexibility to the parent company should it desire in the future to internally restructure its corporate group or to sell or merge all or part of its operations. For example, if in a restructuring transaction the ownership interest in the JV company would be assigned from the parent company to its affiliate, the consent of the Chinese party and the Chinese government approval would be required.[37] However, as PRC law is not directly applicable to such transaction, the sale of the SPV itself does not require consent and approval unless otherwise agreed in the offshore JV contract. Many financial or strategic investors planning to do private placement capitals raisings in anticipation of an ultimate public offering prefer an offshore SPV to an onshore JV. Even many strategic investors not planning for potential exit from the investment may also utilize an offshore SPV for their China investments for internal management purposes. Further, a parent company should also consider the incorporation of the SPV in a tax efficient jurisdiction to take advantage of favorable double-taxation treaties and transfer pricing.[38] The use of the SPV may also provide a vehicle for possible future off-shore private placements or share listings.

Although it is customary for a WFOE to be owned by a single investor, the legislation does contemplate that such enterprises may have more than one foreign investor. Nevertheless, in the latter case, some investors may prefer incorporating firstly an offshore SPV, which will in turn become the sole investor of the contemplated WFOE. In this way, the shareholders' relations will be subject to the jurisdiction of the place where the SPV is incorporated. Such arrangement may benefit investors in many ways. For instance, since the board of directors is to be appointed by the sole investor – the parent company, rather than by different investors who directly invest in the WFOE, the decision making of the WFOE will be streamlined. Also, if the SPV is registered at a place where the majority investor(s) is (are) granted the controlling role in decision making of the SPV, such investor(s) may be in a better position to protect its (their) interest in the SPV, and hence in the WFOE.

With regard to JVs, the Chinese partner or Chinese authorities may require justification for the use of a subsidiary as the foreign party to the JV and may require evidence of the financial viability of the foreign party, such as a bank letter, review of a separate financial statement or similar evidence. In addition, the Chinese party may sometimes require a guaranty from a well-capitalized entity, possibly the parent company of the foreign investor, either as a result of the foregoing review or if the concept of a separate subsidiary as the JV investor is raised only midway through the negotiation of the transaction.

Although there is no minimum participation requirement in most industries for the Chinese investor (e.g., a one percent participation is possible), Chinese law on joint venture corporate governance requires some critical decisions to be unanimous,

[36] This has not been proved to be a major practical concern to date.

[37] The JV law places significant restrictions on the transfer of interests in the JV.

[38] The adoption of SPV can also benefit from a wide net of double taxation treaties. For example, Mauritius is currently a party to 31 double taxation treaties. Mauritius and China concluded a comprehensive treaty on the avoidance of double taxation. As a result, China ventures owned by Mauritius holding structures enjoy a variety of reduced tax rates, especially in the area of withholding taxes on royalty payments. Mauritius companies are entitled to claim a credit for tax paid in other jurisdictions. See Elizabeth Thomson, "Using Mauritius," *Hong Kong Lawyer*, June 2006, 62, 64.