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DEVELOPING A HYBRID VARIANT FROM TRANSPLANTED ROOTS: HONG KONG CORPORATE AND SECURITIES LAW IN THE SERVICE OF A CHINESE INTERNATIONAL FINANCIAL CENTRE

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ABSTRACT

This paper is a chapter of a larger study of Hong Kong law. It measures the quality of Hong Kong corporate and securities law against its unique characteristics and international functions. Hong Kong's legal system was transplanted from Great Britain to a colonial port that was part of a larger colonial network. The transition of Hong Kong from a goods-trade-based entrepôt of the British Empire to an international financial centre of the People's Republic of China has been accompanied by a large buildup of corporate and financial law and regulatory infrastructure. This has prompted a number of changes to the inherited law, but both this initial endowment and new law imported from the US and Commonwealth countries should be adapted to the risks present in Hong Kong – which are different from those in the UK, the US or Australia. Hong Kong must also continue to adapt to the new tasks presented by the rapidly changing Chinese economic and legal framework as well as competitive pressures from offshore markets like Singapore. This paper assesses the quality of Hong Kong corporate and securities law taking these variables into account, and finds that – while meeting many challenges well – it has in some respects adopted off-the-shelf, ill-fitting solutions while failing to adapt its tools to local needs, particularly with regard to the risks posed by controlling shareholders and foreign listed companies.

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A. EVALUATING HONG KONG LAW ON THE BASIS OF LOCAL RISKS

As we have seen in Chapter 1, Hong Kong is fascinating from the points of view of comparative law and socio-economic development. It combined the peculiar characteristics of a colony enduring on the territory of an unconquered albeit weakened China that served as a refuge for subjects fleeing China during various periods of economic, political and social woes, and was then transferred back to China as this country's economy skyrocketed towards global economic leadership, destined to serve a crucial role as booming China's (preliminary?) international financial centre. Britain kept Hong Kong, like any other colony, only because it served commercial and strategic purposes, but unlike almost all colonies, Hong Kong developed into a unique, cultural subunit of the nation from which it was carved out, with a large, homogeneous majority of Chinese "voluntarily"[1] accepting (ultimate) rule (outside of their local, private ordering) by a tiny minority of British officials. The arrangement was accepted "voluntarily" because the colonial government usually presented a better political and economic milieu than did Mainland China during the colony's 156 years of existence. The core of Hong Kong's

[1] As explained in Chapter 1, although Hong Kong was officially ceded to Great Britain as a booty of the first Opium War, a number of factors indicate that this arrangement was attractive to the Chinese people who populated the area: (i) Hong Kong and the Kowloon Peninsula were largely uninhabited, but this changed after the British turned Hong Kong Harbour into its southern Chinese port, (ii) available records show this inflowing population was always well over 90% Chinese, and (iii) histories document a constant flow of Chinese subjects moving fluidly between Guangdong and Hong Kong, but – in a time of numerous rebellions and uprisings - no serious attempt to expel the British from the Island.

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early legal system was a collection of ordinances designed to meet colonial needs, coupled with a link to the common law as it developed in Britain and its empire. The larger outer circle of social ordering in Hong Kong more often consisted of arrangements under Chinese customary law and practice, and we have seen in Chapter 1 that the colonial government openly recognized this. Following a century and a half of incubation during which these English and Chinese ordering arrangements interacted with each other, the community of about seven million Chinese with an anglicized legal system, public administration and sense of justice rejoined their mother country as a "special administrative region." Hong Kong had flipped from being a mainly Chinese component serving British foreign commerce to an anglicized unit serving Chinese international finance. Only history will tell us what impact this small bit of leaven will eventually have on the massive Chinese loaf.[2] The evidence displayed in this chapter's examination of company and securities law, however, shows that Hong Kong's return to China in 1997 is correlated with – or even the cause of – the colony's commercial infrastructure exiting the conservative holding pattern it navigated during most of the Postwar period, and launching into a vigorous programme of renovation in competition with other Asian financial centres, particularly Shanghai and Singapore. Fifteen years after its return to China, Hong Kong's company and securities laws generally meet international standards as to content, but they must also be examined to ascertain whether they meet the particular risks that Hong Kong – with the unique socio-economic constellation outlined in Chapter 2 - presents.

Both company and securities laws are designed to ensure efficient and fair commercial activity. Each of these systems of law enables the creation of entities the law endows with special characteristics like companies limited by shares and licensed broker-dealers, but each also seeks to limit risks arising in connection with the use of such entities. The specific balance of "fairness" that these systems of law attempt to ensure can only be judged in relation to the actual, local context and the forces at work that could provoke unfairness. In company law, fairness is often concerned with balancing the legitimate expectations of the various constituencies of the company (e.g., directors, majority shareholders, minority shareholders, and creditors) and is generally achieved by overcoming the risk that a person to whom the law delegates power will use such power for personal benefit and to the detriment of another constituency in the company. Since the 1970s, these problems of delegated power have been referred to as "agency problems,"[3] even though no constituency in a company acts in a strict legal sense as an agent for another. These problems arise because the use of a corporate entity almost always entails a delegation of power, whether to a professional manager from the company's owners or to a resolving majority of shareholders from those shareholders who find themselves in the minority on a given resolution's vote. Such delegation is inherent to the company structure. For this

[2] By focusing on corporate, securities and tax laws, this study brackets out to a certain extent the central contribution that Hong Kong might make to Mainland China, which is "rule of law" in all its manifestations, particularly in the areas of human rights, environmental regulation, and regulatory monitoring of foodstuffs, cosmetics and pharmaceuticals for safety.

[3] On the concept of "agency problem and "agency costs," *see* Jensen & Meckling (1976: 309).

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reason, company law contains a number of mechanisms designed to allow shareholders to control the actions of management and seek redress against management abuse, as well as to protect minority shareholders against any unfairly prejudicial actions of the majority. Another problem that arises in connection with the corporate form is that both shareholders and the managers they appoint, neither of whom have any liability for the company's debts, control funds lent to the company by creditors. Thus company law also offers tools for creditor protection. As Armour, Hansmann and Kraakman very well explain, each of these three relationships present an instance of agency problems – between shareholders and management, between majority and minority shareholders, and between shareholders and creditors – for which company law has developed countervailing strategies.[4]

Securities regulation, on the other hand, as Langevoort observes, "has two main subject areas: the regulation of the securities markets and the securities industry, and the regulation of corporate issuers and information about issuers."[5] Company law connects with securities regulation because companies issue securities, which are sold to the public and traded on the stock market. Securities regulation attempts to give every investor the opportunity to make an informed decision and ensure that the price at which securities are sold is not distorted. Risks include that investors receive false, misleading or incomplete information about issuers or their securities, that the intermediaries executing trades or holding securities disappear – taking the investor's securities with them – because of dishonesty or bankruptcy, and that some traders exploit information that has not been disclosed to ordinary investors or place unsupported pressure on the price at which ordinary investors buy or sell securities. Thus, securities regulation focuses on requiring issuers to disclose information to investors,[6] licensing and supervising market participants,[7] and policing against the abuse of market integrity through insider dealing or market manipulation.[8]

The intensity of each of the risks referred to above can vary depending on the socio-economic and institutional context in which companies are operating or securities are being traded. The gravity of each agency problem in a given company will depend on the real shape of the company in question, which is a factor not only of legal institutions, but also of the ownership patterns in similar companies in the economy where it is incorporated.[9] For example, where shareholdings are widely dispersed

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[4] Armour, Hansmann and Kraakman (2009: 35).

[5] Langevoort (2009: 1027).

[6] *See* the discussion in Parades (2003: 417-430).

[7] *See* IOSCO (2010: 11): "There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake. Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk."

[8] *See* IOSCO (2010: 12): "Regulation should promote transparency of trading. Regulation should be designed to detect and deter manipulation and other unfair trading practices."

[9] For a discussion of the varying risks associated with "block" or "dispersed" shareholding, *see* Cheffins (2010); Barca & Becht (2001); Coffee (2001).

among a number of poorly organized investors, collective action problems will augment the risk of management abusing the rights of shareholders, but where only a few, well-organized shareholders own a company, it will be relatively simple for them to monitor and control management. The risk that, absent regulatory requirements, an issuer will not release true and complete information to investors will depend on the governance regime to which the issuer is subject, the nature of the instruments sold, and the sophistication of the investors, as well as market expectations. The risk that absent regulation traders will abscond with securities, operate with insufficient capital, trade on inside information or manipulate market price will vary as a factor of market size and customs, as well as in relation to the real impact of reputational sanctions on a given trader's profits.

The company law and securities laws in a specific socio-economic setting should provide countervailing strategies against those agency problems, risks and abuses that are most likely to occur in that setting. When regulatory tools are transplanted or borrowed from another jurisdiction, however, it is possible that the regulation implemented, while effective in the setting from which it is borrowed, will not address the real dangers presented locally.[10] For example, at least since 2000, it has often been the case that an image of the "Berle and Means" corporation[11] dominates discussion on corporate governance, so that a jurisdiction might be expected only to introduce American-style remedies (designed for typical US agency problems) to boost its corporate governance rating, even if the jurisdiction's economic and shareholding structure is very different from that in the US.[12] Such a cosmetic fix can leave pressing local agency problems unaddressed, and in the case of a former colony like Hong Kong, the probability is high that measures could be imported (from the UK or a Commonwealth country) whether or not they fit local conditions. The analysis in Chapter 2 of the Hong Kong economy with a focus on the corporate groups that dominate it flagged some trouble spots that should attract legislative and regulatory attention. We saw that various business sectors have direct representation on the Legislative Council, that the banking sector has been historically strong and active, that block shareholders often dominate large, listed companies, and that corporate groups conduct coordinated activity in broad sectors of the economy. To this must be added that the vast

[10] This is a well-known danger of transplanting law from one jurisdiction to another. As law develops within a specific socio-economic framework it is natural that it address its original context's problems. However, the country receiving the transplant will have different needs and capabilities, particularly thanks to a different set of institutions and cultural attitudes toward the regulated area. Without adjustment, local problems can remain unaddressed, while organs serving important functions in the "donor" country remain useless in the new environment. *See* Berkowitz, Pistor & Richard (2003).

[11] The reference is to *The Modern Corporation and Private Property*, published by Adolf Berle and Gardiner Means in 1932, which first formulated the problem of separating ownership and control where shares are widely dispersed. As Roe explains, "'As the number of stockholders increases, the capacity of each to express opinions is extremely limited.' As a result, corporate wealth is held by shareholders as a 'passive' investment while managers control the corporation." Roe (1991: 12).

[12] *See* Clarke (2006: 205-216) for an analysis of the why the transplanted US institution of "independent" nonexecutive director into Chinese companies is not an effective corporate governance measure. Another example is under pressure from Anglo-American oriented institutional investors, the German code of corporate governance recommends inserting the US institution of an "audit committee" into the *Aufsichtsrat*, or supervisory board, a body made up of non-executive directors exactly for the purpose of appointing and supervising the managing directors, including their preparation of the accounts. *See* the discussion in Cahn & Donald (2010: 450-451).

majority of the companies listed on the SEHK are not incorporated in Hong Kong, and that nearly all Hong Kong incorporated companies are private companies.[13] The presence of these characteristics in the Hong Kong economy tell us much about the entities using the legal system and how they are controlled, and what risks the law should at least consider addressing. For purposes of the analysis in this Chapter, I formulate these structurally determined risks as follows:

- The power of business and professional associations through direct legislative representation as functional constituencies may have been employed to stymie company and securities law reform or shape the content of such laws to an extent not acceptable from the perspective of a representative government;
- Strong majority shareholders may abuse their companies and the rights of minority shareholders;
- Subsidiaries could be subjected to detrimental decisions benefiting other group companies;
- Creditor protection may tend to favour well-organized, sophisticated creditors like banks, to the detriment of unsophisticated creditors;
- The limited power held by small, private companies could lead to company law legislation failing to recognize the exigencies of SMEs;
- Persons investing in the stock market could be damaged by governance abuses in the management of issuers incorporated under foreign company law; and
- Hong Kong is a geographically small area, with a relatively tight community and set of business leaders who know each other, which could lead to abuse of inside information and market manipulation.

Section B will look at the first of these questions through an examination of how Hong Kong company and securities law has developed over the years. Although law reform in Hong Kong has often been glacially slow, there is no clear correlation between the interests of specific functional constituencies and the speed at which company and securities law were enacted or updated in Hong Kong. The remaining questions listed above will be examined in section C of this chapter on the basis of the law as it now stands, with particular focus on the written law. Enforcement in Hong Kong will be examined in Chapter 4. With respect to company law and the presence of large shareholders in Hong Kong, it will be seen that Hong Kong has insufficient protection for minority shareholders against majority action, although the judiciary has taken a strong stand in favour of investor protection on a number of occasions,[14] and has repeatedly underlined the importance of protecting investors.[15] The rules available for the governance of corporate groups are rudimentary, but on the whole above

[13] *See* subsections C.4 and C.5 of this chapter.

[14] *See* e.g., *Re PCCW Ltd* [2009] HKEC 738, CA (attempted circumvention of minority headcount vote invalidated); *Luck Continent* [2012] HKEC 567 (extension of unfair prejudice action to a listed company).

[15] For example, in response to an Australian court's restrictive interpretation on how a shareholder right to information should be applied, Harris J of the Hong Kong Court of First Instance observed regarding an identical provision: "By enacting section 152FA, the legislature provided an important new procedure for the protection of shareholder rights and interests and the community's more general interest in the maintenance of good corporate governance. Section 152FA should therefore be interpreted and applied in a manner consistent with these legislative objectives. This can be achieved through taking a generous approach to the interpretation of what constitutes an interest 'reasonably related' or 'germane' to the applicant's status as a shareholder." *Wong Kar Gee Mimi v Hung Kin Sang Raymond* [2011] HKEC 1164.

average among common law jurisdictions.[16] The influence of banks and the legal profession, both of which are formally represented in the LegCo and benefit from these complex security arrangements, likely contributed to the retention of company law charges, and path dependence might have worked against the introduction of a stronger capital maintenance regime for unsecured creditors. As a result, Hong Kong law contains strong tools for the protection of sophisticated creditors and few safeguards for other types. The rules for private companies have been repeatedly amended in recent years, showing a local legislation that is responsive to the needs of small business, which constitute the primary users of the Hong Kong company form. About 73% of companies listed on the SEHK, the exchange capable of boasting the best regulatory standards in China, are incorporated neither in Hong Kong nor in China, but in the Cayman Islands or Bermuda, although their centre of business operations is mainly in China. It is doubtful that any defect in Hong Kong company law has driven companies to incorporate in such jurisdictions before listing on the SEHK, and the popularity of such law likely instead reflects embedded inefficiencies with the Chinese corporate and securities laws. In the alternative route of incorporating and listing in China, incorporation would be expensive, listing would be bureaucratically difficult, and any funds received from foreign investors as well as dividends to such investors would be subject to numerous controls on investment and exchange.[17] As for market integrity, Hong Kong's law and regulations meet international standards, and as discussed in Chapter 4, the steady flow of enforcement actions, taken together with an absence of large insider trading or market manipulation scandals being uncovered, tend to indicate that the existing risks are being addressed effectively. Moreover, perhaps for the same reasons that small countries tend to have less corruption,[18] it appears that the reputation impact within the small financial community of Hong Kong has made both formal and informal reputational sanctions on issuers, broker-dealers, and gatekeepers (auditors, lawyers, listing sponsors) a strong enough deterrent to ensure a high level of legal compliance without "heavy-handed"[19] regulation. Before turning to these questions, section B will examine the development of Hong Kong company and securities law and the reasons behind stagnation or reform.

[16] As will be discussed below, the options range from a specialized framework of statutory provisions, as is used in Germany, to a general reliance on court made equitable duties, as are employed in Delaware. *See* Cahn & Donald (2010: 677-689).

[17] On incorporation and listing, *see* Wang (2013: chapters 4 and 9), on round-trip investment, *see* Wei (2010: 123-135).

[18] *See* Amin (2011).

[19] As will be discussed in section C, much of Hong Kong regulation is expressed in the form of guidelines issued by the SFC and listing rules issued by the SEHK, neither of which have directly enforceable civil or criminal penalties.

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B. LAW TRANSPLANTED (ONLY) AS THE NEED AROSE

1. Slowly evolving company law

Loh argues that the allocation of separate votes to general and functional constituency representatives for the passage of bills that are introduced into the Legislative Council by persons other than the government is "designed to thwart legislative initiative."[20] It is generally thought that the Competition Bill, which suffered neglect and languished in the LegCo for over 10 years, was an example of such ability to thwart legislative change.[21] As will be explained below, company law in Hong Kong has evolved at a pace that – although it never sank to that of the Competition Bill – would clearly have been unsatisfactory for a leading financial centre. From the evidence available in connection with amendments proposed and adopted, however, the stagnation of the statutory company law in Hong Kong seems more a case of negligence than of vested interests bent on impeding reform. Its accelerated development in recent years correlates with Hong Kong's handover to China and its growth as an international financial centre.

Hong Kong received its company law and securities law, as well as the shape and philosophy of its financial regulation, through the colonial administration as transplants from Great Britain – either directly or in forms that had already been adjusted for use in other colonies. Its tax law harks back to the Colony's founding as a free port.[22] As discussed in Chapter 1, the basic commercial framework for the Colony's operation was laid down with a set of ordinances in 1843-44, including linking decision-making in the colonial courts to British common law. Hong Kong's first Companies Ordinance (CO) was enacted in 1865,[23] and was modelled on the English Companies Act 1862.[24] Providing the core of a standard companies act, the 161 section CO 1865 provided for the creation of companies limited by shares, by guarantee and without limit on liability,[25] their management[26] and their winding up.[27] The required constitutional documents were the memorandum and articles of association (a feature of Hong Kong law until 2014),[28] and just as is done today, a model articles was appended to the Ordinance as Table A of Schedule 1. The Ordinance also provided for annual general meetings[29] and

[20] Loh (2009: Kindle location 447).

[21] Loh (2009: Kindle location 446).

[22] An Ordinance for the Incorporation, Regulation, and Winding-up of Trading Companies and other Associations, No. 1, 4 March 1865.

[23] Halsbury's Law of Hong Kong, S.95.002.

[24] Although the size of the Ordinance more closely resembles the CA 1856, the fact that the Ordinance included treatment of insurance companies, a feature not found in the CA 1856, Cheffins (2010: 166, Table II), indicates that the CA 1862 rather than the earlier law was the drafters' point of reference.

[25] CO 1865, secs. 8, 9, and 10.

[26] CO 1865, Part III.

[27] CO 1865, Part IV.

[28] CO 1865, Sec. 15.

[29] CO 1865. Sec. 49.

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a vote by proxy unless denied in the articles,[30] as well as for the creation of a Companies Register,[31] to which constitutional documents[32] and copies of resolutions must be submitted.[33] The 1865 Ordinance was then replaced by the Companies Ordinance 1911 (following the UK Companies Act 1908), which brought in more detailed rules on capital, such as for the issue of warrants,[34] greater specification and binding duties for the keeping of accounts,[35] and statutory rules on prospectuses for the public sale of shares.[36] The 1911 Ordinance was replaced by the more detailed Companies Ordinance 1932 (following the UK Companies Act 1928), which remained the basic framework of company law in Hong Kong for the next 80 years, until the Companies Ordinance 2012 replaced it. Given that the details of management under the UK model are specified in the articles of association, which can be privately adapted to changing circumstances, and common law decisions from both the UK and the (now) Commonwealth countries continued to evolve and feed into the Hong Kong courts, company law cannot be said to have stood still during this 80 year period.[37] For example, in a 1976 action, shareholders of the property management company Chinese Estates Ltd. sought to have the company wound up for lack of a "substratum", i.e. that it was no longer pursuing its object following sale of its property holdings, but the Hong Kong court referred to recent decisions of UK[38] and Commonwealth courts to reach a holding that was much less formalistic than earlier doctrine: the company should survive given its substantial assets and the possibility that it can continue business.[39] The company, which survived, eventually through acquisition and reorganization became the holding company of a diversified investment group.[40] A 1978 action[41] gives a good example of how the company law of Hong Kong has evolved in courts until today. The High Court was faced with the question whether to approve a request that the Financial Secretary investigate the affairs of a company under an open-ended provision of the Ordinance.[42] Finding no guidance in Hong Kong or the UK, the Court surveyed decisions across the Commonwealth, finding guidance in South Africa, New Zealand and British Columbia from which it formulated a principle for deciding the Hong Kong question of law.[43]

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30 CO 1865, Sec. 51.

31 CO 1865, Sec. 160.

32 CO 1865, Sec. 160.

33 CO 1865, Sec. 53.

34 CO 1911, Sec. 38.

35 CO 1911, Sec. 77.

36 CO 1911, Sec. 82-86.

37 Examples of company law applied by Hong Kong courts will be discussed in section B.

38 *Particularly Re Kitson and Co Ltd*. [1964] 1 All ER 435.

39 *Re Chinese Estates Ltd.* [1976] HKCU 36.

40 *See* the website of Chinese Estates Group at www.chineseestates.com, group profile > group structure (last accessed 31 July 2012).

41 *Re San Imperial Corporation Ltd.* [1978] HKCU 34.

42 In question was CO sec. 143. The section was later amended in 1984.

43 *San Imperial* [1978] HKCU 34, at 3-6.

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Thus, despite antiquated statutory provisions, much of Hong Kong company law remained modern through the activity of the courts, which were free to seek and adopt solutions that had been formulated in the courts of other jurisdictions whose law harked back to a UK companies act.

However, it does not speak well for Hong Kong as a business centre that the colonial administration left the CO 1932 largely unchanged for over fifty years. The first significant push for renovation of the company law came, interestingly, in the same year as the Sino-British Joint Declaration, when in 1984 Hong Kong company law took what some call the "great leap forward to 1948,"[44] incorporating for the first time many of the changes that were introduced in the UK Companies Act of that year.[45] This historical correlation of dates marking improved law and milestones in Hong Kong's entry to China might also include causation, as it is reasonable to assume that both the Hong Kong government and leading figures in business knew the role a well-developed commercial infrastructure could play in the rebirth of the Mainland Chinese economy.[46] Indeed, in 1994, the government instructed a consultant to review the Hong Kong Companies Ordinance, with a report due in 1997,[47] the year of the Colony's return to China.

Although the Hong Kong Companies Ordinance was not completely revised until 2012, from 1984 - when a Standing Committee on Company Law Reform was established together with the "great leap" revision – the Ordinance was amended regularly. These amendments have been primarily designed to bring in bits and pieces of newer UK and even US law (indirectly through Australia),[48] and a number of the changes exemplify an increased focus on shareholder protection:

- Loosening of the rules on financial assistance for listed and private companies;[49]
- Allowing the SFC or official receiver to petition the court for disqualification and removal of company directors;[50]
- Elimination of the common law *ultra vires* doctrine;[51]

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44 Bates (1984: 167).

45 In 1962, a Companies Law Revision Committee was appointed to consider and make recommendations on Hong Kong's company law. In ten years, the Committee published two reports: the Protection of Investor Report and the Company Law Report. The Company Law Report was based on the Cohen Committee Report of 1945 and the Jenkins Committee Report of 1962 in the UK, supplemented by consideration of local conditions in Hong Kong and developments in other Commonwealth jurisdictions. The 1973 recommendations of the Committee in the Company Law Report mainly endorsed the proposals contained in the reports of its English counterparts. *See* Bates (1984: 167-68) and Kwan (2012: 2.1.2).

46 In a managed economic environment, it is not unusual for steps such as these to be planned in advance. For historical background of the political background to the choice of Hong Kong as a form for listing Chinese state operated enterprises, *see* Meng (2011: 257-259).

47 Halsbury (2012: 95.0002).

48 An example of such transplantation was a provision introduced in 2004 to give shareholders a right to request access to company books and records for a "proper purpose," now s 152FA of the Hong Kong Companies Ordinance (s 740 of CO 2012) and s 220 of the Delaware General Corporation Law.

49 Introduced by the Companies (Amendment) Ordinance 1991.

50 Introduced by the Companies (Amendment) Ordinance 1994

51 Introduced by the Companies (Amendment) Ordinance 1997.

- Relief from share premium reserve requirements in the case of 90% acquisitions of a company with shares or reorganizations of owned groups;[52]
- Introduction of written resolutions in lieu of general meetings;[53] and
- Introduction of the right under statute to bring a derivative action against directors on behalf of the company.[54]

Particularly the increased availability of derivative actions and the use of written resolutions present advantages for minority shareholders, and do not support the thesis of majority shareholder power thwarting amendment of Hong Kong company law. The statutory derivative action allows remedy against management for misconduct if the court grants leave for the petition to go forward,[55] and shareholder petitions have found good reception in the courts.[56] This piecemeal approach of annual amendments could have been the result of Hong Kong's longstanding policy of conservative, minimum interference in the market interacting with knowledge of its growing role as China's gateway to foreign finance in competition with Shanghai and Shenzhen, and compounded by the global "corporate governance movement" that perhaps reached its climax with the US Sarbanes Oxley Act of 2002.[57] The result of adding piecemeal amendments to a statute from 1932 was a law that might generally be assessed as complete, albeit poorly organized, sometimes with antiquated wording, and at places internally repetitious or even conflicting.[58] If the piecemeal evolution had been carried on annually with changes corresponding to recent developments in belief about best practices, the activity would resemble that of the US State of Delaware, where since 1967 the bar and business

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[52] Introduced by the Companies (Amendment) Ordinance 1999.

[53] Introduced by the Companies (Amendment) Ordinance 2000.

[54] Introduced by the Companies (Amendment) Ordinance 2004.

[55] An innovation of the statutory derivative action was the adoption of the concept of "specified corporation," which was defined as "a company or a non-Hong Kong company" (former CO s 2), and although the 2012 Ordinance eliminates this concept, it expressly applies statutory derivative actions to non-Hong Kong companies (CO 2012, s 722). Under the former Ordinance, actions could be brought for "misfeasance", which was defined as meaning "fraud, negligence, and default in compliance with any enactment or rule of law or breach of duty" (former CO s 168BB(2)). This concept remains, although the word "misfeasance" has been changed to the more readily understandable "misconduct" (CO 2012, s 731).

Under s 168BC(3) of the statutory derivative action as introduced in 2004, leave to bring an action would be granted upon satisfaction of four preconditions: (i) it appears to be prima facie in the interests of the company to grant leave; (ii) there is a serious question to be tried; (iii) that the company itself has not brought proceedings or if it has, it has not "diligently continued, discontinued, or defended those proceedings; and that at least 14 days before filing with the court, the applicant has served written notice on the company, setting out his intention to apply to the court and the reasons for his intention.

[56] Hong Kong courts have found the preconditions for a grant of leave present a low threshold for the plaintiff shareholder, so that the action may not be lightly dismissed. For recent treatment, *see Li Chung Shing Tong (Holdings) Ltd* [2011] HKEC 1192 (Court of First Instance) and *Waddington Ltd v Chan Chun Hoo & Others* (2008) 11 HKCFAR 370 (Court of Final Appeals).

[57] The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

[58] The law contained two different, partially inconsistent rules on the sale of shares at a discount, sections 46 and 57, only one of which survived in the new bill introduced to the LegCo in 2011. Rules on financial assistance were in provisions provisionally numbered from 47 to 47G, and statutory derivative actions were in sections with auxiliary section numbers running from 168B to 168BK. Article 98 in Table A of the Ordinance in force as of 2013 (Chap 32) still conflicted with s 157B of the Ordinance, despite the latter's express provision that an article in conflict would have no effect.

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communities have fed suggestions to the state legislature on a regular basis, but the legislature never revisits fundamental structural properties of its law, as there is a tacit understanding that businesses rely on Delaware not to modify radically the framework around which they have planned and built.[59] Thus, a failure to follow the UK in its regular issue of newly renovated companies acts, such as those enacted in 1985 and 2006 – which largely implement EU directives – would not, in itself, be a symptom of uncompetitive regulatory activity in Hong Kong.

The open question of whether specific groups exercise unfair influence in the formulation of Hong Kong company law, particularly through the functional constituencies, arose during the last days before the Companies Ordinance 2012 was enacted. The Companies Bill contained a provision holding auditors criminally liable if they either "knowingly" or "recklessly cause a statement required to be contained in an auditor's report … to be omitted from the report."[60] The Chairman of the committee charged with preparing the Bill for a vote by the Legislative Council, the Honourable Paul Chan, represented the accountancy functional constituency.[61] With the argument that the accounting industry can discipline itself, the Hong Kong Institute for Chartered Public Accountants, Hong Kong's primary auditors association, proposed that the clause be removed.[62] The Committee responded to this by noting that the provision had "support from SFC, and deputations including Federation of Hong Kong Industries … [and] The Hong Kong Electronic Industries Association," as well as a secondary accounting association, "The Institute of Certified Management Accountants," because of the clause's "benefit in enhancing the accountability of auditors and integrity of the financial reporting system."[63] The clause remained in the Bill,[64] albeit with assurances that under interpretative guidance to be provided by the Companies Registrar, "junior accountants will not face criminal liability" as a result of the provision.[65] Another hotly debated provision might say even more about the fairness of lawmaking in Hong Kong, given that it is designed to protect minority shareholders in the context of corporate reorganizations. As explained in Chapter 2, block-holding majority shareholders constitute the greatest threat to balanced corporate governance in Hong Kong, and a recent, high-profile case discussed in section [C.2 of this chapter] brought the machinating skills of majority shareholders to the attention of the media. The result was an amendment that could be called balanced, given that it appears both reasonably designed to address inefficiencies in the

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59 With respect to the evolution of the Delaware General Corporation Law, *see* Romano (1985); Roe (2003); Roe (2009); Roe (2009a); Armour, Black & Cheffins (2012).

60 *See* sec. 399 Companies Bill 2011.

61 *See* www.legco.gov.hk, members' biographies.

62 Report of the Bills Committee on Companies Bill, LC Paper No. CB(1)2221/11-12, para. 106. Available at www.legco.gov.hk, bills committees > bills committee on companies bill (last accessed 30 June 2012).

63 Report of the Bills Committee on Companies Bill, LC Paper No. CB(1)2221/11-12, para. 107.

64 *See* s 408 CO 2012.

65 Enoch Yiu, "Auditors will be liable under law change," *The South China Morning Post* (13 July 2012).

minority protection mechanism and did not reduce protection for those persons who may seek to block a self-serving transaction initiated by a majority shareholder.[66] Thus, as the discussion of the substance of Hong Kong company law in section C will evidence, although Hong Kong company law does leave room for improvement in substance, its shape and the pace of its evolution do not seem to have been prejudiced by the direct representation of business interests in Hong Kong lawmaking. However, the extensive use of foreign incorporation means that a great deal of the regulatory burden for good governance has been shifted from the company law to securities laws and listing rules in the Hong Kong market.

2. Crisis-driven securities regulation

The Hong Kong laws regulating sale of and dealing in securities compete well with those of other financial centres, both formally and, as will be discussed in Chapter 4, in terms of enforcement. Unlike the regulatory competition for corporate charters often discussed in the US or EU context, the competition in which Hong Kong engages is financial: foreign companies enter Hong Kong to access its capital market and seek funds at costs that benefit from Hong Kong's regulatory framework. The round-trip model of companies with China-focused operations that incorporate in a Caribbean jurisdiction and list on the SEHK places significant strain on this regulatory framework. The foreign investment, capital account, and mutual recognition regimes between mainland China and Hong Kong do not yet allow Hong Kong to compete with the mainland for corporate charters – in spite of significant progress made by the Closer Economic Partnership Arrangement (CEPA). A Hong Kong incorporated company cannot simply start doing business in China the way a Delaware company might do business in California or a UK company might do business in France. Although the nine phases of the CEPA completed by 2012 made steady progress in liberalizing cross-border financial activity and trade, no provision is made for free corporate mobility between China and Hong Kong.[67] The field of battle between Hong Kong and other jurisdictions in regulatory competition is clearly corporate finance: the SEHK and HKFE, supported by the framework of the SFO, the quality of market participants like brokers and banks, the infrastructure supporting funds transfers, clearing and settlement, and the regulatory authorities that license, supervise and discipline market participants – the SFC and HKMA. The importance of the Hong Kong Dollar in this context must also be

[66] For a discussion of the so-called "headcount rule," *see* section [C.2.]

[67] The specific commitment expressed in the financial services subsector of CEPA IX provides for continued use of local companies on each side of the mainland-Hong Kong border, as the liberalization measures are designed: "To allow Hong Kong securities companies which satisfy the qualification requirements as foreign shareholders of foreign-invested securities companies, and Mainland securities companies which satisfy the requirements for establishing subsidiaries, to *set up equity joint venture securities investment advisory companies* in the Mainland. The equity joint venture securities investment advisory company shall be *a subsidiary of the Mainland securities company*, the scope of business of which shall focus specifically on carrying on securities investment advisory businesses. The percentage of shareholding of the Hong Kong securities company could, at a maximum, reach 49% of the total shareholding of such joint venture securities investment advisory company." CEPA. Annex, Supplements and Amendments IX to the Mainland's Specific Commitments on Liberalization of Trade in Services for Hong Kong, s 7. Financial Services.

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highlighted, given that from the beginning of mainland China's economic transformation it has provided a solid currency whose exchange is both full and free.[68] Lastly, a strong community of professional advisors acting as "gatekeepers" provide what is hoped to be effective supervision and enforcement in the financial sector.[69] Although Hong Kong market institutions have been developing for over 100 years, the laws and regulations governing this area of "securities regulation" were slow to come to Hong Kong. In the 40 years since their first introduction, these laws and regulations have come to meet or surpass international best practices. Unlike the development of company law, securities regulation in Hong Kong – as is generally true in the rest of the world[70] – has been established, expanded or improved in the wake of financial crises.

Although securities trading in Hong Kong dates back to at least to the mid-nineteenth century,[71] and an Association of Stockbrokers was established in 1891,[72] which could provide private controls on securities trading, particularly after its reorganization into the Hong Kong Stock Exchange in 1914,[73] statutory rules for exchanges, broker-dealers and market conduct were not introduced until 1973.[74] Stimulated in part by the ideological redefinition and subsequent isolation of China following 1949,[75] Hong Kong's financial sector strengthened throughout the 1950s and 1960s, so that Colony's Financial Secretary could remark that Hong Kong was "'attracting capital from outside … to what could be an embarrassing degree.'"[76] In light of that increasing activity, the colonial government asked its Companies Review Committee to look at market regulation, and in 1971 the Committee recommended "the appointment of a Commissioner for Securities to assume the registration and monitoring process" for broker-dealers, supported by "an advisory committee composed of men knowledgeable in the securities industry."[77] However, no concrete steps toward the creation of such a body were taken at that time. Even as equity trading overflowed the Hong Kong Stock Exchange and fed the creation of three new exchanges formed in 1969, 1971 and 1972 – the "Far East Exchange," the "Kam Ngan Stock Exchange," and the "Kowloon Stock Exchange," respectively[78] – no specific,

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[68] On the maintenance of the Hong Kong Dollar's stability through two financial crises, *see* Sheng (2009: chapters 10, 15).

[69] Meng (2013: [●]).

[70] From the UK "Bubble Act" of 1720 to the US Dodd-Frank Act of 2010, regulation of the financial markets has followed public choice, which tends to demand change only when losses have been suffered by market failure of one kind or another. *See* e.g., Banner (1998) and Coffee (2012).

[71] HKEx (1999:1).

[72] Id.

[73] Id.

[74] Material used in this section is drawn in part from *Hong Kong Stock and Futures Exchanges – Law and Microstructure* (Thomson Sweet & Maxwell: 2012). I thank the publisher for the right to use such material.

[75] *See* Goodstadt (2007: 90-94).

[76] Goodstadt (2007: 164), quoting a statement of J.J. Cowperthwaite made in 1967.

[77] Fell (1992:41).

[78] Fell (1992: 38-39).

secondary market rules were put in place. Only a Stock Exchange Control Ordinance, enacted in early 1973, was drafted to prevent further fragmentation of the market through the opening of more new stock exchanges.[79] However, when, after reaching a peak of 1,775 points in March 1973, the Hang Seng Index dropped about 70% to 433 points at year's end,[80] the colonial government decided to act. In March 1974, at a time when the Hang Seng Index had bottomed out around 400 points, the government adopted a "Securities Ordinance"[81] and a "Protection of Investors Ordinance."[82] The Securities Ordinance imposed licensing and prudential requirements on firms engaging in securities dealing, whilst the Investor Protection Ordinance policed market integrity. The Securities Ordinance imposed initial and continuing licensing requirements on both securities exchanges and broker-dealers,[83] created an informally staffed commission to supervise the securities market and a compensation fund for investors damaged by brokers,[84] and outlawed short selling, market manipulation and fraud in connection with the purchase or sale of a security, generally.[85] In 1978, a prohibition against insider dealing was added to this Ordinance,[86] and an Insider Dealing Tribunal was created.[87] Although these efforts may appear late compared to the US creation of insider trading rules in 1942,[88] it is useful to remember that even the 1978 Ordinance preceded EU efforts in this area by over ten years.[89] The Investor Protection Ordinance was a slim, nine section statute that focused solely on punishing reckless or intentional misrepresentation or advertisement in connection with inducement to purchase securities.[90] The penalty imposed for inducing anyone fraudulently or recklessly to invest in securities was imprisonment of up to seven years and a fine of up to HK$1 million.[91] A Commodities Trading Ordinance[92] was added to this inchoate regulatory system in 1976,

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[79] HKEx (1999: 2). Although today such lawmaking might be understood as an affirmative measure of securities regulation taken to maximize the network effects (liquidity) of securities trading, increase transparency, and thus improve market quality, in the context of 1970s Hong Kong, a control on the number of exchanges might better be seen simply as further evidence of a long-standing government stance according to which, in Goodstadt's words, "[r]estrictive practices proliferated … in any area of business that did not face direct competition from abroad." Goodstadt (2005: 5).

[80] *See* HKEx (1999: 2); Fell (1992:42); McGuinness (1999:30).

[81] The Securities Ordinance, Chapter 333, 1 March 2974.

[82] The Protection of Investors Ordinance, Chapter 335, 29 March 1974.

[83] Securities Ordinance (1989 edition), secs. 20-97.

[84] Securities Ordinance (1989 edition), sec. 109.

[85] Securities Ordinance (1989 edition), secs. 80, 135-136, respectively.

[86] Securities Ordinance (1989 edition), secs. 141A-141F.

[87] Securities Ordinance (1989 edition), secs. 141G-141L.

[88] *See* 17 CFR § 240.10b–5.

[89] The first European Economic Community (as it then was) legislation against insider dealing was Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, Official Journal, L 334, 18 November1989, p. 30.

[90] Protection of Investors Ordinance, secs. 3-6.

[91] Protection of Investors Ordinance, secs. 3.

[92] The Commodities Trading Ordinance, Chapter 250, 1 September 1976.

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to license and supervise commodities exchanges[93] and dealers[94] under the auspices of an informally staffed commission, as well as to establish a compensation fund to reduce the risk for investors of defaulting broker-dealers.[95]

Following the 1986 entrance into force of a 1981 Stock Exchange Unification Ordinance,[96] the four, existing stock exchanges were merged into the Stock Exchange of Hong Kong (SEHK) in 1986, and in the same year the popular Hang Seng Index Futures were introduced on the Hong Kong Futures Exchange (HKFE).[97] The next significant crisis pushing the development Hong Kong securities regulation forward was a market failure affecting both the stock and the futures exchanges. In 1987, the HSI lost about 52% of its value, falling from 3968.70 points to about 1917 during the month of October.[98] As prices rose, the HKFE had neglected to raise margin requirements for futures traders or to increase the capital of its guarantee fund, so that when the crash came and investors betting long on the HSI found themselves with unmanageable liabilities, this brought the futures market to the point of insolvency.[99] As it would during the 1997-1998 Asian financial crisis when its currency was under attack,[100] and again during the 2008-2009 global financial crisis when faced with wide-spread losses from Lehman credit-linked notes,[101] the Hong Kong government deviated from its announced *laissez faire* principles and stepped into the matter directly. In 1987, the government bypassed the Securities Commissioner and arranged a "rescue loan" of HK$ 2 billion for the HKFE guarantee fund.[102] The next step it took was in November 1987 to commission a study of its regulatory framework, and it established a Securities Review Committee, chaired by Ian Hay Davison, "to review the constitution, powers, management and operation of the Stock and Futures Exchanges and their regulatory bodies."[103] The subsequent "Davison Report"[104] recommended, *inter alia*, "replacing the two [existing, lay] Commissions … with a single independent statutory body outside the Civil Service … headed and staffed by full-time regulators … charged with ensuring the integrity of markets and the protection of investors … [having] extensive reserve powers to intervene if [the

93 Commodities Trading Ordinance (1989 edition), secs. 13-25.

94 Commodities Trading Ordinance (1989 edition), secs. 26-65.

95 Commodities Trading Ordinance (1989 edition), secs. 76-98.

96 The Stock Exchanges Unification Ordinance, Chapter 361, 1 February 1981. Pursuant to section 27, commencement date of the Ordinance was 2 April 1986.

97 Fell (1992: 71); HKEx (1999: 3).

98 HKEx (2009:4); Fell (1992: 194-95).

99 Fell (1992: 196).

100 *See* Sheng (2009: 263-273).

101 *See* Chapter 4, section [●].

102 Fell (1992: 198). This consisted of HK$1 billion from the government's Exchange Fund and HK$1 billion contributed in equal parts by HSBC, Standard Chartered Bank and the Bank of China. SFC (2002: 31-32).

103 SFC (2002: 25).

104 The formal title was "The Operation and Regulation of the Hong Kong Securities Industry." *See* SFC (2002: 25).

exchanges] fall down on the job [of primary supervision]."[105] To implement this recommendation, the Securities and Futures Commission Ordinance was enacted in 1989,[106] which created a new regulatory agency, the Securities and Futures Commission (SFC). Compared to the Securities Commission of seconded market participants previously used, the SFC is given significantly more independence from the market, a clearer mandate in licensing broker-dealers and investment advisors, enhanced powers of investigation, and authority to launch actions for injunctions, removal of directors, and criminal prosecution.[107]

The last steps in creating the main framework of the regulatory infrastructure used in Hong Kong today took place in 2000 and 2002. The first was to demutualize the SEHK and the HKFE, and place them and their clearing houses, under a holding company, the Hong Kong Securities Clearing Company Ltd (HKEx), in which the government has a significant shareholding, and power in the appointment of management. The Financial Secretary has the right under the SFO to appoint up to eight members of a recognised exchange company's board of directors,[108] and the HKEx' articles of association state that the appointment of its chairperson must be approved by the chief executive of the HKSAR,[109] and that the SFC may veto any planned appointment to the post of chief executive or chief operating officer of the HKEx.[110] The second step was to codify the existing securities laws in a single ordinance, the Securities and Futures Ordinance, which in addition to creating a new Market Misconduct Tribunal (MMT)[111] into which the Insider Dealing Tribunal was merged, reorganized and combined the pre-existing pieces of legislation that, as discussed above, had been enacted in response to crises during the previous quarter century, including:

- The Securities Ordinance (1974);
- The Protection of Investors Ordinance (1974);
- Commodities Trading Ordinance (1976);
- Stock Exchange Unification Ordinance (1981);
- Securities (Disclosure of Interests) Ordinance (1988);
- The Securities and Futures Commission Ordinance (1989);
- Securities (Insider Dealing) Ordinance (1991); and
- The Exchanges and Clearing Houses (Merger) Ordinance (1999).

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105 SFC (2002: 37).

106 The Securities and Futures Commission Ordinance, Chapter 24, 1 May 1989.

107 For a general discussion of the SFC's structure, independence and powers, *see* Donald (2012: 2.3.2). Section 213 SFO allows the SFC to seek injunctions against broker-dealers and listed companies, and s 214 SFO allows the SFC to take action against management irregularities. For questions of market integrity, the SFC can take both civil and criminal action against violation of rules against market manipulation and insider dealing. *See* s 388 SFO. These enforcement powers will be discussed in greater detail in Chapter 4.

108 SFO s 77(1), (5).

109 HKEx Articles of Association, art 111(2).

110 The HKEx Articles of Association, art 111(3)(b).

111 Part XIV.

As will be discussed below in section C, the SFO has recently been amended to include stronger rules on the disclosure of price sensitive information and will soon be amended to incorporate a regime for information on and the clearing and settlement of over-the-counter derivative products. In following, the Hong Kong corporate and securities framework is examined for an ability to meet, not expectations deriving from rules considered leading because formulated in the US and Europe, but the needs and risks arising in the specific socio-economic environment which is Hong Kong in the early 21st century.

C. How Good Are the Hong Kong Company and Securities Laws?

1. Does company law protect against majority shareholder abuse?

As in other systems of company law, Hong Kong companies limited by shares make decisions through ordinary or special shareholder resolutions,[112] reached by either the simple majority or three quarters of the vote cast, respectively. Majority voting as the highest forum for company decisions presents a compromise position under which not every member will have his or her way with the company he or she owns in part. Such decision-making is used in companies because a unanimity requirement for decision-making could paralyse a corporation, prejudicing investment and thus render the corporate form very unattractive. As a result of majority voting, persons holding nearly 50% of the voting power may be forced to accept decisions of the majority on ordinary matters (such as allotting shares)[113] and persons holding up to 25% of the voting power may be so forced on special matters (such amending the articles of association).[114] To address the risk of majority abuse, company law has developed a number of strategies that allow minorities to have a proportionately stronger voice and to seek redress when necessary. *A stronger voice* can be achieved by mandating that a higher majority be required for a decision, such as that for a special resolution, by giving a separate class or disinterested shareholders a separate vote, such for variation of class rights,[115] by allowing a shareholder to "accumulate" all her votes on a single person for election when votes are cast for board members,[116] or by granting multiple voting rights to shares in certain circumstances, such as giving preference shares multiple votes regarding the declaration of dividends the year following a decision by the ordinary shareholders not to make distributions.[117] *Redress* can be built into the law by giving a

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112 *See* CO 2012, secs. 563-564.

113 *See* CO 2012, sec. 141.

114 *See* CO 2012, sec. 88.

115 This is provided for in HK CO 2012, sec. 180(3).

116 Hong Kong law does not provide for cumulative voting. The Company Law of the People's Republic of China, which allows cumulative voting if provided for in the company's articles, defines it as follows: "a cumulative voting system shall mean, in the election of directors or supervisors by the general board of shareholders, the number of voting rights granted under each share is the same as the number of directors or supervisors to be elected, and the shareholders may use all of their voting rights for a single candidate." PRC Company Law, art. 106.

117 This would be provided by contract, such as the terms of issue of preference shares.

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minority reaching a certain percentage of the vote a right to challenge a majority decision,[118] giving even a single shareholder the right to bring an alleged breach of the law to the court, or empowering a public supervisory authority to act in this regard. This study focuses on the latter, two techniques.

To challenge the behaviour of a majority shareholder, company law offers one of two causes of action: that the majority acted in an unfairly prejudicial manner, as provided for in UK law and systems of law deriving from it, including Hong Kong,[119] or that the majority breached a duty of loyalty to the whole of the company and the minority, as is provided for in, *inter alia,* the law of Delaware and that of Germany.[120] Both approaches seek to redress the unfairness of actions that are technically legal, but normally entail an element of bad faith. The majority shareholder has the legal right to undertake every act that the percentage of its holding allows it to resolve on, but if such actions are prejudicially unfair to the minority, each of these two causes of action, in principle, allow redress. The UK "unfair prejudice" approach and the "duty of loyalty" approach found in the US and Germany diverge greatly as applied in courts, with the former being limited to "quasi-partnership" situations. The origins of the UK unfair prejudice remedy, which is the main cause of action offered minority shareholders by Hong Kong company law, is understood as an extension of fiduciary principles from partnership law, as Lord Hoffman explains:

> company law has developed seamlessly from the law of partnership, which was treated by equity, like the Roman *societas*, as a contract of good faith. One of the traditional roles of equity, as a separate jurisdiction, was to restrain the exercise of strict legal rights in certain relationships in which it considered that this would be contrary to good faith. These principles have, with appropriate modification, been carries over into company law.[121]

For this reason, a court hearing an unfair prejudice claim seeks to understand whether the majority shareholder has breached the "terms of the association" which are "contained in the articles of

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[118] For example, Hong Kong law gives a minority constituting 10% of a company's voting rights the power to veto a resolution to merge or reorganize the company. *See* CO 2012, sec. 674(2)(a)(ii)).

[119] The HK Companies Ordinance has provided a statutory unfair prejudicial remedy since 2004. Under sec. [168A – *update*] of the Ordinance, a member of the company can apply to the court for an order on the ground that the affairs of the company are being or have been conducted in a manner which is unfairly prejudicial to the interests of the members generally or of some part of the members. The Ordinance further sets out six types of relief which may be granted by the court as sees fit:

(1) require the company to refrain from doing or do an act which the petitioner has complained it has omitted to do,
(2) authorize civil proceedings to be brought on behalf of the company,
(3) appoint a receiver or manager,
(4) regulate the conduct of company's affairs in the future,
(5) order share purchases,
(6) award damages and interest.

CO sec. 168A(2)(a). Although the court has wide discretion to make such an order, the most commonly sought and granted remedy is a buy-out of the petitioner's shares. Cheung (2008b: 348). This is a strong reason for not allowing unfair prejudice actions in the context of listed companies, given that shareholders may easily sell their shareholding on the market.

[120] *See* Cahn & Donald (2010: 574-581).

[121] *O'Neill and Another v. Phillips and Others* [1999] 1 W.L.R. 1092, 1098.

association and sometimes in collateral agreements between the shareholders."[122] Because an otherwise valid exercise of a legal right will only be deemed unfair where there is a "collateral agreement" between the shareholders, UK law has traditionally restricted such actions to shareholders of private companies.[123] Lord Hoffman, quoting the decision of Parker J in *Re Astec (BSR) plc.*[124] observes:

> "in order to give rise to an equitable constraint based on 'legitimate expectation' what is required is a personal relationship or personal dealings of some kind between the party seeking to exercise the legal right and the party seeking to restrain such exercise, such as will affect the conscience of the former." . . . I have no difficulty with this formulation. But I think that one useful cross-check in a case like this is to ask whether the exercise of the power in question would be contrary to what the parties, by words or conduct, have actually agreed. Would it conflict with the promises which they appear to have exchanged?[125]

It is not likely that retail, or even most institutional, investors in a corporate group dominated by a founding shareholder would informally "exchange promises" with the majority shareholder, making application of the unfair prejudice remedy to listed companies highly unlikely.[126] Yet the primary majority/minority problem in Hong Kong is that existing when founding shareholders from the Hong Kong economy or an administration of the Chinese State brings a company to the market and sells a portion of its shares to investors. Thus the UK unfair prejudice remedy as classically understood is not helpful for addressing the primary agency problem facing company law in Hong Kong. The response has over time taken shape in two steps, each discussed below. First, Hong Kong took[127] the novel step of creating a parallel public avenue of redress by giving its securities regulator, the SFC, a statutory right to petition courts to take action on a number of theories, among which is unfair prejudice. Second, as Hong Kong courts after 30 June 1997 are no longer bound by UK precedent,[128] at least one recent decision extended the application of the unfair prejudice remedy to a listed company.[129]

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[122] *Id.*

[123] Another useful example is: "Although fairness is a notion which can be applied to all kinds of activities its content will depend upon the context in which it is being used. Conduct which is perfectly fair between competing businessmen may not be fair between members of a family. In some sports it may require, at best, observance of the rules, in others ("it's not cricket") it may be unfair in some circumstances to take advantage of them. All is said to be fair in love and war. So the context and background are very important." *Id.*

[124] *Re Astec (B.S.R.) Plc*. [1998] 2 B.C.L.C. 556, 588. With respect to the generally unavailability of an unfair prejudice action against a the impersonal circumstance found in a listed company, also *see Re Blue Arrow plc* [1987] BCLC 585*, Re Posgate and Denby (Agencies) Ltd* [1987] BCLC *8, and Re Saul D Harrison & Sons plc* [1995] BCLC 14.

[125] *O'Neill* [1999] 1 W.L.R. at 1101.

[126] *See In Re Blue Arrow plc* [1987] BCLC 585.

[127] In its current form, the pertinent section 214 has been in the SFO since it came into force in 2003.

[128] This is a self-evident aspect of the handover to China, but is discussed and affirmed by the HK Court of Final Appeals in *Solicitor (24/07) v Law Society of Hong Kong* [2008] HKEC 431, 586.

[129] It should be noted, as will be discussed below, that the *Luck Continent* decision did not openly break with precedent, but transformed it so as to pull the development of common law in a new direction.

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Beyond this, compliance with the minimum public float requirement for listing on the SEHK[130] is monitored continuously, and a failure to meet it can lead to suspension.[131] The combination of these elements, if continued and (preferably) extended, would present a solid framework for the protection of minority shareholder rights.

(a) Public defence of minority shareholders

When a company is listed on a stock exchange, its shares are liquid and there is small incentive to take judicial action against an abusive majority shareholder rather than simply selling one's shares on the market. As such, even when an effective remedy for breach of minority rights is available, shareholders faced with prejudicial behaviour from dominating shareholders may exit the company rather than choosing to incur the expense of seeking redress from a court. This can lead to a situation in which both misbehaviour of a dominant shareholder goes unchecked and the percentage of an issuer's public float trading among outside shareholders remains small or even shrinks, the latter problem being addressed by monitoring and sanction – as discussed in subsection (c). A possible solution to this mismatch of interests and costs and its undesirable effects on enforcement is to empower a supervisory authority – somehow generally funded, such as by tax revenue, a regulatory levy on exchange trading, or fines paid by offenders – to act for the benefit of the minority. Hong Kong law has provided such a "public defender" route to the control of dominating shareholders through unfair prejudice since 1994.[132] The SFO expressly empowers the SFC to ask the Court of First Instance (CFI) to take action against a listed company if it finds that the company's business or affairs have been conducted in a manner:

(a) oppressive to any of its members;
(b) involving theft, fraud, or misfeasance towards any members;
(c) withholding reasonably expected business information from any members; or
(d) unfairly prejudicial to any members.[133]

The relief available includes the removal of a director or other officer from all management, a cease and desist order, an order to the management of the corporation to itself bring suit, placing the company under a receiver, or "any other order it considers appropriate."[134] This tool has been particularly useful for policing management in the foreign ("overseas") companies that dominate listings on the SEHK. With only one exception, the companies in connection with which the action

130 SEHK Listing Rules, Rule 8.08(1)(a). At 25% of total issued share capital, this is a rather low requirement.

131 SEHK Listing Rules, Rule 6.01(2).

132 Originally Securities and Futures Commission Ordinance, sec. 37A, since 2003, SFO, sec. 214. With respect to the date sec. 37A was inserted into the now repealed SFCO, *see Securities and Futures Commission v Mandarin Resources Corp. Ltd & Another* [1997] HKLY 192. This provision also allows the SFC to seek redress for the kinds of management misbehavior normally challenged in shareholders derivative suits.

133 SFO, sec. 214(1).

134 SFO, sec. 214(2).

has been applied were incorporated in Bermuda or the Cayman Islands,[135] and normally fall into the "red-chip" category: i.e., companies operating in and controlled by persons from mainland China, but incorporated in a foreign jurisdiction and listed in Hong Kong. Although the SFC has had this powerful tool at its disposal for nearly two decades, it has been used only 14 times, with 11 of those occurring from late 2008,[136] and the companies against which, or against whose directors, the SFC sought orders had in most cases already been suspended from trading and were mired in various other legal problems.[137] As such, the SFC has employed the action more as a tool for mopping up a messy market, particularly disqualifying directors who had driven their company into the ground, than protecting market integrity before the company runs completely off the track.

The 2012 case of *Re Styland Holdings Ltd (No 2)*[138] is representative of both the advantages and disadvantages of SFC actions under section 214. In this case, a company founder and his spouse built and served on the various boards of a multinational corporate group, with the parent company, Styland Holdings Ltd, incorporated under Bermudan law and listed on the SEHK. These controlling shareholders caused Styland's various subsidiaries to enter into a number of transactions that were both damaging to the respective subsidiaries and beneficial to themselves or family members, such as loans to and support for the company of a nephew of the founder's co-director/wife.[139] An advantage of the SFC taking these actions forward is its team of forensic accountants and lawyers with good regulatory experience, investigative powers, and its interagency network based on numerous MoUs, all of which allow the SFC to produce detailed analyses of multinational corporate organizations and the flows of money through their various accounts, often, as in the *Styland* case, returning to the dominant shareholder-directors. For example, one of the various instances in which the SFC demonstrated that funds flowed back the Styland founder showed that in connection with a purchase of a shareholding, a company unrelated to Styland paid a sum to a Styland subsidiary, which transferred funds to second Styland subsidiary, which made a transfer to another company unrelated to Styland (whose sole director was, however, an employee of the Styland group), which made

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[135] Styland Holdings Ltd, Pearl Oriental Innovation Ltd, GP NanoTechnology Group Ltd, and Wah Sang Gas Holdings Ltd were incorporated under the law of Bermuda, while Warderly International Holdings Ltd and Rontex International Holdings Ltd were incorporated under the law of the Cayman Islands. Mandarin Resources Corp. Ltd was incorporated in Hong Kong. This information is provided in the decisions cited in following.

[136] A search of WestLaw and Lexis databases, conducted on 1 August 2012, with the broad search parameters "(37A or 214) & Securities & Commission" revealed only 12 companies that had been challenged under the provision.

[137] This was the case with Mandarin Resources Corporation Limited (*see Securities and Futures Commission v Mandarin Resources Corp. Ltd & Another* [1999] HKEC 1055 CA), Styland Holdings Ltd (*see Styland Holdings Ltd (No 2)* [2012] 2 HKLRD 325 CFI), Warderly International Limited (*see Securities and Futures Commission v Yeung Kui Wong* [2010] HKEC 1637), and Wah Sang Gas Holdings Limited (*see Wah Sang Gas Holdings Ltd* [2009] HKEC 892).

[138] [2012] 2 HKLRD 325.

[139] *See* the discussion of Iwana Company Ltd's purchase of shares issued by Inworld Holdings Ltd, the option granted by the latter to Mr Keven Ngai (nephew of Yvonne Yeung), and loan by Iwana Company Ltd to Mr Ngai. *Re Styland Holdings* [2012] 2 HKLRD 325, at paragraphs 24-55.

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payment to another unrelated company (which was directed by the founder couple's nephew who also was a director of other Styland companies), which then for no clear reason transferred funds to a company 100% owned beneficially by Styland's founder.[140] This resulted in a finding of breach of directors' fiduciary duty by that founder-director, and contributed to an order disqualifying him from current and future director positions. On the other hand, by the time the SFC brought proceedings against the directors and founding member of Styland Holdings Ltd, the SEHK had already delisted the company over four years earlier, the strongest sanction available to the exchange, so that the SFC was primarily ensuring that the directors involved in Styland's abuses were not able to regroup into another corporate scheme for a number of years. A recent action filed by the SFC may indicate, however, that it is seeking to police existing listed companies more aggressively. In November 2012 it filed an action against three directors of Hong Kong listed company First China Financial Network Holdings Ltd, seeking disqualification of directors who arranged a related-party transaction benefiting a subsidiary in which one of them had a significant holding.[141] This occurred at a time when, although First China Financial was suffering significant losses,[142] it was still in good standing on the GEM board of the SEHK. Nevertheless, the action focused on directors, and as we have seen in Chapter 2, dominant shareholders – not self-interested directors[143] – present the greatest threat to balanced corporate governance in the Hong Kong economy, a threat which should be addressed with adequate tools.

(b) Applying the unfair prejudice action to listed companies

Hong Kong courts have applied the unfair prejudice rules consistently with their UK colleagues in spite of the prominent mismatch between the agency risks present in the two economies. Although – as Barma J observed in *Luck Continent* – such application does not legally restrict unfair prejudice actions to companies in which a personal relationship among the members has been established (i.e.,

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140 *Re Styland Holdings* [2012] 2 HKLRD 325, at para. 80.

141 *See* "SFC seeks court orders against former and current directors of First China Financial Network Holdings Ltd," SFC Enforcement News, 12 Nov 2012, available at www.sfc.hk, home > news & announcements > enforcement news.

142 *See* First China Financial Network Holdings Ltd, Third Quarterly Report 2012, available at www.hkexnews.hk, Listed Company Information.

143 Hong Kong law contains the standard measures used to limit the risks of director power, even if such risks are low, given the great power of the shareholders that elect them to office. As we have seen, individual members may bring derivative actions against directors for misconduct and a majority of the members voting at one time may remove a director without cause. In addition, the boards of listed companies must contain at least 3 (constituting at least 1/3) independent, non-executive directors. Hong Kong followed international trends in gradually increasing its use of independent directors. The SEHK introduced a provision in its Listing Rules in 1993, requiring listed companies to have at least two INEDs on their boards of directors. Ho (1997:507). In 2004, the SEHK increased the minimum number to three (Listing Rules, Rule 3.10(1)), and required that the board contain at least one INED with "appropriate professional qualifications or accounting or related financial management expertise (APQs)" (Rule 3.10(2)). As from 2013, INEDs must constitute at least 1/3 of the board of a listed company (Rule 3.10A). The Listing Rules also provide that listed companies must establish an audit committee (Rule 3.21) and a remuneration committee (Rule 3.25) comprised solely of non-executive directors (NEDs).

private companies), all reported decisions awarding relief[144] had addressed this sort of small company in which tacit agreements or expectations can be understood to exist. The prejudicial breaching of such tacit agreements or expectations by the majority shareholder is then seen as unfair. In a 2012 judgment on an unfair prejudice action, the Hong Kong Court of Appeal broke this mould for the first time, albeit on the basis of very unusual facts, and granted relief to one shareholder of a listed company challenging the behaviour of another shareholder in the voting of company shares as unfairly prejudicial. Given the strong presence of controlling shareholders on the Hong Kong market and – as discussed with reference to *Re PCCW Ltd*, discussed below – the efforts of Hong Kong courts to protect unsophisticated minority shareholders, this opening of the unfair prejudice action to such companies was meaningful for Hong Kong.

The first unfair prejudice action to award relief to a shareholder of a listed company was *Luck Continent Ltd v Cheng Chee Tock Theodore* [2012] HKEC 567. Like many cases that tug common law development in a new direction, *Luck Continent* had unusual facts. First, the action was filed by a majority, not a minority, shareholder, Luck Continent Ltd, which had acquired the listed company CY Foundation Group Ltd through a reverse merger.[145] Through a required public offering of shares, the plaintiff's investment vehicle dropped from a holding of approximately 97% to about 46% of issued shares, and the plaintiff was forced off the board.[146] When he sought to call a meeting to regain control of the company by removing directors with a simple majority of votes, as is required under the SEHK listing rules, the company's counsel informed him that the removal would require a special resolution.[147] The drop in Luck Continent's holding meant that the plaintiff was well below the 75% threshold to adopt a special resolution.[148] The "prejudice" resulted from the fact that CY Foundation Group Ltd's articles of association did not allow removal of a director with an ordinary resolution, but rather demanded a special resolution, so that they breached the SEHK listing rules, which mandated that removal be possible with a simple majority.[149] This discrepancy would eventually result in the company being de-listed from the SEHK.[150] Even though when the SEHK threatened the company with sanction and a number of general meetings were called at which proposals were made to correct

[144] *Re Shun Tak Holdings Ltd* [2009] 5 HKLRD 743 examined an application on unfair prejudice against major shareholders and directors of Shun Tak Holdings Ltd, a company listed on the SEHK, but the court rejected the petition, holding that the action was actually derivative in nature against directors for misconduct.

[145] *Luck Continent* [2012] HKEC 567, para. 3.

[146] *Luck Continent* [2012] HKEC 567, paras. 5, 9, 11.

[147] *Luck Continent* [2012] HKEC 567, para. 11.

[148] *Luck Continent* [2012] HKEC 567, para. 15-16. The original concern was not to amend the articles, but to remove directors and regain control of the company's management. Because Luck Continent did not have 75% of the votes, it was unable to remove directors under the existing articles (which called for a special resolution), at which point it became interested in the deviance of the articles from the listing rules requirement.

[149] *See* SEHK Rules, Appendix 13, together with Appendix 3, s 4(3).

[150] *Luck Continent* [2012] HKEC 567, para. 14.

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the situation by amending the articles, a shareholder with a holding exceeding 25% blocked the resolution.[151] The delisting of equity securities is widely understood to decrease their value. This decrease in value presents the second unusual aspect of *Luck Continent.* Unlike most company decisions alleged to create unfair prejudice, here we find a failure to act that has a causal relationship to damage with 100% probability occurrence: blocking the vote to bring the company into compliance with the rules will certainly have the prejudicial effect of the company being delisted from the SEHK, so that the court had no doubt that the relief requested would eliminate the prejudice.[152] With respect to the existence of an agreement or understanding among members that was breached, the CFI found that there was a tacit agreement – whether through collateral contract, contract for the benefit of a third party, or implied promise – between the company and the shareholders that the company comply with the SEHK listing requirements, and thus equity demanded such agreement be enforced.[153] As such the company's continuing failure to meet the listing rules (as caused by the blocking shareholder) unfairly prejudiced the plaintiff's interests, and the court ordered that the company's articles of association be amended to allow for removal of directors by majority vote.[154]

Luck Continent's logical extension of UK precedent to listed companies and the arrangements accompanying listing could indeed prove lucky for minority shareholders in Hong Kong – and for the quality of Hong Kong law seeking to safeguard fair management in listed companies. The bonds between compliance with listing rules, remaining listed on the SEHK, and the existence of a liquid market for shares are beyond all doubt: if the first falls the others will too. It is therefore unlikely that courts will find it problematic to see a breach of arrangements and understandings among shareholders when such rules are breached. However, a breach of these rules could also be seen as "misconduct" by the company's board. If a court were of a mind to focus on technical doctrine and ignore the equity of the matter, it could play on the distinction between "misconduct" (the basis of a derivative action) and "mismanagement" (the basis for an unfair prejudice action) to dismiss applications on a theory of unfair prejudice as abuse of process.[155] Hong Kong law specifically provides that a court may order the commencement of an action in the company's name against any

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[151] *Luck Continent* [2012] HKEC 567, paras. 16-17.

[152] The problem at the core of the complaint was compliance with a rule, which is binary (one either complies or does not) and results in sanction or delisting from the exchange. Therefore, unlike most business decisions, the opportunity costs of not making the decision could be known in advance with certainty. This fact permitted the court extraordinarily to apply the unfair prejudice remedy to the actions of a minority shareholder.

[153] *Luck Continent* [2012] HKEC 567, para. 97.

[154] *Luck Continent* [2012] HKEC 567, paras. 100-103.

[155] This was done in *Re Shun Tak Holdings Ltd* [2009] 5 HKLRD 743. In that case, the holding company and majority shareholder of a subsidiary in which the plaintiff was a shareholder failed to cause the subsidiary to pay dividends – an action which under Hong Kong law requires that both the board and the members do their part. Ignoring both the role of the majority shareholder in the payout of dividends and the express provision for an action against misconduct in the Companies Ordinance, the court through Kwan J found the petition to be a disguised derivative action and an abuse of process. *See* also *Re Chime Corp Ltd* [2004] HKEC 1503, CFA.

person for misconduct as one form of relief for unfair prejudice.[156] Regretfully, the courts which have dismissed unfair prejudice actions as derivative actions in disguise have failed to comment on why, if the two remedies are mutually exclusive, LegCo included such provision in the Ordinance. One can hope that a result of the diminishing shadow of UK case law over the Hong Kong courts and the increasing need of Hong Kong to take the lead in providing good law to China, courts will have the courage bravery to craft the solutions that Hong Kong needs rather than those with which the Privy Council would have approved.

If Hong Kong courts were to allow minority shareholders of large companies to seek redress when the majority uses its power to cause the company to take actions unfairly detrimental to the minority, this would bring it in line with non-UK legal systems like Germany, Delaware and California, which require majority shareholders to use their powers of control over the company fairly. Germany's High Federal Court[157] has explained that the majority shareholder has a fiduciary duty because it is "able to influence the company's management to the prejudice of the interests of their fellow shareholders in the company, thus requiring introduction of a counter-balancing duty to take such interests into consideration."[158] The Delaware Supreme Court has also concluded, despite lacking statutory requirement, that "[a] parent does indeed owe a fiduciary duty to its subsidiary …. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary."[159] The California Supreme Court has stated that a "comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material properly governs controlling shareholders."[160] Each of the cases in which this duty was expressed concerned the exercise of a shareholder vote resulting in a transfer of value from the minority to the majority shareholders: in the *Linotype*[161] and *Ahmanson*[162] cases, the majority voted to transfer the most productive assets of the company into an entity they alone controlled, and in *Sinclair*[163] the parent chose not to cause a subsidiary (with minority shareholders) to take action against another (wholly owned) subsidiary for breach of contract.

156 "[T]he Court may make … an order that proceedings … be brought in the company's name against any person." s 725(2)(a)(ii) CO 2012. In the former CO, the relevant provision s 168A(2)(a)(ii) was essentially identical ("the court may … order that such proceedings … be brought in the name of the specified corporation").

157 The *Bundesgerichtshof.* In this "civil law" jurisdiction, the high court itself has taken the initiative to craft an equitable fiduciary duty because the overall framework of the statute demands balance and fairness, but did not provide a specific solution for such abuse.

158 *In Re Linotype,* Doc. No. II ZR 75/87, BGHZ 103, 184 (1988), reprinted in translation in Cahn & Donald (2010: 585).

159 *Sinclair Oil Corporation v. Francis S. Levien*, 280 A 2d 717, 720 (1971).

160 *Jones v H.F Ahmanson & Co*, 1 Cal.3d 93, 112.

161 *See* Cahn & Donald (2010: 583-584).

162 *See Ahmanson,* 1 Cal.3d 93, at 102-105.

163 *See Sinclair*, 280 A 2d 717, at 722-723.

The Delaware court has also applied this fiduciary standard of fairness in circumstances where a parent company sought to force through a merger between a subsidiary with minority shareholders and another, wholly-owned subsidiary.[164] The fiduciary duty of majority shareholders resembles that imposed on directors, given that company law gives both company organs (board and general meeting) power over the entire company, and it is implicit that this power must be used for a proper purpose, not for advantageous self-dealing. Although use of the unfair prejudice action in Hong Kong company law meets international standards under the UK company law model, neither the UK nor major Commonwealth countries like Australia, Canada or New Zealand have an economy in which large, controlling shareholders play such a dominant role as they do in Hong Kong. For this reason, introduction of a fiduciary duty or duty of loyalty for controlling shareholders would be doctrinally appropriate for Hong Kong. This would greatly benefit minority shareholders, particularly in the context of the corporate groups, and strengthen Hong Kong's position as a financial centre where retail and institutional investor can purchase minority stakes with low legal risk. Application of actions for unfair prejudice beyond intimate, quasi-partnership arrangements, such as happened in *Luck Continent*, is a good step in the right direction. The next section focuses more closely on the treatment of corporate groups under Hong Kong company law.

2. Does company law address the specific risks of corporate groups?

As Chapter 2 shows, corporate groups are prevalent in the Hong Kong economy. Some are the results of British merchants' activity in Hong Kong in coordination with other holdings. Others started as family concerns locally, and grew into multinationals headed by listed companies.[165] In 1997, the Hong Kong Society of Accountants reported that nine out of ten of listed companies in Hong Kong had one family group holding 25 percent or more of the issued shares.[166] In 2000, Claessens, Djankow and Lang found that around 65 percent of listed companies on the SEHK were family owned enterprises (FOEs).[167] While the listing of large, Chinese state owned enterprises (SOEs) has significantly changed the balance of SEHK market capitalization away from the FOEs, it has reinforced the strong presence of corporate groups with dominant shareholders on the Hong Kong securities market. With a market structure characterized by the dominance of family or Chinese government owned enterprises, the Hong Kong legal and regulatory framework should show particular focus, strength and competence in regulating corporate groups.

164 *See* e.g., *Weinberger v UOP, Inc.* 457 A 2d 701 (1983); *Kahn v Lynch Communication System, Inc.* 638 A 2d 1110 (1994).

165 Wong (1985). Also see Lawton (2007).

166 Hong Kong Society of Accountants (2007).

167 Claessens, Djankow and Lang (2000).

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Relationships in corporate groups are troublesome because of the fundamental conflict between each member of the group being an independent body corporate with, as a matter of law, its own interests and internal decision-making process, and the fact that a subsidiary company will, as a matter of business strategy, only exist at all if this benefits the overall interests of the holding company. Economic unity collides with company law separateness. Many aspects of a company's operations provide opportunity for controlling shareholders to extract value from the firms they control (often referred to as "tunnelling") in various ways. As Atanasov, Black *et al* observe, seen generally, "there is both cash-flow tunneling (diversion of on-going cash flow) and 'equity tunneling' (extraction of value via financial transactions that affect ownership claims, rather than the firm's operations)."[168] Beyond tunnelling by extracting funds from a subsidiary to the latter's detriment or causing a subsidiary to transact to its own detriment while benefiting the parent or another group company, and unfairly diluting the holding of minority shareholders through majority-driven changes in the capital structure, a parent can also abuse the group form by placing risks in a group company despite the fact that it would not have the means available to cover the potential, resulting liabilities. In tunnelling, the interests of a subsidiary's minority shareholders will be damaged disproportionately, given that the majority shareholder will benefit from the transfer of funds to itself or another company it controls, or through a transaction that is unfavourable for the subsidiary company in question while benefiting the parent or another of its subsidiaries. In the case of undercapitalisation, creditors of the individual group company are placed at risk of receiving partial or no payment on a claim, despite the fact that the company's activity is inseparable from the economic operations of the group as a whole.

Against the prejudicial extraction of rents by controlling shareholders, the tool kit of available solutions range from a full blown statute on parent-subsidiary relationships (as is done in Germany)[169] to a judicially crafted remedy for unfair prejudice to the minority (as is done in the UK and Hong

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[168] Atanasov, Black, Ciccotello & Gyoshev (2010: 156).

[169] This is provided for in the German Stock Corporation Act (*Aktiengesetz*) at §§291-338, which actually *permits* many forms of tunneling, provided that necessary approvals are obtained and – in most cases – compensation is provided to the minority shareholders. This is done by creating a special category of "enterprise agreements" (*Unternehmensverträge*). As explained in Cahn & Donald (2010: 683-684) (citations omitted): "Enterprise agreements may subject a subsidiary company to the instructions of its parent (*Beherrschungsvertrag*) or divert all or part of the profit of the subsidiary into the coffers of the parent (*Gewinnabführungsvertrag*). Enterprise agreements must be approved by a 75 percent majority of the votes cast by the dominated or profit-transferring company's shareholders and, if the parent corporation is an AG, by 75 percent of the votes cast by its own shareholders. Prior to the shareholder vote, the *Vorstand* must prepare a report on the contents of the agreement, focusing particularly, in the case of a profit transfer agreement, on the amount of compensation to be given for profits diverted. Unless the subsidiary is wholly owned, enterprise agreements must be examined by auditors. Like charter documents and shareholder resolutions, an enterprise agreement does not take effect until it is entered into the commercial register for the seat of the subsidiary. A domination agreement (*Beherrschungsvertrag*) directly overrides §76 of the *Aktiengesetz* by subjecting the *Vorstand* of the subsidiary to the instructions of the parent. The range of such instructions is quite open-ended, and could include orders to relinquish corporate opportunities, make discount deliveries, transfer proprietary information, and perform services without compensation. Another possible effect of a domination agreement is that, when the parent is not subject to co-determination and the subsidiary is, the effects of co-determination on the subsidiary are essentially side-stepped."

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Kong) and has been already discussed above.[170] Against the parking of risk in undercapitalized subsidiaries, solutions range from mandatory minimum capital requirements (as is done in Germany and other EU countries),[171] to statutory presumptions that the corporate entity should in certain circumstances be disregarded (as is done in China),[172] to judicially crafted equitable standards on when the corporate entity of the subsidiary should be disregarded (piercing the corporate veil).[173] In dealing with groups, Hong Kong law provides less-than-effective protections for minority shareholders and average protection for creditors. Creditor protection will be addressed in the following section.

Beyond the action for unfair prejudice, Hong Kong law offers few statutory protections for minority shareholders of subsidiaries outside of the context of major corporate transactions. Although, similarly to EU law, Hong Kong puts the control of share capital in the hands of the members[174] (rather than delegating this power to the board as is done in Delaware[175]), unlike in the EU[176] Hong Kong company law does not offer existing shareholders pre-emptive rights.[177] Giving majority shareholders power over the allocation of shares does not solve the problem of majority abuse, although it may be seen as making such transactions more visible and giving minority shareholders an opportunity to voice their concerns. Generally, this arrangement of rights and powers is in line with what might be expected to arise in an economy, like that in Hong Kong, where large shareholders are common and the power of small shareholders has only recently been advocated. For the consummation of major transactions that would alter the position of minority shareholders, such as reorganizations of the outstanding shares, takeovers and share buy-backs, Hong Kong statutory provisions and the courts that administer them are somewhat more robust in their protection of minorities. A reorganization of the shares of a company through consolidation or division will require approval of both 75% of the votes cast at a meeting to approve it and a majority in number of the members voting at such meeting,[178] plus court sanction.[179] As will be discussed below, the requirement of approval by a majority of members (a "head count") led to a high profile judicial intervention in 2009, and the result of ensuing controversy was that the Companies Ordinance 2012

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170 *See* section C.1.b.

171 Under EU law, all *public* companies must have a minimum capital of 25,000 euro under art 6(1) Second Company Law Directive, but this is not required for *private* companies, so that capital requirements for the latter differ from jurisdiction to jurisdiction. *See*

172 *See* Company Law of the People's Republic of China, art. 64.

173 *See* Thompson (2005); Huang (2012).

174 *See* CO 2012, s 141.

175 *See* DGCL s 152.

176 *See* Second Company Law Directive, art. 29.

177 These could be created in the company's articles.

178 CO 2012, s 674(1)(c).

179 CO 2012, s 673.

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now allows the court to dispense with that test.[180] For a reorganization of the shareholding structure that takes the form of a takeover or buy-back, the court does not have this power to disregard the position taken by the minority shareholders, which in such cases is structured not as an approval, but as a right to veto the transaction by vote of 10% of the shareholders not participating in or affiliated with the offer ("disinterested shares").[181] This requirement of 10% of the minority shareholders disinterested in the transaction was newly introduced in the 2012 Ordinance would plainly be easier to meet than under the head count rule. In the case of a takeover[182] or share buy-back[183] that reaches 90% of the company's share capital, the remaining minority shareholders also have a right to be bought out at the original offer price within three months after the closing of the offer.

Under the current company law, it is unclear when courts might decide to disregard a minority vote on a scheme to reorganize the shareholding structure of a company. Such intervention would of course tip the balance against the minority shareholders and thus be very important for the quality of minority protection in Hong Kong. A 2009 decision under the previous Companies Ordinance has, however, shown something of how the Hong Kong courts view the position of dispersed, minority shareholders in corporate groups. The case involved a utility, the Hong Kong Telecommunications Limited, the shares of which retail investors had purchased as a source of retirement income due to their low risk and the steady stream of dividends expected.[184] In 2000, in the context of the telecommunications industry's move into data and wireless, a reorganization of shareholdings resulted in Hong Kong Telephone becoming a wholly owned subsidiary of Pacific Century CyberWorks Limited (PCCW Ltd), which was listed on the SEHK. In 2008, at the height of the global financial crisis, the controlling shareholders of PCCW Ltd proposed a reorganization that would roll up the company through a delisting and a buyout of the dispersed shareholders, who constituted a numerical majority in this case, at a price slightly above market, which was at an historical low for PCCW shares at that time. The majority controlling shareholders were PCCW's chairman, Richard Li Tzar Kai (son of Li Ka Shing), who through various companies owned about 28% of the stock, and an SOE, China United Network Communications Group Company Limited (Unicom), which held about 20%.[185] The reorganization, through which about 52% of the shares, which were held by smaller shareholders including retail investors, would be cancelled and their holders cashed out at an

[180] CO 2012, s 674(1)(c)(ii) ("the members agree to the arrangement … if … *unless the Court orders otherwise*, a majority in number of the members present and voting … agree to the arrangement") emphasis added.

[181] CO 2012, s 674(2). "Disinterested shares" are generally shares other than those held (i) by the offeror or its nominee or agent, (ii) an associated person or company of the offeror. CO 2012, s 674(3).

[182] *See* CO 2012, s 700. However, the majority will have a corresponding right to squeeze these minority shareholders out. *See* CO 2012, s 693-696.

[183] *See* CO 2012, s 718. Also in this case, the majority will have a corresponding right to squeeze these minority shareholders out. *See* CO 2012, s 712-714.

[184] *Re PCCW Ltd* [2009] HKEC 738, CA at para 4.

[185] *See* Circular Issued by PCCW, "Proposed Privatization of PCCW by Joint Offerors," 6 December 2008, 53-55, available at www.hkexnews.hk.

historically low price, required (i) approval of 75% of the company's capital, (ii) a majority of the company's shareholders counted per head, and (iii) sanction of the court.[186] Although it was very likely that Richard Li and Unicom would obtain 75% of the capital by value in favour of the transaction, they apparently did not want to leave the "head count" portion of the approval to chance. The controlling shareholders' vehicle that was being used to purchase the shares of PCCW had until recently owned an insurance company, which it sold to the Fortis Group, where the former chairman stayed on as deputy chairman.[187] Although the court did not have to reach a finding of fact on this point, it appears that the controlling shareholders agreed with Fortis that the latter would distribute bonuses in the form of PCCW shares to agents, employees, friends and family, arrange to register these shares individually in the name of each person (rather than in the name of the clearing house's nominee, as is usually the case), and pre-complete proxy forms so the recipients need only tick "yes" for the transaction to turn their PCCW shares into cash.[188] The result was that the transaction to buy out the minority shareholders at a record low price was approved both by 75% of the capital and by a majority of the individual shareholders. As the CFI explained: "Of the 859 Independent Shareholders who voted against the Scheme, 829 (96.5%) were registered as shareholders prior to 30 October 2008, prior to the announcement of the privatisation proposal. Of the 1404 Independent Shareholders who voted for the Scheme, 1,288 (91.7%) were registered as shareholders after the Scheme was announced."[189] The controlling shareholders were in this way able to summon and marshal a 'clone army' of retail investors on very short notice.

In its examination of this arrangement in the context of exercising its duty to sanction or disapprove of the transaction so supported by twin majorities, after hearing additional evidence from the SFC on how the majority shareholder had packed the ballot box for the head count portion of the vote, the CFI concluded through Kwan J that: "There is no discernible public policy in Hong Kong regarding share splitting in the context of a scheme for privatisation of a company."[190] As such the Court sanctioned the squeeze out of the retail shareholders. The Court of Appeal unanimously reversed the CFI's decision. Hong Kong law did not offer the Court any particular principle, such as a fiduciary duty of controlling shareholders, to apply to the creation of the extra votes through such deliberate distribution of packets, but nonetheless the Court found that what the controlling shareholders and Fortis had done was "vote manipulation". Rogers V-P, in his opinion for the Court of Appeals, disagreed that the creation of such votes was an acceptable practice:

> Frankly, the arguments that amounted to little more than that there was nothing wrong with vote manipulation are, on analysis, extraordinary. I do not consider that any right thinking

186 *See* former Companies Ordinance (in force until 2014), s 166(2).

187 *Re PCCW Ltd* [2009] HKEC 738, CA at para 16.

188 *Re PCCW Ltd* [2009] HKEC 738, CA at paras 42-65.

189 Re PCCW Ltd [2009] HKEC 553, CFI at para 61.

190 Re PCCW Ltd [2009] HKEC 553, CFI at para 151.

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> member of society could condone a situation where the law required that a vote should be taken so as to balance the fairness between the holders of shares in different proportions and deliberate steps had been taken to distort that vote; in this case, it may be said, at minimal cost to those responsible. Vote manipulation is nothing less than a form of dishonesty. The court cannot sanction dishonesty. It is also a form of coercion where the wishes of the minority in number of shares are overridden by those who hold the majority of the shares; that is the very thing that … the court should see should not be allowed to happen.[191]

With reference to what a "right thinking" Hong Kong "society" would make of the practice, Justice Rogers was formulating new common law in Hong Kong, turning commonly held standards of correct behaviour into law through judicial decision[192] just as common law courts have done for over 800 years, and the decision was indeed popular in the Hong Kong press.[193] Lam J, after agreeing with Rogers' decision, reinforced it by stressing that the burden of proof rested on the persons promoting the reorganization to satisfy the court that the vote had "come to a decision representative of the class in question."[194] Especially in light of the fact that the decision at first instance was written by a leading company law jurist in Hong Kong, the Court of Appeal position shows a clear interest of the Hong Kong judiciary to protect retail investors caught up in the schemes of controlling shareholders. As we have seen, the LegCo has since amended the Companies Ordinance to empower a court to disregard both approval and *disapproval* of a scheme, which amendment followed arguments of a tyranny of the minority in Hong Kong companies, and as such, it is uncertain how the courts will interpret this provision in the future. Nevertheless, the PCCW decision, the willingness of the courts to extend the unfair prejudice action (discussed in subsection C.1.b, above) and the statutory provisions discussed in this section that tend to privilege use of individual small companies over use of groups with many small companies, appear to indicate an awareness among Hong Kong lawmakers of the risks presented by groups and a willingness to take action.

3. Does company law protect both unsophisticated and sophisticated creditors?

Beyond the agency problems between management and members, and that between majority and minority members, another important agency problem that increases the risks inherent to the company form is that between the company and its creditors.[195] Creditors of a company can range from the most sophisticated contractual creditors, such as banks, to the least prepared and unwilling victim of a

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191 *Re PCCW Ltd* [2009] HKEC 738, CA at para 71.

192 *See* Eisenberg (1991: 150).

193 Since the appellate decision was handed down in 2009, I have discussed it with hundreds of Hong Kong law students and find nearly universal approval of the court's view of "right thinking".

194 *Re PCCW Ltd* [2009] HKEC 738, CA at para 122. Barma J also agreed, stating: "I agree that this appeal should be allowed on the basis that the court cannot be satisfied that the majority by number of the shareholders of PCCW who voted in favour of the scheme at the adjourned scheme shareholders meeting held on 4 February 2009 fairly represented the class of scheme shareholders as a whole." *Id* at para 167.

195 Armour, Hansmann and Kraakman (2009: 35).

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tort. When a debt is payable on a given future due date, the company can be thought to hold funds to cover the debt, essentially as an agent of the creditor. Limited liability, which means the debts of the company are payable exclusively by the company, regardless of how little resources it may have and how abundant the resources of the members may be, is at the core of this problem. It can tempt members to behave opportunistically toward creditors by increasing their company's liabilities while extracting its capital through payment of dividends, imprudent loans or other distributions for which the company receives no tangible asset in return. Such behaviour can be particularly common in corporate groups, where risk management may advise partitioning potential liability from assets in different components of the company group. Traditional techniques of creditor protection include a system of robust security interests, requirements that a company hold minimum capital, restrictions on the distribution of assets to members, the possibility of disregarding the corporate entity (piercing the corporate veil) to hold members liable for a company's debts, and disclosure of the company's financial position to potential creditors. The creditor protection regime under Hong Kong company law might be thought of as average among highly developed legal frameworks, although it tends to provide much better protection for sophisticated than for unsophisticated creditors. The most prominent creditor protection mechanisms under Hong Kong law as seen in international comparison are a traditional array of fixed and floating charges and an above-average framework of mandatory disclosure. Both of these tools would more benefit sophisticated, contracting creditors, who have time to look at a company and enter into a security arrangement with it. Beyond these protections, Hong Kong law also provides modest requirements for capital maintenance, albeit without any form of required minimum capital, and a moderately strong doctrine of veil piercing.

Security interests for sophisticated creditors. Recently, Hong Kong had an opportunity to remove charges from its company law, as have Canada, Australia and New Zealand,[196] but chose to retain this specialized security interest offered exclusively to companies. The opportunity arose during the process of amending its Companies Ordinance from 2009 to 2012, when the drafting team looked to Australia and New Zealand often, and frequently adopted solutions employed in those common law jurisdictions. When it came to charges, however, they chose not to follow those other former UK colonies by hiving off company law charges into an American-style system of security interests. As a result, Hong Kong company law continues to include a system of secured lending that is available

[196] For Canada, *see* Personal Property Security Act [RSBC 1996] Chapter 359; for New Zealand see Personal Property Securities Act 1999, Public Act 1999 no. 126; for Australia, *see* Personal Property Securities Act 2009. The basic framework for a general system of registered securities is found in Article 9 of the US Uniform Commercial Code (UCC), which is a model law that has been adopted with slight variations in all 50 US states. As the Secretary for the initial draft of UCC article 9 has explained, "[t]he organizing concept which underlies Article 9 is that security transactions should be differentiated with reference to the status of the person whose property secures the debt and the kind of property put up as collateral-thus: consumer goods; farm products; and property used in business enterprises, which is subdivided according to whether it is intended for use in the business (equipment) or for sale (inventory) or represents the proceeds of the sale of inventory ('accounts receivable,' 'chattel paper,' etc.)." Gilmore (1951: 27). For further history of article 9, *see* White and Summers (2000: 1-7).

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exclusively to companies and whose use depends upon relatively sophisticated legal documentation and advice. The priority of charges depends on intricate judicial doctrine developed over a century of litigation, and the registration system for charges does not include all information necessary to subsequent lenders, making register notice incomplete. Register notice is a key to the effect of security interests against competing creditors, as it provides a presumption that the entire world has knowledge of what is entered in the register. The "crystallization" of a floating charge into – for most purposes – a fixed charge, is an extremely important event, yet one that the register is incapable of notifying to the lending community. Moreover, lenders have for many decades attempted to improve the bite of floating charges (which by nature allow disposal of the charged asset, including by the grant of a fixed charge) through inserting "restrictive" or "negative" pledge clauses into floating charges, which often act contractually (i.e., only between the parties to the debenture) to crystallize the floating charge if the chargor attempts to grant a subsequent, superior charge, such as a fixed charge. Such clauses also receive no constructive notice through the register, but depend on private notice directly given in order to be effective.[197] To use this form of protection, a creditor must have time and bargaining power to negotiate the terms of the debenture creating a charge, as well as the legal expertise and knowhow to navigate through the legal technicalities and techniques entailed in the use of fixed and floating charges to secure a debt, plus a suitable network to provide actual notice of crystallization and restrictive clauses. The continued use of the charge system clearly benefits sophisticated creditors to the detriment of their less well-equipped competitors.

Disclosure by unlisted companies. Disclosure requirements for companies listed on the SEHK are essentially identical to those of other major exchanges.[198] For unlisted companies, the considerable amount of information a Hong Kong public company must generate on an annual basis sets Hong Kong apart by considerably facilitating the negotiation of both secured and unsecured credit with such companies. Unlike other major jurisdictions, such as the US (Delaware) or the UK, Hong Kong requires unlisted public companies and large private companies to provide detailed annual financial statements and a report on business operations signed by directors.[199] Exemptions from such requirements are available for wholly owned subsidiaries (included in the holding company's reporting) and "small private companies," which are companies with no more than 50 members, whose shares are not freely transferrable, whose total revenue and total assets both do not exceed HK$100 million, and which do not employ more than 100 persons.[200] Other companies must annually prepare financial statements or summary financial statements that conform to applicable accounting standards and in any case "give a true and fair view of the financial position of the company,"[201] and

[197] *See* the discussion in *ABN Amro Bank v Chiyu Banking Corp Ltd* [2001] 2 HKLRD 175.

[198] *See* SEHK Listing Rules, Chapters 12, 14, 14A, 16.

[199] *See* CO 2012, s 429.

[200] CO 2012, s 361 and Schedule 3, s (1). If the company meets two out of three of the assets, revenue and employees requirements, it can qualify for a reporting exemption.

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lay them before the annual meeting.[202] These financial statements must be accompanied by a signed directors' report that sets forth, *inter alia*:

- The principal activities of the company during the year past; [203]
- particulars of any matter material for the members' appreciation of the company or whose disclosure would not harm the company's business; [204]
- principal risks facing the company and important events that have affected the company in the past year;[205]
- an indication of the company's future development; [206] and to the extent necessary to understand the business' development and performance,
- an analysis of the key performance indicators; [207]
- the company's environmental policies and compliance with law;[208] and
- key relationships with employees, customers and suppliers.[209]

The directors' report and financial statements, together with an auditor's report on the financial statements must be filed each year with the Companies Registry in an "annual return", which must also contain "particulars of the total amount of the indebtedness of the company," and "particulars relating to members and share capital of the company."[210] In this way, not only members of a company, but also creditors and potential lenders have access to detailed information regarding the shareholding structures, business operations, finances, and indebtedness of all but the smallest private company in Hong Kong.

Capital maintenance for unsecured creditors. The capital maintenance provisions found in Hong Kong company law are moderate and are linked to annual disclosure, in that they protect a "share capital" that is an arbitrary figure fixed by the members, but disclosed to the public. This aspect of Hong Kong law more resembles the US Model Business Corporation Act, which never employed minimum capital and made the concept of par value optional in 1986,[211] more than the UK Companies Act (whether 1985 or 2006), [212] which incorporates minimum capital requirements for public companies in compliance the EU Second Company Law Directive. In 2012, Hong Kong abandoned the measure of par value to determine appropriate share capital (arbitrary par x number of issued

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[201] CO 2012, s 380.

[202] CO 2012, s 429.

[203] CO 2012, s 390(1)(b).

[204] CO 2012, s 390(2).

[205] CO 2012, Schedule 5, s 1.

[206] CO 2012, Schedule 5, s 1.

[207] CO 2012, Schedule 5, s 2. A detailed Companies (Directors' Report) Regulation requires additional disclosures, of particular note among which is statements on any financial dealings between the company and directors.

[208] *Id.*

[209] *Id.*

[210] CO 2012, s 662 in connection with Schedule 6.

[211] *See* Model Business Corporation Act, §§ 2.02(b)(2)(iv) and 6.40(c).

[212] *See* Companies Act 2006, ss 761, 763.

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shares = share capital) and replaced it with a combination of a declared amount and a solvency test. Now, upon forming a company, the incorporators must state some amount of “share capital”,[213] and this capital may not be distributed to members.[214] Beyond this, for any distribution that would lead to a reduction of the declared share capital directors must inspect the state of the company’s finances and issue a “solvency statement”,[215] which is a technique borrowed directly from the UK Companies Act 2006.[216] This system of capital maintenance works together with the disclosure requirements discussed above, in that any creditor who has looked at the company’s annual disclosures will know the amount of share capital,[217] although they would not have access to information on liabilities incurred in the current year, which might have already exhausted such amount during the current accounting period. The solvency statement is a declaration signed by each director making it that, “immediately after the transaction there will be no ground on which the company could be found to be unable to pay its debts,” and that this condition will remain during the next 12 months.[218] The use of declared share capital and dependence on directors to verify solvency for the protection of creditors follows a dominant thread used in US corporate law, where the quality of corporate action in many areas ultimately hangs on the ability of the court to enforce the duties of directors to act with due care, skill and diligence and in the interest of the company.[219]

For a reduction of capital, Hong Kong retains the favoured UK element of introducing court supervision, and in 2012 set up an approval process that closely tracks the procedure laid out in Companies Act 2006.[220] As a result, the procedure for a reduction of capital employs the three different safeguards of directors’ duties when deciding on solvency, supermajority approval and court review. First, if the directors propose a reduction they must accompany their proposal by a solvency statement, which second, the shareholders must approve by a supermajority of 75% of the votes cast (special resolution).[221] Third, before the resolution can be become effective, notice of the decision

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213 *See* CO 2012, s 68(2) and Sch 2, s 8(1)(b).

214 CO 2012, s 297(1).

215 *See* CO 2012, ss 206, 259.

216 *See* Companies Act 2006, s 643.

217 The “annual return” filed for public view in the Companies Registry must state “particulars relating to … share capital.” *See* CO 2012 s 664(3)(a) and Schedule 6, s 1(f)(i).

218 CO 2012, ss 205-206.

219 *See* Model Business Corporation Act, §6.40(d) (directors’ determination of solvency for distributions to shareholders); Delaware General Corporation Law, §§152, 154 (directors’ determination of what consideration may be contributed for shares and the value of such consideration is binding in the absence of “actual fraud in the transaction,” and directors determine what portion of such consideration will be capital for purposes of capital maintenance); *Zapata Corp. v Maldonado*, 430 A2d 779 (1981) (the determination of a board of directors whether a derivative action should go forward will be given great weight absent conflicts of interest); *Moran v Household International Inc.*, 500 A.2d 1346 (1985) (a board has discretion to impede a takeover offer it finds unattractive, provided that it does not completely preclude the takeover).

220 *See* Companies Act 2006, ss 641-649.

221 CO 2012, s 216.

must be published and sent directly to creditors, giving them five weeks to ask the court to cancel the resolution,[222] and the court may confirm or cancel the resolution on "any terms and conditions it thinks fit."[223] In this way, although no specific amount of capital must be present in order to form a company, the amount that creditors rely on from earlier disclosures cannot be changed without court approval if the creditors find the change objectionable. This system will of course benefit only contracting creditors, and will offer no comfort to the unwilling tort victim creditors of a Hong Kong company.

Veil piercing under Hong Kong law. As in many other jurisdictions, the doctrine used to decide whether legal personality should be disregarded and payment for a company's debt may be demanded of the company's members has been crafted in case law. Unlike the United States, where veil piercing principals are phrased in an unruly jumble of tautological metaphors,[224] and the UK rule, according to which limited liability is never taken from a public company regardless of perceived abuse,[225] Hong Kong's courts have formulated a rule that is fair and relatively unproblematic to apply. The leading case on this point is *Mitrans Shipping*,[226] where Bokhary JA formulated the rule as follows: "Using a corporate structure to evade legal obligations is objectionable. The courts' power to lift the corporate veil may be exercised to overcome such evasion so as to preserve legal obligations. But using a corporate structure to avoid the incurring of any legal obligation in the first place is not objectionable."[227] The line is therefore drawn between incorporation in advance of a liability and incorporation that changes the state of affairs in which a liability is incurred, with the former fair play and the latter grounds for piercing the corporate veil. As a result, Hong Kong courts seem to have taken Thompson's advice that they "ought to recognize the widespread acceptance of risk-shifting through … corporate planning ... [and] keep in mind the first mover advantage accorded private ordering in such a setting to establish the separate corporate entity," and that the dealings between the parties might include "implicit or explicit pricing reflected in that planning."[228] Fraud, changing the arrangement of liability after an obligation exists, is another matter, and grounds for disregarding the corporate veil.[229]

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222 CO 2012, s 218.

223 CO 2012, s 222.

224 With reference to veil piercing under US company law, Easterbrook and Fischel (1985: 89) have observed that: "'Piercing' seems to happen freakishly. Like lightning it is rare, severe, and unprincipled.'"

225 Since *Salomon v A Salomon & Co Ltd* [1897] AC 22, UK courts have shown a strong tendency to respect the limited liability of company members in public companies regardless of the circumstances. Recent examples are found in *Adams v Cape Industries plc* [1990] 1 Ch 433 and *Re Polly Peck International plc (in administration)* [1996] 2 All ER 433.

226 *China Ocean Shipping Co v Mitrans Shipping Co Ltd* [1995] 3 HKC 123.

227 *Mitrans Shipping* [1995] 3 HKC at 127.

228 Thompson (2005: 635).

229 Thompson's theory for the application of veil piercing in common law also agrees on this point Thompson (2005: 628-29).

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The *Mitrans* rule is complementary to Hong Kong's extensive array of disclosure requirements, discussed above, which allow contractual creditors to understand exactly what form of private ordering has been set up to limit liability, and survey the financial condition of their contractual counterparty. If the balance of liability is changed after inspection and contracting by introducing a new entity or shifting assets among entities, it is equitable for the court to intervene, but if the corporate structure and financial condition were visible beforehand and the arrangement of liability remains unchanged, there is no reason for judicial intervention. It does not, however, address the dilemma of a tort victim who is unfortunate enough to be damaged by a corporate vehicle for which shareholders have carefully planned and made arrangements to reduce the liability that would arise on exactly such an occasion. For tort creditors, the Hong Kong rule on veil piercing appears harsh. Addressing this situation, Hansmann and Kraakman conceive the planning activity of a business that arranges its corporate structure in the face of a known liability that *could* arise for a certain kind of tortuous action it may engage in as "evasion".[230] Seen from this perspective, the owners or management clearly perceive the liability the can arise from a planned activity even though a claim has not yet arisen, and take action to *evade* it. Although there is no indication that a Hong Kong court would interpret the avoid/evade distinction differently in contract and tort situations, the distinction offered by Hansmann and Kraakman, if brought into the *Mitrans* test, could allow Hong Kong courts to pierce or let stand the corporate veil according to a rule that is fair and predictable for obligations arising in both contract and tort.

4. Does company law sufficiently serve private companies?

Another question in this evaluation of Hong Kong company law goes to the balance of equities in lawmaking, rather than agency risks in the company form. At the close of 2011, nearly 99% of companies registered in Hong Kong were "private companies," a percentage that has remained relatively stable in recent years: 2008 (98.6%), 2009 (98.7%), 2010 (98.8%).[231] Like the distinction in US law between a corporation and a close corporation, and exactly the same as the UK public company/private company distinction, a Hong Kong private company is incorporated and operates under the same statutory framework as a public company with certain special provisions made for its smaller size. The Companies Ordinance defines "private company" as one having no more than 50 members (excluding employee members) and whose shares are subject to a restriction on transfer and may not be freely offered to the public.[232] There is no restriction on the activities private companies may perform or the dimension of the assets they may hold. A private company may be incorporated

[230] Hansmann & Kraakman (1991: 1881).

[231] The figures for 2011 were 945,464 private companies out of a total of 956,392 registered. *See* www.cr.gov.hk, statistics > local companies on register (accessed 5 December 2012).

[232] *See* CO 2012, s 11.

by an individual founding member[233] without any specific amount of capital,[234] and for a modest fee. Moreover, following the UK model, election of directors and management of the company are provided for almost solely in the articles of association, which can be drafted in ways to, for example, place all the power of the board in a single person and eliminate elections of this or other directors altogether.

As such, the private company form is well suited to the start-up enterprises and small businesses that are common in the Hong Kong economy. As discussed in Chapter 2, investigation of the leading corporate groups in Hong Kong has not shown the private company form necessarily to be popular as a vehicle for ultimately holding shares at the top of a given corporate pyramid, although it did appear[235] to show that this form is common for subsidiary members of a corporate group. Thus, if the rules on the private company form have been crafted for a particular use to suit the needs of persons employing the private company form, such use would be both as a subsidiary unit in a corporate group and a vehicle for smaller businesses. The accommodations accorded this form in the Companies Ordinance appear commensurate with such uses, although they also seem designed to discourage the unnecessary fragmentation of economic activity into complex groups.

As discussed in the previous subsection, Hong Kong company law presents an extraordinarily extensive disclosure regime for companies that are not listed. It operates on three levels: the directors of a company must maintain registers, which are open to the general public, prepare and disseminate information to members on an annual basis, which information is also filed together with an "annual return" at the Companies Registry, and disclose information to members when they so request for a "proper purpose". The Companies Ordinance provides that a company must keep an updated register of its members,[236] of any debentures issued,[237] and also of fixed and floating charges.[238] Annual disclosure takes the form of a directors' report to be presented to the members at each annual general meeting, together with the annual financial statements (prepared according to the appropriate version

[233] *See* CO 2012, s 67(1).

[234] *See* CO 2012, s 68(2) and Schedule 2, s 8.

[235] A definitive answer on this question would require accessing the Companies Registry for all of the subsidiary companies operating within the major corporate groups studied. The opinion that private companies "appear" to be popular as subsidiaries is based on the small number of shareholders active in such companies. Private companies may have no more than 50 shareholders, excluding employees.

[236] CO 2012, s 627. This register must be kept in either English or Chinese, stating the members' names and addresses, shares and amount paid in by each member, the date at which each person was entered in the register, and the date at which any person ceased to be a member. A company with more than 50 members must also create an "index" of members with the same information. CO 2012, s 630.

[237] CO 2012, s 308. This register must be maintained for any debentures that are not transferred by simple delivery (i.e., registered instruments) and must be kept in either English or Chinese, stating the holders' names and addresses, amount held by each holder, the date at which each person was entered in the register, and the date at which any person ceased to be a holder.

[238] CO 2012, s 352. This register must include the following information on every charge affecting the company's property: the amount secured by the charge, the property providing the security, and the chargee of the particular charge.

of Hong Kong Financial Reporting Standards),[239] the notes to which must disclose emoluments, retirement benefits, severance payments, and any credit paid to directors.[240] The directors' report is a detailed presentation of the company, its financial position, business activities, any resignation or indemnity of directors, and all significant transactions involving related parties.[241] It compares to disclosure required from listed companies under common provisions of securities law or listing rules. Beyond keeping specified registers and making annual disclosure, companies must provide access to documents if either (i) five or more members or (ii) members constituting at least 2.5% of voting rights so request in "good faith" and for a "proper purpose," and the court decides that the request should be granted.[242]

From the above, it is easy to understand that the costs for providing the level of annual disclosure required in Hong Kong can be significant. The Companies Ordinance exempts qualifying private companies[243] from preparing a directors' report on the annual activities of the company,[244] and from most accounting disclosure except that regarding financial assistance given in the context of employee share schemes,[245] and information regarding parent and subsidiary companies (which would not apply in the case of a small enterprise operating independently).[246] As a wholly owned subsidiary enjoys a blanket exclusion from preparing financial statements, the reporting duty would in such case be passed up to the holding company,[247] which would not have to include the exempted company in its consolidated accounts.[248] Such accommodations, like those allowing one person companies with streamlined governance and financial rules, are by no means new, and are standard policy measures to stimulate the activity of small and medium enterprises (SMEs). What is unusual, yet also structurally predictable in Hong Kong, are provisions expressly extending allowances such as limited disclosure to *groups* of private companies. Nevertheless, as most cases in Hong Kong raising allegations of management or controlling shareholders violating company law entail abuse of multi-entity groups, it is sound regulatory policy that the set of accommodations is structured to favour use of individual, small companies rather than groups of small companies. A holding company of a corporate group that does not include a company licensed to perform any form of financial service will be exempt from

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239 S.122(1).

240 CO 2012, s 383.

241 *See* CO 2012, s 388 and Schedule 5, as well as the Companies (Directors' Report) Regulation [currently in draft].

242 CO 2012, s 740.

243 *See* CO 2012, s 359. This category does not include any entity licensed for financial services such as banking, brokerage or insurance. Qualifications focus on limits which total assets and revenues may not exceed. *See* CO 2012, Sch 3, s 1.

244 *See* CO 2012, s 388(3)(a).

245 *See* CO 2012, Sch 4 s 1 in connection with ss 280, 281.

246 *See* CO 2012, Sch 4 ss 2 and 3.

247 *See* CO 2012, s 379(2).

248 *See* CO 2012, s 382(3).

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most disclosure, provided that it qualifies as a group of "small private companies" or a group of "eligible companies".[249] Aside from the requirement that it not include a financial services company, the other main determinants in meeting this qualification are the definitions of "small" and "eligible" as they apply to corporate groups. A group of *small* private companies is one in which two of the following three apply: neither total revenue nor total assets of the group exceed HK$100 million, nor does the group employ more than 100 persons.[250] For a group of *eligible* private companies, the financial ceilings are doubled. It is one in which two of the following three apply: neither total revenue nor total assets of the group exceed HK$200 million nor does the group employ more than 100 persons.[251] The financial requirements for both of these categories are the same whether applied to classifying an individual company as "small" or "eligible" or so classifying the homonymous group, which – if reduction of costs through exemption from disclosure requirements is an aim – provides a clear disincentive to multiply the number of companies a single holding company operates.

A similar pattern is visible in the rules on loans or other forms of credit between a company and its directors or their controlled companies.[252] As applied to private companies, these rules are much more flexible than those applicable to public companies, for they only restrict the making of loans, but not the extension of other forms of credit from a company to its directors or the directors of a holding company.[253] This changes if the company is a subsidiary in a corporate group that includes a listed company as its parent, and in this latter case, all restrictions applicable to public companies also apply to the private company.[254] By making provision for minimal and streamlined management structures, reduced disclosure and flexibility in related party transactions, Hong Kong company law provides the normal set of benefits and exemptions for companies used in SMEs. Moreover, by extending some such benefits to groups of small companies while clearly favouring stand-alone small companies through limits on total revenue and assets, Hong Kong law appears to recognize both the presence and the dangers of complex corporate groups in its economy. As such, it seems that the legislative process did aim to serve the majority of its corporate constituents, even if the overall balance of disclosure requirements under Hong Kong company law falls clearly on the side of investors and lenders, rather than entrepreneurs.

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249 *See* CO 2012, s 359(2)(b).

250 CO 2012, s 364 and Schedule 3, ss (1)(7), (1)(8). Specified conditions apply to application of the rubric "small" during periods in which a company in existence either begins to meet these criteria or later ceases to meet the criteria.

251 CO 2012, s 365 and Schedule 3, ss (1)(10), (1)(11). As with a group of small companies, specified conditions apply to application of the rubric "eligible" during periods in which a company in existence either begins to meet these criteria or later ceases to meet the criteria.

252 *See* CO 2012, Part 11, Division 2, Subdivision 2.

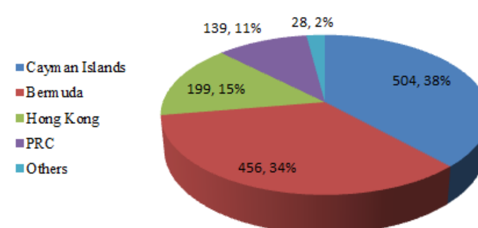
253 CO 2012, Part 11, Division 2, Subdivision 2 prohibits a private company making loans to directors without the approval of disinterested shareholders, but does not impose a like prohibition for indirect loans triangularly structured (referred to as "quasi-loans") or credit transactions, although these latter prohibitions apply to public companies and private companies in a group with a listed company.

254 CO 2012, s 491(1), definition of "specified company", (b).

5. Do company and securities laws sufficiently limit risks from foreign listed companies?

As of the end of 2011, a total of 1,496 companies were listed on the SEHK. Of the 1,326 companies listed on the Main Board, only 199 (15%) of them were incorporated in Hong Kong, 504 of them (38%) were incorporated in Cayman Islands, 456 (34%) were incorporated in Bermuda, 139 (11%) were incorporated in the PRC, and 28 (2%) were incorporated elsewhere, including in the British Virgin Islands, the UK, Canada, Brazil, Germany, Japan, Jersey, Luxemburg, Singapore and a US state, such as Delaware or California. Thus, about 85% of companies listed on the SEHK are incorporated under a system of company law other than Hong Kong law, which also conforms with the statistic, discussed above, that the vast majority of Hong Kong incorporated companies are private, not public, companies. Hong Kong company law is used primarily for small, private companies, whist those companies which are incorporate outside of Hong Kong. Although the HKEx examines the law of a jurisdiction before allowing its companies to list on the SEHK, and as discussed below, requires that companies adjust their internal governance before and during listing, it still means that the Hong Kong market is host to a vast smorgasbord of corporate governance and finance regimes. This increases Hong Kong's attractiveness as an international financial centre only if it is able to contain investor's agency risks in this homogeneous mass of legal systems that it brings within the matching engine of the SEHK.

Figure 3.1. Origin of SEHK Main Board Companies (number, percentage)



Source: HKEx Factbook 2011.

This task is greatly ameliorated by means of an outreach section of the Hong Kong Companies Ordinance that applies many of the governance and remedial provisions of Hong Kong company law to these companies. The Ordinance provides that a company incorporated outside Hong Kong which establishes a "place of business" in Hong Kong is a "non-Hong Kong company,"[255] and must register with the Hong Kong Companies Register.[256] At the close of 2012, there were 8,848 non-Hong Kong companies so registered.[257] Although for companies not listed in Hong Kong, the exact circumstances

[255] CO 2012, s 2, "non-Hong Kong company".

[256] CO 2012, s 776.

[257] *See* www.cr.gov.hk, statistics > non-Hong Kong companies (accessed on 14 February 2013).

under which a "place of business" is found to exist will be open to debate,[258] the Ordinance expressly includes a share transfer or share registration office,[259] which overseas companies listed on the SEHK must maintain in Hong Kong,[260] within the definition of that term. Beyond registration of an agent for service of process and filing information on directors,[261] the Companies Ordinance also requires that each non-Hong Kong company annually publish a return with information on its organization and activities, as well as accounts if required by the rules of another jurisdiction or a securities exchange,[262] and provides that Hong Kong courts may entertain members' actions of the following types against such companies, their members and their directors: [263]

- actions for unfair prejudice affecting the interests of some or all members,[264]
- actions against conduct causing the company to breach the CO,[265]
- shareholder derivative actions against management misconduct,[266] and
- actions to allow members constituting 2.5% of voting rights (or five members collectively) to inspect company records.[267]

The SEHK Rules expressly apply Hong Kong standards for the duty of care and fiduciary duty apply to the directors of listed companies,[268] which greatly reduces the risk of a local court finding that – in hearing a derivative or unfair prejudice action – it had to apply a listed company's home law, perhaps containing less rigorous standards, to such actions. This ensures a significant amount of *company law* monitoring (beyond the application of securities law) over the internal governance of the 85% of Hong Kong listed companies whose affairs would otherwise be governed solely by foreign law.

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258 CO 2012, s 774. The factual circumstances constituting establishment of a "place of business" were discussed in *The Artemis (Cargo Owners) v Artemis Transportation Corp* [1983] HKLR 364, where the Court of Appeal held that to prove the existence of a "place of business," it is necessary to consider three matters: (1) The acts relied on to show that an agent is carrying on business must have continued for a sufficiently substantial period of time; (2) the acts should have been done at some fixed place of business; (3) the agent must be here in the form of a person carrying on business for the company in Hong Kong, it is not enough to show simply that the company has an agent here. The Court of First Instance recently considered the question in *Yung Kee Holdings Ltd* [2012] HKEC 1480, where in denying jurisdiction for an unfair prejudice action against the British Virgin Islands holding company of a well-established Hong Kong company, it held that "if a foreign holding company, carrying out a business internationally through subsidiaries some of which operate in Hong Kong, decides to hold some of its regular board meetings in Hong Kong that does not of itself mean that it has established a place of business here even if some of its subsidiaries clearly have done so." para. 38.

259 CO 2012, s 774.

260 SEHK Listing Rules, Rule 19.05(3)(a), (4). For a separate discussion of SEHK listed companies as non-Hong Kong companies subject to registration, *see Yung Kee Holdings Ltd* [2012] HKEC 1480, para. 42.

261 *See* CO 2012, ss 786 and 802.

262 CO 2012, s 789.

263 *See* CO 2012, s 722.

264 CO 2012, s 724.

265 CO 2012, s 728.

266 CO 2012, s 732.

267 CO 2012, s 740.

268 *See* SEHK Listing Rules, Rule 3.08.

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As discussed above in section C.1, regarding *Luck Continent Ltd v Cheng Chee Tock Theodore*, the reason the Bermudan company could be sued in a Hong Kong unfair prejudice action is because the Hong Kong Company Ordinance specifically pulls such non-Hong Kong companies within its ambit. As also explained in section C.1. regarding *Re Styland Holdings Ltd* (another Bermudan company), the SFC has power to take judicial action against such companies on theories such as a breach of the duty of care or fiduciary duty, or action by management or controlling shareholders that unfairly prejudices the interests of some or all of the members. The expressly applicable Hong Kong standards have been applied to non-Hong Kong companies under these provisions.[269]

Beyond the above effects of the Companies Ordinance, the SEHK Listing Rules also further adapt foreign law to local standards by requiring that foreign and "overseas" issuers insert a number of provisions into their articles of association to bring their internal governance framework in line with that of Hong Kong company law.[270] These provisions include for, e.g. Cayman Island companies, ensuring that directors can be removed with an ordinary resolution,[271] prohibiting company loans to directors or companies controlled by directors,[272] and requiring a special resolution (75% of votes cast) to amend the articles of association.[273] These requirements are in addition to those governance measures required of all listed companies independently of company law, such as that 1/3 of each board be nonexecutive independent directors,[274] and that the board include an audit committee[275] and a remuneration committee.[276] The aggregate of the substantive measures introduced via the Listing Rules and a listed company's articles of association (amended pursuant to the listing rules), together with the jurisdiction given to the Hong Kong courts for a number of corporate actions – whether commenced by a shareholder or the SFC – appears to tie foreign companies sufficiently into Hong Kong law so as to reduce substantially the risks of them importing poor governance rules into Hong Kong through their listing on the SEHK. As securities laws apply to activity on a given market rather than according to the state in which an actor entity is incorporated, Hong Kong's securities laws and regulations – discussed immediately below – apply to all persons engaged in relevant activity in Hong Kong.

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269 *See* e.g., *GP Nanotechnology Group Ltd* [2009] HKEC 1677, para. 42.

270 SEHK Listing Rules, Chapters 19A and 24.

271 SEHK Listing Rules, Appendix 13B, Rule 5(1).

272 SEHK Listing Rules, Appendix 13B, Rule 5(2).

273 SEHK Listing Rules, Appendix 13B, Rule 1.

274 SEHK Listing Rules, Rule 3.10(A).

275 SEHK Listing Rules, Rule 3.21.

276 SEHK Listing Rules, Rule 3.25.

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6. Do securities laws and regulations prevent market abuse?

Even if Hong Kong company law extends into the listed companies incorporated in many foreign jurisdictions, the entity-centred nature of company law means that it can only go so far in policing dealings on the market. Securities laws, regulations and rules, including listing rules, must fill the remaining gap. They must address risks arising from the two significant factors regarding listed companies in Hong Kong. First, as seen in Chapter 2, controlling, insider shareholders abound in Hong Kong. Second, as discussed above, the vast majority of the companies listed on the SEHK are based in jurisdictions that are not known for especially high quality corporate governance: China, Cayman Islands and Bermuda. The measure of Hong Kong securities law must be taken in relation to the risks posed by these market characteristics rather than merely as a measure of the extent to which they mimic US or European best practices. As discussed above, SEHK rules supplement and standardize the governance structure of non-Hong Kong companies, while company law extends the reach of minority shareholder remedies into their operations. The SFC has recently sought to bolster gatekeeper impact in Hong Kong by introducing rules to ensure that the investment banks which act as managers in the public offerings of these companies fulfil their roles as gatekeepers.[277] To protect the integrity of the prices of listed securities discovered in secondary market trading, effective protection against insider dealing and manipulated prices are of great importance. Given the number of sophisticated, controlling shareholders in the small Hong Kong market, trading by insiders is common and constitutes a significant part of exchange turnover.[278] Although neither regulatory authorities nor the media have uncovered any cases of insider dealing indicating a hidden pattern of previously undetected abuse, older studies of price movements in connection with earnings announcements and share repurchases concluded that inside information was being abused on the Hong Kong market.[279] Currently, Hong Kong has a framework of laws, regulations and enforcement against market abuse meet or exceed international standards, although the more pertinent question is whether this framework fills the needs of an environment in which controlling shareholders are regularly privy to information regarding the inner workings of their companies and market participants remain in very close contact. Further empirical analysis of prices in connection with the release of market sensitive information would be useful for a more robust evaluation, and it could be useful for such data to be recorded and published continuously, such as in SFC annual reports. In following, three elements of market regulation are singled out for examination: rules on insider dealing, market manipulation, and the gatekeeping duties of investment banks sponsoring IPOs.

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[277] *See* SFC, Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, ss 17.1-17.15.

[278] Chapter 2 has shown the predominance of controlling shareholders in Hong Kong companies. In 1998, 541 out of the 680 firms listed on the SEHK Main Board registered sales or purchases of their shares by insiders. Cheuk, Fan & So (2006: 76). Also *see* Zhu, Chang & Pinager (2002).

[279] *See* Cheng & Leung (2008: 435); Jaggi & Tsui (2007: 218).

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<u>(a) Rules against insider dealing</u>

Hong Kong's framework of rules against insider dealing contain the standard, three part mix: insider dealing is prohibited, transactions by insiders are recorded, and inside information is subject to rapid disclosure requirements. The first of these prohibitions is the oldest and the last has only recently been introduced, while the recording of director's dealings is required only by listing rules. The city's first legislative prohibition of insider dealing is comparatively old, coming in 1973,[280] a full twenty years before a comparable law in – to take one example for illustration – Germany.[281] Over a period of three decades this legislation was adjusted, amended, reformulated, and finally codified in the SFO in 2003.[282] In 2012 an enhanced rule on the prompt disclosure of inside information was adopted for incorporation in the SFO.[283] The tribunal where most civil[284] insider dealing cases are heard has also changed from an "Insider Trading Tribunal"[285] to a "Market Misconduct Tribunal"[286] – which move paralleled the European Union's broadening from a directive on insider dealing to one that also included other forms of market abuse,[287] such as price manipulation. As seen in following, the rules and enforcement protecting market integrity in Hong Kong do provide some elements to counter the serious risks posed by large shareholders in the small Hong Kong corporate and financial community. However, it would be possible to strengthen these protections further.

The prohibition of insider dealing is expressed in ss 270 SFO, and attaches civil,[288] criminal[289] and disqualification of office sanctions to persons "connected with" a listed company who have "inside information" about the company and (a) deal in the company's listed securities, (b) "counsel or procure" another person to so deal, or (c) give the information to another "having reasonable cause to believe that the other person will" do (a) or (b).[290] A dedicated provision specifies that contemplation of a takeover bid is inside information which triggers these provisions.[291] Importantly for Hong Kong, the definition of "connected with" the company expressly includes a "substantial" shareholder of the company, which is defined as any shareholding exceeding five percent of share

[280] *See* Annotated Ordinances of Hong Kong, Securities (Insider Dealing) Ordinance, Chapter 395, Introduction, LexisNexis.

[281] *See* The Securities Trading Act (*Gesetz über den Wertpapierhandel* - WpHG), first enacted 26 July 1994.

[282] *See* SFO ss 270-273.

[283] Now SFO, Part XIVA, added by the Securities and Futures (Amendment) Ordinance, no. 9 of 2012.

[284] Hong Kong provides for both civil and criminal prosecution of insider dealing.

[285] *See* Securities Ordinance 1973, Chapter 333, s 141G (now repealed).

[286] *See* SFO, ss 251-265. One reason for the creation of the MMT was that the sophisticated market practices and techniques used to manipulate market prices make it very difficult to prove the criminal standard of "beyond a reasonable doubt" to convict for market manipulation. SFC (2000b: Para. 20).

[287] *See* Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse), 2003 O.J. (L 96) 16, replacing

[288] *See* SFO, 281.

[289] *See* SFO, 291.

[290] SFO, s 270(1)(a), (c).

[291] SFO, s 270(1)(b)

capital,[292] as well as persons holding office in a "related" company,[293] which means in the company's holding company, a subsidiary or a subsidiary of the holding company of the company whose shares are traded.[294] There are four separate routes that may be taken to enforce this prohibition, all of which potentially see SFC as the initial actor. First, the SFC may seek summary disposition of "less significant" offenses in a magistrate's court.[295] Second, the SFC may refer a matter to the Secretary for Justice for criminal prosecution,[296] and penalties range up to a fine of HK$10 million and 10 years imprisonment.[297] Third, either the SFC[298] or an injured party[299] may seek a civil penalty in the MMT against the inside dealer. Fourth, the SFC may in the CFI seek injunctive relief against the inside dealer so as to restrain against action, obtain restitution or protect property against removal,[300] an SFC power that was challenged but ultimately affirmed in a 2012 Court of Appeals Decision.[301]

The transactions of insiders are monitored and recorded according to two sets of rules. First, all shareholdings or options to acquire the same in listed companies reaching 5% of share capital and any 0.5% change thereafter[302] must be notified to the company and the exchange within three business days after it arises.[303] A like duty applies to short positions,[304] although the newer reporting rules discussed below create transparency at a lower threshold. Second, directors must report their dealings in the company's shares pursuant to a "Model Code for Securities Transactions by Directors of Listed Issuers," which however applies only on a "comply or explain" basis.[305] Pursuant to this Code, directors of a company listed on the SEHK may not buy, sell or mortgage shares in the company during a 60 day period preceding publication of the annual results and during a 30 day period preceding the publication of the quarterly or semi-annual results,[306] and must request prior clearance for such sales, purchases or mortgages from the board chair or a director specified for this purpose,[307]

[292] *See* SFO ss 247(1)(b), (3).

[293] *See* SFO ss 247(1)(c), (ii).

[294] SFO Sch 1, s 1(3), "references to related corporation."

[295] *See* SFO s 388 and *Securities and Futures Commission v Tiger Asia Management LLC* [2011] HKEC 824 CFI, at para 18.

[296] *See* SFO s 252A(2)(a), (4).

[297] *See* SFO s 303.

[298] SFO s 252(1).

[299] SFO s 281.

[300] *Securities and Futures Commission v Tiger Asia Management LLC* [2012] 2 HKLRD 281 CA, at paras 29-37.

[301] *Securities and Futures Commission v Tiger Asia Management LLC* [2012] 2 HKLRD 281 CA.

[302] *See* SFO ss 310(1), 313(1), 313(7), 315(1).

[303] SFO ss 324-325.

[304] SFO s 310(4).

[305] SEHK Listing Rules, Appendix 14, para H, and "Model Code for Securities Transactions by Directors of Listed Issuers" (Directors' Dealings Code), para D.

[306] Directors' Dealings Code, para 3.

[307] Directors' Dealings Code, para 8.

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and the latter must create and apposite register of transactions.[308] Any short positions held by directors in their company's shares must be entered in a register that is available for inspection by all directors and members.[309] Obvious avenues to strengthen this regime would be to apply a blackout period to substantial shareholders of the company as well as to directors, and to place the directors' reporting requirements on a statutory basis with the record being available to both the exchange and the SFC for inspection.

Statutory backing was, instead, recently given to the duty to disclose inside information to the public as rapidly and fairly as practicable. Pursuant to this new rule, a listed company must "as soon as reasonably practicable" disclose to the public any inside information that "has come to its knowledge,"[310] unless the information is a trade secret or concerns ongoing negotiations and the confidentiality of the information is preserved.[311] In the context of this new statutory requirement, the SFC has provided an extensive comment on the nature of "inside information" and the likelihood that a given item of information would trigger a requirement to disclose in a given set of circumstances, basing its analysis on a roughly 20 year series of decisions regarding the prohibition of insider dealing,[312] which should substantially reduce the risk of unwittingly violating the law. The disclosure must be effected in a matter that provides "equal, timely and effective access by the public."[313] The SFC may bring action against a company, its directors and officers for a failure to disclose, in the context of which the MMT is authorized to order the disqualification of directors and levy fines against directors and CEOs of up to HK$8 million.[314] As the following chapter explains, while the prosecution of insider trading in Hong Kong has not been particularly aggressive or high-profile, a steady stream of cases does provide a credible deterrent to the market.

(b) Rules against price manipulation

The other major type of market abuse to which Hong Kong law addresses its attention is market manipulation. Market manipulation has been prohibited since 1974, and the SFO currently provides an articulated network of prohibitions for various types of distorting practices, while a combination of SFC and SEHK rules provide a framework for regulating and monitoring short selling, and the SFC operates an ongoing process of electronic surveillance to detect trade-based price manipulation.[315] The types of market manipulation codified in the SFO are the following:

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[308] Directors' Dealings Code, para 9.

[309] SFO s 352.

[310] SFO s 307B(1).

[311] SFO s 307D(2). Similar exceptions apply to the receipt of liquidity from the government Exchange Fund and cases where the SFC has waived the requirement because disclosure would violate local or foreign law. SFO s 307E.

[312] SFC (2012: paras 13-37).

[313] SFO s 307C(1).

[314] SFO ss 307I, 307N.

[315] This system is designed by SMARTS, a monitoring tool which analyzes the nexus between combinations of trades and share price impact, created by Michael Aitken.

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- "false trading," which is understood to include trading that intentionally or recklessly creates the misleading impression of an active market or creates or maintains an "artificial" price, and expressly includes wash sales;[316]
- "price rigging," defined as including wash sales and fictitious transactions that have the effect of stabilizing or maintaining a given price, unless a contrary purpose is demonstrated;[317]
- "disclosure of information about prohibited transactions," which is an attempt to multiply the effects of transactions otherwise constituting market misconduct by making the transactions themselves known to others;[318]
- "disclosure of false or misleading information inducing transactions," if the actor knows or acts recklessly overlooking that a statement or omission is misleading as to a material fact;[319] and
- "stock market manipulation," technically defined as entering into two or more transactions intended to move price and then benefit from another trader's action or inaction.[320]

As in the case of insider dealing, these different acts constituting market misconduct may be prosecuted along a civil route in the MMT or a criminal route by referring them to a court. As will be discussed in detail in the following chapter, MMT hearings of some sort of market misconduct are common proceedings, as are lesser sanctions imposed by the SFC on licensed intermediaries.

(c) Rules on short sales

Short selling can be a powerful component of sequenced trading strategies designed to inject unsupported price pressure into the market, and as such, the discipline of short selling should be considered in any treatment of the market's effective regulation against market abuse. The discipline of short-selling in Hong Kong is imposed from a number of angles. First, the SFO prohibits naked short sales – that is, sales of a security which the seller neither owns, has an option to nor has borrowed – altogether,[321] and imposes a potential penalty for violation of two years imprisonment.[322] Every person who sells short through a broker or other agent must provide the latter with documented proof of compliance with this requirement,[323] and the exchange participant entering the trade must earmark it for the matching system as a short sale.[324] In this way, the SEHK and the SFC gather data on short selling market impact. The SEHK allows permitted short selling only in a specific list of designated securities for which liquidity is deemed sufficient,[325] and further requires that for most of

316 SFO s 274; for the criminal offence, s 295.

317 SFO s 275; for the criminal offence, s 296.

318 SFO s 276; for the criminal offence, s 297.

319 SFO s 277; for the criminal offence, s 298.

320 SFO s 278; for the criminal offence, s 299.

321 SFO s 170(1), which states that the seller must have "a presently exercisable and unconditional right to vest the securities in the purchaser of them."

322 SFO s 170(4).

323 SFO s 171(1).

324 SFO s 171 in connection with SEHK Rules, Sch 11(5)(b).

325 SEHK Rules, Rule 563D(1).

these securities a short sale may not be entered for lower than the current, lowest ask price.[326] The SFC has issued further reporting rules on short positions in listed securities, which require that short any position exceeding 0.02% of the class of securities by value or HK$30 million be notified to the SFC at the close of each week,[327] which publishes the information on its website.[328]

(d) Requirements for investment banks sponsoring public offerings

Efforts have also been made to guarantee the quality of gatekeeping professionals in Hong Kong. In 2012, the SFC recommended that the SFO be amended expressly to provide that investment banks advising on and underwriting public sales of securities in connection with a public listing of securities (sponsors) be considered liable together with the issuer and its directors for material misstatements or omissions in prospectuses.[329] The SFC also announced amendments to its Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission to introduce rules that in essence turn the existing best practices of sponsors into firm, regulatory standards.[330] The provisions of the Code do not have the force of a regulation, but function as authoritative interpretations of the meaning of requirements set out in the SFO, particularly what is necessary for a market participant to be considered “fit and proper” to retain its license under the SFO.[331] The provisions regulating sponsors are a new section 17 of the Code of Conduct, and apply to all aspects of a sponsor’s activity, requiring, *inter alia,* that the sponsor thoroughly understand and provide good advice to its client on compliance with applicable law,[332] undertake a rigorous and responsible investigation of the issuer to identify and correct or disclose any material issues,[333] have reasonable grounds to believe that all statements made in a prospectus, whether the character of the statements is non-expert or expert, are sufficient to avoid misunderstanding, true, accurate and complete,[334] collaborate with the relevant exchange and the SFC, bringing to its attention any failure of the issuer to comply with law or applicable rules,[335] and “maintain adequate records so as to demonstrate to the SFC its compliance with the Code.”[336] This encapsulation of best practice in a Code, compliance with which will affirm the underwriter’s or manager’s eligibility to remain licensed to perform the

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[326] SEHK Rules, Sch 11(15).

[327] Securities and Futures (Short Position Reporting) Rules, ss 3(2), 4.

[328] *See* www.sfc.hk, > Regulatory functions > Market infrastructure & trading > Short position reporting > Aggregated reportable short positions of specified shares.

[329] SFC (2012b: para 39). “Sponsors” are persons who are licensed to engage in an activity defined in Schedule 5 of the SFO as “Type 6: advising on corporate finance,” which are in business terms called underwriters or managers.

[330] *See* SFC (2012b: Appendix A).

[331] *See* Code of Conduct, s 1.5.

[332] Code of Conduct, ss 17.3, 17.6.

[333] Code of Conduct, s 17.4.

[334] Code of Conduct, s 17.5, 17.7.

[335] Code of Conduct, s 17.9.

[336] Code of Conduct, s 17.10.

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functions of a sponsor, aims expressly to reinforce Hong Kong's role as a provider of quality regulation in connection with financial services. As the SFC observed, "[i]nitial public offerings … have been an important feature in the growth of Hong Kong's … overall development as a leading international financial centre. In order to help Hong Kong maintain its position as a leading venue for fund-raising it is vital that the IPO regulatory regime enables market participants to invest and raise new funds with confidence."[337] As will be discussed in the following chapter, these rules follow an historically significant disciplinary action against a licensed sponsor.

Given the significant pressures placed on the Hong Kong supervisory bodies by concentrations of wealth in Hong Kong and listed companies whose ultimate owner is the Chinese government, it is very hard to draw a conclusion as to the adequacy of the measures discussed above to protect market integrity. A fuller picture will be achieved when the analysis of enforcement in Chapter 4 joins this doctrinal evaluation of Hong Kong's company and securities laws.

D. Reducing the Risks of Automated Trading through Taxation

Hong Kong tax law will be considered by Jeff Vanderwolk in Chapter 5 of this text. Here, however, it is useful briefly to note the effect that Hong Kong's tax on the transfer of shares has had on market quality. The Hong Kong stamp duty was first introduced in 1866.[338] The current Stamp Duty Ordinance applies to legal documents conveying or certificating interests in: immovable property located in Hong Kong, shares of "stock the transfer of which is required to be registered in Hong Kong," bearer instruments issued in Hong Kong or regarding shares of Hong Kong companies, and duplicates and counterparts of such documents.[339] The Ordinance exempts from duty certain transactions in derivatives entered into by market participants and transfers of stock effected by options market makers for hedging purposes.[340] As a result, for every sale not exempted (such as most sales of shares) a stamp duty at 0.1% of transaction value must be paid by both buyer and seller, and a transfer deed stamp duty of HK$5.00 must be paid by the seller.[341] Together with fees levied by the HKEx (which include a transaction levy at 0.003% of transaction value, paid by each side, a trading fee at 0.005% of transaction value, paid by each side, a trading tariff at HK$0.50 on every transaction, and a transfer fee of HK$2.50 per share certificate paid by the buyer for each new certificate issued),[342] Hong Kong is a very expensive market in which to make trades.[343]

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337 SFC (2012b: para 8).

338 Stamp Ordinance, No. 12 of 1866.

339 Stamp Duty Ordinance, Chapter 117, s 4 and Schedule 1.

340 Stamp Duty Ordinance, s 19(1D), Schedule 4, and Schedule 1 together with the Stamp Duty (Jobbing Business) (Options Market Makers) Regulation, Chapter 117A, s 3.

341 Stamp Duty Ordinance, Schedule 1, "Hong Kong Stock".

342 *See* www.hkex.com.hk (accessed 6 Oct 2012). The investor compensation levy (0.002% of the consideration of a transaction, charged to both sides) was suspended because the value of the fund exceeded $1.4 billion.

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High Frequency Trading (HFT), as its name suggests, is a broker-dealer market model in which trades are entered into with frequency far beyond the capacity of human traders through computers guided by algorithms, and the number of trades per minute could aim to approach the current upper limit processing capacity of the SEHK Automatic Order Matching and Execution System (AMS), which can handle 30,000 orders per second.[344] Although the dangers and possible benefits of HFT for an equity market are still being debated, various studies and post-mortem analyses of incidents have found that HFT can create feed-back loops that drive extreme short term volatility, lead to small order size and low execution rates that drive larger trades into specialized "dark pool" venues, thus fragmenting the market, and create unacceptable imbalances in markets between those who have massive computing power and those who do not, dramatically affecting fairness and market integrity.[345] The advent of HFT algorithmic trading essentially means the end of securities markets as we have known and regulated them – as venues in which good information about issuers allow skilful traders to allocate capital efficiently to its most productive use.

One way to slow down HFT is to make trades more expensive. The European Commission on 14 February 2013 approved a proposed Directive that would allow cooperation among 11 EU member states to impose a minimum 0.1% tax on transactions in securities and 0.01% on derivatives transactions.[346] One stated purpose of the proposed Directive is to create "appropriate disincentives for transactions that do not enhance the efficiency of financial markets."[347] Although the Hong Kong stamp duty was certainly not created to that end, but is perhaps evidence of an era in which the financial sector had less influence on fiscal policy, it serves the same purpose as the proposed European measure. The presence of HFT in Hong Kong has remained negligible, and the Hong Kong market has remained a source of capital for new growing enterprises – particularly those in mainland China – rather than a venue for sophisticated gaming. It is difficult to say whether this historical accident will persist in the face of the lobbying efforts of information technology vendors and broker-dealers promoting the HFT business model. SFC regulations on computer driven trading, proposed in 2012, are still under consultation at this time.[348]

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[343] Material in this section is borrowed from *The Hong Kong Stock and Futures Exchanges – Law and Microstructure* (Sweet & Maxwell: 2012). I am grateful to Thomson, Sweet and Maxwell for permission to use this material.

[344] HKEx (2010: 2).

[345] For a full discussion of the advantages and disadvantages of HFT, *see* Donald (2012: 22-25, 225-231.

[346] *See* European Commission (2013: art 9).

[347] *See* European Commission (2013: 2).

[348] *See* SFC (2012a).

E. DO HONG KONG COMPANY AND SECURITIES LAWS MEASURE UP?

This chapter has attempted to measure the quality of Hong Kong company and securities law against the particular risks and challenges presented by the shape of the Hong Kong economy and the functions of its capital market. It takes the findings of Chapter 3 on the groups dominating the Hong Kong economy and available information about the nature of companies listed on the SEHK and examines the law and regulation of the Hong Kong market for their adequacy to meet the given tasks. The state of affairs at the outset is that Hong Kong has devised almost none of its law from scratch. Company law – both statutory and case law – has been imported from the UK and its other former colonies. Much of the securities law has arrived in Hong Kong directly or indirectly from the US. Neither the UK nor the US have an economy dominated by controlling shareholders of the type found in Hong Kong. Neither the UK nor the US must host a vast majority of listed companies that are incorporated in foreign jurisdictions. Neither the UK nor the US serve as financial markets for another jurisdiction with an economy that is dramatically larger than its own, whose law is still a project in development, and whose government controls the companies constituting about 40% of domestic market capitalization, as Chinese SOEs do on the Stock Exchange of Hong Kong. Hong Kong must adapt its transplanted tools to a new and evolving context.

The element of path dependence in Hong Kong's legal development is then primarily derived from the fact that important components of its legal system were not designed for circumstances like its own. Otherwise, given that Hong Kong has always been a service component of a larger whole, it is perfectly adapted to the role of an international financial centre for China. A major difficulty in this regard is that Hong Kong law and policymakers must supplement the governance frameworks for companies owned by the same government that ultimately controls the fate of Hong Kong's economy and regulators. This presents an extremely delicate position for regulatory enforcement, as will be discussed in Chapter 4. Moreover, Hong Kong undertakes this task while competing with two much simpler market models to its North and South: the clearly inland Shanghai market and the clearly offshore Singapore market. Given the difficulty of the task it is astounding how well Hong Kong has done. The analysis in this chapter has shown only minor gaps requiring better, future adjustments. The main adjustment necessary is to realize that the governance risks faced in Hong Kong listed companies are not primarily those between professional managers and dispersed shareholders, but those between controlling shareholders (often also in management) and minority, outside investors. As such, adjustments should be made on a number of fronts.

The judiciary should formulate a company law fiduciary duty for controlling shareholders or follow *Luck Continent* in applying the unfair prejudice action to public and listed companies. The prosecutorial efforts of the SFC should be augmented, and it should be ready to use ss 213 and 214 SFO before companies become zombies suspended from listing on the SEHK and in various stages of winding up. It order better to protect unsophisticated creditors, such as employees and tort creditors,

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courts should consider interpreting the "evasion" test under *Mitrans* to cover the premeditated entry into a high-risk business with an undercapitalized vehicle while other companies in the group remain well stocked with assets. The judiciary, the LegCo, the SFC and the HKEx should not hesitate to extend their reach and regulation over, and discipline of, the 85% of listed companies that are incorporated abroad. If the safeguards built into Hong Kong company law are steadily increased while Hong Kong does little more to improve its governance of companies incorporated in the Cayman Islands, Bermuda and other offshore locations, Hong Kong will continue to encourage the round-trip model of foreign incorporation and local listing. Having over half of the companies listed on the SEHK use this model brings with it so much complexity and uncertainty that the exchange appears to be tempting fate to bring a major scandal that will seriously damage both investors and Hong Kong's reputation for good governance and regulation. With respect to market integrity, Hong Kong should ensure that insider shareholders receive as much monitoring and discipline against insider dealing and market manipulation as do directors.

In short, Hong Kong must worry less about signaling foreign investors in their own language, by adopting their favorite UK and US governance strategies – which are designed for circumstances different from its own – and more crafting safeguards against its own, home grown risks. Although such international distinctions certainly enhance Hong Kong's reputation, the LegCo and regulators should focus less on winning the Heritage Foundation's prize for "freest economy" 18 times running and more on consolidating its position as the rule of law island for the Chinese economy. In light of what Hong Kong has done since the mid-1980s, there is good reason to believe that policy makers and regulators in Hong Kong will continue to be vigilant and focused on improving market quality. This study aims to contribute to that process. In the following chapter, the patterns of Hong Kong's regulatory behavior will become more visible through an examination of the enforcement of the regulatory framework in the exchanges, by the regulators and in the courts.

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