

# **Consultation Paper on the Proposal to Empower the Securities and Futures Commission to Initiate a Derivative Action on Behalf of a Company**

## **Consultation Conclusions**

### **INTRODUCTION**

The Financial Services and the Treasury Bureau (FSTB) and the Securities and Futures Commission (SFC) released a consultation paper on 27 May 2003 for a two-month consultation on the proposal to empower SFC to initiate, without court approval, a derivative action against wrongdoers in relation to a listed company (the Proposal). Under the Proposal, SFC may, out of its own resources, initiate a derivative action on behalf of the members of the company where the company is unwilling or unable to do so, and where the exercise of the power is both in the public interest and in the interest of the company concerned. Any damages awarded by the court will go to the concerned company and not the aggrieved shareholders. This paper summarises the public comments received and sets out the way forward.

2. The Proposal is one of the recommendations made by the Standing Committee on Company Law Reform (SCCLR), as part of its Phase I Review of Corporate Governance. The issue of a joint consultation paper on the Proposal by FSTB and SFC to follow up SCCLR's recommendation has been included as one of the initiatives in the Corporate Governance Action Plan presented to the Panel on Financial Affairs of the Legislative Council in January 2003.

### **RESPONSE TO THE PROPOSAL**

3. A total of 31 submissions have been received, 21 from market regulators and operators/professional organizations and trade bodies, and ten from individuals or firms. Four of them do not express any preference; seven give their support to the Proposal; eight suggest the Proposal be held in abeyance for the time being and 12 are against the Proposal. A list of the submissions received is at the **Annex**.

## **Arguments for the Proposal**

4. Seven respondents are in support of the proposal. They consider that the Proposal would improve corporate governance and enhance protection of shareholders, in particular the minority ones. There are views that the enhanced powers for SFC under the new Securities and Futures Ordinance (SFO) may not cover all the situations, and hence the Proposal may help fill the gap if any. For example, under section 385 of SFO, SFC has the power to intervene in third party civil proceedings in which SFC has an interest by virtue of its statutory functions. In other words, SFC may exercise this power only after the shareholders have initiated proceedings. Under the Proposal, SFC may initiate derivative action where aggrieved shareholders do not want to do so for fear of potential personal liability for costs. A respondent has also suggested that by dispensing with the requirement of court approval, there will be no “trial within a trial” which will only increase litigation costs. Of the seven respondents who are in support of the Proposal, three are individuals.

## **Arguments for holding the Proposal in abeyance**

5. Eight respondents suggest that the Proposal should be held in abeyance. Their major arguments are as follows –

- (a) **Role of SFC:** As a regulator, the primary role of SFC is to establish an appropriate regulatory framework and to ensure proper compliance with it rather than interfering in commercial disputes among shareholders.
- (b) **Use of public resources:** It is inappropriate for a regulator to expend public resources on private commercial disputes. As any damages awarded by the Court would go to the company rather than the shareholders or SFC, it would appear that SFC is transferring public funds indirectly to a listed company.
- (c) **Enhanced powers of SFC and shareholder protection under the new SFO:** The new SFO has enhanced SFC’s powers in taking action against corporate abuses and protecting shareholder

interests. For example, SFC is empowered under section 385 of SFO to intervene in third party civil proceedings in which SFC has an interest by virtue of its statutory functions. Some consider that adequate measures for shareholders' protection are in place. They recommend the effectiveness of the new measures/powers introduced under SFO, including the "dual filing" system in deterring corporate misconduct, be evaluated before considering whether or not to pursue the Proposal. There is no strong case at this stage for giving SFC the power to initiate a statutory derivative action.

- (d) **Civil Justice Reform:** The Judiciary is considering whether, in principle, to adopt a group litigation scheme in Hong Kong, such as class action procedures which would empower shareholders to seek redress collectively. Any decision about whether or not to introduce the Proposal should therefore be postponed until after the conclusion of the Civil Justice Reform and should take into account its findings.
- (e) **Means to seek redress under the Companies Ordinance:** There are rights of redress available for aggrieved shareholders under the Companies Ordinance<sup>1</sup>. The Companies (Amendment) Bill 2003 also proposes enhancing shareholders' remedies by giving shareholders a statutory right to initiate derivative actions. The need for the Proposal could be evaluated later if further enhancement of the shareholders' remedies are considered necessary after the passage of the Bill.
- (f) **Investors' responsibility:** The fundamental means of protecting shareholders lies with investor education. The message that investors should be responsible for their own investment decisions should be properly reinforced.
- (g) **Shareholder apathy:** The Proposal may undermine efforts to encourage shareholders to take action to protect their own interests in civil disputes and run the risk of engendering further shareholder apathy as shareholders may prefer relying on SFC to

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<sup>1</sup> Section 168A of the Companies Ordinance provides for a statutory remedy against unfair prejudice.

take action.

- (h) **Practices in overseas jurisdictions:** Apart from Australia, no other common law jurisdiction has empowered a regulator with a statutory right to initiate derivative actions on behalf of a listed company. The case for introducing such a statutory right may not be overwhelming. It would be useful to obtain further information about the effectiveness of statutory derivative actions overseas and the experience in Australia before considering the Proposal further.
- (i) **Enforceability of judgements in other jurisdictions:** There may be practical difficulties associated with the enforceability of judgements in an overseas jurisdiction in which a listed company is incorporated. This is exacerbated because 80% of the companies listed here are incorporated outside Hong Kong. An assessment of ramifications of the Proposal should be conducted before considering the Proposal further.
- (j) **Macroeconomic environment of Hong Kong:** One respondent comments that it is not the right moment to carry out too many reforms as Hong Kong is still undergoing economic recovery.

### **Arguments against the Proposal**

6. The major arguments of the 12 respondents who are against the Proposal are largely the same as those set out in paragraph 5(a), (b), (c), (e), (g), (h) and (i) above. Additional arguments put forward by these respondents are as follows –

- (a) **Resource implications:** Case selection, investigation and administration of the Proposal by SFC would be costly and time-consuming.
- (b) **Subjecting SFC to judicial review proceedings:** There is a risk of SFC being subject to judicial review proceedings if the Proposal were implemented. The argument that SFC's statutory power to initiate derivative actions on behalf of listed companies

in the public interest may act as a deterrent does not justify the costs involved.

- (c) **Investors' rights of recourse:** Under the Proposal, SFC may at a certain stage of the legal proceedings enter into a settlement agreement with the wrongdoers. As the agreement would be binding on the company including its members, the investors would be deprived of their rights of recourse.
- (d) **Funding arrangements:** The proposed diversion of funds from the Investor Compensation Fund will run contrary to the spirit and purpose of the Fund which is for direct compensation to investors who suffer from default by brokers.

## **WAY FORWARD**

7. In view of the limited support for the Proposal and the numerous reservations expressed by the vast majority of respondents, we consider that the Proposal should be held in abeyance for the time being pending –

- (a) the passage, enactment and implementation of provisions relating to shareholder remedies under the Companies (Amendment) Bill 2003 (which is currently being scrutinized by the Legislative Council);
- (b) the accumulation of further experience in implementing SFO; and
- (c) the conclusion of the Civil Justice Reform.

8. The Administration and SFC will keep the implementation of SFO and the Companies Ordinance under constant review in light of public comments, and seek to enhance investor protection through relevant measures. SFC will also continue its efforts in investor education with the aim of enhancing investors' understanding of corporate activities and of their rights as shareholders. Minority shareholders will be encouraged to participate more actively in the way companies are run through the exercise of their voting rights at general meetings. Also, in the event that the Companies (Amendment) Bill

2003 is enacted, SFC will play its part in increasing investor awareness of their new statutory rights of redress as aggrieved shareholders.

Financial Services and the Treasury Bureau  
Securities and Futures Commission  
18 November 2003

**Submissions in response to the Consultation Paper  
on the Proposal to Empower the Securities and Futures Commission to  
Initiate a Derivative Action on behalf of a Company**

1. Asian Capital (Corporate Finance) Limited
2. BNP Paribas
3. Consumer Council
4. Deloitte Touche Tohmatsu
5. Executives of Hong Kong Exchanges and Clearing Limited
6. Hong Kong Bar Association
7. Hong Kong Monetary Authority
8. Hong Kong Society of Accountants
9. Hong Kong Society of Financial Analysts
10. Hong Kong Stockbrokers Association
11. Lingnan University
12. Linklaters
13. Morgan Stanley
14. Mr Stephen Y L Cheung
15. Mr Low Chee-keong
16. Mr Wilson Yam
17. Norton Rose
18. S H GOO and Anne Carver
19. The American Chamber of Commerce in Hong Kong
20. The Association of Chartered Certified Accountants
21. The Association of International Accountants
22. The Chamber of Hong Kong Listed Companies Limited
23. The Chartered Institute of Management Accountants Hong Kong Division
24. The Chinese General Chamber of Commerce
25. The DTC Association (The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies)
26. The HK Association of Online Brokers
27. The Hong Kong Institute of Company Secretaries
28. The Institute of Securities Dealers
29. The Law Society of Hong Kong
30. A trade body
31. A chamber of commerce