

TOPIC 2 - OVERVIEW

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1. OUTLINE OF HONG KONG'S LEGAL SYSTEM

1.1 Sources of Hong Kong's Laws

1.1.1 Common Law

- Not created by statute or by authority of sovereign, but developed in law courts
- Authority derived from long usage and cemented by doctrine of precedence
- Principles of development of common law in England have been adopted and extended in Hong Kong
- Judges interpretation of common law and legislation form case law

1.1.2 Equity

- Has developed its own case law, addressing issues of fairness and justness
- Where there is a conflict between common law and equity, equity generally prevails
- Remedies under equity, which apply in the financial services industry, include:
 - **Injunctions:** court orders prohibiting someone from doing something
 - **Specific performance:** court order that a person must carry out his part of the contract
 - **Equitable rescission:** aims to restore the parties to their original positions before the contract was entered into
 - **Rectification:** the court clarifies the contract when it does not properly record the intentions of the parties to it

1.1.3 Mercantile Law / Commercial Law

- Various pieces of commercial law, including the Sale of Goods Ordinance and the Bills of Exchange Ordinance

1.1.4 Primary and Subsidiary Legislation

- **Primary legislation** consists of Ordinances enacted by the Chief Executive, with the advice of LegCo (drafted by Government)
- **Subsidiary legislation** is drafted by non-Government bodies, as delegated by LegCo, and referred to as Rules
- SFC has extensive powers to make rules under SFO

1.2 Independence of the Judiciary

- Judiciary is completely independent of other parts of Government
- Judges are not politically appointed; decisions based on interpretation of law
- Judges are not pressurized by Government, LegCo, media or pressure groups

1.3 Categories of Hong Kong's Laws Relevant to Exam

1.3.1 Criminal Law

- Defines offences against the community and how persons may be investigated, charged, tried and punished
- Punishment may include imprisonment
- Case is brought by the State e.g. **Department of Justice**
- Case has to be proved '**beyond reasonable doubt**' and burden of proof is on the prosecutor

1.3.2 Civil Law

- Provides remedies for individuals or businesses that have suffered loss from the actions of another person
- Not primarily intended to punish wrongdoer
- Plaintiff (injured party) brings action against defendant
- Court order or award is made if plaintiff can prove claim on '**balance of probabilities**'

1.3.3 Contract Law

- A contract is an agreement between two or more persons creating obligations enforceable under law
- Examples are:
 - Purchase or sale of security/futures contract
 - Acceptance by an investor of an IPO
 - Undertaking to manage a mutual fund
 - Purchase of a leveraged foreign exchange contract

1.3.4 Law of Agency

- Agency is a fiduciary relationship, created by express or implied contract, where the agent may act on behalf of the principal
- Agent binds principal by words and actions
- Stockbroker can be agent of client; account executive may be considered agent of employer
- A principal is liable for the acts of the agent, who is a fiduciary....

1.3.5 Fiduciary / Fiduciary Relationship

- A person who owes another person duties of good faith, trust, confidence, honesty and care
- The agent has a duty to act for the benefit of the principal

1.3.6 Law of Tort

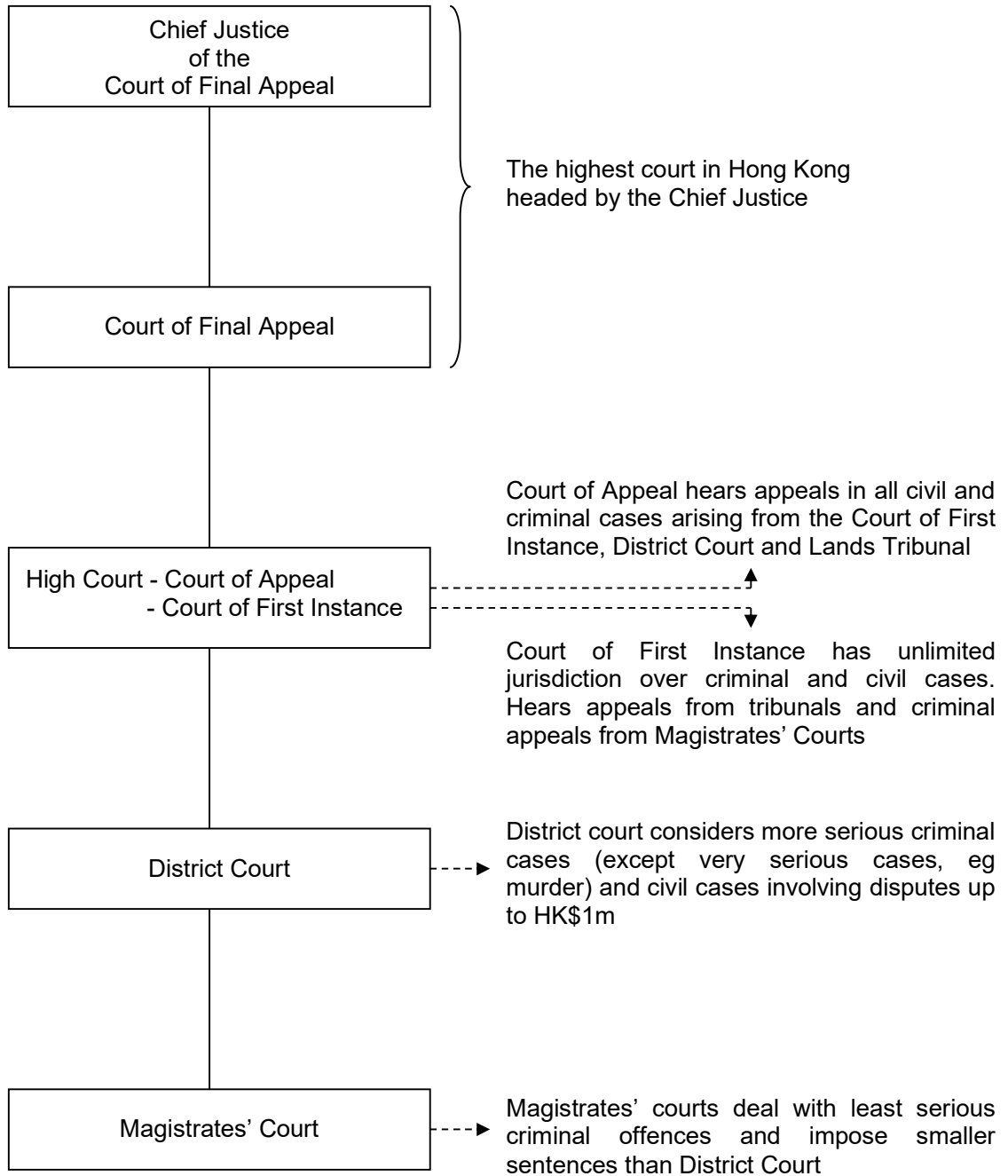
- In situations where **no contract exists**, a wrong or tort can occur when one party suffers a loss or damage from the actions of another
- Financial advisers who are negligent in giving advice may be exposed to actions in tort

1.3.7 Employment Law

- Under common law, an employer must provide an employee with:
 - Remuneration
 - Indemnity for expenses, losses and liabilities
 - A safe working environment
- Under common law, an employee must demonstrate skills and competence, faithful service, obedience and confidentiality

1.4 Hong Kong's System of Law Courts and Tribunals

1.4.1 The Law Courts



1.4.2 Administrative Tribunals

- Established by the Government as needed, eg **Market Misconduct Tribunal** and **Securities and Futures Appeals Tribunal**
- May require members to have a high level of knowledge of subject matter
- The idea is to quicken the legal process
- Need less strict levels of proof than courts
- Fewer formal procedures; can complete hearings quickly

1.4.3 Arbitration

- Business disputes can be resolved by arbitration
- HK International Arbitration Centre was set up to provide domestic arbitration (both parties in HK) and international arbitration (one party is overseas)
- **Arbitration Ordinance** provides statutory framework for arbitration
- Arbitration is fast, cheap, informal and private
- Used as a means of resolving disputes arising from leveraged foreign exchange trading

2. NEW COMPANIES ORDINANCE AND RELATED MATTERS

The NCO covers all areas regulated under the old CO, except the prospectus regime and the winding-up insolvency provisions which remain regulated under the old CO, now referred to as Companies (Winding Up and Miscellaneous Provisions) Ordinance

2.1 Separate Legal Entity

- A company is:
 - A legal entity distinct from its members
 - A legal person and can make contracts, take legal action, sue and be sued, own property and commit crimes and torts
 - Has perpetual succession and will only cease if dissolved

2.2 Private, Public and Guarantee Companies

There are 3 distinct types of companies.

2.2.1 Private Company

- Restricts the right to transfer its shares
- May not have more than 50 members
- May not offer shares (or debentures) to the public
- Is not limited by guarantee

2.2.2 Public Company

- Does not restrict the right to transfer its shares
- May have more than 50 members
- Is not a guarantee company

2.2.3 Guarantee Company

- Does not have share capital
- Members liability is limited by the company's articles to the amount that the members undertake to contribute to the assets of the company in the event of its being wound up

2.3 Listed Company

- A company that has any of its shares listed on a recognized stock market

2.4 Articles of Association

- Considered to be the single constitutional document of a company, forming an agreement between the company and its members
 - Companies can adopt model articles of association provided in the Companies (Model Articles) Notice, consisting of four parts including matters relating to:
 - Officers, including powers, duties, appointments and disqualifications of directors and company secretaries
 - Members, including meetings and voting procedures
 - Capital, such as share capital, rights and dealings with shares and dividends
 - Miscellaneous provisions such as communications to and by the company and administrative arrangements

2.5 Share Capital

- Under the NCO, shares in a company have no nominal value
- No requirement for a company to have authorized capital
- Companies are given the power under their articles to issue different classes of shares such as:
 - ordinary shares
 - preference shares
 - redeemable shares

2.5.1 Ordinary Shares

- Also referred to as equity or common shares
- Entitled to share in distribution of past and current profits, but rank after all other shareholders and creditors
- Entitled to any assets/payout in a liquidation after all other creditors have been paid
- From 30 April 2018, companies listed on the Stock Exchange of Hong Kong are permitted to issue shares with different voting rights. Previously, this was considered a violation of the one share one vote principle, however commercial considerations dictated the introduction of **weighted voting rights** – see Topic 8 for further coverage

2.5.2 Preference Shares

- Must be authorized in the company's articles
- Entitled to receive dividends at a fixed rate, with priority over ordinary shares
- Participating preference shares have the right, not only to a fixed dividend, but also to share in some part of remaining distributable profits

2.5.3 Redeemable Shares

- Redeemable preference and ordinary shares may be issued if authorized by articles of association
- May be redeemed at the option of the shareholder or company
- May only be issued if company has already issued shares that are not redeemable
- Redemption must be paid out of distributable profits, the proceeds of a new share issue, or share capital
- Redemption can only occur if shares are fully paid

2.6 Debentures

- The term debenture in UK refers to corporate bonds backed by some form of security, whereas the US and Canada use the term to describe any type of bond
- The holder of a debenture is a creditor of the issuing unit and receives interest at a fixed rate
- For the purposes of the exam, debentures may be secured or unsecured
- Debentures can be for a fixed term or irredeemable
- Debenture holders rank before all types of shareholder

2.6.1 Secured and Unsecured Debentures

- Debentures may be secured by a fixed or floating charge on specific assets of a company or all of them
- An unsecured debenture ranks as an unsecured creditor; a secured holder has prior rights to the security

2.7 Meetings and Procedures

- Company meetings of shareholders provide the only opportunity for shareholders to exercise any control over the affairs of the company or take part in its operations
- New Companies Ordinance requires Annual General Meetings to take place
- Companies are allowed to dispense with the requirement to hold AGMs by passing a written resolution or a resolution at a general meeting with unanimous shareholders' consent
- Other general meetings can be requested by directors, shareholders, and the court.

2.7.1 Annual General Meeting (AGM)

- Companies must hold an AGM within the following periods:
 - Public companies: within 6 months of the accounting year-end
 - Private and Guarantee companies: within 9 months of the accounting year-end
- The business of an AGM includes:
 - Consideration of annual accounts
 - Declaration of dividends
 - Election of directors to replace those retiring
 - Appointment of auditors
 - Questioning of directors by members

2.7.2 Resolutions

- Resolutions may be passed by circularization and signed by all members, except for:
 - Removal of auditors before expiry of office
 - Removal of director before end of term of office
- } Require ordinary resolutions at a general meeting

2.7.3 Special Resolution

- Passed by at least 75% of members at a general meeting
- 21 days notice of the meeting is required
- Printed copy of resolution must be lodged with Company Registrar within 15 days
- Special resolution required for:
 - Reduction of share capital
 - Company liquidation
 - Alteration of articles of association

2.7.4 Ordinary Resolution

- a resolution passed by a simple majority of those present and voting at a shareholders' meeting. Notice must be given

2.8 Powers of Shareholders

2.8.1 Powers Exercisable by Members in a General Meeting

- Changes to articles of association and company name
- Matters relating to buybacks
- Issue of shares at a discount
- Alteration of capital, including reduction
- Variation of class rights
- Corporate arrangements and reconstructions
- Appointment and removal of auditors
- Removal of directors
- Disposal of company assets
- Approval of payments for loss of office
- Winding-up petitions under court order and voluntary winding-up

2.8.2 Protection of Members and Minority Shareholders

- A company may vary the rights of the holders of a class of shares – **the holders of at least 10%** of the total voting rights of the shares of that class may petition the court to have the variation cancelled, if against their interests
- **An individual member** may petition the court if the affairs of the company are being conducted in a manner prejudicial to the interests of the members generally

2.8.3 Protection of the Interests of Minority Shareholders

(in relation to internal procedures)

- Members with 5% of paid-up capital carrying voting rights, may ask the directors to call a meeting; if the directors refuse, the members may do so
- 100 members or 10% of the holders of issued shares may ask the Financial Secretary to appoint an investigator to look into the company's affairs

2.8.4 Judicial Protection of the Minority

- In addition to statutory safeguards, a court may intervene to allow an individual member, or members, to bring an action:
 - To enforce some personal right (personal action)
 - To enforce a right of a group of members (joint action)
 - Where the alleged wrongdoers control the company so it's not possible to bring the action in the company's name (derivative action)

2.9 Directors and Officers

2.9.1 Directors

- A director includes any person who occupies the position of director, by whatever name he is called
- A public company must have at least 2 directors
- A private company must have at least 1 director
- Must be appointed by the members acting in general meeting

2.9.2 Shadow Directors

- Persons in accordance with whose directions or instructions the directors of a company are accustomed to act

2.9.3 Officer

- Per NCO, includes a director, manager or company secretary

2.10 Qualifications, Powers, Duties and Liabilities of Directors

2.10.1 Qualifications of Directors

- Must be at least 18 years old
- Must not be an undischarged bankrupt
- Must not be disqualified by court order

2.10.2 Powers of Directors

- General powers to manage the business of a company are vested in the directors
- Directors can exercise all the powers of the company except those otherwise required by the NCO, the articles, and any directions given by special resolution
- Members in general meeting may only intervene in management if directors are:
 - Unwilling to act
 - Seeking approval to act beyond their powers
 - Acting in breach of their fiduciary duties
- Under common law, directors should have board meetings with a proper quorum, passing resolutions that must be minuted

2.10.3 Duties of Directors

- Directors have a **fiduciary relationship with the company**. They must act with the utmost good faith towards the company, act for the benefit of the company, exercise their powers for the proper purpose and not allow conflicts of interest to prevail
- Directors **must act with reasonable care, skill and diligence** as reasonably expected of persons of their experience and knowledge
- Directors are **not required to give continuous attention** to a company's affairs
- Directors are **justified in relying on officials** to whom duties are delegated

2.10.4 Liabilities of Directors

- In relation to various offences, directors may incur liabilities due to:
 - Breaches of fiduciary duties
 - Failure to act with reasonable care, skill and diligence
 - Breaches of statutory duties
 - Failure to prepare financial statements when required to do so
- If a director breaches his duties, the company:
 - May obtain an injunction to stop the action
 - May cancel a company contract if the director did not declare a personal interest in the contract
 - May force directors to account for profits wrongfully earned by dealing with the company's property

2.10.5 Financial Arrangements with Directors

- Directors with a direct or indirect significant interest in a transaction, arrangement or contract with the company, must declare the nature and extent of the interest – as soon as reasonably practicable
- Directors' fees should be determined by the company in general meeting
- A company cannot, directly or indirectly, without the approval of its members
 - Make a loan to a director of the company or a body corporate controlled by such a director
 - Enter into a guarantee or provide security for such a loan
 - Make a loan or guarantee to a company in which a director has a controlling interest

2.11 Audits and Investigations

- Hong Kong companies are required to be audited on an annual basis
- Investigations may be ordered by the Financial Secretary or the company may itself carry out a private investigation

2.11.1 Appointment of Inspectors by Financial Secretary

- The Financial Secretary is required to appoint inspectors to investigate the affairs of a company if the court declares that an investigation should be carried out
- The Financial Secretary may also order an investigation if:
 - An application is made by the specified number of members
 - Company passes a special resolution requesting such an appointment
 - He suspects that the company's affairs have been conducted to the detriment of members/creditors
 - He suspects fraud or misconduct

2.11.2 Duty to Assist the Inspector

- All present and past officers and agents of the company, including bankers, solicitors and auditors, are required to assist an appointed investigator
- Exceptions are solicitors, who cannot be forced to provide privileged client information, and bankers, who do not have to provide information other than that relating to the company under inspection

2.12 Liquidations of Companies

2.12.1 Compulsory Liquidation

- A compulsory winding-up by the court
- The liquidator is appointed and controlled by the court
- A company may be wound up by the court if:
 - It has resolved to be wound up by special resolution
 - It does not commence business within a year of incorporation or has suspended business for a whole year
 - It has no members
 - It is unable to pay its debts
 - The Articles of Association stipulates liquidation on the occurrence of particular events
 - The court believe it would be just and equitable to wind up the company
- Petitioners for a compulsory winding up may be:
 - The company
 - A creditor
 - Financial Secretary
 - Registrar of Companies, if company has breached CO or is breaking the law
 - Official Receiver, where there is already a voluntary winding up
 - SFC, if it is in the public interest (see Topic 3: 2.10.3)

2.12.2 Voluntary Liquidation

- A voluntary winding up may be started by members or creditors
- Fewer formalities than a compulsory winding up and therefore more popular
- There are 3 situations where a voluntary winding-up can start:
 - When the period fixed for a company's duration, as per the articles of association, comes to an end
 - The passing of a special resolution for winding up
 - A majority of directors pass a board resolution winding up the company, followed by the delivery of such a statement to the Registrar of Companies

Members' Voluntary Winding Up

- If the directors are able to declare that the company can meet its debts within 12 months from the start of the winding up, a members' voluntary winding up can proceed
- This declaration must be made 5 weeks before the resolution to wind up the company

Creditors' Voluntary Winding Up

- If the conditions for a members' compulsory winding up cannot be met, a creditors' winding up will proceed
- A liquidator and a committee of inspection will be appointed to supervise the process