香港會計師公會
HONG KONG SOCIETY OF ACCOUNTANTS
Incorporated by the Professional Accountants Ordinance, Cap. 50

Our Ref.: C/CGP, M22398 30 September 2003

FSB (Derivative Action Consultation)
Rooms 1801-4, Tower 1,
Admiralty Centre,
18 Harcourt Road,
Hong Kong.

Attn: Division 1

Dear Sirs,

Consultation on the Proposal to Empower the Securities and Futures Commission to Initiate a Derivative Action on behalf of a Listed Company

The Hong Kong Society of Accountants ("the Society") has considered the proposal to empower the Securities and Futures Commission (SFC) to initiate a derivative action on behalf of a listed company ("the Proposal") and the Society's views on it are outlined below.

General comments

From the corporate governance perspective, we believe that Hong Kong should aim to adopt international standards in terms of shareholder remedies and investor protection. In considering whether the Proposal will address perceived gaps in Hong Kong's existing system, we also considered the likely efficacy and the practical implications of the Proposal, and how it might fit into the current and future legal and regulatory framework.

It is our view that the existing common law derivative action does not in practice provide an effective and sufficient remedy for shareholders where a wrong is done to the company, because of the potential costs involved, as well as for the other reasons outlined in paragraph 12 of the Consultation Paper ("the Paper"). It is our understanding that such actions have rarely been pursued in Hong Kong.

Recent and proposed developments

The Society notes that provisions for a statutory form of derivative action have been incorporated into the Companies (Amendment) Bill 2003. This seeks to address some of the key deficiencies with the present system, including provisions to enable plaintiffs to get access to the information necessary to initiate an action and for the court to award costs to the plaintiffs. In the context of the Proposal It would be useful, therefore, to know more specific details about the statutory derivative actions that have been introduced in other jurisdictions, such as Canada, Singapore and New Zealand, and how effective these have been as measures to enhance shareholder protection. Relevant additional information would include statistics in relation to the number of derivative actions that have been initiated so far, the success rate, etc.

It is possible that shareholders wishing to initiate a statutory action under the provisions in the Companies (Amendment) Bill 2003 would face some potential obstacles.

香港金鐘道八十九號力寶中心二座四樓
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong
Tel: 2287 7228 Fax: 2865 6603 / 2865 6776
http://www.hksa.org.hk E-mail: hksa@hksa.org.hk

Wrongdoers might, for example, be able to thwart an action by opposing the plaintiffs' application for an order for inspection, or otherwise attempting to delay the commencement of an action for as long as possible. If the costs began to escalate and the plaintiffs had no assurance that an award of costs would be made in their favour, they might be put off continuing to pursue the action.

Considerations in support of the Proposal

In contrast to private shareholders, however, a regulator such as the SFC has a range of other powers in its armoury that could assist in expediting an action against wrongdoers and it would also be less likely to back down on the grounds of the potential costs in a particular case. The very fact that such power was in the hands of the SFC might serve a deterrent to prospective wrongdoers in some cases. We believe, therefore, that it would be helpful to have some more specific information about the experience of the regulator in Australia, the Australian Securities and Investment Commission (ASIC), which, as indicated in the Paper, already has a power to intervene on behalf on shareholders, and in particular information on the issue of the judicial reviews, referred to in paragraph 30 of the Paper.

Considerations against the Proposal

Although, as suggested above, there are some arguments in favour of the Proposal, we believe that there would also be disadvantages in expanding the regulator's authority at this time. A fundamental question to ask is whether the securities regulator is the most appropriate body to intervene in civil disputes between shareholders? Prima facie, it should confine any interventions to cases of significant public interest, which may be few and far between. At most, therefore, a power conferred on the SFC should be in addition to any right of action given to minority shareholders themselves.

More specifically, as indicated in the Paper, the SFC has only recently been given expanded powers under the Securities and Futures Ordinance (SFO). Now may not be the best time to further increase these, particularly in view of the fact that the three-tier regulatory system is currently under review and the outcome of this could be a further extension of the SFC's role. We would want to be convinced that there is in place an adequate framework of monitoring and accountability, commensurate with any significantly greater scope of powers and responsibilities that may be invested in the regulator.

There is also the question of funding. In our view, the figures quoted in the Paper as to the likely cost of going to trial could be an underestimate, especially as the cases that would warrant the exercise of this power would be likely to be the larger and more complex ones. Furthermore, it is far from obvious that the Investor Compensation Fund would represent an appropriate source of funding for the Proposal.

Notwithstanding the potential difficulties, referred to above, that shareholders may face in successfully initiating a statutory derivate action, we are also of the view that implementation of the Proposal at the same time as introducing into the Companies Ordinance a new statutory action for shareholders may undermine efforts to encourage shareholders to take action to protect their own interests in civil disputes. We understand that the issues of allowing some form of class actions in Hong Kong, as well as permitting lawyers to charge fees on a contingency basis are also presently under consideration. If so, these matters would also have a bearing on the willingness and ability of shareholders to pursue their own legal actions.

It is noted that a majority of the companies listed in Hong Kong are incorporated overseas, and that the legislation in some of these jurisdictions may permit a much wider scope of directors' indemnification than Hong Kong incorporated companies. Accordingly, in order to maintain a "level playing field" in relation to all companies operating in Hong Kong, and to maximise the effectiveness of the Proposal if it were to be implemented, consideration would have to be given to restricting officers of overseas companies to no more than the same level of exemption available to officers of companies incorporated in Hong Kong, as indicated at paragraph 33 of the Paper; otherwise, an overseas company that succeeds in an action in court might in effect have to fund any damages and costs awarded in its favour through the indemnity arrangements or through insurance premiums, which would clearly defeat the object of the exercise. However, putting directors of overseas companies on the same footing as those of Hong Kong-incorporated companies would, it seems, require the introduction of legislation having extra-territorial effect. This could have an adverse impact on Hong Kong's attraction as a place of investment from the perspective of existing and potential investors.

Recommendations

In the light of the above, the Society believes that, rather than taking the Proposal forward at this juncture, a better approach for the time being would be the following:

- Allow the statutory derivative action incorporated in the Companies (Amendment) Bill 2003 to be implemented and operate for a period, and then review its effectiveness.

- Monitor for a period the operation of the SFC's existing powers, such as the power to intervene in third party disputes under section 385 and its expanded powers under section 214 of the SFO, with a view to assessing whether these existing powers could, if necessary, be exercised so as to help remove any "roadblocks" in shareholder initiated derivative actions, and thus enhance the overall deterrent effect.

- Allow the dual filing process under the SFO to operate for a period and review its effect in helping to deter corporate abuse.

- Obtain further information about the effectiveness of statutory derivative actions overseas and of the statutory power of intervention in the hands of the ASIC.

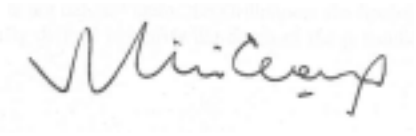
If, in due course, the indications are that there is a need for the Proposal to be further examined, then the other issues raised above should be considered in more detail, including the source of funding and the likely quantum of funding required, as well as the impact on Hong Kong's investment environment of introducing legislation with extra-territorial effect, etc.

If it is ultimately decided that the Proposal should be taken forward then we would also advocate reviewing the proposed grounds for initiating such actions. We would suggest that it should be sufficient if the exercise of the statutory power in the hands of the regulator were to be restricted to the principal grounds of (i) fraud; (ii) default in relation to any legislation; and (iii) breach of any fiduciary or statutory duty. We believe

that the issue of negligence, on the other hand, is by its nature too argumentative as a concept for it to be a suitable generic basis for initiating action.

We trust that you will find our comments to be helpful and constructive. If you have any questions in respect of the points set out above or wish to discuss them further, please feel free to contact Mr. Peter Tisman, the Society's Deputy Director (Business & Practice) at 2287 7084 in the first instance.

Yours faithfully,



WINNIE C.W. CHEUNG
SENIOR DIRECTOR
PROFESSIONAL & TECHNICAL DEVELOPMENT
HONG KONG SOCIETY OF ACCOUNTANTS

WCC/PMT/ay

c.c. SFC (Derivative Action Consultation) (Attn: Corporate Planning) (Fax no. 2293 4099)