Submission to the Legislative Council of the Hong Kong SAR on the matter of The Companies (Amendment) Bill 2002

by

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Dear Legislators,

1. Introduction

Thank you for the invitation to give views on the Companies (Amendment) Bill 2002 (the “Bill”). For those of you who are not familiar with *Webb-site.com*, which I established in 1998, it is Hong Kong’s leading publication dedicated to Hong Kong corporate governance, with over 6,000 readers who have elected to join the electronic mailing list. Through the site, I regularly make submissions to the HKEx and SFC regarding regulatory proposals, often endorsed by submissions from readers, and am pleased to be able to contribute a submission on the latest legislative proposals.

Webb-site.com is not-for-profit and run from my spare bedroom, and so I hope you will forgive my inability to submit this paper in both official languages. To date, Hong Kong still has no full-time representation for investors in the policy-making debate, and this is holding back the reform process. However, that topic is beyond the scope of this paper. If you are interested in how this could be resolved, establishing a representative body to pursue (i) policy reform, (ii) corporate governance appraisal and (iii) consolidated enforcement of shareholder rights, then please see the HAMS Proposal at http://webb-site.com/HAMS. That proposal would require enabling legislation.

I am currently the only shareholder representative on the Shareholder Sub-committee of the Standing Committee on Company Law Reform. I am also a member of the Takeover Panel and the bimonthly SFC Shareholders Group. I was formerly an investment banker specializing in advice to companies and governments around Asia. For further information on my background, see http://webb-site.com/aboutus.htm.

In the interests of brevity I have restricted this paper to areas of the Bill with which I disagree. Should their be any opposition by other parties to the other proposals in the Bill, I would be pleased to give views to the committee in person or in writing on why the provisions of the Bill should be adopted.

2. Uniformity of application

I believe that the laws of HK should be applied uniformly to companies registered under the Companies Ordinance (“CO”), whether they are (i) incorporated in Hong Kong or (ii) incorporated elsewhere and registered in HK as an oversea company. The fact that they have registered means they have established a place of business here. The *quid pro quo* is that the laws of HK should apply. There are a number of areas in the CO in which the law applies only to HK-incorporated companies, and not to those incorporated overseas, or is ambiguous about its application.

In the listed arena, over three quarters of companies listed on the Stock Exchange of Hong Kong Limited (“SEHK”) are incorporated overseas, the bulk of them in two British colonies, Bermuda and the Cayman Islands, as well as the PRC and UK. Each of them is registered in HK as an oversea company under Part XI of the CO. Although each jurisdiction of incorporation has its own company law, it is incumbent on Hong Kong to even out the playing field as far as possible, by uniform application of its laws.

3. Reducing threshold for shareholders’ proposals

There are two parts to this proposal, the 2.5% threshold and the 50-holder threshold.

3.1 The 2.5% threshold

I support the reduction to 2.5%. This still means that there will be no more than 40 shareholders who have the power individually to propose a resolution, and in most cases fewer than 40. In practice, minority shareholders who do not have representation on a board are the ones most likely to need this power, since those who control the composition of the board can make shareholder proposals through board resolution.

In the listed arena, when a company may be only 25% (or in the case of large companies, less) held by the public, the 2.5% threshold is still a high hurdle.

3.2 The 50-holder threshold

In the case of the 50-shareholder threshold, I support this in principle, but the detail is wrong, requiring that requisitioning shareholders hold an average par value of $2,000. The par value of shares normally has no bearing on the value of an investment in a company. It is entirely arbitrary. Some companies may have a negligible amount of share capital, but a very high amount of net assets. Others have a market value which is less than the par value of their share capital.

For example, imposing a requirement that the average shareholder owns HK$2,000 of par value would mean, in the case of Sun Hung Kai Properties Ltd, a market value per holder of HK$180,000 (4,000 shares worth HK$45 each) while in the case of Sino Land Co Ltd, it would be a market value of HK$4,250 (2,000 shares worth HK$2.125 each).

I presume the intention behind the drafting is to guard against resolutions being proposed by persons with only nominal shareholdings, but the result is unfair to shareholders of companies with low par value relative to market value or net assets per share. While market value fluctuates, it would be feasible to link the requirement to the latest audited net assets per share, or zero if higher. This would work for listed and unlisted companies. However, I believe there is a better way, see (3.4) below.

3.3 Dilution of the average

If you decide to retain the requirement for a minimum average par value, the law should be amended to clarify that this applies to the *50 largest* shareholdings held by requisitionists. Otherwise, a management might seek to defeat a requisition by “flooding” the requisitionists with tiny shareholdings, diluting the average below the specified amount. For example, if 50 holders with an average of $2,000 par value submit the proposal, but then management arranges for 10 shareholders with $1 each to joint the requisition, the average would be reduced to $1,667.

3.4 Deposit instead of minimum number

However, instead of the requirement to have a minimum number of requisitioning shareholders, the same goal of deterring frivolous proposals could be achieved by imposing a deposit requirement. The requisitioning shareholders would need to make a deposit to defray the costs of the proposal, and if the proposal receives at least a minimum percentage of shares voted in favour (say 5% of the issued shares), then the deposit shall be refunded on the basis that the proposal had sufficient merit to be circulated, even if it was defeated.

This is in the same spirit of electoral deposits by those wishing to stand for elected office in a government, to prevent no-hopers from joining the ballot.

3.5 Expenses provisions are fundamentally unfair

Legislators should be noted that when an incumbent board (who often are appointed by controlling shareholders) decides to make a proposal to shareholders, the costs of convening the meeting are met by the company. By contrast, when minority shareholders wish to make a proposal, the law currently requires shareholders to meet the "expenses" which are determined by management. This is fundamentally unfair, and it should be replaced by the deposit system. The deposit would eliminate any company expenses incurred on proposals which have no support. The amount of deposit should be set by law rather than by management, because the proposals are often opposed by management, and they will therefore seek to exaggerate the true costs of executing shareholder requisitions. These costs are not easily determined and can otherwise be subjective. For example, when the proposal involves including an extra paragraph as a resolution in the notice of Annual General Meeting in a 100-page annual report which would be printed and dispatched anyway, then what is the cost of the proposal? Arguably it is just the cost of extra ink and typesetting.

The amount of deposit could be set in relation to the number of registered shareholders of the company, since the cost of requisitions generally relates to the cost of printing and mailing a notice to each shareholder.

3.6 Summary of views on shareholder proposals

In summary of this section, you should:

- abolish the requirement that each of the 50 shareholders holds a specific average par value of shares;
- require that the requisitionists make a specific deposit to defray costs, at a fixed amount per registered shareholder (say HK$10);
- if the proposed resolution receives the support of more than 5% by value of shares voted in general meeting, then refund the deposit.

4. Removal of directors by ordinary resolution

I support this. The existing provision is asymmetrical – it takes only a 50% majority to appoint a director in general meeting, but a 75% majority to remove him/her. As a result, we have bizarre situations in takeovers where an offeror has gained 50% of the votes but can only win control by "flooding" the board with their own appointees, and then setting a limit on the number of directors, leaving the incumbents in a minority. I know of one listed company which had over 60 directors as a result.

I note with some alarm that LegCo Assistant Legal Adviser Kau Lin Wah wrote to you on 28-Jan-02 saying:

> "Allowing the removal of directors by ordinary resolution would advance the interests of shareholders. **However, this may at the same time affect the readiness of directors to make hard decisions which are unpalatable to investors**" (emphasis added).

That is exactly what is intended! Decisions which are "unpalatable" to a majority of shareholders are generally decisions which are not in their best interests. To suggest otherwise is to suggest that, for example, it should require a 75% majority of the voting electorate to replace an incumbent Legislator with an opposing candidate. Would that be fair?

The 50% majority rule for director removals would make election and removal symmetrical and bring Hong Kong into line with the UK Companies Act.

5. Recording the number of shareholders (Clause 38)

I fail to see the relevance of recording when the number of shareholders has fallen to 1 or increased to more than one. This is a waste of time and paper. A company is a company, whether or not it is ultimately controlled by a single person.

6. Quorum for a company with only one member (Clause 42)

I fail to see the point of this. If there is only one member, then a written resolution of that member has the same effect as a shareholders meeting (see CO s116B), and there is thus no need for him to hold a meeting with himself. Meetings, by definition of the word "meeting", require at least two participants.

7. Sole director acting as Secretary (Clause 56)

I fail to see why the sole director of a company should be prohibited from acting as Secretary of the company. There is no obvious conflict of interest that is solved by having the sole director appoint a separate Secretary. This imposes an unnecessary burden on the sole owner and director of a very small business where that person wishes to use a limited liability company to delineate his/her liabilities. That person must then find a third party to act as Secretary, inevitably incurring expenses.

Indeed, the whole concept of a statutory "Secretary" may be somewhat archaic – there are very few references to the obligations of a Secretary in the CO. Duties to file documents with the registrar and similar obligations tend to be imposed on the company rather than on any specific officer, with liability for non-compliance extending to "every officer who is in default".

In certain overseas jurisdictions, the appointment of a Secretary is optional. It is time to consider removing this obligation in Hong Kong.

8. Hong Kong's Competitiveness

I note from the minutes of your earlier deliberations that certain Legislators have expressed concern that *"the Government should avoid over-regulating the market as this would damage Hong Kong's competitiveness"*. I have heard this time and time again from defenders of the *status quo* lax regulatory environment.

Let me assure members that, on the contrary, the continued slow pace of reform of our regulatory system is damaging HK's economic competitiveness. There is an overall "sovereign discount" on the price investors are willing to pay for securities, reflecting the risk of bad corporate governance damaging their investments. This discount can be narrowed by a tighter framework of rules and laws which provides better protection for minority interests.

The flip-side of a corporate governance discount is a higher cost of capital for issuers in HK's market. This reduces the competitiveness of HK-listed companies relative to companies with access to lower-cost capital, and deters good businesses from going public, inhibiting their growth. Although some listed companies may profess high standards of corporate governance, they will still be affected by this sovereign discount for the risk that they may go bad later, as the lax rules and laws allow them to.

On *Webb-site.com* you will find numerous HK case studies which read like a "how to" guide to expropriate from minority shareholders. If there are 50 ways to leave your lover, there must be 100 ways to abuse minority shareholders.

Legislators should attach priority to the promised review of the regulatory system, including the removal of the regulation of listed companies from the HKEx to the SFC, adding statutory backing to the Listing Rules and tightening of their corporate governance provisions, and the introduction of a class action and contingent fee system to empower shareholders to seek their own remedies, providing an additional deterrent mechanism to bad governance.

Perhaps the greatest lesson that HK can learn from recent failures of corporate governance in the US is that their system reacts far more efficiently when weaknesses are exposed. Less than a year after the Enron story broke, the US Sarbanes-Oxley Act is now law, executives of failed companies are facing criminal sanctions, and those that do not go to jail will face class-action lawyers who are providing some possibility of compensation from the auditors and directors of such companies.

I would remind you that some of the modest proposals in today's Bill date back to the Pascutto Consultancy Report on the CO which was first commissioned in November 1994. We need to move a lot faster.

If Hong Kong wishes to sustain its leading position as a capital centre for China and Asia, then it must accelerate the upgrade of its regulatory framework.

Yours faithfully,

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