Shirley SL LAM
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To: Arthur CP AU/FSB/HKSARG@FSB
cc:
Subject: Companies (Amendment) Bill 2003

----- Forwarded by Shirley SL LAM/FSB/HKSARG on 05/05/2004 14:36 -----

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Subject: Companies (Amendment) Bill 2003

To Shirley Lam
for Secretary for Financial Services and the Treasury

Dear Ms Lam,

Thank you for your letter of 22-Apr-04.

As an investor I am very concerned with the Committee State Amendments (**CSAs**) to the proposed Statutory Right of Derivative Action (**SDA**) in the Companies (Amendment) Bill 2003, in several respects. I urge the Government and Bills Committee to consider these concerns.

1. New hurdles

A key objective of the SCCLR's proposal for an SDA was to remove the requirment for a "trial within a trial" which exists in s168A for the purposes of determining the standing of an applicant to commence a derivative action (see page 59 Chapter 3, para 15.25(a), SCCLR Phase I report, Jul-01).

The CSA to introduce a requirement to seek leave to bring proceedings and its several criteria is tantamount to reintroducing the "trial within a trial". If the member bringing the proceedings has to show that the proceedings are brought "in good faith" and "in the best interests" of the company, and that the question is "serious", then that may provoke a detailed analysis of the case before the proceedings can even begin.

The Bill originally contained an ability (s168BD) for a defendant to apply for the case to be **struck out** on the grounds that it was "not in the best interests" or that the the proceedings had not been brought in good faith. I believe that system is the most appropriate way to handle frivolous, vexatious or nuisance actions.

The onus should be on the defendant to show why the proceedings are not in the interests of the Company, not on the member to show that they are. Likewise, it should be up to the defendant to show that the member is acting in bad faith, not up to the member to prove that he is acting in good faith. The member should be entitled to the presumption that he is acting in good faith and in the interests of the company until proven otherwise, in line with the common presumption of innocence. As far as I know, it is not required in other forms of litigation in Hong Kong that a plaintiff jump through such hoops before they can begin an action.

As a secondary matter, what is the purpose of the word "best" in this drafting? Does the use of this superlative introduce a requirement to show that the proceedings are the best possible course of action having examined all possible courses of action? That, again, would be a time and resource-consuming barrier.

I do not see why it should be necessary for the member to show that "it is probable that the specified corporation will not itself bring the proceedings". Surely, the fact that the corporation is not bringing such proceedings should be sufficient. If the corporation wishes to stop the SDA, then it should be up to the corporation to show that it is going to bring proceedings within a stated and reasonable timeframe, rather than for the member to peer into the minds of the directors and prove that the company is unlikely to bring proceedings. The CSA places too great a burden on the member.

Similarly, I do not see why a member should have to show that there is a "serious question to be tried". What is meant by "serious"? Is a monetary quantum required? Surely it should be up to the defendant to show that the complaint is "not serious", and again, I believe the right to apply for the case to be struck out or dismissed is sufficient. Anyone spending time and money bringing proceedings should be entitled to a presumption that the matter is serious unless proven otherwise.

So in summary, the only criterion that seems to be appropriate if you are to introduce a requirement for leave to bring proceedings is to show that notice of such proceedings was given to the specified corporation (except where the court has dispensed with this). The CSA you have proposed basically rolls back a lot of the purpose of the SCCLR and reinstates the "trial within (or before) the trial".

2. Members-only kills the Bill?

One thing you appear to have completely overlooked is the investor ownership system of companies listed in Hong Kong. This oversight results in a Bill which is of no real use to investors, but it can be rectified, as I show below.

The investing public (excluding controlling shareholders, directors and employees), including both institutional and retail investors, hold almost all their shares through banks, brokers and custodians, and in some cases through "investor participant" accounts, and in each case these banks, brokers, custodians and investor participants hold the shares in accounts with the Central Clearing and Automated Settlement System (**CCASS**) operated by Hong Kong Securities Clearing Company Limited (**HKSCC**), a wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited (**HKEx**). (disclosure: I am an investor-elected non-executive director of HKEx). HKSCC in turn holds all of these shares through a single registered shareholder, HKSCC Nominees Limited (**HKSCCN**). You can think of HKSCCN as being the front-man for the entire investing public. So for most investors, they are not **"members"** of any listed company in the legal sense, because the registered holder of their shares is HKSCCN.

This gives rise to a practical problem. If an investor (institutional or retail) wishes to bring an action under the proposed SDA, then he has no standing to do so. He must persuade HKSCCN, as the member of the relevant corporation, to bring the action instead. It seems to me unlikely in the extreme that HKSCCN would co-operate in bringing such an action. It is a nominee of the clearing system and is not geared up to participate in corporate litigation. There is also a question over whether HKSCCN, if it did co-operate, would be exposing all of the shares it held to the consequences of the action, rather than just the shares beneficially owned by the investor who wished it to bring proceedings.

I strongly urge that the law should provide not just for a "member" to bring proceedings, but for "any member or person beneficially interested in the securities of

the specified corporation at the time of the alleged wrong-doing". If you do not make this amendment, then the rest of the Bill is relatively pointless, because most of the time, the beneficial owners of the securities will be unable to use it, not being registered shareholders of the company.

Although I was not a member of the SCCLR, I was a member of the SCCLR's Shareholder Sub-committee (in fact, I was the only shareholder on that subcommittee) and I did make this point at the time it was discussed several years ago, but it seems that this was lost in the drafting. The SCCLR's Jul-01 consultation paper on SDAs spoke of "shareholders" rather than "members", leaving it unclear whether they meant to include beneficial shareholders, but the Bill's drafting speaks only of members, and that is a potentially fatal flaw.

3. Scripless

The question of membership of a corporation relates to the long-running scripless saga.

In his budget speech of 3-Mar-99, over 5 years ago, Donald Tsang set a goal of modernising the financial infrastructure, including the introduction of "a secure, scripless securities market". He appointed a Steering Committee on Enhancement of Financial Infrastructure (**SCEFI**) which issued its report in Sep-99, recommending a 2-year timetable for converting to a scripless securities market, presumably by Sep-01. However, this did not happen. So another committee was established, (**SCEFI II**, or the Return of SCEFI) which did some more steering, and reported in Aug-02 that "the Implementation Working Group for Scripless Market Infrastructure has been formed and market consultation on the proposal has been completed. The implementation team is now working on legislative amendments". However, that hasn't happened either. In Sep-03, the SFC published a conclusions paper on its consultation, recommending a split-register model in which HKSCC and the Registrars would maintain the two non-overlapping parts of the register of members with electronic linkage between them. Any CCASS Participant would then be a "member" of the listed company.

Building on this, In Oct-03, HKEx published yet another consultation paper on a "Proposed Operational Model" which, incidentally, said that the "Scripless Implementation Working Group" had been formed by the SFC only after the conclusions paper had been published in Sep-03, which contradicts the statement in the SCEFI II report over a year earlier that the group had been formed and was working on legislative amendments. I don't know which of these two versions is the truth.

This is where things started to go wrong. In item 6 of its status report as of 15-Apr-04, HKEx states that it is basically abandoning the introduction of a scripless market and in particular the split-register proposal, and instead the only thing it plans to do for now is to dematerialise some of the immobilised scrip (so-called jumbo-lots representing large numbers of shares) that it holds in its vaults on behalf of its participants. It states that "future development would be driven by market demand". This pace of progress is analogous to the "future development" of democracy in Hong Kong and is a far cry from what Donald Tsang and SCEFI originally proposed. It leaves Hong Kong behind other markets, including the mainland, which has been scripless since the markets re-opened in the early 1990s. It preserves the livelihood of a few registrars, and substantially reduces the investment cost for HKEx, but it does not, in my view, serve the public interest in having a more modern financial services economy or the narrower interest of the investing public. 5 years after Donald Tsang's budget speech, we are really no further forward on the scripless plan.

Returning to the Bill of 2003, what this means is that there is no material chance, within the next 5-10 years, of having a system in which CCASS Participants are recognised in law as "members" of a company holding scripless shares. They will remain as customers

of a nominee, HKSCCN, which for most investors will be the only member with legal standing to bring SDAs. That is why it is **imperative** that you broaden the scope of the Bill to include beneficial shareowners, whether or not they are registered members of the company.

Regards

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