SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

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SFC
證監會

Ashley Alder 歐達禮
Chief Executive Officer 行政總裁

13 March 2012

Ms Sharon Chung
Clerk to the Bills Committee
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong

By Fax: 2840 0797
& By email: bc_03_10@legco.gov.hk

Dear Ms Chung,

Legislative Council Bills Committee on Companies Bill meeting on 23 March 2012 to receive views on the retention of the headcount test for members' schemes (clause 664)

This letter responds to yours of 14 February 2012 on this matter.

The Securities and Futures Commission (SFC) set out its views on the need for retention of the headcount test in what became clause 664 of the Companies Bill in its submission of 28 January 2010 in response to the Government's CO Rewrite Consultation Paper entitled Draft Companies Bill First Phase Consultation issued in December 2009. A copy of the SFC's submission is attached.

The SFC remains of the view that the headcount test serves as a potentially important check to counterbalance the value test. This can be significant for minority shareholders in the context of privatisations or takeovers since schemes, once sanctioned, will bind dissenting shareholders and permit the compulsory acquisition of their shares. Any perceived imbalance in the current test in section 166 of the Companies Ordinance (Cap. 32) appears to have been addressed by the inclusion in clause 664 of a new discretion for the court to dispense with the headcount test. This discretion will not only cover situations where there is evidence of vote manipulation by the majority to secure approval of a scheme, but will also apply to situations where there is evidence that the minority has resorted to such manipulation to defeat a proposed scheme.

However, we think that, in any future law reform exercise, there is merit in exploring whether or not minority protection might be achieved more effectively by aligning the test in the Companies Ordinance with that in Rule 2.10(b) of the Code on Takeovers and Mergers and Share Repurchases (which is non – statutory but already applies to privatisations of listed

companies) whereby a resolution to approve a scheme can be defeated if the number of votes cast against it is more than 10% of the votes attaching to all disinterested shares.

Yours sincerely,

Ashley Alder
Chief Executive Officer

Encl.

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Andrew Young 楊以正
Chief Counsel, Legal Services 法律服務部首席律師

28 January 2010

Our Ref:

Companies Bill Team
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong

By Fax (2869 4195) and By Post

Dear Sirs,

Re: Draft Companies Bills – First Phase Consultation

Please find enclosed the response of the Securities and Futures Commission to the questions raised in Chapter 6 (on the "Headcount" Test) of the CO Rewrite Consultation Paper entitled Draft Companies Bill First Phase Consultation.

Yours faithfully,

Andrew Young
Chief Counsel
Legal Services

Enclosure

SFC's Response to Chapter 6 of the Consultation Paper

Draft Companies Bill – First Phase Consultation

1. This is a response by the Securities and Futures Commission (SFC) to Chapter 6 of the Financial Services and Treasury Bureau's consultation paper entitled CO Rewrite – Draft Companies Bill First Phase Consultation issued in December 2009.

2. Question 1 in Chapter 6 of the Consultation Paper asks: *"In respect of members' schemes of listed companies, which of the following options do you prefer? Please explain the reasons.*

   Option 1: retain the headcount test;

   Option 2: retain the headcount test but give the court a discretion to dispense with the test; or

   Option 3: abolish the headcount test.

3. The SFC supports Option 1 to retain the headcount test. The SFC is strongly opposed to the abolition of the headcount test (Option 3) and is of the view that it should be retained for members' schemes (whether of listed or unlisted companies) and for creditors' schemes. As regards members' schemes and in circumstances where there is evidence to suggest manipulation of the headcount test by the minority, the SFC sees some merit in Option 2 which proposes to give discretion to the Court to dispense with the headcount test.

4. The SFC is strongly of the view that the headcount test should be retained because it serves as an essential check to counterbalance the value test. This check is particularly important for minority shareholders in the context of privatisations or takeovers since schemes, once sanctioned, will bind dissenting shareholders and permit the compulsory acquisition of their shares.

5. Whilst the value test ensures that only proposals that have the support of a substantial majority in value of the independent shareholders will become binding, the purpose of the headcount test is

"to provide a degree of protection for the interests of the smaller shareholders, by ensuring that a proposal which does not enjoy broad based support among shareholders individually cannot be forced through by a small minority of individual shareholders who between them control a large stake in the company. In an extreme case, absent the headcount requirement, a single shareholder holding 75% of the shares in the class voting on the proposal would be in a position to ride roughshod over the objections of all other shareholders in that class."[1]

6. In the SFC's view, it is fair and sensible that a scheme should be required to enjoy the support of a substantial majority by value and a simple majority by number of those voting on the scheme. The policy underlying the two pronged test is to strike a fair balance between the interests of both large and small shareholders. The SFC is strongly of the view that this policy has a sound foundation and that the headcount test should be retained.

7. Upon analysis, there is little substance to the arguments for abolishing the headcount test. The disadvantages or inconveniences identified in the consultation paper neither outweigh the benefits of keeping the test nor justify removing a protection for the minority which has been enshrined in Hong Kong legislation for a century.

8. It is said that the headcount test places significant veto power in the hands of small shareholders, out of proportion to their financial contribution to the company and that this may deter companies from proposing a scheme. Whilst it is possible under the dual test for those with a small economic interest to block the wishes of those with a large interest, potential inconvenience is not a reason to dispense with the headcount test. Still less can it be regarded as a disadvantage which outweighs the benefits of the test. Despite their small economic interest, there may be good reason for minority shareholders to oppose a scheme that is put forward by a few shareholders with a large stake. The merits of a scheme are not necessarily measured simply in economic

[1] Per Barma J in *Re PCCW Limited*, CACV 85/2009, Judgment dated 22 April 2009, paragraph 177

terms. The headcount test was specifically designed to protect the interests of the minority. Objections based on disproportionality merely highlight the need for the test.

9. The veto argument is not unique to Hong Kong yet other jurisdictions have retained the headcount test. Indeed this point was significant in the recent decision of the UK Government to reject the proposal to abolish the headcount test. Lord Goldsmith, Attorney General at the time the issue was debated in the House of Lords in 2006, stated that because schemes of arrangement could affect the interests of minority shareholders against their wishes, these procedures should be "*carefully regulated*". Removing the headcount test "*would mean that larger creditors and members could impose their will on smaller creditors and members. We do not think it is right to remove that important safeguard at the moment*". In response to the argument that abolition of the test would facilitate schemes for companies and large creditors and members, the UK Government's view was that this would be achieved at the expense of the interests of small minority members and creditors. The UK Government was not persuaded that the right balance would be struck if the test was abolished.[2]

10. It is significant that the headcount test is found in the companies' legislation of all the main common law jurisdictions against which Hong Kong benchmarks itself. This includes the following overseas jurisdictions in which companies listed in Hong Kong are registered: Bermuda, the Cayman Islands and the UK. Some 72% of the companies listed here are registered in those jurisdictions. Other notable jurisdictions that have the headcount test include Australia and Singapore. Abolition would put Hong Kong out of step with all these jurisdictions leaving minority shareholders in Hong Kong registered companies (constituting 15% of the total number of companies listed here) less protected than those of such other jurisdictions, which would be a retrograde step.

11. The headcount test has been criticised because it is said that beneficial owners who hold their shares through the Central Clearing and Settlement System (CCASS) are effectively disenfranchised from voting in the test

[2] See House of Lords Hansard, 28 March 2006, column 324-326 and 16 May 2006, column 217

because their names do not appear in the register of members. Accordingly, as the majority of investors hold their shares through CCASS, it is said that the headcount test is not indicative of the decisions of the majority of those who own shares. In response, it is observed that it has long been a fundamental principle of Hong Kong company law that a company does not take cognisance of trusts or beneficial interests behind its register. The SFC does not accept that persons holding through CCASS are disenfranchised and unable to participate in the headcount test. There are steps which they can take in order to vote, as described in paragraphs 6.14 (b) and (c) of the Consultation Paper, albeit that the practicalities involved may deter some owners from taking these steps. Nevertheless, where a shareholder wishes to have his vote count, both in terms of the shares he holds, and in terms of headcount, he is at liberty to take steps to have the shares registered in his own name.

12. In any event, the objections arising from the manner in which shares are held in CCASS are addressed by the operational model for a scripless securities market now proposed[3] for Hong Kong. Under the proposal, investors holding shares in CCASS will have several options to have their name registered on the register of members. Those that exercise one of those options will enjoy the full benefits of legal ownership and will be able to vote without the need to take the steps discussed in paragraph 6.14.

13. Under the proposed scripless model, investors holding shares through CCASS who wish to be registered on the register of members will be able to hold their shares in one of three accounts: a segregated account with their broker, bank or custodian ("Participant Sponsored Account"), an Investor Participant Account or an account with the relevant share registrar ("Issuer Sponsored Account"). The investor will also have a choice either to administer the account himself or to let his broker, bank or custodian do this for him. By reducing the need for paper and making share registrars a new category of CCASS Participant, it is envisaged that the proposed model will increase opportunities for straight-through-processing and enhance efficiency.

[3] See the Joint Consultation Paper on A Proposed Operational Model for implementing a scripless securities market in Hong Kong issued on 30 December 2009 by the SFC, Hong Kong Exchanges and Clearing Limited and the Federation of Share Registrars Limited.

Transfers of securities into accounts in CCASS will constitute registered transfers and confer legal title upon settlement.

14. As regards the timetable for implementing a scripless securities market, this will depend largely on when the operational model is finalised. The aim is to issue a consultation conclusions paper in the second quarter of 2010 and to finalise the model as soon as practicable thereafter. The necessary legislative amendments and rules will be finalised after the operational model has been settled. Given the changes that are expected in light of the scripless proposals, it is clearly inappropriate in analysing the headcount test to give significant weight to the objections based on the current operation of the CCASS system. It would be contradictory to facilitate the enfranchisement of minority shareholders through the scripless reforms while at the same time to curtail their ability to make their votes count at a crucial juncture by abolishing the headcount test.

15. It is also suggested that the headcount test should be abolished because it attracts or is prone to manipulation. The SFC considers this argument unfounded. Despite the long existence of the headcount test, no credible evidence has been produced to support the suggestion that attempts to manipulate the vote are common.[4] Indeed some market commentators have suggested that vote splitting is not a common occurrence.[5] The SFC's own analysis also supports this conclusion.[6] In the last twenty years, the SFC has only intervened in privatisations twice in relation to suspected manipulation.[7] Further, the SFC shares the view expressed by Lord Goldsmith[8] that the theoretical possibility of share manipulation is not a good enough reason to do

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[4] A statement was filed in *Re PCCW Limited* that it was not uncommon for arbitrageurs to split their shares into board lots or to acquire board lots and register them in the name of nominees in order to increase the number of their votes. However, the Court of Appeal regarded that statement as an assertion unsupported by reference to specific cases that had occurred prior to the scheme and therefore carried little weight. See paragraph 5 of the Court of Appeal's Reasons for Refusal of Further Evidence dated 16 April 2009.

[5] See David Webb's article entitled "PCCW-Grounds of Appeal" dated 13 April 2009 at www.webb-site.com.

[6] The SFC applied to the Court of Appeal in *Re PCCW Limited* for admission of this evidence. The application was refused because the statement it was intended to counter (referred to in note 4 above) carried insufficient weight in any event to warrant the inclusion of further evidence at that stage.

[7] In addition to the proposed privatization of PCCW, the SFC intervened in 1992 in the privatization of Chinese Estates Holdings Limited.

[8] House of Lords Hansard, 16 May 2006, column 217

away with the protection the headcount test provides.

16. The consultation paper refers to the possibility that the minority could manipulate the headcount test to block a scheme with the effect that the scheme would never get to Court. Though this concern is unsubstantiated, the SFC can see merit in Option 2 which, whilst retaining the headcount test, would give the Court discretion to dispense with the headcount test in circumstances where there is evidence that the result of the vote has been unfairly influenced by share manipulation by the minority.

17. It is argued that the headcount test is inconsistent with the one share one vote principle in other provisions dealing with shareholder meetings in the Companies Ordinance. We would observe that if there are any inconsistencies with such a principle, these existed at the time the Companies Ordinance was enacted. It does not justify abolition of the test. It is also noted that there are other statutory provisions in Hong Kong that incorporate the requirement for a majority in number.[9]

18. Finally, it is suggested that in the event the headcount test were abolished, Rule 2.10(b) of the Codes on Takeovers and Mergers and Share Repurchases already provides sufficient protection for minorities. The SFC considers such analysis unsafe. Firstly, the takeovers regime does not apply to all types of schemes and is premised on voting by disinterested shareholders only. Secondly, this overlooks the fundamental point that the Codes do not have the force of law and that the protections for minorities contained in Rule 2.10(b) were always intended to be in addition to, and not in substitution for, the statutory protection entrenched in section 166 of the Companies Ordinance.

Securities and Futures Commission

28 January 2010

[9] See s.114(3)(b), s.116(1) proviso, s.227D(2), s. 254(1) of the Companies Ordinance; Article 52 proviso (b) of Table A (Schedule 1 to Companies Ordinance); s. 2 (definition of special resolution) and s.100B(4) of the Bankruptcy Ordinance.