Decapitate the headcount

Submission to Legislative Council Bills Committee on clause 664 of Companies Bill 12th March 2012

Dear Members,

Thank you for you invitation to give views on clause 664 of the Companies Bill.

Background

Late on 14-Jan-2009, via Webb-site.com, Hong Kong's leading non-profit corporate and economic governance site, I received an anonymous tip-off alleging that there was a vote-rigging scheme in which hundreds of insurance sales agents would each receive one board lot of 1,000 PCCW Limited (**PCCW**, 0008) shares, and that in return, they would sign a proxy form which would allow the holdings to count in favour of a privatisation by Scheme of Arrangement (**SoA**). Despite the anonymity of the complaint, the details were so specific that I immediately informed the SFC, which initially took no action.

Such a vote-rigging scheme, particularly one so blatant, with equal numbers of shares being registered on the same day to persons licensed to the same insurer or giving the same address, is relatively easy to verify, because one will find abnormal entries in the register of members, commonly known as the "share register". On 29-Jan-2009, the first working day after Chinese New Year and the penultimate day before a book closure for the meeting, I went to the registrar and sampled the 26,000-member register, finding direct evidence of the scheme. I filed this with the SFC, which then swung into action and deployed extensive resources to investigate the vote-rigging. They opposed the SoA in the courts, losing in the Court of First Instance but winning in the Court of Appeal.

This episode brought renewed focus to the procedures in the Companies Ordinance for approving schemes of arrangement, which date back to the Victorian era and require approval not only 75% by value of shares or credits voted, but also a majority in number of members (shareholders) or creditors in the "class" affected by the scheme, the latter criterion being known as the "headcount". Hence, in the course of rewriting the Companies Ordinance, the Government has consulted the public in an exercise starting on 17-Dec-2009, on whether the headcount rule should be abolished or amended.

Our view

In the article Vote-rigging plan for PCCW meeting (1-Feb-2009), Webb-site urged the SFC to intervene in the court to stop the PCCW scheme of arrangement, because although we disagree with the headcount criterion, we believe that the law should be enforced until it is abolished. As we said then, the criterion is archaic and anarchic because:

1. it goes against the 1-share-1-vote principle
2. it gives disproportionate voting weight to small shareholders
3. it attracts attempts to corrupt the vote (for or against a scheme)
4. the Listing Rules (since 1-Jan-09) require all shareholder meetings to be by poll (1-share-1-vote) rather than a show of hands. The headcount is like allowing a show of hands to veto the outcome of a poll vote.

The principal of a majority headcount harks back to the 19th century when most shareholders held shares in their own names rather than in the names of nominees or custodians. Even then, the rule was misguided and capable of manipulation by vote-splitting, but this problem was become worse with the increase over the last century of institutional investment, where large blocks of shares are held by single institutions (on behalf of thousands or millions of pensions and mutual fund investors) through a handful of custodians, each custodian having only 1 vote on a headcount.

Similarly, the introduction in the 1990s of the Central Clearing and Automated Settlement System (**CCASS**) operated by Hong Kong Securities Clearing Co Ltd (**HKSCC**) brought great efficiencies to the clearing and settlement of securities transactions but resulted in most retail investors holding stock not in their own names but in the name of HKSCC Nominees Ltd (**HSCCN**, a 100% subsidiary of HKSCC), the *de facto* central depository, which in turn holds stocks for banks, brokers and custodians. The banks and brokers in turn hold stocks for retail investors. HKSCCN only has 1 vote in a headcount.

The results is that the vast majority of publicly-held shares are represented by HKSCCN, a single registered shareholder. Even with scripless registration (if and when it finally arrives), this problem will not change much, because most investors will still hold their stock through banks, brokers and custodians, each of them having a

single account on the electronic register of members. Under the headcount rule, it is then possible for a large number of small registered shareholders to defeat the wishes of the vast majority of affected shareholders. For example, as a result of Project Poll (see below), Webb-site has 5 registered shareholders, each holding 2 shares, in each of the blue-chip companies of 2003. We would have 5 votes in an SoA headcount, against 1 held by HKSCCN. How is that fair?

Protection of minorities

The clear intent of the original headcount rule, although poorly implemented, was to provide protection for minorities against abuse, a principle which Webb-site has spent 14 years fighting for. We would not advocate scrapping the headcount rule if we thought that it would cause harm to minority interests.

For many years, SoAs under section 166 were seen by companies as a relatively "easy" way to execute a takeover or privatisation, by proposing to cancel all the publicly-held shares in exchange for a payment, which would require a 75% approval of shares voted. The alternative was a general offer (**GO**). Using section 168, the offeror can compulsorily acquire the outstanding shares but only if the offer has received acceptances for 90% of the shares under offer. Similar (but not identical) provisions apply in the Cayman Islands and Bermuda, where about 74% of HK-listed companies are domiciled. Put simply, 75% of votes cast (and not all shareholders vote) was often seen as an easier hurdle to compulsory purchase than to acquire 90% of all outstanding shares.

However, in the 1990s, the Takeover Panel closed this loophole, and Rule 2.10 of the Takeover Code was further refined in 2001 (after I joined the Panel) to its present form, in which a takeover or privatisation by SoA will fail if 10% of the disinterested shares vote against the scheme. We can call this the "**10% objection**" rule. For example, if an offeror already owns 60% of a company and tries to privatise it by SoA, then, then it fails if 4% of the shares (being 10% of the class) vote against the scheme.

I believe that the 10% objection rule is the proper protection, but it should be noted that the Takeovers Code has no statutory backing. So in addition to abolishing the headcount rule, I submit that **the 10% objection rule should be included in the Companies Ordinance**. It should also remain in the Takeovers Code which applies to companies incorporated outside HK, and as a separate matter, the Takeovers Code should have statutory backing, so that persons can be fined or jailed for breaking it, or at least be required by a civil tribunal to comply with the Codes or pay compensation. Currently the stiffest penalty is a "cold shoulder" order, ordering brokers and other intermediaries not to provide market access to the offender.

Private companies and creditors' schemes

The headcount rule should be abolished for all SoAs, not just SoAs involving members of listed companies. The vote-splitting risks are similar for private companies, except that by section 29 they are limited to 50 members. This cap has the additional risk of a "race" to bring the number of shareholders up to 50 by vote-splitting before or after proposing an SoA. A further category is unlisted public companies, which could have more than 50 members but not fall within the protection of the Takeovers Code. They would benefit from having the 10% objection rule included in the Ordinance. The same issues apply to a creditors' SoA - someone who is determined to block a scheme, against the wishes of a large majority by value, can slice up the debt and assign it to multiple nominees who could vote against, thereby blocking the scheme. A 10% objection rule would be more appropriate to protect the interests of objecting creditors without frustrating a scheme which has over 90% support by value.

Parallels in real estate

The principle of protecting minorities against compulsory purchase of their shares, whether in an SoA or GO, is similar to the principle of protecting minority holders of an apartment building from compulsory purchase of their property. Section 3 of the Land (Compulsory Sale for Redevelopment) Ordinance (**LCSRO**) allows for a compulsory sale by auction of land upon application by person(s) who own not less than 90% of the undivided shares in a lot. It does not contain a headcount requirement, for a majority of owners (regardless of the number of shares they each own in the land) to be in favour of redevelopment. It has been deemed in the public interest that if 90% of the shares actively agree, then the public interest in redevelopment outweighs any wishes of those who own 10% or less of the shares in the land lot. This is as it should be, but if the Government did not see fit to include a headcount rule in the LCSRO, then why does it insist on retaining one in the Companies Ordinance?

It should be said that there is nothing magical about 10%, but I believe it strikes about the right balance. We got there only because we have 10 digits on our hands - if mankind had evolved with 8 digits, then we would likely be counting in octal and thinking in terms of 1/16 or 1/8 as a threshold.

I am not in agreement with the subsequent relaxation of this requirement to 80% in the case of buildings with

9 or fewer units or occupied more than 50 years (30 years for industrial buildings). I think that a 20% objection threshold is too high, and that if you cannot persuade the holders of 90% of the merits of a proposal then you should not be able to literally bulldoze the assets of the remainder. But that is a subject for another day.

Project Decapitate

Webb-site's 2003 Project Poll successfully forced blue-chip companies to stop holding their meetings on a show of hands (1-person-1-vote) and start counting on a 1-share-1-vote basis (known as "poll voting"), including proxies which were previously ignored. This brought increased fairness and transparency of shareowners' views on proposals. Once we had neutralised the opposition from tycoons using Project Poll, the Listing Committee found itself able to make poll-voting mandatory for all shareholder meetings, starting 1-Jan-2009.

If the Government, and you as legislators, do not see fit to abolish the headcount rule in the Companies Ordinance, then the next time a HK-incorporated company proposes a privatisation (or even a redomicile) by SoA, Webb-site will consider financing and launching "Project Decapitate", to demonstrate how anarchic the headcount rule is. We will buy a board lot (typically 1,000 or 2,000 shares) and offer each reader of Webb-site (and we have over 20,000 on the mailing list) a single share in the company for free, and invite them to vote one way or the other in the SoA. We will not tell them which way to vote, so this will not be "vote-rigging" in that sense. It will throw such uncertainty into the SoA that its proponents will almost feel obligated to go out and orchestrate vote-rigging in favour, otherwise the headcount will turn into a lottery. Meanwhile, the market price during the offer will reflect this uncertainty.

To completely avoid the risk that our readers' votes might be excluded from the headcount by the court, we will also consider pre-emptively distributing to each participating reader 1 share in each of say, 20 HK-listed HK-incorporated companies, large and small, which are not currently under offer. Sooner or later one of them will be. In the meantime the new registered shareholders will get the benefit of direct communications and the right to attend AGMs for the food. Think of it as a perpetual cake voucher. The participants would not attempt to sell these shares, because the transaction costs will be far higher than they are worth. They can just frame the certificate and take pride in being a well-fed shareholder activist.

Concluding remarks

The Government, despite receiving a clear majority of submissions (mostly from listed companies) in favour of abolishing the headcount, wishes to keep it. I do not believe we should place the onus on courts to decide when a headcount has or has not been rigged, or if it hasn't been rigged, whether the views of a large number of small shareholders should outweigh the views of the vast majority by value.

For once, I find myself in agreement with the tycoons. The Government seems to hold the view that because other jurisdictions which inherited this rule from English law have not seen fit to abolish it, nor should HK. That is not a logical reason for maintaining a rule which is absent in many other jurisdictions. HK has the 10% objection rule which some other places do not. Too often, the Government is afraid to make reforms based on logical reasoning and instead makes changes only years after others have done the same. HK, which claims to have a competitive advantage in innovation, should not be afraid of leading by legislative example.

So please abolish the headcount rule, and legislate the 10% objection rule. I will be pleased to attend your meeting on 23-Mar-2012 to answer any questions that you may have.

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