ALLEN & OVERY

BY FACSIMILE (2840 0797) and BY POST

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Dear Sir

Written submission on the retention of the headcount test for members' schemes (Clause 664 Part 13 Division 2 Companies Bill)

At the request of the Legislative Council Bills Committee on Companies Bill (the ***Bills Committee***), we are writing to record the presentation made orally by our Ms Bernardine Lam to the Bills Committee at the meeting held on 23 March 2012 to receive views from interested parties on the above Clause.

INTRODUCTION

- Thank you for giving Allen & Overy the opportunity to present our views to the Bills Committee.
- We **strongly** support abolishing the headcount test in its entirety. We do **not** support the introduction of any court discretion to disregard the headcount test in circumstances where there is evidence that the result of the vote has been unfairly influenced by activities such as share splitting. We do **not** support introducing statutory backing to the 10% objection rule under Rule 2.10(b) of the Takeovers Code.
- In the limited time (i.e. 5 minutes), we would not repeat all the arguments already put forward by various listed companies, industry bodies and representatives in support of such abolition, most of which we fully agree. We would only draw your attention to the following critical considerations:

HISTORY OF THE HEADCOUNT TEST

- The dual share value test and headcount test have been in place in respect of schemes of arrangement in the United Kingdom since the Joint Stock Companies Act of 1870 and in Hong Kong since at least the 1911 version of the Companies Ordinance. The headcount test was originated from the days when the procedure applied only to **insolvent** company schemes with creditors presumably to place a check on the ability of creditors with large claims to carry the day. These provisions were extended not only to **non-insolvent** schemes with members in Hong Kong at the time but also now to companies where nominees or custodian holding of shares, CCASS involvement and, perhaps to a lesser extent, share splitting practices, are prevalent.

- Such headcount test is **archaic**, inherited from a **completely different context** then, and with the **evolution** of the regime for nominee/custodian holding, registration process and pricing structure for transfer, withdrawal and exercise of voting rights associated with shares in Hong Kong listed issuers to what it is now, **it has morphed into a perfect ground for voting manipulation and abuse**

COURT DISCRETION

- Clause 664 (2)(d)(ii) of the Companies Bill, which has the effect of conferring on the court a discretion to dispense with the headcount test for members schemes so as to tackle the problem of share splitting by parties opposing a scheme, has been seen by some as an improvement from the current position. We disagree for the following reasons:

    - It is **unclear** when the courts will exercise its discretion and there is therefore an element of uncertainty.

    - Under the current regulatory regime (s.166 Companies Ordinance), the court is duly empowered to give, and any members scheme to which such section applies is required to receive, the court's sanction for it to become effective.

    - As we have seen in past cases, such as PCCW's in 2008/2009, the courts (both in first instance and the Court of Appeal) had to consider the question of whether it should exercise its discretion by refusing to sanction the scheme which has been approved by the statutory majority. There, the court was performing its statutory function of examining the scheme to see whether **it can be said to be in the interest of the shareholders class as a whole**. All three judges in the Court of Appeal decided to exercise the court's discretion by refusing to sanction the scheme – with the focus **not** on whether the votes should be counted or why did those shareholders cast their votes that way, but whether the scheme should be sanctioned.

    - In particular, Hon Rogers VP referred to and applied the following from Buckley on the Companies Acts 14th edition: "In exercising its power of sanction the court will see, first that the provisions of the statute have been complied with, second that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent, and thirdly, that **the arrangement is such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve**."

- This serves to illustrate two important points:

  - the existing Hong Kong legislation already recognises the court's assessment of the merits of the members' scheme as its statutory function, and

  - retention of the headcount test will more likely than not result in significant regulatory, judiciary, issuers and shareholders resources being incurred (and wasted) on investigating into the question of whether there has been share splitting or other form of share manipulation deployed when the scheme is put to a vote by the scheme shareholders. The Hong Kong Court of Appeal has only recently reiterated that this is the wrong focus even under the then law. This rather begs the question why we need the headcount test at all.

- To propose a retention of the headcount test, and **then** confer on the court a discretion to dispense with such requirement could result in the court either (i) allowing a members' scheme which has either been voted down by majority, or (ii) disallowing a members' scheme which has been voted through by majority, where there is a "basis" (the Bill is silent as to what this basis might be) for the court to exercise its discretion to override the majority's decision. As we have illustrated above, under the existing regime in Section 166, the court is in a position to make a determination that the scheme is approved or sanctioned as it is in the interests of the shareholders class as a whole to do so (the only issue which matters) **without** retaining the headcount test, **without** introducing any additional court discretion, and **without wasting** various constituencies' time, costs, expenses and effort and efficiency delving into the **non-core question** of whether there has been a case of voting manipulation by whether the majority or minority shareholders.

THE PROPOSED SCRIPLESS MARKET

- It has been argued that the problem that beneficial owners are disenfranchised due to CCASS will soon be resolved when the proposed scripless market is implemented in Hong Kong.

- However, whilst the new model gives investors the opportunity to hold securities in their own name, they will still be allowed to do so through a nominee account (e.g. with their broker, bank or custodian).

- It is unclear how many investors will continue with this practice, and therefore this does not completely address the issue.

MARKET COMPETITIVENESS

- It has been argued that many similar jurisdictions have **not** yet abolished the headcount test.

- In itself, this is not a very convincing argument. Hong Kong needs to take this opportunity to be a leader and not a follower.

10% OBJECTION RULE

We support the Bills Committee's previous conclusion that codifying the 10% objection rule requirement is **not** appropriate for many reasons, including:

- there may be difficulties in defining "disinterested shares" in the absence of administration by SFC.

- for this requirement to extend to **non-listed** companies/private companies having a small number of shareholders, the application of Rule 2.10(b) of the Takeovers Code may give too strong a veto power to a few shareholders.

- if the main objective of enshrining this requirement in the Companies Ordinance is for the additional deterrent effect which this may be perceived to create for its breach, not only is it difficult to visualise how this particular requirement can be breached (whether it is a Code or Companies Ordinance requirement), but there are also no statistics to prove that past instances of non-compliance with the Takeovers Code were attributed to the leniency of the sanctions imposed by the Code.

Yours faithfully

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