Bills Committee on Companies Bill
Response to Bills Committee
Request for further submissions on the Headcount Test

At the Bills Committee meeting with deputations on 23 March, the Chairman asked HKGCC, represented at the hearing by Mr. William Brown, to provide further submissions on two matters. The first was to explain in more detail HKGCC's position on the approach proposed in SFC's submission of 13 March 2012. The second was to provide more information on the position in other jurisdictions. We deal in this letter with the first of these two matters.

In its submission of 13 March, SFC:

(a) supports the amendment to the Headcount Test currently contained in the Bill, i.e. giving the court a discretion to dispense with the Test (e.g. whether there is evidence of vote manipulation); and

(b) advocates exploring in any future law reform exercise whether aligning the Test in the Companies Ordinance with Rule 2.10 (b) of the Takeover Code would give more effective minority protection.

We deal with each of these points in turn.

Retaining the Headcount Test, but giving the court the power to dispense with it

HKGCC (and several other deputations) have pointed out the problems with this proposal.

First, it does not deal with the serious flaws in the Headcount Test itself. To reiterate briefly what these flaws are, the Headcount Test (i) is fundamentally unfair between minority shareholders themselves since it is contrary to the "one share one vote principle"); (ii) effectively penalizes the vast majority of minority shareholders in Hong Kong who choose for convenience to hold their shares through a nominee company (since the latter only counts as one "head" in the Headcount Test); and (iii) harms the financial interests of minority shareholders, since even if the vast majority of minority shareholders wish to take advantage of the proposed scheme to realize their investment, they can be prevented from doing so by a handful of minority shareholders who, for whatever reason, wish to block the proposed scheme.

Secondly, it only purports at most to address one other problem with the Headcount Test, namely that the Test encourages vote manipulation. However, even here it is unnecessary, since the court already has the power to refuse to approve a scheme where there is vote manipulation, and indeed exercised this power in the PCCW case. Moreover, adding another court process which is unnecessary will potentially create further uncertainty, and deter beneficial schemes from being proposed. Investigating whether vote manipulation has taken place is a lengthy and costly process, as again demonstrated in the PCCW case.

It is much more effective and efficient to tackle the root cause of the problem by removing the Headcount Test itself.

Should the Headcount Test be replaced by the 10% Rule?

SFC accepts that the"10% rule" contained in the Takeover Code "might" be a more effective means of protecting minority shareholders than the Headcount Test, and raises the possibility that it could be incorporated into the Companies Ordinance as part of "any future law reform exercise". We would make the following points here:

1. We would go further than SFC and state that the 10% rule certainly is a more effective means of protecting minority shareholders. It addresses the fundamental unfairness of the Headcount Test by giving proper recognition to the "one share one vote" principle, while at the same time giving due weight to the wishes of the minority by adding an additional safeguard over and above the 75% of votes required for other major shareholder decisions – a safeguard which does not exist in other jurisdictions such as the UK and Singapore. Moreover, the 10% rule is buttressed by a range of other safeguards for minority shareholders, such as the requirement for a committee of independent non-executive directors to advise the minority shareholders, the requirement of that committee to obtain the advice of an independent financial adviser, and the court's ultimate power to refuse to approve a scheme if not satisfied that it is fair to minority shareholders.

2. There is no need to incorporate the 10% rule into the Companies Ordinance, and this suggestion is problematic for the following reasons:

    - The 10% rule is decided as the appropriate mechanism, after careful consideration, purely in the context of listed companies. Such a rule is inappropriate for private companies, which typically have a small fraction of the number of shareholders which a listed company has. In the context of a private company, the 10% rule may give too much of a veto power to a few shareholders. In any event, schemes of arrangement for private companies are rare.
    - In the context of listed companies, statutory backing for the 10% rule is unnecessary. There is no evidence that listed companies have proceeded with schemes of arrangement in spite of more than 10% of the disinterested votes being cast against the proposed scheme, and it is difficult to envisage how this could happen, given that the scheme needs to be approved by the court.
    - Moreover, the Takeover Code, as administered by SFC, is a much more flexible and appropriate instrument for dealing with any necessary protections for minority interests, over and above the statutory requirement for approval of schemes. SFC, as the responsible authority, is close to the market, and any changes in processes required to accommodate the changing circumstances can be more readily

identified and implemented through the Code than by legislation- as indeed happened with the introduction of the 10% rule itself.

Conclusion

Given the compelling case for removal of the Headcount Test, and the overwhelming views that it is detrimental to minority shareholders and that other safeguards are effective in protecting them, the Headcount Test should be removed in this Companies Ordinance reform, not left to a future law reform exercise, which (if it happens at all) may be many years away. Given that other jurisdictions either have no Headcount Test or are in the course of removing it, Hong Kong may well have fallen behind other jurisdictions by then, contrary to the Government's policy intention of promoting Hong Kong as a major international financial centre.

Bills Committee on the Companies Bill
Further Submission on the Headcount Test:
The position in other jurisdictions

At the Bills Committee meeting with deputations on 23 March, the Committee Chairman invited HKGCC to provide further information on the position in other jurisdictions as to whether or not they have a headcount test.

The position can broadly be summarized as follows: while the UK and certain other jurisdictions have retained the headcount test, at least on a temporary basis, a growing number of jurisdictions have abolished it or are in the process of doing so. We provide further details in respect of various jurisdictions below.

U.S.A.:	no headcount test
Canada:	no headcount test
New Zealand:	no headcount test: abolished in 1993
Sri Lanka:	no headcount test: abolished in 2007
India:	Companies Bill 2011 currently before parliament: proposes removal of headcount test
Ireland:	new Companies Bill proposes removal of headcount test
Pakistan:	Companies Ordinance currently under review
Gibraltar:	Government has recently announced plan to review Companies Act
Australia:	Corporations and Markets Advisory Committee (CAMAC) has advised Government to remove headcount test. Government has still to decide.
Singapore:	Steering Committee has recommended following current Australian legislation: the court has the discretion to dispense with the headcount test in appropriate circumstances. Government has not yet decided. So both the Australian (and Singaporean) position may change.
UK:	Company Law Review Steering Group in 2001 proposed abolition of headcount test. Government decided to retain it "for the time being".
British Virgin Islands, Cayman Islands, Bermuda	Headcount test as in UK: likely to follow any change in UK position.

Conclusions

From the brief overview of other jurisdictions above, it is reasonable to draw the following conclusions:

1. Of the **7** governments which have specifically reviewed whether the headcount test continues to be appropriate (New Zealand, India, Sri Lanka, Ireland, the UK, Australia and Singapore), **only 1** (the UK) has decided to retain it. Even there, Government indicated that this may be on a temporary basis. **4 governments have decided to remove it completely**, or have presented proposed legislation before the legislature to do so. The other 2 have not yet decided. Singapore is alone in proposing (like Hong Kong) to follow current Australian legislation, i.e. giving the court the discretion to dispense with the headcount test in appropriate circumstances. But Australian legislation may change, as noted above, and Singapore has not yet made a final decision.

2. If Hong Kong does not abolish the headcount test in this Companies Ordinance review, there is a real risk that it might soon be **alone** amongst all of the jurisdictions above in retaining the headcount test. At the very least it will be seen to be a "follower" rather than a "leader", in direct contrast to our Government's policy of maintaining and enhancing Hong Kong's position as a leading international financial centre.