
**HONG KONG'S INDEPENDENT THINK TANK**

# MISSION IMPOSSIBLE: CASTING A PROXY VOTE IN HONG KONG

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## Executive Summary

- Major barriers exist that virtually prohibit many Hong Kong equity investors from exercising their right to attend and vote at shareholder meetings.

- The root of the problem lies in the failure of listed company registers to recognize beneficial owners as members of the company or, in other words, as shareholders.

- Any person or institution that allows their stock broker or custodian to hold their shares for them is a beneficial owner.

- Listed companies, the stock exchange, nominees and stock brokers are either not permitted to or economically discouraged from forwarding circulars, proxy statements and other corporate communication to beneficial owners.

- Similar obstacles exist that in practice dissuade beneficial owners from placing voting instructions, or in the extreme completely prevent them from doing so.

- Even if a beneficial owner manages to submit a proxy voting form, further barriers exist that may well bar him or her from attending the meeting.

- At the meeting itself, except for privatizations and connected transactions on the GEM, there is little likelihood that proxy votes will actually be counted, unless enough shareholders overcome further barriers to demand it.

- Nominee practices produce many of the barriers, due in part to their inability to represent each shareholder's interests. In a show of hands, for example, nominees will vote contrary to the instructions given by those with the minority opinion.

- Stock brokers are often beneficial owners first point of contact. Brokers are reluctant to pursue a client's voting interests as this results in costs but no revenue.

- When practiced effectively, proxy voting can be an additional line of defense protecting beneficial owners from controlling shareholder abuse.

- Reform of the proxy voting system in Hong Kong is needed urgently, if the equity market is to attain the global level of importance that regulators and the executive branch desire.

- The SFC's scripless trading initiative and relevant SCCLR proposals would significantly improve the situation, and should be enacted as soon as possible.

- Further reform is needed, such as mandating broker participation in the proxy voting process at the listed company's expense, as well as facilitating demands for polls, if not requiring polls on all resolutions.

# Mission Impossible: Casting a Proxy Vote in Hong Kong

Shareholder voting occurs at designated times, usually during the annual general meeting (AGM), but also at extraordinary meetings called for specific events like privatizations. The modifier *proxy* is often applied to a shareholder vote, to designate the right that investors in a company's shares have to appoint representatives to attend the meeting and vote on their behalf. This trait has led to terms such as *proxy vote* itself, *proxy fight* (when a group of investors vies for control of the company), and *proxy form*, the sheet used by investors to record their voting preferences.

Proxy voting is a well-established tradition globally but, unfortunately in Hong Kong, there exist a series of major impediments to its effective operation. The impediments are large and well entrenched, so much so in fact that often only the interests of controlling shareholders are ever served when resolutions are put to a vote. This does not have to be the case, as this paper will argue. But first, it is important to understand why proxy voting matters at all.

## 1.0 Why Proxy Voting is Important

Innate to the concept of shareholding is the right to vote according to an investor's equity in a company, or put more simply the right of "one share, one vote". This fundamental, although generally under-utilized, aspect to shareholding should be viewed as intrinsic to the entire process of equity investment, a right that supplements expectations of dividends and capital gains. Note that voting is a right, but that the receipt of dividends and capital gains is not.

Risking being overly simplistic, it is worthwhile nonetheless to review the key traits of shareholding. First in importance is that equity investors are always the last to be paid, after all suppliers, employees, landlords, debt providers, governments and whomever else that may produce a reasonable invoice. One look at a profit-and-loss statement illustrates this fact clearly enough, with dividends to common shareholders being the last line item before transfers to company reserves. This fact also means that equity investors are the first to lose out on their payments, if the business's sales should shrink for any reason or its costs escalate, albeit the upside in shareholder returns can be uncapped if sales greatly exceed expectations.

Why are shareholders the last to be paid and the first to lose out on their payments? In law, equity investors are recognized as "members" of the company in which they purchase shares, although not as owners of the business as is often assumed in practice. This distinction as members entitles shareholders to a pro rata distribution of the surplus on a solvent liquidation of the company's assets. A solvent liquidation implies that all creditors have been paid in full, and only the surplus over and above these payments, if any exists, is available to shareholders.

This is, of course, a financial right, and one that only exists on the winding up of the company. Notice that there is no requirement in law to pay shareholders ahead of liquidation, which in practice means that dividends are not a legal right. Furthermore, the financial right as it stands does not extend to the management of the company's assets and liabilities. The directors and managers of the company legally bear these responsibilities.

Shareholders are, fortunately, entitled to vote on who should be the company's directors, albeit this decision can be largely, if not completely, influenced by the principal shareholders. Nevertheless, one of the key mechanisms in place that allows equity investors to communicate their views on the management of the company is the vote on re-election or replacement of directors.

Looking beyond liquidation, one of the important implications of equity investment is that the decisions that company managements make to a large extent influences the return that all shareholders will earn. This truth applies more so to equity returns than to the payments that company creditors expect to receive, since the latter are always ahead of shareholders in the queue to receive the company's cash.

Suppliers, landlords and staff not only are paid before shareholders, but they also are paid according to agreements with broadly fixed terms. If any of these payments are not made according to contract, then employees can choose to leave or sue the company, landlords can repossess the property, and suppliers can freeze future deliveries. In the extreme, these creditors can petition to have the company's assets liquidated, using the proceeds to make up for any outstanding payments that are due.

Equity investors, however, do not enjoy such privileges. As members of the company they invest in, they bear the same risk of loss that the business's founders do. Furthermore, for shareholders, including minorities, there are no fixed payment terms. If minority investors are displeased with the return on their investment, then generally the sole recourse is to sell their stock. Of course, if returns are unsatisfactory, then minorities are likely to find that the value of the stock has depreciated materially in the market, illustrating the elusive quality of unrealized capital gains.

But, does it really have to be this way? Or, addressing the issue more specifically, who should the managers of the company be working for? The strict, legal answer is the company, and the company has responsibilities to a host of other stakeholders besides shareholders. However, managers ultimately report to the board of directors, and the members of the board are elected by shareholders. So, in practice, equity investors have the capacity to exert a material influence on the management of the company through their selection of directors. All they need to do is to exert that influence in the proxy vote.

Looking at the question from another angle, managers are hired to work for the well-being of the company. One implication is that managers are striving to earn profits. If this were not the case, then accumulating losses would mean that a growing number of creditors could not be paid and ultimately the company would be bankrupt. Over time, only a profitable company is a viable business model.

This brings the discussion full circle, since profits produce reserves, while the surplus that, in law, is what shareholders are entitled to in the event of a solvent liquidation are drawn from these reserves. So, by extension, the long term interests of the company and shareholders coincide. The implication is that, by working in the interests of shareholders, managers are best serving the company that hired them.

A final way to look at the question is with respect to the competition for capital. Both equity and debt markets value profitable companies more highly than loss-making ones. In fact, they value very profitable companies more highly than averagely profitable ones. The higher the returns, the easier it is to raise capital in the markets at a lower cost. Taken to the extreme, when economic conditions are difficult and new capital is needed the most, debt and equity markets are the most risk averse, making capital either unavailable or very expensive for less profitable or loss-making companies. Since recessions are inevitable within economic cycles, managers who are not working in the best interest of shareholders could be threatening the long term survival of the company.

The opinion of this paper is that managers should be working in the best interests of shareholders, which implies that they are also working in the best interests of the company. It so happens that this path also ensures that the economic interests of all other stakeholders are met.

But, what happens in practice? Do company managers really act in the best interests of shareholders? Or, at least in the best interests of *all* shareholders? The answers to these questions vary from company to company. The record of some managements over the years is beyond reproach, and these companies have justifiably earned the trust of minority investors. At the other extreme, however, there are companies whose managements have made decisions that benefit few people beyond a core inner circle.

It is important at this juncture to accept that what may be in the best interests of controlling shareholders, may at the same time actually harm the interests of minority shareholders. While it would be nice to believe that such instances are rare, history suggests otherwise.

Equity investment is, at the end of the day, about making money. Controlling shareholders and managers have the power to act in ways which maximize the money that they themselves make, regardless of what happens to the returns of minority investors, and can do so while remaining compliant with existing securities laws. Furthermore, since shareholders have no contractual rights to specific payments, they are more exposed to abusive management behavior than any company creditors. There are numerous examples of such behavior, with some of the most common including:

1) The purchase of assets from majority shareholders at high prices;
2) The disposal of assets to majority shareholders at low prices;
3) Service agreements with majority shareholders at inflated terms;
4) Overly generous issuance of management stock options or;
5) The issue of new shares to related parties when stock prices are low.

While this list by no means exhausts the potential for majority shareholders to extract value from minorities, it does begin to illustrate the process. In the first and third examples, cash is taken directly out of the company, leaving less available for shareholders in the form of dividends. In the second, a cash producing asset is sold at less than its fair market value, diminishing the future return that shareholders will receive. In the latter two, management or majority shareholders are able to increase their relative share of the vote and dividends at low prices, leaving less of each available to minorities.

Bearing in mind the already high financial risk inherent to equity investment, it seems unfair, to say the least, that the interests of minority shareholders could be put at even greater risk as a result of actions taken by controlling shareholders. Fortunately, there is recourse that can, when pursued actively, reduce these instances of controlling shareholder abuse. This is where proxy voting comes into play.

All reliable jurisdictions around the world, including Hong Kong, have statutes requiring that certain key management decisions are voted upon by all shareholders, usually at the annual general meeting, although extraordinary meetings can also be called. These decisions include:

1) Asset acquisitions or disposals which are valued at a large amount, relative to the company's net asset value;
2) Connected transactions with the controlling shareholder or a related party;
3) Approval of share option schemes;
4) Amendments to the memorandum and articles of association;
5) A privatization proposal;
6) Policies regarding the issue or repurchase of shares;
7) The re-election of company directors and auditors; and
8) The declaration of dividends.

The ability of minorities to influence the outcome of a vote depends on a number of circumstances. On relatively mundane matters, such as the re-election of directors or the declaration of dividends, all shareholders have the right to vote. If the controlling shareholder and related parties own more than 50% of the issued shares, then the board's proposals will almost certainly be passed.

Even in these instances, there is value in minorities expressing their dissatisfaction, when appropriate, through a vote against a proposal. If done in significant numbers, it is a loud and clear message to the majority shareholders and management, whose own interests are usually directly related to the market value of the company.

If nevertheless the inner circle chooses to consistently ignore such messages, it stands to reason that minority investors will in growing numbers sell their shares, thus driving down the value of the major shareholder's interest in the company, as well as the company's ability to raise new equity capital. Of course, management could be conspiring to eventually privatize the company on the cheap, but in this regard minority proxy votes can have sufficient weight to block a privatization bid.

In more significant transactions, the proxy vote elevates in importance dramatically. If the controlling interests, for example, seek to privatize the company or enter into many types of connected transaction with it, the ensuing resolution either requires a higher approval threshold or is put exclusively to minority shareholders. The rules in Hong Kong vary on the percentages needed to overturn a proposal, depending on its nature. The scenarios can be summarized as follows:

| **Resolution Type** | **Approval Threshold** | **Voting Method** |
|---|---|---|
| Ordinary resolution | More than 50% of votes cast (in connected transactions, the connected party must abstain) | Show of hands or poll (GEM rules require a poll on connected transactions) |
| Special resolution | More than 75% of votes cast | Show of hands or poll |
| Privatization by Scheme of Arrangement | Majority in number of voters, representing 75% by value, with not more than 10% of independent shares voted against the proposal | Poll |

In a number of these instances, minority votes are clearly given teeth, and unfavorable proposals can be rejected. This is not merely theoretical. In January 2003, the privatization proposal of Henderson Investment was voted against by a sufficient number of minorities (10.2% of eligible shares, or 2.5% of the entire company – Henderson Land owns 75% of the issued equity) to result in the rejection of the proposal. Considering that the privatization was priced, according to one estimate, at almost a 40% discount to the market value of the company's assets, minorities were likely well served. It is also interesting to note that the share price has subsequently risen above the privatization price on a number of occasions.

Similarly, in July 2003, the privatization of Kerry Properties by Kerry Holdings was also rejected, although by a much larger percentage, at a court meeting of independent shareholders. At the meeting, 56% of shares voted, representing almost 35% of independent shareholders and 8.3% of the issued capital of the company (Kerry Holdings was deemed to control 76% of the shares under the Takeover Code), voted against the proposal. Again, shareholders were probably well served, since the proposed privatization price was almost 40% below the adjusted net asset value, as set out in the privatization

circular of 23 June 2003. Since the proposal was voted down, the share price has also on occasion risen above the privatization price.

A shareholder's voting rights are an important tool that, when exercised, can play an integral role in ensuring fair corporate governance. Proxy voting, in this sense, is a supplement to regulatory oversight, although it differs in a crucial way. The mandate of regulators only covers the behavior of companies and their managers with respect to various corporate laws and listing rules. However, when it comes to deciding whether a transaction with a related party should or should not proceed, it is entirely up to minorities through the proxy vote to ensure fair treatment – the regulators only require that the proposed transaction be disclosed and voted upon.

In concluding this section, it seems appropriate to remember why terms such as *equity* and *share* were first employed. From the beginning, it was accepted that the relationship between directors, the company and its shareholders is one dependent on trust. The long term success of investing in a company's shares depends on the *equitable* treatment of minority investors by company founders and managers, through such acts as the *sharing* of dividends. It was in this spirit that proxy voting was created, and it is through the act of voting that minority interests are reinforced.

## 2.0 The Barriers to Proxy Voting in Hong Kong

### *2.1 Receiving corporate communication*

Before an investor can place sensible voting instructions, she or he first needs to know what is being voted on. This simple statement, one would think, would return the equally simple response that the investor should first read the information circular outlining the voting issues before ticking the boxes on a proxy form. Unfortunately, as far as Hong Kong equities are concerned, the situation is not that simple.

The odyssey of proxy voting in Hong Kong begins with the surprisingly arduous task of simply receiving an information circular or a proxy form. The task is made arduous due to the number of intermediaries between the investor and the listed company, and ultimately the declining imperative to forward corporate communication as the number of intermediaries grows.

To understand this better, it is important to first know how listed shares are held in Hong Kong. There are two ways, either in registered or in beneficial form, the latter of which can be sub-divided between beneficial owners and investor participants. A brief description of each method is as follows:

1) *Registered shareholder*: title to the shares is registered in the investor's own name, which is recorded in the listed company's "register of members".

2) *Beneficial owner*: an investor who holds shares through an intermediary, such as a broker or custodian. Either the intermediary's nominee or that of the central share depository (increasingly the case) is the registered entity.

3) *Investor Participant (IP)*: an investor who holds shares in a dedicated account with the central share depository, CCASS[1]. The shares are registered with the listed company in the name of CCASS's nominee, HKSCCN[2]. While technically also beneficial owners, IPs enjoy a simpler proxy voting process, although setting up an IP account can be challenging[3].

So, how are Hong Kong equities most commonly held? The answer depends. For controlling shareholders, who rarely make market transactions, it makes more sense to register their shares, since this facilitates their ability to vote, as will be shown later in this paper, and avoids custody costs.

For minority shareholders, however, who generally place greater value on the ability to transact when they want, it makes less sense to register. Virtually all listed shares traded on the Stock Exchange of Hong Kong (SEHK) must be settled through CCASS, which means that, when a registered holder wishes to sell in the market, the certificates must be deposited with CCASS and transferred into the name of HKSCCN in order to settle the transaction. Brokers will generally not accept sale orders until the stock is in the system and duly transferred to HKSCCN, a process which can take several days or even weeks.

The data supports the argument that beneficial share ownership is substantial for SEHK listed shares. According to CCASS, at 30 June 2003, HKSCCN held 29.3% of the value of all shares listed in Hong Kong, and 53.6% of their volume (these numbers contrast with trading statistics whereby CCASS acts as the counterparty for almost 100% of the trades which go through the Hong Kong stock markets).

The large discrepancy between HKSCCN's value and volume market shares implies that at least some stocks with high share prices, hence large values per unit of volume, have a significant proportion of their shares not kept within the CCASS system. One obvious example would be HSBC, whose shares also trade actively in London, where registration and nominee services also can be chosen. At the end of June, HSBC's market capitalization accounted for 25% of the value of the entire Hong Kong stock market, meaning that anomalies like its dual primary listing can have a material impact on CCASS data.

However, companies with purely Hong Kong listings also affect the CCASS statistics. CLP Holdings, with a market capitalization of almost US$10bn at the end of July 2003, had only 34.4% of its shares held by HKSCCN, according to the company's internal records. This is a stock which regularly trades above HK$30 per share, a high number for a Hong Kong listed company.

The CCASS data, meanwhile, only accounts for shares deposited with HKSCCN. There are other nominee services in the market, notably run by some of the large banks in Hong Kong. This fact implies that beneficial ownership is greater than the HKSCCN numbers indicate, potentially much greater. This fact in itself is intriguing, considering the need to settle share transactions through CCASS and therefore register those shares in the name of HKSCCN. A possible explanation is that some controlling interests or long term institutional shareholders hold their interests through nominees other than HKSCCN.

IPs, meanwhile, account for a small proportion of all shareholding in Hong Kong, numbering at about 12,000. Furthermore, IPs account for a small portion of trading. The first table below shows that the daily average amount of investor settlement instructions (ISIs) in CCASS ranged from HK$50m to HK$90m in the first half of 2003, or an average of HK$65m. An ISI represents a trade by an IP through CCASS. In contrast, settlement instruction (SI) activity, or trading by institutional and individual investors through intermediary participants such as stock brokers, averaged HK$9,900m per day over this period. IPs, therefore, accounted for a meager 0.7% of stock market trading activity.

| Daily Average of Investor Settlement Instructions (ISIs) Settled in CCASS (one sided ISIs are counted) | | | |
|---|---|---|---|
| MMM-YY | Number of ISIs | ISIs by Market Value (HK$ Billion ) | ISIs by Shares (Billion) |
| Jan-03 | 308 | 0.07 | 0.05 |
| Feb-03 | 276 | 0.05 | 0.03 |
| Mar-03 | 305 | 0.05 | 0.04 |
| Apr-03 | 292 | 0.06 | 0.04 |
| May-03 | 370 | 0.07 | 0.19 |
| Jun-03 | 537 | 0.09 | 0.07 |

*Source: CCASS, http://www.hkex.com.hk/stat/statistics/statistic16.1.htm*

| Daily Average of Settlement Instructions (SIs) Settled in CCASS (both delivering and receiving SIs are counted) | | | |
|---|---|---|---|
| MMM-YY | Number of SIs | SIs by Market Value (HK$ Billion) | SIs by Shares (Billion) |
| Jan-03 | 14,518 | 16.10 | 5.92 |
| Feb-03 | 14,662 | 16.84 | 5.69 |
| Mar-03 | 15,494 | 17.92 | 6.91 |
| Apr-03 | 16,093 | 19.93 | 7.29 |
| May-03 | 17,977 | 21.38 | 8.91 |
| Jun-03 | 19,420 | 22.72 | 9.13 |

*Source: CCASS, http://www.hkex.com.hk/stat/statistics/statistic16.1.htm*

The core assumption at this stage of the discussion is that the majority of non-controlling shareholders in Hong Kong are beneficial owners. This is also the position that places them furthest from the listed company, a problematic situation to be in when it comes to receiving regular corporate communication.

As we have noted already, shares held by beneficial owners are legally registered in the name of a nominee, meaning that the listed company has no record of a beneficial owner's shareholding rights. As a result, beneficial owners are not sent any corporate communication directly from the listed company, nor informed of any shareholder vote, unless the beneficial owner proactively asks to receive them.

However, a beneficial owner cannot ask the listed company directly for corporate communication and expect a favorable reply, although one may be received on an ad hoc basis. From the company's perspective, the beneficial owner is not a shareholder, since his or her name is not on the register. Only the beneficial owner's nominee is recognized as one. To receive corporate communication in a regular and timely fashion, therefore, the beneficial owner may then choose to approach the nominee.

Unfortunately, nominees in general will not forward corporate communication either to beneficial owners, since their relationship is with the broker or custodian, not the end investor. From the nominee's perspective, it is the broker's responsibility to inform beneficial owners of their rights and obligations as shareholders of listed companies.

Hong Kong Exchanges and Clearing Ltd (HKEx) has admittedly taken steps to rectify this problem with respect to HKSCCN. The listing rules now require registrars of listed companies to inform HKSCCN of any event resulting in corporate communication that will be sent to shareholders. CCASS participants are then informed of the event electronically via CCASS terminals. The participants are encouraged to submit via the same system the names and addresses of clients holding shares in any listed company initiating an event. Based on the information received, HKSCCN will forward the list, in the form of printed labels, to the registrar which will then send corporate communication directly to beneficial owners. The list is updated with each event.

While the exchange should be applauded for taking these steps, the statistics suggest that there is much more work to be done on this front. In the first half of 2003, CCASS created about 500,000 address labels for 1,475 corporate events. With almost 1,000 listed companies in Hong Kong, it can be deduced from this data that the average listed company in Hong Kong has three events per year which result in the release of corporate communication.

Meanwhile, there are about one million equity investors in Hong Kong, according to a survey published on 22 April 2003 by HKEx[4]. The previous year's survey concluded that the average Hong Kong investor held shares in three listed companies. Assuming three events per company per year, this means that about 9m separate corporate communication documents could be sent out every year to Hong Kong investors, or 4.5m every six months. These numbers significantly underestimate the actual total, since they do not count all the overseas investors in Hong Kong equities, many of whom will be institutional investors and holders of many more than three stocks.

As noted above, HKSCCN acts as the nominee for 54% of all issued shares by volume and 29% by value on the SEHK. Depending on which is the better measure of the actual percentage of shareholders captured within the system, the 500,000 address labels sent to company registrars by HKSCCN in the first half of this year equated to between 21% and 38% of the labels that could have been sent, when accounting for only the one million equity investors in Hong Kong. Spreading those address labels across both local and overseas investors would greatly reduce those percentages.

So, to receive timely corporate communication, beneficial owners in the majority of instances still need to approach their brokers. Assuming a favorable response, the broker then forwards the request to its own nominee or HKSCCN which in turn passes the request on to the listed company. The annual report, shareholder circular or proxy voting form is then sent to the beneficial owner.

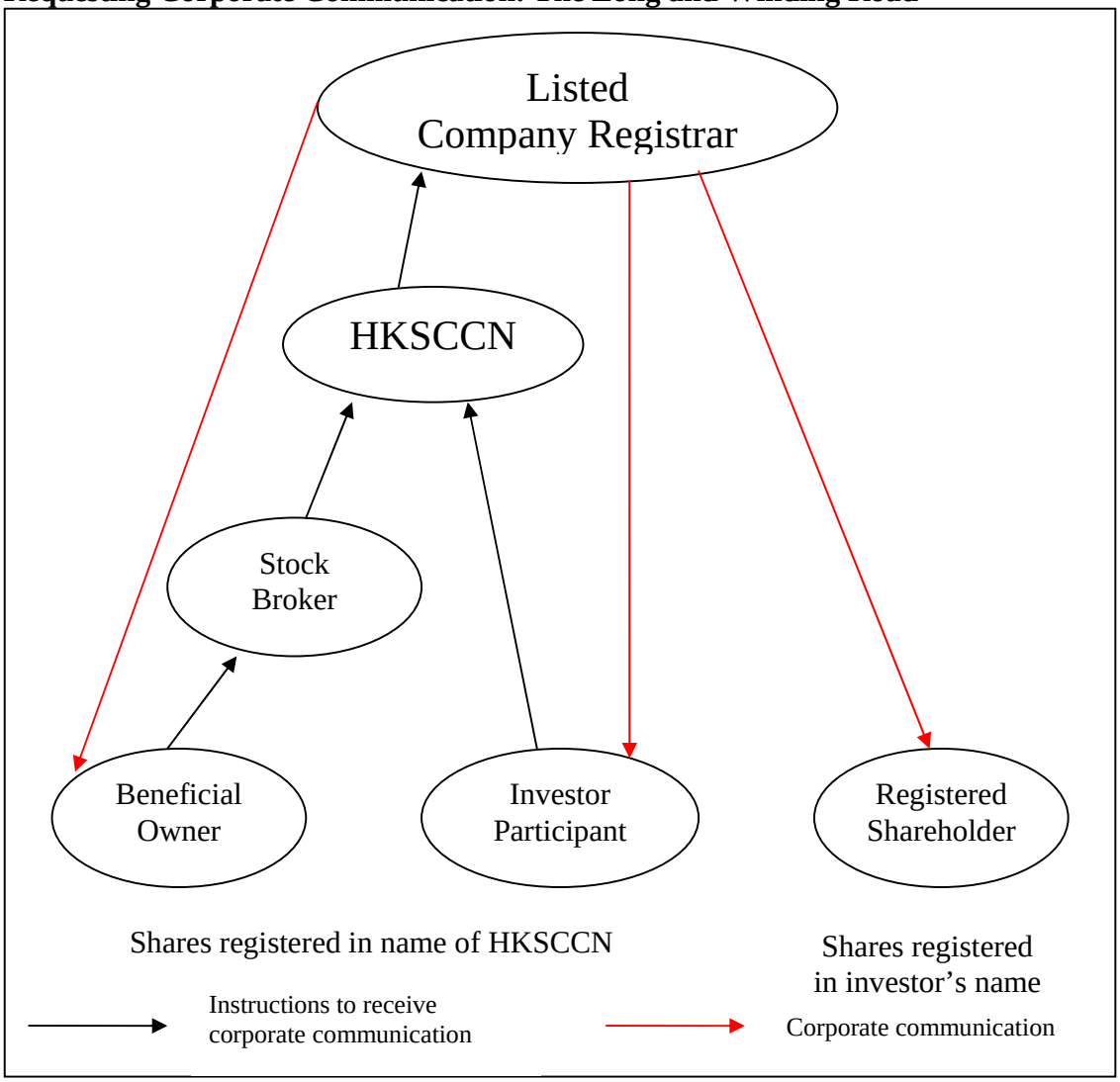
Ideally, as a part of their service to clients, brokers would ensure that beneficial owners receive all corporate communication from each company in which their clients own shares. As discussed above, a minority clearly are doing just that through HKSCCN, although far too many are not. In theory, this step should be relatively easy, since as participants in CCASS, brokers can establish sub-accounts for their clients, giving the latter the same access to listed company information as the broker receives. In practice, however, intermediaries have no incentive to provide this service. In fact, they have every incentive not to.

The total permutations of matching individual corporate event notifications with individual investors are enormous. From an intermediary's perspective, they are also costly, especially when nominee services other than HKSCCN's are employed. In these instances, the CCASS system cannot be used to transmit corporate communication delivery instructions. The alternative is to either develop a new in-house system or to employ staff to print labels manually. In the extreme, imagine the man-hours that would be required every year to ensure that all corporate communication from the 999 locally listed companies is sent to the right people among the million equity investors in Hong Kong and the unknown number overseas.

Brokers, furthermore, are not paid to timely inform investors of corporate events. They are paid to execute trades, and there is as a result an entrenched unwillingness within the industry to incur the costs that would be necessary to provide this service on a consistent and comprehensive level. While CCASS has taken a step to overcome this inherent inertia, the evidence suggests that this is in no way enough to ensure that all investors in Hong Kong equities who wish to stay adequately informed can do so.

Beneficial owners, therefore, have no choice but to take the initiative, if they wish to be actively involved in the major decisions which affect the companies in which they own shares. Investors also have to recognize that, aside from instances when their holdings change (ie: share consolidations or bonus issues) or monetary decisions are required (scrip or cash dividends, or whether or not to participate in a rights issue), their intermediaries may actually refuse to keep clients regularly informed of corporate events due to the costs that would be incurred.

**Requesting Corporate Communication: The Long and Winding Road**




*Adapted from a flow chart in "Knowledge is key to shareholding" in the April 2003 issue of Exchange, an HKEx publication.*

If this does prove to be the case, there is a last recourse that should work, at least in terms of gathering information, although it may not be much help in furthering a shareholder's proxy voting objectives. Most corporate communications must be published in English and Chinese on the HKEx website (www.hkex.com.hk), found by following the "Listed Companies Information Search" link and completing the relevant search fields. The notable exceptions to this requirement are proxy forms and disclosures of appointment or resignation of directors.

Thanks to the Internet, therefore, investor access to information has strengthened somewhat, in that information crucial to making voting decisions is now readily available. However, there is no complete, automatic procedure involved. Beneficial owners bear the sole responsibility for remaining informed of what corporate actions can be voted upon, when the meetings are being held, and what the voting alternatives are. This is how shareholder democracy is practised today for most minority shareholders.

For IPs and registered shareholders, however, the prospects are far more sanguine. IPs are asked, upon opening an account with CCASS, whether they wish to have corporate communication sent directly to them from the listed companies in which they own shares[5]. As long as they respond in the positive, the corporate communication will from that moment be sent automatically. However, as they are not registered shareholders, IPs do not normally receive proxy forms, since only HKSCCN, as the registered shareholder, can complete a proxy form.

Registered shareholders, meanwhile, do not even have to respond to a question in order to receive corporate communication. A listed company will, as part of its ongoing obligations to shareholders, send out its annual reports, circulars and other investor communication material directly to all those on its register of members.

### *2.2 Submitting voting instructions*

After shareholders have received the explanatory documents and, in the case of registered shareholders, proxy voting forms, they have the core material they need to vote. As no doubt is obvious at this stage of the paper, the ease with which a vote can be cast is dependent on how investors hold their shares.

Again, registered shareholders have the simplest path to follow, since they are in direct communication with the listed company. They merely tick off the boxes on the proxy form that has been sent to them, indicating whether they vote in favor or against the various resolutions, and then send the completed form to the company at the address specified on the form. Registered shareholders also have the automatic right to attend shareholder meetings or, if they prefer, to nominate a proxy to vote on their behalf – in most cases, the form specifies the chairman of the meeting by default, and if the shareholder wishes to appoint someone else, then the shareholder must amend the proxy accordingly.

IPs, meanwhile, must communicate their voting instructions through HKSCCN. They have the option of asking HKSCCN to inform the listed company that the IP would like to attend as a HKSCCN proxy. If this option is not taken, then HKSCCN will either submit a proxy form to the listed company, appointing the chairman to vote on its behalf, or send a staff member to attend and vote. In either case, the vote expressed in HKSCCN's completed proxy form or delivered by its representative will be based on the net decision of all shareholders who have submitted their voting preferences. Furthermore, unlike registered shareholders, IPs do not have the option of appointing a third party to attend the meeting as their proxy.

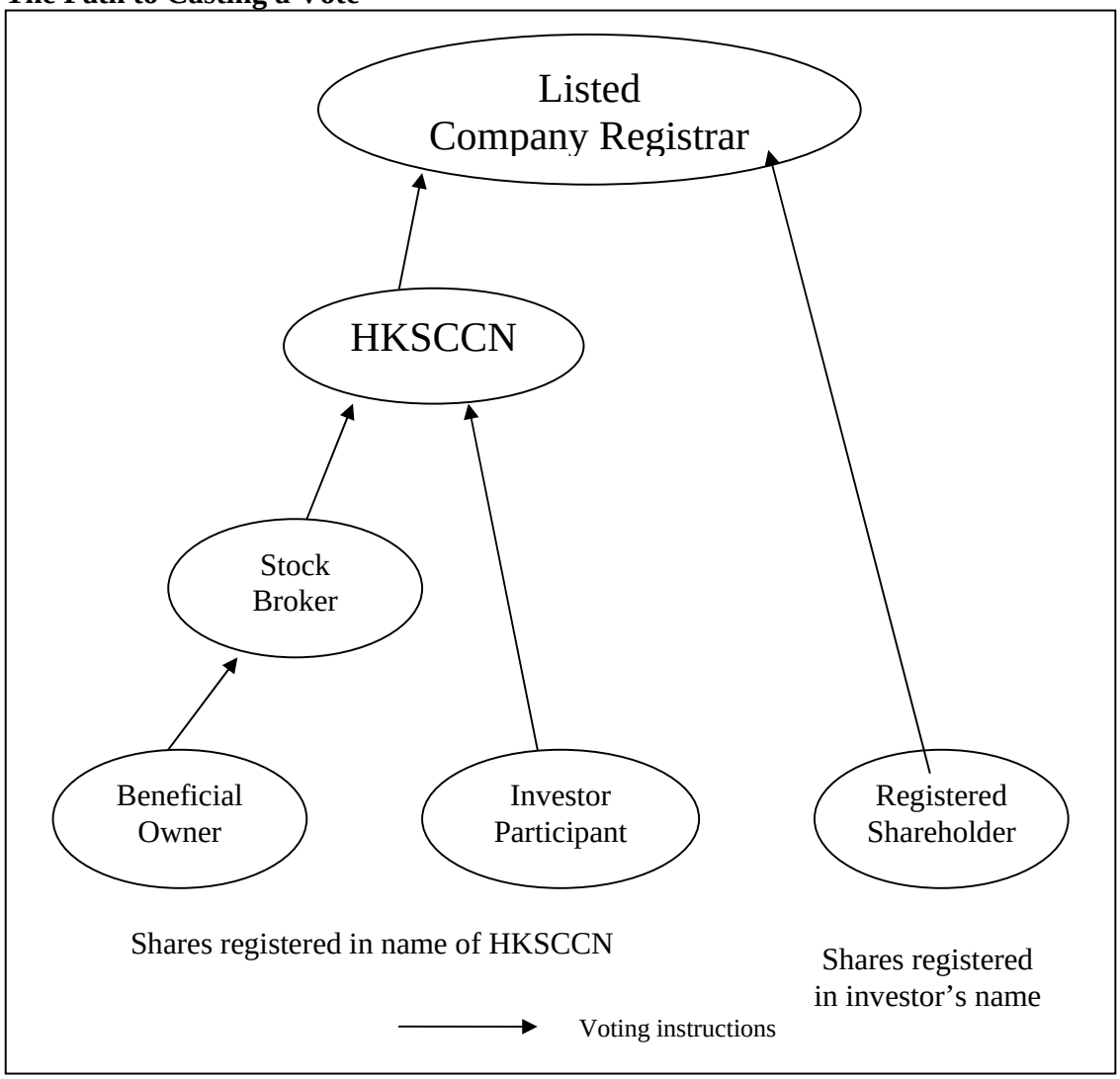
While an IP may prefer the option of attending the meeting, this may not be possible. Whether a proxy can be appointed to attend and vote at listed company meetings is determined by the constitutions of the respective companies and applicable laws. As many locally listed companies are incorporated outside of

Hong Kong, what is permissible will vary widely, although in Hong Kong itself the number of proxies that a nominee, or any other registered shareholder for that matter, can appoint is limited to two[6].

Lastly, and most relevantly, beneficial owners complete the same process as IPs, except with an extra layer of bureaucracy, namely from the broker that holds their shares. The latter must be told to inform its nominee of the voting instructions, and whether the investor wishes to attend the meeting with the same hindrances applicable to IPs.

The process is simplified somewhat for brokers who use the HKSCCN nominee services, since the instructions can be transmitted through the CCASS terminals. However, as the data on the delivery of corporate communication via this mechanism illustrates, broker use of the CCASS network for anything beyond trading purposes is not high. For investors who want their votes submitted, a degree of persistence may be necessary.

**The Path to Casting a Vote**




*Adapted from a flow chart in "Knowledge is key to shareholding" in the April 2003 issue of Exchange, an HKEx publication.*

*2.3 The shareholders' meeting*

So far in this discussion, the institutional barriers to proxy voting do not really involve the listed companies themselves. This trend changes, however, once the shareholder meeting is called to order.

The striking truth about proxy votes held by Hong Kong-listed companies is how rarely the votes are actually counted. This statement may seem paradoxical. What is the point of putting important questions of corporate direction or governance to a shareholder vote, if there is no intention of actually tabulating the results. This situation exists because there is a convenient alternative to counting votes, and it is counting hands.

The proper term is a "show of hands", and it appears to be a relic of another century when information traveled by ship, not by optic fiber or satellite signals, and tallies were performed by hand rather than with electronic calculators and computers. In a show of hands, the chairman of the meeting asks shareholders in attendance to vote on the resolutions one at a time. When asked who is in favor, those who are raise a hand, while those against raise a hand when their turn comes. The hands are counted and the majority decides the outcome of the resolution.

It is worth noting that the vote of an investor with a million shares carries equal weight in a show of hands as does another with only 2,000. This is extremely relevant to this discussion, because when a nominee attends a shareholder meeting, representing the interests of potentially dozens of shareholders, the nominee like everyone else can raise only one hand. Furthermore, the nominee will vote according to the net decision of all represented shareholders, meaning that the nominee will necessarily vote contrary to the instructions given by those shareholders with the minority opinion!

To say the least, a show of hands can easily compromise the voting intentions of IPs and beneficial owners alike, as well as registered shareholders who nominate as proxy the chairman, who again can raise only one hand, quite often in support of all resolutions.

Taking a less cautious stance, deciding resolutions by a show of hands can be seen as unethical, because it deprives shareholders of the right to be counted according to their proportional interest in the shares of the company. It is also a system that can be far too easily manipulated. For example, controlling shareholders could stack a vote, if they so chose. All they would need to do is enlist a sufficient number of willing employees to buy a minimum number of shares each, register them, turn up on the day of the meeting and raise their hands.

Fortunately, as always in this discussion, there is an alternative, and in the jargon it is known as a "poll". A poll does what the name implies, that is it ensures that the vote attached to each share is counted, similar to a poll conducted in the political arena. In other words, one share, one vote, and not the one person, one vote rule that applies under a show of hands.

Polls, however, are for the most part not automatic events at Hong Kong shareholder meetings. There are certain instances when they are, such as for privatization proposals, but by and large polls are not required. To otherwise occur, they must be "demanded" by shareholders attending a meeting.

To have the right to demand a poll, usually either a shareholder or group of shareholders must own 10% of the total number of shares in issue (a high barrier), or a minimum number of shareholders, as defined by the company's articles of incorporation, must attend the meeting (in person or by proxy) and demand a poll. The latter is the more practical route, since the minimum number of shareholders is usually five or

less, depending on the jurisdiction covering the company's activities (for Hong Kong incorporated companies, the minimum number is two). Of course, following this path assumes that shareholders have actually been permitted to attend the meeting! As a point of interest, the chairman also has the individual right to demand a poll.

It is worth remembering how a nominee will act in this situation. As the legal but not beneficial owner of the shares it is representing at the meeting, the nominee will refuse to make a decision or take any action on the shares without prior authorization from the beneficial owner. This means, in this context, that unless a shareholder instructs a nominee to demand a poll, the nominee will not do so.

Furthermore, the nominee may only consider the minimum 10% shareholding criterion, as is the case with HKSCCN. Legally, a nominee will have the right to only one vote when demanding a poll, even if a sufficient number of its beneficiaries have been permitted to attend the meeting. For this purpose only, they are jointly regarded as one vote in a show of hands. Due to this bureaucratic constraint, the nominee will know that it alone cannot force a poll on the minimum number of shareholding criterion, and may use this fact as a reason not to demand one. Of course, it could be argued that the nominee should demand a poll anyway if its beneficiaries request it, with the possibility that other attending shareholders will join forces with the nominee.

Demanding a poll gained some fame in financial circles over the last AGM season, due to the work undertaken by corporate governance advocate and editor of Webb-site.com, David Webb. He was invited to share some of his views on the subject, which are reproduced as follows:

> "One must ask, what is the point of HKSCCN collecting voting instructions from brokers, banks, custodians and investor participants, who clearly want their votes to be counted, and then failing to demand a poll? HKSCCN should amend its operating procedures to state that it will demand a poll in respect of all shares voted through its system, unless otherwise instructed. In other words, a participant could tick a box saying 'do not demand a poll in respect of my shares' and failing which, HKSCCN would demand a poll. It is unlikely that any investor would want to vote and yet not want their votes to be counted. As HKSCCN holds more than 10% of the issued shares of most listed companies, this rule change would have the effect of triggering a poll most of the time.
>
> "Of course, a far simpler and more effective solution would be simply to amend the Listing Rules of SEHK so that all listed companies are required to count all votes on a poll and to publish the results. HKSCCN and SEHK are fellow subsidiaries of the same company, HKEx. So far, although HKEx has proposed to make poll voting mandatory for connected transactions on the main board (as it is on the GEM), it has declined to do so for what it terms 'less important matters'[7]. This appears to be a euphemism for 'matters on which the controlling shareholder can vote' but yet, we should remember that a controlling shareholder does not always have a majority (50%) shareholding needed to be certain of passing an ordinary resolution, and even less often has the 75% needed to be certain of passing a special resolution. Furthermore, even when they do, it should be a matter of interest to the investing public and to the company to measure the dissenting votes. The 'less important matters' include items such as major acquisitions and disposals, share issues, amendments to the constitutional documents of the company, and share option schemes."

In February 2003, Webb launched "Project Poll". He bought 10 shares of each of the 33 companies in the Hang Seng Index, as well as HKEx itself. He split those shares into 5 registered shareholdings, and has

successfully required polls in all the shareholder meetings held so far, except for the AGM of HSBC Holdings plc, which holds its meetings in London, where his proxy was eventually unable to attend. By requiring Hong Kong's largest companies to conduct poll voting always, his aim is that they will drop their opposition to making the practice mandatory for all companies under the Listing Rules. He is also requiring polls in smaller companies in which he is an investor. Unfortunately, there is no requirement under the Listing Rules for the results of polls to be announced, but he works around this by exercising legal powers to obtain a copy of the minutes of meetings, and then publishing them on Webb-site.com if the company declines to publish them.

### *2.4 Bogging down the shareholders' meeting*

There is the argument that defenders of the status quo employ which states that not all decisions are of such importance that they need to go through the time-consuming process of a poll. To an extent, this argument is true. When across-the-board polls have been undertaken at shareholders' meetings in Hong Kong, rarely has the proposed dividend been voted down, for example. Furthermore and more curiously, incumbent directors have almost always retained their positions.

However, while it may be true that mundane voting matters can be adequately dealt with through an expeditious show of hands, the point of this paper is that shareholders who wish to participate in a proxy vote should at the very least have the practical ability to demand that all of their votes are counted. The current system in Hong Kong, however, places significant barriers to having votes counted on a one-share, one vote basis for not only mundane matters, but important ones as well.

These barriers frankly ought to be dismantled. Whether proxy votes are then counted by poll or show of hands should then be up to the decision of individual shareholders. Put more bluntly, since equity investors take substantial financial risks, they should as a quid pro quo have the right to be heard by the company managements who have the power to greatly affect the value of these investments.

This last statement is, of course, not only true of the proxy vote, but also of the meeting itself. Shareholders ought to have the right to question management on its decisions, or lack of them. But, when there are material barriers to minority investors even attending a shareholders' meeting, all forms of adequate communication with management are severely compromised, if not cut off completely.

## 3.0 Fixing the System

In June of this year, the OECD released the "White Paper on Corporate Governance in Asia". The document is based on a series of five roundtable meetings held over a four year period between the OECD, the World Bank and a variety of government and professional bodies around Asia. The resulting paper covers a broad range of corporate governance issues, while asserting a handful of clear priorities with appropriate recommendations that governments around the region should aim for. Relevant to this discussion is the following recommendation:

> "Legislators and securities and exchanges regulators should promote effective shareholder participation in shareholder meetings. In particular, rules on proxy and in absentia voting should be liberalized and the integrity of the voting process should be strengthened."[8]

The OECD white paper went on to say:

> "Listed companies should be encouraged, at their expense, to hire independent and reputable professionals to collect proxies and organize proxy procedures in a predictable manner. Moreover, shareholder protection groups should be allowed to assist minority shareholders in consolidating their votes at general shareholder meetings, including by way of proxy. Custodians and nominees should be able to split or apportion their votes to carry out the instructions of the beneficial owners for whom they act.
>
> "Regulators and shareholder protection groups should together develop a set of rules and practices to ensure integrity and transparency in the proxy process. Such rules should assign clear responsibilities for reaching beneficial owners in the dissemination of information and in facilitating their participation in the corporate decision-making process."[9]

Considering the tenor of this paper so far, it should be clear that we favor implementing these steps in Hong Kong. More specifically, we would argue that effective reform is needed to ensure that the following goals are achievable in practice for all shareholders, whether they hold their shares in registered or beneficial form:

1) The timely delivery of corporate communication.
2) The right to attend shareholder meetings.
3) The right to speak and vote at these meetings.
4) The right to demand a poll.
5) The right to appoint a proxy.
6) The expectation that nominees will act as instructed on an individual shareholder basis.

Achieving these goals requires significant changes in behavior by stock brokers, custodians, nominees, CCASS, registrars and the listed companies themselves. It may also require appropriate changes in securities regulations, as well as stronger Securities and Futures Commission (SFC) oversight.

Furthermore, if the government truly aspires to help Hong Kong develop into one of the top financial centers in the world on a par with London and New York, as has been repeatedly expressed in Chief Executive policy speeches, then it ought to actively participate in strengthening the proxy voting system, initiating new legislation, if required. The weight of global professional opinion would be on the government's side if it took this stance.

It is important to remember that shareholder democracy is not merely about supporting or voting down resolutions. It is about making the directors of listed companies more accountable to shareholders. The integrity of the SEHK itself is defined by the treatment that investors expect to receive once they have exchanged their money for shares in Hong Kong listed companies. This integrity influences the willingness of people around the world to continue investing in Hong Kong equities, which ultimately determines the size of the market itself as well as its performance.

From another perspective, minority investors have a long term vested interest in the strengthening of proxy voting rights. With the advent of defined contribution pension schemes, notably Hong Kong's own Mandatory Provident Fund (MPF), individuals are increasingly responsible for the performance of their own pension assets. How much money is available on retirement will result from investment decisions made by ordinary people throughout their lives.

Equities, meanwhile, remain one of the cornerstone investment options recommended by the money management and investment advisory industries, especially for those with long term investment horizons,

which clearly include pensions. The degree to which MPF or other scheme contributors will benefit from long term Hong Kong equity investment will depend in part on the integrity of the market. If shareholder abuse is resisted by both the regulatory structure and effective minority shareholder oversight, then pensioners stand to make higher returns than would be the case in a market where controlling shareholders are able to profit at the expense of investors with negligible influence on management decisions.

Whether minority investors choose to participate in proxy votes is another issue that on consideration is not relevant. Shareholder apathy is not a reason to maintain the currently broken system. In fact, it could be argued that the limited shareholder participation in proxy votes, individual and institutional alike, is a symptom of how ineffective the current system is in Hong Kong. If access to shareholder meetings is essentially barred, then it should be no surprise that beneficial owners rarely bother to try to attend or appoint a proxy.

## 4.0 Legislative Proposals Worth Supporting

### *4.1 Scripless trading*

In February 2002, the SFC released its "Consultation Paper on Proposals for a Scripless Securities Market"[10]. Comments from the public were invited through May of that year, and a working group was formed to determine how best to implement scripless trading, to oversee the implementation following the consultation period, and to provide community education regarding the changes.

Among the several benefits that would likely accrue, the specific proposals, if implemented as described in the consultation paper, would go some way to closing the broad gap between listed companies and beneficial owners. From the perspective of this paper, the SFC's proposals should be pursued by the community as soon as is practicable.

The creation of a scripless market begins with splitting listed companies' register of members into two parts, a CCASS register and an issuer register. From there, the consultation paper makes six proposals which are summarized as follows:

1) **CCASS Register**: CCASS participants, including brokers, custodians and IPs, would automatically become registered shareholders. All share certificates held by CCASS would be cancelled, transforming the CCASS register into a scripless one. Deposits of share certificates into CCASS would continue to be permitted, but withdrawals would cease.

2) **Issuer Registers**: For an interim period, both scripless and certificated shares would exist. Shareholders could deliver certificates to registrars for cancellation and creation of scripless holdings. The issuer registers would be updated on-line with the CCASS register to form the complete register.

3) **Shareholder Choices**: Shareholders would be able to hold their scripless shares in either of the following three forms:

    a. Beneficial form, through a broker, custodian or nominee, with their names not appearing on either register.
    b. Recorded on either register, with the same degree of control that existing registered shareholders enjoy.

c. Recorded on either register, but with authority given to a broker or custodian to make transfers for trading or security pledging purposes. The intention is that this form would allow the receipt of corporate communications and the exercise of voting rights.

4) **Communications Hub**: Provided by FinNet, the IP-based hub would provide standardized communication of scripless share transfers on or between registers, including an updating of the name on the register that coincides with the T+2 settlement period.

5) **Legislative Changes**: To supplement the existing legal framework for share certificates within the Companies Ordinance with regulations for scripless holding and transfer methods. This proposal would also seek legal arrangements to achieve similar results for companies incorporated overseas and in the mainland.

6) **Initial Public Offerings (IPO):** To require IPOs to offer subscription options for scripless holdings, with the option of the issuer to make the entire IPO scripless. The ultimate goal is that, after sufficient experience is gained, all IPOs would be entirely scripless.

Scripless trading would offer cost and operational benefits to a number of interested parties, including savings on settlement services for stock brokers, lower registration costs for listed companies once the necessary systems have been created, and easier and cheaper management of share inventories for CCASS. The only party to lose out on these proposals would be share registrars, who would not be able to charge a fee on re-registering scripless shares.

The benefit to shareholders themselves would be mainly through an easier path to registration. The proposals, however, do not address all of the issues raised in this paper, only a few of them. The path from beneficial owner to listed company register, for example, would shrink by only one intermediary, as CCASS would no longer be a conduit to the share registry but become one itself. Beneficial owners would still deal directly with their broker or, for institutions, their custodian, and there is no aspect to the proposals which compels brokers to forward corporate communication or handle voting instructions. Having said that, IPs would automatically graduate to registered shareholder status.

One of the SFC proposals does state that investors would have the option to have their shares registered in their own name, either with or without a stock broker or custodian providing share transfer services. The devil is in the details for this proposal, and regrettably few details were provided in the consultation paper.

The main barrier to the effective implementation of this proposal is the intermediary. The same cost barriers that currently discourage brokers from forwarding corporate communication could also be at work in re-registering scripless shares. CCASS systems may be up to the task, and the issuer registers' systems are required to become up to it, but nowhere in the proposals does it say that brokers have to invest in the technology which will facilitate registering the names of their clients on scripless shares. And if they do not, then shareholders may gain a registration option in theory, but not in practice.

Finally, the behavior of nominees is not addressed at all in the proposals. For example, listed companies' articles of association will continue to restrict the number of proxies that can be nominated, thus ensuring that HKSCCN will not demand a poll when requested by any beneficial owner holding less than 10% of an issuer's shares. This same restriction will continue to bar many beneficial owners from attending shareholder meetings, once the nominee's proxy limit has been reached. And, of course, in a show of hands, nominees will only be able to vote the majority opinion of all beneficial owner votes received, thus essentially disenfranchising the minority.

*4.2 The Standing Committee on Company Law Reform (SCCLR)*

The SCCLR was formed in 1984 to advise the Financial Secretary on amendments to the Companies Ordinance and other related ordinances. In June of this year, the SCCLR released "A Consultation Paper on Proposals Made in Phase II of the Review", its second paper outlining proposals aimed at improving corporate governance [11] (the consultation period will end on 30 September 2003).

The review addresses a broad spectrum of issues that can be covered by the term corporate governance, among which are a few proposals which pertain directly to proxy voting. The following are extracts from those proposals that are relevant to the topic of this paper:

- **Communication with shareholders**
    - "…the SCCLR… proposes that notices should be given personally or sent by post to shareholders unless the shareholders agree to adopt electronic means of communication including the use of personal identification numbers." (paragraph 21.27)
    - "…the SCCLR proposes that specific provisions should be made for the delivery of proxies by electronic means..." (21.94)
- **The shareholders' meeting**
    - "Connected transactions must be disclosed and subject to a disinterested shareholders' vote." (17.11)
    - "The SCCLR reconfirms its previous proposal… that voting on connected transactions must take place on a poll." (17.13)
    - "Members of the SCCLR had diverse views… some members proposed that voting by a show of hands should discontinue whereas others believed that the chairman's discretion to call a poll should remain intact. In view of this, the SCCLR would like to obtain further views before deciding how to proceed." (21.64)
    - "…the SCCLR proposes that absentee voting should be permitted…" (21.71)
    - "The SCCLR also proposes that electronic voting should be permitted... The Companies Ordinance should be amended to enable rather than to compel electronic voting while the Listing Rules should encourage such voting." (21.72)
    - "…the SCCLR proposes that… multiple proxies should be permitted." (21.79)
    - "The SCCLR proposes that proxies should be allowed to vote on a show of hands and to speak at the meeting." (21.83)

The above proposals address some of the criticisms raised by this paper of the proxy voting process in Hong Kong which were not covered by the scripless trading initiative of the SFC.

The proposal permitting electronic transmission of proxy voting instructions, with the shareholder option to receive meeting notices electronically, would serve to eliminate some of the cost of communicating with shareholders. Whether this would be sufficient impetus to encourage nominees and brokers to

proactively transmit corporate communication and voting instructions is debatable, although at least it would be a step in the right direction. To overcome this obstacle once and for all may well require mandatory compliance, with a requirement that listed companies bear the cost.

Requiring polls on connected transactions is an obvious move that HKEx should implement unilaterally, especially as it would merely be an exercise in aligning main board requirements with those already in place on the GEM. The significance is that passing a connected transaction is often in the vested interest of the controlling shareholder, which increases the risk of abuse in the more malleable show of hands voting method.

The lack of a clear view on whether the show of hands method should be eliminated entirely is not surprising, considering the feedback we have received to date from a wide range of parties. The argument of those opposed rests mostly on the time and cost of conducting polls for relatively mundane matters. The answer that should satisfy all parties is to advance electronic voting methods (as SCCLR advocates) that, properly constructed, would allow for low cost and rapid polls to be conducted.

Allowing multiple proxies addresses some of the main obstacles presented by the nominee system. If enacted, beneficial owners should then expect nominees to appoint them as proxies when requested, and to demand a poll if enough beneficial owners place such an instruction, assuming that multiple proxies would be allowed to vote individually on the question of whether or not to demand a poll. It would furthermore be in the beneficial owner's best interest to select his or her own proxy, since the nominee would continue to vote the net opinion of votes represented in a show of hands. The barriers imposed by brokers, meanwhile, would remain in place whether this proposal were enacted or not.

Allowing proxies to vote in a show of hands and speak at meetings would probably appear self-evident to the layman. The fact that it is not the universal practice now, notably when demanding a poll, is a testament to the inequities of the current proxy voting system. This proposal should be enacted as soon as possible.

## Notes

1) CCASS: Central Clearing and Automated Settlement System which is operated by Hong Kong Securities Clearing Company Limited, a wholly-owned subsidiary of HKEx. CCASS was created to facilitate electronic trading. For a brief description of the advantages of CCASS, go to www.hkex.com.hk/clrsett/services/p7.htm.

2) HKSCCN: the nominee company of Hong Kong Securities Clearing Company Limited. The services are provided to Corporate and Investor Participants of CCASS.

3) A local investor described the process to the paper's author as: "Here is what you have to do to open an IP account with HKSCC Nominees Ltd. and claim outstanding dividends:

* Go in person to Vicwood Plaza between 10 a.m. – 3.45 p.m. (Mondays to Fridays only).

* Provide the following documents
  - IP A/C opening form
  - Copy of and original ID card
  - Current account number
  - Two completed dividend claim letters
  - Purchase Contract Note
  - Share Certificates and Transfer Deeds
  - Transfer Receipt
  - Letter to request Stock Withdrawal Receipt

* Pay the following charges
  - HK$10 each for Stock Withdrawal Receipt
  - Service charge of HK$200 for each dividend claim
  - HK$10 for each lodge of claim form
  - HK$200 for Issue of Transfer Receipt"

4) "Survey shows one in five Hong Kong adults invests in Hong Kong stocks or derivatives", www.hkex.com.hk/news/hkexnews/030422news.htm.

5) See the April 2003 issue of *Exchange*, an HKEx publication, at www.hkex.com.hk/publications/guide/exchange_apr03.htm, under "Knowledge is key to share voting".

6) Corporate Governance Review by the Standing Committee on Company Law Reform, A Consultation Paper on Proposals made in Phase II of the Review, June 2003, paragraph 21.75.

7) Consultation paper on Listing Rules, Jan 2002

8) See www.oecd.org/dataoecd/4/8/2956790.pdf, paragraph 85.

9) Ibid, paragraphs 88-89.

10) The consultation paper can be downloaded from the SFC website, www.hksfc.org.hk/eng/bills/html/index/index3.html.

11) The consultation paper can be downloaded from the Companies Registry website, www.info.gov.hk/cr/scclr/index.htm.