CHAPTER 1
BACKGROUND

PENNY STOCKS INCIDENT

1.1 On 25 July 2002, the Hong Kong Exchanges and Clearing Company Limited (HKEx) released a "Consultation Paper on Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Criteria and Cancellation of Listing Procedures". The HKEx proposed, among other things, that shares of listed companies should be consolidated if their trading prices fell below HK$0.50 (penny stocks). Delisting would follow, after certain procedures and with recourse to appeal, if the companies concerned failed to consolidate their shares. The consultation was to finish by the end of August 2002.

1.2 On 26 July 2002, 577 (76%) of the 761 stocks on the Main Board suffered a loss. The total market capitalisation of the stocks with a quoted closing price of HK$0.50 or lower fell by HK$10.9 billion (US$1.4 billion), roughly equivalent to 10% of the market capitalisation of these stocks and about 0.3% of the total market capitalisation of the Main Board. Strong market reaction led the Financial Secretary (FS) to appoint a Panel of Inquiry on the Penny Stocks Incident (PIPSI) comprising Mr. Robert G. Kotewall and Mr. Gordon C. K. Kwong to look into the circumstances surrounding the incident and submit a report with conclusions and recommendations by 10 September 2002.

1.3 The Panel of Inquiry submitted its report (PIPSI Report) to the FS on 9 September 2002. One of the recommendations made was that the Government should review the three-tier (Government, Securities and Futures Commission (SFC) and HKEx) regulatory structure of the securities and futures markets over listing matters, in particular the existing structure, roles and operation of the Listing Committee.

EXPERT GROUP AND ITS TERMS OF REFERENCE

1.4 The FS accepted the Panel's recommendation and announced on 26 September 2002 the appointment of a three-member Expert Group to review the roles and functions of the Government, SFC and HKEx over matters relating to the listing of securities and issuers with listed securities, the operation of the regulatory structure as regards listing matters, and the lines of communication among the three tiers of the regulatory structure, and make recommendations for improvements.

1.5 The Expert Group is chaired by Mr Alan Cameron and has Dr Raymond Ch'ien and Mr Peter Clarke as members.

1.6 The detailed terms of reference of the Expert Group are as follows –

(a) With a view to increasing the effectiveness, efficiency, clarity, fairness and credibility of the regulatory system for the securities and futures markets of Hong Kong, and ensuring the integrity of the markets and the proper protection of the investing public, to –

(i) review the roles and functions of the Government, SFC and HKEx and its subsidiaries over matters relating to listing of securities and issuers with listed securities;

(ii) review the operation of the regulatory structure as regards listing matters;

(iii) review the lines of communication among the Government, SFC and HKEx; and

(iv) recommend changes and improvements relating to issues in (i) to (iii) above where appropriate.

(b) In conducting the review, the Expert Group shall have regard to –

(i) the need to maintain the status of Hong Kong as an international financial centre;

(ii) developments in the local and international securities and futures markets;

(iii) the competitiveness of Hong Kong as a centre for listing companies from the Mainland, Asian-time-zone and global capital markets;

(iv) the diversity of issuer and investor bases of the Hong Kong securities and futures markets;

(v) the outcome of the deliberations in the Legislative Council in respect of the Securities and Futures Ordinance (SFO) (Cap. 571); and

(vi) the findings and recommendations of the PIPSI.

(c) The Expert Group should also –

(i) invite submissions from interested parties and the public, including but not limited to representatives of issuers, stockbrokers and investing public, Legislative Councillors and the Standing Committee on Company Law Reform;

(ii) consider the regulatory structures and systems in other major markets; and

(iii) use its best endeavours to submit its report before the end of March 2003.

DETERMINATION OF AMBIT AND MODUS OPERANDI

1.7 There was considerable concern in the market, following our press conference on 9 October 2002, that the review might be focused on listing matters in such a way as to neglect other important issues. There were even more critical comments that the review would be no more than a "whitewash" exercise, just to show that the Government had heeded the Panel's recommendation. We always considered that our terms of reference were wide enough for us to study all matters relevant to the regulatory role of the various parties involved and to recommend changes as necessary. And we were assured by the FS at the outset that we were at liberty to look at any issues that are important to the regulation of the securities and futures markets. We have conducted the review on this basis and have not hesitated to identify and bring to the Government's attention issues that are important but may technically be outside our terms of reference.

1.8 We should note that despite the specific reference to "futures" in our title and terms of reference, no issue with respect to the futures market in Hong Kong was raised with us. We will not again refer to the futures market for that reason.

1.9 Though the Chairman is based in Australia, and the two members both have busy schedules, the Expert Group arranged to hold working meetings in Hong Kong at least once every month from October 2002 to March 2003. Between the meetings, we communicated extensively through e-mail and telephone conferencing. In total we had six rounds of working meetings in Hong Kong each lasting between two to six days.

1.10 We divided our work into three stages. The first stage was to solicit views and gather information, during which we received comments and submissions from interested parties, collected and studied information on the current regulatory regime in Hong Kong and the regulatory structures of major markets as well as global trends of market regulation. At the second stage, we evaluated the views and information obtained, and identified key issues of concern. At the final stage, we formulated our conclusions and recommendations, and wrote this report.

1.11 In the course of our review, a full-time secretariat staffed by civil servants has provided us with effective and efficient support in arranging visits and meetings, conducting researches into relevant reference materials, and preparing this report. The members of the Expert Group particularly extend their thanks and appreciation for their hard work, to the dedicated staff of the secretariat.

SOLICITATION OF VIEWS AND SUBMISSIONS RECEIVED

1.12 In accordance with our terms of reference, we have consulted widely with all stakeholder groups. We held a press conference on 9 October 2002 to formally announce the commencement of the review and its remit, and the invitation of submissions. Advertisements were placed in local and regional major financial papers on the same day to invite views and submissions by 20 November 2002. Notwithstanding the deadline, we have considered all late submissions presented to us. Altogether, 28 formal submissions were received from across the industry and the community at large, including the Government, SFC, HKEx, Consumer Council, directors of listed companies, stockbrokers, investment banks, Legislative Councillors, investors and chambers of commerce. A list of the groups and individuals that have sent in written submissions is at Annex 1. We are most grateful to all respondents, many of whom gave considerable time and thought to putting together their submissions.

MEETINGS WITH PARTIES CONCERNED

1.13 From November 2002 to March 2003, we had meetings with 33 interested groups and individuals, and a further 65 individual interviews to gather information and views. We would like to thank them for taking time out of their busy schedules to meet with us and for the frank views expressed during these meetings.

1.14 We also made use of our own networks, and through our own private visits, to talk to industry participants in the United States (US), United Kingdom (UK) and Australia to learn about the latest developments in these major markets and their perception about the Hong Kong market.

STUDY OF REGULATORY STRUCTURES OF MAJOR MARKETS

1.15 In pursuance of our terms of reference, we have researched into the regulatory regimes of the securities markets in the US, UK, Australia, Canada, Japan, Singapore and the Mainland. Most of the information has been obtained from the relevant official websites. A list of these websites is at Annex 2. Where necessary, we have sought further information and clarification from the regulators and exchanges concerned. We have also through our own personal contacts in overseas markets and regulatory bodies obtained updates on the latest developments in the major markets and the global trend of market regulation. Our findings are at Annex 3. We have included in the same Annex a description of Hong Kong's existing regulatory structure, to facilitate comparison with the regulatory structures in other markets. We have not undertaken any special overseas visits as the information obtained by the above means has provided sufficient materials for our study.

1.16 The New York Stock Exchange (NYSE) in the US and the London Stock Exchange (LSE) in the UK are the world's leading exchanges. The LSE is the most international of all stock exchanges with about 470 companies from over 60 countries admitted to trading on its various trading boards. They account for about 21% of both domestic and international stocks listed on the LSE. The experience of the UK regulatory authorities provides us with valuable reference given that about 80% of the listed companies in Hong Kong are incorporated outside the territory. The fact that the LSE has also recently listed on its own exchange has provided a useful comparison with the HKEx. The Australian Stock Exchange (ASX) and the Singapore Exchange Limited (SGX) are also demutualised and listed on their own exchanges. The Toronto Stock Exchange demutualised in 2000 and has become a publicly listed company during the course of our inquiry. We have also looked at the Mainland model having regard to, above all, Hong Kong's goal to serve as the premier capital formation centre of China.

1.17 The findings of our research show that there is a trend towards stock exchange demutualisation, i.e. conversion of a not-for-profit member-owned exchange to a shareholder-owned for-profit organisation. This has been largely driven by the increase in international competition among exchanges, which requires them to operate more efficiently and to have broader access to capital to finance investment in new technology. The key regulatory issue arising from the demutualisation of exchanges is the real and perceived conflicts of interests arising from the arrangement whereby a for-profit commercial entity is also responsible for market regulation, i.e. the listing of companies. The common concern is that a for-profit commercial exchange may be less inclined to refuse listing applications, which are a direct source of income in the forms of listing fees and transaction levies, and less willing to commit the resources that rigorous self-enforcement would require.

1.18 The Technical Committee of the International Organisation of Securities Commissions (IOSCO) has published an Issues Paper on the subject[5]. The Paper contains many useful observations on the nature of conflicts of interests, including that conflicts had been a feature of the traditional member-based model as well. It observes that there is no single "right" regulatory path to follow when exchanges demutualise and self-list, and does not prescribe any solution which should be adopted, as that will depend on the circumstances. We agree, and have not regarded the adoption of a solution in any other place as a sufficient reason to adopt that solution in Hong Kong (nor of course should our report be seen as implying that any other place should necessarily follow our suggested model). But the experiences of other places should be studied, if only to seek to avoid adopting a solution which experience elsewhere has shown may not work as well in practice as theory had suggested.

1.19 We have studied how the exchanges that have been demutualised and listed are responding to this challenge –

(a) In Australia, the ASX addressed the issue by establishing a subsidiary company, ASX Supervisory Review (ASXSR).

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[5] June 2001, available at www.iosco.org.

The ASXSR is an internal review mechanism (with external participation) to provide a level of assurance that the ASX is directing appropriate resources to supervisory functions, but is not independent of the ASX in terms of structure and funding. We understand that notwithstanding the above arrangement, the market is still concerned that conflicts of interests, be they real or perceived, will compromise the ASX's supervisory activities. Despite those continuing concerns, reflected in press coverage, a parliamentary committee reported in February 2002 that no major change to the supervisory framework should be contemplated at that time, but the committee would review the matter if there was a significant material change in ASX operations or should the ASX merge with another exchange or enter into a new alliance with another exchange[6].

(b) In Canada, the TSX Group has established a separate subsidiary, Market Regulation Services Incorporated (RS), to oversee exchange member regulation upon demutualisation. The RS is independent of and structurally separated from the for-profit operations of the Group.

(c) In Singapore, the SGX responded to the concern about conflicts of interests by entering into a Deed of Undertaking with the Monetary Authority of Singapore (MAS). The Deed sets out the arrangements and procedures for handling conflict of interests cases. The SGX's compliance with the listing rules established by its own exchange is supervised by the MAS. The Board of SGX has to appoint a "Conflicts Committee" to consider possible conflicts of interests that may arise from the listing or quotation of SGX shares on its exchange.

(d) In the case of the UK, the LSE transferred the role of UK Listing Authority to the statutory regulator, the Financial

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[6] Senate Economics References Committee, Inquiry into the Framework for the Market Supervision of Australia's Stock Exchanges, February 2002, available at www.aph.gov.au.

Services Authority (FSA), thereby removing altogether any perceived or real conflicts of interests.

1.20 Not all major exchanges are faced with the same conflict of interests issue, although many would argue that there has always been a conflict issue in the way broker-controlled exchanges operated, even if profits could not be distributed to the broker members directly. In the US, the NYSE has been operating on a not-for-profit basis and the issue of perceived or real conflict of interests based on the profit motive has not arisen. Though the listing function in the US is vested in the exchanges, securities must be registered with the regulator, i.e. the Securities and Exchange Commission (SEC), before they are admitted to trading. In the case of the Mainland, both the Shanghai and Shenzhen Stock Exchanges are non-profit institutions, and the listing regime is controlled by the China Securities Regulatory Commission (CSRC) which is the statutory regulator of the securities and futures markets.

1.21 We are persuaded, despite some views to the contrary, that the conflicts of interests arising from an exchange's dual role as a market regulator and a commercial entity are real, and cause concern to both the market and the regulator, and that is why efforts have been made in so many places to tackle the issue. Measures taken usually involve the setting up of a regulatory subsidiary under the exchange, or the signing of an agreement between the exchange and the regulator to set out the procedure for handling conflicts. These measures are aimed at resolving, instead of eliminating, conflicts. The only jurisdiction whereby all possible conflicts of interests have been removed is the UK where the listing function has been transferred from the LSE to the FSA.

1.22 Our research has also provided us with useful reference as to the role played by the regulator. In the US, though the listing function is performed by the exchanges, all securities must be registered with the SEC before trading. In the Mainland, stock issuance is subject to the CSRC's approval. Even in these two cases where the exchanges operate on a not-for-profit basis, and there is accordingly less concern about possible conflicts of interests, the regulators still play an active role in the listing regime.

1.23 We must emphasise that while we have had regard to the regulatory models in other financial markets and the models of best

practice discussed at various international fora, we have not overlooked the unique circumstances of the Hong Kong market, which include the monopoly held by the HKEx, the fact that the majority of the companies listed in Hong Kong are not incorporated here, and the extent to which the market operates as an entry point, with first world infrastructure, to a major but nevertheless emerging market. We have not recommended a wholesale application of a regulatory model which works perfectly well in another jurisdiction, because what works elsewhere may not be in the best interest of Hong Kong. Consistent with our terms of reference, our aim has been to develop a model that can meet the present need of the Hong Kong market and is flexible enough to cater for future developments.

SECURITIES AND FUTURES ORDINANCE

1.24 We commend the Government on the improvements that will be brought about by the implementation of the SFO, which consolidates and modernises the existing ten ordinances regulating the securities and futures markets and will come into effect on 1 April 2003. The regulatory objectives of the SFC spelt out in the SFO are in line with the core objectives of securities regulation promulgated by the IOSCO, namely –

(a) protection of investors;

(b) ensuring that markets are fair, efficient and transparent; and

(c) reduction of systemic risk.

In formulating our recommendations, we have worked within the SFO framework and put forward suggestions that would further improve the regulatory regime.