

CHAPTER 2

DISCUSSION OF SPECIFIC ISSUES

2.1 In this chapter, we discuss in greater detail some of the issues raised in the Executive Summary.

QUALITY OF MARKET

2.2 We have discussed at some length in the Executive Summary the quality of the Hong Kong market, concluding that there is a worrying deterioration in the quality of the new companies listed on both the Main Board and Growth Enterprise Market (GEM) in recent years, in particular the preponderance of small issues which have poor post-initial public offering (IPO) performance, little investor interest and negligible secondary market turnover. We do not intend to repeat the same discussions here but shall provide some more data to substantiate our observations.

2.3 Of the 117 new listings in 2002 (60 on the Main Board and 57 on the GEM), 90% (105 issues) had initial market capitalisation of less than HK\$1 billion (US\$128 million)⁷. Excluding the nine investment companies⁸, 65% (33 issues) of the **Main Board** listings had market capitalisation below HK\$390 million (US\$50 million) which is the minimum required by the Nasdaq **Small Cap** Market.

2.4 Many of the new listings on the Main Board could barely fulfil the minimum IPO requirements. Excluding investment companies, eight listings raised exactly HK\$50 million (US\$6.4 million) – the minimum public float required. Twenty-four of the 57 GEM listings raised less than HK\$50 million (US\$6.4 million). The actual amounts of funds the new listings raised were even lower after deducting listing costs. After allowing for all expenses and any offers for sale, 30 raised less than HK\$30 million (US\$3.8 million) for the issuers.

⁷ All data referred to in paragraphs 2.3 to 2.7 are provided by the SFC.

⁸ We have excluded the nine investment companies that are not subject to any market capitalisation or public float requirement but in fact raised an average amount of HK\$84 million (US\$10.8 million).

2.5 Pre-IPO dividends paid out by some of the 60 Main Board new listings were high compared to the funds raised by listing and the profits earned during the track record period as stated in the prospectus. Twenty-one (excluding investment companies and Mainland State-owned enterprises⁹) paid dividends of over 100% of the company's profit in the year just before the IPO. In three cases the dividend exceeded the aggregate profits of the entire track record period. Eighteen paid out pre-IPO dividends that exceeded the net amounts of listing proceeds they ultimately received.

2.6 Most of the 117 new listings in 2002 generated little public investor interest. Excluding investment companies and listings by introduction, 53 listings had subscription rates of less than five times and 31 had subscription rates of less than two times. In fact, 19 of the offerings were barely covered at less than 1.2 times.

2.7 As at the end of February 2003, 23% of the 117 new listings have seen their share prices drop by over 50%. In three cases, the prices fell more than 90% within a couple of months of initial listing. Eight companies have seen their market capitalisations dropping to values less than the funds they received from listing within just a few months of listing (after discounting the proceeds from any offer for sale).

2.8 All of these facts raise questions about the commercial logic of many of the new listings. Some respondents have suggested that certain listings are carried out to provide a vehicle for manipulation. Others believe that listings are done to create a "shell" that can later be sold – which one reporter has dubbed "real listing, fake fund-raising". Still others observe that listings may be done for reasons of status, not merely personal status for the controlling shareholders, but also status of the kind which will enhance business prospects, add credibility to the company's reputation and facilitate additional financing opportunities, e.g. in the banking sector. It has also been suggested that in some cases, part of the funds "raised" in the listing actually originated from the controlling shareholders or their associates.

⁹ Mainland State-owned enterprises often undergo substantial re-organisations, with significant dividend distributions, before listing. Being part of the transition from state ownership and administration to corporate form and management, this is very different from the cases discussed here.

2.9 None of these suggestions enhances Hong Kong's reputation as an international financial centre.

2.10 The HKEx has also expressed concern about poor market quality. In the seventh issue of the "Exchange" published in January 2003¹⁰, the HKEx pointed out that "the existence of a significant number of poorly-performing companies is still a genuine problem, even if it were only a matter of perception". It suggested that "the starting point in preventing the accumulation of problematic companies is obviously the admission criteria in the Listing Rules." But it also pointed out that "the listing criteria of the Main Board are in fact set at rather high levels by comparison with most developed international markets." A comparison of the quantitative IPO requirements of the Main Boards of major financial markets is at Annex 4. The table is compiled based on the information published by the exchanges themselves. While it can be seen that the quantitative entry criteria set by the Stock Exchange of Hong Kong (SEHK) are in most respects comparable to those of the major exchanges, it is noted that the minimum requirement for a spread of shareholders is low in Hong Kong and as mentioned in our Executive Summary, we believe that this should be increased as a matter of urgency. The SEHK, like the major exchanges, such as the LSE in London, the NYSE in New York and the Tokyo Stock Exchange in Tokyo, has broad discretion and can apply qualitative criteria when considering listing applications. However, we are given to understand that such discretion has been rarely exercised in recent years.

2.11 If Hong Kong is to achieve its stated goal to be the premier capital formation centre of China and one of the top five equities markets in the world, these market quality issues must be addressed and improvements must be made urgently.

¹⁰ The journal is available at the HKEx's website at www.hkex.com.hk.

LISTING COMMITTEE

2.12 The PIPSI Report raised some important questions about the role, responsibilities and effectiveness of the Listing Committee (paragraphs 11.51 to 11.55). Many of the written submissions, meetings and individual interviews also commented on these matters.

2.13 In summary, these issues may be categorised as follows –

- (a) delegation of functions and powers from the HKEx Board to the Listing Committee and the Listing Committee in practice;
- (b) composition of the Listing Committee; and
- (c) part-time volunteers versus full-time professionals.

(a) Delegation of functions and powers from the HKEx Board to the Listing Committee and the Listing Committee in practice

2.14 As the PIPSI Report noted, the terms of reference of the Listing Committee clearly state that it shall exercise all the functions and powers of the Board in relation to all listing matters. The relevant extracts from the HKEx's Listing Rules concerning the Listing Committees of the Main Board and the GEM are at Annex 5. The necessary implication is that the Board has abdicated all responsibilities in this important area, and the Board is not even informed regarding either strategic or operational aspects of listing policy, in an endeavour to demonstrate a clear separation of business and regulatory responsibilities. This was clearly illustrated in the PIPSI Report (paragraph 11.47) where it was found that the Board had not been consulted on the contents of the Consultation Paper on Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Criteria and Cancellation of Listing Procedures.

2.15 We note however that the Listing Committee has in turn sub-delegated back to the Listing Division and the Chief Executive of the SEHK most of these powers and functions subject to review procedures (Rule 2A.02 of the Listing Rules). This inevitably raises questions as to the true substance of the separation of powers. We also note that the Chairman of the GEM Listing Committee, since its inception, has in fact been a member of the HKEx Board, raising further questions as to how real the separation can be.

2.16 Our inquiries have found a lack of clarity as to the real authority and accountability of the Listing Committee.

2.17 Firstly, with the exception of the Chief Executive of the HKEx, the Listing Committee consists of highly experienced but part-time volunteers. These volunteers are unpaid and in many cases view their involvement as public service in much the same way as many of them are involved in charitable or other public spirited activities. They are all busy professionals in their own right and cannot be expected to dedicate a high proportion of their time to Listing Committee matters. We will comment further on this in paragraphs 2.27 to 2.31 below.

2.18 Secondly, the Committee operates without its own support. So far as we can establish, all that has been delegated to it is the right and duty to make decisions, based on material it has not requested, and over which it has no control. It does not control or set its agenda. The detailed work is done by the Listing Division, but the Committee does not consider or approve the Division's budget, nor is it involved in discussions of organisational structure or recruiting or assessing the performance of staff. There is little evidence of a reporting relationship between the Listing Division and the Committee and in practice the former reports to HKEx executives. Some have told us that the Division views the Committee as a step in an internal process. In turn, the Committee may view itself as primarily a consultative body, to provide a check and balance function. It does not seem to consider itself fully responsible for the listing function, or accountable. It does not appear to be asked by the HKEx Board to account for its stewardship of its delegated responsibilities. Some members say that in practice it is not a committee at all but a panel from which a relatively small number of members are drawn for particular cases. Not surprisingly, this set of circumstances seems to have led to considerable frustration for many of those concerned.

2.19 Our findings also suggest that the Listing Committee is handicapped in a number of other ways –

- (a) Since only five of its 25 members are required for a quorum and the members have different skill sets and perspectives, decisions depend too much on the luck of the draw – who is available on the day. Such inconsistent decision-making is not best practice regulation. It has been suggested that the minimum number for a quorum be increased to perhaps eight to ten to provide better balance particularly on policy issues.

It has also been mentioned however that a low quorum may be the only practical solution because in contentious cases many members may not be able or indeed want to attend.

- (b) Decisions made by one group of members are not always circulated to absent members promptly – in some cases not until months later. Since decisions on cases that are appealed are not always circulated to other members promptly, this can lead to inconsistency and a lack of an accurate understanding of precedents.
- (c) Committee members work under considerable time constraints with voluminous papers being made available relatively shortly before meetings. The usual practice is that papers are delivered on Tuesday afternoon for meetings on Thursday, but of course, members all have jobs to do as well. We did hear examples of papers being delivered after the relevant meeting was held.
- (d) The Committee works to an agenda set by the Listing Division and in most cases enters the discussion quite late in the process – when lengthy discussions have already been held by staff with applicants and their representatives, and no doubt understandings reached. Hence, their effectiveness is limited. They have little ability to set their own agenda.

2.20 In summary, the separation of duties necessitated by the current listing regime has led to a flawed structure where accountability is not at all clear, where the valuable time of those willing to serve on the Listing Committee is not well used, and where the wealth of experience available on the HKEx Board and its other committees and panels is not utilised at all (other than through the Chief Executive of the HKEx, and on the GEM Listing Committee, one other director).

(b) Composition of the Listing Committee

2.21 There is criticism of the current structure of the Listing Committee. According to the Listing Rules (Rule 2A.17), the Listing Committee shall consist of 25 members made up in the following manner: the Chief Executive of the HKEx as an ex-officio member or in his absence, the Chief Executive of the SEHK, six exchange participants or directors of

exchange participants, six directors of listed issuers who are neither exchange participants nor officers or employees of exchange participants, and 12 individuals from the following five categories who are neither exchange participants nor officers or employees of exchange participants –

- (a) a director or partner of a fund management firm;
- (b) an officer or senior employee of a merchant bank;
- (c) a barrister or partner of a firm of solicitors;
- (d) a partner of an accounting firm; and
- (e) a person who is otherwise involved or experienced in the securities market and corporate finance matters or securities regulation.

A maximum of four members may come from any of the five categories.

2.22 Many have observed that the heavy weighting of brokers, listed companies, investment banks, lawyers and accountants make the Committee excessively issuer biased. In fact there is currently only one representative from the fund management industry on the Committee even though up to four are permitted. Many respondents suggested that the structure of the Committee needed substantial overhaul with much more investor representation. Some very senior practitioners have even suggested that half of the Committee should be investor based.

2.23 While we certainly sympathise with the thrust of these comments both in terms of cosmetics and in seeking broader perspectives, one practical constraint became apparent during our work. Hong Kong's community of financial intermediaries including brokers, investment bankers, financial advisers, accountants and lawyers is both well developed and deep. The pool of available experienced volunteers is quite large. Similarly there is a well-qualified pool of listed company directors who have many years of experience in Hong Kong.

2.24 In contrast, it is more difficult to find such a deep pool of very experienced international fund managers who are willing and able to dedicate significant time to regulatory oversight. Most fund managers are interested in only a tiny proportion of the new listings in Hong Kong which

in turn represents only a small part of their regional portfolios. A number told us that of last year's 117 issues they had interest in barely a handful. Additionally, some may feel a potential conflict of interests in sitting on the Listing Committee in that they are potential buyers of new listings and could become privy to inside information if involved in discussions of specific cases. There is no such conflict on policy or strategy issues however.

2.25 While there is broad support for more involvement by investors, it will not be easy to implement. Nor should such involvement, by the way, be restricted to the Listing Committee. A number of respondents suggested that the directors of the HKEx and SFC should include investor representatives – at present there are no investor representatives on either the HKEx Board or the Commission. We note that the SFC has included investor representation on its Advisory Committee and established its Shareholders Group which does include a number of institutional investors as well as prominent academics, commentators and professional advisers.

2.26 As to Hong Kong's retail investors, there is limited organised representation and that which does exist is focused quite understandably on investor education and protection, and the number of potential volunteers who can provide representative investor input may be limited. Nevertheless, for Hong Kong's financial markets to develop in a balanced manner, continuing efforts must be made to identify experienced people willing to provide investor representation.

(c) Part-time volunteers versus full-time professionals

2.27 We received considerable comments on this issue. To some, the days of the part-time volunteer are over and the listing decision-making function should be led by highly skilled, independent and experienced professionals. These regulators should be capable of setting strategy, establishing the suitability of companies for listing and deciding whether exemptions from rules are justified. They should also be capable of making decisions recognising commercial reality and balancing their dual roles of investor protection and market development. In this scenario, any part-time Listing Committee would become more of an advisory and appeal panel.

2.28 At the other extreme there are those who believe that the involvement and advice of experienced market practitioners is an essential complement to the rule-based operational style of the current Listing Division. Most commentary regarding the Listing Division begins with a recognition that the staff are hard-working, diligent and thorough but continues to say that turnover is high, experience levels are low, decision-making abilities are limited and the staff tend to operate in a bureaucratic “box-ticking” mode rather than exercising commercial judgement. Some have observed that even very minor issues are brought to the Listing Committee by the Division as an alternative to taking responsibility for their own decisions (a form of upward delegation).

2.29 While attracting and retaining skilled and experienced staff is an issue for most regulators around the world, in the current environment there should be opportunities to strengthen the senior levels of staff with market-experienced professionals. This in turn would help in the training and development of the younger staff and help streamline the listing function by focusing resources on issues of substance as well as detail.

2.30 We note that the HKEx in its submission has proposed a more active role for the Listing Committee as part of its efforts to improve the quality of new listings. This proposal suggests that the Committee should probe the substance of an applicant’s business, the rationale for its application and the relationship between the proposed listing vehicle and any private companies of the controlling shareholders. If the Committee finds any aspect of the application unconvincing, or does not receive satisfactory answers to its questions, it can refer the matter back to the applicant until it is satisfied.

2.31 While we welcome the recognition that these steps should be implemented, we feel that it is both impractical and unfair to expect a part-time body to fulfil this function. Rather, full-time professionals should be responsible and accountable for this work but be able to seek guidance from the Committee when required.

HKEX'S SEPARATE SUBSIDIARY PROPOSAL

2.32 The HKEx, in its various submissions, has recognised the perception problems which exist relating to its listing and enforcement responsibilities. In an attempt to address these concerns, the HKEx has proposed the formation of a subsidiary company to be known as the Hong Kong Listing Limited (HKL), to which the Board would formally delegate the HKEx's listing-related responsibilities both for listing approvals and on-going administration of the Listing Rules. The HKL's constitution would clearly specify its duties and make it clear that the quality and efficiency of listing regulation is the HKL's priority. The HKL's budget would be approved by the HKEx Board.

2.33 The Board of HKL would be known as the Exchange Listing Board (ELB) and would be appointed by the HKEx, using a nomination procedure similar to that of the present Listing Committee. The ELB would consist of non-executive, senior and experienced individuals from the market and may include several of the public interest directors of the HKEx Board. It would include investor representation and would be the decision-making body on all listing policy matters.

2.34 Underneath the ELB would be a new Listing Committee which would deal with individual listing applications and delisting proposals. Members would continue to be volunteers and would include more investors than currently. Panels of five to six members would be drawn, either by lot or rotation, to handle individual cases preserving practitioner input to the decision-making process. To maintain consistency and continuity, the Chairman or Deputy Chairman of the Committee would participate in all panels. Whether the panels would be advisory or decision-making is open to discussion. Either there would be a Listing Appeals Committee, as at present, or the ELB would act in this capacity.

2.35 The ELB would appoint an Advisory Committee, which would include members of the Listing Committee as well as others, to advise it on significant policy initiatives.

2.36 The HKEx considers that the above structure would fully address the lack of clarity regarding the powers and responsibilities of the current Listing Committee, would add weight to the listing function and

preserve market input to the decision-making process. It would also help in recruitment, strengthen the internal “Chinese Wall” between the listing function and the revenue-generating units, and should enable the SFC to feel comfortable in standing back to a greater extent and allowing the ELB to perform its functions. The HKEx also considers that it would clarify accountability which would rest clearly with the ELB except in relation to statutory enforcement which would continue to rest with the SFC.

2.37 We have considered this proposal in detail and have the following responses –

- (a) The proposal demonstrates the HKEx’s recognition of the existing problem and is to be welcomed.
- (b) Using a separate subsidiary leads to a clearer definition of regulatory responsibilities than the existing structure.
- (c) The proposed inclusion of more investor representation in the HKL’s Board and Committees is a positive initiative.
- (d) The proposal to have the Chairman or Deputy Chairman of the Listing Committee participate in all panels would help ensure consistency in decision-making.
- (e) The delegation of listing powers to several layers of part-time professionals would be extremely difficult in practice just as it has been with the existing Listing Committee.
- (f) The fact that the HKEx Board would approve the budget defines where ultimate control would reside.
- (g) The presence of HKEx Board representatives on the ELB, while adding their experience to the decision-making process, re-opens the debate about the true separation of roles.
- (h) There is no discussion of the executive management structure of the subsidiary and the role of the Chief Executive of the HKEx.

- (i) The proposal contains three layers of part-time volunteers: the ELB itself, the new Listing Committee and the Advisory Committee. The evidence received by us suggests that what is required is more full-time professional expertise to handle the listing function, not more part-time volunteers.
- (j) It is questionable whether such a structure would make it easier to recruit experienced professionals, who would prefer clear reporting lines and strong full-time leadership.

2.38 In summary, while the HKEx proposal contains many useful ideas, we are not convinced that the separate subsidiary proposal goes far enough to address existing concerns. The delegation of powers to part-time volunteers has proven difficult in the past and would continue to be problematic in the proposed structure. The perceived conflict of interests issue would not go away and the endeavour to upgrade the level of professionalism of the process would not necessarily be assisted. We cannot support the proposal.

REGULATION OF LISTED COMPANIES

2.39 The spate of corporate scandals involving Enron, World Com, Global Crossing, Tyco and others has highlighted some major problems of corporate disclosure and of corporate misgovernance in the US, and there have been many similar cases in other major markets. In Hong Kong, investors have not been immune to similar corporate misadventures, though on a lesser scale.

2.40 In October 2002, Euro-Asia Agricultural (Holdings) Company Limited announced that it had serious cash flow problems. This was followed by the resignation of its top management, financial advisers and auditors and the suspension of trading of its shares, and reports that its controlling shareholder was being held for investigation on the Mainland. It was reported that Euro-Asia's claim to have had turnover worth HK\$2 billion (RMB2.1 billion) in a three-year period prior to listing did not reconcile with the Mainland taxation authorities' record which showed a turnover figure of less than HK\$95 million (RMB100 million)¹¹.

2.41 In December 2002, some executive directors and executive staff of three companies listed on the Main Board (Yue Fung International Group Holding Limited, Gold Wo International Holdings Limited and Fu Cheong International Holdings Limited), together with a number of other people including an accountant, a financial consultant, a senior manager of an accounting firm, and a director and an owner of other companies, were arrested by the Independent Commission Against Corruption (ICAC) for alleged false accounting and bribery in relation to the listing of the three companies.

2.42 These incidents and others more recently have seriously shaken investors' confidence. The Euro-Asia case in particular has prompted market concern about the regulators' failure to detect false disclosure and the failure of intermediaries to exercise the necessary due diligence in the listing process. Market sentiment is that a critical review of the listing regime and the regulation of financial intermediaries is urgently needed.

¹¹ Caijing Magazine, 20 October 2002 issue.

2.43 Many market participants have told us that the existing listing regime and regulatory framework cannot prevent effectively the kind of corporate misconduct mentioned above from happening repeatedly. Some have pointed to the absence of a lead corporate regulator in Hong Kong while more have lamented the inadequacy of legal deterrence and enforcement against corporate malfeasance, particularly vis-à-vis Mainland based listed companies.

2.44 The principal regulatory roles regarding listed companies are presently split between the HKEx and SFC. There are also other government departments and enforcement agencies that are involved in regulating company activities. The Companies Registry is responsible for the incorporation and registration of companies and the enforcement of various ordinances such as the Companies Ordinance (Cap. 32), Limited Partnerships Ordinance (Cap. 37), Trustee Ordinance (Cap. 29), Registered Trustees Incorporation Ordinance (Cap. 306) and other miscellaneous incorporation ordinances. The Official Receiver's Office administers court insolvencies for both bankruptcies and the compulsory liquidation of companies under the Bankruptcy Ordinance (Cap. 6) and the Companies Ordinance respectively. The Commercial Crime Bureau of the Police (CCB) and ICAC deal with commercial crime and corruption cases involving listed companies respectively. In addition, the FS can launch investigations under section 142 or 143 of the Companies Ordinance.

2.45 In the current three-tier regulatory structure, the HKEx is the "front line" regulator and is solely responsible for the day-to-day administration of all listing-related matters and the supervision and regulation of listed companies through the making and enforcement of the Listing Rules. The Listing Rules are non-statutory and commitment to compliance is effected by means of the HKEx entering into listing agreements, which are commercial contracts, with the issuers. Non-compliance with the Listing Rules may attract sanctions such as private reprimand, public criticism, public censure, suspension of trading or cancellation of listing. These sanctions are however not considered effective by many who argue that reprimands and censures may not serve as sufficient deterrents if the financial gain from the wrongdoing outweighs the loss of reputation. Suspension of trading and delisting will mainly disadvantage the minority shareholders.

2.46 Some respondents felt that the HKEx lacked “teeth” to enforce the Listing Rules rigorously. The HKEx, being a commercial entity and not a statutory regulator, does not have statutory powers of investigation and compelling companies’ cooperation with its investigations. Nor could it impose statutory sanctions. Some said that it did not appear to have sufficient resources to monitor compliance with the Listing Rules at a level that was satisfactory to the market.

2.47 Under the Securities and Futures Commission Ordinance (SFCO) (Cap. 24), and under the new SFO, the SFC has some statutory investigative powers over listed companies and the abilities to bring summary prosecutions and launch unfair prejudice actions. The SFC also administers the Code on Takeovers and Mergers and the Code on Share Repurchases, and has a statutory function of supervising, monitoring and regulating the SEHK’s performance of the listing function. The SFC however devotes the majority of its resources to focus on intermediary licensing and supervision, investment product authorisation, market infrastructure and the enforcement of securities laws and regulations governing, for example, insider dealing, disclosure of interest in securities, etc., but not so much as a corporate regulator of listed companies.

2.48 At present, the SFC relies on sections 29A and 37A of the SFCO (preserved respectively in sections 179 and 214 of the SFO) to deal with misconduct of listed companies. Section 29A authorises the SFC to direct a company under inquiry to produce records and documents if there is suspected fraud, misfeasance, oppressive behaviour or other misconduct towards members of the company, e.g. not providing those members with all the information about the company’s affairs that they might reasonably expect. If, after investigation, the SFC establishes that the affairs of the company have been conducted in a manner unfairly prejudicial to the interests of members of the company, it may, after consultation with the FS, petition the Court under section 37A for an order to –

- (a) restrain the commission of the misconduct;
- (b) commence a derivative action in the name of the company;
- (c) appoint a receiver or manager of the company;
- (d) regulate the conduct of the company’s affairs in the future; or

- (e) compel the company or any of its shareholders to purchase the shares of the other shareholders.

The SFC may also petition the Court under section 45 of the SFCO for an order to wind up a company if the SFC establishes that it is expedient in the public interest to do so.

2.49 The above measures are in practice so extreme as to be of little practical value, and do not usually lead to action against the individual perpetrators. They entail direct intervention by the SFC in the operation of the companies concerned and, in the worst cases, the winding up of the companies. However, in such cases, the companies will have failed substantially. The measures are therefore not effective in the day-to-day regulation of listed companies.

2.50 Other than the Listing Rules administered by the HKEx and the powers conferred on the SFC under the SFCO (and the SFO), listed companies that are incorporated locally are also bound by the Companies Ordinance the greater part of which is administered and enforced by the Companies Registry. However, the Companies Registry has primarily confined its enforcement actions to filing and non-filing cases which are pursued as summary offences at magistrate courts, because of limitations on investigative capabilities and resource constraints. A real problem that is hampering the Companies Registry's work, which is so far as we know unique to Hong Kong, is that about 80% of the listed companies are incorporated elsewhere and are therefore not subject to the provisions of the Companies Ordinance. A significant proportion of these companies have their major business activities elsewhere, which means that their management and the bulk of their assets are located outside Hong Kong. This also affects the regulatory work of the HKEx and SFC as normally a market regulator can assume that the company whose stock is listed on its market is subject to its enforcement activity when necessary – that the company and its officers can normally be found within the legal jurisdiction where the regulator has authority to act. This is not the case for Hong Kong.

2.51 If the current trend continues, which it probably will given Hong Kong's stated objective to be the premier capital formation centre of China, there will be more and more Mainland companies listed in Hong Kong. The growing number of companies from the Mainland, where the legal and commercial infrastructures are still developing, has created new challenges for the regulators.

2.52 The Securities and Futures (Stock Market Listing) Rules made by the SFC under section 36(1) of the SFO, which will come into effect on 1 April 2003, represents a first step towards giving more “teeth” to the Listing Rules. Rule 3 of the said Rules requires, among other things, an application for the listing of any securities issued or to be issued to contain such particulars and information which is necessary to enable an investor to make an informed assessment of the activities, assets and liabilities and financial position of the applicant at the time of the application and its profits and losses and of the rights attaching to the securities. Rule 5 stipulates that an applicant shall file a copy of its application with the SFC after it has submitted its application to the HKEx. Rule 6 empowers the SFC to request further information from an applicant and to object to a listing of any securities. Rule 7 further stipulates that an issuer shall file with the SFC a copy of any announcement, statement, circular or other document made or issued. Together with section 384 of the SFO which makes it an offence for anybody to provide the SFC or HKEx with false or misleading information, the new dual-filing system will enable the SFC to take enforcement action against directors and others who file false or misleading corporate information.

2.53 However, even with the dual-filing requirement, the SFO still stops short of specifying the information that needs to be disclosed by listing applicants and listed issuers, nor does it deal with non-disclosure – failure to file a document in breach of a listing rule requirement, or omissions from a filed document, might not give rise to liability. There is also the worry that the new arrangement may further complicate the delineation of responsibility and accountability between the HKEx and SFC.

2.54 We shall set out our recommendations on how to improve the present situation in Chapter 3. We have taken into account the Corporate Governance Action Plan for 2003 (a copy is at Annex 6), formulated by the Government and other relevant parties to upgrade the quality of the equities market through efforts to bring the corporate governance of companies, in particular listed companies, in line with international standards, when drawing up our recommendations.

2.55 In passing, we should point out that concern has been expressed about the level of communication and cooperation among the three principal enforcement agencies – the SFC, CCB and ICAC. Our inquiries indicate that considerable progress has been made and that the working relationships among the three parties continue to improve. We have been told that the SFC and CCB have regular liaison meetings and joint training sessions, and arrangements have been made for the CCB’s inspectors to be seconded to the SFC.

LISTING RULES

2.56 The existing Listing Rules contain detailed requirements relating to, among other things, the following matters –

- (a) criteria for initial and continuing listing;
- (b) disclosure in listing documents;
- (c) disclosure in periodic reports by listed issuers;
- (d) disclosure of price sensitive or material events and information;
- (e) duties of directors and advisers of listed issuers;
- (f) trading by directors of a listed issuer in its securities;
- (g) certain categories of transactions of listed issuers, including, as defined in the Listing Rules, “notifiable transactions”, which, in turn, include connected transactions, discloseable transactions, major transactions, etc.; and
- (h) certain corporate activities of listed issuers, including secondary issues and placements, rights issues, and granting of share options.

2.57 We have heard strong arguments for providing statutory backing to the Listing Rules. But what does providing statutory backing mean? We interpret it to mean that with statutory backing, suspected breaches of the Listing Rules will be dealt with by a statutory regulator that has effective powers to investigate, including the power to compel compliance, and to impose meaningful sanctions. As a statutory regulator would have a wider range of sanctions than the HKEx on the listed companies and company directors as well as the intermediaries for proven breaches, the enforcement of the Listing Rules under such an arrangement will have more “teeth” than the existing arrangement where the HKEx makes and administers the Listing Rules the compliance with which by issuers are based on contractual listing agreements between the HKEx and the issuers.

2.58 Many of our respondents strongly support statutory backing on this basis. However, some are concerned that this could produce the consequence that the Listing Rules will be subject to vetting by the legislature and can be overturned. Application and administration of the Listing Rules will also become a legalistic process requiring strict rules of legal interpretation. On the other hand, Listing Rules that are not statutory or based on legal provisions are not subject to the same requirements and can therefore be made or amended more quickly and flexibly, but they have been widely regarded as less than effective because of the limited sanctions that can be imposed.

2.59 There is a need to strike a right balance between the desire to ensure effectiveness on the one hand and the desire to satisfy the market's need for speed and flexibility on the other. The same concern arises in other jurisdictions, and is addressed in different ways. But in no major market of which we are aware is it addressed by having the whole set of stock exchange listing rules replicated in the statute subject to legislative process. We do not support this approach.

2.60 The Securities and Futures (Stock Market Listing) Rules which provide for a dual-filing system are in fact a measure to provide some statutory backing for the Listing Rules. It is because the SFC will be able to impose sanctions provided in the SFO on listed companies and their controlling shareholders and directors in proven cases of providing false or misleading information. The issue to consider is whether the Listing Rules need more statutory backing than is provided for by the dual-filing system, and how this should be achieved.

2.61 We shall discuss how this issue could be addressed in Chapter 3.

REGULATION OF INTERMEDIARIES

2.62 The Euro-Asia case and others have prompted extensive discussion throughout the market and strong calls for tighter regulation of intermediaries especially in relation to sponsors of IPOs.

2.63 The SFC is responsible for regulating sponsors and other registered intermediaries. According to the Securities Ordinance (Cap. 333), a non-registered individual cannot deal in securities or act as an investment adviser, which includes handling IPO applications, and will be punished by the SFC if found to do so. The SFC has the power to reprimand, suspend or revoke the licences of those who fail in their duty. The GEM Listing Rules stipulate that sponsors have to register with the SFC as an investment adviser or a securities dealer, or must have been declared by the SFC to be an exempt dealer (Rule 6.13), and observe the Code of Conduct for Corporate Finance Advisers. However, unlike the GEM Listing Rules, the Main Board Listing Rules do not specify that a sponsor must be registered with the SFC.

2.64 Currently, the HKEx requires companies listed on the GEM to have a sponsor for its first two years of operation after being listed. Rule 6.03 of the GEM Listing Rules specifies the role of a sponsor as follows –

“The sponsor’s role is of particular importance to the successful operation of GEM, since it is the expectation of the Exchange that each issuer should, with the guidance and assistance of the sponsor, comply with and discharge its responsibilities under the GEM Listing Rules without having to rely unduly on the advice of the Exchange. In this regard, the sponsor is expected to advise the issuer on those responsibilities in a competent, professional and impartial manner, so providing reassurance to investors.”

2.65 The GEM Listing Rules also lay down the eligibility criteria for sponsors, including previous IPO experience and the engagement of a specified number of employees with sufficient relevant experience. The HKEx can refuse to deal with a sponsor who repeatedly attempts to bring

poor quality companies to the market. For Main Board listings, the Main Board Listing Rules only mention that “the sponsor has a particular responsibility to satisfy himself, on all available information, that the issuer is suitable to be listed” (Rule 3.04). While sponsors are to observe the guidelines set out in the model code for sponsors issued by the HKEx, there are no specific eligibility criteria for sponsors nor is there any prescribed punishment for non-performing sponsors. This difference in eligibility criteria between the two trading boards means that a sponsor who is not qualified to handle GEM listing applications can do IPO listings on the Main Board. In our view, the Main Board, with higher entry requirements on capitalisation, track record, etc., should require greater due diligence on the part of IPO sponsors whose role is crucial to ensuring that issuers fully comply with the listing requirements. We therefore see no valid reasons why the eligibility criteria for sponsors for the Main Board should be less stringent than those of the GEM, which is supposed to have higher risks and is designed for professional and informed investors.

2.66 We have been told that it was often difficult to prove whether the sponsor or the management of the company should be held responsible for the provision of false information in a listing document. This situation has not been helped by the fact that even though the SFC is responsible for the registration and regulation of sponsors, it is the HKEx, instead of the SFC, that has more direct working contacts with the individual sponsors as the front line regulator. This appears to be a fundamentally unsatisfactory arrangement.

2.67 The SFO will tighten the regulation of intermediaries, including sponsors, by requiring each intermediary to nominate at least two responsible officers who participate in or are responsible for directly supervising the business of the regulated activity for which the intermediary is licensed. In addition to existing sanctions, the SFC will be empowered to impose civil fines, the maximum of which will be the higher of \$10 million or three times the amount of the profit gained or loss avoided, for proven misconduct.

2.68 Strengthening the regulation of intermediaries dealing with IPOs will help to ensure that listing applicants comply with the listing requirements, and hopefully help to improve the quality of the securities market. The Government, SFC, HKEx and the intermediaries themselves have over the past few months put forward various proposals

in this area. The HKEx has proposed to consult the market on amendments to the Listing Rules to tighten the regulation of IPO intermediaries, in particular sponsors and financial advisers. The SFC has made proposals to the Standing Committee on Company Law Reform on amendments to the Companies Ordinance to extend the prospectus-related liability to IPO sponsors and possibly other IPO intermediaries, for ensuring quality disclosure to investors. These initiatives are parts of the Corporate Governance Action Plan for 2003 mentioned in paragraph 2.54. Separately, the Hong Kong Society of Accountants has undertaken to strengthen the regulation of their profession, by reforming the process of investigating complaints concerning accountants. We welcome and support these initiatives.

COMMUNICATION AMONG THE THREE TIERS OF THE REGULATORY STRUCTURE

2.69 Our terms of reference require us to look at the lines of communication among the Government, SFC and HKEx. The PIPSI Report (paragraph 4.15) identified four major fora for the Government to communicate and discuss matters of common concern with the SFC and HKEx –

(a) Regular meetings between FS, Chairman of SFC and Secretary for Financial Services and the Treasury (SFST)

These meetings take place about nine times a year, to discuss major developments in the financial markets and to keep the FS posted on the general direction of major market reform initiatives.

(b) Securities and Futures Liaison Meeting

This is a monthly liaison meeting between the Financial Services and the Treasury Bureau (FSTB) and SFC dealing with the latter's housekeeping matters.

(c) Tripartite Meeting

This is a bi-monthly liaison meeting between the FSTB, SFC and HKEx to facilitate general monitoring of issues affecting the development of the securities and futures markets, and communication between the SFC and HKEx.

(d) Coordination Committee

This is another tripartite forum involving the FSTB, SFC and HKEx, that is convened either bi-monthly or quarterly, to identify, discuss and resolve regulatory and policy issues to facilitate the HKEx's implementation of its strategic plan, also referred to as "the McKinsey Report".

2.70 The PIPSI Report also mentioned the **Financial Market Development Task Force** and the **Financial Stability Committee** (paragraph 4.16). The Financial Market Development Task Force is chaired by the SFST and comprises the Chief Executive of the Hong Kong Monetary Authority (HKMA), the Chairman of the SFC, the Commissioner of Insurance, the Director-General of Investment Promotion and the Managing Director of the Mandatory Provident Fund Schemes Authority. It meets once every three months to identify and coordinate, where necessary, new initiatives in promoting the development of the financial markets, with a view to maintaining the status of Hong Kong as an international financial centre. **Five working groups** have been set up under the Task Force to work on the following five specific areas: banking (chaired by the HKMA), debt market (chaired by the FSTB), securities and futures markets (chaired by the SFC), insurance (chaired by the Commissioner of Insurance) and fund management (chaired by the HKMA). These working groups meet as needed. The Financial Stability Committee is chaired by the SFST with the Chairman of the SFC, the Chief Executive of the HKMA and the Permanent Secretary for Financial Services and the Treasury (Financial Services) as members. It meets about once a month and monitors on a regular basis the functioning of the financial markets (including the money, foreign exchange and securities markets) and deliberates on events, issues and developments with possible cross-market and systemic implications, and where appropriate, formulates and coordinates responses.

2.71 In addition to the above fora that were mentioned in the PIPSI Report, we note that there is also a **Risk Management Committee** set up by the HKEx under section 9 of the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555) to formulate policies on risk management matters relating to the HKEx's activities for the HKEx Board's consideration. The Committee is chaired by the Chairman of the HKEx and consists of seven other members of whom five are appointed by the FS (including two non-executive Public Interest Directors, the Chairman of the SFC, the Chief Executive of the HKMA and an outside professional) and two by the HKEx (of whom at least one is a member of the HKEx Board and not the Chief Executive of the HKEx).

2.72 We mention in passing that the presence of the Chairman of the SFC and the Chief Executive of the HKMA on the Risk Management Committee of a listed company seems inappropriate. To the extent that issues relating to financial stability or systemic risk may arise which

require the participation of the HKEx, such issues ought to be discussed by the Financial Stability Committee, co-opting the HKEx. The Risk Management Committee of the HKEx should then be left to perform the conventional functions of a risk management committee of a listed company.

2.73 At the operational level, the Corporate Finance Division of the SFC and the Listing Division of the SEHK meet every month at what is known as the **SEHK-SFC (Listing) Liaison Committee Meetings**, to discuss –

- (a) any matters arising out of the monthly report on the activities of the SEHK in relation to its listing responsibilities;
- (b) matters relating to the regulation of listed companies, and oversight of the SEHK by the SFC in relation to listing-related matters; and
- (c) any policy or other matters, including proposed rule changes, relating to any of the listing functions and responsibilities of the SEHK or the SFC.

Apart from these regular meetings, the staff of the Corporate Finance Division and the Listing Division are in frequent contact over the telephone and through exchanges of letters and e-mails.

2.74 Most recently a **High Level Group** has been set up to discuss the regulation of listed companies. Its membership includes the Chairman of the SFC, the Chairman of the HKEx, the Chief Executive of the HKEx, the Chairman of the Main Board Listing Committee, the Chairman of the GEM Listing Committee, the Chairman of the Panel on Takeovers and Mergers, the Executive Vice President of the HKEx's Listing, Regulation and Risk Management Unit, and the Executive Director of the SFC's Corporate Finance Division. The High Level Group held its first meeting on 9 December 2002.

2.75 The preceding paragraphs demonstrate an abundance of communication channels among the three tiers of the regulatory structure. However, from what we have gathered, despite the elaborate liaison network that has been put in place, actual communication does not seem to work satisfactorily, as pointed out by the PIPSI Report. There is a strong feeling among market participants that the three parties often send confusing, if not conflicting, messages to the market.

2.76 We learnt in addition from some that the atmosphere at the Listing Liaison Committee Meetings has not always been cordial and tension could be high when the Corporate Finance Division commented unfavourably on the Listing Division's work. We realise that some tension is inherent in a regulatory relationship and thus inevitable. So long as the HKEx is performing a regulatory function, i.e. as the front line regulator of all listing-related matters and issuers listed on its markets, it would have to be subject to the SFC's oversight. And as a for-profit listed public company, the HKEx might feel the SFC's regulatory supervision excessive and intrusive at times. The implementation of the dual-filing system which will give rise to some degree of overlap of duties between the SFC and HKEx in respect of listing matters may further complicate the situation.

2.77 We believe that a clear translation of the Government's policy objectives into unambiguous missions of the SFC and HKEx, especially the role of the listing authority regarding the promotion of market quality, and a re-ordering of responsibilities for listing as we recommend, should help to change things for the better. When each party is aware of and accepts its role and responsibilities in the regulatory regime, there should be less need for clarification and negotiation, and still lesser need for intervention and possible friction. Frank discussion and close cooperation would then follow. In due course, the communication channels should be streamlined when mutual understanding and cooperation are at such a level to require less fora and lower frequency for meetings. A greater reliance on ad hoc meetings and setting sunset dates for all new groups (and perhaps some of the existing ones) will impose greater discipline on all concerned, by establishing a requirement to review the usefulness of the continued existence of such fora.