

CHAPTER 3

RECOMMENDATIONS

3.1 In this chapter we set out our proposal in more detail and explain the reasoning behind the concepts. We also discuss the various arguments which have been raised against a significant reform of the listing regime and our response to them. In the next chapter, we discuss some implementation issues, including transitional arrangements, etc.

PROPOSED NEW LISTING AUTHORITY AND LISTING PANEL WITHIN THE SFC

Listing Authority

3.2 We recommend that the listing function should be taken out of the HKEx. The listing function, including the processing of listing applications and the making and administering of rules on listing-related matters, should be performed by a new Hong Kong Listing Authority (HKLA) to be established within the SFC.

3.3 The HKLA should be staffed by highly skilled, full-time professionals who are market experienced and able to exercise proper discretion to process listing applications in pursuance with Hong Kong's objective to be the premier capital formation centre of China and one of the top five equities markets in the world. They should be capable of setting strategies, establishing the suitability of companies for listing in accordance with the Listing Rules, and exercising discretion on whether exemptions from the Rules are justified. The HKLA should look in the first instance to recruit from the staff of the HKEx's Listing Division, many of whom should possess the qualifications and abilities expected of the new HKLA executives. The HKLA should also recruit from outside, both locally and overseas, professionals who can help raise the level of expertise and bring greater credibility. In order to do this, the compensation packages offered will have to be sufficiently attractive. We recognise the importance and the sensitivity of the staff issue, and shall discuss the matter further in Chapter 4.

3.4 The HKLA should be headed by a strong leader who is familiar with the operation of the financial markets and widely respected by people in the industry. He or she should have a clear vision of the roles and functions of the HKLA in the listing regime.

3.5 We further recommend that the HKLA head should be an Executive Director of the Commission to provide a vital link between this important operational unit and the highest decision-making body of the SFC, to report to the Commission on the work of the HKLA, to seek policy guidance and to secure the necessary resources from the Commission for the HKLA to perform its listing function effectively and efficiently.

3.6 The HKLA should be a separate functional unit within the SFC with its own cost-recovery based budget, but should work closely with the other units of the SFC to share information and cooperate in enforcement actions.

3.7 The SFC may make rules under the SFO to provide for the establishment of the HKLA and prescribe its composition, terms of reference and modus operandi. It is however clear that the SFO was formulated on the basis that the status quo with respect to the listing regime, i.e. the HKEx being the front line regulator of listing matters and listed companies, and responsible for making and administering the Listing Rules, was to continue.

3.8 Although the SFO provides sufficient leeway for our recommendations on the transfer of the listing function to be implemented without its amendment, the Government may wish to consider amending the SFO in due course, so that the legislative framework will match the new administrative reality.

Listing Panel

3.9 Decisions of the HKLA should be subject to appeal to a Listing Panel to be set up under section 8 of the SFO, whose status should be similar to that of the Takeovers and Mergers Panel. The Panel should comprise 18 to 20 members appointed by the SFC from the following groups: the HKEx, exchange participants, issuers, investors, brokers, investment fund firms, banks and other market intermediaries such as lawyers and accountants. The quorum for each Panel meeting should be one third of the total number of members, as a larger quorum may be

difficult to achieve given that the Panel members would all have busy schedules and various demands on their time, and that some may not be able to attend meetings to discuss contentious cases in which they may have an interest.

3.10 We have considered suggesting a specific number of representatives from each stakeholder group but have decided against it, having regard to the difficulty in identifying the right personalities in certain sectors who are both qualified and willing to render their service. This is particularly relevant for investor representation. Consideration should thus be given to inviting members of the SFC's Shareholders Group to serve on the Panel. We would stress that the different stakeholder groups should be as evenly represented as possible to ensure that no one group can dominate. We believe a total of 18 to 20 members should allow reasonable representation of each stakeholder group. Each Panel member should normally be appointed on a two-year term and should not serve more than four years to prevent any one member from having direct influence on the listing process for too long a period, except when considered necessary to maintain continuity or when no appropriate replacement can be found. Panel members should be replaced in phases to provide for continuity. We are of the view that terms shorter than two years do not allow members to familiarise themselves with the operation of the Panel and function effectively before their tenure is over.

3.11 The Chairman of the Panel should be a respected member of the industry with unquestionable integrity, and should be prepared to make major contributions in terms of personal expertise and time to lead the Panel to face the many challenges ahead. He or she should not be a Director of the Commission to avoid any perception that the Commission has too much direct influence or control over the Panel. The Chairman and members of the Panel are to be appointed by the SFC in their personal capacity. They should perform their functions independently of the Commission and should tender their advice without fear or favour and in the overall interest of the Hong Kong market.

3.12 Apart from adjudicating on appeals against decisions of the HKLA, the Panel should function as an advisory body providing guidance on listing strategies in the overall context of market development and changes to the Listing Rules to achieve the desired effects. It should be responsible for oversight of both the Main Board and GEM markets. It should also be a proactive group in terms of consultation on new proposals and be included by the HKLA in such discussions as early as possible.

3.13 The HKLA should provide sufficient support to the Panel, which should include general secretariat support for Panel meetings such as preparation of agendas, papers and minutes, as well as research and analysis work. We are aware that this will require considerable resource allocation. But if we want the listing function discharged effectively, this is in our opinion necessary to enable the Panel to successfully perform the role it is given.

3.14 We are mindful of the possible conflict that may arise if the same pool of executives who are responsible for making decisions on listing applications, also provide secretariat support to the Panel which reviews the decisions made by the executives themselves. But we believe that this possible conflict should not be too serious as the Panel's decisions are made by Panel members who are all coming from non-SFC stakeholder groups, **not** the SFC executives. We also think that the Panel, being an advisory and appeal body, may not need to meet frequently and the entailed workload would probably not justify the setting up of a full-time dedicated team to provide support. However, the Government may wish to consider this issue more thoroughly.

3.15 To allow sufficient time for the HKLA executives to build up credibility and hence the market's confidence in their ability to do the job professionally, we recommend that, as a transitional arrangement, during the first 18 months of its inception, the present Listing Committee members supplemented by several investor representatives, should constitute the Panel, and the Panel should be the ultimate authority to approve or reject listing applications, in addition to performing the functions mentioned in paragraph 3.12. A transitional period of 18 months should be sufficient to allow the HKLA to demonstrate its ability to balance regulation and market development in its work. A longer transitional period would not be acceptable as we believe that the market is in urgent need of the changes recommended.

3.16 During the transitional period, the Panel will therefore operate rather like the existing Listing Committees, convening meetings once every week, and the secretariat should provide members with papers for discussion before a prescribed deadline – we suggest, two clear days. Papers that fail to reach members before the deadline should not be considered except in special circumstances and with the Chairman's agreement. The secretariat should assist members to obtain additional information and if necessary research into specific issues to facilitate members' consideration of each case.

3.17 At the end of the transitional period, the Panel should become an advisory and appeal body as suggested in paragraph 3.12. It should then meet less frequently and members can focus more on providing guidance on listing policy and strategies, and adjudicating on appeal cases.

3.18 Parties who are not satisfied with the decisions of the Panel can seek judicial review. During the transitional period, as discussed in paragraphs 3.15 and 3.16, the Panel should adjudicate on appeals in the same manner as that adopted by the existing Listing Committees. However, we recommend that when reviewing a decision, members of the Appeal Panel should be provided with the reasons for the decision and relevant precedents to facilitate their consideration of the case.

ARGUMENTS AGAINST MOVING THE LISTING FUNCTION TO THE SFC

3.19 Within the few submissions and respondents in favour of leaving the listing function with the HKEx there have been some consistent reasons and concerns expressed. These could be categorised as follows –

- (a) The SFC as a regulator would be risk-averse to the extent of inhibiting market development.
- (b) The SFC would be bureaucratic and distant from the market.
- (c) The inability of the HKEx to offer “one-stop shopping”, particularly in the Mainland, would leave it at a commercial disadvantage to other exchanges in an increasingly competitive operating environment.
- (d) The SFC would not be effective as a marketing organisation.
- (e) The concentration of responsibilities at the SFC would create an unduly powerful entity with unprecedented powers.
- (f) Moving the listing function to the SFC would entail the Listing Rules becoming subsidiary legislation subject to legalistic administration.
- (g) Transferring the listing function to the SFC represents a significant departure from the HKEx’s listing document.

3.20 We discuss each of these in turn.

(a) The SFC as a regulator would be risk-averse

3.21 The proponents of this argument would say that any listing authority run by full-time regulators would be unduly risk-averse, legalistic and more intent upon preventing potential problems than market development.

3.22 Our response to this is several fold. Firstly, while this is a logical and fair concern, we believe it is one which can be managed by setting clear goals. It must be clearly articulated that the objective of the HKLA includes achieving Hong Kong's strategic goal for its financial markets, and that the leadership of the HKLA is fully accountable for **both** investor protection and market development and that they will be evaluated and rewarded accordingly. The new SFO largely achieves this already. It includes a specific provision which states that the SFC has the regulatory objective to, inter alia, maintain and promote the efficiency and competitiveness of the securities and futures industry.

3.23 Secondly, it is our view that it is people, and in particular leadership, that define the culture of an entity such as the HKLA. As such, we feel that it is important that the HKLA should be led by a very experienced, independently minded and widely respected individual with many years of experience as a market practitioner. In addition to the leader, there must be sufficient senior staff with the necessary experience to plan strategy and implement the process without undue dependence on the Listing Panel.

3.24 Finally, we would point to international comparisons such as New York, London and indeed the Mainland where a central regulator has not inhibited market development.

(b) The SFC would be bureaucratic and distant from the market

3.25 We received a variety of views on this subject. Some practitioners found the HKEx itself to be excessively bureaucratic and not sufficiently market sensitive. There were certainly those who felt that the SFC was not necessarily more distant from the market and (perhaps because of their intermediary supervision role) the SFC could appear in some respects to be closer to the market than the HKEx. Still others noted a higher degree of responsiveness and professionalism in their dealings with the SFC.

3.26 This is not to say that all input about the SFC was positive, but we are not persuaded that the SFC is noticeably more bureaucratic and distant from the market than the HKEx.

3.27 In any event we are satisfied that with the right system of accountability and leadership structure, concerns about bureaucracy and market awareness can be alleviated.

(c) The inability of the HKEx to offer “one-stop shopping”, particularly in the Mainland, would leave it at a commercial disadvantage to other exchanges in an increasingly competitive operating environment

3.28 There is no doubt that the Mainland has become the focus of attention for exchanges around the world. Not only global leading markets such as the NYSE, Nasdaq and LSE are increasing their marketing efforts but exchanges from Singapore, Australia, Tokyo, Frankfurt and others are also promoting their services.

3.29 Hong Kong has maintained its strong competitive position to date due to its early efforts in developing the H share market and has become the natural home for the bulk of Mainland companies seeking international listings.

3.30 The HKEx considers that its control of the listing function gives it a significant competitive advantage by allowing it to offer “one-stop shopping” for Mainland enterprises. While we can understand the commercial attraction of such an arrangement, it does demonstrate all too clearly the potential conflict of interests issue discussed elsewhere in this report - the temptation to offer regulatory concessions to attract listings. Furthermore, we note that the leading exchanges from both New York and London compete quite effectively without such total control of their “product”, and leading Mainland companies should not and do not appear to have difficulty in coping with a statutory regulator.

3.31 Finally, our judgement is that many of the smaller Mainland companies which have listed in Hong Kong would have been of limited interest to leading global exchanges. Their interest, and that of international sponsors, is in the larger issuers such that many of the recent Hong Kong listings would not have been prime targets for listing elsewhere.

(d) The SFC would not be effective as a marketing organisation

3.32 This concern is, in our opinion, misplaced. It is not the role of any regulator to market actively to potential issuers. If the listing function moves to the SFC, it would still be the role and responsibility of the HKEx to promote its services and its trading platforms. In the same context, as far as we are aware, neither the SEC nor the FSA is involved in direct marketing in the Mainland. Rather it is the market operators such as the

NYSE, Nasdaq and LSE that are responsible for market promotion, not to mention the efforts of the investment banking community and other intermediaries. There is no reason however why the SFC should not visit the Mainland and other places from time to time to add credibility to the HKEx's marketing efforts. Demonstrating that Hong Kong has a world-class regulatory structure and listing regime should be one of the objectives of the SFC and delivering this message to potential listing candidates as well as investors should be one of its responsibilities.

(e) The concentration of responsibilities at the SFC would create an unduly powerful entity with unprecedented powers

3.33 This is an understandable concern, expressed mostly by the small broker community and some smaller listed companies. We note that there is in the current system an effective set of external checks and balances on the SFC's use of its powers. The Non-executive Directors of the SFC oversee its work on a regular basis and act as the first line of independent supervision. Then there is the Securities and Futures Appeals Panel (SFAP) which hears appeals against decisions made by the SFC relating to the registration, regulation and discipline of intermediaries. The SFAP will be replaced by the Securities and Futures Appeals Tribunal (SFAT) which will commence operation upon the coming into effect of the SFO on 1 April 2003. The SFAT will be independent of the SFC and headed by a judge assisted by two lay members with relevant experience. It will have the jurisdiction to review the SFC's decision on the full merits of the case, and the power to affirm, vary or substitute the decision. Parties affected by an SFC decision can also seek judicial review and those dissatisfied with the way the SFC has handled any particular matter can complain to the Ombudsman. There is also the Process Review Panel, set up in November 2000, to review the internal operational procedures of the SFC and to determine whether it has followed its internal procedures, including procedures for ensuring consistency and fairness. The SFC is also subject to the scrutiny of the ICAC.

3.34 We have not seen any evidence to indicate that such checks and balances are inadequate, and feel that the benefits gained by the transfer of the listing function more than outweigh any risk associated with the SFC having more powers as a statutory regulator. If the listing function is transferred to the SFC as we recommend, parties aggrieved by the HKLA's decisions on listing matters can appeal to the Listing Panel, and have further recourse by means of judicial review.

(f) Moving the listing function to the SFC would entail the Listing Rules becoming subsidiary legislation subject to legalistic administration

3.35 Concern was expressed by several parties that making the Listing Rules statutory would render it more difficult to amend the Rules to take account of new investor protection requirements and new financial products. The operation and interpretation of statutory rules were also suggested to be legalistic and likely to generate recourse to the courts, which in turn would reduce the efficiency of Hong Kong's capital formation system. This issue is discussed in detail elsewhere in this report but we emphasise several points here.

3.36 While the SFC is indeed a statutory regulator, it does not follow that the Listing Rules once administered directly by the SFC will necessarily become subsidiary legislation. The SFC already administers non-statutory codes. Some of these codes, such as the Code of Conduct for Persons Registered with the SFC, are detailed guidelines on how the SFC would interpret and apply the statutory requirements as set out in the SFO. Others such as the Codes on Takeovers and Mergers and Share Repurchases represent a consensus of opinion of market participants and the SFC. These non-statutory Codes are administered by the SFC which has the statutory powers to conduct investigations and gather evidence in cases of suspected violations.

3.37 While we agree that non-statutory rules could provide the flexibility for future amendments to align with market development, we strongly believe that the Listing Rules should have statutory backing in order to be an effective regulatory tool. We shall discuss this further in paragraphs 3.44 to 3.48 below.

(g) Transferring the listing function to the SFC represents a significant departure from the HKEx's listing document

3.38 This issue was raised in the context that the comparatively recent listing of the HKEx was on the stated basis of the present regulatory arrangements, and that any change could expose those responsible for the floatation to some legal liability to investors. We are satisfied this is not a real concern, for the following reasons.

3.39 The HKEx was listed on the Main Board by way of introduction, **not** a public offering. The listing document that was distributed to the public was not registered as a listing prospectus with the Companies Registry and would therefore not attract prospectus liability. We recognise that that does not exclude, in theory, common law liability, but as will be seen, that does not arise either.

3.40 Even if the document were argued to be a listing prospectus subject to the provisions of the Companies Ordinance, references to the HKEx's performing the listing function were true and not misleading at the time. No liability should arise from a change of that position now. Any reference made to the existing provision could not have been a representation that there would never be a change of circumstances. This is certainly the view of the institutional investors we have spoken to.

3.41 But there was no such representation on the subject at all. Therefore no investor is likely to be able to argue successfully that they invested on the basis of a representation which has been abandoned, since that representation was never made.

3.42 We are proposing that the HKEx retains the surplus from its listing fees, and that the new HKLA be funded on a cost-recovery basis. We shall discuss this further later in this chapter and in Chapter 4. Arguably (although we do not give investment advice or valuations) the HKEx may be better off, since their management will no longer be distracted by regulatory work and will be free to concentrate on their commercial activities.

3.43 On a related matter, there may also be a concern that the Government may have some responsibility arising from historical statements concerning the administration of the listing regime. We have taken legal advice and are advised that it is improbable that the statements give rise to a substantive legitimate expectation that the Government would not change its policy. The advice notes that the courts have recognised that the Government must remain free to change its policy in the public interest.

LISTING RULES

3.44 We strongly recommend that the Listing Rules should have statutory backing in the sense described in paragraph 2.57 of Chapter 2 and should continue not to be subject to legislative vetting. We also recommend that the HKLA, if our proposal is adopted, should be responsible for making and administering the Listing Rules.

3.45 How the Listing Rules can be given the necessary statutory backing requires careful legal analysis by the Government and other relevant parties. We shall nonetheless discuss some possibilities below.

3.46 One option is to have the SFC make subsidiary legislation under the SFO, linking the Listing Rules to certain general requirements which are sufficiently important for investor protection to be set out in the law, but without turning the Rules themselves into subsidiary legislation. For example, the new subsidiary legislation could require full, accurate and timely disclosure of information **to the satisfaction of the HKLA**, and what would satisfy the HKLA would be set out in the Listing Rules. Specifically, to address one limitation of the dual-filing system as discussed in paragraph 2.53, non-disclosure could become an offence carrying statutory sanctions. The Listing Rules will become a kind of code of practice enforced by the HKLA of the SFC, a statutory regulator. The code itself would be non-statutory, but represent detailed guidance on how the relevant statutory requirements are to be interpreted and complied with. Since the Listing Rules are linked to some statutory requirements and administered by a statutory regulator, there can be a wide range of sanctions on the listed companies and company directors as well as the intermediaries of proven breaches. This arrangement would preserve the non-legislative status, and hence the flexibility, of the Listing Rules.

3.47 Another alternative is to give the Listing Rules the same status as that of the codes and guidelines that the SFC may publish under section 399 of the SFO, upon the transfer of the listing function from the HKEx to the HKLA. This will allow the Listing Rules to remain non-statutory so that they can be changed promptly by the HKLA to respond quickly to market requirements. The HKLA as a statutory regulator will have statutory powers of investigation and obtaining evidence under the SFO in dealing with suspected breaches of the Listing

Rules, and will have access to the array of sanctions in the SFO to punish offenders, which will greatly improve the regulatory regime's effectiveness and credibility. The range of sanctions available for breaches under this option may be more restricted than would be desirable and the limitation of the dual-filing system referred to earlier will remain unaddressed, but it has the advantage of being available immediately.

3.48 The above possibilities will provide statutory backing to the Listing Rules to be made and administered by the HKLA without amending the primary legislation. A further option is to set out the general requirements described in paragraph 3.46 in the primary legislation, i.e. the SFO. It will be a more elaborate legislative exercise that would achieve the same effect as the option described in paragraph 3.46. It may however be desirable in the long term to place the listing requirements in question in the primary legislation to reflect their importance.

3.49 Regardless of which approach the Government adopts to give the Listing Rules the kind of statutory backing that we support, we recommend that the HKLA should in future seek market views and consult the Listing Panel before making changes to the Listing Rules, so that market inputs are properly considered in the process. We understand that the HKEx has adopted different approaches in consulting the market publicly on proposals to make or amend the Listing Rules, depending on the importance of the proposals. For significant changes, the HKEx would issue consultation papers to solicit views on its proposals. For less important amendments, it would publish a paid advertisement in the press to invite comments. For insignificant changes, such as drafting changes, clarifications or administrative matters, it would simply inform the market of the changes to be made by placing paid advertisements in the press. The HKLA should consider adopting similar arrangements. In cases where a decision is made not to consult the market, the HKLA should explain in its announcement the reasons for not doing so. The Listing Panel should nonetheless be consulted in all cases to draw on its expertise.

3.50 We further recommend that while the HKLA should be responsible for the making and administration of the Listing Rules, the HKEx should be allowed to set its own entry and exit criteria and conduct codes or rules with regard to the trading of securities that have been approved for listing by the HKLA on the stock exchange. This will enable the HKEx to define its "brand image".

LISTING FEES

3.51 We recommend that the HKLA should levy fees for processing initial listing applications and for granting continuing listing status, as the HKEx presently does. The fees levied should be set at levels that can cover all the costs of the HKLA performing the listing function, i.e. on a cost-recovery basis, and having regard to the levels of fees imposed by exchanges outside Hong Kong. The rates of fees should be set out in the Listing Rules and the basis for the calculations should be explained to the market as clearly as possible.

3.52 The HKEx should continue to be allowed to impose fees for listed securities to trade on the stock exchange, i.e. for access to its trading platform as a commercial service. The HKEx should propose an appropriate rate for the SFC's consideration and approval. While the fees to be charged by the HKEx should in due course be determined principally by commercial considerations such as competitive forces, in the short term, the HKEx should be expected to pass on to issuers the benefit it will receive from the significant reduction in its cost base as a result of the transfer of the bulk of the Listing Division to the HKLA.

3.53 To minimise impact on the market, the total of the listing fees levied by the HKLA and the fees charged by the HKEx should as far as possible not exceed the listing fees currently charged by the HKEx. We are mindful however that if the SFC is to improve on the regulation of listed companies, it may need to expend more on its new regulatory function. The setting of the fee levels would therefore require careful consideration.

3.54 We believe that the above arrangement is a fair one and would have the least adverse impact on the HKEx as a for-profit commercial entity and to its shareholders, and would at the same time allow the SFC to ensure that the fees charged by the HKEx, which has been given the right to operate the only stock market in Hong Kong, are reasonable and conducive to maintaining the competitive edge of the Hong Kong market.

REGULATION OF INTERMEDIARIES

3.55 We recommend further strengthening the regulation of intermediaries, especially sponsors given the importance of their role in ensuring the quality of listings. Enforcement should be strengthened to ensure that those who are not discharging their responsibilities properly are adequately and swiftly sanctioned. The SFC's new power under the SFO to impose fines on intermediaries guilty of misconduct should provide the Commission with added "teeth" in its enforcement efforts. As mentioned in Chapter 2, the Government, SFC, HKEx and some intermediaries have recently put forward proposals in this area. We support these initiatives and would urge relevant parties to carefully study these proposals so that improvement measures can be implemented at an early date.

3.56 Our proposal to move the listing function to the HKLA within the SFC, if adopted, will enable the SFC, which is responsible for the regulation of intermediaries, to have closer contact with sponsors and thus better monitoring of their performance. It will also clarify accountability as there will be no split regulation and the SFC will be the sole regulator of intermediaries. Enforcement efforts will be swifter and more effective as the SFC will not have to rely on the HKEx for information or wait for referrals or reports from the latter. There will also be synergies within the SFC as its various regulatory functions can complement and support one another.

3.57 We have mentioned in Chapter 2 that currently the Main Board Listing Rules contain less stringent requirements for sponsors than the GEM Listing Rules. We recommend that the SFC should consider providing in the Main Board Listing Rules specific eligibility criteria for sponsors and their role in handling IPOs which should be equivalent to, if not more stringent than, those in the GEM Listing Rules. We believe that this will help the effort to improve the quality of Main Board listings.