
CHAPTER 11

A CRITICAL REVIEW

INTRODUCTION

11.1 Much ink, to which we have now added, has been spilt in discussing a number of areas and issues which could be said, even if at times only remotely, to have had something to do with what we have had to consider. We have tried to collect and collate some of the views and criticisms expressed, what some of the protagonists had to say about them and what we think. We have not aimed at being exhaustive and some of what is reviewed in this chapter has already been dealt with in other parts of the report.

COMMENTS ON THE INCIDENT

11.2 There is overwhelming market and public support for the enhancement of the quality of the securities market in Hong Kong. At the same time, the public is generally critical of some of the actions and utterances of the authorities, both before and after the Incident. Views expressed during the special meeting of the LegCo Panel on Financial Affairs were also supportive of proposals to clean up the problems associated with penny stocks and for an effective and efficient delisting regime. These views, culled from media reports and submissions and representations sent to us, are summarized in the following paragraphs. They are included for completeness so that those concerned may, if they wish, consider the comments further and make changes as appropriate.

Underlying Spirit of the Consultation Paper

11.3 Most, if not all, commentators supported the spirit of the Consultation Paper in fostering corporate governance, increasing transparency and enhancing the quality of the market in Hong Kong. Most agreed that the measures, if endorsed and implemented, would weed out under-performing companies with poor corporate governance and, in turn, benefit investors. Acknowledging that these proposals were generally in line with good international practice, most believed that these measures would be conducive to maintaining and perhaps enhancing Hong Kong's

position as an international financial centre. Noting that a delisting mechanism is already in existence, albeit with criteria which are often unclear and not always easy to apply, most commentators welcomed the introduction of clear, objective, transparent quantitative and qualitative criteria as part of a delisting regime.

Yardstick

11.4 Whilst most supported the introduction of a more effective delisting mechanism, there were those who considered it inappropriate to use the price of a share as a delisting criterion on the basis that a company's share price did not necessarily reflect its financial health. Some penny stock companies were relatively healthy financially while some high-priced stocks had financial problems. Company performance, transparency of its corporate governance structure, and not just the price of its shares, should be considered better indicators of quality. Complaints included that the HKEx only dealt with the symptoms rather than the root cause and that the HKEx and also the SFC should have focused on the profitability and financial performance of companies. We hope that such views would continue to be expressed and be considered in the ongoing consultations.

Number of Criteria

11.5 Some commentators thought that there were too many delisting criteria. There was a suggestion that some of the criteria contradicted one another. As a result, some financially weak companies would be allowed to continue whereas comparatively stronger ones might have to be removed. To avoid confusion, it is suggested that the HKEx should introduce only two to three delisting criteria to remove the poorest companies. Again, these views would have to be considered as part of the ongoing consultation. We note, later on in this chapter, the comments of the HKEx in relation to some of these criticisms.

Minimum Price Threshold and Scope of the Consultation Paper

11.6 By setting the price threshold at \$0.5, the proposals in the Consultation Paper would affect almost half the listed companies on the Main Board. The SFC and the HKEx have, however, estimated that the proposals, when taken together and even if all were implemented, would only result in the delisting of some twenty to thirty companies. If the

intention is to target these companies, the HKEx and the SFC should have been more focused and not cast the net so widely.

11.7 Some professional service providers also commented that the HKEx had under-estimated the knock-on effect of the proposals. Typically, it is asserted, a listed company generates around \$1 million worth of business a year for other supporting services and professionals such as lawyers and accountants. If some 400 companies were to be delisted, the amount of business lost would be as high as \$400 million. The proposals would affect not only investors but would also have an impact on many other service providers and the economy as a whole.

11.8 Most analysts agree that delisting is the most severe sanction possible for a listed company. It should only be used sparingly under justifiable circumstances, as it involves the interests of controlling shareholders, small investors, financial intermediaries and banks. The delisting proposals would affect not only existing listed companies but also those companies (local and overseas) which have plans to list in Hong Kong.

Confusing Message

11.9 Neither the Consultation Paper nor the subsequent press briefings made it sufficiently clear that the \$0.5 threshold was only a trigger for consolidation and not a trigger for delisting. Given that the Consultation Paper was long and technical and the overwhelming emphasis was on delisting, it was understandable that the average investor would perceive the proposal as having the effect of leading to automatic delisting of stocks once they trade below \$0.5.

Alternative Trading Platform

11.10 Some thought that the HKEx should have included exit mechanisms and alternative trading platforms in the Consultation Paper. They pointed to the Pink Sheets and OTC-Bulletin Board. There were also suggestions for a requirement that majority shareholders had to acquire the stakes of minority shareholders if the shares were to be delisted. Without any of this machinery in place, an average investor especially of penny stocks would, understandably, equate delisting with liquidation.

Consolidation

11.11 Some commentators thought that mandatory share consolidation might not necessarily be in the best interests of investors because the process would take time and be costly, and might also divert companies' attention from other priority areas, such as working to engineer a turn-around. There were others who thought that there should have been safeguards against controlling shareholders seeking to privatize at suppressed prices simply by non-compliance. Share consolidation might also create or increase instances of odd lots, lower the prices of such lots and reduce their worth especially for minority shareholders.

Under-estimating the Market Reaction

11.12 Most thought that the HKEx and, to a lesser extent, the SFC had under-estimated how the market would react. Given that the stock market is highly sensitive, and that it is almost customary for market participants to act on confirmed news as well as unconfirmed rumours, the relevant authorities should have been extra careful in crafting market-sensitive proposals even though they were merely for consultation rather than implementation. Bearing further in mind that penny stocks had always been highly volatile and no exit mechanism had been proposed, it was not unreasonable for investors in them to have dumped their stocks before their investment became "wallpaper". There were also assertions to the effect that even ordinary citizens without knowledge of the market should have been able to predict the market reaction and that it was surprising that well-paid executives of the HKEx and the SFC could have overlooked it.

Lack of Market Experience

11.13 There were assertions that the middle level or even senior staff in the HKEx were not experienced commercial people and were not sufficiently sensitive about the market. Some thought that, generally speaking, the market sense which one should be able to expect from an organization such as the HKEx was markedly lacking. There were also complaints from certain trade associations that the HKEx staff did not understand the operation of the Hong Kong stock market. They were really outsiders trying to regulate insiders. This was undesirable and unworkable.

Bad Timing

11.14 Some commented that the HKEx should not have announced the Consultation Paper when the market was already weak. The claims were that the Hong Kong stock market had been bearish since 1997, and had recently been hard hit by the plunge in the US and other leading stock markets. Further, local investors' confidence continued to be weak and the economy was still facing a downturn. The proposal created further uncertainties in the market at a time when stability was much needed.

11.15 A fairly common complaint was about the actual choice of time and day by the HKEx. Most thought that as the proposals were market-sensitive, the HKEx should not have announced the proposal on Thursday, a trading day. Had the HKEx announced the package after the market closed on Friday, the HKEx would have had more time to distribute the Consultation Paper, explain the proposals in greater detail, clarify grey areas and introduce remedial measures before the market opened again on Monday.

The HKEx's Consultation Practices

11.16 A number of smaller brokers criticized severely the HKEx's attitude when it came to consultation exercises. In their view, the HKEx's consultations have all along been insufficient and ineffective. It was, so it is said, common for the HKEx to announce a harsh proposal, not genuinely believed to be desirable or acceptable, with a view to allowing itself more room to manoeuvre and bargain.

Consultation Not Genuine

11.17 Similar groups also claimed that in their experience, the HKEx's consultation exercises were merely intended to inform, to lay the ground, rather than to consult. The proposals had already been decided and were foregone conclusions. The Consultation Paper itself showed that the HKEx already had a clear stance on many of the proposals, on which there were no open-ended questions for consideration and little scope for discussion. Lastly, the consultation period was only to be for a month. For something of this complexity, if the exercise was a genuine one to gather views, how could one month have been realistic?

Lack of Communication between the HKEx and Market Players

11.18 Another fairly common and widely expressed complaint was that there was a lack of communication between the HKEx and market players. In view of the market sensitivity of the proposals, the HKEx should have consulted the trade widely, collected feedback and refined the proposals before releasing the Consultation Paper.

11.19 Some members of the SFC Shareholders Group were quoted anonymously as having said that they had already expressed their reservations on the proposals before the release of the Consultation Paper. However, their views were either not reflected in it or taken into account.

Neglecting the Interests of Small Investors and Companies

11.20 Some local brokers were dissatisfied that the regulatory authorities were seeking to “internationalize” the Hong Kong stock market without taking into account local needs. In addition, they accused the HKEx and the SFC of only taking into account the interests of large corporations and investment houses and neglecting the interests of small and medium sized companies and investors.

No Contingency Plans and Wavering Attitude

11.21 There were allegations that the authorities had no contingency plans in response to the market reaction. Further, the authorities showed indecision when, within three days, they changed their stance. They started off defending the Consultation Paper, then extended the consultation period and, finally, withdrew the relevant section of the Consultation Paper.

Authorities Shirking Responsibilities

11.22 There was much expression of dissatisfaction over the actions and words of senior officials in the Government, the SFC and the HKEx. They were censured for trying to shirk their responsibility, which, it was suggested, cannot be cast off simply by saying that the paper was merely for “consultation”, and “it is difficult to predict market reaction”.

11.23 New accountable officers should not seek quick results by oversimplifying the work procedures. For all policy issues with far-reaching

ramifications, they should prepare fully before any consultation - thorough research and analysis, careful consideration of the acceptability of any proposal, and clear explanation of the policies are all necessary features of any important proposal. Otherwise, even well-intentioned proposals can lead to unfortunate outcomes.

Lack of Co-ordination among the Authorities

11.24 A report expressed indignation at the HKEx's explanation as to why it did not include an exit mechanism in its Consultation Paper by saying that it was the SFC's responsibility. It was felt that the HKEx could have better co-ordinated with the SFC on the proposals before rushing into announcing the whole package.

Comments on the HKEx

11.25 The following comments were directed specifically at the HKEx:-

- (a) Whilst it was in line with present policies and procedures not to have consulted the Board on listing issues, the HKEx Board should have been consulted in this case in view of the far-reaching ramifications on the market and the listing fee income of the HKEx. These were business matters.
- (b) The HKEx was shifting the responsibility of monitoring penny stock companies on to the shareholders. While creating a sound market, the HKEx still has a responsibility to those who invested in that market whether they were big or small investors.
- (c) The HKEx was "bureaucratic". It simply followed past practices. It was not sensitive to investors' interests.
- (d) There was a lack of communication between the HKEx and the trade ever since the merger and change of leadership in 2000, and the communication gap was widening.

Comments on the SFC

- 11.26 The following comments were addressed to the SFC:-
- (a) The SFC was the main culprit in setting the price threshold at \$0.5. As shown in the chronology provided by the HKEx during the LegCo hearing, it was the SFC which had proposed the higher threshold in order to be in line with other international markets. The HKEx had tried to argue for \$0.1 and \$0.3 so that fewer companies would be affected. However, because of the SFC's insistence, the HKEx had no choice but to compromise on a higher threshold and let the market decide.
 - (b) Concerns had already been reflected to the SFC before the release of the proposal. It seems, however, that the SFC had not conveyed those views to the HKEx.
 - (c) The SFC's investigation into the possibility of market manipulation was merely an attempt to deflect criticism. The SFC's high profile investigation into the possibility of market manipulation has scared away some of the clients of the securities firms being investigated.

Role of the FS

- 11.27 On the role of the FS, the public had the following comments:-
- (a) He politicized the incident and tried to shift the blame to the HKEx by saying that it had not notified the Bureau of the Consultation Paper before its release, that it might have underestimated the market reaction and that it might not have given sufficient thought to the issues. It turned out that the Bureau was in fact supplied with an advanced copy of the Executive Summary of the HKEx's Consultation Paper.
 - (b) The division of responsibility between the FS and the Secretary under the new accountability system is unclear.
 - (c) Under the new accountability system, whenever there were major mishaps in implementation of policies and measures

within their policy portfolio, principal officials should bear political responsibility even though they themselves were not personally involved in any action or omission in the process.

- (d) As the most senior official overseeing financial matters, the FS should be responsible for the Incident.

Role of the Secretary (SFST)

11.28 The following views have been expressed about the Secretary:-

- (a) Judging from the Secretary's recent decision regarding the structure of the Listing Committee, the HKEx could not have single-handedly announced proposals with far-reaching implications on the stock market in Hong Kong without his involvement. As the delisting proposals hinged on the Government's policies on whether to provide a mechanism for delisted company stocks to trade freely in Hong Kong, the Secretary must have been involved.
- (b) He was not sensitive enough to the dire consequences of the proposal. As he mentioned to the LegCo Panel on Financial Affairs, he had not read the documents which contained important proposals within his policy responsibility. He did not understand, and did not try to understand, the proposals and their implications. He did not take any pro-active action to follow up on the market reaction to the proposals.
- (c) After the Incident, he did not admit responsibility. Instead, he tried to dissociate himself by using various excuses. The Secretary should have tried to understand more about the proposals to be presented by the HKEx and the SFC. This should be seen as co-ordination rather than interference with their work.

Comments on the Three-tiered Structure

11.29 Most people generally agreed that the three-tiered structure embodied sound concepts. However, the penny stocks incident revealed that there were flaws in practice. They urged the Government to review the

three-tiered structure, to clearly delineate the roles and responsibilities of the HKEx and the SFC, and to improve the co-ordination among all parties.

11.30 Many pointed to the apparent conflict of interests of the HKEx, at least since 2000 when it became a listed company and front-line regulator at the same time. A number suggested that the HKEx should focus on developing and promoting new products, leaving all regulatory functions to the SFC. We note that this has become a very common and popular theme. Furthermore, it is said, Hong Kong should follow the practice of the United Kingdom and set up committees for consumers and practitioners.

EVALUATING THE COMMENTS

11.31 We have invited the parties to respond to some of these comments and criticisms in their written submissions and during their interviews. Since the terms of our reference dictate that we confine ourselves to the preparation and release of the Consultation Paper rather than the merits of the proposals, we have not, for the reasons we adverted to in the Introduction to this report, invited too many comments on the merits of the proposals which would be the subject of ongoing and further consultations. Responses and our brief assessment, already interwoven into appropriate places in the report, are set out in the following paragraphs. The roles of the FS and the Secretary are dealt with in the body of the report in Chapter 6 and paragraphs 12.2 to 12.27.

MINIMUM TRADING PRICE THRESHOLD

The HKEx's Response

11.32 The Chief Executive of the HKEx stressed before the LegCo Panel on Financial Affairs that the HKEx initially proposed a one cent figure for consolidation purposes and ten cents as a “floor price” to trigger prohibition on corporate action. It was the SFC which had proposed \$1 and \$5 respectively. Recognizing that the SFC's suggestion would affect too many companies, the HKEx attempted to propose lower consolidation thresholds ranging from 10 cents to \$0.3 but the SFC was not satisfied. The SFC said that “the figure of \$0.3 would give the impression of compromise and lack of resolution. Investors and the market might well get the wrong message.” In the end, “in order not to hold up the whole consultation process, the Exchange eventually agreed to propose to use \$0.5 as the

compromise threshold for the minimum trading price in the Consultation Paper.”

11.33 The SFC did not comment further on the HKEx’s proposal about the threshold. In June 2002, the SFC said that they “had not arrived at a view on the \$5/\$1 and \$2/50 cents issue. But, in any event, the Consultation Paper should discuss the final goal of bringing [Hong Kong] in line with international norms.” The HK\$0.5 threshold thereafter remained throughout the successive drafts and in the Consultation Paper.

The SFC’s Views

11.34 The SFC Chairman’s comments were that:-

- (a) As a policy matter, the basic proposal was rational and reasonable, reflecting the opinions of market participants and commentators, as well as being in line with international practice.
- (b) The SFC’s clear understanding was that the \$0.5 threshold would not, by itself, if implemented, trigger delisting, as listed companies had every opportunity to restore the theoretical share price to above the price threshold, by the simple expedient of share consolidation.
- (c) The SFC had checked with the HKEx that since listed companies could meet the \$0.5 threshold simply by share consolidation, all the delisting proposals relating to company performance and profitability which would potentially affect a variety of companies, would only put 20 or so listed companies at risk of delisting and only many months down the road.
- (d) The proposed threshold of \$0.5 was suggested by the HKEx. The SFC considered that was a reasonable number and that became the final number in the Consultation Paper. The SFC did not insist on a specific threshold.

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- (e) Accepting that the proposed threshold was a reasonable one and that the stand-alone proposal on share consolidation had to be subsumed within the overall package on listing criteria and delisting, the SFC did two other things – first, to alert the HKEx of the fact that the consultation document had become very long, complex and unwieldy, and secondly, to try to get the HKEx to explain at the press conference very clearly not to associate the 50 cents with delisting.

The Panel's Views

11.35 As the proposed \$0.5 threshold would be the subject of the next round of consultation, we should not pre-empt or seek to influence the public's choice. Having regard to all that we have seen, read and heard, much of which is touched on in the narrative in Chapter 7 (see paragraphs 7.10 to 7.45) and the parties' response, we feel that these comments would not be out of place:-

- (a) The crux of what went wrong is that the public associated the threshold with delisting rather than consolidation. Consolidation, initially the focus, was no longer at the forefront in the paper. Media discussion in the two to three months preceding the release also concentrated on delisting. In addition, the two issues were intertwined in a lengthy, complex, and technical Consultation Paper. The \$0.5 threshold thus played a more important role in the Consultation Paper than originally envisaged in the previous stand-alone proposal on share consolidation. Neither the SFC nor the HKEx apparently focused enough on this subtle change. The SFC, in particular, assumed, not unreasonably, that the distinction between delisting and consolidation would be made clear and therefore readily understood. This turned out not to have been the case.
- (b) Given that the SFC had expressed a strong preference for a threshold of \$1/\$5, it seems reasonable to infer that, while it was the HKEx which made the final proposal of \$0.5, it did so having regard to the views of the SFC which, in its turn, was

prepared to have that figure go forward as a basis for consultation.

- (c) In proposing the \$1 threshold, the SFC executives were anxious to find a coherent and logical standard, based on the standard integer of the currency and to bring Hong Kong in line with accepted international practices.
- (d) Whilst both the SFC and the HKEx estimated that only 20 to 30 companies would be at risk of delisting if the whole package of the proposals in the Consultation Paper were implemented, this message was not put across to the public who only knew that about half of the listed companies had share prices lower than \$0.5. As the HKEx's press conference on the 25 July 2002, the Chief Executive of the HKEx was not prepared to and did not provide this figure, which, with the benefit of hindsight, should have been.
- (e) We do not believe that it was wrong or misguided to have regard to international standards, norms and practices provided that they are not slavishly adhered to without regard to Hong Kong's own business environment and economy. We believe that, on the material we have consulted, the \$0.5 threshold for consolidation was a sensible compromise in the circumstances and a reasonable figure for consultation.

ALTERNATIVE TRADING PLATFORM

The HKEx's Response

11.36 Regarding the criticism of the HKEx's failure to include an alternative trading platform in the Consultation Paper, the Chief Executive of the HKEx explained:-

- (a) The Consultation Paper did recognize that "there are views that an alternative trading platform should be set up". However, as explained in the Consultation Paper, the Exchange did not consider it necessary to propose one since the delisting

proposals put forward by the Exchange already provided adequate “early warning” signals to investors. If such proposals were acceptable to the market and they were implemented, investors would have plenty of time to act and to sell their shares in the market before delisting.

- (b) The existing Listing Rules already contain provisions for delisting. In the past three years, seven companies had been delisted and the Exchange did not provide an alternative platform for the trading of the delisted shares. This had not precluded the delisted shares from being traded over the counter.
- (c) The existing delisting criteria were qualitative in nature. The delisting proposals in the Consultation Paper were intended to enhance transparency by introducing clear, quantitative and qualitative continuing listing criteria so that investors would know well in advance whether or not an issuer is in danger of failing to comply with the continuing listing criteria and hence may become subject to the delisting procedure. The new measures, if implemented, would provide more protection for investors because under the current practice, an issuer would have been suspended from trading, sometimes for a long time, before the delisting procedure is implemented. If an issuer is being considered for delisting, its securities are usually already suspended and minority shareholders would not be able to have access to the market. The shares remain suspended from trading until an appropriate rescue proposal has been put forward and approved by the Listing Committee. If a rescue proposal is either not put forward or not approved, the issuer will be delisted.
- (d) Even if delisting procedures are invoked, they allow time for the relevant issuer to remedy the breach and there will not be immediate suspension of its shares.
- (e) The package includes a streamlined appeal mechanism should the relevant issuer be dissatisfied with a first-instance delisting decision.

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- (f) The proposals put forward by the HKEx in the Consultation Paper are proposals only and they are published with the object of facilitating consideration and comment by the market. If the market response indicates a clear demand for alternative trading arrangements to be introduced as an integral part of a delisting package, the HKEx will be prepared to consider such a demand in a separate consultation exercise.
- (g) Whether an alternative trading platform should be established and, if so, how such a platform should be operated and regulated, involve complicated and detailed consideration of a whole range of regulatory and operational matters.
- (h) In considering whether to mention the possible introduction of an alternative trading platform, the HKEx had taken into account views expressed in the SFC's paper on the Quality of Hong Kong Market – A Critical Review⁶², which remarked that:-

“The OTC platforms typically provide a less regulated environment where misconduct could be widespread..Whether Hong Kong should consider market segmentation, however, raises some difficult questions. Many statutory provisions currently apply (and would apply under the Securities and Futures Bill) only to listed securities. The statutory monopoly of the HKEx for operating a stock exchange would also need to be examined. But more fundamentally, it remains doubtful whether our economy and the market are large enough to support a third listing segment (in addition to the Main Board and GEM).”

The SFC's Response

11.37 The SFC had these observations to offer:-

⁶² This is an internal study conducted by the SFC and sent to the HKEx and the Bureau in December 2001. See paragraph 2.3. The paper was subsequently updated and presented to the media on 25 July 2002.

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- (a) The HKEx is a publicly listed company accountable to its shareholders and it is its business decision whether or not it wishes to run a board for delisted companies. It was and is free to consult the market as to whether its views on this issue were or are in the right direction. There are no SFC rules or regulations against the establishment of a mechanism to trade delisted stocks, provided that all the brokers dealing with such products are registered. The SFC is open-minded on this issue. If, for example, there are sufficient parties interested in establishing an alternative market, or if other plausible options arise from the market consultation, the SFC would expect the HKEx to consider the matter further, and so would the SFC.
- (b) The SFC executives did bring up an exit mechanism with the HKEx's Listing Division. However, the HKEx decided that it would not propose the establishment of an alternative market. Nevertheless, it is clear that the notion of an alternative trading market is not a closed debate; feedback on the question of exit would have to be taken into account in formulating policy following the consultation exercise.
- (c) The software and hardware are already available at the HKEx to have a third board. AMS3 is so powerful that if a specific code is assigned to delisted stocks, market participants who wanted to trade a 4-digit type stock could do so. It can even be cleared through Central Clearing and Settlement System.
- (d) The reservation expressed in the SFC's paper on the quality of the Hong Kong market are merely the SFC's preliminary views.

The Panel's Views

11.38 Our views are as follows:-

- (a) The way the matter is dealt with in the Consultation Paper would have indicated to the uninformed and many others that the HKEx did not consider it necessary to propose such a mechanism. It would not have been unreasonable to conclude

that the HKEx already had a very clear stand on the matter. In other words, even though the HKEx noted that there might be market concerns, it did not appear to be prepared to invite views on this issue at this stage. This may have led to the misgivings felt.

- (b) Whilst it is correct to say that a delisting mechanism already exists without an alternative trading platform, the actual number of stocks delisted is only seven over three years. When there is added to the lack of an alternative platform the misapprehension that the \$0.50 trigger would lead to over half of the companies listed on the Main Board to be at risk of delisting, the anxiety of many holding shares in all those companies is understandable.
- (c) Under the current structure, the HKEx should be primarily responsible for deciding whether to set up an alternative trading board. In the preparation stage, the SFC had suggested certain options, but the HKEx had not been keen to pursue them, partly because it was anxious to finalize the package of proposals and partly to avoid opening up a bigger debate on the role of GEM and market segmentation.
- (d) One of the reasons that the Listing Division did not follow up on the options suggested by the SFC was that these issues were within the purview of the HKEx's business units. The SFC has undertaken to raise the issue with the HKEx's business at a suitable time.
- (e) We consider that the failure to have mentioned any possible alternative trading platform in the Consultation Paper or to leave the issue open and invite the public's views were flaws which may have led to misunderstanding about the willingness of the HKEx to consider this as an option, and may have contributed to the anxiety of those who worried that they would not be able to realize their investments.

UNDER-ESTIMATING MARKET REACTION

The HKEx's Comments

11.39 Regarding the criticism that the HKEx had under-estimated the market reaction, the Chief Executive of the HKEx explained that:-

- (a) The proposals in the Consultation Paper had had a long gestation period of close to 18 months. During that time, the fact that the HKEx was considering compulsory consolidation of penny stocks and an improved delisting regime had been regularly reported and discussed in the media. A summary of the media coverage, prepared by the Corporate Communications Unit of the HKEx, is at **Annex 7.2**.
- (b) During the week prior to the publication of the Consultation Paper, media coverage went into some of the details of the proposals, including those concerning penny stocks and the delisting regime, even the threshold of HK\$0.5 below which delisting may result if no remedial action was taken. Many market practitioners were also expressing views in the media. While there were some comments that the HK\$0.5 threshold might be too high, there was no warning or even suggestion of potential panic selling of penny stocks.
- (c) The market had been calm during the period between 17 and the 25 July when the gist of the penny stock and delisting proposals were already in the public domain. The HKEx therefore had no reason to suspect or to assess that the market would respond to the public release of the Consultation Paper in other than a rational and calm manner.
- (d) After the Consultation Paper was released during the noon time market break, there was no exceptional market movement during the afternoon trading session.
- (e) Press reports and public comment of market practitioners on the proposals, including the penny stock proposal, in the morning of

the 26 July 2002, were generally neutral or supportive. There were no suggestions that anything untoward was in the offing. Highlights of the media coverage in the morning of the 26 July 2002 are at **Annex 11.1**⁶³.

- (f) This sequence of events illustrates, according to the Chief Executive of the HKEx, that the market reaction on the 26 July 2002 was beyond the reasonable expectation of most people, including media commentators, market practitioners, the SFC and the HKEx.

The SFC's Comments

11.40 The SFC Chairman had the following comments:-

- (a) As this was a Consultation Paper issued by the HKEx about its own regulations, the HKEx made clear throughout that it would take charge of the market consultation process. The SFC did not table the detailed proposals for consultation with the SFC's own groups.
- (b) During the SFC's formal and informal meetings with broker association representatives, no concerns were expressed on the proposed threshold of \$0.5. The HKEx's Listing Committee, which comprised market experts and was the central decision making body in this consultation, also did not raise any market sensitivity concerns during its deliberation on 18 July 2002.
- (c) Even though the key elements of the HKEx's proposals were leaked to the press about a week before the 25 July 2002, there was no feedback from formal and informal sources that the proposal would cause any problem.
- (d) Market consultations are not pre-determined policy decisions with inevitable rule changes. All proposals are subject to discussions and debate. The whole purpose of market

⁶³ The summary is supplied by the HKEx.

consultations is to gauge reaction from as wide a constituency as possible.

The Panel's Views

11.41 With hindsight, a number of commentators have felt able to conclude that the market reaction on the 26 July was entirely sensible and predictable. We note, however, that:-

- (a) As mentioned by the HKEx, media reports on delisting proposals had generally been neutral or supportive. Most of the press reports on the 26 July 2002 after the release of the Consultation Paper were supportive.
- (b) While there were divergent views on the proposals, there were indeed no signs that the adverse reaction would be so great as would lead to panic selling.

11.42 We feel that while we cannot go all the way with the HKEx's comments summarized in paragraph 11.39, we can see why a reaction was not on its or other people's radar screens. We have to realize, however, that the actual consultation paper was not available to the media for comment and one cannot simply take the threshold and the proposals for an improved delisting regime in isolation. What would have caused the panic, and understandably so, was the failure to make clear that the 50 cents threshold was one for consolidation and not one, on its own, to trigger delisting. Coupled with this is the lack of any adequate discussion of an alternative trading platform. We have little doubt that this would have been a matter of some consternation. We are also troubled that there was no systematic way to tap and assess the possible market reaction beforehand. The SFC did not feel able to trigger its consultation network because these were the proposals of the HKEx which was and is sensitive to any perceived interference by the SFC. The HKEx assumed that the Listing Committee could serve as the market sensor while the Committee's actual role was a much more passive one: see paragraphs 11.51 et seq. There was thus a sort of a vacuum in which nobody was actually charged with the responsibility to collect and analyze market views.

11.43 We note that the HKEx relies heavily on the media as the channel to gauge market views and disseminate information to the market. This is clearly a useful avenue. At the same time, it cannot be the only one. Other channels ought to have been engaged: see discussion at paragraph 7.70.

LACK OF MARKET SENSE

The HKEx's Comments

11.44 Regarding the criticism that senior and middle level staff of the HKEx lacked market experience and expertise, the Chief Executive of the HKEx acknowledged that most of the staff in the Listing Division were not market participants in the sense of having worked as brokers, but most had been with the HKEx for many years, and were usually professionally qualified and experienced in listing matters. Also, the Listing Committee was composed of members with different professional expertise, including many who were practising brokers.

11.45 The Chief Executive also told us, and we accept, that:-

- (a) In their day-to-day work, staff had plenty of contact and discussion with market people, including officers of listed companies, financial intermediaries, exchange participants and fund managers. They would have picked up plenty of experience in good time.

- (d) Recent consultation papers from the HKEx provided a fairly comprehensive package of proposals addressing what were considered by the market to be important issues. The result of the consultations showed that the issues that staff of the HKEx had highlighted and made proposals for change were matters which addressed the heart of corporate governance issues.

The Panel's Views

11.46 We note the following statistics:-

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- (a) Of the 71 executives in the Listing Division, 44 (or 62%) worked in the Listing Division for three years or less. Five executives had worked in the Division for ten or more years. The Listing Division, like other organizations, encounters staff turnover from time to time, especially when the market is booming.
- (b) Fifty-nine executives had professional qualifications (mainly lawyers and accountants), 61 had degree qualifications and 49 had both. Thirty-six (50%) of them had less than ten years of working experience.
- (c) The project team responsible for the preparation of the Consultation Paper comprised four people who had worked in the HKEx (or its subsidiaries) from two to 17 years. One of them worked full-time on the project. The other three executives, including the Executive Vice President of Listing, Regulation and Risk Management Unit who headed the team, had also to take care of the day-to-day regulatory functions and several other major projects. There is room for argument as to whether the HKEx had devoted sufficient resources to the Consultation Paper commensurate with the complexities, technical difficulties and sensitivity of the issues involved. On balance, we are not persuaded that the HKEx has failed in this regard.

NO CONSULTATION WITHIN THE HKEX NETWORK

The HKEx's Comments

11.47 On why the Listing Division did not consult the HKEx's Board of Directors on such an important policy issue, the Chief Executive of the HKEx explained:-

“The main reason why we do not consult the Board or the various Consultative Panels is to follow the stipulation of the Memorandum of Understanding (MOU) for complete separation of the Listing Committee and the rest of the business responsibilities of the Board. The various

Consultative Panels, like the Cash Market Consultative Panel, the Derivatives Market Consultative Panel and the Clearing Consultative Panel, are panels established to advise the Board on the business side of the Exchange's work.”

11.48 On why the Listing Division did not consult Board members as individuals to tap their rich pool of experience and expertise, the Chief Executive of the HKEx explained that:-

- (a) “In a way it is following the practice of separation between the Board and the Listing Committee. In the few months earlier this year, there were in fact quite a lot of market comments on the real or potential conflict of interest between the HKEx as a regulator and the HKEx as a listed company for profit purposes. Only after a lot of discussions was it agreed that we should continue to maintain that responsibility but with modifications to the listing governance structure. In the course of that discussion their intention has always been to maintain the independence of the listing governance committees.”
- (b) “The strict separation even regarding tapping the individuals' expertise is maintained so that there should be no complaint about conflict or confusion, or even the perception that the Board or individual Board members are trying to unfairly influence the way in which regulatory development is taking place.”

The Panel's Views

11.49 We accept that if the HKEx were to remain as the “front-line regulator” of listed companies, there has to be a clear separation of the HKEx's business and regulatory functions so that the regulatory side of the HKEx is, and is seen to be, independent, competent and hence credible in performing its functions. Since credibility is crucial, any perception of conflicts of interests must be avoided.

11.50 We take the view, however, that the HKEx's current practice, ironically, deprives it of the rich experience and expertise of members of the

HKEx Board and Consultative Panels. These members, individually or collectively, have the market savvy and on-the-ground knowledge which, in some respects at least, is likely to surpass those of the most accomplished regulator. We agree that the HKEx should not have consulted its Board on listing matters, and the Board should not exercise concurrent jurisdiction over matters to do with listing. It is, however, an unconscionable waste of resources for such available expertise not to be tapped. We believe that the HKEx should create or adopt formal or informal mechanisms to utilize the experience of members of the HKEx's extended family. We are pleased to note that executives of the HKEx, having reviewed the position in the light of this Incident, have proposed new consultative networks along these lines.

Listing Committee

11.51 Within the current structure, the Listing Committee of the HKEx is established as the gatekeeper for listing matters. It is also the channel through which the HKEx seeks external input. It is, and has been designed to be, broadly representative of the market and community interests. It has the necessary exposure and experience to supplement any perceived lack of the Listing Division.

11.52 There may, however, be a gap between the expectation and what happens in practice. The Listing Committee meets every Thursday. Members are generally very conscientious. We have seen minutes of their discussions. They are detailed and thorough. There, however, appears to be structural obstacles which prevent the Listing Committee from achieving maximum efficiency.

11.53 First, the role of the Listing Committee. The terms of reference of the Listing Committee are quite general. The HKEx says that the Listing Committee is the final authority on listing matters, and that the Listing Committee can serve as a bridge between the HKEx and the market. The Listing Committee, however, sees its role as more of a technical one. Even on matters of policy, members see their role as one of improving the Listing Rules in terms of their practicability and workability. Members of the Committee do not consider that they are there to evaluate the underlying philosophy of any proposals or to assess any likely market reaction, since neither is usually flagged for their consideration. They are presented with a product which is usually all but finished. They come in very late in the process. By then, their contribution is really limited to tinkering and fine-

tuning. Practical exigencies, especially as to timetables and practical arrangements, may also lead to a reluctance to suggest fundamental changes late in the day.

11.54 Cogent views have also been expressed that if the Listing Committee is to be an effective sounding board on the market acceptability of any proposals, it would have to be consulted at a much earlier stage, when the philosophy and the details of the proposals are mooted. In this case, the Listing Division circulated the first draft of the delisting paper in April 2002 and did not involve the Listing Committee until 10 July 2002, when the paper was scheduled for publication on the 25 July 2002. In any event, for proposals of this degree of complexity, many would consider an eight day reading period to be on the short side, especially since members are all busy commercial people in their own right.

11.55 The current set-up clearly does not enable the Listing Committee to monitor efficiently the work of the Listing Division. The Listing Committee considers what is tabled before it. It does not decide what is tabled. It has little input in what is put before it until papers are circulated a few days before the meeting.

LACK OF COMMUNICATIONS WITH THE MARKET

The HKEx's Comments

11.56 The HKEx's reasons and concerns about not sounding out the market before public consultation are at paragraph 5.19.

11.57 As to why the views of some advisory groups (such as the SFC Shareholders Group) had not been reflected or taken into account, the Chief Executive of the HKEx explained:-

- (a) While the HKEx could note from media reports that certain issues in relation to penny stocks and delisting arrangements had been discussed by the SFC's Shareholders Group, the Exchange had not been advised by the SFC of the Group's comments. If points of substance had been made, the SFC would have conveyed them to the HKEx.

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- (b) The HKEx now accepts that the SFC's Shareholders Group is part of the consultation structure within the SFC. We have already noted in paragraphs 7.72 to 7.76 of the report exchanges between the two organizations about consulting the Group by the SFC on a separate proposal back in December 2001.

The Panel's Views

11.58 It is perhaps regrettable that the HKEx has shut itself out from the market and consequently deprived itself of much-needed exposure and knowledge to identify and clarify issues, to test concepts, explore various policy directions and formulate policy proposals. Listing Rules are rules of the market and for the market. A two-way communication is important not only in the fashioning and the crafting of proposals that best meet market needs but also to find and build consensus in the process.

11.59 We put down another caveat here. Pre-consultation sounding and even consultation itself carry a measure of risk. Divergent views are more likely to emerge because of vested interests or merely differences in opinion. Even if consultations are completely genuine, not all views expressed can always be accepted or accommodated.

11.60 The SFC should have felt able to consult the Shareholders Group on the HKEx's draft consultation paper. It would have wanted to. It felt inhibited, however, no doubt at least in part by the strongly worded letter from the HKEx and the somewhat imperfect communication between the two organizations.

BAD TIMING

The HKEx's Comments

11.61 The criticism is that the HKEx should not have released the Consultation Paper when the market was weak. The HKEx's view noted that the local and overseas market had been sluggish for some time, and the proposals, if endorsed and implemented, would be beneficial to Hong Kong market in the long-term. The point is also made that if the reforms are in Hong Kong's best interest and they have a role in cleaning up Hong Kong's

market image, they should not wait for an indefinite period. We believe that these are reasonable and well-considered views.

11.62 On the more severe criticism that the HKEx should not have chosen to announce the proposals on Thursday, a trading day, the Chief Executive of the HKEx told us that:-

- (a) The HKEx tries to avoid Fridays to publish consultation papers because the financial papers do not generally report in as much detail over the week-end. (See paragraph 8.8.)
- (b) The details, including the 50 cents threshold, were already in the public domain and the market had not reacted, in an unusual manner, then publishing on a Friday evening with less media coverage over the week-end would not necessarily give the HKEx any indication that the market might respond in an unpredictable manner on the following Monday either.
- (c) The HKEx chose lunch-time for the announcement was to take into account the SFC's suggestion that the announcement should be made after market closed. To the HKEx, it could either be the morning or afternoon close.

11.63 There was also an unfortunate rumour that the date and time chosen (Thursday lunch-time) had to do with the fact that the Chief Executive had planned to go on holiday on the Saturday the 27th. The Chief Executive's explanation, which we accept, is as follows:-

“I don't think it has ever crossed my mind or the minds of my staff that this is the determining factor..There were in fact quite a few discussions among the Bureau, the SFC and the HKEx as to the details of [the arrangements]and the timing for the announcement of the details.”

The SFC's Comments

11.64 The SFC had these comments:-

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- (a) Consultation, as distinct from decisions, would not normally be timed to general market sentiment. To do otherwise risks stifling proposals for significant long range reform that, although potentially controversial, should be exposed for comment in the public interest. Reflecting views of the HKEx, we were also told that, it is to be expected that proposals for reform will be made when markets are under pressure; the working assumption should be that such consultations should go ahead unless there are in fact clear warning signs of any impending problem the effect of which might outweigh the wider public interest in engaging in a consultation.
- (b) As far as the SFC was aware, there were in this case no “warning signs”. It did not spot any nor was it alerted to any. Its concerns were reflected to the HKEx which seemed on top of matters. The substantive proposals were rational, raised the main issues for discussion, and dealt with pressing concerns in the market. They were covered accurately and in detail in the press well prior to the paper’s release. There was no discernible market reaction to this pre-the 25 July publicity.

The Panel’s Views

11.65 We see merit in the comments that, as a general point, market sentiment should not dictate the timing of the release of consultation papers. As Mr Charles Lee reminded us, there is no such thing as “perfect timing” in the real world. If one had been able to choose a bull run which is affected by such proposals, losses can theoretically be even greater. Deferring reform proposals may even be detrimental to the public interest in the long-term. The media coverage in the week leading to the publication of the Consultation Paper was extensive. We do not criticize those who thought that the market was expecting the proposals. We feel, however, that the HKEx’s desire to maximize publicity, not, of course, a criticism in itself, may have allowed possible concerns about the impact on the market to have been, to an extent, sidelined.

11.66 With the benefit of hindsight, we are with all those who have expressed the view that it would have been better had the HKEx announced the package after the close of the market on Friday. Executives could then

discuss the proposals at press briefings, on the wireless and on television which can be followed up with similar efforts over the weekend. There would then be more time to massage and alleviate any concerns and anxiety with suitable messages and measures. Bearing also in mind that the proposals dealt in the main with penny stocks and micro-caps, in other words, stocks owned largely by smaller investors in the retail market, which stocks are known to be highly volatile at the best of times, it is all the more important to have the most careful stage management of the roll-out to ensure that there would be time and procedures in place to deal with any untoward and unexpected reaction.

CONSULTATION NOT GENUINE

The HKEx's Comments

11.67 The HKEx sought to refute this criticism by the following explanation and examples:-

- (a) After consultation with the Corporate Finance Division of the SFC, the Listing Division finalizes the paper and circulates it to all Listing Committee members for discussion. The Listing Committee meets most Thursdays. In the current example, a dozen or so changes were incorporated into the paper as a result of the Listing Committee's comments.
- (b) There was the proposal to extend trading hours. After consultation, there was a strong reaction against evening trading, mixed views on extensions during the day, and ultimately what was decided on was very different from what was in the original proposals.
- (c) In another case before the merger of the HKEx, the Exchange undertook a consultation on share options requirements for the Main Board in May 1999. The Exchange received a total of 26 written submissions from listed issuers, market participants and professional bodies. There were reasoned comments that the proposed requirements in the consultation paper were too restrictive and should be relaxed in order to allow listed issuers more flexibility in the preparation of share option schemes. In

view of the response, the Exchange relaxed the original requirements on the proposal and sought the views of a limited number of parties on the revised proposal in November 1999. Since the revised proposal involved a further relaxation, introduced some new elements, and covered not only the Main Board but also the Growth Enterprise Market (GEM), the Exchange conducted another round of public consultations in May 2000. The Exchange received comments from 14 respondents to the consultation for the proposed Main Board requirements and 157 respondents to the consultation for the proposed GEM requirements.

The Panel's Views

11.68 We note that broker associations have in the past been unhappy about the HKEx's consultation exercises. These, it is claimed, are merely intended to inform rather than to consult. We have not been able to go through all previous consultation exercises, but we have seen examples which we have noted. Suffice it to say that, if this claim is invalid, the HKEx has at the least an image problem, which may have the effect of inhibiting the public from offering comments and therefore undermining the efficacy of its consultation exercises.

11.69 In the present consultation this perception, however unjustified in truth, may have been encouraged by the absence of open-ended questions, the appearance of the HKEx's clear stance on certain key proposals and the brevity of the consultation period (see paragraphs 11.17).

11.70 The image problem may also have something to do with the way the HKEx handles and communicates its conclusions after consultation. The SFC publishes a conclusion report after consultation exercises and includes a detailed summary of the views expressed by respondents and the SFC's response to these views. This practice is now institutionalized in the recently re-enacted Securities and Futures Ordinance. The HKEx does not appear to have a similar practice. Some respondents are aggrieved that their comments on proposals from the HKEx are not accepted and they do not know why. We believe that the SFC's practice is one worthy of consideration and adoption by the HKEx.