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## **CHAPTER 14**

### **RECOMMENDATIONS**

#### **SUMMARY OF RECOMMENDATIONS**

14.1 To the regulators, investors and the economy as a whole, the Penny Stocks Incident has been a costly lesson. We have discussed the whys and the wherefores in the course of our report. We should now let the past take care of itself and move on. The Government and the regulators must be on guard to avoid the recurrence of similar incidents in the future.

14.2 In making our recommendations, we have been guided by what happened, and by the shared views and vision which we have seen expressed. There is a consensus that the authorities should expend their energies to:-

- (a) maintain fair, transparent and orderly markets;
- (b) promote public confidence in the markets;
- (c) secure an appropriate degree of investor protection;
- (d) minimize market misconduct;
- (e) facilitate market innovations and competition; and
- (f) enhance Hong Kong's position as a premier international financial centre.

14.3 We have broadly classified our recommendations into three categories:-

- (a) General recommendations;
- (b) Recommendations on the preparation and release of similar consultation papers and amendments to the Listing Rules; and

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- (c) Other recommendations based on well-reasoned suggestions from reputable and respectable sources. These we think are worth considering in any subsequent review of related matters.

## **GENERAL RECOMMENDATIONS**

14.4 We note the overwhelming support for the enhancement of the quality of the securities market in Hong Kong. We **recommend**, therefore, that the Government, the SFC and the HKEx should press ahead with reform measures to enhance corporate governance, transparency and general quality of financial markets in Hong Kong. We also **recommend** that the authorities should continue to conduct wide consultations on issues of concern to the public.

## **PREPARATION AND RELEASE OF CONSULTATION DOCUMENT**

14.5 Building upon the collective wisdom distilled from the submissions and representations to us, we venture to suggest improvement in these areas:-

- (a) Engaging the market and the public;
- (b) Assessing market reaction;
- (c) Improving the consultation process;
- (d) Reviewing the operation of the three-tiered structure; and
- (e) Strengthening investor education and protection.

### **Engaging the Market and the Public**

14.6 We consider it important for the market and the public to be engaged to the fullest extent practicable and as early as possible so as to:-

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- (a) enable the key issues facing the market to be identified and so that the most suitable proposals can be formulated which best meet the needs of the market;
  - (b) build consensus through the widest practicable participation;
  - (c) instill public confidence in the system by increasing transparency; and
  - (d) facilitate an informed debate on the proposals.

14.7 Building on the efforts already made, we **recommend** that the HKEx, the SFC and the Government should:-

- (a) make the most constructive and efficient use of the existing consultation network;
- (b) expand the network where possible to increase its efficacy;
- (c) ensure that the network is broadly representative; and
- (d) engage the consultation network at an early stage in discussing concept and framework and in formulating proposals.

### ***Making the Best Use of the Existing Network***

14.8 Both the HKEx and the SFC have within their network committees, boards and panels composed of experienced and accomplished individuals well versed in different aspects of the market. We **recommend** that these be tapped as practicable, even if informally and on an individual basis. Specifically, we **recommend** that:-

- (a) The SFC should feel able to consult its Shareholders Group, which has now been formally constituted a statutory committee under the Securities and Futures Commission Ordinance

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(Cap. 24), and its Advisory Committee, on draft consultation papers sent to it for comment by the HKEx;

- (b) The HKEx should feel able to tap the market expertise of individual members of the HKEx Board and its Consultative Panels either in their individual capacity or through a new formalized framework on listing matters currently under discussion within the HKEx, to supplement the role of the Listing Committee;
- (c) The HKEx should engage the Listing Committee at a much earlier stage in discussing the concept and framework of proposals; and
- (d) The HKEx should keep the Listing Committee apprised of its work plans relating to amendments to the Listing Rules and the release of consultation papers.
- (d) The HKEx should consider setting up working parties involving those with the necessary expertise as well as executives of the HKEx.

### *Expanding the Network*

14.9 We note that the Bureau has regular contact and meetings with the stockbroking industry. These contacts are useful opportunities to exchange views and ideas on issues of common concern. The SFC has similar arrangements. We **recommend** that the HKEx consider increasing and improving liaison with brokers and the brokers' associations.

### *Ensuring a Broadly Representative Network*

14.10 We **recommend** that the consultative network, whether existing and new, should comprise key stakeholders namely, corporate and retail investors, intermediaries, credit providers, issuers and those who are able to represent the views of the investing public.

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14.11 We note that the HKEx does not have within its structure any group specifically reflecting the views of consumers or shareholders. In order to ensure that their interests can be known to the HKEx, we **recommend** that the HKEx consider setting up its own consumer panel or shareholders group.

14.12 Small-and-medium size financial intermediaries and companies play a vital role in the financial markets. We **recommend** that the HKEx consider appropriate channels for the views of these groups to be heard.

### ***Engaging the Market at an Early Stage***

14.13 We have noted that the SFC adopts a two-stage process for outside consultation, the conceptual philosophical stage and the detailed proposal stage, and the process seems to work well. We **recommend** that the HKEx consider something similar, which best fits its structure and needs.

### ***Proposals by the Executive of the HKEx***

14.14 We understand that executives of the HKEx have since the Penny Stocks Incident drawn up preliminary proposals to improve the process for sounding out the market in the preparation of consultation papers on proposed changes to its Listing Rules. In essence, they propose to put in place a formalized mechanism under the recently announced listing governance structure concerning non-disciplinary related listing matters. The mechanism will serve as a forum for discussion at an early stage. We **recommend** that these discussions be continued and brought to its Board of Directors as soon as possible.

### **Assessing Market Reaction**

14.15 Assessment of market reaction is not only an art but also a science which requires discipline and management. We note that the recently re-enacted Securities and Futures Ordinance stipulates that the rules submitted by the HKEx to the SFC for approval must contain explanations of their purpose and likely effect, including their effect on the investing public, in sufficient detail to enable the SFC to decide whether or not to approve them. We **recommend** that the HKEx should consider similar arrangements for consultation papers, and not merely those sent to the SFC for comment. Specifically, we **recommend** that:-

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- (a) in seeking the approval of the Listing Committee for the issue of consultation papers, the HKEx should provide its analysis of the likely effect of the proposals, particularly the effect on the investing public, in sufficient detail to enable the Committee to decide whether the Consultation Papers should be published and, if so, on what terms; and
  - (b) in releasing consultation papers, the HKEx should explain fully to the different stakeholders the likely effect of the proposals on the investing public.

14.16 We note that some issues are likely to have major policy ramifications and in some instances the proposals may affect other segments of the financial markets. In these cases, we **recommend** that the assessment of the likely market reaction should be brought to the attention of both the SFC and the Bureau at the earliest opportunity.

### **Improving the Consultation Process**

14.17 In order for consultations to generate informed debate, we **recommend** that:-

- (a) the duration of the periods for consultation should be commensurate with the sensitivity, technicality and complexity of the subjects under consideration;
- (b) consultation papers should, where appropriate, contain general discussions of the concepts, and they should be designed to encourage and allow the public to express their views on general directions and possible options;
- (c) the HKEx should issue conclusion reports on consultation papers, summarizing views expressed in representations made, its observations on and responses to those views and its conclusions; and
- (d) building on the success of its reach-out programmes after the release of its consultation papers, the HKEx should continue

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and expand such programmes. For topics affecting the investing public, the HKEx has to consider organizing special sessions and seminars for them.

### **Reviewing the Three-tiered Regulatory Structure**

14.18 Our considered view is that the structure itself is sound. However, we have received views and representations that there is still room for some refinements and improvements. We have considered them all. Summarized hereunder for consideration by the authorities are the more important and far-reaching ones.

14.19 We **recommend**:-

- (a) the authorities should, once again, critically review whether and if so, how the existing structure, roles and operation of the Listing Committee can be fine-tuned so that it can fully perform its role as the unit of the HKEx with final responsibility over listing matters. (See paragraphs 5.20, 5.21, 7.45(d) and 11.51 to 11.55).
- (b) the HKEx and the SFC should critically review how best to ensure effective co-ordination between them. Specifically, we **recommend** that the HKEx and the SFC:-
  - ◆ further clarify their roles in the Memoranda of Understanding, setting out clear provisions on their functions and responsibilities and the procedures for processing consultation papers and amendments to the Listing Rules;
  - ◆ strengthen the current liaison mechanism, if necessary by introducing a new high level body including on the HKEx side, the Chief Executive, and if appropriate, the Chairman of the Board and the Chairman of the Listing Committee. The SFC Chairman, and if appropriate, an executive and a non-executive director would represent the SFC. Both organizations should feel at liberty to propose topics for discussion. This should allow periodic review of systemic

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and policy issues. This body would be in addition to the working level meetings on operational issues; and

- ◆ clearly identify the areas for joint consultations by the SFC and the HKEx (See paragraphs 5.23 and 5.24).

14.20 We pointed out in the course of our report (see paragraphs 7.80, 11.29 and 11.30) that many respected members of the business community have pointed to the perceived conflicts of interest of the HKEx, at the very least since 2000 when it became a listed company and front-line regulator at the same time. The segregation of the business and regulatory functions within the HKEx has not been considered completely desirable. It may not even be very efficient, when the Board is debarred from being concerned in important matters of the listed company.

14.21 The handling of regulatory issues by both the HKEx and the SFC and the splitting of roles and functions between them not only lead to inefficiencies but also to confusion. Nearly twelve years have now elapsed since the devolution of regulatory functions over listing matters from the SFC to the HKEx, and difficulties over role and responsibilities still exist. We consider it timely for the present arrangement to be reviewed. We, therefore, **recommend** that the Government in conjunction with the SFC and the HKEx review how best to redefine the roles and functions over listing matters with a view to increasing effectiveness, efficiency, clarity, fairness and credibility of the regulatory system. We would only add that the perceived conflicts within the HKEx and the inefficiency and confusion caused by the dual regulatory functions have been commented on not only by market practitioners and financial analysts, but also by many who were and still are members of the extended family of the HKEx. In particular, most have suggested that if a Listing Committee is to be retained, as most believe it ought to be, it cannot be housed under the HKEx. Within the current structure, the only entity under which it can be accommodated is the SFC. We see the sense of all these comments and commend them to the authorities for further consideration.

14.22 We believe that it is a well-tested principle that the Government should distance itself from the day-to-day regulation of the securities industry. We **recommend** that the Government should clearly reposition itself as a facilitator and a co-ordinator and not as a regulator, leaving market forces to work within the broad policy framework and without political

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interference. The Government must communicate its role clearly to the industry and investing public to avoid false and unrealistic expectation.

### **Strengthening Investor Education and Protection**

14.23 Given the prevalence of retail investors in the market in Hong Kong and the predominance of companies which are family-owned or controlled, it would be desirable for the Government, as facilitator, the SFC, as regulator, and the HKEx, as market operator, to put extra care in ensuring the fair protection of minority shareholders' rights. We **recommend** that further and continuous consideration be given to how minority shareholders' rights can be better protected. The daily reports of majority abuse, especially in some of the smaller listed companies, leave an unfortunate image on the Hong Kong market. Besides the small investors are those who need the most help.

### **OTHER RECOMMENDATIONS**

14.24 In passing, we note that the accountability system has added plenty of colour to the Penny Stocks Incident. To ensure the integrity of the three-tiered system and the governance of Hong Kong as a whole, there are issues which may warrant further action. It is for consideration that the Government should, as soon as is reasonably practicable:-

- (a) complete the review on the exercise of statutory powers and functions currently vested with the FS by the Secretary for Financial Services and the Treasury; and
- (b) clarify the division of responsibilities and lines of commands between the FS and the Secretary.