CHAPTER 7
PREPARATION OF THE CONSULTATION PAPER

INTRODUCTION

7.1 On the basis of the material made available to us, we have tried to reconstruct a chronology of the events which have some connection with the Penny Stocks Incident, covering the period from late 2000 to 31 July 2002. Most of the parties involved do not differ too widely over what happened, even if they do not always agree on what should have happened. A detailed chronology is at **Annex 7.1**. This is an essential part of this Report. And for those who are particularly curious as to who knew what, how they knew and when they knew, the chronology should be able to supply most of the answers.

7.2 Broadly speaking, the sequence of events can be divided into five main areas:-

(a) Identifying penny stocks as a problem;

(b) Formulating proposals;

(c) Presenting and releasing the Consultation Paper;

(d) Market reaction; and

(e) The aftermath.

7.3 This chapter describes the first two areas. Chapter 8 discusses the presentation and release of the Consultation Paper. Chapter 9 describes briefly the market reaction to the Consultation Paper and the aftermath. Chapter 10, which is based on the findings of the SFC's recent investigation, sets out in detail what happened on the 26 July and why.

IDENTIFYING PENNY STOCKS AS A PROBLEM

7.4 Penny stocks, micro caps and delisting mechanism have been receiving the attention of the securities industry and the media since late 2000. In October 2000, the Hong Kong Stockbrokers Association brought up this issue for discussion at a regular meeting with the then Financial

Services Bureau. The Association's concern was primarily a technical one. Since the Automatic Order Matching and Execution System (AMS) of the Exchange cannot accommodate trading below one cent, trading of penny stocks has to be done by brokers as odd lots through manual processes via the Semi-automatic Matching System (SAM). This increases the possibility of mistakes in inputting trading orders and hence the risks borne by brokers.

7.5 The Bureau relayed the Association's concern to the SFC, which had already had initial internal discussions on similar issues. It would also appear that the SFC had made known some of its concerns in earlier discussions with the HKEx. The Bureau's letter triggered further discussion within the SFC. Penny stocks were identified as a problem[46] because of its low liquidity, price volatility, susceptibility to manipulation as well as its correlation with poor corporate governance and weak fundamentals. Such a high preponderance of penny stocks was considered to be a blemish on Hong Kong's image as a premier international financial centre. For the subsequent narrative, see paragraphs 7.48 et seq.

FORMULATING THE PROPOSALS

The Proposal in its Embryonic Form

7.6 The first suggestion to address problems associated with penny stocks was made by the SFC's Corporate Finance Division in its reply to the Bureau in December 2000. The Division proposed for consideration a package of measures:-

(a) The Initial listing price should be over HK$1.00;

(b) No corporate action (e.g. sub-divisions or bonus issues) should be allowed if such action would reduce the share price to below HK$1.00; and

(c) There should be compulsory consolidation of stocks to a price above $1.00 if the share price trades below 50 cents for more than 30 days, or for more than 60 out of 90 days.

[46] See paragraphs 2.4 to 2.6 on the problems relating to penny stocks and micro caps.

7.7 In making these suggestions, the SFC's Corporate Finance Division pointed out:-

(a) that the proposals would be a dramatic step and resistance had to be expected. They would, however, send a clear signal to the market that the Government and the regulators intended to upgrade the quality of the market.

(b) The US market deems a stock to be a "penny stock" if it trades below US$1.00 for more than 30 days. In such circumstances, it may be outside the mandate of certain investment funds, subject to a possibility of delisting and ineligible for margin financing. The SFC was concerned about the impact these problems might have on the Hong Kong market since many problems associated with margin financing relate to "penny stocks" and the manipulation activities surrounding them.

Subsequent Evolution

The Main Communications

7.8 From late 2000 to the release of the Consultation Paper on the 25 July 2002, there were on-going discussions within and between the SFC and the HKEx on issues associated with penny stocks. There were also communications with outside parties. The SFS was periodically informed of the progress. No details of the proposal were passed to the Bureau until July 2002 when summaries were communicated to the Bureau. (See chronology at the 10, 17 and 18 of July 2002.) The key exchanges are highlighted below:-

(a) **Between the HKEx and the SFC**

The Listing Division of the HKEx circulated two draft consultation papers on share consolidation and six draft consultation papers on listing criteria and delisting procedures to the Corporate Finance Division of the SFC. The latter provided detailed comments on each draft. The two parties also discussed the issue at four monthly liaison committee meetings and two special meetings. In addition, there were numerous written and telephonic exchanges between them.

(b) **<u>Among the Government, the SFC and the HKEx</u>**

Penny stocks, delisting mechanism and the quality of the securities market were touched upon in very general terms at the FS' regular meeting with the SFC Chairman, two Co-ordination Committee meetings, three Tripartite meetings, one meeting of the Securities and Futures Liaison Meeting and two special meetings convened by the Bureau in mid-July 2002 to prepare for the announcement of a related but separate package of proposals relating to listing and corporate governance. It was noted that the HKEx would issue a consultation paper on delisting mechanism, but the details of the proposals were not discussed. (See chronology at the <u>15, 17 and 23 of July 2002</u>.) On the 10 July 2002, the Bureau obtained a summary table prepared by the SFC on proposed listing criteria and delisting procedures. Also, on the 17 July 2002, the Bureau asked for and obtained the HKEx's Executive Summary of the Consultation Paper.

(c) **<u>Within the HKEx</u>**

A draft of the Consultation Paper was circulated to the Listing Committee on the 10 July 2002. It was considered at its meeting on the 18 July 2002, a week before the release of the Consultation Paper. The HKEx Board of Directors was neither involved nor informed.

(d) **<u>Communications with the Market</u>**

(i) At the Government level, the problems associated with penny stocks appear to have been mentioned two or three times at the regular meetings between the Bureau and the Hong Kong Stockbrokers Association in 2000 and 2001.

(ii) Within the SFC, the Commission (in December 2001), the Shareholders Group (in March 2002) and the SFC Advisory Committee (in May 2002) discussed share consolidation and delisting mechanism but more in the context of the SFC's internal study on the quality of the Hong Kong market.

(iii) Regarding the HKEx, there is no formal record of consultation with outside parties on either the penny stocks issue or the proposals contained in the Consultation Paper. There were, however, informal efforts to inform the media of its plans to introduce a modified delisting mechanism.

(e) **Public Announcements**

(i) The Chief Executive of the HKEx mentioned the proposed delisting mechanism as one of the HKEx's priority areas for 2002 at his year-end briefing in 2001.

(ii) In addition, there were media reports quoting the HKEx executives on share consolidation and delisting.

(iii) On the 20 June 2002, the Financial Secretary mentioned the proposed consultation on delisting in his speech delivered at the cocktail reception to commemorate the second anniversary of the HKEx. (See chronology at the 20 June 2002.)

How the Matter Developed

7.9 First, between late 2000 and April 2002, both the SFC and the HKEx focused their attention on a stand-alone proposal to encourage or require the consolidation of penny stocks. Neither put forward proposals to link consolidation with a revamped delisting regime. In parallel, the HKEx was considering proposals and criteria for initial listing and delisting. It was only on the 30 April 2002 that the HKEx first included the stand-alone share consolidation proposal in the package of measures on listing criteria and delisting procedures in a single draft consultation paper, which was communicated to the SFC. Second, the SFC and the HKEx discussed five price thresholds for consolidation ranging from 1 cent to $1 between July 2001 and June 2002. Third, the HKEx and the SFC both mentioned whether and how alternative trading platforms should be introduced for delisted company stocks. (See chronology at items 52 and 58.) No provision for such an alternative trading platform was included in the Consultation Paper.

EXCHANGES BETWEEN THE HKEX AND THE SFC

Key Exchanges

7.10 As we mentioned in paragraph 7.9, the HKEx did not consider consolidation and delisting together until the 30 April 2002 draft of its Consultation Paper. All the exchanges detailed below prior to that date were figures discussed for share consolidation. We also note that as from the 30 July 2001 (when the first draft paper on share consolidation was sent by the HKEx to the SFC) up to the 10 July 2002 when the SFC commented on the fifth draft of the paper which was similar to the Consultation Paper released two weeks later, the proposals and initial consideration and formulation had come from the HKEx. However, in respect of each draft emanating from the HKEx, the SFC had commented on the proposals in commendable detail and care, making, in many instances, practical points of utility and importance. Their exchanges are detailed in the chronology at **Annex 7.1** and summarized below:-

Date	Event	Proposed Price Threshold		
		Price threshold for consolidation	**Minimum price resulting from corporate action**	**Minimum Initial Public Offer Price**
30.7.2001	The HKEx sent the **first draft paper on consolidation of shares** to the SFC.	$0.01	$0.1	-
8.8.2001	The SFC commented on the first draft paper.	$1	$5	-
20.12.2001	The HKEx circulated the **second**	$0.1	$0.3	-

	draft paper on consolidation of shares.			
25.1.2002	The SFC commented on the second draft paper.	$1	-	-
30.4.2002	The HKEx circulated the **first draft consultation paper on Admission Eligibility Criteria and Continuing Eligibility Criteria (the Consultation Paper)**.	$0.3	$0.3	$1
13.5.2002	The SFC commented on the first draft Consultation Paper.	$1	-	$5
15.5.2002	First Special meeting to discuss the first draft Consultation Paper.	The HKEx disagreed with "$1", but agreed to consider $0.5 or $0.3 as the minimum trading threshold.		
17.5.2002	The HKEx's e-mail to the SFC	The HKEx proposed $0.3 as the minimum trading threshold.		
8.6.2002	The HKEx circulated the **second draft of the Consultation Paper**, and submitted the **tentative timetable for release** of the Consultation Paper to the SFC.	$0.5	$0.5	$2
		"will consult market on $1/$5"		
11.6.2002	The HKEx submitted the **third draft of the Consultation Paper**.	$0.5	$0.5	$2
17.6.2002	The SFC commented on the third draft.	The SFC said that if had not yet arrived at a view of "$1/$5" or "$0.5/$2" proposals.		

20.6.2002	Second Special meeting to discuss the third draft of the Consultation Paper and the SFC's comments.	The SFC did not raise disagreement to "$0.5/$2".
26.6.2002	The HKEx submitted the **fourth draft of the Consultation Paper**.	No further changes in subsequent drafts and communications.
3.7.2002	The HKEx submitted the **second version of the fourth draft of the Consultation Paper** to the SFC.	
3.7.2002	The SFC commented on the second version of the fourth draft of the Consultation Paper by e-mail.	
4.7.2002	The HKEx submitted the first draft of the questionnaire of the Consultation Paper to the SFC Corporate Finance Division.	
5.7.2002	The HKEx e-mailed **the fifth draft of the Consultation Paper** to the SFC.	
10.7.2002	The SFC commented on the fifth draft.	
10.7.2002	The HKEx sent the advanced draft (the sixth draft) of the Consultation Paper to the Listing Committee for deliberation at the meeting on 18.7.2002.	

Note:

Reference to the "HKEx" is to the "HKEx's Listing Division"; reference to the "SFC" means the "SFC's Corporate Finance Division".

First Draft Paper on Share Consolidation

7.11 On the 30 July 2001, the HKEx's Listing Division sent the first draft paper on share consolidation to the SFC's Corporate Finance Division. In essence, the HKEx's paper included two proposals. First, stocks with closing share prices at or below **1 cent** for an aggregate of 20 trading days in any period up to three months should be consolidated to **10 cents** or above. Second, there should be a floor price of **10 cents**. Issuers would be prohibited from undertaking bonus issues, share splits, open offers, right issues and other corporate actions that would lead to the theoretical share price falling below 10 cents.

7.12 The HKEx's focus was on technical issues. The paper mentioned:-

> "Shares are normally traded through the Automatic Order Matching and Execution System (AMS). The minimum price at which securities may be traded using automatching is HK$0.01. Shares may be traded at prices below HK$0.01 by using the Semi-automatic Matching System (SAM). Trading on the SAM system is not as transparent as on the AMS. The Stock Exchange considers that it is undesirable for an issuer's shares to be traded on the SAM for a prolonged period. Consequently, the Stock Exchange proposes to require issuers to present proposals to shareholders to increase the value of their shares if the closing price of their shares falls to [HK$0.01][47] or below. The Stock Exchange will regard a proposal to consolidate an issuer's securities as acceptable."

7.13 In the draft paper, the HKEx also set out possible implications arising from the proposal. First, the HKEx acknowledged that

[47] When numbers are quoted in square brackets in this chapter, square brackets also appear in the original documents.

consolidation would increase the number of odd lots held by investors. The HKEx believed that this could be a matter best addressed on a case by case basis in the light of each issuer's circumstances. Secondly, the HKEx noted some concerns about the costs to the issuer and to its shareholders of a possible consolidation exercise. Such costs included the cost of convening shareholders' meetings, announcing the changes, replacing share certificates and taking professional advice. To minimize some of the costs, the HKEx proposed including provisions to allow a reasonable time for issuers to comply with the necessary formalities in their normal course of business.

The SFC's Comments on First Draft Paper on Share Consolidation

7.14 In its reply on the 8 August 2001, the SFC's Corporate Finance Division expressed two main concerns namely, the scope and threshold for consolidation. On the first:-

> "The paper only deals with one aspect of penny shares – how to deal with shares that trade below 1 cent, the minimum price that the AMS can handle. The more important issue is the way share manipulators concentrate their efforts on shares with a low value."

7.15 On the second concern:-

> "In our view, the right thresholds are around HK$5 [for initial listing] and HK$1 [for consolidation]. We know that a HK$1 level for share consolidation would impact well over half of the companies listed on the Exchange, however that does not justify a lower threshold. Rather, it requires a phased introduction for existing issuers."

Second Draft Paper on Share Consolidation

7.16 On the 20 December 2001, the HKEx's Listing Division submitted a second draft paper on share consolidation to the SFC's Corporate Finance Division. The major change was in relation to the price threshold. The HKEx proposed that "stocks with closing price at **10 cents** or below for an aggregate of [30] trading days in any period of [up to three months] should be consolidated to a level that reaches **HK$0.20** or above." In addition, the HKEx proposed to prohibit corporate actions resulting in the theoretical share price falling below **HK$0.30**.

7.17 The HKEx defended its new proposal by reference to its market impact assessment:-

> "As you noted, setting prices at the **[HK$5 and HK$1]** levels would affect a substantial number of companies. About 63% to 65% of companies on the Main Board and GEM trade at below HK$1. None of the companies listed on GEM trade above HK$5 and only about 8% of companies on the Main Board do so. In the light of your comments, the proposals have been revised and the consolidation price is now suggested to be ten cents."
>
> "On the basis of prices for the three months ended 10 August 2001, this proposal would affect 93 companies on the Main Board and 6 on the GEM. The proposed floor price has also been increased from ten cents to thirty cents."
>
> "Setting the consolidation price at ten cents means that a company's shares may fall a further 90% before reaching the one cent level where trading on an automatching basis is not possible. Likewise, setting the floor price at thirty cents means there is considerable leeway for prices to fall before they reach the consolidation price."

<u>The SFC's Comments on the Second Draft Paper on Share Consolidation</u>

7.18 In its reply on the 25 January 2002, the SFC's Corporate Finance Division re-iterated its concerns over the scope and price threshold. On the first concern, the SFC's Corporate Finance Division remarked that:-

> "The proposed **ten cents/thirty cents** regime remains far short of achieving the ultimate objective. The issue of penny (or cent) stocks is much more than just how the AMS3 trading system could handle order quoted at below one cent per share. Indeed, if system capability were the only concern, we would agree that the proposed **ten cents/thirty cents** regime would be a good solution. But the issue is more complex. There are also questions of quality and market perception."

7.19 On the second concern, the SFC expressed itself:-

> "Nominal prices could lead investors to perceive – incorrectly – that a stock is "cheap" because it is priced in cents. Local market practitioners have long reported this investor psychology. Some issuers, understandably adapt to this psychology and structure their share capital so that their stocks are quoted in cents. As an overall market development, this is undesirable because it is misleading to investors and provides opportunities for market manipulation. It also encourages some investors to look for "gambling numbers" – stocks that others might drive up."
>
> "The SFC's long-term objective in setting a minimum share price is to discourage companies as well as investors from seeing stocks as "gambling numbers" and encourage a proper focus on quality. The **one-dollar** mark is important for psychological reasons. It would also improve our international profile. (Other markets that have minimum share price rules, e.g. New York Stock Exchange, Nasdaq, Neuer Market and the Mainland, set the threshold at the lowest integer value of their legal tender, i.e. US$1, 1 Euro and 1 RMB. Indeed, a HK$1 minimum would be low in absolute value in comparison but would follow this international practice)."
>
> "Two well-respected media commentators have recently called for setting HK$1 as the minimum share price[48]."

7.20 Regarding the HKEx's concern if HK$1 were adopted, the SFC's Corporate Finance Division explained that:-

> "We appreciate that a HK$1 minimum would affect a large number of issuers. This argues for a long transition so that companies could prepare and investors could adapt their behaviour. But as an immediate step, the public consultation appear should clearly set out the long-term objective, together with the relevant positive and negative considerations. We appreciate that

[48] The SFC quoted articles by Mr TSO Yan-chiu in the Hong Kong Economic Journal on 9 January 2002 and an article dated 6 January 2002 by Mr David WEBB on www.webb-site.com.

jumping to a HK$1 minimum is probably ambitious and a phased approach might be necessary."

First Draft of the Consultation Paper on Admission Eligibility Criteria and Continuing Eligibility Criteria

7.21 On the 30 April 2002, the HKEx's Listing Division circulated the first draft of the Consultation Paper on Admission Eligibility Criteria and Continuing Eligibility Criteria (the Consultation Paper) to the SFC's Corporate Finance Division. This draft paper included a package of proposals on initial and continuing listing criteria. As stated in the paper, the proposals were "in line with the aim underlying the Corporate Governance Consultation Paper to enhance the quality of the issuers listed on the Exchange and strengthen Hong Kong's position as an international financial centre." A review of the listing and continuing listing eligibility was necessary "in order to bring our requirements on a par with international standards".

7.22 The first draft of the Consultation Paper covered five sections:- (a) eligibility criteria at the time of approval for initial listing; (b) eligibility for continuing listing; (c) enhancement of continuing listing obligations; (d) procedures for the cancellation of listing; and (e) investment companies.

7.23 The original share consolidation proposal was subsumed within the package. Specifically, the paper proposed, among other things :-

(a) the HKEx would introduce a minimum closing price of **HK$0.3** as a continuing listing eligibility criterion. Where the average price over 30 consecutive days of an issuer is less than **HK$0.3**, the issuer will fail to meet the continuing listing eligibility criteria;

(b) the issuer will be prohibited, during and after the transitional period, from undertaking any corporate actions that will result in securities trading at below **HK$0.30**; and

(c) the minimum initial listing price should be **HK$1.00**.

7.24 The HKEx also proposed new procedures offering a reasonable opportunity to non-compliant issuers to bring themselves back to compliance. At the same time, they would alert the investing public of the imminent delisting or proposed rectifying measures. In the case of the minimum closing price, the application of delisting procedures is subject to an "auto-cured" provision and a transitional period. Whenever the issuer's share price exceeds the price threshold and remains above the level for at least 60 days, the price deficiency would be deemed to be cured, and the new delisting procedures would be disengaged.

7.25 The draft paper also mentioned alternative trading platforms. It stated that:-

> "There are views that an alternative trading platform should be set up to provide shareholders or investors of a delisted issuer with a venue to trade their shares after delisting. We consider that transparent qualitative delisting rules would provide adequate signals to investors and afford them sufficient time to act and make investment decisions. Accordingly, we do not consider that an alternative trading platform for trading of delisted shares is necessary."

7.26 This paper signifies a turning point in the HKEx's philosophy and approach to tackling problems associated with penny stocks. This was the first time the issue of penny stocks has been linked to delisting. According to a media report in May 2001, Mr Lawrence Fok, the then Executive Vice President of the HKEx, had been quoted as saying that unlike the US market where there were alternative trading platforms through the "Pink Sheet" and "Over the Counter (OTC) Bulletin Board", Hong Kong did not have these alternative platforms for the trading of delisted stocks. For all practical purposes, investors would no longer be able to sell their investment if their stocks were delisted. In his view, the solution was to require penny stocks to consolidate, and not to have them delisted.

7.27 Similarly, the SFC in September 2001 published on its website a piece stating that "It would be inappropriate for the regulators to delist a company merely because it recorded losses for over two consecutive years or has a low share price. A company is not unsuitable for listing, just because its share price is below $0.5. The delisting of a company from the Stock Exchange is one of the severest sanctions that can be imposed on a listed company. It will generally hurt the minority shareholders more than the controlling shareholders if such companies were to be delisted. Provided the company has sufficient level of operations or sufficient assets, delisting is only appropriate in exceptional circumstances[49]."

7.28 By marrying the share consolidation proposal with the delisting mechanism, share consolidation was no longer highlighted in the draft Consultation Paper. Instead, it was only implied in the reference to "auto-cured provision". At the same time, the paper did not discuss possible solutions to earlier concerns about the lack of an alternative trading platform and the adverse implications on the interests of minority shareholders.

7.29 On the 15 May 2002, the SFC's Corporate Finance Division and the HKEx's Listing Division had a meeting to discuss the first draft of the Consultation Paper. Before the meeting, the SFC's Corporate Division sought clarifications from the HKEx's Listing Division and completed an internal assessment of the possible implications of the proposal. The assessment indicated that "only 20 or so" companies would be at the risk of delisting but more than 300 companies would need to go through share consolidation. The HKEx's Listing Division had conducted similar statistical analyses with similar findings.

7.30 At the meeting on the 15 May 2002, the two parties discussed the paper and raised the following points:-

(a) **Linking Consolidation to Delisting**. The SFC queried why minimum share price was made a continuing eligibility criterion, failing which delisting would follow. The HKEx explained that this was necessary to enable it to require a company to effect share consolidation or otherwise bring itself back into compliance. The understanding of both parties was that the imposition of a price threshold was to encourage share consolidation. The HKEx's argument was that the sanction of a potential delisting was probably required as a last resort, if, after a long period, the issuer was still unable to comply with the minimum trading price requirement. After discussion, this argument was considered by the SFC to be one within the

[49] This is extracted from an article "Should the SEHK delist listed companies which have recorded loss for 2 consecutive years or if their share prices remained below $0.5 in order to protect the interest of minority shareholders?" in www.hksfc.org.hk/eng/investor/html/questions/edelist.htm.

bounds of reasonableness and acceptable as a suggestion to go out for consultation.

(b) **Price Threshold**. The SFC re-iterated the rationale behind suggesting $1 as the threshold for a minimum trading price. The SFC also stressed that the threshold should receive an informed public debate. In the SFC's views, it was important to set out the positive and negative considerations and make clear that there would be a long transitional period. The SFC did not want to see respondents opting for a lower number just because that seems easy without thinking through the purposes of having a price threshold in the first place. The HKEx disagreed with the SFC's $1 threshold as the change was considered too hasty. Nevertheless, the HKEx agreed to consider further setting the proposed minimum trading threshold at HK$0.5 or HK$0.3.

(c) **Alternative Trading Platform**. The SFC asked whether delisted companies could apply to relist on the Growth Enterprise Market (GEM). The SFC saw no objection to this as a matter of policy. While the HKEx would not reject companies delisted from the Main Board applying to list in GEM provided they met all the prevailing requirements of GEM, the HKEx indicated that it was considering a "cooling-off period" to avoid immediate admission. Otherwise, it would impair the image of the GEM. The Listing Division also mentioned that the question regarding the policy and direction for future development of the GEM was outside the scope of the Consultation Paper. The SFC agreed and indicated that they would raise this policy issue with the HKEx's business section at a later time.

Second Draft of the Consultation Paper

7.31 On the 8 June 2002, the HKEx's Listing Division sent the second draft of the Consultation Paper and tentative timetable to the SFC's Corporate Finance Division. The HKEx recommended, among other things, that the minimum trading price and minimum initial listing price should be $0.5 and $2.0 respectively.

<u>Third Draft of the Consultation Paper and the SFC's Comments</u>

7.32 Three days after sending out the second draft, the HKEx submitted a third draft to the SFC's Corporate Finance Division on the 11 June, highlighting the latest amendments. The SFC provided a very detailed reply with specific comments on 55 different paragraphs and sections. The salient points are set out below:-

(a) **<u>Minimum share price</u>**. The SFC mentioned that it had "not arrived at a view on the $5/$1 and $2/50 cents issue". However, it urged the HKEx to mention in the paper that the final goal was to bring the threshold in line with international norms.

(b) **<u>Impact on shareholders and issuers</u>**. The SFC suggested that the HKEx consider including discussion that the cost of share consolidation would be small, how companies could further minimize costs by timing the approval with their Annual General Meetings, and that many companies already engaged in similar corporate actions. The SFC also suggested that there ought to be some parameters or examples of what measures would likely be considered sufficient by the HKEx to allow a failed company back to long-term, sustained compliance.

(c) **<u>Exit mechanism</u>**. The SFC expressed concern that public shareholders might never get a chance to exit if suspension of trading is immediate and six months later, the company was considered to have failed a continuing listing criterion. The SFC requested the HKEx to discuss assessment of the potential impact.

7.33 On the 18 June 2002, the SFC sent supplementary comments on the third draft. It proposed, among other things, that the HKEx should clarify in the consultation paper whether share consolidation would be taken as an "auto-cured" proposal. Furthermore, it urged the HKEx to ensure that the proposal would not be abused by controlling shareholders so as to achieve automatic privatization by the mere expedient of non-compliance, to the detriment of the interests of minority shareholders.

7.34 The HKEx's Listing Division and the SFC's Corporate Finance Division held the second special meeting on the 20 June 2002 to discuss the third draft. The price threshold and alternative trading platforms were not discussed. Instead, the focus was on other issues such as minimum public float requirements, potential for abuse in certain areas and what constituted "definitive" proposals which would be acceptable to the HKEx in disengaging the proposed delisting regime. According to the HKEx, these comments were taken into account in preparing subsequent drafts.

<u>Fourth Draft of the Consultation Paper and the SFC's Comments</u>

7.35 The HKEx's Listing Division sent two versions of the fourth draft of the Consultation Paper to the SFC on the 26 June 2002 and the 3 July 2002 respectively. The HKEx did not recommend further changes to the threshold of $0.5/$2.

<u>Fifth Draft of the Consultation Paper and the SFC's Comments</u>

7.36 The Listing Division sent the fifth draft of the Consultation Paper and the first draft of the questionnaire to the SFC's Corporate Finance Division on the 4 July and 5 July respectively. On the 10 July 2002, the SFC provided detailed comments and questions on both documents. Specifically, the SFC expressed concern about the length of the document and drafting. The SFC commented that:-

> "The sheer length would no doubt cost some PR points. But we shall leave that to you. Our biggest point on the fifth draft has to do with drafting. Because of successive changes, the draft has gotten very unwieldy. There are also places where the same changes seem to conflict with each other. Below are some examples but no doubt we have only spotted a few out of many. I strongly urge you to have a fresh pair of eyes read over the paper carefully in the next couple of weeks before public release."

<u>Sixth Draft of the Consultation Paper</u>

7.37 On the same day, the Listing Division replied:-

> "Thanks for the note [with comments on the fifth draft]. Most of the points have already been taken up in our latest draft (actually 3 final-touch drafts over last weekend). Will send you the final draft soon. Thanks."

7.38 Later that day, the SFC's Corporate Finance Division requested a copy of the sixth draft which would be circulated to the Listing Committee. It also alerted the Listing Division of the need to get the Corporate Communications Unit (CCU) ready in case of leakage. In the meantime, the SFC would have its Corporate Communications Division refer everything to the HKEx's CCU. Accordingly, the Listing Division sent a copy of the revised draft Consultation Paper to the Corporate Finance Division on the same day.

<u>Sixth Draft Circulated to the Listing Committee</u>

7.39 Still on the 10 July 2002, the Listing Division circulated the advanced draft of the Consultation Paper to all members of the Listing Committee. The covering letter highlighted that the paper would be "discussed as a policy matter at the Listing Committee meeting on the 18 July 2002" and that "the SFC has agreed, in principle, with the contents of the draft and the Division is in the course of finalizing all the issues with the Executives of the SFC."

7.40 Two documents were attached to the covering letter. The first one was a nine-page Listing Division Report prepared by Ms Anne Chapman (Vice President) and Ms Doris Lee (Senior Manager). This was reviewed by Mr Keniel Wong (Senior Vice President) and recommended by Ms Karen Lee (Head of Listing, Regulation and Risk Management Unit). The document included an executive summary and a summary of the salient points. It was highlighted that:-

(a) "As the areas covered are very extensive, Listing Committee members are requested to refer to the Draft Consultation Paper ("the Paper") for details. The SFC has in principle agreed with the contents of the paper."

(b) "[The Listing Division] proposes to issue the Paper to the market before 25 July 2002. The consultation period will be up to 31 August 2002."

(c) "[The Listing Division] recommends Listing Committee members to endorse the principles proposed in the paper."

7.41 The second document was a 110-page draft Consultation Paper, similar in content and presentation to the version eventually released to the public. Despite the SFC's earlier advice that the Listing Committee should be alerted of detailed statistics relating to the proposed delisting mechanism, (see item 18 in Chronology) neither the Listing Division Report nor the Consultation Paper contained any statistical analyses conducted by the Listing Division on the likely impact of the proposals on the market.

Listing Committee Deliberation

7.42 At the meeting on the 18 July 2002 (Thursday), the Listing Committee discussed the Consultation Paper. Nine out of twenty-four members were present. Two members who could not attend the meeting sent detailed written comments to the Listing Division. These comments touched on the fundamental philosophy of a delisting mechanism as well as technical aspects of the proposals. Their comments were tabled but apparently not discussed.

7.43 The meeting commenced at 4:30 p.m. and ended at approximately 6:51 p.m. During the meeting, the Committee discussed the proposals in great detail. The concerns and questions raised were more on the technical aspects. On general issues, it was suggested that the Consultation Paper should include some general questions on whether the Listing Rules should be tightened or relaxed, and whether there were other areas that the market considered that the HKEx should take into account in formulating further continuing obligations. These questions would allow more room for the market to express their views on broad directions. At the end of the meeting, the Head of Listing Division advised members that the Division would amend the Consultation Paper to reflect the comments made and the paper would be issued in the following week.

Finalizing the Consultation Paper

7.44 Between 18 July 2002 and 23 July 2002, the HKEx worked on the final version of the Consultation Paper by incorporating the comments of the members of the Listing Committee. It also fine-tuned the overall contents of the Paper. The Listing Division wrote to the SFC's Corporate Finance Division on the 26 July 2002, saying that it had made twelve major amendments to the sixth draft of the Paper as a result of comments from the Listing Committee.

Observations

7.45 As shown in the narrative of the events:-

(a) The Listing Division was the main driving force in formulating the detailed proposals. It was the initiator who took the lead in crafting the proposals. The SFC's Corporate Finance Division was intimately involved throughout the exercise. Its comments were detailed and comprehensive, covering not only policy but also matters of detail. As such, the SFC had an important influence in the direction and content of the Consultation Paper. The proposed threshold of $0.5 was a direct outcome of the discussion between the SFC's Corporate Finance Division and the Listing Division. It was most probably a compromise figure, acceptable to both sides for consultation purposes. The actual figure was suggested by the Listing Division after discussion between Mr K C Kwong, the Chief Executive, and Ms Karen Lee, the Head of Listing Division. The SFC was also aware of the shift from a stand-alone share consolidation proposal to it becoming absorbed within a package of listing criteria and delisting procedures without further separate express mention.

(b) The Chief Executive of the HKEx and, even more so, the SFC Chairman were not directly involved in the day-to-day exchanges between the two organizations. The extent of the involvement of the senior officers is discussed in greater detail in Chapter 12.

(c) There were in total eight successive drafts of the Consultation Paper during the twelve-month period from July 2001 to July 2002. Three drafts were circulated during the first 10 months, while five drafts were prepared and revised in the last two months, seemingly reflecting a strong determination to publish the Consultation Paper by July 2002.

(d) The Listing Committee, established as the "gatekeeper" for listing matters, was not involved at any stage in mapping out the general direction. When it had to consider the paper on the 18 July 2002, it did not have statistical analyses to assess the potential market impact. Nor did it appreciate that it was something they had to focus on. It was informed of, but not apparently consulted on, whether and when to release the Consultation Paper. Its endorsement was sought only on the "principles" contained in the Paper. Members were given about a week to read and consider the lengthy documentation. It has been suggested that the timing was also inopportune since the summer time was traditionally when some members took their vacations. Be that as it may, nine out of twenty-four members were able to attend the meeting to discuss this major policy issue. Some of the detailed written comments sent by two absent members who were unable to be present were neither discussed at the meeting nor apparently followed up afterwards, except on one issue which is not germane to this discussion. Those who turned up or submitted comments should be commended for the care they took and for the insights they offered. They are certainly not to be criticized for the events of the 26 July 2002.

INVOLVEMENT OF THE GOVERNMENT

Chronology of Events Involving the Government

7.46 As mentioned in paragraph 7.8(b), the questions of penny stocks, delisting mechanism and the quality of the securities market were touched upon in general terms at two Co-ordination Committee meetings, three Tripartite meetings, one meeting of the Securities and Futures Liaison meeting and two special meetings to prepare for the announcement of the package regarding listing matters. As part of the background to these exchanges were three parallel developments:-

(a) The Bureau under Mr Stephen Ip had taken the initiative to increase liaison with the SFC and the HKEx by setting up tripartite meetings to enable the parties to discuss issues of common concern.

(b) The SFC had conducted an internal study on the quality of the securities market in Hong Kong. It completed its study in December 2001, and shared its findings with the Government and the HKEx, as well as with its consultation network.

(c) The new accountability system was introduced on 1 July 2002. Publicity arrangements were in place to introduce the newly appointed Secretary for Financial Services and the Treasury between 1 July 2002 and 31 July 2002.

7.47 These three developments were taking place when the successive drafts of the Consultation Paper were being prepared. They may have had some bearing, at any rate indirectly, on the Penny Stocks Incident. The key exchanges involving the Government are summarized in the following table and paragraphs (For more details, see the chronology at **Annex 7.1**):-

Date	**Event**
October 2000	Regular meeting between the Secretary for Financial Services (SFS) (Mr Stephen Ip) and the Hong Kong Stockbrokers Association (HKSbA) when the Association expressed concern over penny stocks.
October 2000 to November 2001	Liaison between the Bureau and the SFC's Corporate Finance Division to follow up on the penny stocks issue.
16.2.2001	The Bureau suggested the SFC's Corporate Finance Division look into problems associated with penny stocks and that any proposals should be put to the market for consideration.

Date	Event
2.11.2001	The Bureau wrote to the SFC, copied to the HKEx, suggesting the HKEx engage the HKSbA direct to hear its view in mapping out proposals to address share dilution and other investor protection issues.
12.12.2001	The SFC Chairman wrote to the SFS attaching a copy of the SFC's internal study on the Quality of the Hong Kong Securities Market (the Study), after the Commission was briefed on the findings of the Study at its meeting on 3.12.2001.
13.12.2001	Securities and Futures Liaison Meeting held between the Bureau and the SFC.
21.12.2001	The SFC Chairman wrote to the HKEx Chairman attaching a copy of the Study.
19.1.2002	The HKEx Chairman responded to the SFC Chairman's letter of 21.12.2001.
24.1.2002	First Tripartite Meeting involving SFS, the SFC Chairman and the Chief Executive of the HKEx.
1.3.2002	Co-ordination Committee Meeting involving SFS, the SFC, the HKEx and senior staff.
19.3.2002	Second Tripartite Meeting.
30.4.2002	The SFC Chairman submitted the SFC's Quarterly Report (for the quarter ending 31 March 2002) to the FS. The FS was made aware in general terms of the HKEx's plan to introduce a revised delisting mechanism in 2002.
30.5.2002	Co-ordination Committee Meeting.
7.6.2002	Third Tripartite Meeting.
20.6.2002	The FS had a regular meeting with the SFC Chairman. Later that day, the FS delivered a speech at a cocktail reception to commemorate the 2nd anniversary of the HKEx.
28.6.2002	The SFS drafted a letter for the FS to send to the HKEx Chairman, expressing concern over corporate governance of listed companies and inviting the HKEx Chairman to consider improvement measures.
1.7.2002	Frederick Ma Si-hang assumed office as the Secretary for Financial Services and the Treasury (the Secretary).
3.7.2002	The HKEx Chairman responded to the FS' letter of 28.6.2002, and outlined the HKEx's plans to tighten up initial and continuing listing eligibility criteria (including treatment of penny stocks) and delisting procedures for the Main Board.
8.7.2002	The SFC Chairman wrote to the Secretary informing him of the

Date	Event
	SFC's key initiatives to improve the quality of the Hong Kong listing market and upgrading the standard of corporate governance.
9.7.2002	First special meeting to discuss PR Rollout Plan for the Secretary for 24.7.2002.
9.7.2002	Head of the HKEx's Listing Division informed the Bureau of the HKEx's timetable for circulating the Consultation Paper.
10.7.2002	In response to the Bureau's request, the SFC's Corporate Finance Division sent the Bureau the SFC's summary on proposed initial and continuing listing criteria (the "SFC Summary Table").
17.7.2002	Securities and Futures Liaison Committee held between the Bureau and the SFC.
17.7.2002	The HKEx faxed the Executive Summary of the draft Consultation Paper ("the HKEx Executive Summary") to the Bureau.
17.7.2002	The Bureau passed the SFC Summary Table to SFST's private office.
17.7.2002 Evening	SFST out of Hong Kong (returning to office on Monday, 22.7.2002).
23.7.2002	Second special meeting to finalize PR Rollout Plan for the Secretary on 24.7.2002.
24.7.2002	Joint press conference by the Bureau, the SFC and the HKEx on related but separate package of corporate governance and streamlining of listing processes.

From October 2000 to November 2001

7.48 At the bi-monthly meetings co-chaired by the Secretary for Financial Services and the Chairman of the Hong Kong Stockbrokers Association in October 2000, the Association raised the problem relating to the trading of shares below one cent. The Principal Assistant Secretary (Securities), at all material time Miss Salina Yan, with the day-to-day responsibility for securities matters, immediately relayed the Association's concern to, and continued to follow up with, the SFC's Corporate Finance Division thereafter. The Association re-iterated its concern at subsequent meetings. The Bureau wrote on the 2 November 2001 to the SFC's Corporate Finance Division, and copied the letter to the Chief Executive of the HKEx and the Head of the Listing Division, suggesting the HKEx engage the Association direct to hear its views in mapping out proposals on share dilution and other investor protection issues relating to the Listing Rules.

7.49 During communications with the SFC, the Bureau expressed concern over problems associated with penny stocks and their implications on Hong Kong's reputation as an international financial centre and on investor protection. On the 16 February 2001, the Bureau also raised the issue that delisting would deprive small shareholders of the chance to liquidate their position through the Exchange and that the US model might not be the solution in Hong Kong. Noting that the SFC was reviewing the subject with the HKEx and that there was no clear-cut solution to the problem, the Bureau considered that the sensible thing to do would be to put the issue to the market for its views.

December 2001 to January 2002

7.50 The SFC completed its internal study on "the Quality of the Hong Kong Listing Market: A Critical Review" (the SFC study). After briefing the Commission on the study in early December 2001, the SFC Chairman wrote to the SFS and subsequently to the Chairman of the HKEx attaching a copy of the report.

7.51 In his letter of the 12 December 2001 to the SFS, the SFC Chairman expressed concern that the SFC study confirmed public perception of the deteriorating quality of the Hong Kong market. In particular, the study raised serious questions about the significant numbers of poor-quality listings, the type of companies then being listed, and the standard of those companies. The study also pointed out that those issues, if not addressed, would adversely affect Hong Kong's aspirations as a premier international financial centre.

7.52 The SFC's letter dated 21 December 2001 to the HKEx Chairman, also copied to the SFS, covered a broader range of issues including the following:-

(a) **Regulatory Approach**. Whilst it was part of an international trend to emphasize disclosure regulation more than merit regulation, reliance on disclosure had to mean that there should be full, accurate, timely and meaningful disclosure. Secondly, effective disclosure regulation was premised upon proper investigatory capabilities and stern enforcement. Thirdly, disclosure did not mean every applicant was necessarily dealt with in the same manner. Risky businesses required more disclosure, when all the relevant facts and potential traps had to be highlighted. Fourthly, every successful market had some form of merit regulation.

(b) **Entry, Exit and Gate-keeping**. The Main Board's measures of quality for regulating initial entry were crude. When it became clear a company no longer had any credible business that was sufficient to justify a listing status, delisting should follow.

(c) **Going Forward**. The SFC and the HKEx should work on (i) seeking quality companies to list in Hong Kong; (ii) stepping up disclosure standards and enforcement; and (iii) putting in place meaningful ongoing quality assurance standards.

7.53 The HKEx Chairman responded to the SFC Chairman on the 19 January 2002. This letter was also copied to the SFS. He highlighted the following:-

(a) **Continuing Listing Requirements**. The HKEx had earmarked for improvement its delisting regime as one of the top priority projects for 2002. The HKEx envisaged that the delisting project would review the continuing listing qualifications and address the need for expediting the delisting procedures. The HKEx aimed to complete its study and produce suggestions for changes for discussion with the SFC's executives in the first quarter of 2002. Depending on the outcome of the discussion, the HKEx could consult the market in the second quarter.

(b) **Penny Stocks**. As for penny stocks, the HKEx agreed that it would be desirable to set a floor level of trading prices. The HKEx also mentioned that the executives of the HKEx and the SFC had been discussing this in the course of 2001. The HKEx had proposed that issuers be required to consolidate shares to a theoretical price of 30 cents if the shares had been trading below 10 cents for more than 20 days during a period of

3 months. The HKEx also proposed to prohibit corporate actions by issuers which would result in the theoretical value of the share price falling below 30 cents. The HKEx indicated that it had submitted a draft consultation paper to the SFC executives for comment. (This would be the second draft of the share consolidation paper dated the 20 December 2001, on which the SFC commented on the 25 January 2002.) Subject to those comments, the HKEx proposed to consult the market in the second quarter of 2002. In the summary table attached to the Chairman's letter, it was mentioned that depending on the outcome of the discussion with the SFC, the HKEx might consider combining the listing criteria and penny stocks issue into one consultation.

7.54 The SFS, having communicated the market's concerns to the SFC and the HKEx, was kept in the broad picture of the parties' discussions over market quality, the HKEx's plan to issue consultation papers in relation to penny stocks and the delisting mechanism, as well as the proposed consolidation thresholds of 30 cents/10 cents.

Tripartite Meetings and Co-ordination Committee Meetings

7.55 After receiving the SFC Chairman's letter of the 12 December 2001, the SFS decided to take up the various issues raised by the SFC Chairman by way of tripartite meetings amongst himself, the SFC Chairman and the HKEx's Chief Executive as these issues would affect the development of Hong Kong as an international financial centre. In co-ordinating the first meeting, the Principal Assistant Secretary (Securities) of the Bureau, Miss Salina Yan, wrote to the SFC for suggestions of the issues to be covered at the first meeting. At the same time, she referred to the statutory powers conferred on the SFC to regulate the market operator, including the power to intervene if the situation warranted. She also stressed the need for the regulator to articulate the problems and its views to the market operator clearly.

7.56 The first tripartite meeting took place on the 24 January 2002 and was chaired by the SFS. The SFC Chairman, the Chief Executive of the HKEx and the Deputy Secretary for Financial Services (1) were present[50].

[50] For details on the membership and terms of reference of the Tripartite meeting, refer to **Annex 4.11**.

Up to the 31 July 2002, three meetings had been held on the 24 January 2002, 19 March 2002 and 7 June 2002. The meetings covered a wide range of issues, which were not discussed in detail.

7.57 In addition, the SFS also chaired or attended the Co-ordination Committee Meetings and the Securities and Futures Liaison Meetings[51].

First Tripartite Meeting on 24 January 2002

7.58 At the first tripartite meeting on 24 January 2002, the Chief Executive of the HKEx reported that it was working on delisting and reviewing entry qualifications as part of its drive to improve market quality. The SFC Chairman also agreed to expedite the examination of the HKEx's proposal for compulsory consolidation of penny stocks when the share price dropped below **30 cents**. Comments were in fact sent back by the SFC on the next day.

Co-ordination Committee Meeting on 1 March 2002

7.59 In its progress report made to the Co-ordination Committee meeting on 1 March 2002, the Chief Executive of the HKEx informed the SFC and the HKEx Chairman that the background study on continuing qualification criteria was in progress. Key elements or principles of the proposal would be ready for internal clearance by the end of March 2002. The next step would be market consultation in the second quarter of 2002 and implementation in the last quarter of 2002.

Second Tripartite Meeting on 19 March 2002

7.60 At the second tripartite meeting on 19 March 2002, members again noted that the HKEx was working on its Phase II review, namely, the compulsory consolidation of penny stocks and, separately, a floor price for delisting, as part of its drive to improve market quality, and that the HKEx would discuss proposals with the SFC in one to two months' time. The SFS again raised the issue of engaging the market. The SFS welcomed the Chief Executive of the HKEx to join his regular meetings with stockbrokers

[51] For details on the membership and terms of reference of the Co-ordination Committee meetings and the Securities and Futures Liaison Meeting, please refer to **Annex 4.12** and **Annex 4.10** respectively.

to maintain a dialogue with opinion makers in the industry and to better manage market reaction to changes.

Third Tripartite Meeting on 7 June 2002

7.61 At the third tripartite meeting, the Chief Executive of the HKEx said that the HKEx aimed to consult the public on the proposals on penny stocks and delisting in July 2002. The SFS mentioned that it was important for the SFC and the HKEx to be seen to be addressing questions of minority shareholders' rights. Emphasis about this issue should be put into the proposal on quality of disclosure and the forthcoming proposal for delisting.

SFST Assumed Office on 1 July 2002

7.62 With the introduction of the new accountability system on 1 July 2002, the Hon Frederick Ma Si-hang and Mr Tony Miller assumed office as Secretary for Financial Services and the Treasury (the Secretary) and the Permanent Secretary for Financial Services and the Treasury (Financial Services) (PSFS) respectively. Included in their comprehensive briefing papers was an outline of the measures to improve the corporate governance standards in Hong Kong. This mentioned, briefly, that a public consultation by the HKEx on delisting and penny stocks was in the offing.

1 July to 24 July 2002

7.63 Starting from early July 2002, the Bureau co-ordinated with the SFC and the HKEx with a view to drawing up a package of proposals and PR rollout plan for the Secretary on "enhancing corporate governance and streamlining processes". The emphasis in this package was not on penny stocks or delisting which were barely adverted to. The Bureau convened two special meetings on the 9 and 23 July 2002 to discuss and finalize the package. In the process, the Bureau, the SFC and the HKEx exchanged notes on the PR plan. The Listing Division of the HKEx also mentioned to the Bureau and the SFC its intention to circulate the draft Consultation Paper to the Listing Committee on the 10 July 2002, to hold the Committee meeting on 18 July 2002 and to publish the Consultation Paper on the 25 July 2002.

7.64 To prepare for the joint press conference to be held on the 24 July 2002, and in case the new Secretary might be asked about the delisting proposals which were already in the public domain, the Principal Assistant Secretary (Securities) obtained a summary prepared by the SFC on the "Proposed Admission and Continuing Listing Criteria and Delisting Procedures" (the SFC Summary Table) from the SFC's Corporate Finance Division on the 10 July 2002. On the 17 July 2002, because she had not been able to seek confirmation from the SFC as to the finality of the SFC Summary Table, she also obtained from the Listing Division a copy of the Listing Division Report and an Executive Summary of the latest draft Consultation Paper circulated to the Listing Committee (the HKEx Executive Summary). Later, after having been told that the SFC Summary Table was the final version, she passed the SFC Summary Table (but not the HKEx Executive Summary) to the Administrative Assistant to the Secretary on the 17 July 2002. The SFC Summary was in many ways a more concise and self-contained document which was also easier to understand.

<u>Involvement of the Financial Secretary</u>

7.65 The Financial Secretary was not involved in the meetings and correspondence detailed in paragraphs 7.48 to 7.64. He was made aware, in very general terms, of the HKEx's plan to introduce a new delisting mechanism in 2002. First, in the SFC's Quarterly Report for the quarter ending 31 March 2002 submitted to him on 30 April 2002, it was mentioned that the HKEx was currently considering tightening the quality of listed companies by introducing more stringent delisting criteria, and that the HKEx would consult the market in the second quarter. A copy of the report was, as usual, also sent to the SFS.

7.66 Secondly, on the basis of the draft points-to-make provided by the Bureau, the Administrative Assistant to the FS provided the FS with draft remarks for the HKEx's second anniversary cocktail reception held on the 20 June 2002. The FS deployed the remarks accordingly, which mentioned that the HKEx would shortly put forward another consultation paper on the delisting mechanism to improve the quality of the market.

7.67 Thirdly, in a letter dated the 3 July 2002 from the HKEx Chairman, it was mentioned that:-

> "We have proposed to the SFC certain tightening up of the initial and continuing listing eligibility criteria (including treatment of penny stocks) and delisting procedures for the Main Board. We are finalizing the

consultation paper with the SFC and will issue it by end-July/early August. The aim is to implement the new rules in the first quarter of 2003."

OBSERVATIONS

7.68 As shown in this narrative:-

(a) The Bureau was aware that the HKEx, in consultation with the SFC, had been working on the proposals on compulsory share consolidation, listing criteria and delisting procedures. Both the HKEx and the SFC updated the FSB on the progress, in general terms, from time to time. Specifically, the Bureau was made aware that the proposals on share consolidation and delisting would be combined into one consultation paper to be issued in late July/early August 2002. In the second week of July 2002, the Bureau was informed of the timetable for the release of the Consultation Paper.

(b) No member or Bureau of Government was involved in the formulation of the proposals, even if it was the Bureau which had, at an early stage, expressed views on the possible solutions to problems associated with penny stocks, and suggested that the proposals should be put to the market for consideration.

(c) The Government was not informed of the details of the proposals and did not receive copies of the Consultation Paper until the 26 July 2002. The Bureau was made aware of a proposed consolidation threshold of 30 cents/10 cents on 19 January 2002 in the letter from the HKEx Chairman to the SFC Chairman which was copied to the SFS. There was also brief discussion at the first tripartite meeting on the 24 January 2002. The Government did not have any of the details until receiving the SFC's summary on 10 July 2002 and the HKEx's Executive Summary on the 17 July 2002. Both went in the first instance to Miss Yan. They were requested as background material to facilitate in the preparation of the new Secretary for the joint press conference on the 24 July 2002. It was not anticipated that issues about delisting and penny stocks would be raised at that briefing, but a good civil servant is always prepared!

COMMUNICATIONS WITH THE MARKET

The HKEx

7.69 The HKEx has a dedicated unit, the Corporate Communications Unit (CCU), to assess market and public interest. For the proposals in the present Consultation Paper, the CCU was tasked with keeping track of all media reports, handle media enquiries and make appropriate publicity and PR arrangements relating to the roll-out. According to the HKEx, the market and the investing public were kept informed of its plans through the media:-

(a) The CCU collected over 100 media reports on penny stocks and delisting mechanism from 11 January 2001 to 25 July 2002, a summary of which is at **Annex 7.2**[52]. This is an extremely useful document and shows the level of details available to the public, issues discussed in the media and the market reaction to the various proposals available for discussion at different times.

(b) The HKEx had informal discussions with market participants in early 2001. The initial focus was on share consolidation, on which mixed views expressed by the market were noted.

(c) On 20 December 2001, the Chief Executive of the HKEx, in presenting the HKEx's 2002 business plans at a press conference, mentioned that it was conducting an internal study to revamp the share delisting mechanism.

(d) The Chief Executive of the HKEx further mentioned in what is now often referred to as a stand-up interview with journalists after its annual general meeting on 17 April 2002 that it would publish a consultation paper on a delisting mechanism.

52 The summary is supplied by the HKEx, and is only available in Chinese.

(e) The CCU organized a series of media interviews and luncheons for the Chief Executive and Head of the Listing Division in May and June 2002. The quality of listed companies was one of the issues discussed. The media arrangements included a lunch with the editors of seven major Chinese language newspapers, interviews with several major English- and Chinese-language newspapers and interviews with two electronic media organizations. In these forums, the HKEx communicated to the news media its plan to publish a consultation paper on listing and continuing listing eligibility criteria.

(f) On 16 July 2002, at the invitation of the editor of the South China Morning Post, the Chief Executive of the HKEx, the Head of the Listing Division and the Head of the CCU, visited the newspaper's newsroom and had an informal discussion with members of its editorial team. Without disclosing any details, the Chief Executive mentioned, among other things, that the consultation paper on listing eligibility had been submitted to the Listing Committee for consideration. He also mentioned that there would be qualitative and quantitative continuing listing criteria.

7.70 The HKEx did not keep records of its informal attempts to engage market participants directly or indirectly in formulating its proposals. In this connection, we note also that:-

(a) The HKEx's efforts were targeted at the media rather than market participants, particularly small investors. This is not, as such, a criticism and clearly the media is as good a forum as any to disseminate information. The media, however, until things go wrong, are not usually an adequate repository of public concerns.

(b) Whilst the HKEx had access to a large pool of distinguished community leaders and leading practitioners sitting on its Board, Panels and Committees, the HKEx did not tap their views, either informally or formally. The HKEx has taken a very strict view of the segregation of its business and regulatory functions. Staff felt that that segregation inhibited or even prohibited the informal consultation of members of the Exchange family in their personal capacity. The HKEx has now re-thought this. More later.

(c) As mentioned in paragraphs 7.39 to 7.45, the Listing Committee was not involved until the final stages.

(d) The fact that the Hong Kong Stockbrokers Association chose to reflect its concerns over listing matters to the SFS (the policy overseer) rather than the HKEx (market operator) is some indication of the inadequate engagement of and communications between the HKEx and the stockbroking community. This is a constant refrain, we note, in the representations made by some of the invited parties to the LegCo Panel on Financial Affairs hearing on the 31 July 2002. The submissions sent to us are much more explicit and severe in making these, and related, points.

The SFC

Consultation Networks

7.71 The SFC has an established and well-oiled consultation network – the Commission itself, the Shareholders Group and the Advisory Committee. The SFC briefed all three on its internal study "the Quality of the Hong Kong Market: A Critical Review" (the Quality Paper) in December 2001, March 2002 and May 2002 respectively. The SFC did not consult the three groups on the HKEx's draft Consultation Paper. It had received a severely worded letter from the HKEx in December 2001, detailed below, when it had passed onto the HKEx comments from the Shareholders Group regarding certain other proposals of the HKEx which were due to be published in another consultation paper. The SFC became wary of the HKEx thinking that it was overstepping its bounds or that it was interfering with how the HKEx was conducting its own consultations.

Consulting the Shareholders Group on the HKEx's Proposals

7.72 On 12 December 2001, the Listing Division of the HKEx wrote to the SFC's Corporate Finance Division, expressing concern over a letter from the secretary for the SFC's Shareholders Group with comments on the

HKEx's proposed amendments to the Listing Rules relating to corporate governance. The head of the HKEx's Listing, Regulation and Risk Management Unit, after consulting the Chief Executive of the HKEx, put the matter this way:-

> "I am very surprised indeed, and rather concerned, to note that our draft paper was discussed at the Shareholders Group meeting, and comments on the papers have been officially passed to us via the secretary for the Shareholders Group. The draft consultation paper was not a finalized version. The Listing Committee had not even considered our proposals. The paper was provided to you in the context of our very good working relationship with mutual trust in terms of confidentiality. We did not expect, and are very concerned, that another organization other than your office has reviewed and discussed the paper before the proposals are finalized and deliberated by the Listing Committee."
>
> "Would you therefore please advise whether the SFC provided the Shareholders Group a copy of our draft consultation paper."
>
> "As for the views of members of the Shareholders Group, we consider it is only appropriate that they be considered in the market consultation process at the appropriate time. We will consider their views in our analysis of the responses."
>
> "In light of the above, please confirm that in future draft policy papers provided by us to the SFC in confidence will not be passed to the Shareholders Group for discussion unless prior agreement has been given by us."

7.73 In its reply on 14 December 2001, the SFC's Executive Director for Corporate Finance (Mr Ashley Alder) said this:-

> "I fully appreciate your concerns about confidentiality and information dissemination. You can be assured that your drafts of the consultation paper has not been circulated to anyone outside the Commission staff. The Shareholders Group was appointed to advise the Commission on matters of interest to shareholders. To

see the body as an "organization" would be a misconception, its function is integral to the SFC's work and it should be viewed as an important mechanism enabling us to make decisions and arrived at views which are informed by the Group's input. Furthermore, the Government has repeatedly and increasingly stressed the importance of this Group in the work of the Commission and the need for us to seek the views of the Group members on relevant proposals. Indeed, to formalize its set-up and enhance its profile, we are in the process of making the Group a statutory committee under Section 6 of the SFC Ordinance."

"Given the importance of the issues that the draft proposals address and the key advisory role of the Group, I am convinced that had we not consulted the Group at this stage we would have been subject to justifiable criticism, including by members of the Group. Exercises like this are what the Group is for."

"Again, I assure you that the draft consultation papers were not circulated. We made only a very brief summary of the potential proposals, having also reminded members that they were to be kept strictly confidential and, in particular, that all members are bound by the applicable statutory secrecy provisions."

7.74 The HKEx and the SFC had no further correspondence or meetings on this subject. The SFC has since this incident not discussed any Listing Rules changes with its Shareholders Group. The SFC has also not conveyed the comments of the Shareholders Group to the HKEx. Neither has the views of the Shareholders Group been sought by the HKEx. We note that in the newspaper summaries put together by the HKEx (**Annex 7.2**), an item against the 15 March 2002, shows that Mr Ashley Alder was reporting to the LegCo Panel on Financial Affairs of the views of the Shareholders Group on penny stocks and delisting.

7.75 There is a slight change in direction and tone in the submission provided by the Chief Executive to us:-

"In so far as the Shareholders Group is concerned, the Exchange accepts that the Group is part of the

> consultation structure under the SFC and believes that the SFC would have raised with the Exchange any serious comments from the Shareholders Group, as the SFC considered appropriate, during the course of preparation and discussion of the contents of the draft Consultation Paper. As shown in the SFC's letter of 14 December 2001, there was a specific understanding between the Exchange and the SFC that the SFC would not consult "outside parties", the Shareholders Group being considered by the SFC as a formal set up within the SFC."

Observations

7.76 We hope that the current direction can be maintained. If Mr Kwong's current understanding had earlier been communicated to the SFC, instead of the strongly worded version, the SFC would have been able to consult its Shareholders Group fully on the HKEx's consultation papers and proposals, and could have raised with the HKEx the well-considered comments of that Group. As it was, the SFC felt inhibited from consulting its Shareholders Group on the HKEx's actual proposals. The previous attitude of the HKEx, rightly or wrongly held, had the effect of preventing the SFC from fully engaging its network in gauging market feedback which would have benefited the HKEx.

Shareholders Group Meeting on the 6 March 2002

7.77 Whilst the SFC did not consult its Shareholders Group and Advisory Committee on the actual proposals contained in the HKEx's draft Consultation Paper, the questions of penny stocks, share consolidation and delisting were discussed when the SFC's Quality Paper was considered.

7.78 On the 6 March 2002, the Shareholders Group discussed the question of problems associated with penny stocks in Hong Kong. Members expressed diverse views, some of which are summarized below:-

(a) They generally agreed that penny stocks were susceptible to manipulation. The prevalence of penny stocks fostered a punting environment and created credibility problems.

(b) They had mixed views on whether a delisting sanction was a fair and effective way to tackle problems associated with penny stocks. Some investors would simply equate delisting with liquidation. Members called for adequate protection for investors so that they would not lose out once the stocks were delisted. Some members suggested the introduction of alternative trading platforms. Proposals included the Pink Sheet, the Over-the-Counter Bulletin Board, relisting on the Growth Enterprise Market and the introduction of a "third" board or a "sick ward". The "sick ward" would also have a clear signaling effect, suggesting that investors should pay special attention to the risk elements of this segment of the market.

(c) Members generally supported the introduction of quantitative criteria to make the delisting mechanism more transparent and practicable. The members did not, in general, consider that the trading price would be a good indicator of a company's performance. Some members also thought that a price threshold of $1 may be too arbitrary.

7.79 The SFC did not formally or informally relay these views to the HKEx, but some of the views expressed were gently worked into its own comments on successive drafts sent to it for comment by the HKEx.

Advisory Committee Meeting on the 13 May 2002

7.80 At its meeting on the 13 May 2002, the SFC Advisory Committee discussed, among other things, the quality of the Hong Kong listing market and regulation of corporate information disclosure. The Committee did not discuss penny stocks specifically. The question was more on whether the existing regulatory framework was effective to enhance the quality of the listing market in Hong Kong. It was pointed out that the HKEx was a profit-making entity, and that it might have, or be seen to have, conflicts of interest in exercising its profit-making business function and regulatory function. Moreover, it was felt that the Listing Committee did not actually have the power that it should have. And because the HKEx also had no investigatory powers, some members, suggested that in the long run the SFC should consider taking over the HKEx's listing (and regulatory) functions because of the conflicts of interest inherent in the position of the

HKEx. These comments reflect views held fairly widely, and mirrored in many of the submissions and representations made to us. Members also felt that there should be in the listing rules more stringent minimum entry requirements.

<u>Government</u>

7.81 The Government was not involved in the consultation of the market. The market had brought up the issue for discussion with the Bureau during its regular liaison meetings. The Government's approach was, first, to convey those sentiments to the HKEx and the SFC and, secondly, to encourage the HKEx to engage the market so that other views could be reflected to the HKEx and the SFC.

OVERALL OBSERVATIONS

<u>Formulating the Proposals</u>

7.82 The HKEx's Listing Division was the main architect of the proposals contained in the Consultation Paper. Staff in the SFC's Corporate Finance Division provided detailed comments on successive drafts. Neither the HKEx nor the SFC had sought the views of the Government and the usual consultation network to which the Government had recourse in gauging market feedback was not engaged. The HKEx's action was, to a large extent, dictated by its practice of not conducting sounding out exercises beforehand and influenced by its belief, a not unreasonable one, that the paper was a consultation paper, and precisely the instrument designed to seek broadly based views and comment on its proposals. The market and the public would be afforded ample opportunity to express their views during the consultation period.

7.83 In the formulation stages, the HKEx and the SFC did discuss an issue of concern to the public, namely whether there should be an alternative trading platform. As this is an issue of some importance, we recapitulate some of the key discussion points in the following paragraphs.

<u>Alternative Trading Platforms</u>

7.84 The initial focus of the HKEx was on the mandatory consolidation of penny stocks, and the amending of its rules relating to delisting was to be a separate issue. The question of delisting and alternative platforms for delisted stocks were however touched upon by the SFC in December 2001 in its internal study, which contained these observations:-

> "In a number of markets, penny/micro cap companies unable to become listed on an exchange (or having been delisted from an exchange) would be traded in the over-the-counter (OTC) market. The OTC Bulletin Board and Pink Sheets in the US are two well-known examples. The UK, Taiwan and Korea also have similar "junior markets" catering for small companies of unknown quality."
>
> "These OTC platforms typically provide a less regulated environment where misconduct could be widespread. Yet clear segmentation between OTC and exchange markets serves as a forceful risk warning to investors. It also protects the reputation of the main market from being tarnished by poor-quality issuers."
>
> "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 market are large enough to support a third listing segment (in addition to the Main Board and the GEM)."

7.85 Between December 2001 and June 2002, the Listing Division and the SFC's Corporate Finance Division also discussed two other possible alternative trading platforms.

(a) **<u>Re-listing on GEM</u>**. As mentioned in paragraph 7.30(c), the SFC had suggested the possibility of allowing delisted companies to be relisted on the GEM. The Listing Division was not enthusiastic. First, the GEM was set up, not as a second board, but as a board for growth enterprises. The future development of the GEM is a policy decision outside the purview of the Listing Division. Second, immediate and automatic relisting on the GEM after delisting might create an image problem for the GEM. There should be a "cooling-off" period before relisting would be allowed. Third, delisted companies must also meet the listing criteria for the GEM.

(b) **Adding a Prefix "4" before its Stock Code**. In early June 2002, the SFC also suggested the possibility of allowing delisted companies to remain traded, but with a prefix "4", commonly regarded as meaning "dead" in Cantonese, to distinguish them. This idea probably evolved from the "sick-ward" suggestion discussed by the Shareholders Group on the 6 March 2002 (see paragraph 7.78(b)). The Listing Division thought it would be confusing to have both regulated and unregulated markets operating on the same trading platform. The SFC's Corporate Finance Division did not pursue the subject further.

7.86 These proposals were not taken further, apparently also for the following reasons:-

(a) The Listing Division took the view that as companies would have nearly two years to bring themselves back to compliance, investors would have plenty of time to exit, and, if a company failed only the minimum trading price requirement, it could quite simply rectify the position by share consolidation. In the end, those companies which would have to be delisted were not likely to have any value or investor interest, and are most likely to be companies with fundamental and incurable problems, rather than simply companies the shares of which were trading below 50 cents.

(b) Related to (a), the SFC's and the HKEx's assessment was that the number of companies affected by the whole delisting package would be around 20 or between 20 and 30. Given the small numbers, it was doubtful whether a third board would be viable and justifiable. This figure of around 20 or between 20 and 30 was arrived at by applying to listed companies all the other proposed criteria for delisting. It was a given that companies whose only problem is a share price below 50 cents would be able to avoid the delisting process by share consolidation.

(c) The Consultation Paper was intended to seek the views of the public. It was to be an opinion gathering exercise on the basis of comprehensive discussion of proposals. If the market felt strongly that there should be an alternative trading platform or, for that matter, any other reform, the HKEx would consider the suggestions. This was, to the HKEx and the SFC, the whole purpose of having a consultation paper.

7.87 Whilst we do not, and cannot, say that any of these views are unreasonable or implausible, there is little doubt in our minds that they should have been suitably ventilated and discussed in the Consultation Paper. It should have been anticipated, especially by the Listing Division, that the average man or woman in the street is not likely to possess the necessary knowledge and insight to consider these different concepts in a sophisticated manner, and they will be concerned that, without a listing, their shares would or might be worthless.