
**Report of
the Panel of Inquiry on
the Penny Stocks Incident**

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Legend of Abbreviations

AMS	Automatic Order Matching and Execution System
Bureau	The Financial Services Bureau (before 1.7.2002) The Financial Services and the Treasury Bureau (since 1.7.2002)
CE	Chief Executive of the Hong Kong Special Administrative Region
FS	Financial Secretary
FSA	Financial Services Authority
FSB	Financial Services Bureau
FSTB	Financial Services and the Treasury Bureau
GEM	Growth Enterprise Market
HKEx	Hong Kong Exchanges and Clearing Limited
MOU	Memorandum of Understanding
LegCo	Legislature Council
MSCI	Morgan Stanley Capital Investment
OTC	Over-the-counter
PRP	Process Review Panel
PSFS	Permanent Secretary for Financial Services and the Treasury (Financial Services)
SAM	Semi-automatic Matching System
Secretary	The Secretary for Financial Services and the Treasury
SEHK	Stock Exchange of Hong Kong Limited
SFAP	Securities and Futures Appeals Panel
SFC	Hong Kong Securities and Futures Commission
SRC	Securities Review Committee
UK	United Kingdom
US	United States

EXECUTIVE SUMMARY

INTRODUCTION

1. On the 25 July 2002, the Hong Kong Exchanges and Clearing Limited (the HKEx) released a “Consultation Paper on Proposed Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Criteria and Cancellation of Listing Procedures” (“the Consultation Paper”) for public consultation. As part of the package, the HKEx proposed that prices of listed companies’ shares quoted at below \$0.5 should be consolidated, failing which, after a series of procedures and possible appeals, delisting may follow. There were a number of other proposed criteria for delisting in the Consultation Paper. The consultation period was to last until the end of August 2002.

2. On the 26 July 2002, 577 (or 76%) out of the 761 stocks listed on the Main Board recorded a loss. The aggregate market capitalization of stocks with a quoted closing price of \$0.5 or below as of the 25 July 2002 (penny stocks) declined by \$10.91 billion, representing about 10% of the market capitalization of that sector and about 0.3% of the total market capitalization of the Main Board. Sixty-six stocks (62 of which were penny stocks) suffered a decline of 20% or more. The top loser saw a price plunge of 88%. On the 27 July, the HKEx decided to extend the consultation period to the end of October and, a day later, announced its decision to withdraw Part C of the Consultation Paper, the section dealing with “Continuing Listing Eligibility Criteria” to be re-issued in October 2002.

3. The market reaction and concern expressed about the Incident led the Financial Secretary (FS) to appoint a panel of inquiry to look into the circumstances relating to the preparation and release of the Consultation Paper. The Panel was asked to submit a report with conclusions and recommendations by the 10 September 2002.

4. During the inquiry, the Panel received 71 written submissions from 20 organizations and eight individuals, and interviewed 11 individuals.

MAJOR FINDINGS

5. The HKEx (i.e. the Listing Division and the Chief Executive) was the main architect of the proposals contained in the Consultation Paper. The Securities and Futures Commission (SFC), mainly the Corporate Finance Division, was intimately involved throughout the exercise in providing detailed and comprehensive comments covering not only policy but also matters of detail. The SFC had an important influence in the direction and content of the Consultation Paper. The proposed threshold of \$0.5 ultimately chosen by the HKEx was a direct outcome of the discussion between the SFC and the HKEx.

6. 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 HKEx and the SFC. The Chief Executive of the HKEx, however, provided direction on key issues, including the \$0.5 threshold, and was kept informed throughout of the progress.

7. The Listing Committee of the HKEx, established as the “gatekeeper” for listing matters, was not involved until about two weeks before the release of the Consultation Paper. The Chairman and the Board of Directors of the HKEx had very little to do with the direction and details of the Consultation Paper.

8. The Government became aware of the problems and issues associated with penny stocks, and the quality of the securities market, from about late 2000. It was kept in the general picture, via the then Financial Services Bureau, mainly by the SFC, but also by market participants and later on by the HKEx as well. The Bureau, the Secretary for Financial Services and the Treasury (the Secretary) and the FS were aware of the HKEx’s plan to issue a consultation paper covering a number of areas including a revised delisting mechanism. The details of the proposals were not discussed with the Government nor was its input sought. Summaries of the proposals were supplied to the Bureau by the SFC and by the HKEx on the 10 July and the 17 July respectively.

9. The SFC had discussed the general issues about the quality of the securities market with the full Commission (December 2001 and May 2002), with its Shareholders Group (March 2002) and its Advisory Committee (May 2002). There is no formal record of the HKEx having

conducted extensive informal consultation with outside parties on issues to do with penny stocks or the proposals contained in the Consultation Paper. There were, however, efforts since 2001 to keep the media informed of its plans to introduce a modified delisting regime.

CONCLUSIONS

10. Our conclusions are set out in the following paragraphs.

Conclusion No. 1

11. There is overwhelming market and public support for the improvement of the quality of the securities market in Hong Kong. There is a clear consensus that the authorities should work together to enhance Hong Kong's position as a premier international financial centre.

Conclusion No. 2

12. The authorities should press ahead with reform measures, and not allow the Penny Stocks Incident to derail or slow down the ongoing reforms.

Conclusion No. 3

13. Initiating and implementing reforms involve care, consideration, sensibility and resolve on the part of those involved. Market practitioners and the public have expressed a strong wish to be heard. The success of market reforms depends on informed public debate.

Conclusion No. 4

14. The Government, the SFC and the HKEx have demonstrated resolve to introduce reforms as soon as possible, although sectors of the public may not share the authorities' view on the desirability and pace of the reforms.

Conclusion No. 5

15. The Penny Stocks Incident has confirmed the need to tackle the problems associated with penny stocks. The Incident seemed to have been the result of a combination of factors which fed on and magnified each other. The release of the Consultation Paper by the HKEx may have been the trigger for the plunge on the 26 July, but it was not the only factor.

Conclusion No. 6

16. The whole consultation would have been better managed if more pre-consultation activities had been carried out and if the market had been engaged in developing the concept and details of the proposals.

Conclusion No. 7

17. The HKEx and the SFC have worked diligently, and had adhered to the well-established practices in the processing of similar consultation papers. With the benefit of hindsight, the HKEx could have improved the arrangements had there not been certain structural obstacles, including the lack of engagement of its consultation network, the somewhat unclear role and expectation of the Listing Committee, the occasionally tense relationship with the SFC, all of which prevented the HKEx from making full and complete use of the knowledge, experience and expertise which could have been available to it.

Conclusion No. 8

18. The reaction of the authorities after the 26 July and the expectations and debate to do with the newly introduced accountability system led to much criticism and discussion. There was a perception that the roles of the Government, the SFC and the HKEx within the three-tiered regulatory structure suffered from a lack of clarity over, in particular, the delineation and division of responsibilities amongst the three parties.

Conclusion No. 9

19. There is overwhelming support for the continuation of the three-tiered regulatory structure, which is considered to have served Hong Kong well over the past 13 years. It may, however, be time for the structure to be fine-tuned to ensure better co-ordination amongst the three layers.

RECOMMENDATIONS

20. We recommend improvements in five 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

21. 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 identify the key issues, build consensus, instill public confidence and facilitate informed public debate.

22. Building on the efforts already made, we **recommend** that:-
- (a) the HKEx, the SFC and the Government should make the most constructive and efficient use of the existing consultation channels including the HKEx Board, the Consultative Panels, the Listing Committee and the SFC's Shareholders Group. The HKEx should consider setting up working parties on major policy proposals;
 - (b) the HKEx should consider increasing and improving liaison with the stockbroking industry to increase its efficacy;
 - (c) the HKEx should ensure that the consultative network, whether existing and new, should comprise key stakeholders including investors, intermediaries, credit providers, issuers and those who are able to represent the views of the investing public. Specifically, the HKEx should consider setting up its own consumer panel, shareholders group and groups for small-and-medium sized financial intermediaries and enterprises; and

-
- (d) the HKEx should consider, in appropriate cases, a two-staged consultation process: conceptual philosophical stage and the detailed proposal stage.

23. We welcome the initiatives taken by executives of the HKEx to devise new mechanism to improve the process for sounding out the market in the preparation of consultation papers on proposed changes to its Listing Rules. We **recommend** that these discussions be continued and brought to its Board of Directors as soon as possible.

Assessing Market Reaction

24. We **recommend** that:-

- (a) in seeking the approval of the Listing Committee for the issue of consultation papers, the HKEx should provide to the Committee its analysis of the likely effect of the proposals, particularly on the investing public, in sufficient detail and in good time to enable the Committee to fully consider the proposals, make changes and to decide, ultimately, whether to issue the paper;
- (b) in releasing consultation papers, the HKEx should explain to various stakeholders the likely effect of the proposals, in particular on the investing public; and
- (c) for consultation involving major policy ramifications or where the issues affect other segments of the financial markets, the HKEx and, where applicable, the SFC should bring these matters to the attention of the Government at an early stage.

Improving the Consultation Process

25. 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. 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 the views expressed in the representations made, its observations and responses to those views as well as its conclusions; and
 - (d) the HKEx should continue and expand its reach-out programmes.

Reviewing the Three-tiered Regulatory Structure

26. The three-tiered regulatory structure itself is sound in principle, but can do with refinements. We **recommend** that the authorities:-

- (a) critically review whether and if so, how the existing structure, roles and operation of the Listing Committee can be improved;
- (b) clarify the roles, responsibilities and procedures for processing consultation papers and amendments to the Listing Rules;
- (c) strengthen the current liaison mechanism at senior levels of the HKEx and the SFC; and
- (d) clearly identify the areas for joint consultation by the SFC and the HKEx.

27. In the medium-term, the Government, the SFC and the HKEx should review how best to redefine the roles and functions over listing matters with a view to increasing the effectiveness, efficiency, clarity, fairness and credibility of the regulatory system.

28. The Government should clearly position itself as a facilitator and co-ordinator and not as a regulator. This role should be unambiguously communicated to the industry and to the investing public to avoid false expectations.

Strengthening Investor Education and Protection

29. We **recommend** that:-

- (a) careful consideration should be given to how minority shareholders' rights should be protected; and
- (b) measures to enhance investor education be considered to enable investors to make informed choices.

OTHER RECOMMENDATIONS

30. We **recommend** that the Government should, as a matter of priority:-

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

FINAL REMARKS

31. This inquiry should not be taken as a fault finding exercise. We did not discover the serious cancer which we were led to believe existed. Instead, we uncovered some instances of errors of judgment, some perhaps even understandable in the circumstances, a few mishaps, examples of miscommunication and some systemic wrinkles here and there. None of the shortcomings we have identified are in themselves major. The combination of circumstances, however, led to the unanticipated events of the 26 July and the less than favourable public response to how the matter was dealt with thereafter by the authorities.

32. To the regulators, investors and the economy as a whole, the Penny Stocks Incident has been a costly lesson. 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. We hope that lessons can be learnt and improvements put in place for the future.

CHAPTER 1

INTRODUCTION

THE PENNY STOCKS INCIDENT

1.1 Penny stocks, micro-caps¹ and delisting mechanisms have been receiving the attention of the securities industry and the media for the past two years. Suggestions for reform were formally introduced to the public on the 24 July 2002² when the Secretary for Financial Services and the Treasury (the Secretary), in the context of announcing other measures, mentioned that the Hong Kong Exchanges and Clearing Limited (HKEx) would release a consultation paper which would deal with issues to do with listing and delisting on the 25 July 2002.

1.2 At about noon on the 25 July 2002, the HKEx conducted a press briefing to introduce its “Consultation Paper on Proposed Amendments to the Listing Rules relating to Initial Listing and Continuing Listing Eligibility and Cancellation of Listing Procedures” (“the Consultation Paper”). The HKEx recommended, among other things, a revised mechanism to delist companies which fail to meet what were described as continuing listing eligibility criteria. As part of the package, the HKEx proposed that stocks with share prices quoted at HK\$0.50 or below should be consolidated, failing which, after a series of procedures and possible appeals, delisting may follow. The consultation period commenced on the 26 July, and was to end by the 31 August.

1.3 The Consultation Paper did not have any major impact on the securities market on the afternoon of the 25 July. When trading commenced at 10:00 a.m. on the 26 July (Friday), all was relatively normal until around 10:45 a.m. Thereafter, for about an hour, there was a large

¹ There is no official definition of “penny stock” and “micro-cap” in Hong Kong. Recently, the term “penny stocks” has been used to describe stocks which trade at below a certain price, say \$0.5. “Micro caps” are usually those companies with small market capitalization. There is no standard definition. The figures of HK\$100 million or US\$20 million have both been used.

² On 24 July 2002, the Financial Services and the Treasury Bureau, the Hong Kong Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited conducted a joint press briefing announcing a package of measures to improve the listing structure and procedures. This did not include proposals relating to delisting.

sell-off of stocks, leading to prices tumbling. Out of the 761 stocks³ listed on the Main Board, 577 (or 76%) recorded a loss, 151 (or 20%) had no price change and 33 (or 4%) made gains. Of the 370 penny stocks (i.e. stocks with closing prices at or below \$0.5 on 25 July), 283 (or 76%) recorded a loss, 75 (or 20%) was unchanged and 12 (or 3%) increased in price. The aggregate market capitalization for penny stocks declined by \$10.91 billion, representing about 10% of the market capitalization for that sector and 0.3% of the total market capitalization of the Main Board. Sixty-six stocks (62 of which were penny stocks) suffered a decline of 20% or more. The top loser saw a price plunge of 88%.

1.4 In view of the strong market reaction, the Secretary and, separately, the Hong Kong Securities and Futures Commission (SFC) and the HKEx stressed on the 26 July that the proposal was only part of a market consultation exercise. They stressed that it would take a few months to formulate the rules for implementation, and even if new rules were to be adopted, there would be a 12-month transitional period before they are implemented. On the 27 July, the HKEx announced its decision to extend the consultation period to the 31 October. A day later, the HKEx announced its decision to take out the whole of Part C of the Consultation Paper on continuing listing criteria as part of the current consultation. The HKEx undertook to strengthen the proposals and publish a supplementary paper by the end of October and would allow the public another three months to express its views.

1.5 Whilst stock prices stabilized after the 29 July, the incident continued to generate widespread disquiet. Against this background, the Financial Secretary appointed a panel to look into the incident and to recommend measures for improvement.

APPOINTMENT OF THE PANEL

1.6 On the 31 July 2002, the Financial Secretary announced the appointment of a panel of inquiry to look into the circumstances relating to the preparation and release of the Consultation Paper on 25 July 2002.

1.7 The terms of reference of the Panel were:-

³ This figure includes tradable stocks and excludes suspended shares.

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- (a) To examine the existing procedures for the preparation and making of new or amended Hong Kong Exchanges and Clearing Limited (HKEx) rules and regulations, including the process of consultation with the trade and the public;
 - (b) Having regard to the findings in (a), to review the arrangements for the preparation and release of the Consultation Paper;
 - (c) To make recommendations as to the measures to be adopted to improve where necessary the co-ordination in and procedures for the preparation and making of similar rules and regulations in the future, including the process of consultation with the trade and the public; and
 - (d) To submit a report with conclusions and recommendations to the Financial Secretary by 10 September 2002.

SCOPE OF THE INQUIRY

1.8 It became apparent to us from the very beginning that the issues of concerns surrounding the penny stocks incident were many and varied. We were on a very tight schedule and even if the terms of reference had permitted, we would not have been able to cover more than we have. Clearly we would not have been able to consider all the rules of the HKEx or issues of compensation. At the same time, encouraged as we were by the public utterances of the Financial Secretary and the Chief Executive of the HKSAR after our appointment, we felt able to consider various matters of public interest and concern which may not, on a very strict reading, be within the scope of the words employed in the Terms of Reference. We felt that it was important and necessary to supply the necessary background and context without which our report would have been less meaningful. While we obviously could not venture beyond our mandate, we felt able to construe our remit fairly generously where necessary. We anticipate that there may still be those who would say that our focus has nonetheless been too narrow and some who would say we have cast our net too widely.

1.9 Within the time and with the resources available to us, and given that we have been appointed to look into fairly specific areas, we felt that while we could take a broad view in a number of instances, we nevertheless had to adopt a balanced approach and be guided by the

framework of the Terms of Reference. In the end, within that framework, we decided that we would:-

- (a) cover the Listing Rules of the HKEx; and
- (b) focus this inquiry on the background and arrangements for the preparation and release of the Consultation Paper. The substantive issues or the merits of the proposals would, in any event, be outside the Terms of Reference, however broadly construed.

1.10 Besides, there are the consultation exercises being conducted and to be conducted by the HKEx, between now and the end of October and beyond. Any extensive consultation, which we believe would be desirable and necessary, would be beyond our remit and resources and not something we could have accommodated within the time designated. All we would say, at this stage, is that the proposals deserve full and open discussion and debate.

MODUS OPERANDI

1.11 To discharge our task, we:-

- (a) collected all available public documents and media reports on the Penny Stock Incident, some of which going back to the beginning of 2001;
- (b) invited all parties directly or indirectly involved in the incident to provide detailed chronologies, written statements, copies of relevant documents and suggestions for improvement;
- (c) invited interested parties to provide written submissions; and
- (d) conducted meetings with those who had some involvement or participation in the events.

1.12 During the inquiry, the Panel received 71 written submissions from 20 organizations and eight individuals. Included among the respondents were all those individuals and bodies who made representations

to the LegCo Panel on Financial Affairs on the 31 July 2002, major organizations associated with the financial services industry in Hong Kong, members of the Legislative Council and many individuals who were prepared to share their views with us. The Panel interviewed 11 individuals.

1.13 Where appropriate, the Panel provided undertakings to respondents who requested that submissions from them would be used only for the purpose of the inquiry and would be treated in the strictest confidence. The Panel further undertook, in some instances, at the request of certain respondents, to refrain from quoting from their submissions without their written permission. For these reasons, we have not appended any of the submissions to this report. None of the protagonists, save for the HKEx, requested similar undertakings. And the HKEx only requested undertakings in respect of sensitive information which we thought reasonable in the circumstances.

1.14 All the submissions were carefully reviewed and, in many instances, additional information and clarification were requested from the respondents. The facts presented and views expressed in the submissions and in meetings with us and the voluminous documentation supplied to us formed the basis of our consideration of the issues involved. We express our gratitude to all those who have participated in the inquiry, supplied information or offered views and advice to us. Their names are set out at **Annex 1.1**.

STRUCTURE OF THE REPORT

1.15 This report is divided into three parts. The first part sets out the background of the regulatory framework of the securities industry. This became necessary when, in the course of our inquiry, we detected much misunderstanding and some misguided commentary and criticism. We feel that fairly full background information is desirable to facilitate a detailed analysis and understanding of the Penny Stocks Incident and related issues. The second part describes the preparation and release of the Consultation Paper up to the appointment of this Panel. It highlights the interaction amongst the various parties and the circumstances surrounding the whole event. The third part summarizes key findings and recommendations of the Panel.

CHAPTER 2

OVERVIEW OF THE HONG KONG STOCK MARKET

INTRODUCTION

2.1 This chapter provides a brief overview of the Hong Kong stock market, summarizes the problems relating to penny stocks or micro caps, and identifies certain key stakeholders in the securities market. We believe this would be useful to the consideration and understanding of the events leading up to the preparation and release of the Consultation Paper. It would also be essential background when we come to suggest improvements for the future.

OVERVIEW OF THE HONG KONG MARKET

2.2 As at the 30 July 2002, there were 934 companies⁴ listed on the Hong Kong stock market, with an aggregate market capitalization of HK\$3,868 billion. This includes 790 companies trading on the Main Board, with market capitalization of HK\$3,802 billion (or 98% of the total), and 144 listings on the Growth Enterprise Market (GEM), with a market capitalization of HK\$66 billion (or 2% of the total). The HKEx is the only exchange company in Hong Kong.

2.3 Based on a study conducted by the SFC⁵, the performance and ranking of the Hong Kong market on the international scale in 2001 are as follows:-

⁴ The number excludes warrants, I-shares and Nasdaq stocks but includes listed companies which were still suspended as at 30 July 2002. For companies under suspension, their market capitalization was based on closing prices prior to suspension multiplied by the units of issued share capital.

⁵ “Quality of the Hong Kong Market – A Critical Review”, the SFC, 12 December 2001. The data show the position as at 2001.

Performance Indicators	The HKEx	Ranking in the World
Total market capitalization	\$438 billion	10 th
Total turnover for first 9 months in 2001	\$188 billion	17 th
Turnover velocity ⁶	0.47	26 th
Funds raised	\$117 billion	7 th
Weighting in world investment portfolios ⁷	0.7% of total	14 th

PENNY STOCKS OR MICRO CAPS

2.4 Despite certain undoubted achievements of the Hong Kong market, the market and the SFC have had concerns:-

- (a) The market is heavily dependent on a few issuers. As of end May 2002, the seven largest companies accounted for 52% of our market capitalization. They also contributed 37% of the total turnover during the first five months of the year.
- (b) Turnover is low. Twenty six percent of the companies listed on the Main Board had average daily turnovers of less than \$100,000 in 2001.
- (c) There are many stocks with low trading prices, (i.e. penny stocks) and many with small capitalization (i.e. micro cap). As at the end of May 2002, about 73% of stocks in Hong Kong's Main Board traded below US\$0.2, compared to 57% in Singapore, 54% in Australia, 20% in London and Taiwan, below 1% in Tokyo and Korea, and none in New York or Mainland China. Among all the listed companies on the Main Board, 95 companies, or 12% of the total, have individual market capitalizations of less than HK\$100 million, the

⁶ Turnover velocity is turnover divided by market capitalization. The figure represents the average for the nine months ended 30 September 2001.

⁷ After the re-balancing of the Morgan Stanley Capital Investment (MSCI) World Index to account for free float.

minimum required for initial listing. Details are shown below:-

Price as at end-May 2002 (HK\$)	(1) Stocks in Hong Kong (Note 1)		(2) Aggregate Daily Turnover (Note 2) (HK\$ million)		(3) Aggregate Market Capital- ization (HK\$ billion)		(4) Companies Reported a Net Loss	
		%		%		%		% (4)/(1)
Below 0.01	10	1.3%	1.8	0.0%	1.7	0.0%	10	100.0%
0.01+ to 0.1	97	12.4%	105.5	1.5%	20.1	0.5%	76	78.4%
0.1+ to 0.5	249	31.9%	391.4	5.6%	95.9	2.4%	145	58.2%
0.5+ to 1	127	16.3%	311.9	4.5%	85.3	2.1%	39	30.7%
Above 1	298	38.2%	6184.7	88.4%	3788.4	94.9%	37	12.4%
Total	781	100.0%	6995.3	100.0%	3991.3	100.0%	307	39.3%

Source: The HKEx Monthly Trading Statistics

Notes: 1. Excluding six companies under delisting procedures
2. Based on turnover in January to May 2002

2.5 For the past two years, commentaries in the media and views expressed in the market combined to urge the relevant authorities to tackle the issue of penny stocks. The following are some of the concerns raised:-

- (a) Since the Automatic Order Matching and Execution System (AMS) of the HKEx cannot accommodate trading below one cent, trading of many penny stocks has to be done by brokers as odd lots manually via the Semi-automatic Matching System (SAM). This increases the possibility of mistakes in inputting trading orders and brokers have to bear the risk of loss if they are unable to rectify the errors.
- (b) Trading on the SAM is not as transparent as on the AMS. It is, therefore, undesirable for an issuer's shares to be traded on the SAM for a prolonged period.
- (c) Penny stocks are prone to market manipulation since a small amount of capital and a few trades may suffice to move the

price, and a small movement in share price can lead to a significant percentage change.

- (d) There were many instances of intentional reduction of share prices, through stock splits, rights issues and other fund raising activities carried out to the detriment of the minority interests.
- (e) Whilst a share's listed price is not necessarily an indicator of a company's quality, some companies trade at low prices because of weak fundamentals, either because they are loss-making⁸ or because they have a small or reduced asset base. The proliferation of low-quality penny stock companies is considered by many as a blot on Hong Kong's image as a premier financial centre.
- (f) Stocks with low share prices are wrongly perceived by the less well-informed as cheap. Some small investors are also tempted to buy these stocks on a punt.
- (g) The charging structure is such that the transaction costs in percentage terms for penny stocks are higher than those for higher priced stocks. The burden on investors is therefore disproportionately larger.

2.6 Having regard to what other leading markets do to maintain quality, there was a widely felt need to improve the quality of the Hong Kong market by:-

- (a) actively identifying quality candidates for listing from other jurisdictions and devoting efforts to attract them to the Hong Kong market;

⁸ According to the SFC's Paper "Quality of Market and the Case for More Effective Delisting mechanism" (July 2002), market cap and stock price are negatively correlated with financial performance of the listed companies. 72 out of the 95 companies with market cap below HK\$100 million were loss-makers, whereas only 2 out of the 71 companies with market cap larger than HK\$5 billion reported losses. Among the 107 companies with prices below HK\$0.1, 86 or 80% were reporting losses, compared to 12% for companies traded above HK\$1.

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- (b) ensuring proper “gate-keeping” through more stringent initial listing requirements as well as strict enforcement of disclosure, corporate governance and other regulatory rules; and
 - (c) amending existing delisting rules and introducing meaningful continuing listing requirements to weed out poor-quality companies and to signal that questionable businesses are not welcome.

KEY STAKEHOLDERS IN THE SECURITIES INDUSTRY

Interested Parties

2.7 Apart from the Government, the SFC, the HKEx and the issuers, there are three main interested parties in the securities market namely, investors, securities intermediaries and credit providers.

Investors

2.8 According to a recent survey conducted by the HKEx⁹, 93% of the trading on the Hong Kong cash market¹⁰ is on shares. In terms of trading value, overseas institutional investors and local retail investors are the two major contributors, accounting for 38% and 36% respectively. Local retail trading has always had a large share, though the ratio has fluctuated over the past decade from about one-third to over 50%, depending on market sentiment. Local institutional investors account for 19%¹¹. Local retail investors make up the largest numbers of customers. It is thought that there were over one million retail investors in the Hong Kong stock and derivatives markets in 2001. Or, to give it more perspective, one out of five adults in Hong Kong invested in stocks or derivatives. This figure is more than twice the ratio of 9% in 1992.

⁹ The five surveys conducted by the HKEx are (a) Cash Market Transaction Survey; (b) Derivatives Market Transaction Survey; (c) Retail Investor Survey; (d) Derivatives Retail Investor Survey; and (e) Primary Market Survey. Latest reports on all of the above surveys are available on HKEx’s website (<http://www.hkex.comhk/research/research.htm>).

¹⁰ Cash market includes shares, warrants, debt instruments, unit trusts and Exchange Traded Funds.

¹¹ The data are extracted from an article in the SFC Quarterly Bulletin Summer 2002 “Increasing Investor Participation: Insights from the HKEx Surveys”. Principal trading and overseas retail investors accounted for 4% and 3% respectively. The Bulletin is available on the SFC’s website (http://www.hksfc.org.hk/eng/press_releases/html/index.html).

Securities Intermediaries

2.9 As at 30 June 2002, there were 715 securities intermediaries including 707 securities dealers and eight margin financiers. Based on the SFC's latest survey¹², securities intermediaries employed about 17,000 people in 2001. 41% of these employees worked in firms with fewer than 50 staff, 27% in medium sized firms of 51 to 200 people and the remaining 32% in firms with over 200 staff. In 2001, the total value of transactions in securities amounted to \$7,248.8 billion¹³, representing an annual increase of 41% over 2000. However, from responses collated by the SFC, net profits of securities intermediaries had dropped substantially (by 90% from \$4,290 million in 2000 to \$429 million in 2001). Brokers complain of declining turnover and increasing competition from banks. Small-and-medium-sized firms were hit the hardest.

2.10 Similar to other mature markets, margin trading is now active in Hong Kong. In June 2002, there were 571,534 active cash clients and 57,358 active margin clients. Margin financiers, most of whom are also securities dealers, are bound by the Financial Resources Rules approved and administered by the SFC to ensure adherence to prudent capital adequacy ratios.

Credit Providers

2.11 Credit providers, mostly financial institutions, also play an important role. They are the ultimate source of finance. Investors, securities dealers and margin financiers often use shares as collateral for bank loans. Fluctuations in share prices have implications on the value of collateral and the statutory ratios of financial institutions. Banks are also increasingly competing for securities business.

OBSERVATION

2.12 The authorities and the various stakeholders acknowledge the need to improve the quality of the Hong Kong securities market. The crux is how best to achieve this. The success of any major proposals hinges on

¹² Business Activities Surveys on Securities/Futures Intermediaries and Exempt Persons conducted by the SFC for October 2001. The response rate was 88%.

¹³ The value of transactions includes trading equities and bonds both in Hong Kong and overseas.

the concerted efforts of many stakeholders whose size, nature of business and interests may be very different. Furthermore, as the securities and banking sectors are both involved, regulators have to be mindful of the possible knock-on effects on other sectors of the economy.

CHAPTER 3

THE THREE-TIERED REGULATORY FRAMEWORK FOR THE SECURITIES AND FUTURES INDUSTRY

INTRODUCTION

3.1 This chapter outlines the three-tiered regulatory framework for the securities and futures industry and describes the roles of the Government, the Hong Kong Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx).

THE THREE-TIERED REGULATORY FRAMEWORK

Origin of the Three-tiered Structure

3.2 The existing regulatory framework for the securities and futures industry is a “three-tiered structure”. Its genesis can be traced back to the recommendations of the “Report of the Securities Review Committee” (the “SRC Report”) published in 1988¹⁴. The three-tiered structure is reflected in the Securities and Futures Commission Ordinance (Cap. 24), the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555), and the recently enacted and substantially recast Securities and Futures Ordinance (Cap. 571) and other related legislation.

3.3 We would note that while this structure is commonly referred to as the “three-tiered regulatory structure”, we do not think that it is an accurate description of the roles and functions of the three constituent bodies. For one thing, the role of the Government cannot, with any regard for the accurate use of language, be described as a regulator in the commonly accepted sense. The SFC is clearly a regulator, but its position is not without its unusual features, some of which we will look at later. Similarly,

¹⁴ Following the stock market crash in October 1987, the then Governor appointed the Securities Review Committee (SRC) headed by Mr Ian Hay Davison to review, among other things, the constitution, powers, management and operation of the government offices responsible for regulating respectively the securities and futures markets at the time; and to recommend changes that were desirable to ensure the integrity of the markets and to protect investors. The SRC published its Report in May 1988 and recommended, among other things, the establishment of a new market regulatory outside the civil service to replace the then Securities Commission, the Commodities Trading Commission and the Office for Securities and Commodities Trading.

the HKEx, although commonly described as the “front-line regulator”, is only a regulator in a limited sense since it possesses no statutory powers of investigation and its powers, such as they are, are conferred by the Listing Agreement entered into by issuers seeking a listing. In other words, the source of the HKEx’s regulatory powers is in contract. There are those who would consider it a straining of language to describe a party with the right to enforce a contract as a regulator even though that contract relates to listing and an issuer’s obligations and duties under it. We note that, on occasions, in material emanating from the HKEx, instead of describing itself as the “front-line regulator”, the HKEx often describes part of its functions as “administering the Listing Rules”.

3.4 The essence of this structure is that the operation of the market should rest with a market operator (i.e. the HKEx) close to the market under the watchful eyes of an independent regulator (i.e. the SFC) staffed with personnel equipped with the requisite expertise and market experience. The Government maintains a broad policy interest and concern in the development of Hong Kong’s financial markets as part of Hong Kong’s economy.

The First Tier – The Government

3.5 At the first tier, the Government has overall responsibility under Article 109 of the Basic Law to provide an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre. Consistent with the spirit of the SRC report and international practices, the Government distances itself from the day-to-day regulatory function. It performs its function by appointing the SFC and making sure that the SFC is, and is seen to be, a credible and independent regulatory body vested with the necessary power and equipped with professional expertise to discharge its duties. The Government’s non-interference in the market place, unless exceptional circumstances obtain, is, in common with the views contained in the submissions to us, a practice we believe ought to be maintained.

3.6 The role of the Government is underscored in the recent debate on the Securities and Futures Ordinance 2002. As the Administration explained to the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000:-

“The Government recognizes that while delegating its regulatory responsibilities to the SFC, it cannot delegate to the SFC all its accountability to the public for a properly regulated securities and futures market. The public expects that the Government has a duty to ensure that the SFC does its job properly, and that the Government will be held ultimately accountable if the SFC falls down on its job. The public also expects that the Government should play an effective role in co-ordinating among the various financial sector regulators as financial institutions become increasingly involved in multi-sector services, and responding to the rapid changes in the financial system. This goes beyond the regulatory remit of the SFC, as its functions and powers cover basically the securities and futures market, and hence may not allow it to address matters which straddle different financial sectors and affect the economy as a whole.”¹⁵

3.7 One of the focal points in the debate in the Legislative Council was whether the Government should have a reserve power¹⁶ which, among other things, would enable the Chief Executive (CE) to give the SFC written directions. The power envisaged would only be exercised after consultation with the Chairman of the SFC, upon being satisfied that it is in the public interest to do so, and in furtherance of any of the SFC’s regulatory objectives or the performance of any of its functions. The provision is viewed as a “tool of last resort” for the Government. As the then Secretary for Financial Services, Mr Stephen Ip, explained:-

“The reserve power can be exercised by the Government only in extraordinary emergencies to safeguard public interest. Probable cases include failure of checks and balances, improper performance of duties by the SFC or fluctuations in the financial market that warrant prompt action by the Government to stabilize the financial

¹⁵ Paper No. 2B/01 presented to the Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000 on 4 May 2001.

¹⁶ The reserve power covers, among other things, the power set out in section 11 of the Securities and Futures Ordinance (Cap. 571).

market with the co-operation of the SFC and other regulators.”¹⁷

3.8 The Government likens the reserve power to “a nuclear deterrent against any malfunctioning on the part of the SFC” and is the only statutory tool available to the Government for the effective application of remedial measures in a critical situation. Quoting William O Douglas, a former Chairman of the US Securities and Exchange Commission, and later an Associate Justice of the United States Supreme Courts, “[government] would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.”¹⁸

3.9 Regarding the public perception of the Government’s role, the then Secretary for Financial Services added that:-

“During the consultation period of two years or so, the market participants and the public did not raise any opposition to [the proposed reserve power], which reflects that the public expects the Government to ensure the stability of the financial market.”

3.10 Dissenting views in the Legislative Council (LegCo) were cogently and vociferously expressed that “an independent regulating authority, free from political interference, is fundamental to a modern regulatory system which commands respect and confidence. The regulatory authority must not only be independent, but clearly seen to be independent.”¹⁹ We see the force of those general sentiments.

¹⁷ Speech by Mr Stephen IP, then Secretary for Financial Services, at the meeting of the Legislative Council on 13 March 2002 to move the resumption of second reading of the Securities and Futures Ordinance and a Consequential amendment to Clause 11 of the Bill.

¹⁸ William O Douglas, “Democracy and Finance”, 1940.

¹⁹ Speech by Dr. the Hon Margaret NG at the meeting of the Legislative Council on 13 March 2002 on the Consequential Amendment to Clause 11 of the Securities and Futures Bill 2000.

3.11 In deliberating on the appropriate distribution of powers between the Government and the regulatory bodies, the Bills Committee on the Securities and Futures Bill and Banking (Amendment) Bill studied the accountability arrangements for regulators in the UK and the US²⁰. In the UK, the Financial Services and Markets Act 2000 (FSM Act), which went into force in December 2001, established the Financial Services Authority (FSA) as an independent regulator for the financial market. While members of the FSA Board are appointed by, and may be removed by, the Chancellor of the Exchequer, there is no provision in the FSM Act which empowers the Treasury or the executive branch of the government to give directions to the FSA. Instead, the Act stipulates other checks and balances such as empowering the Treasury to commission inquiries into the FSA's regulatory activities of public concern, requiring FSA to give evidence to Parliament periodically, and appointing an independent review on resources management of the FSA.

3.12 Similarly in the US, the securities and futures markets are regulated by the independent Securities and Exchange Commission and the Commodities Futures Trading Commission respectively. Their Commissioners are appointed by the President with the consent of the Senate. They are required to make reports to Congress and to attend hearings regularly. However, Congress has no power to interfere with the work of these bodies. Neither the executive branch nor the legislature has any power of direction over the Commissioners. The report of the delegation of LegCo members noted that legislation in the UK and the US do not confer upon the executive branch of the government any overriding power to direct the activities of the regulators. The checks and balances are ensured, not through reserve power of the government but through the power to appoint and require the bodies to make reports and give evidence to the legislature.

3.13 Recognizing the differences in the constitutional frameworks governing the operation of market regulators in other places, a LegCo majority, on balance, accepted the Administration's proposal to retain

²⁰ In April 2001, the LegCo Panel on Financial Affairs and the Bills Committee on Securities and Futures Bill and the Banking (Amendment) Bill 2000 visited London, Washington DC and New York to study the financial systems of the United Kingdom and the United States of America. Details of the findings are set out in the "Report on the Financial Systems in the United Kingdom and the United States of America" published in June 2001. The Bills Committee's conclusions, having regard to the findings of the study, are included in the Report of the Bills Committee on Securities and Futures and Banking (Amendment) Bill 2000 (LC Paper No. CB(1)1217/01-02) on 5 March 2002.

reserve powers over the SFC in order to perform its roles as the “watchdog to the watchdog”.

3.14 To summarize, the Government should be kept free from the day-to-day regulatory functions. It should focus on the following:–

- (a) It should keep the regulatory framework under constant review and to maintain fair, transparent and orderly markets. Its role is also to promote public confidence in the markets and to secure appropriate degrees of investor protection and to minimize market misconduct. Further, it should facilitate market innovations and competitions and act to enhance Hong Kong’s position as a premier international financial centre²¹;
- (b) It should ensure that there are sufficient checks and balances within the system;
- (c) It should act as co-ordinator of the various regulators of the different financial sectors;
- (d) It has reserved for itself powers in exceptional cases or in emergencies, which should be used only where there are cases of failure of the checks and balances, improper performance by the SFC or fluctuations in the financial markets which warrant prompt action by the Government to stabilize the financial markets and Hong Kong’s economy with the co-operation of the SFC and other regulators; and
- (e) In other words, the Government should be a facilitator and co-ordinator, amongst other things, rather than a regulator. It should provide the sound environment under which Hong Kong’s financial markets can develop and prosper. It should not intervene, save in exceptional circumstances. This, by and large, is also the Government’s view of its role and a view shared by most.

²¹ Speech by Mr Stephen Ip, then Secretary for Financial Services, at the meeting of the Legislative Council on 13 March 2002.

The Second Tier – The SFC

3.15 At the second tier is the SFC, which serves as the watchdog of market operators. Operators include the exchanges and clearing houses (now merged), as well as market intermediaries. Established by the Government in 1989, the SFC was designed in line with the following recommendations of the SRC Report:-

- (a) The SFC should be a statutory body completely outside the civil service and to have adequate staffing and funding. It should be accountable to the Administration. While it is not part of the civil service, it should be part of the wider Government machinery;
- (b) While the Government should continue to provide an overview, all the statutory regulatory powers should be vested in the SFC in order to ensure its independence;
- (c) To avoid undermining the SFC's independence, the Government should not be represented on its board or advisory committees; and
- (d) The role of Government should be to ensure that the SFC does its job properly. Only if the SFC fails should the Government be free to reach an independent view as to what is the right course of action.

3.16 In line with the SRC recommendations, the Government introduced the following safeguards:-

- (a) The Chief Executive of the HKSAR (CE) appoints the Chairman and other directors of the SFC board and has the power to dismiss them;
- (b) The CE is able to give the SFC directions in exceptional circumstances;
- (c) The SFC has to present an annual report and its statement of accounts to the CE who would lay them before the Legislative Council;

-
- (d) The SFC Advisory Committee should be appointed by the SFC with the approval of the CE; and
 - (e) The SFC should develop and submit its annual budget to the Legislative Council.

3.17 In addition, the Government introduced the following checks and balances:-

- (a) Fees and charges levied by the SFC are required to be set out in subsidiary legislation and subject to negative vetting by the Legislative Council;
- (b) The more important decisions of the SFC have to be made by the full board of the SFC, and are not delegable unless with the approval of the Legislative Council;
- (c) An independent Securities and Futures Appeals Panel (SFAP) is established to hear appeals from parties aggrieved by certain decisions made by the SFC. Under the newly enacted legislation, the SFAP is upgraded to a Securities and Futures Appeal Tribunal, which will be chaired by a judge and operated on a full-time basis with an expanded remit;
- (d) Judicial review by the Court of First Instance of the SFC decisions is available;
- (e) Complaints against the actions of the SFC or any of its staff may be lodged with the Office of the Ombudsman; and
- (f) A Process Review Panel (PRP) was appointed in November 2000 to review internal procedures of the SFC to ensure that they are fair and reasonable. The PRP has to submit its report to the Financial Secretary with a view to its publication subject to the SFC's statutory secrecy obligations.

3.18 In practice, the SFC is the principal regulator of the securities and futures market. It acts independently in performing its regulatory functions, and is not required to be answerable to the Government on its day-to-day exercise of regulatory powers. The slightly unsatisfactory feature is

the relative inability of the SFC to regulate listed issuers with which it has no contractual relationship. The situation has been improved somewhat with the implementation earlier this year of the dual filing system so that at least the SFC has some basis for monitoring listed issuers. Otherwise, it is only when, sometimes fortuitously, the Takeovers Code provisions are triggered that the SFC has the jurisdiction to intervene in corporate irregularities of listed issuers.

3.19 Implicit in the system is the belief and the foundation that the SFC has, or should have, professional expertise, knowledge of local market conditions and international good practices, a sound mechanism to gauge the views of stakeholders, as well as the credibility and vigilance to perform its functions effectively. Should the SFC not possess or be denied any of these attributes, the checks and balances will be undermined. By and large, our inquiries confirm the efficiency of the SFC and the existence of those important attributes in its role as regulator.

The Third Tier – The HKEx

3.20 At the third tier, and closest to the ground, the market operators play a self-regulatory role and perform certain public functions, such as risk management and market surveillance. As we mentioned earlier, the HKEx is not vested with any statutory investigatory powers and has to rely on the terms of the listing agreements entered into by issuers. At present, there is only one exchange in Hong Kong (the HKEx). To increase competitiveness and to meet the challenges of an increasingly globalized market, the Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited demutualised and together with Hong Kong Securities Clearing Company Limited merged under a single holding company, the HKEx. The merger was completed on the 6 March 2000 and the HKEx listed its shares on the Stock Exchange on the 27 June 2000.

3.21 As a self-regulator, the HKEx is responsible for ensuring an orderly and fair market in securities and futures contracts traded on or through the HKEx. It must also ensure that risks are managed prudently.

3.22 The HKEx is subject to checks and balances including the following :-

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- (a) Under the Merger Ordinance (Cap. 555), the HKEx must act in the interest of the public, having particular regard to the interests of the investing public;
 - (b) The Government has the power to appoint a specified number of members to the Board of the HKEx;
 - (c) The SFC is the statutory regulator of the HKEx including its wholly owned subsidiaries of the Stock Exchange of Hong Kong, the Hong Kong Futures Exchange, and the Hong Kong Securities Clearing Corporation Limited. The SFC is responsible, in general, for supervising and monitoring the activities of the HKEx. The SFC, as the regulator, may serve “restriction notices” and “suspension orders” on the HKEx;
 - (d) The SFC may direct the HKEx to cease to provide or operate specified facilities or services in emergencies; and
 - (e) The SFC is empowered to approve any new or amended listing rules before they can be implemented.

3.23 The SFC and the HKEx have signed four major Memoranda of Understanding (MOU)²² in the past two years, in not dissimilar items, to facilitate a co-operative working relationship between the parties. Under the MOU, in seeking the SFC’s approval for any amendments to the Rules of the HKEx, it must engage the involvement of the relevant SFC staff at a stage of the amendment process which will reasonably enable the SFC to

²² The MOUs are –

- (a) Amended and Restated MOU Governing Listing Matters (6 March 2000), Amended and Restated Addendum to MOU Governing Listing Matters (6 March 2000); and First Supplement to the MOU Governing Listing Matters (21 August 2000);
- (b) MOU for the Listing of Hong Kong Exchanges and Clearing Limited on The Stock Exchange of Hong Kong Limited (19 June 2000);
- (c) MOU on Matters Relating to SFC’s Oversight, Supervision of Exchange Participants and Market Surveillance (20 February 2001); and
- (d) MOU for the Listing of Hong Kong Exchanges and Clearing Limited on The Stock Exchange of Hong Kong Limited (22 August 2001).

have sufficient knowledge of the nature of the proposed amendments and to raise issues of concern²³.

REVIEW AND REFINEMENT

3.24 Since the introduction of the three-tiered regulatory framework in 1989, there has not been any major review of the structure, though refinements have been made especially in the enactment of the Securities and Futures Ordinance 2002.

3.25 Until the sell-off of penny and small-cap stocks on the 26 July 2002 following on from the publication of the HKEx Consultation Paper the day before, there has not been too much unhappiness over the structure, which is based on a solid foundation and has worked reasonably well.

3.26 Clearly, even prior to the 26 July 2002, there are those within the financial services industry who would voice the occasional complaint over, for instance, the lack of engagement by the HKEx of brokers, some of whom claim to be ignored, and the perceived excessive powers of the SFC. This should occasion little surprise. There would be something very wrong with the regulators if all those regulated have nothing but praise for them.

3.27 Our considered view is that the three-tiered regulatory structure itself is sound. We refer later to certain areas in which we have received representations and over which we suggest for consideration some refinements and improvements.

²³ **Annex V** to the MOU on Matters Relating to SFC's Oversight, Supervision of Exchange Participants and Market Surveillance (20 February 2001).

CHAPTER 4

ORGANIZATION, COMMUNICATION AND CONSULTATION CHANNELS

INTRODUCTION

4.1 The success of the three-tiered structure hinges on a clear division of responsibilities amongst the parties, a clear understanding of where the divisions lie, and co-ordination within and amongst the respective organizations. This chapter identifies the parties involved in the regulation of the securities industries, outlines the communication channels within and amongst them, and elaborates on the mechanisms through which they gauge and assess market views.

RELEVANT PARTIES

The First Tier – The Government

4.2 Within the Government, the Financial Secretary (FS) is the most senior official having broad policy direction and governance over the financial, economic and employment sectors. The Secretary for Financial Services and the Treasury (the Secretary), as one of the eleven Directors of Bureau, is the head of the Financial Services and the Treasury Bureau (the Bureau) and, in a sense, the custodian of policies in financial services and public finance. He is responsible for determining policy objectives and goals. This would include the initiation, formulation and implementation of policies and to monitor their effectiveness in areas of financial services. The division of responsibilities between the FS and the Secretary is considered and discussed in greater detail in Chapters 6 and 12. We shall refer to the parties as the FS, the Secretary and the Bureau. The Secretary is also referred to in places as the SFST.

4.3 Within the Bureau, the Secretary is underpinned and assisted by the Permanent Secretary for Financial Services and the Treasury (Financial Services) whose portfolio covers the whole financial services sector. We refer to him as “the Permanent Secretary”. There is a team of three civil servants directly involved in the interface with the securities sector. The organizational chart is detailed at **Annex 4.1**. For the purposes of our

report, the FS is the Honourable Antony Leung, the Secretary is the Honourable Frederick Ma and the Permanent Secretary is Mr Tony Miller.

The Second Tier – The SFC

4.4 The SFC is a statutory body appointed by the CE. There are currently 11 Directors, five of whom are Executive Directors, including a Chairman, and six are independent Non-Executive Directors²⁴. The Commission is supported by six committees, details of which are at **Annex 4.2**. The SFC has a total staff of just over 400 in four operational divisions and two supporting divisions²⁵. The Corporate Finance Division, under the direction of an Executive Director, is responsible for, among other things, overseeing the Stock Exchange's listing-related functions and responsibilities. The Division has a staff of 36 (26 executives and 10 supporting staff). Details of the organization of the Corporate Finance Division is at **Annex 4.3**. Within the SFC, the Corporate Finance Division (and the SFC Chairman who oversees all divisions) is involved in the regulation of listing matters. At all material times, the Chairman of the SFC is Mr Andrew Sheng and the Executive Director of the Corporate Finance Division is Mr Ashley Alder.

The Third Tier – The HKEx

4.5 The HKEx is a listed company governed by a Board of Directors consisting of 15 members (1 executive and 14 non-executive directors including a Chairman). In addition, there are six Committees²⁶ and three Panels²⁷ with members drawn from a wide spectrum of the business and professional sectors. **Annex 4.4** sets out the relationship and membership of the Board and its Committees. The Terms of Reference and membership of the Consultative Panels are at **Annex 4.5**.

²⁴ When the new Securities and Futures Ordinance comes into force, there would be no fewer than eight members of the Commission, and the majority must be Non-Executive Directors.

²⁵ The four operational divisions are Corporate Finance Division, Intermediaries & Investment Products Division, Supervision of Markets Division and Enforcement Division. The two supporting divisions are Legal Services Division and Corporate Affairs Division.

²⁶ The six Committees are (a) Executive Committee; (b) Audit Committee; (c) Investment Advisory Committee; (d) Risk Management Committee; (e) Remuneration Committee; and (f) Nomination Committee.

²⁷ The three Panels are: (a) Cash Market Consultative Panel; (b) Clearing Consultative Panel; and (c) Derivatives Market Consultative Panel.

4.6 The Chief Executive of the HKEx oversees seven functional units including the Listing, Regulation & Risk Management Unit²⁸, and supervises four business units through a Chief Operating Officer²⁹. An organizational chart of the HKEx is at **Annex 4.6**. The Chief Executive of the HKEx, at all times material to this report, is Mr K C Kwong.

4.7 Within the HKEx, the Listing, Regulation & Risk Management Unit is directly responsible for performing the regulatory function of the HKEx. The Head of this Unit is Ms Karen Lee. Its Listing Division supervises the listing process and the ongoing compliance by issuers with their obligations under the listing rules. Its organizational chart is at **Annex 4.7**. In addition, the HKEx's Corporate Communications Unit operates as a "two-way conduit" between the HKEx and the public. It handles media relations as well as investor relations and education programmes.

4.8 The person and bodies involved in listing matters are the Chief Executive of the HKEx, the Listing Division and the Listing Committee. The Corporate Communications Unit would only be indirectly involved.

Segregation of the HKEx's Business and Regulatory Functions

4.9 As provided for in the Amended and Restated Memorandum of Understanding Governing Listing Matters (MOU) signed by the SFC and the Stock Exchange of Hong Kong (SEHK)³⁰ on the 6th March 2000, the SEHK is "solely responsible for the day-to-day administration of all listing related matters with respect to the stock market in Hong Kong"³¹. As the HKEx has both business and regulatory functions, the HKEx's administrative structure is designed in such a way that a "Chinese wall" exists within the organization, segregating the business units from the regulatory unit. This mechanism seeks to ensure that the HKEx is, and is seen to be, performing

²⁸ The other six functional units are (a) Corporate Communications; (b) Corporate Strategy; (c) Finance, Treasury & Administration; (d) Group Internal Audit; (e) Human Resources; and (f) Legal & Secretarial Services.

²⁹ The four business units are Exchange, Clearing, E-Business & Information Services as well as IT/Systems.

³⁰ The Stock Exchange of Hong Kong Limited (SEHK) is one of the subsidiaries of the HKEx, the holding company. Other subsidiaries include the Hong Kong Futures Exchange Limited and the Hong Kong Securities Clearing Company Limited.

³¹ Paragraph 2.4 of MOU.

its regulatory function in a fair and independent manner, not influenced by its own business considerations. In line with this approach, the HKEx Board has delegated its functions and powers in relation to listing matters to the Listing Committee. The Board does not exercise concurrent jurisdiction in relation to any matters to do with listing. The Board is neither involved in nor informed of policy and operational matters relating to listing. This is a matter of importance and the roles of the Board and the Listing Committee are often misunderstood even by those in the industry.

The Listing Committee

4.10 With the delegated authority from the Board, the Listing Committee is the “gatekeeper” for all listing issuers, though aggrieved parties may appeal to the Listing Appeals Committee of the HKEx chaired by the Chairman of the HKEx. There are currently two Listing Committees, one for the Main Board and the other for the Growth Enterprise Market. The Listing Committee has a membership that is “broadly representative of the various securities industry groups with interests in the proper regulation of the stock market”³². All Listing Committee members are nominated by an independent Nomination Committee³³ and approved by the Board of the SEHK³⁴. Currently, there are 25 members serving on the Main Board Listing Committee, including six Exchange Participants³⁵ or their directors, six representatives from listed companies, twelve market practitioners and users and also the Chief Executive of the HKEx. At present, the Chairman of the Listing Committee is not a director of the HKEx Board. The Chief Executive is the only bridge between the HKEx Board and the Listing Committee. The current membership and terms of reference of the Listing Committee for the Main Board are at **Annex 4.9**³⁶.

³² Paragraph 2.6 of MOU.

³³ The Nomination Committee has three SFC representatives and three HKEx representatives.

³⁴ See **Annex 4.8**.

³⁵ Under the Listing Rules, "Exchange Participant" means a person: (a) who, in accordance with the Listing Rules, may trade on or through the Exchange and (b) whose name is entered in a list, register or roll kept by the Exchange as a person who may trade on or through the Exchange.

³⁶ The appointment and functions of the Listing Committees are set out in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited approved by the HKEx Board and by the SFC, and made under section 34 of the Stock Exchanges Unification Ordinance. The appointment of the Listing Committee is stipulated in Listing Rule 2A.20 to 2A.23.

4.11 The main reason given for placing listing matters under the HKEx is that the HKEx is closer to the market. The staff of the HKEx is expected to have the necessary market expertise and experience. The HKEx would also have access to a large pool of market practitioners through its extensive network.

CO-ORDINATION WITHIN AND AMONGST DIFFERENT PARTIES

Within the First Tier – The Government

4.12 Before 1 July 2002, the Secretary for Financial Services and the securities team in the Bureau were geographically located in the same office, in Admiralty Centre. They had frequent contacts through meetings, oral and written exchanges. They saw each other in and around the office. Starting from 1 July 2002, the Secretary for Financial Services and the Treasury (the Secretary) has his personal private office headed by an Administrative Assistant. This is now situated at the Central Government Offices. The Permanent Secretary and the other Bureau staff responsible for securities matter remain in Admiralty. Correspondence between the Bureau goes through the Administrative Assistant to the Secretary, who screens the incoming mail for the Secretary. The different geographical location of the two offices assumed significance in the course of the events in July 2002. It may have contributed to a degree of miscommunication and misunderstanding which led to unfortunate consequences.

Within the Second Tier - The SFC

4.13 The Chairman of the SFC has regular meetings with his Executive Directors. He also chairs and participates in Commission meetings and some Committee meetings. The day-to-day operation of the Divisions rests with the Executive Directors, who keep the Chairman informed of major issues.

Within the Third Tier – The HKEx

4.14 The Chief Executive of the HKEx has regular meetings with his senior staff. The Listing, Regulation & Risk Management Unit reports directly to the Chief Executive, who attends monthly meetings with the senior executives of the Unit and receives their reports on the general

progress of major tasks. In addition, the Unit Head reports, discusses and seeks approval and guidance from the Chief Executive on all key issues.

Between the First and Other Tiers

4.15 Between the first tier and the other two tiers, there are four major forums to co-ordinate and discuss matters of common concern:-

- (a) ***The FS' regular meeting with the SFC and the Secretary*** is held about nine times a year to discuss major developments in the financial market and to keep the FS posted on the general direction of major market reform initiatives.
- (b) ***The Securities and Futures Liaison Meeting*** is a general liaison meeting between the Bureau and the SFC on, essentially, housekeeping matters. It is chaired by the Secretary and held on a monthly basis. Details are at **Annex 4.10**.
- (c) ***The Tripartite meeting*** is another liaison group comprising the Bureau, the SFC and the HKEx to facilitate the general monitoring of issues affecting the development of the securities and futures market in Hong Kong and, from the Bureau's perspective, to increase the communication channels between the SFC and the HKEx. Meetings are held every other month. Details are at **Annex 4.11**.
- (d) ***The Co-ordination Committee*** was set up in 2001 to identify, discuss and resolve regulatory and policy issues and to facilitate the HKEx's implementation of its new strategic plan³⁷. Details are at **Annex 4.12**. This is a small group chaired by the HKEx Chairman and consists of the Permanent Secretary, the Chief Executive of the HKEx and the SFC Chairman, assisted by a senior Deputy Secretary of the Bureau. Meetings are held once every two to three months.

4.16 In addition, the Secretary also chairs the Financial Market Development Task Force and the Financial Stability Committee, both of which discuss issues concerning the financial market in general rather than

³⁷ The New Strategic Plan is also referred to as "the McKinsey Report".

the securities market in particular. The SFC Chairman is a member of both committees³⁸.

Between the Second and Third Tiers

4.17 Apart from the two forums mentioned in paragraph 4.15(c) and (d), the senior management of the SFC and the HKEx do not have regular meetings to discuss matters of common concern. At the operational level, staff of the SFC and the HKEx have frequent contact over the telephone, e-mail and written exchanges. For listing matters, the Corporate Finance Division of the SFC and the Listing, Regulation & Risk Management Unit of the HKEx conduct monthly liaison meetings. The terms of reference and membership of these meetings are at **Annex 4.13**.

CONSULTATION AND MARKET ASSESSMENT

4.18 The Government, the SFC and the HKEx each have fairly extensive networks to gauge public opinion.

The Government

4.19 As part of the Government's ongoing efforts to engage market participants, the Bureau has had meetings with the stockbroking community since 1995. In the context of steering the Securities and Futures Bill through the Legislative Council, the Bureau intensified these efforts and monthly luncheons with the Hong Kong Stockbrokers Association have turned into regular meetings since mid 2000.

The SFC

4.20 The SFC also has an extensive consultation network:-

³⁸ The Financial Market Development Task Force is chaired by the Secretary to identify and co-ordinate, where necessary, new initiatives in promoting the development of Hong Kong's financial markets, with a view to maintaining the status of Hong Kong as an international financial centre. Other members include the Chief Executive of Hong Kong Monetary Authority, Commissioner of Insurance, Director-General of Investment Promotion, InvestHK and Managing Director of Mandatory Provident Fund Schemes Authority. The Financial Stability Committee monitors the functioning of the financial markets in Hong Kong, including the money, foreign exchange and securities market, and deliberates on events, issues and developments with possible cross-market and systemic implications, and where appropriate, formulates and co-ordinates response.

-
- (a) ***The SFC Advisory Committee*** was established under the SFC Ordinance (Cap. 24). It has a broad-based membership representing the interests of investors, intermediaries, listed companies and other participants. Its membership and terms of reference are at **Annex 4.14**. Under the recently re-enacted Securities and Futures Ordinance, the Advisory Committee must meet at least once every three months and additional meetings may be convened by the SFC Chairman or any three other members. It serves as a bridge for the SFC to reach providers and users of financial services in the securities and futures market.
- (b) ***The Shareholders Group*** was formed in early 2001 as a forum to gauge the views of shareholders and consumers. The underlying belief is that maintaining a level playing field among all shareholders and holding directors and management of listed companies accountable to shareholders are pivotal to enhancing investor confidence, safeguarding market integrity and ensuring the proper functioning of the securities market. Through bi-monthly meetings, the Shareholders Group serves as the SFC's advisor on different aspects of the regulatory framework relating to the protection of minority shareholders and enhancing good corporate governance. Its membership and terms of reference are at **Annex 4.15**. It has, since June 2002, been upgraded to a statutory committee under section 6 of the SFC Ordinance (Cap. 24).
- (c) ***Specialized Standing Committees*** are formed under section 6 of the SFC Ordinance to assist its work. There are currently more than ten such committees involving the market and the investing public. Examples are the Committee on Unit Trusts, the Takeovers and Mergers Panel and the Investor Education Advisory Committee.
- (d) ***Working Groups*** of relevant expertise are set up to assist the SFC formulate draft rules, codes and guidelines on specific subjects, such as the regulation of Automated Trading Services. The practice is to release preliminary drafts to the relevant working groups for consideration and technical input. Amendments are then made in the light of their contributions

before released for public consultation. Most of these rules deal with technical issues. The SFC takes into account expert views on the drafts in their formative stages. It also seeks input from the Consumer Council, institutional investors, academics and others on relevant subjects.

4.21 The SFC usually adopts a two-stage process for outside consultation when formulating new proposals to amend subsidiary legislation or any of its codes. Before embarking on public consultation, the SFC conducts informal soundings through its consultation networks. The aim is to test the key concepts with knowledgeable individuals of repute, especially those who can be counted on to maintain confidentiality. The SFC also engages practitioners in the drafting process, where appropriate, through working groups and standing committees.

The HKEx

4.22 As mentioned in paragraph 4.5, the HKEx has a large family of non-executives serving on its various boards and panels. This is a large pool of market experience and expertise.

- (a) All **Directors of the Board** are distinguished members of the community drawn from business and the professions. Either individually or collectively, Directors provide a ready repertoire of advice and skills on matters relating to the HKEx.
- (b) The three **Panels** were set up to advise on specific business areas namely, the cash market, derivatives and clearing. As illustrated in **Annex 4.5**, the Panels provide market expertise and advice to the Board on international trends, the needs of intermediaries, issuers, investors and other market participants, technological challenges and new product opportunities in the respective markets. The Panels also serve generally as a “sounding board” for policy recommendations, strategic initiatives and major investments in respective of the various markets.
- (c) The **Listing Committee**, with its wide representation based on market knowledge and experience, provides specific advice on listing and other incidental regulatory matters.

-
- (d) On non-listing matters, the HKEx has also, on occasions, set up ad hoc **working groups** to study issues of concern to the market.

CHAPTER 5

PROCEDURES FOR THE PREPARATION AND RELEASE OF LISTING RULES AND AMENDMENT THERETO BY THE HKEX

INTRODUCTION

5.1 This chapter describes the existing procedures for the preparation and release of new or amended Listing Rules of the HKEx.

LISTING

5.2 Listing is the process whereby a security of a public company is admitted for trade on an exchange. For the Hong Kong Exchange, the listing process is regulated by the “Rules Governing the Listing of Securities (the Listing Rules)”³⁹. The Listing Rules set out, among other things:-

- (a) the qualifications that must be met in order to obtain a listing;
- (b) the continuing obligations public companies have to comply with as a condition for the listing of their securities; and
- (c) sanctions against non-compliance, including suspension and cancellation of listing.

AUTHORITY FOR MAKING OR AMENDING LISTING RULES

Transfer of Authority from the SFC to the Exchange and from the HKEx Board to the Listing Committee

5.3 Until the end of 1991, both the SFC and the Stock Exchange of Hong Kong (SEHK) were responsible for overseeing the listing of securities. To avoid duplication between the SFC and the SEHK, the SFC transferred

³⁹ Further rules and ordinances regulating the initial listing and continued listing of securities on the Hong Kong Exchange are found in the Securities (Stock Exchange Listing) Rules and the Companies Ordinance(Cap. 32).

its listing functions to the SEHK in 1991, subject to systematic checks and balances within the SEHK. The SEHK became the so-called front-line regulator of the listing process in Hong Kong. The arrangements are contained in the Memorandum of Understanding (MOU) Governing Listing Matters between the SFC and the SEHK first signed in 1991 which was overtaken by the Amended and Restated MOU in March 2000 following the merger and listing of the HKEx.

5.4 Within the HKEx, the HKEx Board has delegated to the Listing Committee⁴⁰ its functions and powers in relation to listing matters over which it does not exercise any concurrent jurisdiction. The Listing Committee is thus the constituted authority on all matters related to listing, including the approval of consultation papers, and thereafter, the endorsement of any new and amended Listing Rules before they go for final approval of the HKEx's Executive Committee, the Board of the SEHK and then lastly, the SFC. The Listing Division⁴¹, which forms part of the executive structure of the HKEx, underpins and supports the Listing Committee in discharging its functions.

5.5 While the SFC has the ultimate authority over the final promulgation of any listing rule, which would likely have been formulated by the HKEx after consultation with the market, the MOU contains no provision which mandates the SFC's approval over the HKEx's consultation papers before they are allowed to be published. In practice, the SFC and the HKEx work closely on proposals once these have been fashioned, even at the general principle stage, by the HKEx.

PROCEDURES FOR AMENDMENTS TO THE LISTING RULES

Four Stages

5.6 The procedures adopted by the Exchange for the preparation and release of new and amended Listing Rules have been in place since 1991. The detailed procedures are set out in the following paragraphs. Broadly speaking, the process can be divided into four stages: initiation, preparation and release of proposals, market consultation and, lastly, approval.

⁴⁰ Please also refer to paragraphs 4.9 to 4.11.

⁴¹ The Listing Division is one of the three divisions in the Listing, Regulations and Risk Management Unit. See paragraph 4.7 and **Annex 4.7**.

Initiation

5.7 The HKEx initiates action on changes to the Listing Rules under the following circumstances:-

- (a) Where there are market comments and feedback, whether by direct representation to the HKEx or through views expressed in the media, that the Listing Rules need to be amended in the light of market developments, the Listing Division of the HKEx will consider whether amendments are necessary.
- (b) The HKEx monitors developments in other leading security markets and considers whether its own rules need to be amended in the light of current international trends.
- (c) In the course of administering the Listing Rules, executives of the Listing Division identify areas which need to be amended to clarify grey areas and to remove loopholes.
- (d) When the SFC points to the need for specific rule amendments, the HKEx has to consider and follow up.

5.8 The HKEx adopts different approaches in preparing amendments to the Listing Rules depending on the importance of the proposals. For significant changes, the HKEx issues a formal consultation paper to seek market views on the proposed amendments. For less significant changes, the HKEx publishes a paid announcement of the proposed changes in the press and invite comments on such proposed changes. For insignificant changes such as administrative matters, no formal consultation is made. The HKEx informs the market of the changes when they are implemented also by way of paid announcements in the press. These are usually not matters of substance. They may involve drafting or other minor clarification.

5.9 Since the merger in early 2000, the HKEx has made 33 amendments to the Listing Rules. A breakdown is provided below:-

Types of Amendments	Number
Significant Changes with consultation papers	8
Less significant changes with paid announcements, inviting comments on proposed changes	2
Insignificant changes with paid announcements upon implementation	23

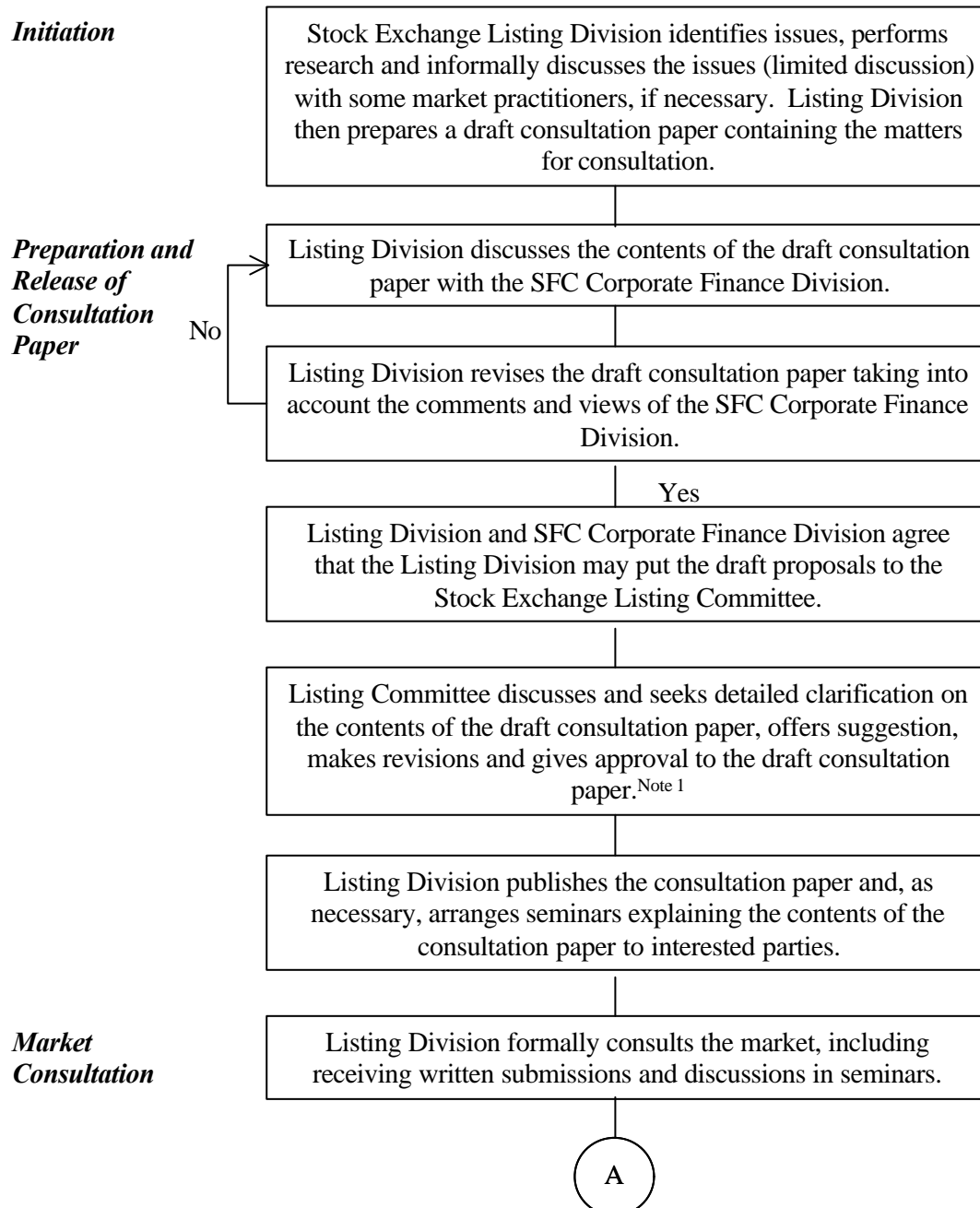
Preparation and Release of Consultation Papers

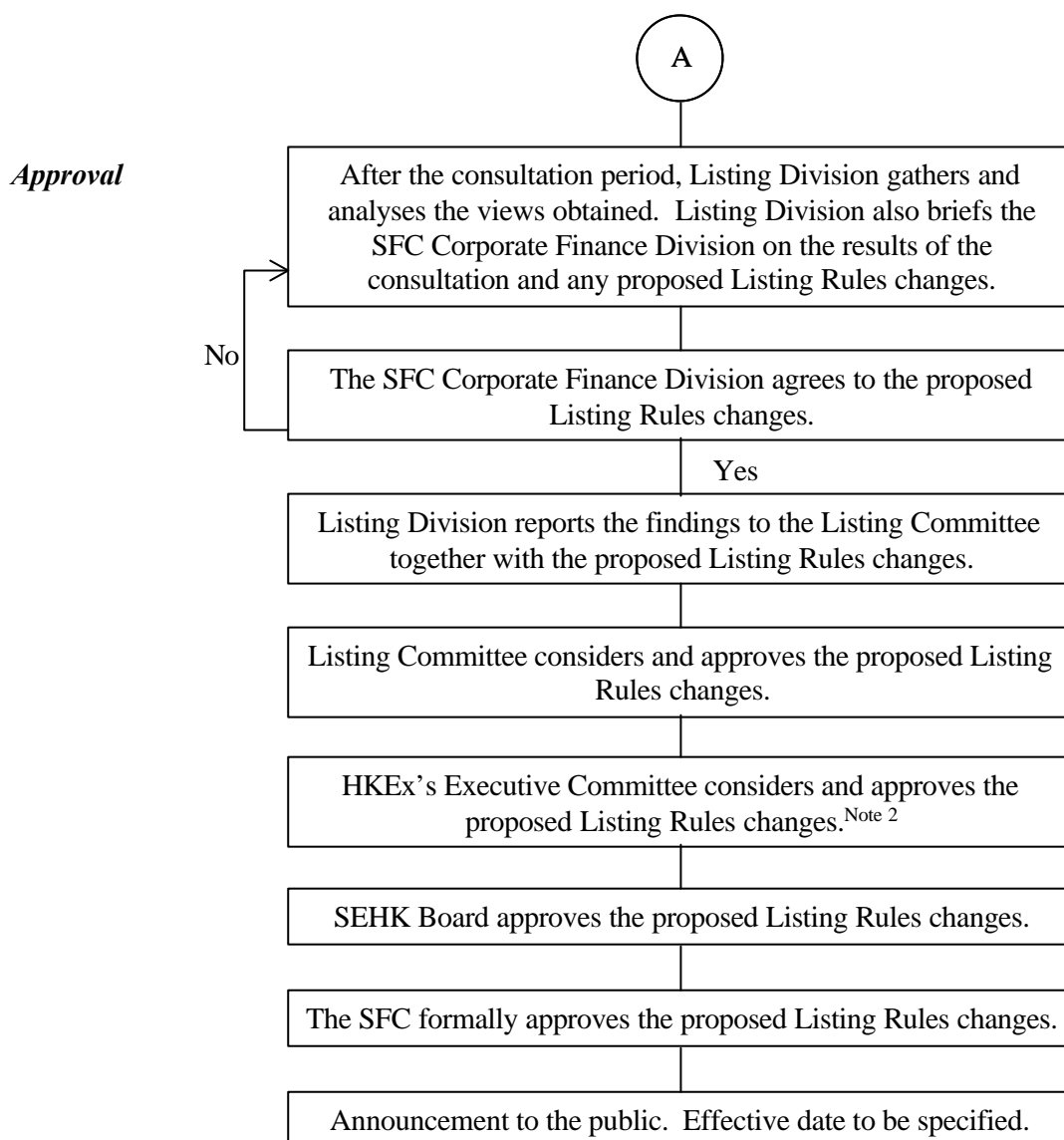
5.10 For significant changes which would be the subject of a consultation paper, the Listing Division follows the procedures as illustrated in the Flow Chart in **Figure 5.1**. First, the Listing Division formulates detailed proposals after analyzing the issues, studies the relevant listing rules of other major markets, prepares any relevant statistics to assess the impact of the proposals, and notes any relevant market comments in the media. Where necessary, the Listing Division seeks independent views, especially on technical issues.

5.11 Under the MOU between the SEHK and the SFC, the HKEx need not consult the SFC on draft consultation papers before releasing them to the public. However, as a matter of practice, the Listing Division prepares discussion papers and seeks comments from the Corporate Finance Division of the SFC. The Listing Division revises these papers taking into account the views of the SFC. Depending on the significance of the matters to be consulted, the Listing Division may arrange meetings with the SFC to discuss the contents of draft papers. The review and revision process tends to continue until the SFC indicates that it has no further comments or that it agrees with the contents of the draft paper.

Figure 5.1

**Flowchart for Issuing Consultation Papers and
Approving Proposed Listing Rules Changes**





Note 1 : Listing Committee comprises members from exchange participants, listed company representatives or market practitioners. Listing Rule 2A.01 states that, inter alia, SEHK Board has arranged for all of its powers and functions in respect of all listing matters to be discharged by the Listing Committee.

Note 2 : Since the merger of the exchanges and the clearing houses, any Listing Rules changes have to be approved by HKEx's Executive Committee prior to their approval by SEHK Board.

5.12 While the SFC and the HKEx do not necessarily agree on all issues even after prolonged discussion, it is usual, in practice, for some compromise solution to be worked out, especially since the proposals go for public consultation anyway. The parties tend to be pragmatic about this and some acceptable formulation is usually arrived at for the proposals to go forward.

5.13 After consultation with the Corporate Finance Division of the SFC, the Listing Division finalizes the paper and circulates it to all Listing Committee members for discussion. The Listing Committee meets almost every Thursday. In general, the Listing Division dispatches the agenda and papers to members of the Listing Committee on Monday afternoons or Tuesday mornings for the Thursday meeting. For policy matters including consultation papers, the Listing Division normally dispatches the papers the week before, so that committee members will have at least a weekend to review the relevant papers.

5.14 Listing Committee members' views and suggestions are incorporated in the consultation paper before issue. Where the Listing Committee has made significant changes to the proposals, such changes are usually communicated to the SFC before they are incorporated into the consultation paper, which the Listing Division then arranges for publication.

5.15 The Listing Committee is regarded as the final authority for the approval and release of consultation papers on listing matters. Without its approval, no proposal can go for consultation.

Market Consultation

5.16 The duration of consultations varies. It has ranged from three weeks to three months⁴². As a general practice, the HKEx announces the release of the consultation paper in a press release or a press briefing. The HKEx's publicity arrangements depend on the significance of the

⁴² The consultation period for the Paper on corporate governance was originally three months but was subsequently extended to four months.

proposal. For major proposals, such as the Consultation Paper on Proposed Amendments to the Listing Rules relating to Corporate Governance in January 2002, after its release, the HKEx held three seminars (in English, Putonghua and Cantonese) for listed issuers with about 560 attendees. The HKEx also gave nine presentations at meetings with professional bodies to discuss the proposals and hosted nine luncheon meetings with 54 representatives from listed issuers. The HKEx also provided a telephone enquiry service for those interested parties who might have queries on the contents of the consultation paper. The HKEx received 503 responses to the Consultation Paper on Corporate Governance. Of these 503 responses, 110 were from listed issuers, 12 were from trade or professional associations and the remainder from market practitioners and the investing public.

Approval

5.17 After the consultation period, the Listing Division gathers and analyzes the views obtained and, if necessary, revises the proposed amendments. The revised amendments go through the following five steps before obtaining final approval:-

- (a) The Listing Division discusses the proposed amendments with the Corporate Finance Division of the SFC. The discussion continues until the SFC indicates that it has no further comments and is in agreement with the proposed amendments.
- (b) The Listing Division then reports the findings, together with the revised proposed amendments, to the Listing Committee for approval.
- (c) The Listing Division next submits the proposed amendments approved by the Listing Committee to the HKEx's Executive Committee for authorization. (The Executive Committee comprises four HKEx Non-Executive Directors and the Chief Executive of the HKEx.)
- (d) After authorization, the proposed amendments go to the SEHK Board for final approval within the HKEx. (The SEHK Board comprises only the executives of the HKEx. See **Annex 4.8.**)

-
- (e) The SFC is then asked to approve the new and amended Listing Rules.

5.18 After approval, the HKEx issues a paid announcement setting out brief details of the amended rules and informing the market of the effective date of such rules. Depending on the complexity of the subject matter, the whole amendment process may take many months. In certain instances, the HKEx also allows a reasonable transitional period for listing companies to comply with the new rules.

OBSERVATIONS

No Pre-consultation Sounding Exercise by the HKEx

5.19 Whilst the HKEx takes into account market views in initiating changes to the Listing Rules, it has been its standard practice not to sound out different segments of the market on the details of its proposed changes before public consultation. The HKEx's four main concerns are as follows:-

- (a) Sounding out prior to public consultation would result in the uneven dissemination of information, leading to certain segments acquiring knowledge of some of the issues before the market in general.
- (b) Any proposed amendments should be considered in their proper contexts with detailed analysis and arguments. Informal sounding out of segments of the market on detailed rule changes without a properly formulated consultation paper may lead to misunderstanding and hence less reliable feedback.
- (c) Prior consultation may result in pre-consultation lobbying and unnecessary pressure being exerted on the SFC or members of the Listing Committee, seeking to influence the content of any consultation proposals.
- (d) A formal consultation paper should be taken as only the beginning of a market wide consultation with detailed proposals on specific amendments.

Involvement of the Listing Committee

5.20 Whilst the Listing Committee is the authority for approving the issue of consultation papers on listing matters and the main gatekeeper for amendments to the Listing Rules, it is noted that:-

- (a) The Listing Committee is not involved until the draft consultation paper is almost finalized for consultation. In other words, the Listing Committee is not normally involved in earlier debates or discussion on the underlying philosophy, objectives and principles to be covered in the consultation paper.
- (b) Members of the Listing Committee, who are usually busy commercial people, and working on a voluntary basis, have only a few days to read the agenda and papers. Even for consultation papers containing detailed proposals with far-reaching implications, such as the one under consideration, members are accorded no more than a week or so to examine the proposals.
- (c) In some instances, and the current one is an example, consultation papers are not accompanied by detailed statistical data or impact analyses conducted by the Listing Division to facilitate the consideration by the Listing Committee, even though they are available and would have been produced if asked at the actual meeting when the paper is being considered.
- (d) There may be differences of perception and expectation of staff of the HKEx and those of the Listing Committee regarding the role of the latter. The terms of reference for the Listing Committee are expressed in very general terms⁴³. The Listing Committee perceives its role as “technical” in nature. Even for policy matters, the role is seen as one of improving the Listing Rules in terms of their practicability and workability. Members of the Listing Committee do not consider that their role is to determine market reaction unless they are specifically asked and they were not on this occasion. On the other hand,

⁴³ See **Annex 4.9**.

the HKEx staff appear to expect the Listing Committee to advise on all issues which may arise of any of the proposals, including technical issues and market impact, even if the latter has not been raised as an issue for consideration. The Listing Committee, all conscientious people, will consider any issue flagged for their attention as well as any other matters which occur to them. By the time of their involvement, however, it is usually considered too late to make radical changes or to question underlying assumptions meaningfully. (See further paragraphs 7.45(d), 11.51 to 11.55.)

- (e) At present, the Chief Executive of the HKEx is the only bridge between the Board and the Listing Committee. The Listing Committee operates independently, and has no ready access, as such, to the pool of expertise on the HKEx Board except through the Chief Executive.

5.21 In view of these considerations, there are questions over whether the existing structure, roles and operation of the Listing Committee needs to be fine-tuned so that it can fully perform its role as the body on the HKEx with final responsibility over listing matters.

Role of the SFC

5.22 As shown in **Figure 5.1**, the procedures involve the interaction of the HKEx and the SFC, particularly between the Listing Division of the HKEx and the Corporate Finance Division of the SFC. There are three points worth noting.

5.23 The first is whether certain important policies with far-reaching implications for the market should be the subject of joint consultations by the SFC and the HKEx. Under Section 7 of the Amended and Restated MOU in March 2000, the SFC and the SEHK agreed to work together on future policy development, particularly regarding the introduction of statutory obligations for listed companies in respect of certain “agreed areas”. These “agreed areas” include the listing document, supplementary information, accounts, liability of advisers and penalties. The SFC and the SEHK have pledged to consult each other or issue joint consultation documents on these areas. The list of “agreed areas” does not appear to have been revised. Between 1990 and 1997, the SFC and the HKEx issued three joint

consultation documents⁴⁴. There is no formal mechanism to determine when a joint consultation paper should be issued. It is for consideration that there should be.

5.24 Secondly, there are no clear agreements between the HKEx and the SFC on whether and to what extent the SFC should engage its consultation network, both formal and informal, in scrutinizing the concept and details of the HKEx's draft proposals before they are released to the public by the HKEx. For the SFC's own amendments, the SFC usually adopts a two-stage approach. It conducts informal sounding on the broad concepts and then consults further on the details. (See paragraph 4.21.) When dealing with the HKEx's proposed amendments to its Listing Rules, the SFC does not consult informally. On an occasion in December 2001 when the SFC had discussed in general terms the HKEx's preliminary proposals with its Shareholders Group, the HKEx staff had expressed grave reservations. The SFC has since taken the view, not without justification, that it has to be careful not to be seen to be treading on the HKEx's turf. As befits the relationship between regulator and the regulated, there is an abiding tension in their co-existence even when they are in the co-operation mode. To say that this is inevitable may be pessimistic, but it would not be too far from the truth. A lot more tact (and understanding) is needed to assuage sensibilities which may at times be delicate. (See further details in paragraphs 7.71 to 7.76.)

5.25 Thirdly, there are differences of understanding of the role of the SFC as perceived by the SFC and by the HKEx. The SFC considers its role as "a sounding board" to the HKEx's proposals whereas the HKEx considers the SFC as having the "final say" over the HKEx's proposals. This point will be covered in greater detail in Chapters 7 and 11. Suffice it to say that both points of view appear to us to be incomplete, not to say inaccurate. (See further paragraphs 7.8(a), 7.10, 7.45 and 7.83.)

⁴⁴ There were three SFC/HKEx joint consultations in June 1990, June 1995 and June 1997:-

- (a) June 1990: joint consultation on the ability of a Hong Kong company to purchase its own shares; the project was launched in response to a request by the Standing Committee on Company Law Reform and covered issues under the Companies Ordinance;
- (b) June 1995: joint consultation on suitability of persons serving as directors of listed companies; the project arose from concerns about nondisclosure of directors' criminal records; and
- (c) June 1997: joint consultation on offer mechanisms; the SFC was involved because the issues of price stabilization and market manipulation were within SFC's regulatory a role.

CHAPTER 6

THE ACCOUNTABILITY SYSTEM AND ITS IMPLICATIONS

INTRODUCTION

6.1 This chapter describes, as best we can, the new accountability system introduced on 1 July 2002. We also try to discuss its implications on the three-tiered regulatory framework. We have, however, to admit that it has not been possible to conduct very meaningful or full research. Such an exercise will most likely fall completely outside our Terms of Reference however benevolently construed. We also acknowledge that neither of us claim to be political scientists or theorists on constitutional structures.

ACCOUNTABILITY SYSTEM

6.2 A new accountability system was introduced with effect from 1 July 2002, to tie in with the Chief Executive's second term of office. As the Administration explained, the objectives of the system are to: strengthen the accountability of principal officials; ensure that the Government can better respond to the needs of the community; enhance co-ordination in policy formulation; strengthen the cooperation between the Executive and the Legislature; ensure effective implementation of policies and provide quality services to the public⁴⁵. Under the accountability system, there are three Secretaries of Departments and 11 Directors of Bureau.

ROLE OF THE FINANCIAL SECRETARY

6.3 The Financial Secretary (FS) is one of the three Secretaries of Department. He assists the Chief Executive (CE) in supervising relevant policy bureaux and in ensuring harmonization in policy formulation and implementation in the financial, economic and employment areas. He also covers specific priority areas of the CE's policy agenda. The FS exercises

⁴⁵ See Legislative Council Paper "Accountability System for Principal Officials" presented by the Constitutional Affairs Bureau on 17 April 2002 and re-iterated in Items for Establishment Subcommittee of the Finance Committee EC(2002-03)2 also issued by the Constitutional Affairs Bureau for discussion on 6 June 2002.

statutory functions, for example, in respect of public finance and monetary affairs. He is responsible for the Government budget in accordance with the CE's policy area. Included in his job description are the duties to "explain Government policies to and answer questions from the Legislative Council, members of the public and the media".

6.4 In relation to the financial services sector, the FS has a wide range of statutory powers to appoint members to key boards, appoint inspectors, make rules, and approve budgets and business plans of regulators. At the same time, the FS has the duty to consult specified committees before exercising certain powers. Some of his statutory powers and duties are set out at **Annex 6.1**.

ROLE OF THE SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY

6.5 The Secretary for Financial Services and the Treasury (the Secretary) is one of the eleven Directors of Bureau. Like the FS, the Secretary is not a civil servant. He is the head of the Financial Services and the Treasury Bureau (the Bureau), and is responsible for determining policy objectives and goals, how they are initiated, formulated and implemented and how effective they are in practice. His list of duties is wide. They include:-

- (a) gauging public opinion and responding to the needs of the community;
- (b) setting policy objectives and goals, and developing, formulating and shaping policies;
- (c) exercising the statutory functions vested in him by law; and
- (d) overseeing the delivery of services by the executive departments under his purview and ensuring the effective implementation and successful outcome of policies.

6.6 The Secretary has inherited some of the statutory powers previously vested in the Secretary for Financial Services. Such powers include permitting the disclosure of classified information by the SFC,

varying the amount of the special levy payable to the Futures and Unified Exchanges and appointment of members of the Securities and Futures Appeals Tribunal. In addition to his own statutory powers, the Secretary provides support and advice to the FS in exercising a range of statutory powers vested in the latter.

IMPLICATIONS OF THE ACCOUNTABILITY SYSTEM ON THE THREE-TIERED REGULATORY FRAMEWORK

6.7 There is nothing that we have been able to consult which indicates that the Administration intends to change the principles and practices of the existing regulatory regime as a result of the newly introduced accountability system. That notwithstanding, the emphasis on the accountability of principal officials may have heightened the public expectation about the role and responsibilities of the Government. Two points are noteworthy.

Statutory Powers and Functions of the FS and the Secretary

6.8 As a result of a recent amendment to the Interpretation and General Clauses Ordinance (Cap. 1) which took effect on 1 July 2002, the definition of “Financial Secretary” includes “Secretary for Financial Services and the Treasury” unless otherwise specified in the relevant legislation or unless there is contrary intention in law. Hitherto, the definition of the FS included “the Secretary for the Treasury”. The recent amendment to include the Secretary appears to have been a consequential amendment to the nomenclature under the new accountability system. Statutory powers and duties currently vested in the FS can, thus, unless a contrary intention has been expressed, or unless otherwise specified in the relevant legislation, be exercised by the Secretary.

6.9 We have sought clarification from the Secretary for Constitutional Affairs, who advised that:-

- (a) As a matter of general policy, it is intended that only those statutory powers and functions relating to public finance, for example, those powers and functions under the Public Finance Ordinance (Cap. 2) which were previously exercised by the Secretary for the Treasury should now be exercised by the Secretary for the Financial Services and Treasury. In taking

over the responsibility of the former Secretary for Financial Services, the Secretary has not been invited to exercise any of the statutory powers and functions of the FS in respect of the financial services policy area. In exercising the statutory powers and functions relating to public finance, the standing arrangement is that the Secretary is not required to report to or inform the FS unless the Secretary considers it appropriate to do so. That said, the Secretary is accountable to the FS in exercising such statutory powers and functions in the sense that the FS assists the CE in supervising the Bureau and the Secretary.

- (b) The Bureau is conducting a review of the relevant legislative provisions and expects to complete the review before the end of the year. The intention is to formalize the pre-existing arrangements for the exercise of these powers and functions between the FS and the Secretary under the new accountability system.

Responsibility over Executive Departments

6.10 As one of the Secretary's duty is to oversee the delivery of services by the executive departments under his purview and to ensure the effective implementation and successful outcome of policies, a question has been raised as to whether the SFC or the HKEx are executive departments under his purview, and whether the Secretary should be accountable for the effective implementation and successful outcome of their policies.

6.11 On this point, the Secretary for Constitutional Affairs advised that:-

- (a) Generally when the Government refers to "executive department" as it does in the context of the accountability system, it means Government departments for which a Director of Bureau has responsibility. It does not include statutory agencies within the purview of the Director of Bureau.
- (b) Specifically in the context of the Secretary, the term "executive department" is not intended to include the SFC and the HKEx.

-
- (c) Directors of Bureau are accountable for matters falling within their policy portfolios and in extreme cases, they may have to step down for serious policy failures. They are responsible for all aspects of their portfolios. They are responsible for overseeing the work of the executive departments falling within the purview of their respective portfolios and the delivery of services by such executive departments. They are thus accountable for such executive departments. In the case of statutory agencies within the purview of the relevant Directors of Bureau, due regard would have to be given to the relevant statutory provisions. Such statutory agencies may be required under the statute under which they are established to act independently in certain aspects. In general, subject to the relevant legislative provision, statutory agencies enjoy a high degree of autonomy in their day-to-day operations, while the Government's policy objectives are determined by the relevant Directors of Bureau.

OBSERVATION

6.12 We agree that under the three-tiered structure, neither the SFC nor the HKEx can in any wise be considered executive departments under the purview of the Secretary. The departments contemplated are clearly those within the Government and not institutions outside the civil service, especially in the case of the SFC the rationale of which is to be independent of the Government. The HKEx is, of course, a publicly listed company governed by its own board of directors and other executives. This point will be discussed in greater detail in the context of the role of the FS and the Secretary in Chapter 12.

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 problem⁴⁶ 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) **Among the Government, the SFC and the HKEx**

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 15, 17 and 23 of July 2002.) 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) **Within the HKEx**

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) **Communications with the Market**

- (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
		<i>"will consult market on \$1/\$5"</i>		
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.”

The SFC’s Comments on the Second Draft Paper on Share Consolidation

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 price⁴⁸.”

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 circumstances⁴⁹.”

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/enq/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.

Third Draft of the Consultation Paper and the SFC's Comments

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) **Minimum share price.** 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) **Impact on shareholders and issuers.** 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) **Exit mechanism.** 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.

Fourth Draft of the Consultation Paper and the SFC's Comments

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.

Fifth Draft of the Consultation Paper and the SFC's Comments

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.”

Sixth Draft of the Consultation Paper

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.

Sixth Draft Circulated to the Listing Committee

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.”

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- (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.

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- (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 2 nd 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 present⁵⁰.

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 Meetings⁵¹.

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.

Involvement of the Financial Secretary

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.

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- (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.

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- (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.

Government

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

Formulating the Proposals

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.

Alternative Trading Platforms

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) **Re-listing on GEM.** 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 “sickward” 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.

CHAPTER 8

THE PRESENTATION AND RELEASE OF THE CONSULTATION PAPER

PRESENTATION

8.1 In commenting on the fifth draft of the Consultation Paper, the SFC's Corporate Finance Division expressed concern about the length and drafting (See extract at paragraph 7.36). It urged the Listing Division to have a "fresh pair of eyes" to go through the draft. We pause to note that in the preparation of the consultation paper on corporate governance, the HKEx engaged an external consultant to edit the paper. This was not done for this Consultation Paper. Perhaps, it should have been. Had there been more time, may be it would have been looked at and edited with outside help. In any event, for this case, the CCU assisted in the editing of the draft for public consumption.

8.2 It has been pointed out by a number of commentators, including market professionals and financial analysts that:-

- (a) The proposals are technical in nature.
- (b) The Paper is over 100 pages long.
- (c) There is no direct or specific emphasis that the price threshold of \$0.5 is merely a trigger for consolidation rather than delisting.
- (d) The paper does not include any proposal on or discussions of the merits or otherwise of an alternative trading platform.

TIMING FOR THE RELEASE OF THE PR PACKAGE

8.3 Three press conferences or media briefings were held on the 24th and 25th of July 2002:-

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- (a) **24 July 2002 (p.m.).** After a briefing for the LegCo Panel on Financial Affairs, the Secretary, in conjunction with the SFC Chairman, and the Chairman and Chief Executive of the HKEx, held a joint press conference to announce their consensus on a three-pronged programme to enhance the quality and competitiveness of the Hong Kong market. The three measures were the establishment of an integrated Listing Committee with even broader representation, the introduction of a streamlined listing process and stronger back-end enforcement of disclosure requirements.
- (b) **25 July 2002 (late morning).** At a media briefing, the Corporate Finance Division of the SFC announced the findings of its study⁵³ on the quality of the Hong Kong stock market. The paper benchmarked Hong Kong's market against leading stock markets in the world and concluded that it was important for Hong Kong to have an effective delisting mechanism to facilitate an orderly exit of companies that were no longer suitable for listing. Only SFC staff attended the press briefing.
- (c) **25 July 2002 (around noon).** The Chief Executive of the HKEx conducted a press briefing to announce the release of the Consultation Paper on Initial Listing and Continuing Listing Eligibility Criteria (the Consultation Paper).

8.4 The Secretary, the SFC Chairman and the Chairman and the Chief Executive of the HKEx were present at the press conference on the 24 July only. The Government's whole preparation since early July was for this package. It was to be, we suspect, the Secretary's coming out party and the platform for him to make an impression. The second briefing was related to a paper prepared by the SFC in December 2001. It was an abbreviated version as the actual paper was considered too technical and negative. The SFC's idea on the timing of the second briefing was to set the scene and present a united front with the HKEx on the latter's proposals. For the third press conference, only the HKEx's executive personnel, and not even its Chairman, were at the press conference launching the Consultation Paper. There can be no question, despite not very well-thought out

⁵³ The study is entitled "Quality of Market and the case for More Effective Delisting Mechanism". An excerpt can be found in http://www.hksfc.org.hk/eng/press_releases/html/index.html.

assertions to the contrary, that this was the Consultation Paper of the HKEx and not anybody else's.

TIMING FOR THE RELEASE OF THE CONSULTATION PAPER

The HKEx's Plan

8.5 As shown in **Annex 7.2**, the HKEx's plan to introduce a revised delisting mechanism has been widely reported in the media since early 2001. The HKEx had committed itself to releasing the Consultation Paper in July 2002.

- (a) On the 8 June 2002, the HKEx sent the second draft of its Consultation Paper to the SFC which included a tentative timetable targeting public consultation on the 15 July 2002.
- (b) On the 3 July 2002, the Chairman of the HKEx had written to the FS in answer to his concerns and mentioned that a consultation paper would be issued "by end July/early August".
- (c) On the 9 July 2002, the Listing Division informed the Bureau of the timetable for circulating the paper to the Listing Committee on the 10 July for deliberation on the 18 July and for public consultation on the 25 July.
- (d) In an article in the HKEx's magazine, the Exchange, released to the media and the public on the 17 July 2002, the HKEx indicated the imminent publication of the Consultation Paper. The article said that the Consultation Paper would cover the requirements for initial listing eligibility, the requirements for continuous listing eligibility and delisting procedures. The circulation of the July edition exceeded 3,000 copies.

Why 25 July 2002?

8.6 The HKEx chose the date and time for the release of the Consultation Paper. It had exchanged notes with both the Bureau and the SFC about that date. In picking the date, the HKEx took into account the following:-

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- (a) The HKEx had made public and other commitments (see paragraph 8.5) regarding its plan to announce the Consultation Paper on the 25 July 2002, or in July 2002.
 - (b) The exercise was a market consultation exercise. Market comments and media enquiries were expected.
 - (c) There would be the joint news conference chaired by the new Secretary on Wednesday, the 24 July 2002, to announce the revised listing structures and corporate governance reforms. The HKEx Board would also be meeting in the morning of Friday, the 26 July 2002, to decide on the extension of trading hours, with an announcement anticipated after the meeting. The HKEx did not want the news conference on the Consultation Paper to clash with these other events. The messages could have been confusing to the public.
 - (d) Since some of the proposals in the Consultation Paper were already widely reported, the HKEx wanted to publish the consultation paper as soon as possible.
 - (e) Because of the lead time for producing the Consultation Paper after incorporating comments of the Listing Committee made on the 18 July, Thursday the 25 July was the earliest possible day the HKEx could publish the Consultation Paper.

8.7 The HKEx was anxious to maintain the 25 July date even though the first printed copies of the Consultation Paper could only be delivered to the HKEx on the morning of the 26 July 2002 because of a production delay. The HKEx could only distribute photocopies of the Consultation Paper to journalists just before the press conference on the 25 July. Printed copies of the Consultation Paper were sent out to stakeholders only on the following day.

Why a Thursday?

8.8 There is a widely held view by market participants that the HKEx should not have released the Consultation Paper in the course of a trading day. Quoting the following examples, the Corporate

Communication Unit (CCU) of the HKEx drew our attention to its practice of not releasing major announcements on Fridays “because there are fewer readers of financial news over the weekend and certain important financial newspapers, do not publish on Saturdays and Sundays, including Asian Wall Street Journal, Hong Kong Economic Times and Hong Kong Economic Journal”. (Note: we have since found out that the latter two newspapers do in fact publish on Saturdays, although not on Sunday. If the CCU had also realized that at the time, perhaps it would not have considered Friday so inappropriate.) These examples were:-

Consultation Paper Relating to	Release Date	Time
Derivatives and Warrants	31.5.2001 (Thursday)	After market closed
Extension of Trading Hours	4.9.2001 (Tuesday)	Lunch break
Corporate Governance	21.1.2002 (Monday)	3:00 p.m.
Dissemination of Listed Issuers’ Announcements	12.3.2002 (Tuesday)	After market closed
Third Party Clearing	10.7.2002 (Wednesday)	After market closed

8.9 The main concern of the HKEx was, it seems to us, to maximize publicity and media coverage. How the proposals might have affected the market would not appear to have been at the forefront of the minds of the CCU.

PRESS CONFERENCE

8.10 Seventy-three journalists from 39 news organizations attended the press conference. Twenty-eight journalists also joined the media lunch. The Chief Executive of the HKEx announced the release of the Consultation Paper and responded to media questions.

8.11 During the media lunch, the Chief Executive and the Head of Listing, Regulation and Risks Management requested that journalists report the proposals comprehensively and avoid sensational reports and headlines. They also made the following points:-

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- (a) Listed companies trading below the \$0.5 share price threshold would not be immediately delisted.
 - (b) There would be a 12-month transition for companies to raise their share price to the threshold level, and that consolidation would be one way for companies to comply with the requirement.

8.12 We note, however, that neither the six-page press release nor the media briefing paper emphasized these points. Also, in response to questions on the likely number of companies which may be delisted, the Chief Executive did not provide any numbers. His rationale was that until after the consultation has gathered in the views of the market, it was not possible to know which of the criteria for delisting would be in place and until those were decided, it was not possible to tell how many companies would have had to be delisted.

8.13 Mr K C Kwong has acknowledged, very fairly, that with hindsight, the message could have been made clearer and that he could have further emphasized that there would not be automatic delisting of stocks trading below the threshold, and that the number of companies which may be at risk of delisting, even if all the proposals were accepted by the market and implemented, would likely be small (i.e. 20 to 30).

DISTRIBUTION OF THE CONSULTATION PAPER

8.14 The HKEx sent the press release and consultation paper to over 90 news organizations, over 170 analysts and fund managers from 96 local and overseas investment firms, by fax and by email. In addition, the HKEx posted the press release and the Consultation Paper on its website on the afternoon of the 25 July. On the 25 July, there were 114 and 34 visits to its website to browse the English and Chinese versions of the Consultation Paper respectively. The numbers increased to 330 and 180 respectively in the following day.

8.15 Hard copies were made available on the 26 July 2002. Throughout the day, 123 English copies and 104 Chinese copies were picked up from the HKEx office.

CHAPTER 9

THE SIX EVENTFUL DAYS – 26TH TO 31ST JULY

MARKET RESPONSE

9.1 The Consultation Paper did not have any major impact on the market on the afternoon of the 25 July. When trading commenced at 10:00 a.m. on the 26 July (Friday), all was relatively normal until around 10:45a.m. Thereafter, for about an hour, there was a large sell-off of stocks, leading to prices tumbling. Out of the 761 stocks listed on the Main Board, 577 (or 76%) recorded a loss, 151 (or 20%) were unchanged and 33 (or 4%) made gains. Of the 370 penny stocks (i.e. stocks with closing prices at or below \$0.5 on 25 July), 283 (or 76%) recorded a loss, 75 (or 20%) had no change and 12 (or 3%) increased in price. The aggregate market capitalization for penny stocks declined by \$10.91 billion, representing about 10% of the market capitalization of that sector and 0.3% of the total market capitalization of the Main Board. Sixty-six stocks (62 of which were penny stocks) suffered a decline of 20% or more. The top loser saw a price plunge of 88%.

9.2 Chapter 10 describes in detail what happened on the 26 July and why.

THE AFTERMATH

Overview

9.3 The six days after the release of the Consultation Paper were eventful. The chronology of events is summarized below:-

Time	Event
26.7.2002	Friday
a.m.	The HKEx dispatched hard copies of the Consultation Paper; The HKEx' s reach-out programmes commenced.
a.m.	Unusual movement of stocks started at about 10:45 a.m.
p.m.	The Secretary met with the media, stressing that it was only a paper for

Time	Event
	consultation.
p.m.	The HKEx issued press statement to clarify proposals on penny stocks.
p.m.	The SFC issued a press statement.
Evening	The Secretary, after consulting the HKEx Chairman, gave a media stand-up, saying that the price threshold of \$0.5 was subject to further discussion.
27.7.2002	Saturday
Whole day	The FS discussed with the Secretary the market reaction and the need for prompt action during the CE's Retreat in a hotel in the New Territories.
a.m. and p.m.	The HKEx announced extension of the consultation period by two months to 31.10.2002 and its plan to publish a supplementary paper on the delisting proposal, first through radio programmes in the morning, then by press release in the afternoon.
p.m.	The FS asked his Administrative Assistant to arrange a meeting with the Secretary, the SFC and the HKEx to discuss the way ahead.
Late afternoon	Administrative Assistant (AA) to the Secretary requested the Principal Assistant Secretary (Securities) of the Bureau (Yan) to prepare a chronology of events for the Secretary's reference by 29.7.2002 (Mon).
28.7.2002	Sunday
lunch	The Secretary and the HKEx Chairman gave luncheon to brokers.
4:00 p.m.	Meeting among the FS, the Secretary, the SFC Chairman, Chairman and Chief Executive of the HKEx.
6:00 p.m.	Press conference by the Secretary, the SFC Chairman, the HKEx Chairman and Chief Executive, announcing the withdrawal of Part C of the Consultation Paper (delisting proposals).
29.7.2002	Monday
a.m.	<p>In response to media enquiries, the FS mentioned that the HKEx:-</p> <ul style="list-style-type: none"> • might not have given sufficient thought to the details of the proposal; • might have under-estimated the market reaction; and • had not notified the Bureau of the Consultation Paper prior to its

Time	Event
	release.
p.m.	The Bureau (Yan), after completing the chronology and consulting the Permanent Secretary (Miller) and the Deputy Secretary, (Au), passed the chronology to AA to the Secretary.
30.7.2002	Tuesday
	The Secretary, the Chairman and Chief Executive of the HKEx and the Chairman of the SFC met to prepare for the special meeting of the LegCo Panel on Financial Affairs.
31.7.2002	Wednesday
a.m.	Further meeting of the Secretary, the SFC Chairman, Chairman and Chief Executive of the HKEx to prepare for the special meeting of the LegCo Panel on Financial Affairs.
p.m.	The FS announced the appointment of a Panel of Inquiry on the Penny Stocks Incident.
p.m.	Special meeting of the LegCo Panel on Financial Affairs.

26 JULY 2002

Morning and Early Afternoon

9.4 After the unusual stocks movement in the morning, the HKEx and the SFC alerted the Bureau to the market reaction, and continued to monitor the movements in the market. The Secretary received a call from one of his contacts informing him of the plunge. He then got in touch with the Chief Executive of the HKEx. Afterwards, he clarified publicly that the proposals were merely proposals, that the consultation period would be until the end of August, that the proposals, even if endorsed, would only be implemented in late 2002 or early 2003, and that companies would be given a 12-month period to comply. He also reiterated that the authorities would seek the views of the market before implementing the proposals and that the measures would enhance transparency and the quality of the market. In the early afternoon, the FS was informed by his Administrative Assistant that the market had reacted strongly to the HKEx's proposals and that the Secretary had already made a clarification in the public. Later in the afternoon, the Secretary phoned the FS, updating him on the market situation.

The HKEx' s Press Statement

9.5 The HKEx issued a press statement in response to media enquiries. The statement clarified that:-

- (a) The proposals were only part of a market consultation relating to the Main Board Listing Rules.
- (b) The HKEx expected a variety of responses from market participants.
- (c) It would take a few months to formulate the rules for the implementation of any changes after the consultation.
- (d) If any rules on delisting of existing penny stocks were adopted, there would be a 12-month transitional period before implementation.

The SFC' s Press Statement

9.6 The SFC also issued a press statement to echo the HKEx' s statement:-

- (a) An effective delisting mechanism was good for the market as a whole and for the reputation of Hong Kong as an international financial centre.
- (b) The proposals were for public consultation. No decision would be made until after the consultation had been completed. There would also be a long transitional period for stocks to meet the listing requirements or for their orderly exit if necessary.
- (c) The trading volume had not been heavy. Turnover for the top 30 losers was \$84.3 million, about 1% of market turnover. One of them (Terabit Access Technology International Ltd), accounted for \$51 million. Of the 30 stocks, 22 were below 10 cents at the closing prices on 25 July 2002, and none above

25 cents. The loss of market capitalization attributable to those 30 stocks amounted to about 0.06% of the total market capitalization.

The Secretary's Media Stand-up

9.7 In a media stand-up that evening, the Secretary made another appeal to the public not to panic. Reiterating that the proposals were under consultation, he stressed that the suggested threshold of 50 cents was only a proposal subject to further discussion.

27 JULY 2002

The HKEx's Clarification and Extension of Consultation Period

9.8 The HKEx decided to extend the consultation period by two months to the 31 October 2002 to "give individuals and organizations more time to consider the proposals and submit their response and comments." The HKEx also undertook to publish a supplementary paper relating to the proposal to delist stocks priced below 50 cents. The HKEx emphasized that it was "genuinely consulting the market on the package of proposals set out in the Consultation Paper". The HKEx then provided details on how interested parties could contact them to express their views. The decision was announced first through radio programmes in the morning, then through press statements in the afternoon.

Discussion between the FS and the Secretary

9.9 During pauses in the CE's Retreat, the FS and the Secretary discussed the market reaction to the HKEx's Consultation Paper and the need for prompt action to address the anxiety in the market. In view of the public concern, the FS requested his Administrative Assistant to arrange a meeting in the afternoon of Sunday, the 28 July 2002 with the Secretary, the SFC and the HKEx to discuss the way forward.

28 JULY 2002

Luncheon with Brokers

9.10 The Secretary and the HKEx Chairman had a luncheon meeting with brokers. During the luncheon, brokers expressed concerns about not being consulted on the delisting proposals and the problems of having 50 cents as a delisting criterion for delisting. There were also worries about potential brokers' default. After the luncheon the HKEx Chairman suggested withdrawing the delisting proposals from the Consultation Paper.

Meeting at the FS' Residence

9.11 At the meeting, the HKEx Chairman said that in view of the market concern about the delisting proposals, the HKEx planned to withdraw those proposals from the Consultation Paper for the time being. It was agreed that the Secretary, the SFC Chairman, and the Chairman and Chief Executive of the HKEx would hold a press conference at 6:00 p.m. to announce the withdrawal and further explain the rationale behind the proposal to alleviate public anxiety.

Press Conference at 6:00 p.m.

9.12 The Secretary, the SFC Chairman, and the Chairman and the Chief Executive of the HKEx attended the press conference. Statements were made. Salient points of the statements made are set out below:-

- (a) **The HKEx.** The HKEx Chairman said that the market mistakenly believed that shares with a market price below 50 cents were to be delisted. They clarified that the HKEx was proposing that companies' stocks falling below 50 cents should and could address the deficiency by consolidating their shares, or by other means. To meet the concerns and clear up misconceptions, the HKEx had decided to take out the whole of Part C of the Consultation Paper (on continuing listing and delisting) for separate discussion with the market in order to strengthen the proposals. The HKEx would publish a supplementary consultation paper at the end of October and the market would be given three months to express its views.

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- (b) **The SFC.** The SFC Chairman stressed that what was proposed about delisting was for consultation only. No decision had been made. The SFC would continue to work with the HKEx on this matter. The SFC would also watch the market very closely to see if any manipulation of the market had taken place.
- (c) **The Secretary.** The Secretary re-affirmed that the Government supported the establishment of a mechanism for listing and delisting that commanded consensus. A comprehensive and sound delisting mechanism would help enhance corporate governance and improve the quality of the market. This would in turn protect investors' interests effectively. He added that the Government, the SFC and the HKEx appreciated that some people in the market had misunderstandings about the delisting mechanism proposed by the HKEx.

9.13 At the conference, the SFC Chairman was asked whether the SFC was involved in the HKEx's proposal for a 50 cents minimum share price threshold. The SFC Chairman's answer in Cantonese was that the SFC "did not discuss with the Exchange any one price". Another question brought forth a not dissimilar answer. It was only when asked for the third time that the SFC Chairman, who had been groping for his words with apparent difficulty, managed to say that "of course, a range of prices were discussed; a dollar, several tens of cents, and other prices were all discussed. But the SFC did not specify one price."

29 JULY 2002

Preparing a Chronology of Events for the Secretary

9.14 In the late afternoon of 27 July 2002 (Saturday), the Administrative Assistant to the Secretary (Miss Clara Tang) asked the Principal Assistant Secretary (Securities) (Miss Salina Yan) to prepare a chronology of what happened for the Secretary's reference by 29 July 2002 (Monday). Miss Yan went back to her office on the 28 July 2002 (Sunday) to do this task. Not knowing the purpose of the chronology, she was under the impression that it should show the broad developments since the penny

stocks issue came to the knowledge of the Bureau. Since the relevant files were not available, she was only able to put together a brief chronology of the relevant events. On the 29 July 2002 (Monday), after completing her draft, she passed it to the Deputy Secretary and Permanent Secretary for quick comments. She then sent the chronology to the AA to the Secretary. The chronology did not mention the HKEx Executive Summary which she had received on the 17 July since it was, in her view, similar to the SFC Summary Table which she had passed to the AA to the Secretary on the 17 July. This understandable omission in the chronology led to some unfortunate consequences. The Secretary thought that his Bureau never received anything from the HKEx and this was what he told the FS who repeated it before the press on the same day. This led to criticism of both the Secretary and the FS and certain extravagant and intemperate allegations of lying and bad faith.

The FS' Remarks

9.15 In responding to media enquiries on his way back to the office on 29 July 2002, the FS said that:-

- (a) the HKEx had not consulted the Bureau on the Consultation Paper before its release. He hoped that the parties concerned would improve the situation in the future.
- (b) the HKEx might not have given sufficient thought to the details of the proposal, or it might have under-estimated the market reaction. He expressed the hope that the HKEx could improve on this aspect in the future.

30 JULY 2002

Discussion between the Bureau and the Secretary

9.16 On the morning of the 30 July 2002, realizing that the HKEx's Executive Summary might be regarded as a material document in the overall shape of things and noting that the document could be confused with the SFC's Summary Table, (as it appeared to have been during the special session before the LegCo Panel on Financial Affairs on the 31 July) Miss Yan drew this to the attention of the Deputy Secretary, Miss K C Au,

and confirmed that she had received the HKEx Executive Summary (on the 17 July) at a tele-conference with the Secretary and the Deputy Secretary. It is worth a quick reminder that the Permanent Secretary, the Deputy Secretary and the Miss Yan all had their offices in Admiralty Centre, while the Secretary and his AA had offices in the Central Government Offices. The Secretary does not recall this message. He thought that he was informed the next morning. We do not think anything turns on this difference.

31 JULY 2002

Clarification

9.17 On the morning of the 31 July 2002, the Secretary convened a meeting with the SFC Chairman, the Chairman and Chief Executive of the HKEx and the Bureau to prepare for the special meeting of the LegCo Panel on Financial Services that afternoon. Before the meeting, the Deputy Secretary, Miss Au, said that there were rumours that the Bureau had obtained a copy of the Consultation Paper before its release. To clarify exactly who knew what, Miss Yan confirmed at the meeting that she had received the SFC's Summary Table on 10 July 2002 and had passed it to the Secretary's Administrative Assistant on the 17 July 2002. She had also received the HKEx's Executive Summary from the HKEx's Listing Division on the 17 July 2002 but she did not pass this on to the Secretary. It was then that the Secretary became aware that the Bureau had received a copy of the HKEx's Executive Summary and he then mentioned this to the FS afterwards.

Preparation

9.18 During the preparatory meeting, the Secretary, the SFC Chairman and the HKEx Chairman read out drafts of the statements they were to read out in the afternoon. The Chief Executive of the HKEx had a draft available, which he said was about 60% complete. The draft did not contain the detailed chronology that was in the statement he read out in the afternoon.

Special Meeting of LegCo Panel on Financial Affairs on 31 July 2002

9.19 At the Special meeting of LegCo Panel on Financial Affairs, representatives of the Government, the SFC and the HKEx attended. There were other interested parties who were invited to make representations. The Secretary, the SFC Chairman, the Chairman and the Chief Executive of the HKEx each read out their statement. During the meeting, the parties commented on their respective roles and action. Brief capsules are set out in the following paragraphs.

The Secretary

9.20 In his answers to questions from Legislative Councillors, the Secretary mentioned that:-

- (a) He “accepted a certain degree of responsibility”.
- (b) Neither the SFC Chairman nor the Chief Executive of the HKEx had called him to inform him of the details of the Consultation Papers.
- (c) If he was asked whether he would have stopped the proposals had he realized that there would be such a strong market reaction, he would definitely have said yes. We note that there was an unclear passage when the Secretary, seemingly flustered and probably somewhat frustrated, appeared to have said that had he been aware of the proposals, he would definitely have stopped them. In context, it is clear to us that he was saying that if he had been able to foresee what happened on the 26 July, he would have done something to prevent it. It is plain that the Secretary did not deny that he was aware of the Consultation Paper (though not the details) or that it was to have been published on 25 July 2002.
- (d) It only came to his attention on the 31 July 2002 that a colleague had obtained a summary table from the SFC which was passed to his office. However, he had not read the document, "since the papers and files in my office were piling up like a mountain and that I could not possibly have read every

document" (our rough translation). He was not aware that the SFC Summary Table arrived in his in-tray on the 17 July when he was about to rush out to dinner and thereafter to the airport for his trip to England. (For details, see items 115 and 174 in the chronology at [Annex 7.1](#)).

- (e) In connection with the three-tiered regulatory structure, the Secretary said repeatedly, and here we are paraphrasing, that the division of responsibility ordained by the structure meant that he did not have to know the details of any consultation proposals from the HKEx. Nor ought he to have known or found out.

9.21 Most of these assertions, although in some ways reasonable and even justifiable, if put across somewhat differently, did not go down well. The Secretary was bombarded with a series of hostile and severe criticisms to which he was unable to acquit himself with either clarity or distinction. It would have required the skills and experience of a much more seasoned bureaucrat to have come out of that barrage relatively unscathed.

The SFC Chairman

9.22 The SFC Chairman stated that "The SFC is the statutory regulator of the HKEx. If there are any errors in regulation of the HKEx, I think the Commission must be responsible, too. I personally bear responsibility. The Consultation Paper was issued by the Stock Exchange, the SFC discussed with them. So therefore, we cannot escape part responsibility in this and I said if we have done anything wrong, if any of my staff have done anything wrong, I bear full responsibility."

Chief Executive of the HKEx

9.23 In his statement, the Chief Executive of the HKEx included a chronology on how the HKEx arrived at the 50 cents price threshold after a series of discussion with the SFC. It was pointed out that the SFC had, in the first instance, proposed \$5 and \$1 as the threshold for initial listing and consolidation. The implications and inferences drawn in the media from the Chief Executive's statement the next few days were favourable. He was the only one to have apologized. And had it not been for the HKEx's

insistence, the price threshold for delisting seemingly proposed by the SFC would have been \$1 which would have caused even more havoc on the 26 July. There were also later suggestions that the sequence of events referred to by the Chief Executive showed that the SFC's involvement was much more than previously understood, that its efforts to distance itself from the debate was unbecoming and that the SFC Chairman's remarks on 28 July 2002 about not having discussed any (one) price with the HKEx was shown to have been a lie.

9.24 As we have made clear in passing, we do not share these criticisms of the SFC: see paragraph 7.10. All in all, the HKEx and its Chief Executive were the only parties who had a relatively good press the next few days.

CHAPTER 10

WHAT HAPPENED ON THE 26 JULY 2002 AND WHY

INTRODUCTION

10.1 The following section relies substantially on a report prepared by the SFC dated the 3 September 2002. We have added our views where appropriate.

GENERAL COMMENTS

10.2 It has been widely reported that the “Penny Stocks Incident” on the 26 July was triggered by the release of the Consultation Paper by the HKEx. The information gathered by the SFC confirms that is likely to be at least partly true. However, this is not the whole picture.

10.3 There have been rumours of collusion by brokers and market participants to derail the HKEx’s proposals by driving penny stocks down on the 26 July 2002. The SFC has not been able to identify sufficient evidence that supports the existence of a conspiracy to manipulate penny stocks. Nor has the SFC found evidence of a concerted sell-off by brokers or banks in response to client margin shortfalls.

10.4 On the 26 July, many investors apparently did not appreciate that the Paper was a consultation. The SFC’s view is that just because the market reacted as it did, it does not mean that the HKEx somehow should have anticipated that reaction and should not therefore have released its proposals. The SFC, in common with the HKEx, thought that the public was aware of the substance of the HKEx’s proposals from accurate leaks made by several reputable newspapers with large circulation from the 26 June onwards.

10.5 Much has been written recently about the lot of small retail investors, who have lost money, paper or real, in the market on the 26 July 2002. There is a very respectable body of opinion to the effect that the vast majority of retail investors understand that penny stocks are inherently more volatile than Hang Seng Index constituent stocks. Indeed volatility can be a prime attraction because these stocks may give investors a better chance of

making a superior percentage profit for the small cost (relative to companies with large capitalization) involved in buying one or two board lots. Frequently, investors buy into a penny stock on incomplete information and with a limited understanding of the underlying company.

ECONOMIC OVERVIEW

10.6 Through 2002, the U.S. markets have been on a downward trend in the face of corporate scandals and poor economic conditions. In July 2002, U.S. investors pulled a record US\$50 billion out of U.S. equity funds – the largest monthly net outflow in history – apparently because of a lack of confidence in the stock markets. The S&P 500 index dropped by 13.8% in the first half of 2002, compared with a decline of 7% in the Hang Seng Index. Many market analysts consider that Hong Kong’s market will remain sluggish at least until the U.S.A. shows consistent signs of economic recovery. Market prices and turnover have been declining in broad terms in Hong Kong for some months. This has depressed market activity and the share performance of all but a few of Hong Kong’s largest and best run listed companies. This was the economic background to the publication of the Consultation Paper on the 25 July 2002.

PRESS COVERAGE PRIOR TO THE ANNOUNCEMENT

10.7 To assess the impact of the Consultation Paper, the SFC studied the press coverage of the HKEx’s proposals prior to the announcement made at noon on the 25 July 2002. We refer to a few items hereunder. A relatively complete summary is at [Annex 7.2](#). On the 26 June 2002, Sing Tao ran an article suggesting that the HKEx proposed to force penny stocks to consolidate. On the 17 July 2002, South China Morning post (‘SCMP’) reported accurately that the HKEx planned to introduce a “compulsory consolidation rule to eliminate penny stocks”. On the 18 July 2002, SCMP reported that the HKEx planned to set 50 cents “as the threshold below which companies would have to consolidate their shares or inject capital to boost their prices”. Similar reports appeared in the Hong Kong Economic Times and Sing Tao on the 19 July 2002. Between the 20 July and the announcement on the 25 July 2002, more newspapers started to cover the story. In general, commentators welcomed the HKEx’s proposals although some expressed reservations whether HK\$0.50 was the appropriate threshold. There was no hue and cry indicating there might be a strong negative reaction to the release of the formal proposals.

THE MARKET IN THE PERIOD FROM THE 26 JUNE 2002 TO THE 25 JULY 2002

10.8 The market behaviour in the period from the 26 June to the 25 July is summarized below :-

- (a) The general tone of the market was weak during the period. There were 14 days of net declines during the period, compared with seven days of net advances from the 26 June to the 25 July, 2002. As noted above, the Hong Kong market was tracking the general weakness and uncertainty in the U.S. markets over the same period.
- (b) Overall, the higher priced stocks advancing or declining outnumbered the number of penny stocks going up or down in the same period⁵⁴. There is no evidence that investors were selling their penny stocks in response to the leakage of the HKEx's proposals. If that had been the case, one would have expected the number of declining penny stocks to outnumber the declining higher priced stocks.
- (c) The number of penny stocks registering no price changes consistently was higher than the higher priced stocks recording no price changes⁵⁵. This was particularly obvious for stocks that registered no daily turnover at all.
- (d) The clear trend was that penny stocks tend to demonstrate higher volatility when compared to the behaviour of higher priced stocks.

⁵⁴ In the 22 trading days to the 26 July, 2,353 higher priced stocks recorded advances, compared with 1,592 penny stocks. 3,878 higher priced stocks recorded declines, compared with 2,514 penny stocks recording declines.

⁵⁵ During the same period, 3,325 penny stocks recorded no price change, compared with 2,776 higher priced stocks. In fact, during this period, 2,015 penny stocks recorded no turnover volume, whereas 1,344 higher priced stocks recorded no turnover volume.

THE BEHAVIOUR OF THE MARKET ON THE 25 JULY AND THE 26 JULY 2002

The 25 July 2002

10.9 Press commentaries on the market for the 25 July 2002 did not suggest anything dramatic had occurred that day.

The 26 July 2002 – Immediately after opening

10.10 Prior to the market opening at 10:00 a.m. on the 26 July 2002, no unusual movements were anticipated. Wall Street had been flat overnight (Standard & Poor 500 moved only 0.44% lower overnight) suggesting, if anything, that Hong Kong would remain largely unchanged. In headline articles, almost all local newspapers reported the release of the Consultation Paper. There was no suggestion that the proposal was a shock to the market. There was some focus whether \$0.50 was an appropriate threshold, noting that over 50% of the Main Board issuers might be affected. On balance, the media seemed to support the proposals.

10.11 At 10:00 a.m., the market opened with a small downward bias. None of the brokers interviewed by the SFC subsequently foresaw any sharp movement in the market. While there were quite a number of losers in the market just after opening, nothing suggested any significant changes were about to occur given the bearish sentiment which had been overhanging the market for some time.

After 11:00 a.m. on the 26 July 2002

10.12 The situation started to deteriorate after 10:45 am as more and more stocks started to record further losses. While many stocks recorded losses (over and above those incurred over the previous few months) in relatively dismal turnover, Terabit Access (491)⁵⁶ stood out as the heaviest loser in heavy turnover. From about 11:00 a.m., according to the SFC

⁵⁶ Formerly known as Wellback Holdings Limited, Terabit Access engages in the manufacturing of consumer electronic products. In November 2001, there was a change in control in which Mr Lau Kwok Fai, currently the Vice-Chairman of the company, acquired 18.4% of the share capital of the company and became the controlling shareholder. Since the change of control, the company embarked on new acquisitions into technology companies in Taiwan and saw its share price more than triple before the sell off.

investigation, the market began to associate the market's decline with the proposals announced by the HKEx the previous day. Rumours also started to circulate that margin financiers had liquidated client securities as a result of the sharp decline in share prices of penny stocks. The selling climax for all stocks for the day came prior to the morning closing.

10.13 A noticeable recovery was seen in the market in the afternoon on an intra day basis. Out of a total of 283 penny stocks⁵⁷ that fell on the 26 July 2002, 63 of them had recovered more than 20% from their respective intra-day lows in the afternoon session. Among these 63 recovering stocks, four of them (including Terabit Access) rebounded more than 100%. Nothing comparable occurred in the higher priced stocks.

10.14 A summary of the statistics for the 26 July 2002 is as follows:-

- (a) 283 penny stocks registered price declines. The total decline in market capitalization was \$10.9 billion, or 10.1% compared with the previous day.
- (b) In terms of market capitalization, these penny stocks accounted for 2.6% of total market capitalization of \$3,664 billion on the 26 July 2002.
- (c) Turnover in penny stocks amounted to \$558.9 million or 7.6% of total market turnover, compared with \$221.2 million or 3.3% in the previous day.
- (d) Total market capitalization declined by \$61 billion or 1.6% on the 26 July 2002. Overall market turnover increased by 7.9% to \$7.4 billion on a decline in the Hang Seng Index of 1.1%.

⁵⁷ "Penny Stocks" refer to stocks with closing share price quoted at or below \$0.5 on the 25 July 2002.

LOSS IN MARKET CAPITALIZATION ON 26 JULY 2002

10.15 One measure of loss that can be applied to stock markets is to calculate the loss of market capitalization⁵⁸. By this measure, the drop in the value of penny stocks resulted in a decline in market capitalization for these companies of \$10.9 billion in aggregate. This is approximately equivalent to 22% of the amount lost by all other companies whose share price was above \$0.50 on the same day. When compared to the loss in market capitalization for the whole of the Main Board, the loss is about 0.31%, which is not hugely significant in the context of the whole market.

10.16 The market's activity on the 26 July 2002 was centered on 160 shares trading below HK\$0.20 at the opening. These shares recorded the biggest jump in trading volume and turnover and the sharpest declines in share price (and hence market capitalization). Volume and turnover of penny stocks increased a respective 3.4 times and 1.5 times when compared with the previous day.

CHURN RATE

10.17 Churn rate is defined as the volume of market turnover of an issuer in relation to its outstanding shares in issue⁵⁹. This indicator is useful in understanding how reliable the market price is in reflecting the collective views of investors in the share of a company. A low churn rate is normally the result of either outstanding shares being cornered or of the fact that the market has no interest in that particular issuer. An issuer with a low churn rate is also susceptible to higher volatility in its share price. The statistics also show that:-

⁵⁸ Market capitalization is the product of market price multiplied by the shares in issue of the listed company. It is also commonly referred to as the market value of a company. By definition if the share price of a company drops, there will be a loss in market capitalization.

⁵⁹ Theoretically it is better to use the free float of an issuer (i.e. after deducting the shares controlled by the controlling shareholders) instead of the shares in issue as the base. The shares controlled by the controlling shareholders are normally not used for trading purposes.

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- (a) Seven issuers recorded an average loss of 16.5% without any turnover⁶⁰. In terms of loss in market capitalization, they contributed a loss of \$281 million.
 - (b) Issuers with a low churn rate can exert a very significant leveraging impact on the loss of market capitalization. A total of 133 stocks (of which only 14 had a price above \$0.50 on the 25 July 2002) with churn rates of lower than 1%, contributed an aggregate loss of market capitalization of \$8.4 billion. A mere turnover of \$145 million is responsible for an average price decline of 18.5%, ranging from 10.2% to 53.6%.

10.18 It is apparent that in many circumstances, significant losses were recorded on the back of a very low churn rate. The degree of significance increases the lower the share price of that stock becomes. This is consistent with the notion that lowly priced stocks tend to be monitored by fewer investors on a regular basis. They are subject to bigger price movements in the case of a sudden influx of buy or sell orders. There is a prevailing psychology amongst investors to refrain from making any investment decision (while still holding on) on investments that have already resulted in significant paper losses. Some of these penny stocks were at one time high flyers.

BEHAVIOUR OF DECLINING STOCKS PRIOR TO THE 26 JULY 2002

10.19 From the 31 December 2001, only 16 of these stocks managed to record gains for the period while 89 declined. On average, the gainers posted gains of 37% whereas the decliners registered an average loss of 34%. Included in the gainers was Terabit Access (491) which had made a gain of 198% since the beginning of the year 2000 prior to its sell off on the 26 July 2002. If Terabit Access is excluded, the average gain would be reduced to 26%. Only five stocks managed to record a loss of less than 20% from

⁶⁰ Under the AMS system, the closing price of a listed company may be adjusted even if there is no transaction done for the day. Take an example of a situation whereby someone is prepared to sell a stock and finds that no bidder is around. He can keep making successive offers at lower prices. In this instance, so long as the last offer (the lowest) is lower than the previous day's closing price, this lower offer will be considered as today's closing price. (Please note that the actual mechanism is slightly more complicated.)

their highs of the year⁶¹. Sixty-two stocks registered losses of more than 40% prior to the 26 July 2002. Amongst these losers, 45 of them had closing prices at or below \$0.10 on the 25 July 2002.

10.20 Thus, most of the top declining stocks registered significant losses to their share price prior to the 26 July 2002. The losses in value of these stocks on the 26 July 2002 represented a fraction of the total losses incurred as a result of their earlier price declines from their previous high for 2002 or from their closing price prior to the 31 December 2001.

10.21 It can be seen that many penny stocks had been losing value for sometime. It is therefore inaccurate and wrong to suggest that investors in penny stocks lost all their money overnight. The lion's share of investor losses occurred prior to the 26 July 2002. While the percentage drops in the value of penny stocks that day looked dramatic, the actual losses represented by those percentages were quite small when compared with actual losses suffered in the previous six months. For example, Grand Field Group (Code: 115) that saw its share price declining from \$0.087 to \$0.06 (a drop of 31% and ranked 13th amongst the top losers on the 26 July 2002) was trading around \$0.70 in mid-March 2002. China Star Entertainment (Code: 326) which lost \$0.012 on the 26 July 2002 to reach \$0.027 (a drop of 31% again and ranked 14th on the top declining list) was trading around \$0.27 in early January 2002.

10.22 The SFC has also noted that prior to the 26 July 2002 a few companies published very poor results and that these may also have contributed to weakness in the market for those individual shares. On the 24 July 2002, Asia Tele-Net and Technology (Code: 679 and the 4th top loser) reported a loss of \$132 million for its final results for the year ending the 31 March 2002. The loss per share was about \$0.0245, roughly equivalent to 94% of its share price on the 25 July 2002. Also on the 25 July 2002, Asia Resources Transportation (Code: 899) and (the 19th top loser) reported a loss of \$136 million for its final results for fiscal year 2002. The loss per share was about \$0.075, about two times (in absolute terms) its share price of \$0.036 on the 25 July 2002. The extremely low turnover in those shares (due to an absence of bidders) in a fast falling market is consistent with this view.

⁶¹ By definition, this ratio must be negative.

THE MARKET SINCE THE 26 JULY 2002

10.23 On the back of the withdrawal of Part C of the Paper on the 28 July 2002, a number of the penny stocks rebounded on the 29 July 2002. However, in light of the prevailing weak economic environment and the uncertainties of the overseas market, the rebound was very selective. While it is widely believed the announcement of the Consultation Paper triggered the sell-off, there were rumours that a group of brokers had met on the evening of the 25 July and conspired to derail these proposals by deliberately driving penny stocks down the next day. In turn, this is alleged to have caused the margin squeeze already mentioned.

PRELIMINARY FINDINGS

10.24 The SFC's preliminary findings are as follows:-

- (a) It has information that the announcement of the Consultation Paper and the general weakness of penny stocks in the weeks prior to the 26 July 2002 were the principal reasons for some sellers wanting to sell.
- (b) However, the lack of liquidity in many penny stocks (in the form of a lack of demand) exacerbated the situation.
- (c) None of the brokers with whom the SFC had been in contact foresaw the magnitude of the decline that subsequently occurred.
- (d) None of those brokers said they had been squeezed by margin calls from their banks. They said it was their client's decision to sell that day, not theirs.
- (e) Some of the brokers interviewed by the SFC pointed to the sharp fall of Terabit Access as having a significant psychological impact on market behaviour on the 26 July 2002, but this was not a unanimous view.

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- (f) Terabit's fall was fuelled by forced sales by brokers as a result of margin calls. To date, the SFC has no evidence that these were not genuine calls.
 - (g) There is no evidence of widespread forced sales by brokers of client shares pledged for margin, nor were brokers forced to seek further credit from their banks to cover clients' unsettled trades from the 25 July 2002.
 - (h) No systematic overnight short selling has been identified.

THE SFC'S CONCLUSIONS

10.25 Based on the above findings, it is the SFC's view that the sell-off of penny stocks on the 26 July 2002 was primarily an over-reaction by investors to a set of proposals for market consultation that were unfortunately misunderstood by some as policy changes.

10.26 Market sentiment was already weak because of world and local economic conditions. These same factors and the fact that a number of penny stocks continued to have losses contributed to the majority of the top declining stocks suffering significant erosion of their share price long before the 26 July 2002. In fact, the losses incurred on the 26 July represented a small fraction of the losses incurred by penny stocks due to earlier price declines from either their closing prices at the 31 December 2001 or from their previous high in 2002. Investors in these stocks did not lose all their money overnight.

10.27 The true scale and market impact of the decline on the 26 July 2002 should be evaluated against the market as a whole. A large percentage drop in the value of stocks does not necessarily equate to a similarly dramatic drop in absolute value. For example, Dah Hwa International lost 54% of its value on the 26 July 2002 but this represented a drop from \$0.11 to \$0.051 on turnover of a mere HK\$50,000. In many ways, the trading in Dah Hwa is a paradigm of the problems that penny stocks pose for the fair and transparent operation of the market.

10.28 Furthermore, the illiquidity of penny stocks contributed to their volatility. 133 stocks (of which only 14 had a price above HK\$0.50 on the

25 July 2002) with churn rates of lower than 1%, contributed an aggregate market loss of \$8.35 billion. A turnover of only HK\$145 million or 0.2% of total turnover on the 26 July 2002 was responsible for this decline in market capitalization. Compared to the overall losses suffered by the whole of the Main Board on that day, the loss of capitalization in penny stocks accounted for 0.31% of overall capitalization.

10.29 Unfounded rumours were another ingredient in the brew: rumours that a concerted credit squeeze by banks and brokers forced the market down have not been substantiated. Nor is there evidence of a conspiracy amongst a group or groups of investors and/or brokers to manipulate the penny stock sector as a whole.

THE PANEL'S VIEWS

10.30 The Penny Stocks Incident seemed to have been the outcome of a combination of factors which fed on and magnified each other. There was the prevailing unfavourable market sentiment, the generally weak investor confidence, and the inherent volatility of these stocks. We have noted criticisms of the contents of and the arrangements surrounding the release of the Consultation Paper. Clearly its release triggered the reaction on the 26 July, but it would be simplistic and inaccurate to identify the consultation Paper as the single cause of what happened. Unfounded rumours about margin calls, panic reaction to the dumping, an element of when fortune smiles, take advantage as well as unreflecting herd instincts also played a part.

CHAPTER 11

A CRITICAL REVIEW

INTRODUCTION

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

COMMENTS ON THE INCIDENT

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

Underlying Spirit of the Consultation Paper

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

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

Yardstick

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

Number of Criteria

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

Minimum Price Threshold and Scope of the Consultation Paper

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

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

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

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

Confusing Message

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

Alternative Trading Platform

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

Consolidation

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

Under-estimating the Market Reaction

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

Lack of Market Experience

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

Bad Timing

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

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

The HKEx's Consultation Practices

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

Consultation Not Genuine

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

Lack of Communication between the HKEx and Market Players

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

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

Neglecting the Interests of Small Investors and Companies

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

No Contingency Plans and Wavering Attitude

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

Authorities Shirking Responsibilities

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

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

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

Lack of Co-ordination among the Authorities

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

Comments on the HKEx

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

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

Comments on the SFC

11.26 The following comments were addressed to the SFC:-

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

Role of the FS

11.27 On the role of the FS, the public had the following comments:-

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

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

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

Role of the Secretary (SFST)

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

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

Comments on the Three-tiered Structure

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

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

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

EVALUATING THE COMMENTS

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

MINIMUM TRADING PRICE THRESHOLD

The HKEx's Response

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

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

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

The SFC’s Views

11.34 The SFC Chairman’s comments were that:-

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

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

The Panel's Views

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

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

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

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

ALTERNATIVE TRADING PLATFORM

The HKEx's Response

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

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

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

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

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

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

The SFC's Response

11.37 The SFC had these observations to offer:-

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

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

The Panel's Views

11.38 Our views are as follows:-

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

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

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

UNDER-ESTIMATING MARKET REACTION

The HKEx's Comments

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

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

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

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

The SFC's Comments

11.40 The SFC Chairman had the following comments:-

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

⁶³ The summary is supplied by the HKEx.

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

The Panel's Views

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

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

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

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

LACK OF MARKET SENSE

The HKEx's Comments

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

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

- (a) In their day-to-day work, staff had plenty of contact and discussion with market people, including officers of listed companies, financial intermediaries, exchange participants and fund managers. They would have picked up plenty of experience in good time.
- (d) Recent consultation papers from the HKEx provided a fairly comprehensive package of proposals addressing what were considered by the market to be important issues. The result of the consultations showed that the issues that staff of the HKEx had highlighted and made proposals for change were matters which addressed the heart of corporate governance issues.

The Panel's Views

11.46 We note the following statistics:-

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

NO CONSULTATION WITHIN THE HKEX NETWORK

The HKEx's Comments

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

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

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

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

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

The Panel's Views

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

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

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

Listing Committee

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

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

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

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

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

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

LACK OF COMMUNICATIONS WITH THE MARKET

The HKEx's Comments

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

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

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

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

The Panel's Views

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

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

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

BAD TIMING

The HKEx's Comments

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

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

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

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

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

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

The SFC's Comments

11.64 The SFC had these comments:-

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

The Panel’s Views

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

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

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

CONSULTATION NOT GENUINE

The HKEx's Comments

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

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

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

The Panel's Views

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

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

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

CHAPTER 12

ROLES OF INDIVIDUALS

INTRODUCTION

12.1 We have dealt in passing with the roles, functions and participation of the Bureau, the SFC and the HKEx. In this chapter, we draw together some strands relating to the involvement of some of the individuals, namely, the FS, the Secretary, the SFC Chairman, the Chief Executive of the HKEx and officers in the Bureau.

FINANCIAL SECRETARY

His Involvement

12.2 The FS was informed of the HKEx's plan to review its listing rules to streamline and strengthen their enforcement. He was aware of the HKEx's plan to introduce a Consultation Paper on listing criteria and delisting procedures in late July or early August 2002. He was not involved in the formulation of the proposals, and he did not receive a copy of the Consultation Paper or any Executive Summary before its release. He read the Executive Summary of the Consultation Paper for the first time on the Sunday, the 28 July when his Administrative Assistant downloaded a copy from the Internet. More details are at paragraphs 7.65 to 7.67.

12.3 In analyzing the FS' role in the Incident, we have considered, more particularly, the following matters:-

- (a) the division of responsibility between the FS and the Secretary for Financial Services and the Treasury (the Secretary);
- (b) the responsibility of the FS and the Government for this Incident under the current regulatory framework and the new accountability system; and
- (c) his remarks on the 29 July. (See summary at paragraphs 9.15 and entry in the chronology.)

Division of Responsibility between the FS and the Secretary under the New Accountability System

12.4 As mentioned in Chapter 6, the reference to “Financial Secretary” in any Ordinance is to be interpreted to include both the FS and the Secretary. This is the effect of section 3 of the Interpretation and General Clauses Ordinance (Cap. 1). Both the FS and the Secretary are directly accountable to the CE and, unlike the position pre-July 2002, the Secretary no longer reports to the FS in the sense that he is accountable to him. The division of responsibility between them is therefore not entirely clear.

12.5 We know that, in practice, the Secretary assists the FS in carrying out many of his statutory functions, and an organization chart prepared for the LegCo debate on the question of accountability shows the Secretary to be in a grouping under the FS. The theory, and practice, appears to be that while the Secretary is accountable only to the CE, the CE has delegated certain duties and functions relating to Hong Kong’s economy and finances to the FS who, at the CE’s behest, has the role also of supervising the groupings under him, including the Bureau and the Secretary as its director. The Secretary therefore, in practice, reports in the first instance to the FS. He and his bureau also assist the FS in managing Hong Kong’s finances. The set-up is consistent with this understanding since the FS has only a smallish office with an administrative assistant, a press secretary and no doubt clerical and other staff. He has to rely on the Bureau for support and to screen any matters which may arise in, for instance, the securities market, insurance, the mandatory provident fund scheme and, to a lesser extent, the banking sector.

12.6 Under the current framework, the FS is the most senior official looking after the economic, financial, fiscal and employment arenas in Hong Kong, over which he has to consider broad policy. Housed under the Bureau are all these matters relating to the detailed formulation of policy, the sponsoring of legislation through the Legislative Council and the monitoring of other executive bodies.

12.7 In other words, in the actual running of the Government, the FS looks after the biggest possible financial picture. The Secretary carries out his statutory duties and functions as well as assisting the FS when called

upon to do so. There are, of course, practices already in place to ensure the smooth running of the system.

12.8 We are told that the Administration is in the process of working out a clearer division, but that the study has yet to be completed. In the light of the concerns raised over this lack of clarity, even though we are assured that the system works in practice, and that the Secretary has a fairly clear job description (See Annex 12.1), we believe that a clearer demarcation of roles would be welcomed by all and sundry.

12.9 At this juncture, we ought to re-iterate the caveat that our terms of reference (and the time constraints) would not allow us to venture too deeply into these and related areas. Our remaining observations have to be considered in the light of the caveat.

Political Responsibility under the Accountability Systems

12.10 We attempt hereunder to set out our understanding of political responsibility under the accountability system. This is also subject to the same caveat about our terms of reference, the exigencies of time, plus our relative lack of expertise which we have tried to remedy, without notable success, over the past six weeks.

12.11 We start with the relatively simple proposition that there is no universal meaning that we know of which has been used to describe or define the term “political responsibility”.

12.12 Second, different political structures and systems attribute different consequences and effect to the term.

12.13 Third, what political responsibility means or entails depends in large measure on a territory’s history, politics, constitution, constitutional conventions, political sophistication and the system of government. So that in the United States, members of the Cabinet, not being in Congress, are only accountable to the President. In the United Kingdom, where the term originated, one of its consequences, after years of development and refinement, is for the Government to resign if it suffers a major setback in the Parliament. Similarly, cabinet ministers are sometimes expected to resign over major errors or gaffes, including those by underlings, if the delinquency or consequence is sufficiently serious.

12.14 Fourth, as a matter of language, accountability means, or is at least the cognate of, the requirement or necessity to give an account of something, usually of what happened – the obligation to give an explanation, perhaps even to justify what happened or did not happen. It does not usually imply or stipulate what happens after an account has been given. Any further repercussion would depend on what happened, the severity of the consequences and the considerations adverted to in the third point made earlier. The contrast is with a dictator who does not have to explain, justify or to give an account of himself or herself.

12.15 With these preliminary observations, which we recognize lack depth and sophistication, we venture to offer a view as to what ultimately can legitimately be expected of someone in the position of the FS and the Secretary.

12.16 In the context of what we are now discussing, we believe that there are the following four broad categories of responsibilities. The first is policy responsibility. The second is executive responsibility. The third may be described as systemic responsibility, something relating to the design of the system. The fourth one is personnel responsibility, meaning whether those responsible and in a position to do so have appointed the right person(s) to do the job in question.

12.17 We use this incident as an illustration. First, policy responsibility. If a delisting mechanism for under-performing companies is the wrong policy, then allowing the policy would mean that a mistake has been made. If the idea to revise the delisting mechanism is a bad one, then the Secretary and even the FS would have to take at least some of the policy responsibility because they endorsed the principle or concept. In this case, however, there was and is overwhelming support for the policy, though there are different views on how the policy should be implemented, which is precisely why a public consultation was and is necessary.

12.18 Executive responsibility here would be in the crafting, design and drafting of the documentation as well as the rollout and publicity arrangements. Here, this would not be part of the responsibility of the FS or the Secretary.

12.19 Systemic responsibility would involve considering whether the three-tiered system is the right one and within the three-tiered system,

whether each constituent was performing its function. The HKEx to formulate and draft, the SFC to offer suggestions and comment and the Secretary and the Bureau to give the necessary encouragement, support and co-ordination but not interfering. If something went wrong with the actual documentation or the consultation process by the HKEx and with the SFC, then it would not be the Government's systemic responsibility. If, however, the problem had lain with the three-tiered structure, that would be the Government's responsibility because the Government designed the system. In this case, the general view seems to be and our view is that the three-tiered system is sound in principle, though in the light of what happened, some refinements would not be out of place if they can lead to a clearer delineation of responsibilities, especially between the SFC and the HKEx and to better co-ordination within those two tiers.

12.20 Personnel responsibility here relates to whether the right people are in place and who appointed them.

12.21 Also, the FS as the most senior "financial" official would have at least a political duty to find out what happened, and, if necessary, to consider questions of blame and responsibility. Insofar as he is able to, the FS must also ensure that if something has gone wrong, that the problem is corrected as quickly as possible and to take steps to minimize the effect any such mistake may have on the economy. Thirdly, we believe that the FS also has the responsibility to make sure that measures are taken so that similar mistakes or mishaps do not happen again.

Remarks on the 29 July 2002

12.22 The first point about the FS' remarks on the 29 July is that the Stock Exchange had not notified the Bureau of the Consultation Paper. This remark spawned comments that he was finger-pointing before all the facts were known. Also, the allegations were made that the FS was shirking his responsibilities and, worse, that he was misrepresenting the facts when he said that the Government had not been notified of the HKEx's Consultation Paper. It was, however, only on the subsequent Wednesday (31 July), that the Secretary informed him, contrary to what he had previously told the FS, that his staff had received the Executive Summary of the Paper from the HKEx. We have already covered this topic at paragraphs 9.16 and 9.17. The FS was clearly misinformed and no blame

can be laid on him in respect of these remarks. He must be entitled to trust what the Secretary told him.

12.23 Regarding his remarks that the Stock Exchange might not have given sufficient thought to the details and might have under-estimated the market reaction, the reason the FS made them was that the 50 cents threshold did not appear to have been spelt out in the paper as essentially one for consolidation and it was somehow communicated to, or understood by, the public as a delisting criteria and trigger. Also, one of the obvious concerns would have been what shareholders could do if companies in which they hold shares were delisted. The FS took the view that some discussion of the desirability or otherwise of an alternative platform after delisting would have been, at the least, desirable, and may have avoided any panic. And since this was the Consultation Paper of the HKEx, it was reasonable and logical for him to have assumed that these were errors of judgment on the part of the HKEx. We agree. (See paragraph 7.87.)

Observations

12.24 We have already described our views of the four-pronged responsibility of the FS. We are quite unable to say that he has failed to discharge any of those responsibilities. While the Incident may have disclosed some cracks in the actual operation of the three-tiered structure in terms of the delineation of responsibilities, especially between the HKEx and the SFC and what happens within the HKEx and its communication with the outside world, these are more wrinkles for the HKEx to address in the first instance. It is also our view that the FS, in conjunction with the Secretary, should supply the necessary authoritative encouragement to enable these difficulties to be resolved.

SECRETARY FOR FINANCIAL SERVICES AND THE TREASURY

His Involvement

12.25 The Secretary assumed office on the 1 July 2002. He was aware of the delisting proposal, but was not informed of, or consulted on, the details. In the context of preparing for the joint press conference on the 24 July, he was aware that the HKEx would announce the Consultation Paper on the 25 July. On the 17 July, his Administrative Assistant placed in his in-tray a copy of the SFC Summary Table setting out the gist of the

proposal, but he did not see it. He had a dinner engagement that evening after which he flew to London and did not return to his office until Monday the 22 July. Also, he only became aware on the morning of the 31 July that the Bureau had obtained the HKEx Executive Summary which was not passed on to him. He then informed the FS accordingly.

12.26 Between the 25 July and 31 July, he was in constant touch with the FS, the SFC Chairman, the Chairman and Chief Executive of the HKEx as well as his contacts in the business and securities world trying to understand the situation and formulate strategies on how best to handle the incident.

His Responsibilities

12.27 While appearing before the LegCo Financial Affairs Panel, he admitted that he should accept “a certain degree of responsibility”. We have already stated our view that both the Secretary and the FS have the responsibilities described in paragraphs 12.10 to 12.21. Leaving aside the Secretary's sub-par performance before the LegCo Panel meeting (as to which see our views at paragraphs 9.20 and 9.21), we do not think he has failed in the discharge of his responsibilities. We also note that the Secretary joined the Government on the 1 July 2002 and that, thereafter, he had a great deal of catching up to do. The change in job responsibility and culture would have taken some acclimatizing. We have seen his engagement diary. The Secretary clearly had a very full plate. On top of all that, he did not have a close geographical connection with his Bureau staff and communications somehow broke down, leading to confusion and misunderstanding over what actually happened. A very steep learning curve plus things going wrong when the Secretary was still inexperienced in his post contributed to the distressing encounter with the LegCo Panel on Financial Affairs. Moving forward, it is now necessary for the Secretary to take the lead in reviewing such systemic and other issues which may have contributed to what happened on the 26 July.

THE SFC CHAIRMAN

His Involvement

12.28 The SFC Chairman was aware of the delisting initiative, but was not involved in the details, including discussions about the price

threshold, although he was kept generally in the picture. As this was a consultation document of the HKEx, only staff of the Corporate Finance Division were involved in the day-to-day communications with the HKEx. Unless matters of controversy or of important policy were involved, consultation papers of the HKEx would not be submitted to the SFC Chairman for approval or comment. He would be involved after the consultation and rule changes have been made by the HKEx and submitted to the full Commission for approval.

12.29 He was first informed of the idea of mandatory share consolidation in late 2000. There have been general discussions at internal staff meetings and he was briefed on the HKEx's proposals in broad terms in one of these meetings on 30 May 2002. He began to be involved from the 9 July onwards when he participated in a meeting to do with the PR roll-out plan for the 24 July and the SFC issued a press statement on the 25 July. Mr Sheng made certain comments at a press briefing on the 28 July and he first read the Consultation Paper after that briefing. He appeared before the LegCo Panel on Financial Affairs on the 31 July. He did not attend the SFC's media briefing on the quality of the Hong Kong market on the 25 July. We have already seen his earlier correspondence on the quality of the Hong Kong stock market with the SFS, Mr Stephen Ip, Mr Charles Lee, the Chairman of the HKEx and Mr Ma, the then newly installed Secretary.

Remarks on the 28 July

12.1 An important event involving the SFC Chairman was the press briefing on the 28 July during which he made certain remarks in Cantonese, in response to a reporter's question, that the SFC did not "discuss with the HKEx any one price." In a subsequent follow-up question, he said, again in Cantonese, that "of course, a range of prices was discussed; a dollar, several tens of cents, and other prices were all discussed. But we did not specify (指定) one price.". The earlier remark, taken on its own, was considered inconsistent with the events inserted into the chronology presented by the Chief Executive of the HKEx at the special meeting of the Legislative Council Panel on Financial Affairs on the 31 July 2002. There were questions as to whether he was telling the truth.

12.31 We note that:-

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- (a) Mr Andrew Sheng's Cantonese, on matters technical, is less than articulate. He had read his statement in English at the press conference on the 28 July. The others, the Secretary, the Chairman and the Chief Executive of the HKEx, all used Cantonese in the briefing. Mr Sheng's normal practice was to answer media questions in the same language in which the questions were asked - a practice he adhered to, unwisely, on the 28 July.
- (b) After the press conference, Mr Sheng asked his staff whether his remarks may have caused confusion or misunderstanding about the SFC's role. Having checked the relevant record, SFC staff were satisfied that there should be no risk of confusion when the remarks were read in conjunction with the subsequent clarification. The SFC staff also monitored newspaper articles on the Monday and Tuesday. They reported that Mr Sheng had said that the SFC had discussed a range of prices. In view of this, the SFC staff did not see the need for clarification, which might have caused further debate. To assist journalists in understanding the full picture, staff from the Corporate Communications Division of the SFC sent to the media the relevant section of the transcript of the 28 July press conference.

His Responsibilities

12.32 The confusion about Mr Sheng's remark on the 28 July is unfortunate. It should not have led to the serious recriminations subsequently, but it did and, with hindsight, it would have been better to have clarified the matter at the earliest possible moment. We do not, for a moment, consider that Mr Sheng meant to mislead and we also believe that, taking everything he said in context, there should not have been confusion.

12.33 Mr Sheng mentioned at the meeting of the LegCo Panel on Financial Affairs on the 31 July 2002 that he would accept full responsibility if there had been any errors in regulating the HKEx or if he or any of his staff had done anything wrong. We are not convinced that the SFC could have done much more, either in terms of its input into the Consultation Paper (see paragraph 7.45) or to have prevented what happened on the 26 July.

We note the occasional difference and unhappiness between the SFC and the HKEx over their respective roles, philosophies and responsibilities over the regulation of listed companies as well as the communication channels within and between them. This incident has highlighted many of these differences and some of these wrinkles must now be ironed out.

CHIEF EXECUTIVE OF THE HKEX

His Involvement

12.34 The Chief Executive of the HKEx was involved in setting the direction and parameters of the Consultation Paper. The groundwork was done by his Listing Division staff. He did not participate in the day-to-day discussion between the Listing Division and the Corporate Finance Division of the SFC, but he was consulted on all key issues including the negotiation on the price threshold, and the presentation and timing for the release of the Consultation Paper. He discussed so-called “milestone” events with the Listing Division at regular and at ad hoc meetings. He also commented on a late draft of the Consultation Paper. He was a member of the Listing Committee although he did not attend the meeting on the 18 July. He presided at the press conference announcing the release of the Consultation Paper on the 25 July 2002.

His Responsibilities

12.35 As the Consultation Paper was issued by the HKEx, the Chief Executive of the HKEx would have these responsibilities:-

- (a) **Executive responsibility.** He was and is the Chief Executive. This is the HKEx’s Consultation Paper. The Chief Executive need not condescend to all the details, but he has broad policy direction as well as the responsibility to ensure that the crafting, drafting and presentation of the Consultation Paper was all up to standard. As the most senior executive officer in the HKEx, he would have to bear responsibility on behalf of the HKEx for any major policy shortcomings in the preparation and release of the Consultation Paper, for instance the lack of sufficient emphasis that the 50 cents threshold was for consolidation and not for delisting, the lack of adequate discussion about

alternative trading platforms, and the lack of adequate communication with the trade during the formulation process.

- (b) **Systemic responsibility.** The Chief Executive must ensure that proper systems and framework are in place within the HKEx, and between it and the SFC. In this connection, the Chief Executive adhered strictly to the standard practice not to sound out other parties before the actual consultation. He also observed the strict separation of the Board and Listing function with the result that the HKEx was not able to tap into the rich reservoir of expertise in the Board and in the Consultative Panels, to the extent that even the Chairman of the Board had no input into the Consultation Paper. The Chief Executive was following well-established practices. He should not be criticized for having done so. Having said that, we believe that these are practices well worth re-visiting. We have made (paragraphs 5.20, 7.70, 11.49, 11.50, 13.13 and 14.6 to 14.14) some suggestions and we note that the HKEx has produced suggestions of their own which we hope can be considered soon by its Board and by the SFC.

We have also made certain remarks about the role and function of the Listing Committee (See paragraphs 4.10, 4.11, 5.20, 5.21, 7.39 to 7.43 and 7.45(d)). We refer to them here not as a criticism of the Chief Executive of the HKEx for allowing that state of affairs to occur, but to underline the importance of making full use of the experience and expertise within the extended HKEx family (see also paragraphs 4.5 and 4.22)

- (c) **Personnel responsibility.** He was responsible for making sure that sufficient resources in terms of numbers and quality were devoted to the preparation of the proposals. In this case, it is not entirely clear whether, given the inherent complexity of the matter, sufficient resources had been allocated to this important exercise. On balance, we are not convinced that the Chief Executive should be faulted for this.

FINANCIAL SERVICES AND THE TREASURY BUREAU

Involvement

12.36 Within the Bureau, there were three officers directly involved in this case:-

- (a) Mr Tony Miller – Permanent Secretary for Financial Services and the Treasury (Financial Services) (PSFS), who assumed duty on 1 July 2002
- (b) Miss Au King-chi – Deputy Secretary for Financial Services (1), (DS(1)) who oversaw the securities team and the special services team on the Securities and Futures Ordinance
- (c) Miss Salina Yan – Principal Assistant Secretary for Financial Services (Securities) (PAS(S)), who was the officer in de facto charge of securities matters.

12.37 Highlights of their involvement are in the table below. Unless otherwise stated, the principal participant in the events is Miss Salina Yan.

Date	Event/Task
October 2000 to November 2001	Miss Yan relayed concerns expressed by the Hong Kong Stockbrokers Association regarding penny stocks and dilution of shares to the SFC, and following up.
December 2001	Co-ordinated the setting up of the first tripartite meeting.
March – May 2002	Attended meetings of the Co-ordination Committee chaired by the Chief Executive of the HKEx, during which he mentioned the progress on the delisting proposals.
8 July 2002	Set up preparatory meetings to flesh out the key proposals and roll-out plan for the Secretary to announce the listing committee reform.
9 to 17 July 2002	Prepared materials for the Secretary regarding the press conference on 24 July 2002.
10 July 2002	Obtained the SFC Summary Table on the delisting proposals.
17 July 2002	Obtained the HKEx Executive Summary of the Consultation Paper.
17 July 2002	Passed copy of the SFC Summary Table to Administrative

Date	Event/Task
	Assistant to the Secretary.
18 July 2002	Prepared a brief analysis on the delisting proposal for the attention of DS(1) and PS(FS).
29 July 2002	Prepared chronology of events, which was subsequently passed to the Secretary and Financial Secretary, omitting the item about obtaining the HKEx Executive Summary. The chronology was cleared with DS(1) and PS(FS).
30 and 31 July 2002	Informed the Secretary about the omission.

12.38 The Bureau has policy responsibility for the development of the securities and futures market in Hong Kong. The PAS(S) is the main contact point at the working level on matters relating to the SFC and the HKEx. The Bureau did not and does not participate in deliberations by the regulator, the SFC or the market operator, the HKEx, on proposals for public consultation relating to changes to the rules of the HKEx. Where such proposals may support or further government policies, the Bureau keeps an eye on the general progress. The Bureau also reflects to the regulator and market operator any views conveyed to it by market users.

12.39 The Bureau first came across the subject of penny stocks in late 2000 during bi-monthly meetings between the Bureau and the Hong Kong Stockbrokers Association.

12.40 Three incidents are worth underlining. First, Miss Yan, sent a copy of the SFC Summary Table but not the HKEx Executive Summary to the Administrative Assistant to the Secretary. Second, she omitted the obtaining of the HKEx Executive Summary in her chronology for the Secretary, which was also sent to the FS. Third, she did not mention this omission until the morning of the 30 July 2002 and stressed the same to the Secretary on the 31 July 2002.

12.41 Miss Yan explained that she did not consider it necessary to send a copy of the HKEx Executive Summary because the SFC Summary Table was, in her view, “as helpful in the circumstances as the HKEx Executive Summary”. The SFC Summary Table, was in a format fit for submission to the Secretary for quick reference. We believed that her action was, in the circumstances, sensible and reasonable. It was not common for the HKEx to send advance copies of consultation papers or executive summaries to the Bureau. Had it not been for the need to co-

ordinate the PR rollout plan for the Press Conference on 24 July, Miss Yan would not have asked for the HKEx Executive Summary.

12.42 On the second point, Miss Yan explained that she was under the impression that the chronology should show the overall development. Her chronology therefore only included salient events. In her view, the HKEx Executive Summary was similar in nature to the SFC Summary Table. Moreover, she was asked to prepare the document at short notice during the weekend when the office was closed. Since the relevant files were not available, she only managed to put together a rough draft based on what she had. The omission should not have been material, and Ms Yan should not be faulted for leaving out that item in the chronology.

12.43 Miss Yan's action was, in our view, reasonable and understandable given that both the SFC Summary Table and the HKEx Executive Summary were obtained as background material for the joint press conference on the 24 July 2002. They were not supplied to the Bureau as part of the SFC's and the HKEx's efforts to inform the Bureau on the details of the proposals included in the draft Consultation Paper. Both documents served a similar purpose. It was perhaps unfortunate that, not knowing of the omission, the FS had made some remarks on the basis and understanding that the HKEx had not told the Bureau about the Consultation Paper.

Responsibilities

12.44 The Bureau's involvement from late 2000 has been dealt with. It drew to the attention of the SFC the problem, it encouraged the HKEx to engage stockbrokers and it set up and participated in different meetings to encourage better communication between, in particular, the SFC and the HKEx. In the process, we believe it managed to get the balance about right. What it did would not have been seen as interference, yet it provided a level of co-ordination previously lacking. We do not think that the Bureau should be faulted, the mix-up with the summaries and the chronology notwithstanding.

CHAPTER 13

CONCLUSIONS

INTRODUCTION

13.1 It has taken a while to get to this part of the report. Here we draw together the strands from the various parts.

CONCLUSIONS

Conclusion No. 1

13.2 There is overwhelming market and public support for the enhancement of the quality of the securities market in Hong Kong. There is a clear consensus that the authorities should work together:-

- (a) to maintain fair, transparent and orderly markets;
- (b) to promote public confidence in the markets;
- (c) to secure the appropriate degree of protection for all investors, but particularly the minority shareholders;
- (d) to minimize market misconduct and to weed out under-performing companies which damage the reputation of the Hong Kong market; and
- (e) to enhance Hong Kong's position as a premier international financial centre.

Conclusion No. 2

13.3 Building on Conclusion No. 1, we believe that there is a consensus that Hong Kong should press ahead with reform measures which seek to achieve those objectives. The Penny Stocks Incident should not be allowed to derail or to slow down the ongoing reforms.

13.4 Reforms are not always painless. The task of initiating and implementing reforms can be onerous especially under unfavourable market conditions.

Conclusion No. 3

13.5 Initiating and implementing reforms involve care, consideration and sensibility on the part of those involved. We have seen that market practitioners and the public at large have expressed a strong wish to be heard. The success of market reforms depends on informed public debates and discussion and consensus building.

Conclusion No. 4

13.6 The Government, the SFC and the HKEx have demonstrated a clear determination to introduce reforms to enhance the quality of the market. There is a keen desire and almost a sense of urgency which have nonetheless to be tempered with moderation and balance. Plautus is reputed to have said that a cause which is rushed is not a just one.

13.7 Not unexpectedly, different sectors of the market and the community have different views on the needs and pace of such reforms.

Conclusion No. 5

13.8 The Penny Stocks Incident, which has confirmed volatility of these stocks, is some testament to the need to tackle the problems associated with them sooner, rather than later.

13.9 The Incident seemed to have been the outcome of a combination of factors which fed on and magnified each other. There was the prevailing unfavourable market sentiment, the generally weak investor confidence, and the inherent volatility of these stocks. We have noted criticisms of the contents of and the arrangements surrounding the release of the Consultation Paper. And clearly its release triggered the reaction on the 26 July, but it would be simplistic and inaccurate to identify the Consultation Paper as the single cause of what happened. Unfounded rumours about margin calls, panic reaction to the dumping, an element of when fortune smiles, take advantage as well as unreflecting herd instincts also played a part.

Conclusion No. 6

13.10 We are in a position to be forward looking and we have been able to reflect on these matters with hindsight. The whole consultation exercise would have been much better managed if more pre-consultation sounding had been done in the gestation process.

13.11 The HKEx did not formally engage the market in developing the concept and details of the proposal until about two weeks before the publication of the Consultation Paper. The SFC also felt inhibited from involving its network in commenting on the HKEx's proposals during the drafting stage. While the HKEx had been conscientiously keeping track of views expressed in the media, we have noted that that is not a complete substitute for engaging its stakeholders early and often.

Conclusion No. 7

13.12 The HKEx and the SFC have worked diligently in the preparation of the Consultation Paper. The HKEx adhered to its well-established and reasonable practices of processing similar consultation papers. Due process was, in a sense, followed, perhaps too rigidly.

13.13 The HKEx would not disagree that it could have done a better job had there not been some of the structural obstacles already identified. The lack of engagement of its extended family, the somewhat unclear role of the Listing Committee, the slightly tense relationship with the SFC all perhaps contributed to not making full and complete use of the available knowledge, experience and expertise.

Conclusion No. 8

13.14 What happened after the 26 July, and how the authorities reacted, may have generated even more discussion and comment and added an additional dimension to the Incident. The newly introduced accountability system, and what it meant in practice, almost overshadowed the technical issues to do with the Consultation Paper. The Penny Stocks Incident quickly developed into a political hot potato. There were criticisms of the perceived lack of understanding of the roles of the Government, the SFC and the HKEx within the three-tiered structure, the

lack of clarity over the division of responsibilities between the FS and the Secretary as well as what the accountability system entailed.

Conclusion No. 9

13.15 There is overwhelming support for the continuation of the three-tier regulatory structure. It has served Hong Kong well over the past 13 years. At the same time, there are calls for clearer delineation of responsibilities among the three parties and better co-ordination among them.

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

(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.

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

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

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

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.

CHAPTER 15

FINAL REMARKS

15.1 What happened on the 26 July was unfortunate and regrettable. Allegations of wrongdoing and recriminations were rife and intemperate. We have in this report dealt with most of them and the protagonists have all been afforded full and adequate opportunities of dealing with criticisms made against them. In the end, after what we consider to be a very exhaustive (and exhausting) enquiry, for which we had the fullest co-operation from all concerned, we did not discover the serious cancer which some of the commentary and criticism led us to believe existed when we began our task. Instead, we uncovered some instances of errors of judgment, some perhaps even understandable in the circumstances, a few mishaps, items of miscommunication and some systemic wrinkles here and there. None of the shortcomings we have identified are in themselves major. The combination of circumstances, however, led to the unanticipated events of the 26 July and the less than favourable public response to how the matter was then dealt with thereafter by the authorities.

15.2 We have set out our findings at some length. We have erred very much on the side of thoroughness. If we had had much more time, we have little doubt that our report would have been more concise, better organized and more efficiently edited. As it is, we feel we had to include much of the history to give our findings context and to set out the events in some detail.

15.3 Those who think that there are rights and wrongs to be discerned and those who may not embrace all our conclusions and findings would be able to see for themselves much of the raw material from which we worked. Those who feel that the observations we have made, or some of them, are ungenerous or unjustified will, at least, be able to see much of their side of the story presented as well.

15.4 This inquiry should not be taken as a fault finding exercise. We re-iterate that we have come to many of our views with the substantial benefit of hindsight, so that although we too were working against the clock, we had the good fortune of being able to reflect and discuss, to enquire and to seek, without being under the sort of practical pressures which both the

SFC and the HKEx, and to a lesser extent the Bureau, must all have been under.

15.5 In the result, we hope that lessons can be learnt and improvements put in place for the future.

15.6 We have already expressed our gratitude to all of those who have contributed submissions, representations and documentation. Our report would not have been completed on time, and our enquiry would have been much more difficult, had it not been for the dedicated and conscientious support of our secretariat headed most competently and cheerfully by Ms Michelle Li, ably assisted by Miss Stoney Poon, Mr C P Li, Ms Mary Wong, Miss Dorothy Fung, Miss Christine Fong and Miss Michelle Lau, to all of whom our sincere and heartfelt appreciation.

(Robert G. Kotewall)

(Gordon C. K. Kwong)

Representations Received

The following is a list of organizations and individuals who submitted representations to the Panel:-

Constitutional Affairs Bureau

Consumer Council

Dr Edgar W.K. Cheng, GBS, JP

Dr K. S. Lo

Economic Development and Labour Bureau

Financial Secretary's Private Office

Financial Services and the Treasury Bureau

Hong Kong Exchanges and Clearing Limited

Hong Kong Institute of Investors

Hong Kong Securities & Futures Industry Staff Union

Hong Kong Securities Institute

Hong Kong Securities Professionals Association Limited

Hong Kong Stockbrokers Association Limited

Mr C. K. Low

Mr Anthony Neoh, SC

Mr David M. Webb

Ms Christine Loh

Official Receiver's Office

Securities and Futures Commission

Hong Kong Monetary Authority, a submission referred to the Panel by the Secretariat of the Standing Committee on Company Law Reform

The Chamber of Hong Kong Listed Companies Limited

The Hong Kong Association of Online Brokers

The Democratic Party

The Honourable Henry Wu King-cheong, BBS

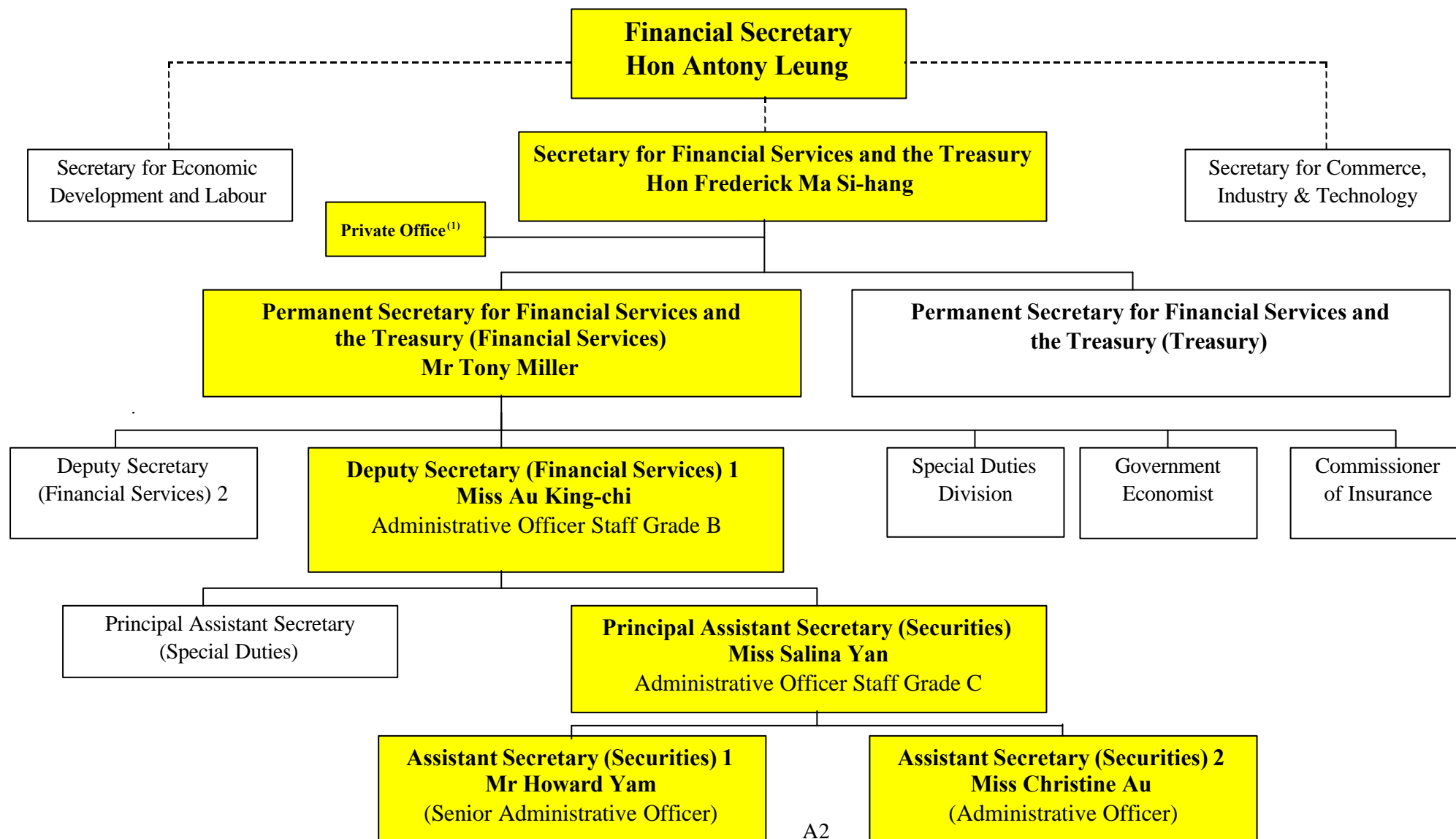
The Honourable Emily Lau Wai-hing, JP

The Liberal Party

The Institute of Securities Dealers Limited

Wocom Securities Limited

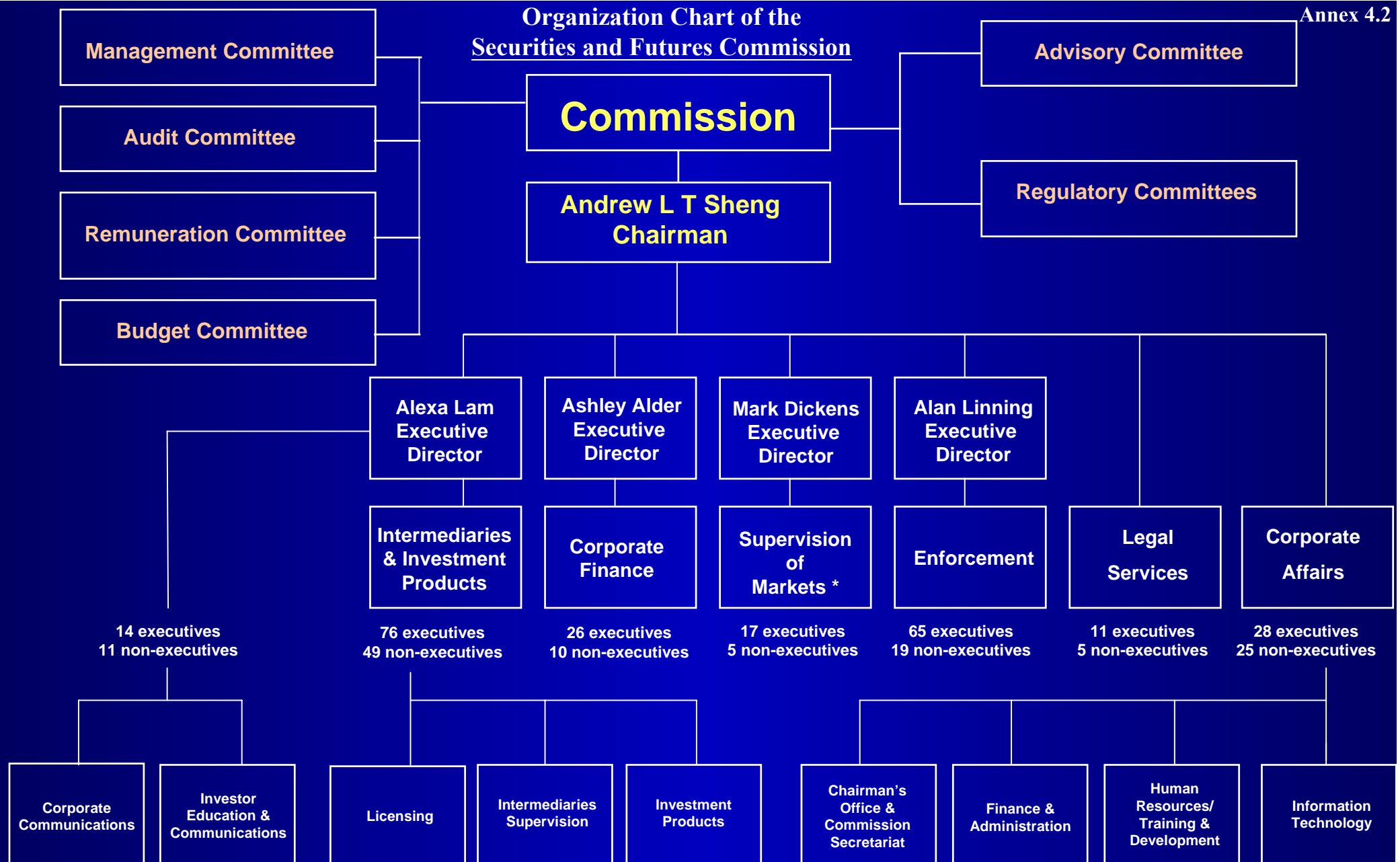
Government Officers Involved in Securities-related Policies



Note 1 : SFST's Private Office comprises an Administrative Assistant, a Press Secretary and a Personal Secretary.

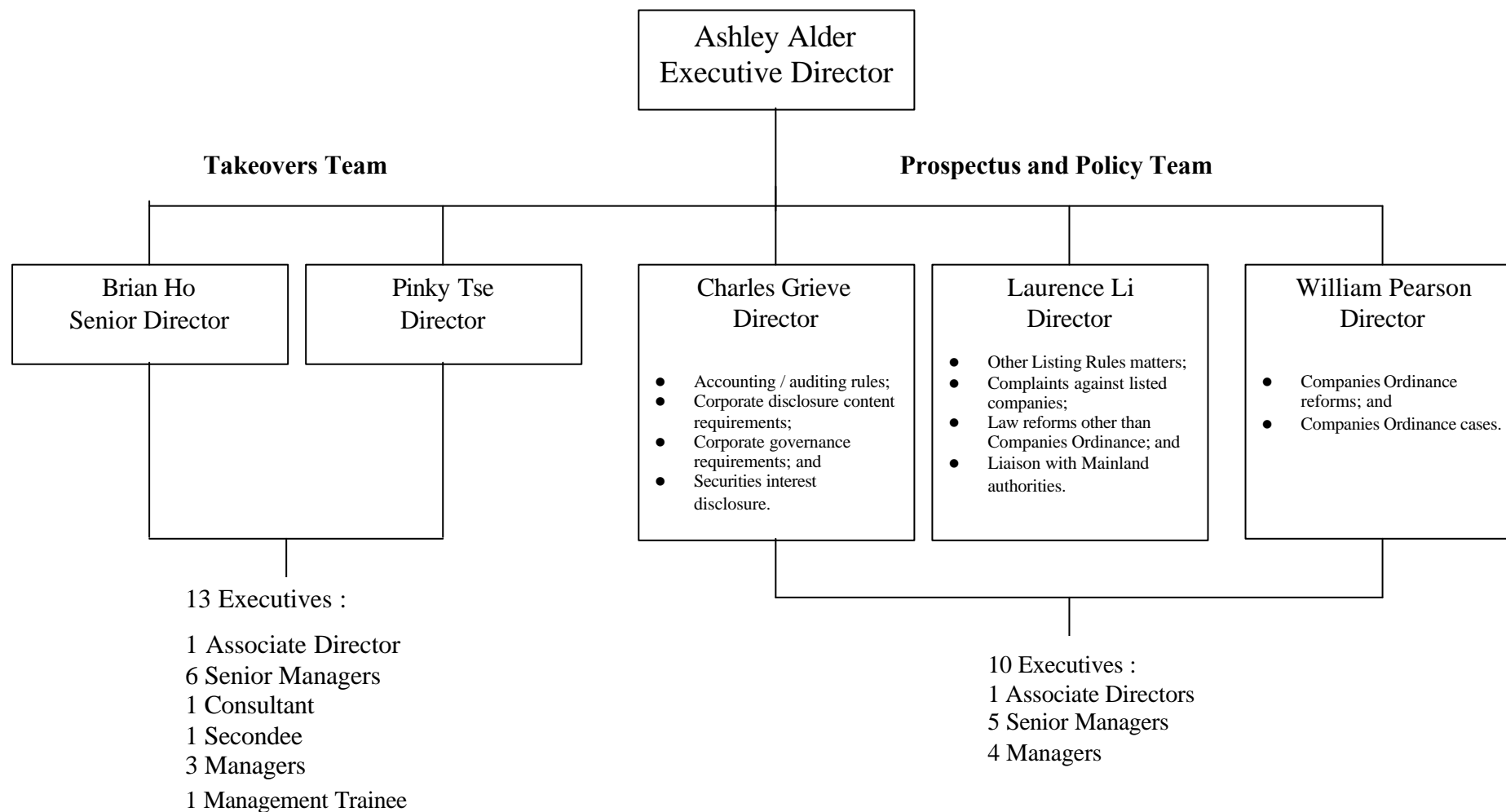
Organization Chart of the Securities and Futures Commission

Annex 4.2



* Including Research Department

Organization Chart of the SFC Corporate Finance Division



Hong Kong Exchanges and Clearing Limited:
Membership of the HKEx Board and Committees

Board of Directors

Non-Executive Chairman :

LEE Yeh Kwong, Charles, GBS JP,
Public Interest Director appointed by the Financial Secretary

Executive Director and Chief Executive :

KWONG Ki Chi, GBS JP,
Ex-officio member

Non-Executive Directors :

Public Interest Director appointed by the Financial Secretary

CHAN Cho Chak, John, GBS JP
FRESHWATER Timothy George
LEONG Ka Chai, JP
LIU Jinbao
LO Ka Shui, JP
STRICKLAND John Estmond, GBS JP
WARD Rodney Gordon

Director elected by the shareholders of HKEx

FAN Chor Ho, Paul, JP
KWOK Chi Piu, Bill
LEE Jor Hung, Dannis, BBS
LEE Kwan Ho, Vincent Marshall
SETO Gin Chung, John
YUE Wai Keung

Membership of Six Committees

Executive Committee

LEE Yeh Kwong, Charles (Chairman)
GREDE Frederick John
KWONG Ki Chi
LEONG Ka Chai
SETO Gin Chung, John

Audit Committee

STRICKLAND John Estmond (Chairman)
FAN Chor Ho, Paul (Deputy Chairman)
FRESHWATER Timothy George
LEONG Ka Chai
YUE Wai Keung

Investment Advisory Committee

FRESHWATER Timothy George
(Chairman)
SETO Gin Chung, John (Vice Chairman)
CLARKE Peter
SUN David
SUN Patrick

Risk Management Committee

LEE Yeh Kwong, Charles (Chairman)
CHAN Cho Chak, John
KWOK Chi Piu, Bill
LAM Kin
SHENG Len Tao, Andrew
STRICKLAND John Estmond
WONG Tung-shun, Peter
YAM Chi Kwong, Joseph

Remuneration Committee

CHAN Cho Chak, John (Chairman)
LEE Jor Hung, Dannis
WARD Rodney Gordon

Nomination Committee

LEE Yeh Kwong, Charles (Chairman)
FAN Chor Ho, Paul
LO Ka Shui

HKEx Consultative Panels

Terms of Reference and Membership

A. Derivatives Market Consultative Panel

Terms of Reference

The Panel should meet at least once a year. Additional meetings should be held as the work of the Panel demands.

2. The duties, powers and functions of the Panel shall be :
 - (a) to provide market expertise and advice to the board on international trends, the needs of intermediaries, issuers, investors and other market participants, technology challenges and new product opportunities relating to the derivatives market;
 - (b) to consider such other topics and matters relating to the derivatives market as may be requested by the board and to report back thereon;
 - (c) generally, to act as a sounding board for policy recommendations, strategic initiatives and major investments in relation to the derivatives market; and
 - (d) to discuss, formulate and advise the board on the foregoing matters in accordance with the request of the board from time to time.

Membership

LEONG Ka Chai (Chairman)	KWAN Pak Chung, Edward
KWOK Chi Piu, Bill (Deputy Chairman)	PUN Tit Shan, Patrick
CHEONG Ying Chew, Henry	WONG Shiu Hoi, Peter
CHING Seih Hong	WONG Shui Tong, Hugh
COWPERTHWAITTE Adam	YEH V-Nee

B. Cash Market Consultative Panel

Terms of Reference

The Panel should meet at least once a year. Additional meetings should be held as the work of the Panel demands.

2. The duties, powers and functions of the Panel shall be:-
 - (a) to provide market expertise and advice to the board on international trends, the needs of intermediaries, issuers, investors and other market participants, technology challenges and new product opportunities relating to the cash market;
 - (b) to consider such other topics and matters relating to the cash market as may be requested by the board;
 - (c) generally, to act as a sounding board for policy recommendations, strategic

- initiatives and major investments in relation to the cash market; and
- (d) to discuss, formulate views and advise the board on the foregoing matters in accordance with the request of the board from time to time.

Membership

LEE Jor Hung, Dannis (Chairman)	CLARKE Peter
FRESHWATER Timothy George (Deputy Chairman)	FUNG Chi Kin
BLOT Raphael	KWOK Tun Ho, Chester
BOKHARY Syed Bagh Ali Shah	LUI Yin Tat, David
CHEN Po Sum	SZE Tsai Ping, Michael

C. Clearing Consultative Panel

Terms of Reference

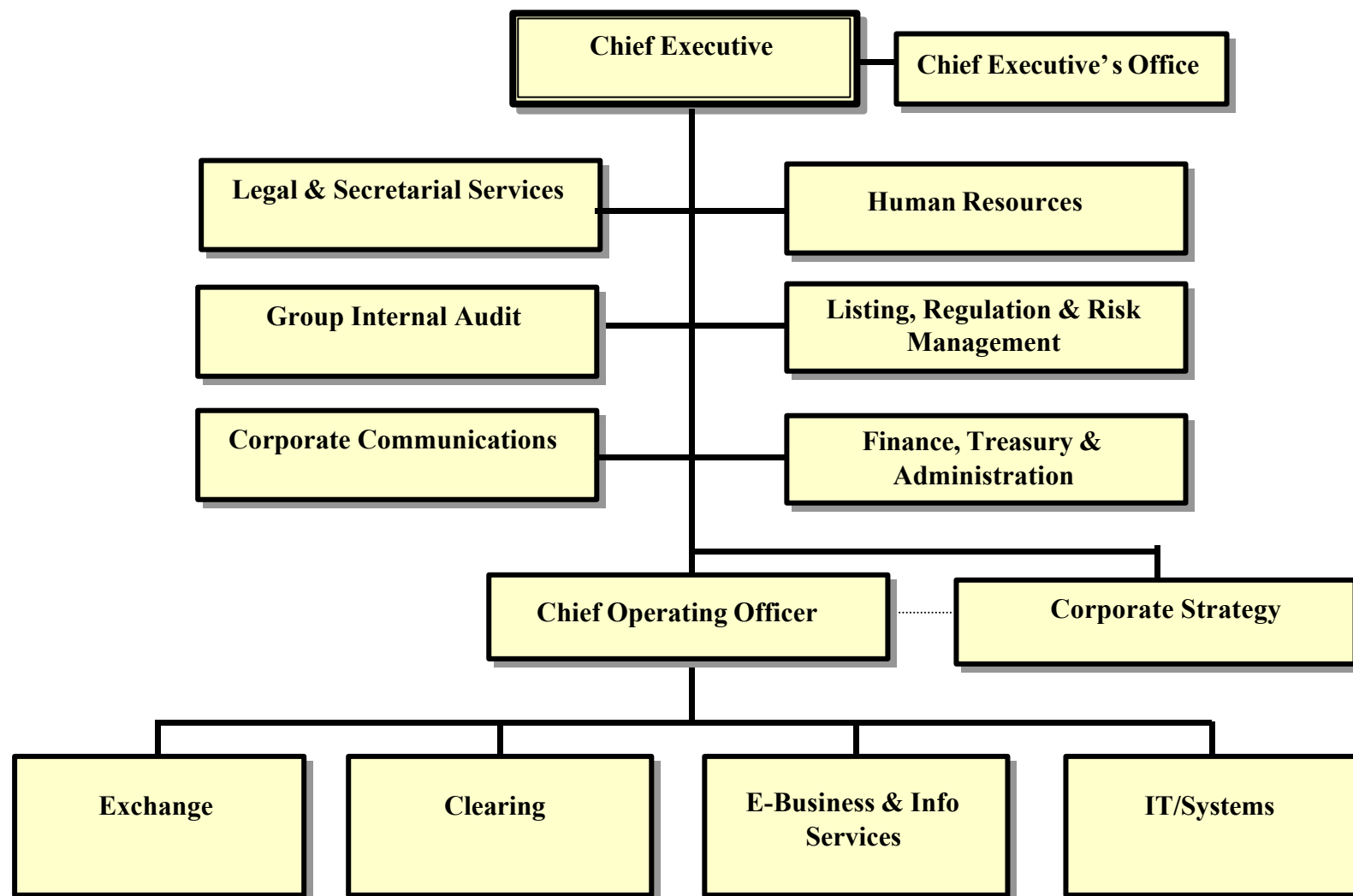
The Panel should meet at least once a year. Additional meetings should be held as the work of the Panel demands.

2. The duties, powers and functions of the Panel shall be:-
- (a) to provide market expertise and advice to the board on international trends, the needs of intermediaries, issuers, investors and other market participants, technology challenges and new product opportunities relating to the clearing;
 - (b) to consider such other topics and matters relating to the clearing as may be requested by the board and to report back thereon;
 - (c) generally, to act as a sounding board for policy recommendations, strategic initiatives and major investments in relation to clearing; and
 - (d) to discuss, formulate and advise the board on the foregoing matters in accordance with the request of the board from time to time.

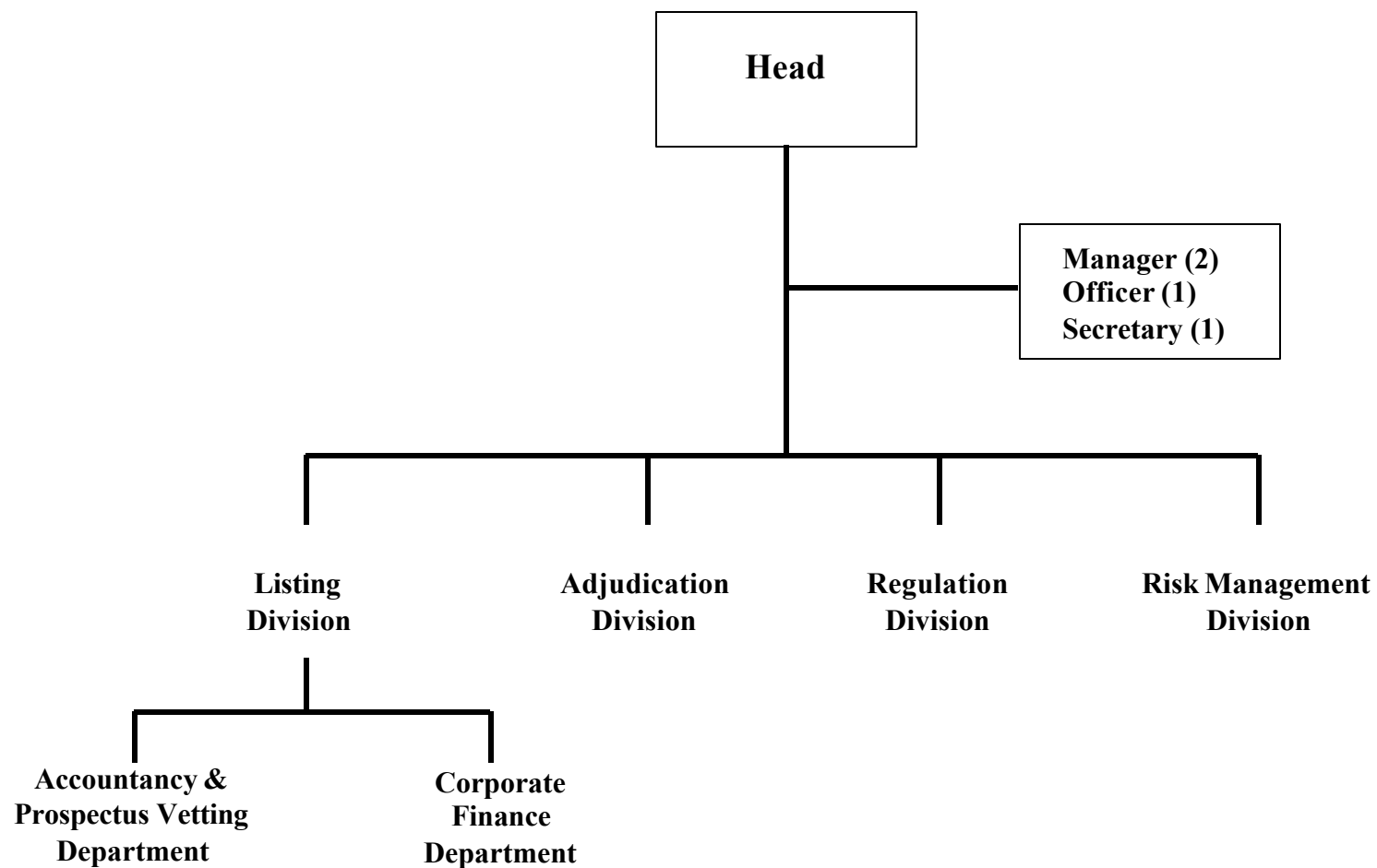
Membership

CHAN Cho Chak, John (Chairman)	IP Kwan Chak, Robert
LEE Kwan Ho, Vincent (Deputy Chairman)	LANCE Robert W
CHAN Henry	WILLIAMS Lyle A
CHAN Hing Wah, Steve	WILLIAMSON John
DIEST Rob van	WONG Lung Wo, James

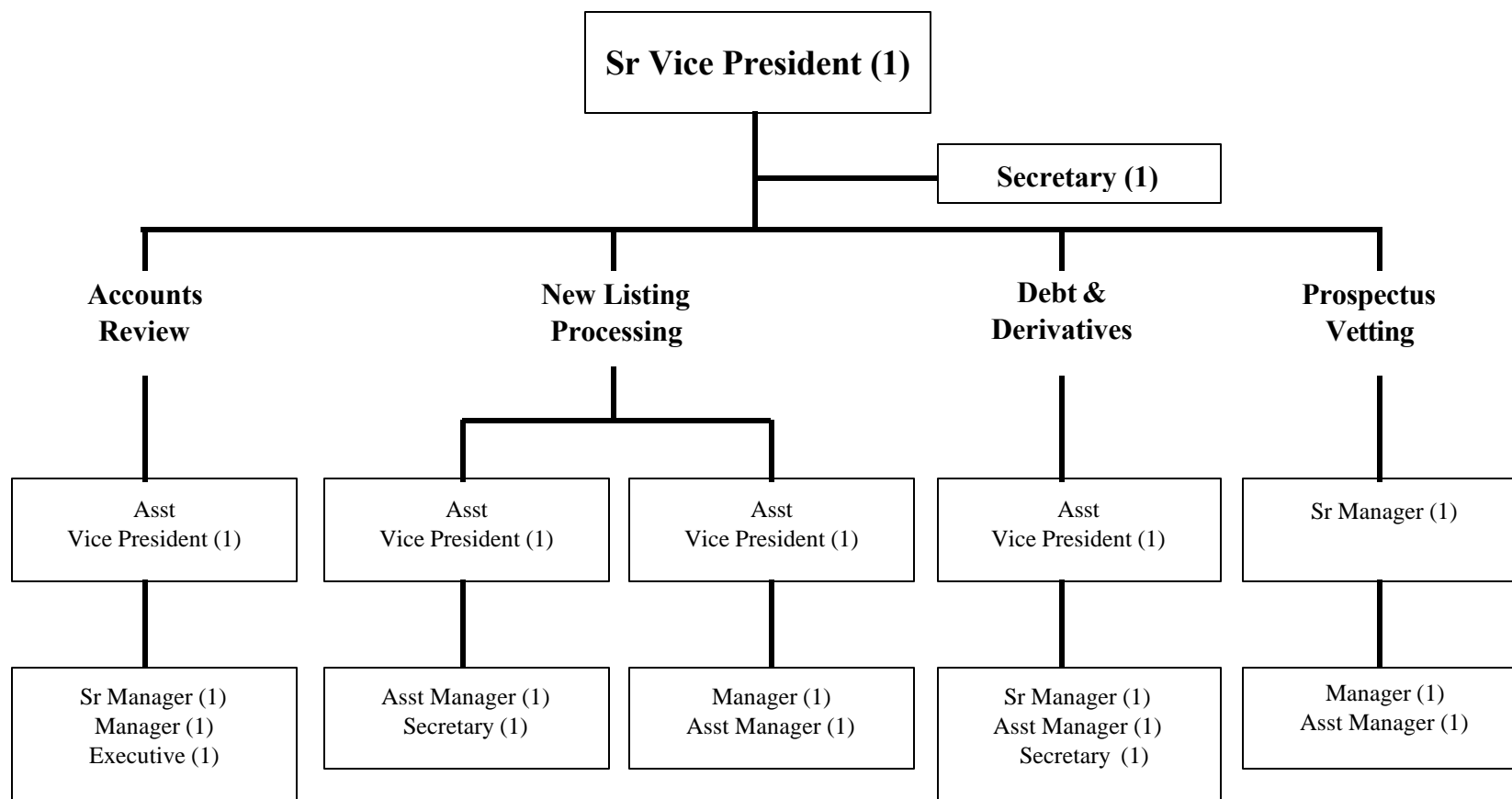
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Organization Chart
(as at 1 February 2002)



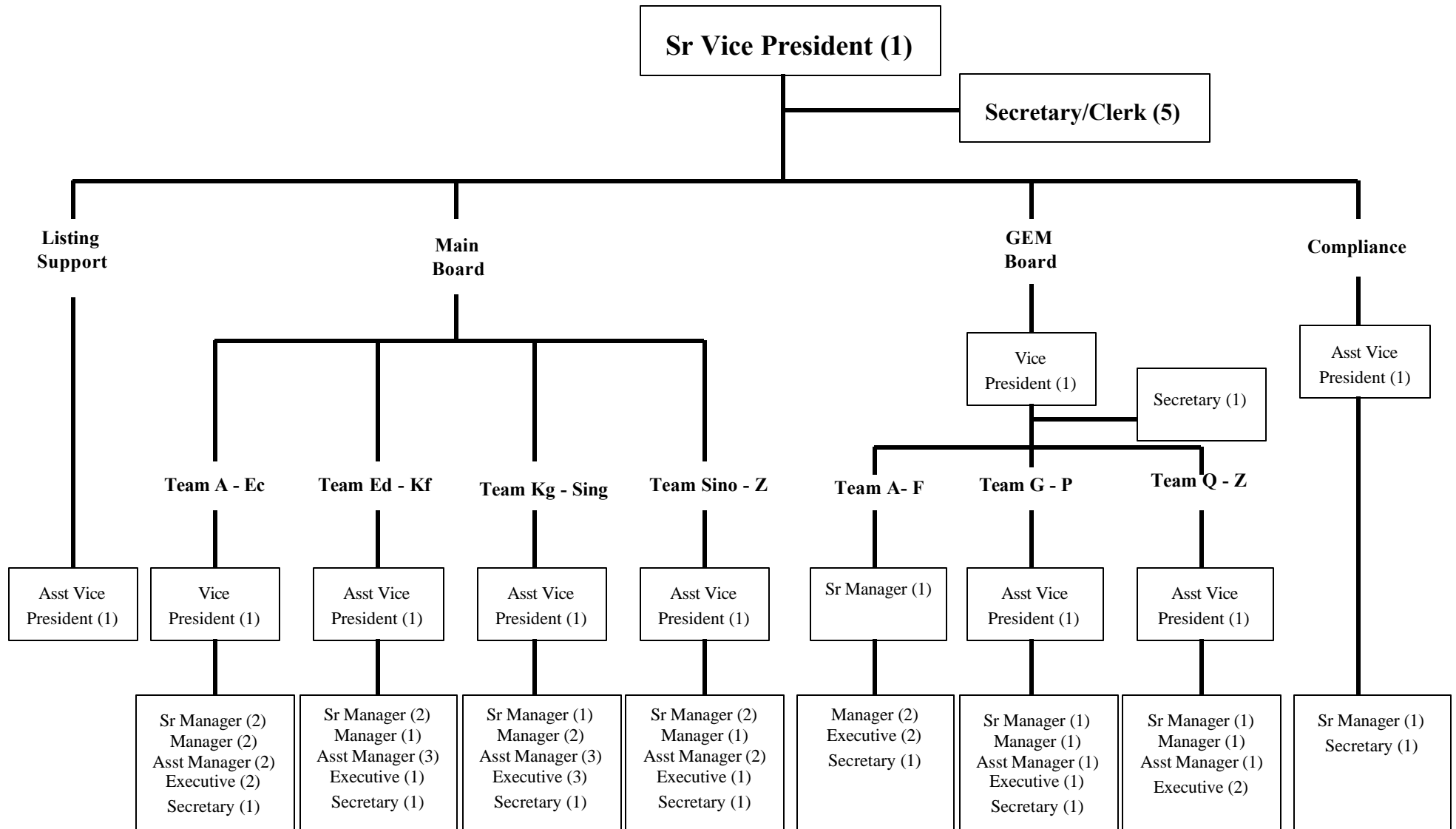
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LISTING, REGULATION & RISK MANAGEMENT UNIT



LISTING DIVISION - ACCOUNTANCY & PROSPECTUS VETTING



LISTING DIVISION - CORPORATE FINANCE



LISTING REGULATION & RISK MANAGEMENT UNIT

Head: Karen Lee

Responsible for performing the regulatory function of HKEx in:-

- Supervising the listing process and the ongoing compliance by issuers with their obligations under the listing rules;
- Market surveillance, including detecting trading malpractice and maintaining market transparency;
- Ensuring the compliance of trading rules;
- Monitoring the financial and open positions of Exchange Participants;
- Administering the admission of Exchange Participants; and
- Ensuring prudent management of market risks.

It is organized functionally into the following divisions:-

LISTING

Responsible for administering listing matters of the Main Board and the Growth Enterprise Market. Its Accountancy & Prospectus Vetting Department is responsible for interpreting and reviewing accounting issues for new listings and ongoing compliance, formulating and drafting accounting policy and listing rules, vetting and authorising prospectuses registration under Companies Ordinance and dealing with corporate governance matters. Its Corporate Finance Department is responsible for processing applications for new listings and further issue by listed companies, monitoring continuing compliance with listing rules by listed companies, interpreting and reviewing listing rules, vetting prospectuses, circulars and company announcements as well as handling disciplinary cases.

REGULATION

Responsible for undertaking market surveillance, conducting investigation of breaches of trading/clearing house rules, reviewing Exchange Participants' financial and operational capability as well as administering Exchange Participant admission.

RISK MANAGEMENT

Responsible for undertaking corporate risk (business, legal and operational) management and conducting market systemic risk analysis.

The Stock Exchange of Hong Kong Limited
Board of Directors

KWONG Ki Chi (Chairman, appointed 6 March 2000)

FOK Kwong Man (Chief Executive, appointed 1 August 2000)

GREDE Frederick John (appointed 1 August 2000)

HKEx' s Main Board Listing Committee

Membership

BECZAK Thaddeus (Chairman), Director of listed company
SUN Patrick (Deputy Chairman), Director of securities company
CHAN Charles, Accountant
CHAN Henry, Director of securities company
CHENG Mo Chi, Moses, Lawyer
CHENG Patrick, Merchant Banker
CHEONG Ying Chew, Henry, Director of securities company
FONG Hup, Accountant
KWOK Kenneth, Lawyer
KWONG Ki Chi, Ex officio
LAM Kenneth, Accountant
LEE Carmelo, Lawyer
LEONG Lincoln, Director of listed company
LI Alfred, Former director of listed company
LO Anthony, Director of listed company
LO Winston, Director of listed company
LUI Yin Tat, David, Director of fund management company
MARGOLIS Richard, Merchant Banker
MOORE Vernon, Director of listed company
ROBERTS Michael David, Director of securities company
SZE Tsai Ping, Michael, Director of securities company
TONG, Carlson, Accountant
WONG Shiu Hoi, Peter, Director of securities company
WONG Wai Ming, Director of company
YEH V-Nee, Director of listed company

Terms of Reference

The Listing Committee shall exercise all the powers and functions of the Board in relation to all listing matters. Its exercise of such powers and functions is only subject to the powers of review of the Listing Appeals Committee (Rule 2A.27 of the amended Listing Rules).

Securities and Futures Liaison Meeting

Functions:-

- The meeting is a general liaison meeting between the Financial Services and the Treasury Bureau (The Bureau) and the Securities and Futures Commission (SFC) dealing with housekeeping issues of the latter.
- No formal terms of reference.

Participants:-

- SFC –
Chairman
Senior staff at the Executive Director level
Chief Counsel
Commission Secretary
- The Bureau –
Secretary for Financial Services and the Treasury
Permanent Secretary for Financial Services
Deputy Secretary (Financial Services) 1
Principal Assistant Secretary (Securities)
Principal Assistant Secretary (Special Duty)
Assistant Secretary (Securities) 1
Assistant Secretary (Securities) 2

Frequency:- Monthly

Tripartite Meeting

Functions:-

- Liaison meeting between the Financial Services and the Treasury Bureau (The Bureau), Securities and Futures Commission (SFC) and Hong Kong Exchanges and Clearing Limited (HKEx) to facilitate:-
 - general monitoring of issues affecting the development of the Hong Kong securities and futures market; and
 - communication between the SFC and HKEx.
- No formal terms of reference.

Participants:-

- Permanent Secretary for Financial Services
- Chairman, SFC
- Chief Executive, HKEx
- Deputy Secretary for Financial Services and the Treasury (1)

Frequency:- Bi-monthly

Co-ordination Committee

Terms of Reference:-

- To identify, discuss and help resolve any regulatory and/or government policy issues relating to the implementation of the McKinsey Report Proposals (new Strategic Plan).
- To facilitate Hong Kong Exchanges and Clearing Ltd (HKEx)'s liaison and consultation with the relevant regulatory bodies and government departments in Hong Kong and the Mainland of China on matters relating to the implementation of the new Strategic Plan.
- To serve as an advisory group to HKEx on the overall implementation of the new Strategic Plan.

Participants:-

FSB	-	Secretary for Financial Services, Principal Assistant Secretary (Securities)
SFC	-	Chairman, Director (Corporate Finance)
HKEx	-	Chairman, Chief Executive and senior staff

Frequency:- Bi-monthly / Quarterly

SEHK-SFC(Listing) Liaison Committee Meetings
Terms of Reference and Membership

Under Section 6.2 of the AMENDED AND RESTATED MEMORANDUM OF UNDERSTANDING (the “MOU”) GOVERNING LISTING MATTERS between the Securities and Futures Commission (the “SFC”) and The Stock Exchange of Hong Kong Ltd(the “SEHK”) dated 6 March 2000, representatives from the Corporate Finance Division of the SFC and representatives from the Listing Division of the SEHK shall meet every month, such meetings to be known as the “SEHK-SFC (Listing) Liaison Committee Meetings”, to discuss:-

- (a) matters arising out of the minutes of the previous meeting;
- (b) any matter arising out of the latest SEHK Monthly Report to the SFC prepared by the Listing Division in accordance with the provisions of the MOU;
- (c) matters relating to the regulation of listed companies, and oversight of the SEHK by the SFC in relation to listing related matters; and
- (d) any policy matters or other matters, including proposed rule changes, relating to any of the listing functions and responsibilities of the SEHK or the SFC, and that proper minutes shall be kept of such meetings.

**Securities and Futures Commission
Advisory Committee
(1 June 2001 – 31 May 2003)**

Membership

Chairman

1. Mr. Andrew Sheng, SBS, JP, Chairman, Securities and Futures Commission

Members

2. Mr. Ashley Alder, Executive Director, Securities and Futures Commission
3. Mrs. Alexa Lam, Executive Director, Securities and Futures Commission
4. Mr. Thaddeus Beczak
Chairman, South China Morning Post
5. Mr. Didier Balme
Chief Executive, BNP Paribas
6. Mr. Ambrose Cheung
Director, Sino Land Company Limited
7. Mr. Paul Chow
Chief Executive Officer, HSBC Asset Management (Hong Kong) Limited
8. Mr. Paul Fan
Chairman, Paul Fan Securities Limited
9. Mr. Keith Ferguson
Chief Investment Officer, Fidelity Investments Management (HK) Ltd
10. Mr. Mario Francescotti
President and Managing Director, Morgan Stanley Dean Witter Asia Limited
11. Ms. Christina Hui
Regional General Manager, Charles Schwab, Hong Kong, Limited
12. Mr. Stephen Hui
Group Managing Director, OSK Asia Corporation Limited
13. Ms. Christine Loh
Chief Executive Officer, Civic Exchange
14. Mr. Samuel Poon
Managing Director, Merrill Lynch (Asia Pacific) Ltd
15. Dr. Eden Woon
Director, The HK General Chamber of Commerce

Terms of Reference

Under Section 10(5) Advisory Committee of SECURITIES AND FUTURES COMMISSION ORDINANCE (Chapter 24), the Commission may request the Advisory Committee to advise it on any matter of policy regarding the performance of any of its functions.

**Securities and Futures Commission
Shareholders Group
(17 June 2002 – 16 June 2003)**

Membership

Chairman

Mr. Ashley Alder	Executive Director Corporate Finance Division, the Securities and Futures Commission
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Members

Mr. Jamie Allen	Secretary General Asia Corporate Governance Association
Mr. Rex Au Yeung	Managing Director and Chief Executive-Asia Principal International (Asia) Ltd
Prof. Andrew Chan	Chairman, Consumer Council Associate Dean, Faculty of Business Administration Chinese University of Hong Kong
Mr. Wing Luk Chan	Financial Commentator, U Six Holdings Ltd
Mr. Vincent Duhamel	Principal and Chief Executive State Street Global Advisers Asia Ltd
Mr. Shu Fai Heung	Managing Director, Sirius Pacific Consultants Ltd
Mr. David Lui	Vice Chairman Schroder Investment Management (Hong Kong) Ltd
Mr. David Tak-kei Sun	Vice-President, Hong Kong Society of Accountants Chairman of Corporate Governance Committee
Mr. Mark Taylor	Chairman, Corporate Governance Panel Hong Kong Institute of Company Secretaries
Prof. Judy Tsui	Head and Professor, Department of Accountancy City University of Hong Kong
Mr. David W. Webb	Editor, Webb-site.com
Mr. V Nee Yeh	Managing Partner, VP Private Equity Ltd

Terms of Reference

1. Maintenance of a level playing field among all shareholders is fundamental to investor confidence and market integrity. Proper functioning of a securities market also depends on directors and management of listed companies being held accountable to shareholders. This ultimately benefits both the listed companies as well as their shareholders.
2. With a view towards furthering the above principles in practice, the Group shall advise the Commission on (principally non- statutory) aspects of the regulatory framework, including issues relating to-
 - a. quality of information available to public shareholders;
 - b. protection of minority shareholders;
 - c. role of institutional investors and their development as a force of checks and balance;
 - d. promoting a high degree of shareholder involvement;
 - e. enhancing good corporate governance in achieving best practice and world-class standards.
3. The Group aims to meet bi-monthly, subject to needs and workload.

**Examples of
Statutory Provisions Conferring Powers
and Responsibilities
Upon the Financial Secretary**

Section	Powers and Responsibilities
A. Securities and Futures Commission Ordinance (Cap 24)¹	
4(1)	Functions of Commission
5(4)	Constitution of Commission
13	Commission to furnish information
16(2)	Auditors and audit
33(15)	Investigations
59(2)(e), 2(j)	Preservation of secrecy, etc.
B. Securities and Futures Appeals Panel Proceeding Rules (Cap 24E)¹	
Rule 20	Remuneration of the members of a tribunal
C. Commodities Trading Ordinance (Cap 250)¹	
14(5)	Extension of time for SFC to give approval of amendments to the constitution, rules of the Exchange Company, etc.
D. Stock Exchange Unification Ordinance (Cap.361)¹	
2	Interpretation
27(1), (2)	The Unified Exchange
40(2)	Extensions of time
E. Securities and Futures (Clearing Houses) Ordinance (Cap 420)¹	
4(9)	Extension of time for SFC to approve rules of recognized clearing houses, etc.
F. Leveraged Foreign Exchange Trading Ordinance (Cap 451)	
(10)	Appointment of members of arbitration panel by FS under rules by SFC
63(2)	Preservation of secrecy, etc.
G. Leveraged Foreign Exchange Trading (Arbitration) Rules (Cap 451C)¹	
4(2), (4)	Constitution of Arbitration Panel
12	Remuneration of Arbitrator

¹ The Ordinance will be repealed upon commencement of the Securities and Futures Ordinance.

Section	Powers and Responsibilities
H. Exchanges and Clearing Houses (Merger) Ordinance (Cap 555) ¹	
7(1), (2), (5), (6)	Exemption from section 3(1) and revocation of exemption
9(3)	Establishment and functions of Risk Management Committee
10(5)	Extension of time for SFC to give approval of amendments to the constitution or rules of recognized exchange controller
20(1), (2)	Financial Secretary may appoint not more than 8 persons to board of directors of HKEC
I. Securities and Futures Ordinance (Cap 571)	
4(f)	Regulatory objectives of Commission
5(1)	Functions and powers of Commission
12	Commission to furnish information
13(3)	Financial year and estimates
15(3)	Accounts and annual report
16(3), (6)	Auditor and audit
24(6)	Extension of time for SFC to give approval of rules or amendments to rules of recognized exchange company
41(6)	Extension of time for SFC to give approval of rules or amendments to rules of recognized clearing house
62(1), (2), (5), (6)	Exemption from section 59(1) and revocation of exemption
65(3)	Establishment and functions of Risk Management Committee
67(6)	Extension of time for SFC to give approval of rules or amendments to rules of recognized exchange controller
77(1), (2)	Financial Secretary may appoint not more than 8 persons to board of directors of HKEC
83(6)	Extension of time for SFC to give approval of rules or amendments to rules of recognized investor compensation companies
118(2)(b)	Appointment of members of arbitration panel
142	Amendment of Schedule 5
216(6)	Securities and Futures Appeals Tribunal
240(9), (10)	Accounts of compensation fund
378(3), (12)	Preservation of secrecy, etc.
Part 1 of Schedule 2: s 7	Deputy chairman and vacancies in office of chairman or deputy chairman

Chronology of Events

Date	Serial No.	Event
26.10.00	1	<p><u>Regular Meeting between Financial Services Bureau (FSB) and the Hong Kong Stockbrokers Association.</u></p> <p>The Hong Kong Stockbrokers Association wrote to the Financial Services Bureau (FSB), suggesting as an agenda item for its regular meeting with the FSB problems of shares falling below one cent, the dilution of shares values at the expense of minority shareholders, and the proliferation of penny stocks.</p>
27.12.00	2	<p>FSB (Salina Yan, Principal Assistant Secretary for Financial Services (Securities)) wrote to the Securities and Futures Commission (SFC) (David Stannard, the then Executive Director (Corporate Finance)) to reflect the concerns of the Hong Kong Stockbrokers Association and sought his advice for the next meeting with the Association.</p>
late 2000	3	<p>SFC had internal discussions about the prevalence of penny shares in the HK market. The discussion also covered a letter from FSB (see item 2 above).</p>
28.12.00	4	<p><u>First Suggestion to Address Problems Associated with Penny Stocks.</u></p> <p>SFC (David Stannard) advised FSB (Salina Yan) that SFC had been discussing related subjects with the Hong Kong Exchanges and Clearing Ltd (HKEx) for some years.</p> <p>SFC (David Stannard) also explained the mechanism of trading of shares below one cent in Hong Kong, the US system of treating shares trading below US\$1 as “penny stocks”, and drew FSB’s attention to the large number of stocks in Hong Kong trading below \$1 and the concern that “penny stocks” are prone to market manipulation.</p> <p>SFC (David Stannard), in explaining the thinking on mandatory share consolidation, said that -</p> <p style="text-align: center;"><i>“One way forward may be a package of measures as follows:-</i></p> <ol style="list-style-type: none"> <i>1. Initial Public Officer (IPO) price must be over HK\$1.00.</i> <i>2. No corporate action (e.g. sub-division or bonus issue) if the</i>

Date	Serial No.	Event
		<i>effect would be to reduce the share price below HK\$1.00.</i>
28.12.00 (Cont' d)	4 (Cont' d)	<p>3. <i>Compulsory consolidation to a price above HK\$1.00 if the share price trades below 50 cents for more than 30 days or for more than 60 out of 90 days.</i></p> <p><i>This would be a dramatic step and one can expect resistance to this. However, it would send a clear signal to the market that the Government and the regulators want to upgrade the quality of the market."</i></p>
Early 2001	5	HKEx held informal discussions with market participants.
02.01.01	6	SFC (David Stannard) wrote to FSB (Salina Yan) attaching a newspaper column on share registration fees charged by brokers as another reason why penny shares are a problem.
15.02.01	7	The Hong Kong Economic Journal (HKEJ) columnist (Lam Heng-sze) commented that the solution to the penny stocks problem is to require share consolidation or to delist those companies which refuse to do so.
16.02.01	8	<p>FSB (Salina Yan) wrote to SFC (David Stannard), referring him to press comments of 15.2.01 (item 7), and the need to seek the views of the market on the possible solutions:-</p> <p><i>"..Our concern here is twofold: our international financial centre reputation and investor protection. The latter is valid as shareholders would need to pay extra shares registration fees if these penny stocks are to be consolidated. This process may repeat itself as the share price drops again. And delisting would just deprive the small shareholders of the chance to liquidate their position thro the exchange. The US model [which focuses more on the reputation of the exchange] may not be the solution here."</i></p> <p><i>"I understand that you are reviewing the subject with HKEx. As there is no clear cut solution to the problem, I think the sensible thing to do is to put the issue to the market for their views."</i></p>
	9	<p>SFC (David Stannard) replied to FSB (Salina Yan), stating that:-</p> <p><i>"At present there is a lot of concern about the share certificate issue charges on a consolidation but that may be able to be</i></p>

Date	Serial No.	Event
		<i>overcome. If we can work something out we will expose it to the public for their views."</i>
10.05.01	10	HKEJ reported that Lawrence Fok, Deputy Chief Operating Officer of the HKEx said it would require share consolidation but not delisting of penny stocks.
13.06.01	11	<p>SFC received a letter from a member of the public, whose suggestions included:-</p> <p><i>"Companies that have 2 consecutive years of losses or with share prices below \$0.5 should be delisted."</i></p> <p>SFC believed this might be a common question among investors and decided to post an answer on its website.</p>
30.07.01	12	<p><u>HKEx's First Draft on Consolidation of Shares.</u></p> <p>HKEx (Mr Mark Bewley, Assistant Vice President, Listing Division) submitted the first draft of a consultation paper on consolidation of shares to SFC. The focus of the paper was the technical concern that HKEx's automatic trading system was unable to handle prices below HK\$0.01.</p> <p>Included in the paper was a proposal to require the consolidation of low-priced stocks (i.e. where the closing price of shares falls to HK\$0.01 or below for an aggregate of 20 trading days in any period up to three months) to HK\$0.1 or above. In addition, any corporate action should not result in a theoretical price falling below ten cents.</p> <p>It was stated in the draft paper that:-</p> <p><i>"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 (SAMS) ... 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 system 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] (square brackets in the original) or below ... The</i></p>

Date	Serial No.	Event
		<i>Stock Exchange will regard a proposal to consolidate an issuer's securities as acceptable ..."</i>
30.07.01 (Cont' d)	12 (Cont' d)	<i>"The Stock Exchange proposes to establish a floor price of HK\$0.10. Issuers would be prohibited from undertaking bonus issues, share splits, open offers, rights issues, and other corporate actions that would lead to a "theoretical" share price falling below the floor price."</i>
08.08.01	13	<p><u>SFC's Comments on the First Draft Paper on Consolidation of Shares.</u></p> <p>SFC (Mr Charles Grieve, Director, Corporate Finance Division) commented on the first draft paper on consolidation of penny stocks.</p> <p>SFC was of the view that HKEx's proposal was not sufficient to deal with the more important issue, i.e. that share manipulators concentrated their efforts on shares with a low value. In SFC's view, the right thresholds were around \$1 and \$5:-</p> <p>SFC's reply said:-</p> <p><i>"the [HKEx's] 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."</i></p> <p><i>"In [SFC's] view the right thresholds are around HK\$5.00 and HK\$1.00. We know a HK\$1.00 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."</i></p>
03.09.01	14	<p><u>FS' Regular Meeting with SFC Chairman</u> (Andrew Sheng).</p> <p>SFC Chairman informed FS that "HKEx had been reviewing its listing rules with an aim to streamline and strengthen their enforcement".</p> <p>The acting Secretary for Financial Services (SFS) (KC Au) was also present at the meeting.</p>

Date	Serial No.	Event
24.09.01	15	<p>SFC posted a Question & Answer on penny shares on its website in response to the letter dated 13.06.01 (item 11):-</p> <p>“Consecutive losses for more than 2 years or a low share price do not necessarily mean that the company does not have sufficient level of operations or tangible assets. There may be external factors that may cause the continuous losses or low share prices, e.g. global economic slowdown or poor market sentiment.”</p> <p><i>“Bearing these factors in mind, it would therefore 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.”</i></p> <p>SFC (Grieve) wrote to HKEx (Ms Karen Lee, Head of Listing, Regulation & Risk Management) on this updating of the website.</p>
01.11.01	16	<p>The Association passed to FSB examples of some listed companies diluting minority shareholders’ interests and suggested that HKEx follow up on such instances.</p>
02.11.01	17	<p>FSB (Salina Yan) wrote to SFC (Mr Laurence Li, Director, Corporate Finance Division) to reflect the concerns of the Hong Kong Stockbrokers Association and passed on the specific examples provided by the Association.</p> <p>FSB (Salina Yan) copied the letter to HKEx (KC Kwong, Chief Executive and Karen Lee, Head, Listing Regulation and Risk Management), informing HKEx that FSB had encouraged the Association to give their views to HKEx direct and suggesting that HKEx engaged the Association in mapping out proposals to address share dilution and other investor protection issues.</p>
28.11.01	18	<p><u>SFC and HKEx held their 124th Monthly Liaison Committee Meeting.</u></p> <p>Delisting and penny shares were discussed as separate subjects.</p> <p>On delisting, the discussion focused on the Listing Committee’s position and argument that protection of minority shareholders justifies exploration of every prospect of restructuring. SFC said that the Listing Committee should be alerted to the relevant statistics in</p>

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		considering the delisting proposal. On penny shares, the meeting noted that HKEx was working on a draft policy paper.
03.12.01	19	<u>SFC Commission Meeting.</u> SFC Corporate Finance Division briefed the Commission on its internal study on the quality of listing and corporate governance in Hong Kong.
12.12.01	20	HKEx (Karen Lee) wrote to SFC (Ashley Alder, Executive Director, Corporate Finance Division) in connection with an <u>unrelated</u> set of draft proposals for amendments to the Listing Rules for enhancing corporate governance. HKEx expressed misgivings that SFC had passed a draft consultation paper to its Shareholders Group for discussion before the proposals had been finalized and deliberated by the Listing Committee. HKEx asked that SFC should not pass draft policy papers to the Shareholders Group for discussion unless with HKEx's prior agreement.
	21	<u>SFC Chairman's Letter to the SFS.</u> SFC Chairman (Andrew Sheng) wrote to SFS (Stephen Ip) attaching a copy of SFC's internal study report on the quality of listing and corporate governance. The paper had been considered by the Commission at an earlier meeting (item 19). SFC Chairman relayed the Commission's concern about the quality of issuers and its request for Commission staff to come up with further solutions. SFC Chairman asked that the matter be discussed at the regular liaison meeting with FSB the next day.
13.12.01	22	<u>Securities and Futures Liaison Meeting between FSB and SFC.</u> The meeting agreed that Tripartite Meetings amongst the heads of FSB, SFC and HKEx should be held to monitor overall progress of key issues affecting the development of the securities and futures market.
14.12.01	23	SFC (Ashley Alder) replied to HKEx's (Karen Lee) letter of 12 December (item 20) to explain its position about discussing HKEx's proposals with the Shareholders Group.

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20.12.01	24	FSB (Salina Yan) wrote to SFC Chairman to ask for suggestions for agenda items for the first tripartite meeting. In setting up the meeting, FSB stressed the independence of SFC as regulator as set out in the Ian Hay Davison Report (the Report of the Securities Review Committee released in May 1988), as well as the powers conferred to the SFC to regulate the market operator under the law.
20.12.01 (Cont' d)	25	Chief Executive of HKEx conducted Year-end-Review press briefing, mentioning the “review of delisting procedures” as one of the priority tasks of HKEx in 2002.
	26	<p><u>HKEx’s Second Draft Paper on Consolidation of Shares.</u></p> <p>HKEx (Mark Bewley) submitted the second draft of the consultation paper on consolidation of shares for SFC’s consideration.</p> <p>Included in the Paper was a revised proposal on consolidating low-priced stocks i.e. shares 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 20 cents or above. In addition, any corporate action shall not result in a theoretical price falling below 30 cents. (Square brackets also appeared in original documents.)</p> <p>In its e-mail to SFC, HKEx defended its proposal by reference to its market impact assessment -</p> <p><i>“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\$1.00. None of the companies listed on GEM trade above HK\$5.00 and only about 8% of companies on the main board do so.”</i></p> <p><i>“In 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 10th August 2001 this proposal would affect 93 companies on the main board and 6 on GEM. The proposed Floor Price has also been increased from ten cents to thirty cents.”</i></p> <p><i>“Setting the Consolidation Price at ten cents means that a company’s shares may fall a further 90% before reaching the</i></p>

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		<i>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."</i>
Sometime on 20.12.01 and thereafter	27	<p>SFC (Laurence Li) and HKEx (Karen Lee) discussed the proposed consolidation of shares in several telephone conversations.</p> <p>During the discussion, HKEx expressed the view that share consolidation would reduce the number of shares of a listed company in circulation and therefore their liquidity. SFC explained that share prices are only "nominal" and the "unit of exchange" is actually the board lot, hence share consolidation has no bearing on liquidity except to the extent that low prices may mislead investors into thinking that they are cheap. Li said he would set out the considerations in detail in a letter.</p>
	28	SFC executives then discussed internally various issues relating to share consolidation, researched into historical data, and estimated the cost impact, before further replying HKEx.
21.12.01	29	<p><u>SFC Chairman's Letter to the HKEx Chairman.</u></p> <p>SFC Chairman (Andrew Sheng) wrote to HKEx Chairman (Charles Lee), sharing the results of the SFC's internal study on the quality of the Hong Kong market, expressing concern on the growing perception of deteriorating quality of the Hong Kong listing market, and raising the need for urgent efforts for SFC and HKEx to work together to reverse such disturbing trend by:-</p> <ul style="list-style-type: none"> ● seeking good quality companies; ● stepping up disclosure standards and enforcement; and ● putting in place meaningful on-going assurance standards on entry, exit and gate-keeping of listed companies. <p>On the subject of delisting, the letter said:-</p> <p><i>"When it becomes clear a company no longer has any credible business that is sufficient to justify a listing status, delisting should follow."</i></p>

Date	Serial No.	Event
		The letter was copied to SFS (Stephen Ip).
29.12.01	30	International Monetary Fund (IMF) conducted Article IV Consultation for the Hong Kong Special Administrative Region, and questioned whether Hong Kong had delisting requirements for consistently poor performers as in other markets. After consulting SFC, FSB replied to the IMF, outlining the existing mechanism under the Listing Rules.
19.01.02	31	<p><u>HKEx Chairman's Response to SFC Chairman's Letter.</u></p> <p>HKEx Chairman (Charles Lee) responded to the letter of 21.12.01 from SFC Chairman (item 29), outlining the work being done by HKEx to address issues of market quality. The share consolidation proposals were mentioned.</p> <p>On penny stocks, HKEx Chairman said that HKEx agreed that it was desirable to set floor trading prices, and had proposed that issuers consolidate their shares to a theoretical price of 20 cents if the shares had been trading below 10 cents for more than 20 days. A table entitled "Summary of Key Action Items" attached to the letter mentioned that the two subjects might be combined into one consultation.</p> <p>The letter stated that:-</p> <p><i>"We have earmarked the improvement of our delisting regime as one of the top priority projects for this year. We envisage that the delisting project will review the continuing listing qualifications and address the need for expediting the delisting procedures. We aim to complete our study and come up with suggestions for changes for discussion with your executives in the first quarter of this year. Depending on the outcome of the discussion, we could consult the market in the second quarter. "</i></p> <p><i>"As to penny stocks, we agree that it is desirable to set a floor level of trading prices. As you might be aware, we have been discussing with your executives in this regard in the course of last year. We have proposed that we should require issuers to consolidate their shares to a theoretical price of 20 cents if the shares have been trading below 10 cents for more than 20 days during a period of 3 months. We have also proposed to prohibit corporate actions by issuers which will result in the theoretical value of the share price falling below 30 cents. We have submitted the draft consultation paper to your executives</i></p>

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		<p><i>for comment. Subject to those comments, we propose to consult the market in the second quarter of this year. ”</i></p> <p>The table attached to the letter stated that:-</p> <p><i>“ ... depending on the outcome of [discussion with SFC executives] and timing for market consultation ... might consider to combine the two subjects into one consultation.”</i></p> <p>The letter was copied to SFS (Stephen Ip).</p>
24.01.02	32	<p><u>First Tripartite Meeting.</u></p> <p>Meeting held amongst SFS (Stephen Ip), SFC Chairman (Andrew Sheng), and Chief Executive of HKEx (KC Kwong) on HKEx-related matters. Deputy Secretary for Financial Services (DSFS) (KC Au) also present.</p> <p>The meeting noted that in addition to the Listing Rules Review on Corporate Governance, HKEx was separately working on delisting and reviewing entry qualifications as part of its drive to improve market quality.</p> <p>SFC Chairman undertook to expedite the examination of HKEx' s proposal for compulsory consolidation of penny stocks when share price dropped below 30 cents (see next item).</p>
25.01.02	33	<p><u>SFC's Comments on HKEx's Second Draft Paper on Consolidation of Shares.</u></p> <p>SFC (Laurence Li) wrote to HKEx (Mark Bewley) on HKEx' s second draft paper on consolidation of shares (item 26).</p> <p>SFC commented that the HKEx' s second draft paper on consolidation of shares was still short of achieving the ultimate objective relating to quality and market perception, and that the setting of a minimum share price could be an important measure to assure quality while noting that arguments had been made against such an approach.</p> <p>It re-iterated that the threshold should be HK\$1.</p> <p>The SFC also considered that the issue should receive the benefit of an informed market debate and a public consultation paper containing a</p>

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		<p>discussion of the relevant considerations would be very helpful.</p> <p>Extracts from SFC' s reply which are worth quoting in extenso:-</p> <p><i>“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.”</i></p>

Date	Serial No.	Event
25.01.02 (Cont' d)	33 (Cont' d)	<p><i>“We begin our analysis at exactly the premise that, as you mentioned in your e-mail, share prices are “theoretical” only. (Some people also refer to this as a matter of “nominal” prices.) Share prices do not reflect how much an investor would have to pay or would receive when trading. The “units of exchange” are board lots rather than number of shares.”</i></p> <p><i>“An important twist to this general point is that 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. Overseas markets have also had similar experiences. (The penny stock debate in the United States is a commonly cited example.)”</i></p> <p><i>“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 could lead to stocks becoming “gambling numbers” rather than representing investments in businesses. Indeed, many commentators have pointed to this phenomenon of retail investors just “buying numbers” as counter to the Hong Kong market developing quality.”</i></p> <p><i>“Our 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. NYSE, Nasdaq, Neuer Markt, 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.)”</i></p> <p><i>“Indeed, you might want to note that two well-respected commentators have recently called for setting HK\$1 as the minimum share price. (See article by Tso Yan Chiu in the Hong Kong Economic Journal on January 9 and article by David Webb dated January 6 as published on <webb-site.com>.)”</i></p>

Date	Serial No.	Event
25.01.02 (Cont' d)	33 (Cont' d)	<p><i>“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 paper should clearly set out the long-term objective, together with the relevant positive and negative considerations.”</i></p> <p>The letter analyzed in detail the mechanics as well as costs of share consolidation and corresponding board lot reduction, then went on to conclude that:-</p> <p><i>“We appreciate that jumping to a HK\$1 minimum is probably ambitious and a phased approach might be necessary. However, the policy objective is an important one. This should be made very clear in the public consultation document, together with the relevant positive and negative considerations, some of which are discussed above.</i></p> <p><i>Incidentally, as I have mentioned to Karen, we agree that revisions to the continuing listing criteria, the delisting procedure, and the rules on so-called backdoor listings will be the primary requirements aimed at assuring quality. But setting a minimum share price can also be an important measure. We understand that arguments have been made against such an approach and we remain open-minded. However, the issue should receive the benefit of an informed market debate. A public consultation paper that contains a discussion of the relevant considerations would be very helpful in this regard.”</i></p>
28.01.02	34	<p>FSB (Ms KC Au) added to an e-mail from FSB (Salina Yan) to SFC (Mr Keith Lui, Commission Secretary) on the same day about subjects to report to the Legislative Council (LegCo) Panel on Financial Affairs. Delisting and penny stocks were mentioned:-</p> <p><i>“Note also that during the meeting the Deputy Chairman of the Panel, the Hon Henry Wu, specifically asked if the [Listing Rules] Review on [corporate governance] addressed his stakeholders’ concern about delisting and penny stocks.”</i></p> <p><i>“In light of the timetable that HKEx just provided to SFC, we told the Hon Wu that these would be subjects of separate HKEx consultation and we would seek Panel’s view when the proposals were ready, possibly sometime in May – July.”</i></p>

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29.01.02	35	SFC (Laurence Li) forwarded to FSB (Salina Yan) a copy of his letter of 25.1.02 to HKEx (item 33) for information.
07.02.02	36	<p>Meeting of the Directors of SFC.</p> <p>Laurence Li briefed others on key findings in the study on the quality of the Hong Kong listing market. Li said that HKEx was working on tougher delisting rules and a proposal on mandatory share consolidation for penny stocks. Li also referred to the discussion with HKEx on price threshold for share consolidation.</p>
26.02.02	37	<p><u>SFC and HKEx held their 126th monthly Liaison Committee Meeting.</u></p> <p>The Committee's discussion on "continuing listing qualification/delisting" focused on making minimum number of shareholders a continuing obligation.</p>
01.03.02	38	<p><u>Meeting of Co-ordination Committee</u> (Co-ordination Committee¹).</p> <p>The meeting was chaired by HKEx Chairman (Charles Lee) and attended by SFC Chairman (Andrew Sheng) and SFS (Stephen Ip).</p> <p>The meeting noted progress of HKEx's deliberation on delisting and plan to conduct market consultation in the second quarter of 2002.</p>
06.03.02	39	<p><u>Meeting of Shareholders Group.</u></p> <p>SFC presented its study on the quality of the Hong Kong listing market to the Commission's Shareholders Group. The Group discussed:–</p> <ul style="list-style-type: none"> • the problems associated with penny stock in Hong Kong; • the possibility of tighter continuing listing requirements; and

¹ In mid 2001, the Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited jointly initiated and funded a consultancy study by McKinsey and Company entitled "A Plan to be Successful in the New Chinese and International Capital Markets". The report which set out proposals to further develop Hong Kong as a premier financial centre in Hong Kong, was completed in July 2001, and endorsed by Securities and Futures Commission and Hong Kong Exchanges and Clearing Limited. A Co-ordination Committee chaired by Chairman, Hong Kong Exchanges and Clearing Limited, with representatives from the Hong Kong Exchanges and Clearing Limited, Securities and Futures Commission and Financial Services Bureau was set up in September 2001. Financial Services Bureau attended the meetings to monitor progress of the key issues affecting Hong Kong's development as an international financial centre.

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06.03.02	39 (Cont' d)	<ul style="list-style-type: none"> more stringent delisting procedures. <p>The SFC did not present any actual proposals on share consolidation or delisting at the meeting.</p>
19.03.02	40	<p><u>Second Tripartite Meeting.</u></p> <p>Members noted that HKEx was working on Phase II of the Listing Rules review concerning compulsory consolidation of penny stocks and floor price for delisting, as part of its drive to improve market quality. HKEx said that it would discuss proposals with SFC in one to two months' time.</p>
27.03.02	41	<p><u>SFC and HKEx held their 127th Monthly Liaison Committee Meeting.</u></p> <p>The meeting discussed the subject of admission requirements and continuing listing requirements. HKEx (Karen Lee) said HKEx would circulate a draft consultation paper by the end of April.</p>
17.04.02	42	<p>HKEx's annual general meeting.</p> <p>Chief Executive of HKEx mentioned with journalists that HKEx would publish a consultation paper on a delisting mechanism.</p>
24.04.02	43	<p><u>SFC and HKEx held their 128th Monthly Liaison Committee Meeting.</u></p> <p>HKEx mentioned its plan to circulate a draft paper on the admission and continuing listing requirements by the end of April. The meeting also noted that FSB paid attention to the project and that the public generally supported a clear delisting policy.</p>
30.04.02	44	<p><u>HKEx's First Draft of the Consultation Paper on Admission Criteria and Continuing Eligibility Criteria (the Consultation Paper).</u></p> <p>HKEx (Karen Lee) submitted the first draft of the Consultation Paper on Admission Eligibility Criteria and Continuing Eligibility Criteria (the "Consultation Paper") to SFC (Ashley Alder). The original share consolidation proposal was now subsumed within the package of delisting proposals.</p>

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		<p>The draft paper included, among others, the following proposals:</p> <ul style="list-style-type: none"> • Introducing a minimum closing price of HK\$0.3 as a eligibility criterion for continuing listing.
30.04.02 (Cont' d)	44 (Cont' d)	<ul style="list-style-type: none"> • Any corporate action must not result in the theoretical price of the shares falling below HK\$0.3. • Introducing a minimum Initial Public Offer price of HK\$1.00. <p>The paper did not consider it necessary to have an alternative trading platform for trading of delisted shares:-</p> <p><i>“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.”</i></p> <p><i>“We recognize that it is impracticable to require issuers to maintain at all times a minimum closing price at the proposed minimum issue price of HK\$1, as market price will invariably be affected by, among other things, the performance of or corporate actions taken by the issuer subsequent to listing. Accordingly, we consider that it is appropriate to allow for a minimum price to be set at a level lower than HK\$1. In this regard, we consider that HK\$0.30 provides a reasonable benchmark as a continuing listing eligibility criterion. It is possible, under the trading system of the Exchange, for bid prices to be input which will have the effect of increasing the closing price even though there is no trading activity. Therefore, we consider that a certain level of trading volume in terms of shares should be required in conjunction with a minimum closing price.”</i></p>
	45	<p>SFC Chairman (Andrew Sheng) submitted the SFC’ s Quarterly Report for the quarter ending 31 March 2002 to the FS (Antony Leung). This mentioned that “HKEx is currently considering tightening the quality of listed companies by introducing more stringent delisting criteria. The HKEx will consult the market in the second quarter.”</p>

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		A copy of the Report was provided to SFS (Stephen Ip).
May-June 2002	46	HKEx (KC Kwong, Karen Lee) attended a series of media interviews and luncheons to communicate its plan to publish a consultation paper on continuing listing criteria.
06.05.02	47	SFC (Daisy Lai, Senior Manager, Corporate Finance Division), in reviewing the first draft of the Consultation Paper, asked HKEx (Miss Ann Chapman, Vice President, Listing Division) to provide a list of companies on the Main Board which did not currently meet the profit requirement.
07.05.02	48	HKEx (Ann Chapman) reverted to the SFC with a list of companies to which a waiver of the profit requirement was granted.
10.05.02	49	<p>SFC completed an internal assessment of the number of companies which would have been subject to the various proposals set out in HKEx' s draft consultation paper.</p> <p>The assessment showed that only 20 or so companies would be at risk of delisting, but more than 300 would need to go through share consolidation.</p> <p>SFC understood from subsequent discussions with HKEx that the latter had performed a similar assessment with similar findings.</p>
13.05.02	50	<p><u>SFC Advisory Committee meeting.</u></p> <p>SFC presented its research paper on the quality of the Hong Kong listing market to the Advisory Committee for discussion. It did not present any actual proposals on share consolidation or delisting to the Committee.</p>
	51	<p><u>SFC's Comments on the First Draft of the Consultation Paper.</u></p> <p>SFC (Laurence Li), before a meeting to be held on 14 or 15 May with HKEx to discuss the first draft of the Consultation Paper, sent his initial and policy comments to HKEx (Karen Lee).</p> <p>SFC indicated again that the minimum Initial Public Offer and trading prices should be HK\$5 and HK\$1. SFC also raised questions on transitional arrangements:-</p>

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13.05.02 (Cont' d)	51 (Cont' d)	<p><i>“We still strongly believe the minimum issue and traded prices should be \$5 and \$1. Our analysis is already set out in detail in my letter to you of a few months ago. In addition, the figure 30 cents gives the impression of compromise and lack of resolution. Investors and the market might well get the wrong message.”</i></p> <p><i>“Any thoughts on transitional arrangements?”</i></p>
15.05.02	52	<p><u>First Special Meeting between HKEx and SFC to Discuss the First Draft of the Consultation Paper.</u></p> <p>HKEx was represented by Karen Lee, Keniel Wong, Anne Chapman and Doris Lee of the Listing Division.</p> <p>SFC was represented by Charles Grieve, Laurence Li and Daisy Lai of the Corporate Finance Division.</p> <p>On the question of imposing a minimum share price as a continuing eligibility criterion, failing which delisting would result, SFC noted HKEx’s explanation that this was a necessary handle to enable HKEx to require a company to effect a share consolidation or otherwise bring itself back into compliance. SFC accepted that linking the minimum share price threshold to delisting was reasonable as a policy matter, as share consolidation would be the obvious remedy and delisting the ultimate sanction for failing to undertake this or other remedial action.</p> <p>On the threshold for the minimum trading price, SFC explained the rationale behind suggesting \$1 as the threshold. SFC said that the threshold should receive an informed public debate and it was important for the Consultation Paper to set out the positive and negative considerations and make clear that there would be a long transition period.</p> <p>HKEx did not agree to set the minimum-trading threshold at HK\$1.00 as the change would be too hasty, but agreed to further consider setting the proposed minimum trading threshold at HK\$0.50 or HK\$0.30.</p>

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15.05.02 (Cont' d)	52 (Cont' d)	The question of whether delisted companies could apply to relist on GEM (as an alternative trading platform) was also discussed. SFC saw no policy objection to such relisting. HKEx held the view that as a matter of agreed policy, GEM was established to facilitate capital raising by enterprises with growth potentials. It would not reject potential GEM issuers which met the requirements of the GEM and this would in principle apply in the same way to companies delisted from the Main Board. However, a “cooling-off period” might be required to avoid immediate admission of a company delisted from the Main Board to GEM. As to the question regarding policy and direction for future development of GEM was outside the scope of the Consultation Paper, SFC agreed that it would raise this policy issue with the Exchange's business section at a later stage.
16.05.02	53	SFC (Daisy Lai) raised follow-up questions with HKEx (Ann Chapman, Doris Lee) on some of the policy issues discussed at the meeting of 15.5.02, including the question of transitional arrangements.
17.05.02	54	<p>HKEx (Anne Chapman) reverted to SFC (Daisy Lai) on the transitional period, stating that:-</p> <p><i>“As for continuing listing criteria, existing issuers will be given a grace period of one year, after which, they must comply fully with the new proposed rules. However, issuers will not be allowed to undertake any corporate actions that will result in the minimum closing price below 30 cents (subject to finalization).”</i></p> <p><i>“New listings after a certain cut-off date (to be decided) will be required to immediately comply with the continuing listing criteria. There will be no grace period for these new issuers.”</i></p>
30.05.02	55	<p><u>Meeting of Co-ordination Committee</u> (see note 1 under item 38).</p> <p>Members noted HKEx's plan to submit a draft consultation paper on issuer delisting regime to the Listing Committee for consideration in June and publication for market consultation in July.</p>

Date	Serial No.	Event
30.05.02 (cont' d)	56	<p>Meeting of the Directors of SFC.</p> <p>Laurence Li updated colleagues on key proposals. He later spoke with Eric Cheng (Senior Director of Surveillance, Enforcement Division) and CK Chan (Associate Director and Head of Corporate Communications), who said that the “300+” number (of companies trading below 50 cents) would need careful handling. Li also consulted Stephen Po (Director, Intermediaries Supervision) about possible effect on brokers and margin financiers.</p>
07.06.02	57	<p><u>Third Tripartite Meeting.</u></p> <p>Chief Executive of HKEx (KC Kwong) said that HKEx aimed to consult the public on the proposals on penny stocks and delisting in July.</p>
Sometime before 08.06.02	58	<p><u>Discussion on the Second Draft of the Consultation Paper.</u></p> <p>SFC (Laurence Li) and HKEx (Karen Lee) discussed, during a telephone conversation, the question of relisting delisted companies on GEM (as an alternative trading platform).</p> <p>SFC (Laurence Li) suggested allowing delisted companies to be traded, but with a number “4” before its stock code. (Note: The number “4” is linked with the word “dead” in Cantonese.)</p> <p>HKEx (Karen Lee) said that since companies would have had nearly two years to bring themselves into compliance, investors would have plenty of time to exit, and, if a company failed only the minimum trading price requirement, it was easy to bring itself back into compliance. Those which would be delisted are not likely to have any value or investor interest. The “cooling off period” might best be addressed by focusing on track record to ensure quality and compliance with the policy of the GEM listings which require continuous ownership and management on one focused line of business. Main Board issuers normally had various businesses rather than only one. HKEx (Karen Lee) also raised the issue regarding potential confusion resulting from having both regulated and unregulated markets operating under the same trading platform.</p> <p>SFC (Laurence Li) did not pursue the subject further.</p>

Date	Serial No.	Event
08.06.02	59	<p><u>HKEx's Second Draft of the Consultation Paper and Tentative Timetable.</u></p> <p>HKEx submitted the second draft of the Consultation Paper and the tentative timetable for release of the Consultation Paper to SFC (via email from Karen Lee to SFC executives).</p> <p>In the second draft paper, HKEx proposed setting the minimum trading threshold at HK\$0.5 and the proposed minimum Initial Public Offer price at HK\$2. The e-mail stated:-</p> <p>“As to minimum share price, we recommend HK\$2 at time of listing and HK\$0.50 for continuing and will consult the market on HK\$5 and HK\$1 respectively.”</p> <p>As for the issue SFC raised at the meeting held on 15.05.02 about delisted companies relisting on GEM, the draft paper said:-</p> <p><i>“In this connection, we should point out that if an issuer, subsequent to delisting, wishes to apply for listing on any market operated by the Exchange, then for track record purposes the commencement date shall be from the date of its delisting from the Main Board.”</i></p> <p>In respect of timetable, HKEx said that subject to SFC's further comments, the plan was to have discussion by the Listing Committee on 04.7.02, to begin public consultation on 15.7.02 and end on 31.8.02, with the Initial Listing Criteria to take effect on 01.1.03 and Continuing Listing Criteria on 01.1.04.</p>
10.06.02	60	HKEx (Karen Lee) e-mailed SFC (Ashley Alder) to clarify the proposed transitional arrangements.
11.06.02	61	<p><u>HKEx's Third Draft of the Consultation Paper.</u></p> <p>HKEx submitted the third draft of the Consultation Paper to SFC (via email from Doris Lee to Ashley Alder).</p>
12.06.02	62	HKEx (Doris Lee) submitted the first draft of the executive summary of the Consultation Paper to SFC (Ashley Alder).

Date	Serial No.	Event
13.06.02	63	HKEx and SFC exchanged comments and information on waivers granted in respect of the minimum public float requirement (which is the subject of one of the initial listing criteria proposals), and the inclusion of the disclosure proposals (as part of initial listing criteria proposals) in the Consultation Paper.
14.06.02	64	HKEx (Anne Chapman) re-sent to the SFC the list of precedent cases for waiver of profit requirements sent on 7.5.02 (item 48).
	65	<p>FSB submitted to the Financial Secretary's Office some draft points-to-make for the Financial Secretary to use at the HKEx's second Anniversary Cocktail Reception scheduled for 20.6.02.</p> <p>One of the points included in the draft was:-</p> <p><i>"HKEx ... will soon [release] public consultation papers regarding tighter mechanism on delisting penny stocks soon".</i></p> <p>A brief also provided elaboration that <i>"HKEx and SFC are reviewing the present delisting mechanism with the aim of strengthening it. A consultation paper will be issued by the end of this year"</i>.</p>
17.06.02	66	<p><u>SFC's Comments on HKEx's Third Draft of the Consultation Paper.</u></p> <p>SFC (Laurence Li) commented on the third draft of the Consultation Paper (via email to HKEx (Karen Lee)):-</p> <p><i>"We have not arrived at a view on the \$5/\$1 and \$2/50 cents issue. But, in any event, the Consultation Paper should discuss the final goal of bringing ourselves in line with international norms." (Referring to paragraph 84.)</i></p> <p><i>"You might want to include some discussion on how the costs of share consolidation is small, how companies do further minimize costs by timing the approval with their AGMs, and how many companies already engage in similar corporate actions (e.g., share splits, name changes)." (Referring to paragraph 188.)</i></p> <p><i>"The existing Rule 6.12(2) [that shareholders should be offered a reasonable cash alternative or other reasonable alternative in the case of a voluntary delisting] seems ought to apply too."</i></p>

Date	Serial No.	Event
		<p>(Referring to paragraph 200.)</p> <p><i>“The threat of delisting might actually play into the hands of majority shareholders wishing to privatize without shareholders' vote ...We need to discuss this.” (Referring to paragraphs 198-206.)</i></p>
17.06.02 (Cont' d)	66 (Cont' d)	<p><i>“Public shareholders might never get a chance to exit if suspension is immediate and 6 months later the company is considered to have failed a continuing listing criterion. We would like to discuss your assessment of the potential impact. A starting point would be statistics on companies that are late with their accounts and how late. In addition, on potential for abuse, see ...above.” (Referring to paragraph 222.)</i></p> <p><i>“In general, while we strongly support the aim to have a quick delisting process, 1 month for coming up with a proposal and 6 months for bringing oneself back into full compliance might appear as very harsh ...We would like to discuss.” (Referring to paragraph 231(e).)</i></p> <p><i>“There ought to be some parameters, guidelines, indicators, or examples of (i) what are or aren't acceptable rescue proposals, (ii) what are or aren't definitive enough, and (iii) what are or aren't likely to be considered sufficient to bring a failed company back into long-term, sustained compliance.” (Referring to paragraph 231.)</i></p>
18.06.02	67	<p><u>SFC's Comments on HKEx's Third Draft of the Consultation Paper.</u></p> <p>SFC (Daisy Lai) provided further comments on the third draft of the Consultation Paper to HKEx (Anne Chapman).</p>
	68	<p>HKEx (Ann Chapman) reverted to SFC (Laurence Li) on SFC's comments in relation to the need to discuss the long-term goal and to the 6-month period for a company to bring itself back into compliance with the continuing listing criteria.</p>
	69	<p><u>SFC's Comments on HKEx's Third Draft of the Consultation Paper.</u></p> <p>SFC (Daisy Lai) e-mailed HKEx (Ann Chapman) to follow up on the various comments including the subject of potential abuse, stating</p>

Date	Serial No.	Event
		<p>that:-</p> <p><i>“We should make sure that the proposal should force voluntary delisting but not being abused by the controlling shareholder to achieve automatic privatization by mere non-compliance.” (Referring to paragraphs 198-206.)</i></p> <p><i>“Please clarify in the consultation paper whether share consolidation will be taken as a proposal or autocure.” (Referring to paragraphs 234-235.)</i></p>
18.06.02 (Cont’ d)	69 (Cont’ d)	<p><i>“We have noticed that the continued listing criteria relating to minimum number of shareholders and public float may have serious impact on takeover situation ...These two criteria may also be prone to abuse (to force delisting). We need to discuss these further ...”</i></p>
20.06.02	70	<p><u>FS’ Regular Meeting with SFC Chairman</u> (Andrew Sheng).</p> <p>SFC Chairman informed FS that HKEx “was planning to issue a consultation paper to provide for a delisting mechanism”.</p> <p>FS was concerned that some recent incidents in HKEx such as failure of the Uninterruptible Power Supply system might tarnish the image of the HK stock market. FS asked SFS (Stephen Ip) to draft a letter to HKEx Chairman to impress upon him the importance of ensuring the quality of the market and the robustness of the trading systems in Hong Kong.</p>
	71	<p><u>HKEx Second Anniversary Cocktail Reception.</u></p> <p>The Administrative Assistant to FS (Howard Lee) provided FS with draft remarks to deliver at the Reception, on the basis of the draft points-to-make provided by FSB on 14.6.02 (item 65).</p> <p>FS’ remarks included:-</p> <p><i>“HKEx will shortly put forward another consultation paper on delisting mechanism to improve the quality of the market.”</i></p>
	72	<p><u>Second Special Meeting between HKEx and SFC to Discuss the Third Draft of the Consultation Paper.</u></p> <p>HKEx was represented by Karen Lee, Keniel Wong, Ann Chapman and</p>

Date	Serial No.	Event
		<p>Doris Lee.</p> <p>SFC was represented by Charles Grieve, Laurence Li and Daisy Lai.</p> <p>The discussion touched upon the proposals on waivers of minimum track record and minimum public float requirements, potential for abuse in certain areas, and what would constitute “definitive” proposal which would be acceptable to HKEx in the context of the proposed delisting regime.</p> <p>The SFC did not raise any objection to the proposal to set the minimum trading threshold at HK\$0.50.</p>
20.06.02 (Cont’ d)	73	<p><u>SFC’s Comments on HKEx’s Third Draft of the Consultation Paper.</u></p> <p>SFC (Daisy Lai) e-mailed HKEx (Ann Chapman) to follow up on some policy issues (concerning potential abuses) arising from the content of the draft Consultation Paper, stating that:-</p> <p><i>“Controlling shareholders seeking to privatize their companies can easily manipulate these two criteria [public float and minimum number of shareholders] to trigger a delisting. We need to address these potential abuses.”</i></p>
21.06.02	74	<p>HKEx (Karen Lee) agreed with SFC (Laurence Li) to resolve the issue by treating the two requirements highlighted in the email of 20.6.02 (item 73) as continuing obligations (as opposed to continuing listing eligibility) so that any non-compliance would result in disciplinary actions rather than delisting.</p>
	75	<p><u>SFC’s Comments on HKEx’s Third Draft of the Consultation Paper.</u></p> <p>SFC (Daisy Lai) e-mail HKEx (Ann Chapman) further to item 73, suggesting that:-</p> <p><i>“We believe it would be very helpful to the market to include some very general criteria/guidelines on what HKEx would look at when determining whether a proposal to restore compliance with the continuing listing criteria is acceptable.”</i></p>
	76	<p>HKEx (Anne Chapman, Doris Lee) and SFC (Charles Grieve, Daisy Lai) exchanged comments and information on turnover velocity (which</p>

Date	Serial No.	Event
		is related to one of the continuing listing criteria proposals) and comparison of the UK and HK prospectus contents requirements.
24.06.02	77	<p><u>SFC's Comments on HKEx's Third Draft of the Consultation Paper.</u></p> <p>SFC (Daisy Lai) sought clarification from HKEx (Ann Chapman) on the contents of the third draft of the Consultation Paper concerning right issue:-</p> <p><i>"We note from the current proposal that rights issue that might result in a theoretical share price below HK\$0.5 will not be approved by the Exchange. We wish to confirm that issuers are not prohibited from undertaking a share consolidation at the same time in order to facilitate a rights issue which may otherwise result in a share price below HK\$0.5."</i></p>
25.06.02	78	<p>HKEx (Doris Lee) reverted to SFC (Daisy Lai) on the question of right issue to confirm that:-</p> <p><i>"We would not object to any rights issue that may result in a share price below HK\$0.50 so long as it is together with other proposals, such as consolidation, that has a net result of raising the share price above HK\$0.50."</i></p>
26.06.02	79	<p><u>HKEx's Fourth Draft of the Consultation Paper.</u></p> <p>HKEx submitted the fourth draft of the Consultation Paper to SFC, together with response to SFC's earlier comments.</p> <p>It was confirmed that:-</p> <p><i>"...public float and minimum number of shareholders will be a continuing obligation rather than continuing listing eligibility criteria."</i></p>
	80	Article in Sing Tao headlined "HKEx Proposes to Force Penny Shares to Consolidate".
27.06.02	81	SFC (Charles Grieve) supplied comments to HKEx (Karen Lee) on the proposals on prospectus disclosure requirements.
28.06.02	82	<u>FS' Letter to HKEx Chairman.</u>

Date	Serial No.	Event
		<p>FS (Antony Leung) wrote to HKEx Chairman (Charles Lee), pointing out, among other things, that “the current state of affairs of corporate governance of listed companies is worrying” and inviting HKEx Chairman to consider improvement measures.</p> <p>The letter was drafted by and also copied to SFS (Stephen Ip).</p>
28.06.02 (Cont’d)	83	SFC (Charles Grieve) and HKEx (Karen Lee) exchanged comments and information on the disclosure proposals.
01.07.02	84	<p>Frederick Ma assumed office as the Secretary for Financial Services and the Treasury (SFST).</p> <p>Financial Services Bureau (FSB) was renamed Financial Services and the Treasury Bureau (FSTB).</p> <p>FSTB prepared brief for SFST (Frederick Ma), outlining the package of measures to improve corporate governance standards. This mentioned also the public consultation on the proposed amendments to the Stock Exchange Listing Rules on delisting and penny stocks.</p>
02.07.02	85	SFST (Frederick Ma) revealed in an interview/radio programme on Metro his thinking about improvements to the listing structure (“reform to listing committee structure”).
03.07.02	86	<p><u>HKEx Chairman’s Response to FS’ Letter.</u></p> <p>HKEx Chairman (Charles Lee) replied to FS’ letter of 28.6.02 (item 82), saying that:–</p> <p><i>“We have proposed to 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 finalising the consultation paper with SFC and will issue it by end July/early August. The aim is to implement the new rules in the first quarter of 2003.”</i></p> <p>The letter was copied to SFST (Frederick Ma).</p>
	87	<p><u>HKEx’s Second Version of the Fourth Draft of the Consultation Paper.</u></p> <p>HKEx’s Doris Lee submitted the second version of the fourth draft of</p>

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		the Consultation Paper to SFC (Ashley Alder).
	88	SFC (Daisy Lai) commented to HKEx (Doris Lee) on some of the outstanding issues in the second version of the fourth draft.
04.07.02	89	HKEx (Doris Lee) submitted the first draft of the questionnaire of the Consultation Paper to SFC (Ashley Alder).
04.07.02 (Cont' d)	90	HKEx and SFC continued to exchange information and comments on the draft Consultation Paper.
	91	SFC (Daisy Lai) confirmed with HKEx (Karen Lee) that SFC had no further comment on the disclosure proposals.
05.07.02	92	SFC supplied further comments to HKEx on the disclosure proposals in the second version of the fourth draft.
	93	HKEx (Anne Chapman) reverted to the SFC (Daisy Lai) on the queries raised on the second version of the fourth draft.
	94	<p><u>HKEx's Fifth Draft of the Consultation Paper.</u></p> <p>HKEx submitted the fifth draft of the Consultation Paper to SFC via e-mail from HKEx (Doris Lee) to SFC (Ashley Alder)</p>
08.07.02	95	<p><u>SFC Chairman's Letter to SFST.</u></p> <p>SFC Chairman (Andrew Sheng) wrote to SFST (Frederick Ma), explaining the key initiatives the Commission were taking to improve the quality of the Hong Kong listing market and in upgrading the standard of corporate governance.</p> <p>A copy of the Commission's internal study conducted in December 2001 was attached, referring to a large number of poor-quality listings.</p> <p>SFC Chairman (Andrew Sheng) mentioned that a key initiative arising from the study was a review of the entry and exit criteria for the Hong Kong listing market, and that HKEx had been working, in consultation with SFC, on a review of the present initial and continuing listing criteria for the Main Board, with a view to releasing a public consultation paper towards the end of July.</p>

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	96	Administrative Assistant to SFST (Clara Tang) relayed SFST's suggestions to reform the Listing Committee to FSTB and sought its assistance in co-ordinating views with SFC and HKEx.
	97	FSTB (KC Au) set up a meeting for FSTB, SFC and HKEx to be held on 9.7 to work on the package of proposals and the rollout plan. The theme of the package would be "enhancing corporate governance and streamlining listing processes".
09.07.02	98	<p><u>First Special Meeting to Co-ordinate PR Roll-out Plan for SFST.</u></p> <p>Meeting amongst FSTB, SFC and HKEx to work out the package of proposals and PR Rollout plan for the press conference scheduled for 24.7.02 to be jointly held by all three to announce the restructuring of the Listing Committee and streamlining of listing procedures.</p> <p>(Note: this package did not cover penny stocks or the delisting proposals which were considered separate items not part of the corporate governance package.)</p> <p>The meeting was chaired by Permanent Secretary for Financial Services and the Treasury (Financial Services) (PSFS) (Tony Miller) and attended by Chief Executive of HKEx (KC Kwong), SFC (Andrew Sheng, Ashley Alder), FSTB (KC Au, Salina Yan).</p> <p>Chief Executive of HKEx (KC Kwong) mentioned at the meeting his plan to release the consultation paper on the delisting proposals on 24/25 July, following SFST's appearance before the LegCo Panel on Financial Affairs on 24.7.02, to introduce the package to improve corporate governance.</p> <p>The meeting also noted that HKEx's "delisting" proposals would be ready for considering by the Listing Committee on 18.7 and for consultation thereafter. Both SFC and HKEx recommended the inclusion of the mention of the "delisting" proposals when the package was to be jointly announced by FSTB, SFC and HKEx by end July, as it would fit in well with one of the three themes of the package, i.e. improving corporate governance. The other two themes are reforming listing committee structure and streamlining listing procedures.</p>
	99	After the meeting, Salina Yan of FSTB was asked to follow up on co-ordinating the input from SFC and HKEx for inclusion in the package and to start preparing briefing materials (Questions and Answers and

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		lines-to-take) on the package.
09.07.02 (Cont'd)	100	<p>In the evening, HKEx (Karen Lee) phoned FSTB (Salina Yan), outlining the HKEx's timetable for release of its Consultation Paper –</p> <ul style="list-style-type: none"> • circulation of the draft Consultation Paper to the Listing Committee on 10.7 for the Committee's consideration at its meeting scheduled on 18.7; and • publication of the consultation paper on 25.7.02. <p>HKEx (Karen Lee) mentioned concerns about the risk of leakage of the proposals in the Consultation Paper before the announcement of the package by SFST on 24.7. Karen Lee also sounded out Salina Yan on HKEx' PR plan for announcing the "delisting" proposals the day after, mainly to ascertain if it would be desirable to defer the publication of HKEx proposals so as not to disrupt the PR plan for the joint announcement scheduled for late July [24.7.02].</p>
10.07.02	101	<p>Salina Yan informed KC Au of the HKEx's timetable and sought views on the concern about leakage, whilst noting that the Chief Executive of HKEx had already indicated to the press that a consultation paper would be published before end July.</p> <p>KC Au advised Salina Yan that the market was expecting the HKEx's "delisting" consultation.</p>
	102	<p><u>SFC Summary Sent to FSB.</u></p> <p>FSTB (Salina Yan) called SFC (Laurence Li) for some lines to take on, and an outline of, the delisting package to prepare for the PR Rollout for the package on corporate governance improvements and streamlining processes to be announced on 24.7 at the joint press conference.</p> <p>SFC (Laurence Li) sent to FSTB (Salina Yan) by email a draft summary table (prepared internally by SFC) on the proposed admission and continuing listing criteria and delisting procedures (the "SFC Summary Table") for Salina Yan's information.</p>

Date	Serial No.	Event
10.07.02 (Cont' d)	103	<p><u>SFC's Comments on the Fifth Draft of the Consultation Paper.</u></p> <p>SFC (Laurence Li) supplied comments to HKEx (Karen Lee) on the fifth draft of the Consultation Paper and the Questionnaire.</p> <p>SFC offered no further policy comments on the fifth draft of the paper, which included the proposal to set the minimum trading threshold at 50 cents.</p> <p>SFC however expressed concern over the drafting, including the length of the document and the drafting:-</p> <p><i>“ ..The sheer length ... would no doubt cost some PR points. But we shall leave that to you. Our biggest point on the 5th draft has to do with drafting. Because of successive changes, the draft has gotten very long and unwieldy. There are also places where the same changes which seem to conflict with each other. Below are some examples but no doubt we've 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.”</i></p> <p>HKEx (Karen Lee) advised SFC that the latest draft of the Consultation Paper had taken into account most of the comments and views of the SFC – “(actually 3 final-touch drafts over last week-end)”.</p>
	104	<p><u>Draft Consultation Paper (Sixth Draft) Sent to the Listing Committee.</u></p> <p>HKEx dispatched the advanced draft of the Consultation Paper to the Listing Committee members (for deliberation at the meeting of 18.7.02).</p>
	105	<p>SFC (Laurence Li) emailed HKEx (KL) to request a copy of the final version HKEx sent to its Listing Committee.</p>
	106	<p><u>Sixth Draft of the Consultation Paper Sent to SFC.</u></p> <p>HKEx (Doris Lee) submitted the sixth draft of the Consultation Paper (i.e. the version sent to the Listing Committee members) to SFC.</p> <p>She also advised SFC that this latest version had incorporated the</p>

Date	Serial No.	Event
		comments and views of SFC.
15.07.02	107	<p>FSTB (Salina Yan) forwarded to the Administrative Assistant to SFST (Clara Tang) a brief for the meeting of the Securities and Futures Liaison Committee (housekeeping meeting with SFC) to be held on 17.7.02.</p> <p>The brief outlined the PR Rollout Plan on listing matters and mentioned the publication of the consultation paper on delisting by the HKEx on 25.7.</p> <p>The brief was also passed to SFC.</p>
16.07.02	108	<p>HKEx (KC Kwong, Karen Lee) visited SCMP newsroom on invitation and held informal discussion with the editorial team members. Without disclosing details, Chief Executive of HKEx mentioned about that a consultation paper on continuing listing criteria had been submitted to the Listing Committee for consideration.</p>
17.07.02	109	<p><u>HKEx Sent Executive Summary of the Consultation Paper to FSTB.</u></p> <p>FSTB (Salina Yan) rang up HKEx (Karen Lee) for some lines-to-take and confirmation of the gist of the delisting package, as she had been unable to contact SFC (Laurence Li) to confirm that the draft summary (the SFC Summary Table prepared by SFC (item 102)) could be taken as final.</p> <p>HKEx (Karen Lee), in response, faxed a copy of the Executive Summary of the draft Consultation Paper (the “HKEx Executive Summary”) and an extract of a covering paper already circulated to the Listing Committee to FSTB (Salina Yan).</p> <p>FSTB (Salina Yan) had by then received confirmation from the SFC (Laurence Li) that the SFC Summary Table included the latest proposals which were put before the Listing Committee.</p> <p>FSTB (Salina Yan) had telephone conversations with HKEx (Karen Lee) and SFC (Laurence Li) asking their views about:–</p> <p>(a) what they would consider to be controversial in the proposals; and</p> <p>(b) what options would be available to investors in companies which</p>

Date	Serial No.	Event
		<p>may be delisted.</p> <p>Salina Yan was advised by Karen Lee that the dampening effect on “shell” buying activities could be a source of complaint.</p>
17.07.02 (Cont’ d)	109 (Cont’ d)	She was advised by Laurence Li that around 25 companies might be at risk of being delisted if all the proposals were to be implemented right away. Mr Li further stressed that minimum trading price was meant to be a trigger for consolidation and there would be a long transitional period.
	110	<p><u>Securities and Futures Liaison Meeting held between FSB and SFC.</u></p> <p>The Rollout Plan for the press conference scheduled for 24.7.02 was noted by the meeting.</p>
	111	<p><u>Communication within FSTB.</u></p> <p>FSTB (Salina Yan), after notifying her seniors (KC Au, DSFS and Tony Miller, PSFS), passed a copy of the SFC Summary Table to Administrative Assistant to SFST (Clara Tang), together with an email:-</p> <ul style="list-style-type: none"> highlighting that the proposals would be considered by the Listing Committee on 18.7 and for publication sometime after the press conference on 24.7; and relaying SFC’ s clarification that the 50 cents proposal was a trigger for consolidation.
	112	The Administrative Assistant to SFST (Clara Tang) then placed a hard copy of the email from FSTB (Salina Yan) together with the SFC Summary Table in the in-tray of SFST (Frederick Ma).
	113	HKEx published its Exchange magazine which contained an article mentioning the imminent publication of the Consultation Paper.
	114	<p>SCMP run an article headlined “Penny stocks face axe” and reported that:-</p> <p><i>“The exchange also plans to bring in a compulsory consolidation rule to eliminate penny stocks.”</i></p>

Date	Serial No.	Event
		<i>“Under the HKEx proposal, a company would be forced to carry out a share consolidation – combining a number of old shares into one new share – if the share price fell below a certain level. Such an exercise raises the theoretical share price.”</i>
17.07.02 (Cont’ d)	115	SFST (Frederick Ma) had a dinner engagement and left HK for London in the late evening (returning to duty on the morning of 22.7.02).
18.07.02	116	<p>Hong Kong Economic Times’ headlined that “Share Price Below 50 Cents, Proposal to Require Share Consolidation”.</p> <p>An article in SCMP headlined “Exchange poised to weed out penny counters”. It reported in detail the 50 cents share consolidation proposal. It quoted a source as explaining that:-</p> <p><i>“We want to give a warning light to the company earlier. The 50 HK cents is not the de-listing threshold. It is the threshold for companies to take corporate action to improve themselves,” the source said.</i></p> <p><i>“Should we set the threshold to a level too low, it may be too late for them to take any action to address their problems.”</i></p>
	117	<p>FSTB (Salina Yan) provided an internal minute to Tony Miller, PSFS via KC Au, DSFS. This contained a brief analysis of the various summaries provided by the SFC and HKEx.</p> <p>Both the SFC Summary Table (item 102) and the HKEx Executive Summary (item 109) were attached to the minute.</p> <p>In the minute, FTSB (Salina Yan) also mentioned, together with the advice she obtained from HKEx (Karen Lee) and SFC (Laurence Li), that about 53.2% of the companies in the Main Board were trading below \$0.5 as at end 2001. This minute did not go to the SFST (Frederick Ma)</p>
	118	<p><u>HKEx Listing Committee Meeting.</u></p> <p>The Listing Committee met for over two hours to deliberate on the proposals in the Consultation Paper. Members in general supported the proposals, including setting the minimum trading threshold at 50 cents, as the basis for consultation.</p>

Date	Serial No.	Event
		<p>Members had comments on various other proposals. They did not mention that the consultation proposals might lead to the dumping of penny stocks.</p> <p>The Committee made certain amendments to other items, and approved the Paper for public consultation.</p>
19.07.02	119	Sing Tao's article headlined that "Mandatory Share Consolidation Will Benefit Market Makers".
19.07.02 (Cont'd)	120	<p>HKEx (Karen Lee) informed SFC (Laurence Li) by telephone that Listing Committee had inserted a question into the Consultation Paper on whether a waiver from the public float requirement should be available in certain takeovers situations. Karen Lee asked whether the question had any Takeovers Code implications. Laurence Li replied that the Takeovers Code applied independently and added that he thought the waivers should not be available as a matter of principle, but, since the Listing Committee had inserted the question, the issue should also be subject to the public consultation.</p> <p>HKEx (Anne Chapman) followed up the matter with the SFC (Daisy Lai) afterwards.</p>
Sometime in the week of 15.07.02	121	<p>SFC (Laurence Li) and HKEx (Karen Lee) discussed over the telephone when HKEx would release the consultation paper. In the course of a number of discussions, the leave plans of the Chief Executive of HKEx (KC Kwong) was mentioned.</p> <p>Karen Lee mentioned that HKEx had planned to release its consultation paper on Thursday (25.7). Laurence Li then asked why not Friday afternoon, suggesting also that SFC could release its research paper on Thursday to "set the scene" for an informed debate.</p> <p>Karen Lee conveyed to Laurence Li the advice of her colleagues in the Corporate Communication Division that Friday was not generally considered appropriate for major releases because there was less media coverage on Saturdays and the news might attract less attention.</p> <p>SFC (Laurence Li) then said that, in that case, SFC would release its research paper on the quality of the Hong Kong listing market over lunchtime on 25.7 so journalists would have a few hours to digest the background facts before the HKEx's briefing (which Li still thought would be after close of business on Thursday).</p>

Date	Serial No.	Event
	122	HKEx (Karen Lee) asked SFC (Laurence Li) for a copy of the SFC' s research paper.
18.07 –23.07.02	123	HKEx worked on the final version of the Consultation Paper by incorporating comments of the Listing Committee members and fine-tuning the overall contents of the paper.
The days leading up to 25.07.02	124	<p>SFC (Laurence Li) spoke with HKEx (Karen Lee) on the telephone numerous times before release of the Consultation Paper.</p> <p>There were discussions of the importance of explaining that the 50 cents threshold was not one for delisting. Karen Lee mentioned she would emphasize that it would not be “arrive at price-line and automatic death” (到價即死).</p> <p>There were discussion regarding co-ordination of the announcement of the new listing governance structures as well as the release of the Consultation Paper and SFC' s research paper.</p>
22.07.02	125	<p>Oriental Daily News columnist (Dr. Stock) wrote that:-</p> <p><i>“Having over 120 penny stocks is a historic record. And half of the listed companies are below \$0.5. We need to know that many penny and low-price companies refuse to consolidate the shares because of sinister motives. They fear that consolidation would put the share price at a higher level, thus increasing the “room” for a fall. Or they wish to continue as low-price stocks, luring investors to see the stocks as easy to punt, so that the companies could suck money from the public shareholders.”</i></p>
23.07.02	126	<p><u>Second Special Meeting to Co-ordinate PR Roll-out Plan for SFST.</u></p> <p>Meeting by SFST (Frederick Ma) with SFC and HKEx to finalize preparations for the press conference on 24.7 to announce the package on the reform of the Listing Committee and the streamlining of listing procedures.</p> <p>The meeting agreed that SFST would preside at the press conference, and SFC Chairman, HKEx Chairman, and Chief Executive of HKEx would also participate.</p> <p>The meeting also agreed that “delisting” proposals as a subject of</p>

Date	Serial No.	Event
		<p>consultation by HKEx would only be very briefly touched upon in the opening of the press conference, and the detailed proposals would be separately announced by HKEx on 25.7. Should any journalist ask about the “delisting” proposals on 24.7, Chief Executive of HKEx would take the question.</p> <p>Members also noted that SFC’s paper on “the Quality of Market and the Case for a More Effective Delisting Mechanism” would be released by SFC on 25.7.</p>
23.07.02 (Cont’d)	126 (Cont’d)	HKEx Chairman (Charles Lee) brought up, at the end of the meeting, his concern that SFC’s research paper might “crowd out” the news reportage on the delisting proposals. PSFS (Tony Miller) agreed and was concerned that the research paper might be considered negative. SFC (Ashley Alder and Laurence Li) said it was important to set the scene for an informed, rational debate about delisting. All agreed the SFC would release a shortened version.
	127	SFC (Laurence Li) e-mailed HKEx (Karen Lee) a copy of the SFC’s research paper.
	128	<p>SFC (Laurence Li) e-mailed Chief Executive of HKEx (KC Kwong) another copy of the SFC’s research paper later in the day, stating that:-</p> <p><i>“I’ve also earlier indicated to Karen that we plan to hold a media lunch that day [i.e., 25.7]. Since the delisting proposals would likely affect the price of some stocks, we assume the Exchange would do its briefing after market closes ... We’ll ask our CC colleagues to contact Henry to touch base.”</i> (Note: “Henry” referred to Henry Law, Head of Corporate Communications at HKEx.)</p>
	129	HKEx (KC Kwong) replied to SFC (Laurence Li), saying that Karen Lee would make contact on the arrangements for media briefing on 25.7.
	130	<p>SFC (Laurence Li) and HKEx (Karen Lee) had two telephone conversations about timing of HKEx’s release of its consultation paper.</p> <p>Karen Lee said in the first conversation that she had to discuss with KC Kwong about the time, after learning from Laurence Li that SFC was going to release its research report on the same day as HKEx’s planned release. She had in mind concerns expressed at the co-ordination meeting (for the announcement of the new listing governance</p>

Date	Serial No.	Event
		<p>structures on 23.7.02) by Charles Lee and Tony Miller (item 126).</p> <p>Karen Lee then reverted to Laurence Li after consulting colleagues of the Corporate Communications Division about the arrangement, and informed him that HKEx would release its Consultation Paper after the close of the morning session the next day, and that HKEx had no views on the timing of SFC's release of its research paper as this was a matter for the SFC.</p>
23.07.02 (Cont'd)	130 (Cont'd)	<p>In parallel, there was also discussion between the personnel of the Corporate Communications Divisions of SFC (CK Chan, Head of Corporate Communications Division) and HKEx (Lorraine Chan, Assistant Vice-President, Corporate Communications Division) about the schedule for HKEx's press conference. SFC asked if HKEx could re-schedule its press conference for the Consultation Paper since it might clash with SFC's news briefing and some information to be given at HKEx's press conference might be price sensitive. Lorraine Chan, after discussing the matter with Karen Lee, informed CK Chan that HKEx would start its press briefing at 12:30 pm on 25.7.</p>
	131	<p>Apple Daily's article headlined that "Share Price Below 50 Cents May Need to Consolidate".</p> <p>News reports on 23.7 and during the preceding week included interviews with and quotes from market practitioners; most thought 50 cents was on the high side, but none predicted that there might be a market scare.</p> <p>Penny stocks did not show signs of disorderly trading or unusual volatility over the previous week's trading.</p>
24.07.02	132	SFST (Frederick Ma) attended the LegCo Panel on Financial Affairs.
	133	<p><u>Joint Press Conference Presided by SFST on the Package of Corporate Governance and Streamlining of Listing Processes.</u></p> <p>SFST, SFC Chairman, the Chairman and Chief Executive of the HKEx attended the joint press conference.</p> <p>In response to a question from a reporter, Chief Executive of HKEx confirmed that a consultation paper on proposals relating to initial listing and continuing listing eligibility and cancellation of listing would be released on 25.7.</p>

Date	Serial No.	Event
	134	HKEx (Anne Chapman) e-mailed SFC (Laurence Li), at 6:21 pm, for information, a copy of the press release on the announcement of the proposals the next day.
25.07.02	135	<p><u>SFC's Press Briefing.</u></p> <p>SFC's Corporate Finance Division held a press briefing on its research paper at 11:30 am to announce the findings of its study on the quality of the Hong Kong stock market.</p>
25.07.02 (Cont' d)	136	<p><u>Chief Executive of HKEx held press briefing to release the Consultation Paper at 12:30 pm.</u></p> <p>Journalists were given a reading session for about an hour to digest the Consultation Paper before commencement of the briefing.</p> <p>A media lunch was arranged for journalists after the press conference. KC Kwong and Karen Lee had requested journalists to report the proposals comprehensively and avoid sensational reports and headline. They had also reinforced the following messages during the media lunch:–</p> <ul style="list-style-type: none"> • companies traded below 50 cents would not be immediately delisted; and • there would be a 12-month transitional period.
	137	HKEx posted the Consultation Paper on its website after the press briefing.
	138	SFC (Laurence Li) e-mailed HKEx (Karen Lee) to request a marked-up final version of the published Consultation Paper.
	139	Trading was seen to be usual on the afternoon of 25.7.
	140	HKEx (Corporate Communications Unit) monitored the reports in the electronic media in the afternoon and noted that the opinions given on the new media by market practitioners on the proposals in the Consultation Paper were generally neutral or supportive.
	141	FS (Antony Leung) learned from the electronic media that HKEx had issued a consultation paper relating to delisting mechanism.

Date	Serial No.	Event
	142	Around midnight, SFST (Frederick Ma) received feedback from a contact that the delisting proposals in the Consultation Paper might have problems.
26.07.02	143	HKEx continued to monitor press reports on the Consultation Paper and saw no indication that the publication of the proposals would trigger a market panic or a major sell-off in low-priced stocks.
	144	Unusual movement of stocks commenced at about 10:45 am and continued for about an hour.
26.07.02 (Cont'd)	145	FSTB (Salina Yan) received reports from a trade association and the SFC that there was panic selling of low price stocks. FTSB (Tony Miller, KC AU) and the Administrative Assistant to SFST (Clara Tang) and Press Secretary to SFST (Louisa Mak) were informed immediately.
	146	At around 11am, SFST (Frederick Ma) received phone call from the same contact referred to in item 142 informing him of the plunge.
	147	SFST (Frederick Ma) told his Administrative Assistant (Clara Tang) and Press Secretary (Louisa Mak) that he had not received anything in writing about the delisting proposals. Clara Tang then pointed out that a copy of the SFC Summary Table had been submitted to him earlier on. Clara Tang then produced a copy of the SFC Table to him.
	148	FS (Antony Leung) was informed by his Administrative Assistant (Howard Lee) that the market had reacted strongly to HKEx's proposal, and that SFST had already clarified publicly that the proposal was only at the consultation stage.
	149	SFST (Frederick Ma) phoned and informed the FS of the market situation, and that he would make a further public statement later in the day to reassure the public.
	150	SFST (Frederick Ma) touched base with Chief Executive of HKEx (KC Kwong) and talked to the media to clarify that the proposals were merely proposals for public consultation.
	151	HKEx despatched hard copies of the Listing Eligibility Consultation Paper to listed issuers, market practitioners and selected professional and business organisations. HKEx launched its reach-out programme to seek market views on the

Date	Serial No.	Event
		<p>paper after release:-</p> <ul style="list-style-type: none"> • HKEx (Karen Lee) communicated with representatives of stockbrokers associations (Ms. Choi Chan Po Sum and Mr. Trini Tsang) inviting views and suggesting the holding of seminars for their members if they considered necessary; • HKEx invited listed issuers and market practitioners to attend seminars (in English, Cantonese and Putonghua) to be held on 12, 13 and 14 August 2002 to explain the contents of the Consultation Paper and solicit market views on the Paper; and
26.07.02 (Cont' d)	151 (Cont' d)	<ul style="list-style-type: none"> • HKEx provided telephone enquiry service for interested parties who might have queries on the contents of the Paper.
	152	FSTB (Salina Yan) received a copy of the Consultation Paper and a letter from HKEx (Karen Lee) inviting comments.
	153	HKEx (Doris Lee) e-mailed SFC (Daisy Lai), at 4:56 pm, summary of the significant amendments made to the Consultation Paper after the Listing Committee meeting of 18.7.
	154	<p>HKEx issued a press statement in the early afternoon:-</p> <ul style="list-style-type: none"> • The proposals were only part of a market consultation relating to the Main Board Listing Rules; • HKEx expected a variety of responses from market participants; • It would take a few months to formulate the rules for the implementation of any changes after the consultation; and • If any rules on delisting of existing penny stocks were adopted, they would still be subject to a 12-month transition period before implementation.
	155	SFC issued a press statement to echo HKEx' s statement.
	156	SFST (Frederick Ma), in the evening, after consulting the Chief Executive of HKEx gave a media stand up, saying the 50 cents threshold was subject to discussion, and appealing to the public not to panic.

Date	Serial No.	Event
27.07.02	157	Chief Executive of HKEx (KC Kwong) discussed the matter with his colleagues. He then rang up SFST and SFC Chairman in the morning proposing that the 50 cents proposal be withdrawn.
	158	<p>SFST suggested to HKEx at the discussion (item 157) that the consultation period be extended.</p> <p>He also asked a contact to organize a lunch for himself and HKEx Chairman to meet with market practitioners the following day.</p> <p>In the evening, he spoke with SFC Chairman and HKEx Chairman about his concern that the plunge of penny stock prices might trigger broker defaults and wider implications on the market.</p>
27.07.02 (Cont' d)	159	<p><u>HKEx's Announcement on the Extension of the Consultation Period.</u></p> <p>HKEx announced extension of the consultation period by two months to 31 October 2002 and its plan to publish a supplementary paper on the delisting proposal, first through radio programmes in the morning, then through press release in the afternoon.</p>
	160	FS (Antony Leung) discussed with SFST (Frederick Ma) the market reaction and the need for prompt action to address the anxiety in the market during pauses in the sessions of the HKSAR Chief Executive's Retreat. (whole day).
	161	FS (Antony Leung) asked his Administrative Assistant (Howard Lee) to arrange a meeting with SFST, SFC Chairman, HKEx Chairman and Chief Executive of HKEx in the afternoon of 28.7 to discuss the way ahead. (pm).
	162	Administrative Assistant to SFST (Clara Tang) requested Salina Yan to prepare a chronology of events for SFST's reference on 29.7. (late afternoon).
28.07.02	163	FS (Antony Leung) continued to discuss with SFST about the market reaction and the need for prompt action in between sessions of the HKSARG Chief Executive's Retreat.
	164	SFST (Frederick Ma) and HKEx Chairman (Charles Lee) had a luncheon with brokers. Afterwards, HKEx Chairman suggested withdrawing Part C of the Consultation Paper (the delisting proposals).

Date	Serial No.	Event
		<p>SFST then met SFC Chairman (Andrew Sheng) in SFC's office. While noting that brokers position was in order on 26.7, SFST raised concern on the settlement in the following week. (3pm).</p> <p>SFST (Frederick Ma) saw a copy of the Consultation Paper for the first time in Sheng's office.</p>
	165	FS read the relevant extract of the Executive Summary of the HKEx's Consultation Paper obtained by his Administrative Assistant (Howard Lee) from the Internet. (before 4 pm).
	166	Salina Yan went back to her office to work on the chronology of event requested by the Administrative Assistant to SFST (item 162) but did not have the relevant files.
28.07.02 (Cont'd)	167	<p><u>Meeting at FS' Residence.</u></p> <p>Meeting amongst FS, SFST, SFC Chairman, Chairman and Chief Executive of HKEx at 4 pm at FS' residence.</p> <p>The meeting agreed to the HKEx Chairman's proposal to withdraw the delisting proposals and to hold a press conference at 6 pm to announce the withdrawal and further explain the rationale behind the proposal to allay public anxiety.</p>
	168	<p><u>Press Conference to Announce the Withdrawal of Part C of the Consultation Paper.</u></p> <p>The press conference was held by SFST (Frederick Ma), SFC Chairman (Andrew Sheng), HKEx Chairman (Charles Lee) and Chief Executive of HKEx (KC Kwong) at 6 pm to announce the withdrawal of the delisting proposals.</p> <p>At the press conference, SFC Chairman responded to a question in Cantonese which was interpreted by some later reports to the effect that the SFC had not indicated a view on the price threshold. (Note : the whole context of all the questions and answers should have made it clear that the SFC had discussed price thresholds with the HKEx.)</p>
29.07.02	169	<p>FS (Antony Leung), in response to media enquiries on his way back to the office, mentioned that HKEx –</p> <ul style="list-style-type: none"> might not have given sufficient thoughts to the details of the

Date	Serial No.	Event
		<p>proposal;</p> <ul style="list-style-type: none"> might have under-estimated the market reaction; and had not informed FSTB prior to the release of the Consultation Paper.
	170	Salina Yan completed the drafting of the chronology of event, under the impression that the chronology should show the overall developments since the subject of penny stocks came to the knowledge of the policy bureau. The chronology did not include the HKEx Executive Summary which she had received from HKEx (item 109) which in her view was similar to the SFC Summary Table (item 102) which she had sent to the Administrative Assistant to SFST. After passing the draft to KC Au and Tony Miller for quick comments, Salina Yan sent the chronology of events to Administrative Assistant to SFST (Clara Tang).
30.07.02	171	In the morning, Salina Yan realized that the HKEx Executive Summary might be regarded as material in the incident and confusion might have been caused in the reference to the term “summary”. She drew the omission from the chronology to the attention of KC Au, who was on a telephone conference with SFST. On KC Au’s suggestion, Salina Yan spoke to SFST, using the speaker phone, confirming her receipt of the HKEx Executive Summary. SFST does not recall this message.
	172	<p>SFST held meeting with SFC, HKEx and his staff to prepare for the LegCo Panel on Financial Affairs meeting scheduled for 31.7.02.</p> <p>SFC Chairman (Andrew Sheng) and Chief Executive of HKEx (KC Kwong) confirmed that they had neither consulted SFST (Frederick Ma) nor sent a copy of the Consultation Paper to him before 25.7.02.</p>
	173	Meeting between FS (Antony Leung), SFST (Frederick Ma) and HKEx Chairman (Charles Lee).
31.07.02	174	<p>Further meeting amongst SFST, SFC Chairman, HKEx Chairman, Chief Executive of HKEx in the morning to prepare for the Special meeting of LegCo Panel on Financial Affairs scheduled for the afternoon.</p> <p>FSTB (Salina Yan), in clarifying the issue of “who knows what”, at the preparatory meeting, confirmed: -</p>

Date	Serial No.	Event
		<ul style="list-style-type: none"> the SFC Summary Table she received on 10.7.02 had been passed to the Administrative Assistant to SFST (Clara Tang) on 17.7.02 (items 102 and 111); and the Executive Summary of the Consultation Paper provided by HKEx (Karen Lee) on 17.7.02 (item 109), had <u>not</u> been passed to SFST's Office. (The Executive Summary was only sent to Tony Miller via KC Au on 18.07.02 (item 117).) <p>SFST (Frederick Ma) became aware that the HKEx had sent a copy of the Executive Summary of the Consultation Paper to FSTB on 17.7.02. He mentioned this to the Financial Secretary afterwards.</p> <p>At the preparatory meeting, SFST, SFC Chairman and HKEx Chairman all read out their draft speeches to be delivered at the LegCo Panel meeting. The draft of the Chief Executive of HKEx was not then complete and did not contain the chronology in his final version delivered at the Panel meeting.</p>
31.07.02 (Cont'd)	175	FS appoints an independent Panel of Inquiry to look into the Penny Stocks Incident.
	176	<p><u>Special Meeting of LegCo Panel on Financial Affairs.</u></p> <p>See detailed discussion in paras. 9.19 to 9.22 of the Main Report.</p>

Legend of Abbreviations

FS	Financial Secretary
FSB	Financial Services Bureau
FSTB	Financial Services and the Treasury Bureau
HKEx	The Hong Kong Exchanges and Clearing Ltd
SFC	Securities and Futures Commission
SFS	Secretary for Financial Services
SFST	Secretary for Financial Services and the Treasury

Persons mentioned in the chronology of events

The Financial Secretary's Private Office

Antony Leung	Financial Secretary (FS)
Howard Lee	Administrative Assistant to FS

Financial Services and the Treasury Bureau (FSTB) / Financial Services Bureau (FSB)

Frederick Ma	Secretary for Financial Services and the Treasury (SFST)
Stephen Ip	Secretary for Financial Services (SFS) (before 1.7.02)
Tony Miller	Permanent Secretary for Financial Services and the Treasury (Financial Services) (PSFS)
King Chi Au (KC Au)	Deputy Secretary for Financial Services and the Treasury (Financial Services) (DSPS)
Salina Yan	Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) (Securities) PAS(FS)
Clara Tang	Administrative Assistant to SFST
Louisa Mak	Press Secretary to SFST

Securities and Futures Commission

Andrew Sheng	Chairman
Ashley Alder	Executive Director, Corporate Finance Division
David Stannard	Executive Director, Corporate Finance Division (before 01/10/01)
Laurence Li	Director, Corporate Finance Division
Charles Grieve	Director, Corporate Finance Division
Daisy Lai	Senior Manager, Corporate Finance Division
Eric Cheng	Senior Director of Surveillance, Enforcement Division
CK Chan	Associate Director and Head of Corporate Communications Division
Stephen Po	Director, Intermediaries Supervision

Hong Kong Exchanges and Clearing Limited

Charles Lee	Chairman
Ki Chi Kwong (KC Kwong)	Chief Executive
Lawrence Fok	Deputy Chief Operating Officer
Karen Lee	Executive Vice President and Head, Listing Regulation and Risk Management Unit
Keniel Wong	Senior Vice President, Listing Division
Anne Chapman	Vice President, Listing Division
Mark Bewley	Assistant Vice President, Listing Division
Doris Lee	Senior Manager, Listing Division
Henry Law	Head, Corporate Communications Unit
Lorraine Chan	Assistant Vice-President, Corporate Communications Unit

(Source:- HKEx)

**2001 年 1 月至 2002 年 7 月 25 日
有關「仙股」及「除牌」的報導概略**

日期	報章	報導概略
2001/1/11	星島日報	<ul style="list-style-type: none"> - 東泰證券鄧聲興直指，上市公司股價成「仙」，通常不外乎過度集資、盈利前景欠佳以及之前出現大量投機買盤所致，就算當局建議強制合併股份，也未必能夠解決股價再跌的問題。 - 譚紹興直指現有仙股問題，當局也要負上一定責任，容許個別質素有問題的股份上市。 - 萬信證券黃國英認為香港當局對待「仙」股手法寬鬆，嚴重影響交易效率，因此贊成當局強制將「仙」股合併。
2001/1/19	太陽報	<ul style="list-style-type: none"> - 霍廣文表示早前曾就仙股合併向業內人士進行非正式諮詢，而業界對此普遍支援。霍廣文強調合併仙股的目的是提高市場透明度，因為現時低於一仙的股份只會在碎股的平臺買賣，而一般投資者是不能知悉當中的交易情況。 - BNP 百富勤梁伯韜認為合併仙股對公司的好處有限，因為股價能否回升很大程度是取決於業績好壞。
	大公報	霍廣文表示，港交所正研究仙股合併事宜，原因是股價低於一仙的股份，只能透過碎股板交易，一般投資者未能得悉交易資料，故有欠透明度。
	公正報 成報	霍廣文表示，港交所有非正式諮詢市場參與者意見，而有關人士普遍支援要求上市公司將仙股合併，主要認為股價太低便不可以透過市場進行交易，難以維持高透明度。

日期	報章	報導概略
2001/1/19 (Cont'd)	亞洲電視 網上新聞	霍廣文表示，會非正式向業界諮詢仙股合併的建議，解釋因股價低過 1 仙，交易所系統會不能顯示，影響公司的透明度。
	香港商報 文匯報 蘋果日報	- 霍廣文表示港交所曾非正式地諮詢業界有關仙股合併的意見，業界普遍支援仙股合併。因低於一仙的股份當作碎股買賣，故合併後可增交易透明度。
	星島日報	- 霍廣文表示交易所考慮將仙股合併，以提高成交的透明度。 - 梁伯韜認為作用不大，因為甚少投資者留意仙股。
2001/1/23	蘋果日報	- 黃紹開強調香港創業板歷史只有一年，交易所不會因股價或市值低而要將有關公司除牌，除非公司本身經營出現問題。
2001/1/29	東方日報	- 作者老周認為港交所可引入美國納斯達克交易所的除牌制度，以淨化本地市場。納所規定，當地掛牌公司股價要長期保持在 1 美元以上，如連續 30 個交易日內股價一直低於規定，會給予 90 日寬限期，其後並要連續 10 個交易日股價維持在 1 美元以上。第二個條例是，如掛牌公司的資產淨值不足 400 萬美元，股價便要保持在 5 美元以上，不符合指標的股票，會受到制裁處分。 - 香港二、三線股的大股東在近十多年來，經常先供股集資，然後高價買資產、「做手腳」令公司蝕本，然後又再供股集資。這些「老千股」的股價不斷大跌，而大股東就因為不斷向股民「抽水」而發達，當股價跌無可跌時，就不惜合併、削減股本，然後再「抽過水」，令小股東跌入無底深潭。因此，納指的機制可以說是對付這些「老千股」的最有效辦法，以限制那些大股東無限量將自己股票向下炒。

日期	報章	報導概略
2001/2/5	成報	<ul style="list-style-type: none"> - 對於港交所有意將某一水平的仙股股價合併為最少五或一角的建議，證券界人士認為此雖可令股票面值增大，但若公司質素並無改善，最終股份亦可能打回原形，並不能吸引投資者買賣。 - 譚紹興認為此舉短期雖可令股票流通量增加，但若該些公司質素並無改善，股份合併後股價仍然會下跌。 - 譚紹興認為，交易所可考慮美國納斯達克市場做法，若某一隻股份股價長期低於一美元，則交易所有權將之除牌。 - 東泰證券鄧聲興認為將股份合併並不能解決問題，而且還會引來削股本等技術上問題。
2001/2/16	經濟日報	<p>黃紹開認為，聯交所在研究仙股合併問題上，應考慮有關措施是暫時性安排，或是成為長期的市場機制。聯交所可考慮規定將股價維持在 1 仙一段時間(例如 3 個月或 6 個月)的仙股進行合併，若合併後再跌為 1 仙股，便可能要除牌。</p>
2001/2/19	大公報	<ul style="list-style-type: none"> - 恒豐證券張華峰表示，同意將仙股合併。 - 霍廣文表示，正研究合併仙股，並向市場進行非正式諮詢，業界反應普遍支援有關建議，並認為此舉可助提高市場透明度。 - 不過，有業界認為，合併仙股未必能解決問題，因為股份合併後，股價仍可以再跌，再次變回仙股。 - 有市場人士建議仿效美國的規例，將在限期屆滿後仍未合股者除牌。 - 張華峰贊同將仙股合併，但認為本港未必需要設立除牌制度，因為聯交所現時已有一除牌機制;若再強加仙股除牌,將為奉行自由體系的香港帶來負面影響。 - 立法會議員胡經昌認為，將仙股合併原則是對的，但在硬性規定將仙股合併之前，必須先

日期	報章	報導概略
		瞭解到個別公司本身的問題所在。
2001/2/19 (Cont'd)	大公報 (續)	<ul style="list-style-type: none"> - 胡經昌並指出，除牌制雖可促使有關的公司努力去進行改善，但壞處卻是令那些只因環境問題導致股價大瀉至變成仙股的公司，永無翻身之日，對一般小股東來說，亦失去了保障。 - 萬信證券許照中則反對將仙股合併，他更強調，即使硬性規定公司必須將仙股合併，亦無人能保證合併後的股價會上升，若只是不停地將仙股合併，只會不斷榨乾小股東的利益。因此，許照中贊成實行除牌制度，勒令取消長期沒有成交的仙股公司的上市地位，及要求該公司清盤。
2001/2/23	蘋果日報 香港商報	沈聯濤正與港交所檢討上市規則，其中包括處理仙股的問題。
2001/3/14	東方日報	<ul style="list-style-type: none"> - 作者老周認為股票是自由買賣，必須盡量減低人為幹預。 - 純以股價低於某價而要除牌，會剝奪股東止蝕機會。
2001/3/20	東方日報	<ul style="list-style-type: none"> - 許照中認為，「除牌制度」可以作為對付一些刻意將股價推低至不合理水平的上市公司(如仙股公司)的管理層或大股東，迫使他們回購股份。 - 近年很多三、四線小型上市公司的大股東或管理層，縱有大量閒資也不願於股價有重大折讓的情況下回購本身股份，寧可以超高價格收購其他公司股份藉以消耗本身的大量現金。對此，許照中認為只有「除牌制度」可以堵塞這個漏洞。
2001/3/22	東方日報	<ul style="list-style-type: none"> - 作者許照中構思中的「除牌制度」，建議上市公司回購本身股份，但有關回購水平則屬主觀看法。 - 雖然在自由市場而言，由條例來規定上市公司的合理價格並不大適當，但只要條例是在公平

日期	報章	報導概略
		的原則下訂定，並無不可。所謂「合理水平」，可從資產淨值及平均市盈率來作考慮。
2001/4/26	經濟日報	在專欄【散戶心聲】中，筆者「不平鳴」反對將仙股合併，因為合併只會為這些公司的大股東提供機會炒低股價壓搾小股民金錢。聯交所及證監會均須三思。
2001/5/10	經濟日報	就市場中要求將股價長期維持在 1 仙股份除牌的建議，霍廣文表示不會效法美國市場，勒令股價長期低迷的股份除牌，因為上市公司一旦除牌，投資者便無法變現。
2001/5/14	信報	<ul style="list-style-type: none"> - 社評談及中美日除牌要求較香港嚴格。 - 紐約交易所規定上市公司必須符合下列條件才不會被除牌：一、連續 30 天股價最少要達到 1 美元；二、公司市值不得少於 5 千萬美元；三、股東權益不得少於 5 千萬美元。若上市公司未能符合上述規定，便會被交易所取消上市資格。 - 日本則要求上市公司要有最少 150 位股東及不能連續三年資不抵債。 - 中國證監會近期也規定將連續三年出現虧損的上市公司除牌。 - 有學者指出除牌機制的問題。 - 中大郎咸平、齊大慶及蘇偉文撰文指出，除牌機制本身存在不少問題:- <ul style="list-style-type: none"> * 被除牌公司的股票喪失流通能力，令投資者不能套現，並引致場外股價大跌。 * 除牌公司會計項目更易被操縱，公司管理層或會更改甚至偽造會計資料，以符合相關盈利規定。 * 如除牌以股價決定，公司大可利用多股合一，從而提高股價，並將除牌的時限拉後，對股東利益反而沒有幫助。

日期	報章	報導概略
		<ul style="list-style-type: none"> - 京華山一數碼金融服務董事鄧君栩不支援仙股除牌，認為應容許仙股繼續買賣。

日期	報章	報導概略
2001/5/14 (Cont'd)	信報 (續)	<ul style="list-style-type: none"> - 社評報導，有證券經紀指港交所曾就成立仙股板向市場作出非正式諮詢，但經紀指出這建議將大大增加電腦系統的費用，可行性成疑，證券界仍傾向將仙股除牌。 - 霍廣文表示如勒令仙股除牌，投資者要買賣私人公司股份變現便極為困難，他們所受的損害更大，故香港不會仿效美國市場，要求仙股除牌。 - 一名經紀透露，仙股成交額備金有限，因此很難令他們支援仙股市場。 - 證券界人士指出，目前在市場上，針對仙股只有兩個考慮方案，第一個是除牌，第二個是正式成立仙股板。但是，對證券商來說，由於仙股成交額備金根本難以支援更改電腦系統的成本，更遑論賺取利潤，故證券行更改電腦的誘因甚少，亦因而並不熱烈支援仙股板。
2001/5/15	成報	「股市漫談」作者許照中認為除牌並非如洪水猛獸，只要有適當的善後安排，股民未必不會接受；相反，讓那些不符合資格的公司繼續掛牌，只有令更多投資者受到禍害。
2001/5/17	信報	沈聯濤表示由於是否需要強制要求仙股除牌的建議涉及修訂《上市規則》，最終需由港交所負責，並向市場作出諮詢。
	香港商報 星島	沈聯濤表示該會將與港交所討論公司除牌事宜，是否引入除牌機制需要諮詢市場意見。
	東方日報	<ul style="list-style-type: none"> - 沈聯濤表示會與聯交所商討除牌制度。 - 大福證券黃紹開指出，仙股問題雖有必要檢討，但是否要除牌則必須要諮詢市場意見，因除牌可能會令仙股股東不能再將股份買賣。
	太陽報 文匯	沈聯濤表示將與港交所研究公司除牌事宜，以配合提高公司管治的目標。

日期	報章	報導概略
2001/5/17 (Cont' d)	大公報	<ul style="list-style-type: none"> - 就設立除牌制度及仙股除牌事宜，沈聯濤認為需要先聽取港交所的看法，以及諮詢市場的意見。 - 另外，創業板上市委員會委員黃紹開表示，由於投資者對除牌機制甚為關注，他認為交易所亦會向市場進行諮詢及參考外國處理手法，但亦擔心仙股除牌不一定對投資者有好處。
	明報	沈聯濤指出，會就本港是否引入除牌機制及是否效法美國等地方引入除牌制度，與聯交所進行商討。
	成報	<ul style="list-style-type: none"> - 沈聯濤表示，該會將與港交所討論公司除牌事宜，而未來亦會諮詢市場意見。 - 對於設立除牌制，市場爭議性頗大，例如除牌的釐定各方人士均有不同意見，故推行有關制度確有難度。 - 目前市場對仙股除牌的建議一般都不大贊成，認為此對公司並不公平，主要公司股價未能反映公司盈利及公司管治水平等狀況，而股價低殘可能是受外圍因素或交投欠活躍有關，他們認為將仙股合併會較為恰當，相信若公司質素良好，股份合併反可增加公司股份流通情況。 - 普遍人士認為監管者應以彈性處理的方法，以考慮長期處於虧損的公司應否除牌。
2001/5/18	SCMP	<ul style="list-style-type: none"> - A low face value not only restricts liquidity in a company's shares but impedes its ability to raise money. - Chairman of the Hong Kong Institute of Investors, Ricky Tam, said a company must improve its business performance and could not only rely on share consolidation in an attempt to stabilize its share price.

日期	報章	報導概略
2001/5/18 (Cont'd)	SCMP (Cont'd)	<ul style="list-style-type: none"> - Ricky Tam said he had reservations about setting up a delisting mechanism in Hong Kong similar to that in NYSE which requires a stock having been traded at a price below US\$1 for more than 30 consecutive days to be delisted from the exchange. He said Hong Kong, unlike the US, had no active OTC market allowing investors to capitalize shares that had been delisted from the official exchange.
2001/5/19	深圳經濟日報	<ul style="list-style-type: none"> - 沈聯濤表示證監會將與港交所就香港是否引入除牌機制進行商討。 - 有專家提出，香港可以仿效美國納斯達克，採取強制仙股除牌的機制。按照納斯達克市場的條例，股價連續 90 日低於 1 美元水平的股份就要除牌。
	大公報	<p>創業板上市委員委員林雄不贊成將仙股除牌，因為對小股東並不公平，而且部分公司的業務必須經歷周期性上落，於一間公司面對低潮時將之除牌，並不公平。</p>
2001/5/25	東方日報	<ul style="list-style-type: none"> - 霍廣文表示，不會勒令仙股除牌，如勒令仙股除牌，投資者往往難以套現，可能所受的損害更大。 - 業界對除牌制度有不同的看法，有經紀認為除牌後對投資者更加不利，但亦有人認為仙股影響股市的健康發展，長遠而言應除牌。 - 大福證券銷售及研究部董事杜冠雄表示，不贊成仙股除牌的制度，認為此政策對小股東打擊甚大，因為公司一旦被撤銷上市地位，股東便會喪失僅有的套現機會，亦影響市場主導的原則。 - 杜冠雄亦認為若仙股除牌建議落實，有關方面須研究復牌機制，研究遭除牌上市公司可透過那些渠道復牌，還是需要重新申請上市；他又認為鼓勵上市公司合併股份較倣效美國勒令仙股除牌制為佳。

日期	報章	報導概略
2001/5/25 (Cont'd)	東方日報 (續)	<ul style="list-style-type: none"> - 新世紀證券董事岑偉納及信誠證券投資部經理連敬涵同樣認為股價不理想的股票應被除牌。岑偉納表示，長期不能改善業務的公司，不應有上市的資格，若果落實仙股除牌制度，可規定股價一仙維持在半年外，亦應考慮公司的業績，若仙股公司同樣連續虧損兩年，便應將其除牌。 - 連敬涵亦認為，仙股存在令股民不斷蒙受損失，有些股票在進行合股下，股價每每大幅下挫，最終受影響的是股民。雖然，勒令仙股除牌，或令投資者無法把股票套現，但仙股問題始終要解決。不過，連敬涵認為仙股除牌並非可行的解決方法，因為仙股的大股東可利用現時的合股方式，令股價不致於到達一仙水平，他建議考慮把市值低於二千萬元至三千萬元的公司除牌，而不應只看股價。
2001/5/31	東方日報	作者老周認為有股票的地方就會有「藍籌股」、「二、三線股」或「仙股」等。如果單純因為「仙股」而要除牌，以求淨化股壇，根本不切實際。
	大公報	鄺其志指出，該所正就上市公司的除牌機制進行全面性的內部研究，主要參考歐洲及美國的做法，預期數個月內可以完成有關報告。
	東方日報 蘋果日報 文匯報	港交所正參考國際上其他國家及地區對上市公司除牌的做法，並就除牌機制進行內部研究，而股價只是其中一個考慮的因素，估計新的機制需待幾個月後才能推出。
	信報	<ul style="list-style-type: none"> - 鄺其志在上海表示，港交所內部正研究主板及創業板的除牌機制，目前正在參考美國及歐洲證券市場的股票除牌機制。 - 港交所發言人解釋說，檢討企業除牌機制，關鍵在於平衡投資者的權益，准許原有投資者有較公平的退出機會，並同時保障小投資者的權益。

日期	報章	報導概略
2001/5/31 (Cont'd)	太陽報	港交所正檢討兩板的除牌機制，要求股價表現太差的公司除牌會是其中一個考慮方案。
	星島日報	<ul style="list-style-type: none"> - 鄭其志表示港交所正內部研究有關問題，計畫參考其他市場的做法，才對現時的制度作出修訂，但至少要數月後才有具體細節公佈，不過公司股價則會是其中一個考慮元素。 - 目前香港市場的除牌制度與美國納斯達克不同，後者是純以股價衡量，低過某個價格公司便要除牌，但香港則是以業務活躍度為準則作決定。
	經濟日報	<ul style="list-style-type: none"> - 港交所擬回應市場意見，研究上市公司除牌機制，並會參考歐美等海外市場，而股價偏低將為考慮因素之一。 - 除牌制度在海外市場並不罕見，美國納斯達克規定上市公司如連續 30 日股價低於 1 美元，便會受到交易所警告，90 日低於 1 美元則會被勒令停牌。 - 除牌制度的研究，為港交所與證監今年全面檢討「上市規則」工作的一部分，鄭其志稱，檢討結果將於數個月內公佈。
	大公報	<ul style="list-style-type: none"> - 港交所正研究的除牌機制，可能會參照其他地區，包括美國及歐洲市場的做法，有關檢討過程中，股價過低亦會一併成為考慮因素。 - 部分業內人士認為應把股價表現不理想的公司，列入監管範圍內；但亦有人表示，這反而會對小股東不利。 - 譚紹興表示，除以企業股價及業績等表現來評估除牌與否，亦應根據公司市值來決定除牌問題。在實行除牌制度時，可參照美國市場，為被除牌的公司提供另類市場，好讓有問題公司能繼續進行買賣，不致令投資者蒙受損失。 - 富昌證券總經理藺常念贊成檢討現行監管制度，讓投資者得到保障，又可避免有公司不停

日期	報章	報導概略
		在市上集資「吸水」。

日期	報章	報導概略
2001/5/31 (Cont'd)	大公報 (續)	<ul style="list-style-type: none"> - 東泰證券鄧聲興卻認為實行除牌制度可能會令投資者所持有的股份變成「一張廢紙」。他亦認為以股價來衡量一家公司的經營狀況並不恰當，彈性處理才是有效方法。
	東方日報	<ul style="list-style-type: none"> - 鄺其志在上海出席研討會時表示，正就上市公司的除牌機制進行全面內部研究，主要將參考歐洲及美國的做法。 - 深滬股市新設的除牌機制，提醒人們注意到除牌機制的實效。有了除牌機制以後，上市公司有限期改善經營的壓力，不會像香港一些上市公司，不理經營如何只會一味在股市集資得過且過。
2001/6/1	香港商報	港交所鄺其志在上海一個會議中指出港交所正就上市公司的除牌機制進行全面性的內部研究，主要參考歐洲及美國的做法，預期數個月內可以完成有關報告。
	星島日報	<p>「謫仙記」專欄:-</p> <ul style="list-style-type: none"> - 在除牌機制上香港較美國及內地落後。 - 香港交易所正研究除牌機制。 - 時富證券董事許雪明認為除牌制度對仙股公司具積極作用，建議港交所可規定掛牌公司的盈利如果在一定時期，如過去三年都出現虧損時，便應除牌。
2001/6/2	星島日報	鄺其志重申應市場需要，港交所正研究除牌機制。
	東方日報	鄺其志表示有關除牌機制會快將諮詢市場意見。
	經濟日報 成報	鄺其志表示香港交易所正就除牌機制進行內部研究。
2001/6/15	太陽報	香港交易所正研究現有除牌機制，考慮細價股是否有被除牌的需要。
	蘋果日報	<ul style="list-style-type: none"> - David Webb 反對細價股除牌機制，認為香港交易所會逼使上市公司合併股份。

日期	報章	報導概略
2001/6/15 (Cont'd)	蘋果日報 (續)	- David Webb 不贊成香港市場採用類似美國市場的除牌制度，要求股價持續一段時間在低位徘徊的上市公司除牌，反而港交所應運用權力，要求仙股把股份合一，如 10 合 1，令股份能夠易於買賣，硬性要求仙股除牌最終只會令投資者受損。
2001/7/3	蘋果日報	社評認為引入除牌機制及莊家制可增加交投量。
2001/7/27	經濟日報	聯交所計劃發表除牌機制諮詢文件。
2001/7/30	大公報	「文鋒」建議創業板引進除牌機制，以改善上市公司質素。
2001/8/1	經濟日報	財政司司長在今年 3 月發表的預算案中，特別指出提高本港公司管治水平，是鞏固國際金融中心地位的重要措施。
2001/9/5	信報	證監會企業融資部執行董事冼達能表示證監會亦關注本港公司管治水平，例如建議主板公司公佈季度業績，以增加透明度。此外亦考慮本港是否需要訂立除牌機制。
2001/9/22	成報	黃國英指「仙股」數目急漲有損金融中心形象；新股上市之時，不應訂價過低，港交所應處理。
2001/10/29	東方日報	作者老周認為聯交所有必要重新制訂一套適時除牌制度，以求保障小股民利益。好似美國納斯達克市場咁樣，當上市公司股連續 30 個交易日收低於 1 美元水平以下者，將會被除牌，交易所方面大可以考慮下呢個規則。
2001/12/7	東方日報	中國證監會日前推出新的除牌制度，凡連續虧蝕三年嘅公司都將被即時停牌，有關公司會有半年時間進行重組，若然仲未得到改善將被即時除牌。本港上市嘅 H 股中，大部份都有發行 A 股，雖則話 A 股、H 股屬兩種不同「產品」，但終歸係涉及同一間公司，若然其 A 股被除牌，將大大打擊其 H 股嘅表現。老周認為，本港監管機構應該制訂一套相關措施。
2001/12/21	東方日報	港交所還提出其他計劃，其中包括檢討除牌程式及檢討有關海外發行人之上市規則等。

日期	報章	報導概略
2001/12/21 (Cont'd)	大公報 太陽報	交易所計劃明年推出現貨市場遙控交易設施，並會檢討買賣單位機制、除牌程式及上市規則等。
2002/1/9	信報	香港創業板在大力引入內地民企上市的同時，也應該引入除牌制度——大陸股市已經實行除牌制，規定一段時間內仍未錄得盈利的公司必須出局，在這方面香港似乎還未及得上內地。
2002/1/22	太陽報	《在商言商》作者認為提升企業管治的建議其實已有不少，例如仿照美國市場訂出更嚴厲的除牌機制、推行投資者集體訴訟等，做到既有監管機構的監督、亦有市場力量的制衡，才可從多方面保障小投資者利益。
2002/3/15	蘋果日報	證監會執行董事歐達禮出席立法會討論公司管治的會議時，透露為回應投資者的關注，證監會屬下股東權益小組曾討論「仙股」及將問題公司除牌的問題，希望瞭解公眾意見。
2002/4/15	信報	<ul style="list-style-type: none"> - 市場人士建議效法美國及中國引入除牌機制，剔除素質差和連續數年虧損的公司。 - 中大郎咸平認為應引入除牌機制及引入一個二等市場。
2002/4/18	星島日報	<ul style="list-style-type: none"> - 證監會股東權益小組於 2002 年 3 月的第 5 次會議上討論有關「仙股」事宜。 - 陳永陸表示推行除牌機制會遇上不少阻力。 - 大福李耀榮認為除牌機制會令小股東「無仇報」。
	南華早報	<ul style="list-style-type: none"> - 港交所正研究有關除牌機制。 - 證監會股東權益小組於 2002 年初曾討論有關「仙股」事宜。
	明報 經濟日報	港交所行政總裁鄺其志指出港交所內部正進行一項研究，考慮收緊現有的上市資格，包括引入持續上市的要求，以及設定最低股價要求，若公司股價長期處於這水平下，便會被除牌。

日期	報章	報導概略
2002/4/19	東方日報	<ul style="list-style-type: none"> - 作者老周認為實施「仙股」除牌制，令小股民有仇有得報，無疑係本末倒置，利己不利人。 - 若非針對「仙股」，長遠而言設立除牌機制亦有其理。
2002/4/20	東方日報	《產經》認為香港股市有充當購併仲介的條件，但也要藉退市機制，平衡投資者的過度風險。
2002/4/23	信報	作者強烈呼籲港交所和監管機構早日引入「除牌機制」以保護小股東的利益和避免浪費資源，更希望港交所在修改《上市規則》除牌機制的同時引入「供股和配股機制」，防止公司利用上市的合法地位連續以供股或配股之名，榨取小股東利益並延長其除牌的命運。
2002/4/29	成報	作者黃國英支援交易所引入除牌機制，但認為以股價作為除牌機制可能並不適宜。
2002/5/2	成報	作者許照中認為經營不善的仙股公司損害了本港作為國際金融中心的形象，應引入更嚴厲的措施如除牌制度。
2002/5/3	蘋果日報	陳永陸認為除牌機制不是隨便推出，因為當中涉及很多技術上問題，而且還需要不少配套措施加以配合，因為除牌基本上是沒有涉及任何價值的交易，假若某公司被剝奪上市資格，小股東基本上沒有任何得益。
2002/5/5	新報	香港交易所高層正式宣告正為長期低於一仙的「仙股」公司研究除牌退市方案。
2002/5/6	信報	《經濟評論》認為退市並不是最終目的，而是確保上市公司總質量的必要途徑。
2002/5/11	信報	港交所應考慮為質素差的創業板公司引入除牌機制，把創業板及主板的低質素公司放到另一個市場，提高主板創業板的質素。
2002/6/4	信報	專欄「米松」指股市有太多「仙股」，港交所及證監會對「仙股」的情況視若無睹。

日期	報章	報導概略
2002/6/10	大公報	港交所鄺其志首次證實檢討除牌制度，以及全面檢討創業板上市條例，期望在條例進一步完善配合下，市場有更佳發展。
2002/6/12	蘋果日報	港府發言人就證監會法規執行部前任高級總監彭張興致函財政政司司長梁錦松表示已採取一系列措施加強法規的內容及執行，並密切關注市場發展，確保公司管治達到國際水平，其中港交所將於未來兩個月，就引入除牌機制及處理仙股問題諮詢市場。
	經濟日報	港交所稱本港主板及創業板上市規則部分要求較英、美市場更嚴謹。交易所亦計劃在未來兩個月內就除牌機制發出諮詢文件。
	The Standard	<ul style="list-style-type: none"> - 證監會的股東權益小組(Shareholders' Group)曾討論將仙股除牌的可行性。 - 香港交易所表示將發出有關除牌機制的諮詢文件。
2002/6/13	The Standard	<ul style="list-style-type: none"> - 聯交所預計將於兩個月內發出有關除牌制及仙股的諮詢文件。
	星島日報	<ul style="list-style-type: none"> - 市場反對以股價高低決定是否除牌的建議。
2002/6/15	明報	香港交易所考慮在一兩個月發出除牌的諮詢文件
2002/6/17	大公報	「文鋒」建議可引入退市機制及把連續三年虧損的公司除牌。
	南華早報	鄺其志表示將於下月發出有關除牌的諮詢文件。
	經濟日報	鄺其志表示研究除牌已到最後階段，正與證監會一起審議諮詢文件草案，相信於短期內發表。鄺氏說會參考海外市場，將股價持續低於某水平股份或連年虧損的公司除牌。他並認為只要除牌機制的期限清晰，投資者在公司除牌前已有足夠時間決定是否沽貨套現。

日期	報章	報導概略
2002/6/18	南華早報	<ul style="list-style-type: none"> - 香港交易所將發諮詢文件建議令表現差的上市公司更容易被除牌。 - 證監會研究員 Geng Xiao 及 Yuhong Yan 表示市場充斥細價股是由於本港欠缺除牌機制及最低股價限制。他們表示一些表現差的公司可能將股價維持在一個低水平，藉以增加流通量及吸引無知的投資者。 - 部份經紀及基金經理擔心小投資者難售出手持的股份，但亦有經紀表示支援引入除牌機制，以提高上市公司的質素。
2002/6/21	經濟日報	葉澍堃表示香港交易所及證監會將為上市公司除牌機制進行市場諮詢。
	明報、 東方日報	葉澍堃表示香港交易所快將推出上市公司除牌諮詢文件有助加強本港的企業管治水平。
	新報	美國市場有 OTC，讓那些被除去上市地位的公司股份持有人可經場外市場將手上股份沽出。
2002/6/23	蘋果日報	信誠證券連敬涵指內地一早有除牌制度，本港仍處於建議階段，希望當局盡快推出除牌制度。
2002/6/24	信報	鄭其志表示除牌制的其中一個研究方向在於強制要求「仙股」合併，提高仙股的透明度，不少經紀反對強制仙股合併，認為對保障小投資者權益無助。
	蘋果日報	黃國英認為引入除牌制度應值得考慮。
	信報	「港交所擬強制合併仙股券商反對」不少經紀反對強制仙股合併，擔心若引進仙股合併，會令小股東損失更多，無助保障小股東權益。
2002/6/26	星島日報	<ul style="list-style-type: none"> - 市場向港交所反映強制仙股合併不能解決問題，亦不能保障投資者利益。 - 港交所現行交易系統對一仙以下的股份交易欠效率及透明度。

日期	報章	報導概略
2002/6/26 (Cont'd)	星島日報 (續)	<ul style="list-style-type: none"> - 港交所的構思是把股份多以合併後不斷打回原形，而又缺乏實質業務的仙股公司除牌，並縮短現有問題公司除牌程式時間。 - 自今年初起，港交所已就此與市場進行商討；市場亦多已反映仙股合併並不能解決問題，除牌對股民並非好事。
2002/6/28	上海證券日報	鄺其志表示將於兩個月內發出除牌及仙股諮詢文件。初步傾向縮短現有問題公司除牌程式時間。
2002/7/3	信報	香港交易所正研究修訂《上市規則》並在短期內就新的上市公司除牌機制諮詢市場。
2002/7/17	南華早報	<ul style="list-style-type: none"> - 港交所引入嚴格「除牌」機制及「仙股」合併機制。 - 有關諮詢於 7 月 18 日於上市委員會討論，通過後將於稍後發表，此做法可避免分析員指控港交所只顧增加上市公司數目的說法。
2002/7/18	經濟日報	<ul style="list-style-type: none"> - 陳永陸認為界線如定 1 角較適合。 - 消息人士指若界線定於 1 角或 2 角未能反映香港為世界級股票市場。 - 監管機構曾考慮以 1 元為分界線。
	南華早報	<ul style="list-style-type: none"> - 港交所計劃要求 5 角以下股份合併，一般認為 1 角以下才是「仙股」。 - 上市委員會成員表示建議嚴格，但委員會將通過文件予公眾諮詢。
2002/7/19	南華早報	<ul style="list-style-type: none"> - 上市委員會成員通過建議，經紀及議員支援計劃但擔心建議步伐太急。 - 張華豐指有需要引入規定將「仙股」合併，但若影響超過半數已上市公司將為市場帶來不穩定因素。張指若 1 角為界線，75 家上市公司受影響。 - 民主黨單仲偕指界線應定為 1 角。

日期	報章	報導概略
2002/7/19 (Cont'd)	星島日報	<ul style="list-style-type: none"> - 詹培忠認為監管機構提出有關建議態度上是正確，但市場更關心公司質素問題。 - 專欄「芝芝」支援強制合併的建議。
2002/7/21	新報	<ul style="list-style-type: none"> - 專欄「北野」指港交所應早強制合併「仙股」。
2002/7/22	蘋果日報	<ul style="list-style-type: none"> - 鄧聲興指強制細價股合併並非良策，反而有機會導致這些股份交投下降。
2002/7/25	星島日報	<ul style="list-style-type: none"> - 專欄「芝芝」指「仙股」除牌機制必須構思成熟，不然會令大股東趁機以低價回購資產。
	大公報	<ul style="list-style-type: none"> - 港交所改革大方向正確，但強制「仙股」合併為市場帶來憂慮。

(Source:- HK Ex)

26 July 2002

Highlights of media reports on penny stocks and delisting

Date	Media	Highlights
26/7/2002	Majority of media	<ul style="list-style-type: none"> - HKEx consultation paper suggested Main Board stocks valued below \$0.50 for 30 consecutive days should be delisted. - Kwong Ki-chi said Nasdaq also had similar minimum share price requirement. - Kwong Ki-chi said there would be a 12-month transitional period for companies to raise their share price to the minimum level, and consolidating shares was one way. HKEx had no intention to establish a new board for delisted shares. - Karen Lee said there were 386 listed companies with share prices under \$0.50. Such companies would not be delisted if their share price bounced back to over \$0.5 and remained at over \$0.5 for the following 60 trading days. - The SFC research paper pointed out Hong Kong had a higher percentage of penny stocks than other cities.
	HKEJ	<ul style="list-style-type: none"> - Francis Leung regarded the requirement of consolidating shares valued below \$0.5 as a numeric game only. - K S Lo said investors would be more disadvantaged if penny stocks were delisted. - The SFC's Director of Corporate Finance Division, Laurence Li, said there was an urgent need to establish an effective delisting mechanism.

Date	Media	Highlights
26/7/2002 (Cont' d)	HKET	<ul style="list-style-type: none"> - Enron issue prompted the HK SAR Government and the SFC to pay attention to badly performing companies. - The HK Government was aware of market opinions over the past year about the maintenance of the listing status of penny stocks - People familiar to the situation said the minimum share price for a delisting mechanism had been discussed before among regulators - HK Stockbrokers Association's Wilfred Wong said whether the share price threshold should be fixed at \$0.5 was worth considering, and whether investors had the chance to exit the market should also be considered. - PWC's partners wondered if the market would be misled about the quality of listed companies if the proposals affected more than half of listed companies. - Sun Hung Kai Securities' 譚秉松 said consolidation allowed penny stocks to escape being delisted. - Some minority shareholders worried that share prices would keep on falling even after the share consolidation.
	Ming Pao	<ul style="list-style-type: none"> - Tang Sing Hing said it was inappropriate to regard \$0.50 as the divider because the most volatile stocks were those under \$0.1. - Tai Fook's Wong Chung Man agreed it would be better to set the price level at \$0.1. - Ricky Tam said although the US also had a delisting mechanism, they also had an OTC market. However, Hong Kong did not have an OTC market, putting investors at a disadvantaged position. - Some feared that the \$0.50 delisting mechanism would be abused. - Li Kam said consolidating shares would increase the cost of market and it was believed that this would affect the turnover of the local market. - K S Lo hold reservations about the proposal and thought delisting penny stocks would be more hurt for investors.

Date	Media	Highlights
26/7/2002 (Cont' d)	Ming Pao (Cont' d)	<ul style="list-style-type: none"> - Securities participants generally agreed that \$0.50 was too high and would increase the difficulties of small brokers. - David Webb said the SFC should be responsible for the delisting mechanism proposal.
	Apple Daily	<ul style="list-style-type: none"> - More than 100 penny-stocks would be delisted when the delisting mechanism is implemented in the first quarter next year. - Chim Pui-chung said setting the minimum share price at \$0.50 and banning listed companies from issuing new shares under the general mandate at less than \$0.50 would help to protect investors. - Cheung Wah-fung said \$0.50 was too high but requiring shares under \$0.10 to be consolidated was acceptable. He believed the new rule could reduce the opportunity of major shareholders to take advantage of minority shareholders.
	Oriental Daily News	<ul style="list-style-type: none"> - An SFC survey showed that 107 listed companies had a share price below \$0.50, about 14 per cent of the total number of listed companies. The survey also pointed out that the ratio did not comply with international standards. - Wilfred Wong worried that it was difficult to sell shares of due to be delisted. - Executives of listed companies said companies needed time and capital to consolidate shares, as share prices would continue to drop after share consolidation. - The financial editorial criticised that the delisting mechanism as too harsh and described it as good thing turned bad.
	The Sun	<ul style="list-style-type: none"> - Some market participants expected that implementation of the delisting proposal would trigger a massive penny-stock consolidation and sell-off.
	Sing Tao	<ul style="list-style-type: none"> - Market participants likened the delisting mechanism to giving small investors the death penalty. If the delisting proposal is to be implemented, it would possibly trigger a massive penny-stock sell-off.

Date	Media	Highlights
26/7/2002 (Cont' d)	Sing Pao/ Hong Kong Daily News	<ul style="list-style-type: none"> - Corporate finance participants said delisting mechanism could help tightening regulation, but it was too harsh on penny-stocks. A trend of share consolidation would emerge. - Professionals in Corporate Finance sector agreed that the delisting mechanism could strengthen regulations to listed companies. However, it was too harsh for delisting of penny stocks. It was expected there would be a lot of shares consolidation exercises.
	Hong Kong Commercial Daily	<ul style="list-style-type: none"> - Frederick Ma said the HK\$0.5 threshold should be determined by market participants and investors should not be too short-sighted. Ma said he did not agree that it was inappropriate for HKEx to have chosen to publish the Consultation Paper when market conditions at the time was poor, thereby increasing market uncertainty. - The editorial said investors' interests should be considered in introducing the delisting mechanism because small investors only selected low price shares. Besides, the new rules would scare off mainland investors if the coverage is too extensive.
	Ta Kung Pao	<ul style="list-style-type: none"> - Wu Man-ching said share prices did not reflect the performance of listed companies. - Trini Tsang said HK\$0.1 was a more appropriate threshold and HK\$0.5 was too high. - Frederick Ma said the consultation paper would help improve corporate governance standards. - The editorial said the consultation would have a negative effect on the market.
	SCMP	<ul style="list-style-type: none"> - Ernest Ip of PWC said the proposals were too harsh and they would cause a lot of listed companies to be delisted.

**Job Description of the Secretary for
Financial Services and the Treasury**

The duties of the Secretary are –

- (1) to gauge public opinion and respond to the needs of the community;
- (2) to set policy objectives and goals, and develop, formulate and shape policies;
- (3) to assist the Chief Executive in policy making as members of the Executive Council;
- (4) to secure the support of the community and LegCo for their policy and legislative initiatives as well as proposals relating to fees and charges and public expenditure;
- (5) to attend full sessions of LegCo to initiate bills or motions, respond to motions and answer questions from LegCo members;
- (6) to attend LegCo committee, subcommittee and panel meetings where major policy issues are involved;
- (7) to exercise the statutory functions vested in him by law; and
- (8) to oversee the delivery of services by the executive departments under their purview and ensure the effective implementation and successful outcome of policies.