
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

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- (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;

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- (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.