Private and confidential

11th December, 2003

by post

Financial Services Branch
Financial Services and Treasury Bureau
18th Floor, Admiralty Centre Tower 1
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Hong Kong

Attention: Proposals to Enhance the Regulation of Listings

Dear Sirs,

Response to the Consultation Paper on the Proposals to Enhance the Regulation of Listing

Thank you for sending us a copy of your consultation paper.

Before answering the specific questions raised in the paper, we would like to make a number of general observations on the context which we believe any effort to upgrade the quality of our securities markets should be made. For ease of reference, figures in square brackets are the relevant paragraph numbers in the Consultation Paper.

Regulation cannot eliminate country risk: As the consultation paper recognises, Mainland issuers "will continue to be a major growth driver" [para 1.2] in the future. The large majority of these companies have no commercial presence in Hong Kong and their executive directors are generally not resident here. Investors in these companies cannot expect that our laws and regulations which are unenforceable in the Mainland can regulate these companies effectively. Nor should our regulations give the appearance that there is an effective enforceable regulatory regime which places these companies on an equal footing to Hong Kong controlled or managed companies. In the final analysis, investors in Mainland issuers are, therefore, reliant on Mainland laws, regulation and business practice. Asia Pulp & Paper, Asia's largest insolvency to date, provides a useful example of this. It is a Singapore incorporated company which was listed in New York. Neither the listing nor the country of incorporation has provided a practical protection to outside shareholders or creditors. The risks ultimately were always those of an Indonesian owned business concern with assets almost exclusively in Indonesia and China. The listing and country of incorporation, both of which appeared to offer "badges of quality" [3.17(b)] only served to reduce the perception by international investors of that risk but not the actual risk of their investment.

Improvement in regulatory standards: Over the past decade there has been a considerable increase in the quantity of regulation and the powers available to regulators. Despite this, it is questionable how effective this regulation has been over the period. Enormous effort is directed towards vetting documents with the unfortunate consequence that documents

published in Hong Kong and, in particular prospectuses supporting new issues, fall well below international standards. Concerns over smaller capitalised companies would suggest that the authorities consider that for many companies corporate governance in this sector also falls below acceptable standards. If anything the economic difficulties since 1997, pressure on margins in the contract manufacturing sector and the sheer scale of speculative investment in the Mainland over the past ten years have made matters worse. The direction of regulation has been to concentrate more of its resources to investigate and punish, rather than using its persuasive powers to curb unacceptable practices and dubious transactions before they had been effected which was much more in the style of the previous office of the Commissioner for Securities. Obviously, the task has become more difficult with the increase in the number of listed companies and the location of their assets. However, it does not appear that for many companies standards of behaviour have improved with greater regulation and greater regulatory powers.

As set out later in our response we are not in favour of the SEHK's Listing Division retaining a regulatory role, but if it is to do so and the Consultation Paper appears to support the SEHK in this, we believe that serious effort must be devoted to improving its performance, rather than relying on the announcement of initiatives which are then not implemented such as the initiative apparently announced by the SEHK in June, 2003 and referred to in the Consultation Paper [1.3]. Aspirations to keep pace with the best international standards [Executive Summary 2] will not be achieved unless the quality of our regulation is maintained at that standard. Accordingly, we would suggest that consideration be given to:

- instituting formal training for personnel in the SEHK's Listing Division. In the past, the SEHK has placed too much emphasis on unstructured on the job training, unlike the SFC. We believe that the only way to achieve consistency in how listed issuers are regulated is for the underlying principles of the Listing Rules, the interpretation of these rules and departmental practice, and the regulatory framework in Hong Kong to be formally taught to all those employed in the SEHK's Listing Division. Effective training would also help the SEHK to be an agent for improving standards of practitioners generally, an issue which is also a matter of legitimate concern;

- conducting a thorough review of the Listing Rules, an exercise which has not been carried out since they were adopted in December, 1989, some fourteen years ago. Additions, policy changes and departmental practice have caused inconsistencies which should be removed. Further the rules and their interpretation should be made fully consistent with their underlying general principles;

- examining the composition of the Listing Committee when it hears certain matters. Much is made in the Consultation Paper of the vital role played by the "market savvy" of the Listing Committee [3.17(c) and elsewhere]. This may be valuable in assessing the suitability of an applicant for listing. However, in disciplinary matters and in matters concerning the interpretation of Listing Rules, it is essential that a majority of the Committee have a working knowledge of the Listing Rules gained from their own professional practice;

- insisting that all Listing Committee decisions and important Listing Division rulings are

published in detail so that a body of precedent can be established in the same manner as the decisions of the Takeovers Panel and the market can be properly informed. It would also improve the decision making process of the Listing Committee; and

– providing better support and guidance to issuers and their advisers. At present Hong Kong is the logical place for Mainland issuers to attract foreign investors and foreign currency investment. This is unlikely to persist. At some time in the future the Mainland capital markets are likely to be permitted to attract foreign investment on a much greater scale than is now allowed. This will certainly arise if and when the Yuan becomes freely exchangeable. At that time, the future of the SEHK and the many people who earn their livelihoods by it will depend not only how it is regarded by international investors but also how it will be regarded by issuers and their advisers. This in turn will dependent on how helpful and efficient the SEHK is perceived to be by issuers, both actual and potential. Little attention has been given to this important aspect of enhancing the position of our capital market in China. Indeed, much effort is directed towards preventing Mainland businesses listing through the reversal of their businesses into small capitalization stocks through the operation of the "back door" listing guidelines. To the extent we fail to attract as many Mainland issuers as we can and encourage them to stay listed here our equity capital market will have a much less certain future.

Human resources available to regulate the securities market in Hong Kong. A matter that has not been addressed in the Consultation Paper is the availability of suitably experienced, trained and motivated people to regulate the securities market in Hong Kong. Intuitively we would have thought the available supply locally of high calibre staff was limited. If we are correct in this, prudence would suggest that these resources should be deployed as effectively as possible. It would also point to a single regulatory structure, rather than two partially overlapping regulators.

The findings of the Expert Group

We would also wish to make the comment that much of what is covered in the consultation paper has been addressed in detail in the Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure. The Expert Group undertook a wide consultation of interested groups. We believe that the findings and recommendations of the Expert Group's report received wide spread support. Mr. Cameron, the Chairman of the Expert Group stated that "The Group is strongly of the view that the interests of Hong Kong will be best served by the Government taking an early decision to implement these proposals. There has already been widespread consultation……" The Expert Group recommended, among other things, that the listing function should be moved from the Exchange to a new division of the SFC and that the Listing Rules should have statutory backing to ensure their effectiveness but should remain non-statutory. In our view the Expert Group's Report was a carefully prepared and considered document and it was initially supported by the Government and the SEHK which stated publicly that it would work to implement its recommendations.

Whether statutory backing should be extended to other requirements of the Listing Rules

The powers of the SFC have been substantially increased with the commencement of the SFO in April, 2003. The dual filing system gives the SFC considerable powers to prosecute companies which misbehave and the Market Misconduct Tribunal also has wide powers to investigate and punish. It is difficult to conceive of a serious breach of the Listing Rules that did not involve the deliberate disclosure of false or misleading information, undisclosed trading in shares or trading in shares in advance of the publication of price sensitive information as serious breaches of the rules almost invariably involve dishonesty. Much has been made in public statements of the inability of the dual filing system to punish failures to disclose at all. However, examples of this type of breach of the Listing Rules is hard to find. In our experience, failure to make announcements under paragraph 2 of the Listing Agreement is usually accompanied by failures to make adequate disclosures in response to the Listing Division's enquiries in compliance with the requirements of paragraph 39. Accordingly, it would appear that the SFC has sufficient power presently to penalise those who commit serious breaches of the Listing Rules. Further, until the effect of these new powers have been established through practice, it would be premature to introduce new powers. We would also add that, in addition to the penalties set out in the SFO, persons who conspire to defraud the SFC by providing it with false information face the risk of criminal prosecution for which heavy custodial sentences can be given.

No mention is made in the Consultation Paper of the alternative suggestion made by the Expert Group at paragraph 3.47 of its report. Under this alternative, were the regulatory function of the SEHK to be transferred to the SFC, the Listing Rules would take on the same status as the codes and guidelines that the SFC may publish under section 399 of the SFO. This will allow the Listing Rules to remain non-statutory so that they could be changed in response to developments in the market. As a statutory regulator, the SFC will have the statutory power of investigation and obtaining evidence under the SFO in dealing with suspected breaches of the Listing Rules and will have access to the sanctions available to it under the SFO to punish offenders. As the Expert Report states [op. cit] this "will greatly improve the regulatory regime's effectiveness and credibility. The range of sanctions for breaches under this option may be more restricted than would be desirable and the limitation of the dual-filing system …… will remain unaddressed, but it has the advantage of being available immediately." Were the decision be made to move in the direction of a statutory listing rule regime, we would be supportive of this alternative. We would also add it would be a structure with which the SFC already had considerable experience through its administration of non-statutory codes.

Although the Consultation Paper envisages an overlap between the SFC and the SEHK in the administration of statutory listing rules [2.26] and is supportive of it, we believe that, were statutory listing rules to be introduced, the argument for retaining a regulatory function at the SEHK will become untenable.

If a number of the rules contained in the Red Book were to be given statutory backing, we believe these would cover the timeliness and accuracy of information published to meet the general principles set out in Chapter 2 of the Listing Rules, being the obligation of directors

under paragraphs 2, 3, 14, 15 and 16 of the Listing Agreement. Statutory backing may also be given to the rules relating to the time when an issuer is required to announce its results contained in paragraphs 10 and 11 of the Listing Agreement and the contents of results announcements and financial statements set out in Appendix 16 of the Listing Rules.

The Consultation Paper asks what kinds of sanctions should be available for breaches of the statutory Listing Rules. While we are not in favour of the introduction of statutory listing rules for the reasons stated and in turn any additional penalties, we believe that for civil proceedings the penalties should be in line with those available to the Market Misconduct Tribunal as suggested in the Consultation paper [2.43] and for criminal penalties they should be the same relative severity as those penalties for criminal offences set out on the SFO.

We would not support over reliance on subsidiary legislation to give statutory backing to the listing rules. If it were to be decided to introduce statutory listing rules this would represent a significant extension of statutory regulatory powers which should be subjected to the full legislative process. Accordingly, the balance between primary and subsidiary legislation set out in paragraph 2.25 of the Consultation Paper appears to be acceptable.

There is one aspect of statutory regulation which concerns us and which is not mentioned in the Consultation Paper. Hong Kong already has an unusually high proportion of its economic activity represented by listed companies. This has been a product of the development of a reasonably sophisticated infrastructure to promote capital raising through a public market and the limited involvement of the government in providing infrastructure and utility services. As the Consultation Paper recognises, the composition of the SEHK is likely to alter markedly in the future with the preponderance of new listings coming from both the private and the state sectors in the Mainland. It can be expected that an increasing number of Hong Kong listed companies will have no significant management presence in Hong Kong or any significant business activity or assets here. In these circumstances, the courts in Hong Kong have no ability to compel such businesses or businessman to obey the laws of Hong Kong. The SFC is alive to these difficulties which is why it has not attempted to investigate matters which have occurred almost exclusively in the Mainland. For these listed Mainland companies adherence to a statutory regime is in effect a voluntary matter. In these circumstances, we are uncertain whether it is necessary to increase the regulation of Hong Kong residents and residents of friendly jurisdictions by introducing listing rules with statutory backing which it is known will not to apply in extremis to Mainland issuers on the SEHK.

This also introduces another difficulty in “benchmarking” the SEHK [Executive Summary] with other international exchanges. In practical terms Hong Kong cannot enforce its requirements on Mainland issuers. The behaviour of these issuers will more likely to be determined by the way they choose to behave in order to raise funds on an international capital market or on the political, legal and regulatory regime in the Mainland.

Possible models of regulatory structure

Model A – Transfer of listing functions to a new division set up under SFC

The arguments in favour of Model A are succinctly put in the Consultation Paper. The regulation of listings by a department of the SFC would remove any overlap and duplication between the SFC and the SEHK's Listing Division; place regulation of listed issuers and their financial advisers under one regulatory body; remove any actual or perceived conflict of interest; facilitate cooperation with the CSRC; and retain for the exchange the final decision on which issuers it will admit for listing. On this latter point, we would envisage that the power to deny a listing of a company which had fulfilled its statutory listing requirements would be exercised only in the most exceptional circumstances. This would follow the model of the Australian Stock Exchange. We would also add that regulation by listed issuers undertaken by one statutory body would be in line with international practice (Annex A, where each jurisdiction selected has a single regulatory structure).

The arguments against the adoption of this conventional model in Hong Kong are stated to be an over-concentration of powers under the SFC, the insufficient "market savvy" of the SFC and the stifling of market innovation. We answer these in turn:

- the risks of over-concentration of power in the SFC: If there are risks of the abuse or over-extension of power by one regulatory agency, it should be addressed by the introduction of sufficient checks and balances. Indeed, it could be argued that the powers available to SFC are excessive given the very broad wording of the SFO and for most people the cost of challenge or redress is beyond their means. However, the Consultation Paper makes no proposal to reduce the powers of the SFC in any way or to increase the supervision over it. The SFC through the dual filing system has a veto right on listings; a power it did not enjoy in practice previously. The separation or duplication of certain powers, which the Consultation Paper supports, does not of itself effectively reduce the abuse of power; it simply allows more than one party the opportunity to abuse it;

- insufficient "market savvy" within the SFC's staff. We do not believe this is a legitimate concern. The Listing Division has little, if any, "market savvy", if by that expression it means a knowledge and understanding of the commercial rationale of a transaction and its financial and stock market consequences. As the Consultation Paper notes [3.27(b)], the business and professional experience of the Listing Committee could be easily replicated by a committee under the SFC. Indeed, it already has in the guise of the Dual Filing Advisory Group; and

- the risk of over regulation and the stifling of innovation. A dual regulatory system with an overlapping jurisdiction is much more likely to be the cause of over regulation than a single regulatory structure. In fact it is the most likely consequence of an overlapping dual regulatory structure. As we have already stated the SFO has given the SFC a much greater ability to interfere in the listing process, a power which it is exercising much more frequently than in the past. This has placed a restriction on the ability of the SEHK to innovate if by this it is intended to allow a greater access to the SEHK's trading platform by making admission easier. Further there is no evidence that the Listing Division is more innovative than departments within the SFC. The regulation of listed issuers by the SFC will not hamper the SEHK from introducing new products and, if the differing approach to the revision of the Listing Rules and Takeovers Code is

any guide, the Corporate Finance Division of the SFC has been more responsive to market developments than its counterpart in the SEHK.

Finally we would draw your attention to paragraph 49 of the Expert Group's report which states that "with the exception of those who have an obvious and understandable interest in the continuation of the status quo, there is an overwhelming consensus that the HKex should be released of its listing responsibilities and freed up to concentrate on its commercial activities."

Model B: Transfer of Listing functions to a new HKex subsidiary

If the issue is the actual or perceived conflict of interest of the SEHK's Listing Division owned by a commercial enterprise, we do not believe artificial structures such as the one suggested will effectively address the problem. Further, we doubt whether the Listing Division would accept in any other listed issuer that a wholly owned subsidiary which had a separate board but one appointed by its holding company and with budget determined by its holding company would be sufficiently independent of its holding company or those who control it to fall outside the ambit of the connected transaction rules. Were these arrangements to address effectively the conflict of interest issues and create a Listing Division which was demonstrably independent of the HKex, we wonder what would motivate the board of HKex to agree to such a structure when it would be assuming the reputational risks of providing an important regulatory function over which it had no effective control. Furthermore this structure was specifically considered by the Expert Group, which rejected it for the reasons given in paragraph 2.38 of its report which states that "the proposal does not go far enough to address existing concerns. The delegation of powers to part-time volunteers has proven difficult in the past and would continue to be problematic in the proposed structure. The perceived conflict of interest issue would not go away and the endeavour to upgrade the professionalism of the process would not necessarily be assisted."

Model C: Transfer of listing function to a new statutory authority independent of both SFC and HKex

The option is obviously wasteful as it would, amongst other things, replicate the investigation capability of the SFC. It also envisages information sharing and other duplications between it and the SFC. Were such a body to be established by statute, reporting to the Government, we see no justification for the HKex to have any input in the appointment of members of its board.

Model D: Expanding the "dual filing" system

This model is basically the retention of the situation as it now exists. To the extent the present system is regarded as a success, it retains this; to the extent the present system presents insurmountable conflicts of interests or unnecessary duplication, these conflicts or duplications remain.

As we have stated above, were statutory listing rules to be introduced, we believe the maintenance of the existing system would be undesirable as the duplication of effort would

be such a clear waste of resources.

The dual filing system has not been in operation long enough for an assessment of its "success" to be made [Executive Summary 8, and 38]. Our experience is that the involvement of the SFC has not delayed the listing process. Comments from the SFC are received shortly after the draft prospectus and the initial application is made to the SEHK and the SFC's comments are usually relevant, covering matters of principle. Thereafter, comments are received by the Listing Division, the standards of which have remained unaltered. The length of the listing timetable is largely determined by this process. We would have to repeat that the listing process in so far as it involves the Listing Division could not possibly be described as containing any "market savvy". We believe that the most partisan supporters of the Listing Division and its retention of a regulatory role would agree with this statement. No "market savvy" would be lost if the regulation of listings were to pass to another agency. There is none to lose. As we have already mentioned, to the extent that "market savvy" is a quality that the Listing Committee brings to the assessment of a new applicant for listing this can easily be replicated without duplication. As it is, we have in effect two listing committees, a committee of that name and the Dual Filing Advisory Group which can assess a listing and advise the SFC to terminate a listing application. Further, we can see no reason why the regulation of the listing process by the SFC would hamper market development of the HKex. No cogent argument is advanced as to why this would be the case.

We do not believe this model retains the benefit of enhancing cross border cooperation with the CSRC [3.26]. It is obviously more effective for Hong Kong's cooperation with the CSRC to be handled by a single agency.

The model quite clearly fails to remove the real or perceived conflict of interest of the HKex as a "for profit" company and a securities regulator, if it is intended for the Listing Division to retain its regulatory function in largely its present form which is what we understand Model D to be. Clearly the conflict would largely be eliminated by passing the administration of the "Red Book" to the SFC or another separate statutory body. The SEHK would retain its right to approve listings, even if this would remain for practical purposes a residual right and would not be exercised except in exceptional circumstances. It is difficult to envisage an institution which appears to be concerned with market development routinely refusing listings to applicants which have met all the regulatory requirements. Further, the approval of listings would not require a large staff as it would be essentially an administrative process.

We are not convinced that there are any advantages which can be offered by an overlapping regulatory system conducted by two separate institutions. Few activities are regulated in this way anywhere as it must have the potential to create muddle and confused authority. It is obviously manifestly wasteful of the resources of the regulators and those they seek to regulate. If Hong Kong is to remain competitive it should not create regulatory structures which do not use resources efficiently. It will simply create an unnecessary cost in obtaining a listing here. What puzzles us is why the SEHK wants to retain a subsidiary regulatory position when it has accepted that serious cases will be the preserve of the SFC. This is not explained in the Consultation Paper.

We would like to thank you for giving us the opportunity to comment on the Consultation Paper. Should any matter require further explanation, please let us know.

Lastly, we understand you may wish to quote extracts from submissions which you have received. While we have no objection to extracts being quoted from this letter, we would ask that we are notified beforehand so that we know the context in which extracts will appear.

Yours faithfully,
For and on behalf of
Anglo Chinese Corporate Finance, Limited

Christopher Howe	Stephen Clark	Dennis Cassidy
Managing Director	Managing Director	Director, head of Corporate Finance

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[Cecilia\Misc\Ltr to Financial Service Branch]