

**Comments on the
Consultation Paper on
Proposals to Enhance The Regulation of Listing**

Hong Kong Stockbrokers Association

Background

1. As a result of the Penny Stock incident, an Expert Group was formed to Review the Operation of the Securities and Futures Market (the “Expert Group”). In March 2003, the Expert Group published its’ report which recommended that the Listing Function be removed from HKEx and given to a statutory body. This recommendation was based on the following premises:
 - a. The quality of listed issuers is deteriorating.
 - b. This is a result of listing too many small and illiquid companies with marginal business plans.
 - c. The HKEx is a commercial entity that does not have powers to enforce its listing rules.
 - d. The HKEx as a commercial entity has a conflict of interest as the front line regulator of listed companies, and as the operator of the market.
2. In view of the recommendations of the Expert Group, FSTB has identified a number of issues on which it is now seeking comments from the market. Broadly speaking, these issues revolve around the following:
 - a. The legal status of the Listing Requirements.
 - b. The respective roles of the HKEx and the SFC in enforcing the Listing Requirements.
3. The FSTB has also identified 4 possible models of regulatory structure that may be adopted to address these issues and enhance the regulation of listing:
 - a. Model A: Transfer of listing function to a new division set up under the SFC.
 - b. Model B: Transfer of listing function to a new HKEx subsidiary.
 - c. Model C: Transfer of listing function to a new statutory authority independent of both SFC and HKEx.
 - d. Model D: Expand the current “dual filing” regime.
4. Our comments on the Consultation Paper are organised as follow:
 - a. Quality of Listed Issuers.
 - b. Role of the HKEx.
 - c. Need for Statutory Backing of Listing Requirements.
 - d. Conflict of Interest.

- e. Model A: Listing under SFC.
- f. Model B: Listing under new HKEx subsidiary.
- g. Model C: Listing under new independent authority.
- h. Model D: Expand “dual filing”.

Quality of Listed Issuers

- 5. Hong Kong has established itself as a major international financial centre, and currently ranks 8th in the world in terms of market capitalisation. Over the past 20 years, we have evolved from listing local companies with their operations mainly in HKG to the premier capital-raising centre for the PRC. In order to continue in this role, we must ensure that international investors are comfortable with our legal and regulatory framework. The fact that we have achieved our current world rankings in the face of strong competition from developing financial centres is testament to international investors’ confidence in our market.
- 6. However, since the Asian Financial Crisis, there is a perception that the quality of listed issuers has been deteriorating. Concerns have been raised over:
 - a. Post IPO financial performance of some listed issuers.
 - b. Too many small and illiquid companies listed.
 - c. Some high-profile corporate scandals.
- 7. While we agree that the above concerns are not without basis, we wish to point out that we are not alone in having these problems. A company’s financial performance is very much dependent on the state of the economy, and the Asian Financial Crisis has made it very difficult, if not impossible, for many companies to achieve their financial targets.
- 8. The prolonged slump in the stock market has also meant many companies’ share prices do not reflect their underlying value. Share prices and turnover in a company’s shares, in and of themselves, do not reflect a company’s worth. They are reflections of the sentiment of the investing public and the appetite for risk in the face of a bear market

9. Of more concern are the corporate scandals and blatant stock manipulation. We submit that the corporate scandals that have come to light have less to do with listing requirements being too lax and more to do with outright fraud. That being the case, we believe that the solution is to pursue the wrong doers and bring them to justice. Stock manipulation is fully covered in the SFO and the SFC has more than sufficient powers to investigate and punish the manipulators.

Role of the HKEx

10. We disagree with the perception that the HKEx is somehow responsible for the low share prices of listed issuers and corporate scandals because it approves too many listing applicants *regardless of the quality* (our emphasis) or is deficient in performing its duties as frontline regulator of the market.
11. The HKEx has a public interest role in addition to being a commercial entity. At the time of the merger of the exchanges and the clearing house, the issue of public interest was closely scrutinised, and the HKEx's role was clearly defined under the Exchanges and Clearing Houses (Merger) Ordinance. Provisions in the Merger Ordinance, the SFO, and the MOU between the HKEx and the SFC requires that:
 - a. HKEx gives precedence to public interest over its own interests.
 - b. Control over appointment of the HKEx Board of Directors and senior management structure is vested in the CE of the SAR, and the SFC.
 - c. HKEx fees and charges, and listing rules are subject to SFC vetting and approvals.
 - d. The SFC is responsible for oversight of the Listing Function including periodic audits.
12. We will discuss the issue of potential conflict of interest in a later section. In the meantime, suffice it to say that we believe there are more than sufficient checks and balances in place to ensure that the HKEx carries out its' public interest responsibilities.

Need for Statutory Backing

13. HKG operates under a “disclosure-based” regime that is dependent on disclosure that is full, accurate and timely. We are of the view that in spite of the problems, a disclosure-based regime is still preferable to a “merit-based” regime, which has significant shortcomings such as:
 - a. Who decides on the relative merits of a company?

- b. Open to charges of unfair treatment by applicants.
14. As no regime can provide an absolute guarantee, therefore the emphasis must be on transparency and integrity. In most major jurisdictions, the Companies Ordinance covers corporate governance. However, over 80% of the listed issuers are domiciled outside HK (and therefore not subject to the HK Companies Ordinance). Thus the Listing Rules is the only tool for regulating such companies, and we agree that some statutory backing should be given to the Rules to ensure that appropriate disclosure is made of relevant information to facilitate informed decision making.
 15. However, giving statutory backing to the Listing Rules does not necessarily mean removing the Listing Function from the HKEx. The HKEx can still administer the Listing Rules and refer cases of breach to the SFC for it to take appropriate action.
 16. Currently, the Listing Rules are sometimes seen as the starting point for negotiation. Whether or not, the Rules are given statutory backing, it is necessary for appropriate codes and guidelines to be made available to clarify interpretations. Codes and guidelines on their own do not carry sufficient weight to ensure good corporate governance.
 17. In addition to giving statutory backing to the Listing Rules, it is necessary for the SFC to be seen to be enforcing the rules, in order for it to have a deterrent effect. As to whether this is acceptable, we believe that there is already a precedent set whereby the SFC can, under the SFO, fine participants up to \$10 million and impose imprisonment for what amounts, in extreme cases, to administrative errors.

Conflict of Interest

18. The Report of the Expert Group suggested removing the Listing Function from the HKEx because it believed that there is an inherent conflict of interest in the role of the HKEx as a for profit operator of the stock market, and its role as frontline regulator. We believe that the issue had already been thought through and appropriate safeguards put into place to ensure that the HKEx carries out its public interest role.
19. In addition, we submit that if the Listing Function were to be moved to the SFC, we would actually remove one of the key checks and balances. As the SFC currently has oversight of the HKEx Listing Function, we believe that the SFC will face a conflict of interest in attempting to be both the frontline regulator, and carry out its statutory role as market watchdog.

Model A: Listing under SFC

20. As discussed above, we do not support the proposal to transfer the listing function to the SFC. The SFC is the market watchdog, and to transfer what amounts to day-to-day supervision functions over more than 1,000 listed issuers would have the opposite effect of depriving the SFC of the ability to provide an oversight function.
21. The issue of lack of statutory backing can be easily addressed by incorporating some of the Listing Rules in secondary legislation e.g. as part of the SFO Rules, and it is not necessary that the entire Listing Function be moved to the SFC in order to achieve this.
22. There is a very real concern that moving the Listing Function to the SFC would create an over concentration of powers in one body, and may lead to over regulation, inflexibility, and lack of innovation in the market. Of all the major markets, only the UK has adopted this regime.

Model B: Listing under new HKEx subsidiary

22. If the issue of conflict of interest is real, then moving the Listing Function to an HKEx subsidiary does not remove the conflict. However, if there is no conflict of interest, then the market will be saddled with the additional costs of duplicated facilities without having achieved any real benefits. No major market has adopted this model.
23. We would consider this model to be inferior to Model D. However, if it is considered that there is a conflict of interest, then we would support this model as our second choice.

Model C: Listing under new independent authority

24. This model is intellectually tempting but we believe that it would cause an operational nightmare in actual implementation. It would create yet another layer of regulatory supervision and may in fact create more gaps and overlaps in regulation of the market. There will likely be confusion as to the appropriate entity responsible for regulatory functions.
25. We do not support this model. No major market has adopted this model.

Model D: Expand “dual filing”

26. The dual filing regime was implemented in April 2003 and has only been in operation for just over half a year. By all accounts, it has been operating smoothly and has not caused any additional regulatory burden on the listed issuers. We believe that sufficient time should be given to the dual filing regime to prove its effectiveness, before we consider the need to make massive changes to the regime.
27. The one rationale for removing the Listing Function from the HKEx is the need for statutory backing of the Listing Rules which is primary tool for regulating those listed issuers domiciled outside HK. This can be achieved by enhancing the dual filing regime to include some of the key Listing Rules in subsidiary legislation. As to what part of the Listing Rules to include, we believe that should be the subject of detailed legal research, and consultation with market practitioners. . As stockbrokers, we do not feel competent to comment on the specifics of the “red book” requirements and to respond to sections 2.34 and 2.43 of the Proposals.
28. In any case, Listing Rules that are included in subsidiary legislation should be removed entirely from the “red book” for avoidance of doubt and to ensure that only one entity has responsibility for enforcing the regulation. In order to facilitate these discussions and consultations, it would be useful to have as a starting point the models adopted by different jurisdictions. We can then make the appropriate adjustments to reflect our unique market conditions.
29. We believe that an expanded “dual filing” regime provides the best of both worlds. It gives a wide range of options and tools for the regulation of listed issuers with sanctions ranging from administrative fines to criminal imprisonment.
30. However, a “shared regulations” regime would require the SFC and HKEx to work closely together for the benefit of the market. The SFC already performs an annual audit of the Listing Function, and this can be extended to a continuous review using a methodology similar to the Process Review Panel. In addition, the budget of the Listing Committee may be submitted to the SFC for comments to improve oversight of the Listing Function.
31. The current 3-tier regime already has in place mechanisms where the efforts of the SFC and HKEx are co-ordinated through the FSTB.

Conclusion

32. Our 3-tier structure has proven effective over the years. As a responsible and mature market, we need to review our regulatory structure from time to time to ensure that it is appropriate, effective and efficient. However, we must refrain from transplanting “quick fixes” which do not take into account our market’s particular circumstances.
33. Any changes to the regulatory regime should be thoroughly researched and determined to be appropriate for our market before being implemented, preferably in a staged manner. A “big bang” approach may be appropriate in some markets, and indeed might be the only way forward. However, we believe that at our current stage of development as the fund raising centre for the PRC, we need market stability and clarity, and massive disruptions should be avoided at all costs.