Submission to
Financial Services and the Treasury Bureau of
Government of the Hong Kong SAR
in response to the consultation paper on
Proposals to Enhance the Regulation of Listing
(“PERL Paper”)

by

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1. Introduction

It is with some regret that I find myself making this submission at all, for it is in response to a consultation which is unnecessary and in my view designed to dilute and delay much-needed reforms which were previously recommended by experts appointed by the Government.

On 26-Sep-02, following the recommendations of the report of the Panel of Inquiry into the Penny Stocks Incident (the "PIPSI report"), the Government acting through the Financial Secretary appointed "three distinguished members" to the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure (the "Expert Group"). After six months of research, consultations and submissions from anyone who cared to express a view, the Expert Group made unanimous recommendations on how to proceed. In essence, their main recommendations were:

- that the function of regulation of listed issuers, including approval of initial listing and regulation after listing, be fully transferred from The Stock Exchange of Hong Kong Limited ("**SEHK**"), which is a wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited ("**HKEx**"), to a Hong Kong Listing Authority ("**HKLA**") established under the Securities and Futures Commission ("**SFC**");
- that decisions of the HKLA would be subject to appeal to a "**Listing Panel**" established under section 8 of the Securities and Futures Ordinance ("**SFO**", Cap 571) and comprising outside practitioners and investors, which would also advise the HKLA on listing policies and changes to the Listing Rules, performing similar functions in relation to the Listing Rules as the existing Takeovers and Mergers Panel does to the Codes on Takeovers and Mergers and Share Repurchases (the "**Takeover Code**");
- that the listing rules be given statutory backing, without themselves necessarily becoming statutes, and that the SFC should be empowered to impose meaningful fines on major shareholders and directors of, and advisers to, listed companies, with appropriate appeal mechanisms.
- that the HKLA should charge listing fees to recover the costs of regulation (but not to make a profit), but that the profit currently made by HKEx from its regulatory function (that is, the difference between listing fees and regulatory costs) should be retained by HKEx by introducing fees for "admission to trading" – in other words, the transfer of the regulatory function would not affect the profit of HKEx and would be "bottom-line neutral" both to the HKEx and to listed issuers.

1.1 My views on the Expert Group report

I made a submission to the Expert Group and I agree with the above recommendations, subject to the following refinements:

- I believe that the regulation of listings and takeovers should be harmonised, so that the Listing Rules and Takeover Code are made and administered by a single authority, and so that both have statutory backing. It would be inconsistent to give statutory backing and hence "teeth" to the Listing Rules and not to the Takeover Code; both are aspects of corporate regulation.
- Structurally, this harmonisation implies that the proposed HKLA and the existing Corporate Finance Division of the SFC (which administers the Takeover Code) should operate as a single entity – which could be called the Hong Kong Listings and

Takeovers Authority ("**HKLTA**"). It also then makes sense for a single advisory panel of market practitioners, the "Listings and Takeovers Panel" ("**LTP**"), including a majority of investor representatives, to advise the HKLTA on both the Listing Rules and Takeover Code, rather than having a separate Listing Panel and Takeovers Panel.

- The decisions of the statutory authority would have to be subject to appeal, and a statutory body under the SFO already exists to handle that, the Securities and Futures Appeals Tribunal ("**SFAT**"). Chaired by a judge, the rest of its members are market practitioners, although they should include a lot more investor representatives – I don't see any on the list at present. In essence, the LTP and the SFAT should have a heavy overlap, subject to the need for judicial expertise in the SFAT.
- As an interim step between the HKLTA and SFAT, the LTP could handle initial appeals of the HKLTA decisions in a non-judicial setting, as the Takeover Panel currently does.

1.2 The Government's response to the Expert Group report

The Government initially endorsed the report, with the Financial Secretary saying on 21-Mar-03:

> "We will work with relevant parties, particularly SFC and HKEx, to draw up a programme for implementing the Expert Group's recommendations for the transfer of listing functions."

It is worth noting that the entire process of creating HKEx from the negotiated merger of two mutually-owned exchanges and multiple clearing houses, which was initiated and backed by the Government, took place in just a year. If the Government had proceeded with the same vigour to implement the Expert Group recommendations, which on their face were far simpler than the HKEx merger, then by now we would be working with a much more effective regulatory structure.

Instead, we are no further forward, because the Government, bending to pressure from vested interests who are heavily represented among its 800-member electorate, backtracked. On 10-Apr-03, the Financial Secretary of the day announced:

> "In view of the far-reaching implications and to ensure effective implementation, the Government will do more research and will consult the community further. In particular, we will work closely with the [SFC] and the [HKEx]"

1.3 The PERL Paper

Almost six months later, on 3-Oct-03, the PERL Paper was published. Unfortunately, the paper devotes zero space to the *"effective implementation"* of the Expert Group recommendations. Government did not make a single reference to the HKLA or the Listing Panel which were proposed in the Expert Group report. Instead, the Government has taken a giant leap backwards and acted rather like an examiner trying to contrive a 4-way multiple-choice question, when he knows that only one answer is correct and has to throw in three "trick" answers to confuse the reader. So the PERL paper asks readers to choose between options "A, B, C or D" - with "A" being the correct answer previously reached by the Expert Group, but this time faintly disguised as "Transferring listing functions to a new division set up under SFC". So here's your multiple-choice question. Should we:

(A) Transfer listing functions to a new division set up under the SFC

(B) Transfer listing functions to a new HKEx subsidiary

(C) Transfer listing functions to a new statutory authority

(D) Expand the "dual filing" system

As any schoolchild knows, if you don't know the right answer, then the easy way to find it is by elimination. So here we go:

Option (B) is best described as "do nothing" - it is just a perpetuation of the existing system - HKEx already has a subsidiary, SEHK, which administers the Listing Rules and puts proposals for rule changes and disciplinary hearings to the Listing Committee. Re-arranging deck chairs on the Titanic will not save the ship. However many committees and boards you create, there would be no escape from the fact that the subsidiary would remain part of a for-profit group and make its own rules, subject only to approval (but not direction) by the SFC.

Option (C) is best described as "set up a second SFC" or "set up a 4th tier". It is so obviously stupid that not even the HKEx management supports it, so we won't discuss it further. It was probably just thrown in by the examiner who thought that 3 choices would seem too simple.

Option (D) is an exercise in duplication and confusion, rather like having two air-traffic control bodies simultaneously running the same air space. When a plane hits the mountain, each controller will point at the other and nobody will take responsibility. That's what you get with dual vetting and dual filing, and it's only a matter of time before we have major casualties. And option (D) implicitly means keeping the listing function at HKEx, whether in the current subsidiary or a new one, it really makes no difference. Since (D) implies (B), and (B) is wrong, we know that (D) must be wrong.

And that leaves you with option (A).

2. The Submission of HKEx

As a director of HKEx, I voted against its submission dated 14-Jan-04. My views on regulatory structure have been consistent over time and were well known when investors who hold shares in HKEx chose to elect me to the board of directors on 15-Apr-03, without any endorsement from the board. Investors also rejected 3 incumbent directors who were endorsed by the board for re-election. It can be presumed from this that investors do not view my position on this matter as destructive to the financial success of HKEx.

Indeed, I believe that by creating a high quality efficient and effective regulatory structure, we will attract better issuers and more investors to the market, growing the business of HKEx, while at the same time deterring crooks and con-artists from entering and abusing the market.

As a director of HKEx, I am required by the SFO to put the public interest (and in particular the interest of the investing public) ahead of all others, and I do not think I would be doing that if I did not pass critical dissenting comment on the following areas of the submission. Nor would I be doing justice to the investors who elected me if I remained silent.

2.1 Defects in the Listing Rules

In paragraph 1 of its submission, HKEx states:

> "HKEx does not consider that the defects in the present system lie in the content of the Listing Rules…"

I believe this is wrong. There are numerous problems with the Listing Rules, which I have documented in detail over the last 5 years on Webb-site.com. Some of these relate to the corporate governance provisions of the Listing Rules, and others to disclosure requirements. HKEx's statement is directly contradicted by the fact that it has launched numerous

consultations on reforms to the Listing Rules. If there were no defects in the content of the Listing Rules, then there would be no need to amend them. Unfortunately, many of these reform proposals have subsequently died a quiet death under pressure from vested interests.

It is HKEx's submission that apart from *"certain core disclosure obligations"* all of the Listing Rules would remain in its fiefdom. If the Government accedes to this, then we can expect a perpetuation of the glacial pace of reform in which Hong Kong is getting left behind our regional and global counterparts.

2.2 Reduction of resources allocated to regulation per listed company

HKEx claims in paragraph 14 of its submission:

> "there is no evidence that HKEx has failed to devote adequate resources to regulation"

This claim can be refuted by simple analysis. HKEx goes on to state that the total staff headcount of the Listing Division has increased from 54 "in 1991"[1] to 85 in 1994 and 118 at present. What it doesn't state is that at the end of 1991, there were only 357 listed companies, but this had increased to 529 at the end of 1994, and at the end of 2003, there were 1,037 listed companies. **This means that the average number of listed companies per member of regulatory staff** (including secretaries), after dipping from 6.61 in 1991 to **6.22 in 1994**, **then increased by 41% to 8.79 at the end of 2003**.

It is unlikely that the regulatory workload created by the average listed company has decreased – indeed, as disclosure requirements have increased over the last decade, the workload per company has almost certainly increased. For example, GEM issuers have to report quarterly, but in 1991 and 1994 there was no GEM and all companies reported twice-yearly. Furthermore, increased disclosure means that prospectuses are longer than they used to be and so should take longer to review. Similarly, the introduction of dual-filing means that some regulatory time is devoted simply to liaising with the SFC, forwarding their comments to listing applicants, and sending responses back.

Assuming that the average hours worked per member of staff is the same as in 1994, the 41% increase in the number of companies per person **corresponds to a 29% decrease in the number of person-hours allocated to the regulation of each company**, in other words, a reduction of resources per regulated company.

In the same period, the stock exchange turnover, from which HKEx derives percentage-based trading and settlement fees as well as scrip fees, has increased 128% from $1,137bn in 1994 to $2,598bn in 2003. In fact, every way you look at it, the resources allocated by HKEx to regulation have failed to keep pace with the market's growth:

	1994	*2003*	*Increase*
Market capitalisation	$2,085m	$5,278m[2]	153%
Market turnover	$1,137bn	$2,598bn	128%
Number of listed companies	529	1037	96%
Headcount of Listing Division	85	118	39%

[1] It is not clear to what date in 1991 and 1994 these figures refer, so we generously assume they mean 31-Dec-91 and 31-Dec-94, rather than the beginning of those years, when there were fewer listed companies.

[2] At 30-Nov-03

Meanwhile, the number of people in the enforcement section of the Listing Division has only recently moved out of single digits. The current Listing Division headcount of 118 has been reached after a recent hiring wave, which by amazing coincidence has taken place while the regulatory structure is under review. On 25-Nov-03 Paul Chow put the headcount at 109[3], so it increased by 9 in the last 5 weeks of 2003.

Investors must wonder whether this recent enthusiasm for regulation will persist long enough to restore the headcount to levels commensurate with the market growth since 1994.

I note that HKEx in its submission did not offer any statistics on the budget of the Listing Division in 1991, 1994 and 2004 or the proportion of stock-related revenues (including listing fees, transaction fees, clearing and settlement fees) that this expenditure represents.

2.3 Not International Standards

In its defence of the status quo, HKEx in paragraph 15 on page 13 states:

> "The Listing Rules have been upgraded to international standards…"

Just who are they kidding? Hong Kong has consistently lagged behind the standards set by international best practice. Take, for example, the frequency of reporting. There can be no doubt that higher frequency reduces the information asymmetry between insiders (managers and controlling shareholders) and outsiders (investors). It is particularly important when the largest shareholder also has day-to-day information access as a member of management. In many markets, including, to name a few, the US, Singapore, Thailand and mainland China, quarterly reporting is now mandatory. In Hong Kong, despite HKEx proposing such a reform in late 1998 and again in Jan-02, it has been dropped. If it ever comes, we are likely to be the last significant market in Asia to introduce quarterly reporting. We are faced with the embarrassment of seeing those H-Share issuers who also have mainland A-Share listings report quarterly in Hong Kong, not because our rules require it, but because the mainland does.

Furthermore, HKEx proposals in Jan-02 to shorten the deadline for reporting annual results from 4 months to 3, and for half-year results from 3 months to 2, have been aborted.

Take another example – poll voting (one share, one vote). The OECD White Paper on Corporate Governance in Asia, published on 10-Jun-03, came out of an "Asian Round Table" in which both HKEx and the SFC participated. On voting practices, paragraph 86-87 stated:

> "There are a number of practices across Asia that prevent or impede effective shareholder participation in shareholder meetings. These practices include:.. (vii) prohibitions on voting in absentia;...(ix) vote by…show of hands; (x) failure to record the conducting and outcome of meetings in ways that are verifiable."
>
> "Where the above practices can be corrected through simple changes in laws, regulations or listing requirements, Asian policy-makers and regulators **should effect these changes without delay.**" (emphasis added)

These practices are all prevailing in Hong Kong and could easily be changed by the Listing Rules, but HKEx persists in allowing public listed companies to get away with conducting their meetings behind closed doors, with voting on a show of hands in which each attending shareholder gets 1 vote, rather than 1 vote per share, and all votes mailed in by absent shareholders are ignored. Even the latest consultation on the relevant Listing Rules in Jan-02, the final results of which were announced in Jan-04, stated that HKEx would only require

[3] SCMP, 26-Nov-03 "Chow denies defensive tactics in expanding listing unit"

poll voting where independent shareholders' approval was sought, but not for *"less important matters"*. I believe that if anything is important enough to require shareholders' approval, then the votes should be counted properly, 1 share 1 vote, including absentee proxies. The so-called *"less important matters"* include major acquisitions, disposals, changes to the constitution of the company, approving share option schemes, electing directors, granting mandates to dilute shareholdings and so on. There is no indication from HKEx that it will implement the OECD recommendations. The Listing Rules are **not** up to international standards.

HKEx also owns HKSCC Nominees Ltd, which as the nominee of the central depository (a *de facto* monopoly), holds the majority of shares which are owned by the public (other than controlling shareholders and directors). HKSCC goes through the charade of receiving voting instructions from investors (directly and via banks, brokers and custodians) and then sends a single person to the meeting who does not demand a poll. Its input systems do not include a facility for instructing HKSCC to demand a poll. Implicitly, HKSCC assumes that those who give it voting instructions do not want their votes to be counted, when it should assume the opposite. It is a shameful joke.

It is only as a result of my own "Project Poll" where I bought 10 shares of each Hang Seng Index company and split them into 5 registered names that I was able to require poll voting in meetings of each constituent in 2003. These companies complied without difficulty.

The implementation of fair voting procedures in the Hong Kong stock market should not depend on a single activist – it should be automatic. There is no point in having Listing Rules which require shareholders' approval for anything if the votes are not going to be properly counted. The SFC has taken this point on board in its Takeover Code, where Rule 2.9 requires all votes to be conducted by a poll. But unless the SFC invokes its "nuclear" powers under Sections 36 and 23(5) of the SFO, it cannot force HKEx to change its Listing Rules to require poll voting.

The OECD recommendations should be implemented without delay, requiring all votes to be held on a poll and independently verified. I recognise that in saying this I am talking to a government which disregards the voting wishes of all but 800 of its citizens, and that a disproportionate number of those 800 control or manage listed companies.

2.4 Corporate Governance Rules

Note that under HKEx's proposal, all aspects of the Listing Rules other than *"certain core disclosure obligations"* would remain under its control. That means that HKEx and its Listing Committee would continue to hold a veto over reforms to corporate governance rules such as whether we get mandatory poll voting, or whether controlling shareholders continue to elect their cousins, paid advisers and golfing buddies as so-called independent directors, rather than allowing independent shareholders to elect the independent directors.

And if you think HKEx, as a listed company, is in the vanguard of corporate governance reform, then you should note that until 2003 it conducted its own shareholders' meetings behind closed doors and voted on a show of hands until I (representing 5 holders of 2 shares each) forced poll voting in the 2003 AGM at which I was elected, and after some debate succeeded in persuading the Chairman to admit media observers to the viewing gallery of the exchange.

The SFC, in a press release on 29-Jan-04, said:

> "The [SFC], as a statutory body, can only exercise functions given to it by the legislation. It has no desire to extend its jurisdiction beyond the SFO to non-statutory areas, such as corporate governance…"

In my view, this ducks the SFC's statutory objectives (s4, SFO) to *"maintain and promote the fairness"* of the market and to *"provide protection for members of the public"* when investing in the market. Corporate governance rules have everything to do with market quality because they determine the relationship between the listed company and its shareowners. In fact, disclosure is just a sub-set of corporate governance, determining the flow of information between a company and its shareowners.

In paragraph 2.1 of its submission, the SFC appears to agree, stating that market quality involves:

- the types of companies admitted to listing;
- corporate governance; and
- the quality of disclosure.

In paragraph 2.6, the SFC states:

> "exchange rules and codes about corporate governance describe best practice standards…These should set a higher standard than statutory governance rules"

Implicitly, then, the SFC accepts that there should be "*statutory governance rules",* but then rejects the notion that its jurisdiction should extend to *"non-statutory areas, such as corporate governance"*. So the submission is internally inconsistent.

It is also logically inconsistent for the SFC to advocate statutory backing for disclosure rules but not for (other) corporate governance rules, as both are aspects of market quality.

What the debate comes down to is a division of provisions between statutory obligations, non-statutory listing rules (with no teeth) and voluntary Codes of Practice. I have no objection to anyone promoting Codes of Practice, and companies have always been free to go beyond minimum regulatory requirements (as a few do). But I believe that all regulatory requirements currently in the Listing Rules should be made statutory and administered by the SFC.

2.4.1 The UK situation

In the UK, all the Listing Rules are administered by the UKLA with statutory backing, including the Listing Rules on corporate governance. There are also voluntary codes of practice, but the formulation and implementation of these is driven by institutional investors who, in the near-absence of controlling shareholders, can set the agenda in corporate governance through their voting power. It would be inappropriate to rely on this in Hong Kong, where nearly every company has a controlling shareholder. As Richard Williams, Head of Listing at HKEx and a former head of listing policy at the UK regulator, says[4]:

> "Regulators in the UK make efforts to harness these market forces and to design regulations which take account of the benefit of their influence. The role of institutions in Hong Kong is far less visible at present and, given corporate ownership structures, may never achieve the same level of influence."

In the absence of these market forces, due to Hong Kong's control structure, we need statutory corporate governance obligations which can be backed with regulatory teeth.

[4] *Exchange*, Jan-04

Institutions in HK can do nothing more than register protest votes in AGMs, and cannot even do that unless they are lucky enough to get a poll. At most AGMs, a show of hands silences all dissenting proxies.

2.4.2 The US situation

There is a growing recognition that the US Model is flawed. The SFC also notes (para 2.7) that in the USA, the model it advocates, there has been a shift towards a statutory governance regime through the Sarbanes-Oxley Act. Since Sarbanes-Oxley, there have been revelations at the NYSE which bring the governance problem into greater focus. The exorbitant pay package of Dick Grasso as CEO was approved by the Board of NYSE and its compensation committee, and in doing so they compared his earnings to the compensation of CEOs of US companies, which had been bloated by share option gains in the 1990s, which in turn had often arisen from option schemes adopted without shareholders' approval, as no such approval was required by the NYSE rules. Dick Grasso sat on the board of Home Depot as an independent director and member of its compensation committee, and a co-founder and director of Home Depot chaired the NYSE's compensation committee – again, nothing in the NYSE rules on independent directors prevented this cross-directorship. The NYSE, which is in competition with other US exchanges for listings, has a natural incentive to provide corporate governance rules which are favourable to management, since they choose where to list.

The NYSE also allowed brokers to vote shares in listed company meetings when they had no client instructions to do so, stacking the deck in favour of management. The difficulty that US investors have in even getting proposals onto the AGM agendas of widely-owned companies again is indicative of major gaps in the US statutory governance framework. With an abrogation of responsibility by conflicted institutional investors, and weak statutory governance rules, management of US companies have been able to entrench themselves against the interests of investors, treating them as outsiders rather than owners of the company. For example, in many past cases, management have implemented "poison pills" that require management approval for a change of control of the company, allowing themselves to extract golden parachutes on a negotiated exit, or to frustrate the wishes of the owners to accept a takeover. Hong Kong should not model itself on that system.

2.5 Composition of the Listing Committee

At paragraph 55 on page 31, HKEx holds out some hope that if Model-D is adopted:

> "the composition of the Listing Committee would be altered to improve the balance between issuer and investor representatives"

Yet it stops there, and makes no commitment or specific proposals. The statements of HKEx management have been ambivalent at best on this issue. There is in fact no "balance" but a complete imbalance in which only 2 out of the 25 members of the main board Listing Committee are investor-based. In a presentation to the Institute of Directors on 25-Nov-03, Paul Chow, CEO of HKEx, acknowledged as a fact the *"heavy sell-side weighting"* of the Listing Committee and under *"possible enhancements"* he suggested *"increase representation of investors"* but then on the same presentation slide suggested *"maintain proper balance of the composition"* of the committee. It seems logically impossible to both "increase" and "maintain" the same thing – rather like going faster while maintaining one's speed.

This is in my view just lip-service to reform. Quashing hopes, two days later on a roadshow in Hangzhou, Mr Chow said that the proposal was "preliminary" and "not a priority".

Even if Mr Chow were minded to water down the dominance of listed issuers and their advisers, he would have to get the approval of the Listing Committee itself, since the composition of the committee is set out in the Listing Rules, and any changes to the rules have to be approved by the Listing Committee.

Incidentally, the Government's PERL Paper is delusional in this respect. At paragraph 12 on page 7 it refers to:

> "SEHK Listing Committees which comprise a balanced mix of market users".

They're about as balanced as a one-legged cat. **Given that investors are the people who end up suffering from loose corporate governance rules and dodgy IPOs, they should have the majority voice on the Listing Committees.**

In the SFC's submission of 29-Jan-04, they make the same point, advocating a new advisory group which would be:

> "comprised wholly of market participants (with a weighting toward investor/buy-side representation)"

In other words, a majority of investor-based members.

2.6 Appointment of the Listing Committee

HKEx also has a veto over new members of the Listing Committee, because the body which appoints them, the Listing Nominating Committee, comprises 6 members, of which 3 are appointed by HKEx and 3 by SFC. So nobody can be appointed to the Listing Committee without the agreement of HKEx. This represents a conflict of interest because HKEx is a listed company governed by Listing Rules made by the committee. HKEx can, if it chooses, exclude any pro-reform candidates from the Listing Committee. Because of this, it cannot be said that the Listing Committee is independent of HKEx.

For true independence from HKEx, if Model-A is not implemented and a committee of HKEx continues to make Listing Rules, then all members of that committee should be appointed by the SFC.

2.7 Appeal Mechanisms

HKEx, in attempting to criticise Model-A, has indulged in scare-mongering which in my view is not supported by the facts. At paragraph 39 on page 26 of its submission, it states:

> "Faith in and respect for a regulatory system depends on the knowledge that it is possible for market participants to challenge in good faith the decisions of the regulator, without fear of retribution and with confidence that they will receive a fair hearing….If the regulator knows that his decisions are difficult or impossible to challenge, there is an inevitable risk that such decisions could become **arbitrary or high-handed**." (emphasis added)

As a conditional statement, that is true, but HKEx offers no evidence to suggest that the decisions of the SFC's HKLA would be *"difficult or impossible to challenge"*. If roads were vertical, they would be difficult or impossible to drive on, but motorists are not concerned about that because there are no vertical roads.

In fact, there is evidence to the contrary, which HKEx ignores in its submission. The SFC is already the front-line regulator of the Takeover Code, and has a tried and tested mechanism for appeals of its decisions to the Takeovers Panel which I believe is accepted and respected by the market.

Similarly, the Expert Group proposed that appeals of the HKLA's decisions would be handled by a Listing Panel of market practitioners (or as I propose, a Listings and Takeovers Panel), and then there would be the higher level of appeal to the SFAT. There is every reason to believe that these would provide the appropriate safeguards against a maverick regulator.

Indeed, HKEx employs a similar appeal structure, which involves a committee of market practitioners (the Listing Committee) which hears appeals of the Listing Division's decisions. There is no more risk of a rogue regulator in Model-A than there is in the existing structure.

In fact, the SFC's appeal structure for the Takeover Code is more transparent than that of HKEx, because under paragraph 16.1 of the Introduction to the Takeover Code, unless there are confidentiality considerations, the rulings of the Panel, and the reasons for those rulings, are published and investors in the affected company can understand what is going on. By comparison, the Listing Committee operates in a black box and does not announce its rulings or the reasons for those rulings. HKEx sometimes publishes case studies as "Listing Decisions", but these are always without naming the affected company, so investors in that company are none the wiser.

I should also note that since the SFO came into effect on 1-Apr-03, there has not been a single market misconduct tribunal, not a single criminal prosecution for insider dealing, and according to SFC statements, it has commenced investigations of only 11 listed companies. It has only used fining powers against one regulated person out of the many thousands that it regulates. Again, there is no evidence that the SFC has acted in an *"arbitrary or high-handed"* manner and there are checks and balances against such behaviour in the future, including the SFAT, chaired by a high court judge, and of course the fact that the SFC has limited financial resources with which to pursue cases.

2.8 You cannot legislate conflict away

HKEx, at several points in its submission and previously, has claimed that a safeguard against conflicts of interest is provided by the obligation it has under the SFO to put the public interest ahead of any other interest. This in my view has no real effect, because it would be a huge hurdle to prove a breach of this obligation in court. Indeed, the very fact that it was found necessary to include this provision in the Exchanges Merger Ordinance in 1999/2000, when HKEx was created, speaks to the recognised existence of the conflicts which should have been resolved then, not 4 years later.

2.9 More committees is not the answer

In advocating model D, HKEx suggests more committees – a Listing Policy and Appeals Committee ("**LPAC**"), a Disciplinary Appeals Committee ("**DAC**"), and an independent committee of the Board of HKEx to review the performance of the listing function and its budget as well as quarterly reports from the LPAC and the Listing Committee. None of this removes the inherent conflicts in the system. You can re-arrange the deckchairs on the Titanic as often as you like, but the ship will still go down.

In the case of the board committee, this would not remove the fundamental fact that the Listing Division is part of a for-profit group and its budget is ultimately set by the Board. To the extent that it makes profits from listing fees (less costs), there is no undertaking that these will be reinvested in regulation rather than used to pay dividends or fund other parts of the group. Even if it did not make a profit from listing fees alone, one cannot ignore the fact that without listed companies, there would be no transaction, clearing and settlement revenue on the Exchange, nor even any stocks on which to make futures contracts.

In the case of LPAC and DAC, HKEx still proposes that the members would be *"nominated in the same was as the present Listing Committee"* – in other words, HKEx would have a veto over the appointment of members – so the committees cannot be said to be independent of HKEx.

2.10 SFC oversight of HKEx is in practice weak

HKEx proposes that the SFC should carry out an annual review of the quantity and quality of resources allocated to the Listing Division.

This proposal has no real value. The SFC already has a statutory supervisory role over HKEx, a role referred to by HKEx at several points in its submission as a "watchdog", but this is hampered by the fact that the SFC does not set the budget or personnel policies of the Listing Division. The staff of the Listing Division ultimately report to the CEO of HKEx, not to the SFC. The power to hire, fire, promote, demote, reward or penalise these staff is completely outside of the SFC, and rests with the management of HKEx. In fact, the SFC has even less power over these staff than it does over the staff of brokers and fund managers – since these staff are licensed, whereas the staff of the Listing Division are not.

Even if the SFC concluded that inadequate money or quality of staff had been allocated to regulation, HKEx naturally would disagree, and there is no clear system for arbitration. This would lead to all-out conflict and is not in the interests of Hong Kong.

Although management has often claimed that all of the listing functions have been delegated to the Listing Committee, its Chairman, Marvin Cheung, made plain the limitations of its role, as he said in an interview in Oct-03 with *HK Accountant* magazine:

> "My priority is to make sure that the role of the Listing Committee is transparent.. so that people are aware that we are not a committee that has accepted from the Board of the Exchange the full responsibility for listing matters. From time to time, the chairman of the Exchange, and others, have loosely suggested that they have delegated items or functions to the Listing Committee - if that is the case, where is my budget? Do I have the right to hire and fire people? If not, how have you delegated it to me?"

3. Constitutional Issues

It is accepted by all sides that there are three ways in which the content of the current Listing Rules could be implemented within a statutory framework. In essence these are:

1. primary legislation (an Ordinance)
2. subsidiary legislation (statutory rules subject to negative vetting by LegCo)
3. Codes and Guidelines made by the regulator.

3.1 Primary Legislation

Dealing first with primary legislation, I think it is inadvisable to put all the Listing Rules into primary law, because it would be too difficult to modify and update the "Listing Ordinance" fast enough to keep pace with the evolution of financial markets. Most of the 60 members of the Legislative Council do not have any experience as either regulators or market practitioners, and it would be unfair to expect them to make detailed decisions in this area.

3.2 Subsidiary Legislation

After public consultation, Listing Rules in the form of subsidiary legislation would be gazetted and tabled in LegCo under the negative vetting system set out in Section 34 of the Interpretation and General Clauses Ordinance (Cap 1). Under that section, LegCo normally

has 28 days to raise objections and amend the Rules, extending the period in 3-week blocks if it so chooses.

The system of subsidiary legislation governing financial markets is already well-practiced – a look at the SFO will show no less than 35 pieces of subsidiary legislation ranging from the "Unsolicted Calls – Exclusion Rules" (cap 571A) to the "Insurance Rules" (cap 571AI).

HKEx submits at paragraph 40 on p26:

> "If the [Listing] Rules take the form of subsidiary legislation, this would be likely to make the issue of a new set of Listing Rules a major and potentially controversial and politically-charged exercise, absorbing a large amount of administrative resources and legislative time."

Again, I believe that is scare-mongering to frighten the Government, which naturally seeks to avoid showdowns with the Legislative Council. But by the HKEx's own submission, there is no defect in the Listing Rules (see above), so there is no reason to think that a *"major"* and *"politically-charged"* overhaul of the Listing Rules would be needed. All that would happen in the first instance is that the wording of the existing Listing Rules would become subsidiary legislation, substituting the words "the Exchange" with "the Commission" and making other appropriate changes, including, for example, the appeals procedures and the composition of the Listing Panel. Upgrades to the rules can then be made as appropriate using the process described above.

If they haven't scared you with political bogeymen, then HKEx goes on to say:

> "Despite this cost, it would be unlikely to lead to any improvement in the substance of the Listing Rules".

But I see no reason why a subsidiary legislation process should be any less successful in reforming the Listing Rules than the current process, which has often involved proposals which take years to go nowhere – witness, for example, quarterly reporting. If you are a lawyer or investment banker sitting on the Listing Committee with a bunch of the biggest tycoons as your clients, you are hardly going to go against their wishes.

At least, with an increasingly democratically-elected LegCo, decisions should become pro-investor, pro-consumer. If I had a choice of submitting Listing Rules reforms to the next LegCo (where half its 60 members will be directly elected) and to the current Listing Committee (where only 2 out of 25 are investor representatives) then I would much rather put my trust in LegCo.

Incidentally, Section 36 of the SFO already empowers the SFC to make Listing Rules, subject to prior consultation with the Financial Secretary and HKEx, and it has made the Securities and Futures (Stock Market Listing) Rules ("**SMLR**", cap 571V), which enabled the current "dual-filing" system. So the primary legislative framework is already in place – all that is needed is the political mandate to use it.

Apart from establishing the dual filing system, until now, the SFC has never invoked Section 36 (or its pre-SFO version), because unless it had Government endorsement to do so, it would invoke the kind of political backlash from vested interests seen against the Expert Group report. Both HKEx and SFC have at different times described this as the *"nuclear option"*. The fallout would result in a regulatory nuclear winter, so this is not an effective check or balance against the conflict of interest that HKEx has in making and administering the rules.

3.3 Codes and Guidelines

The third method of providing statutory backing would be to implement the Listing Rules not as subsidiary legislation but as a "Listing Code".

For some understanding of how this would work, Government should consider how the SFO already regulates financial intermediaries such as fund managers and brokers (including their human representatives), and then ask itself why there should not be a regulatory or disciplinary regime for listed companies and their directors. So let us briefly look at the regime for financial intermediaries.

Under Section 169(1) of SFO, the SFC may publish codes of conduct setting practices and standards with which intermediaries are expected to comply. Examples of existing Codes include the Fund Manager Code of Conduct and the Corporate Finance Code of Conduct.

Under Section 169(4):

> "a failure on the part of any intermediary… to comply with… any code of conduct… shall not in itself render him liable to any judicial or other proceedings, but may be taken into account in considering…whether it is a fit and proper person to be or remain licensed or registered"

Under Section 194(2):

> "where a regulated person is…guilty of misconduct; or the [SFC] is of the opinion that a regulated person is not a fit and proper person… the [SFC] may…order the regulated person to pay a pecuniary penalty not exceeding the amount which is the greater of (i) $10,000,000; or (ii) 3 times the amount of the profit gained or loss avoided…as a result of his misconduct…"

Under Section 399:

> "the [SFC] may publish… such codes and guidelines as it considers appropriate for providing guidance…" in relation to any of its regulatory objectives or functions.

In reaching findings of "misconduct" as defined in Section 193, the SFC is required to have regard to the provisions of any code of conduct published under Section 169 or Section 399.

Now it is fair to say that, in the SFO, Hong Kong now has a regulatory regime for fund managers and brokers which in most respects is on a par with international practice. The potential for financial penalties provides a deterrent to bad behaviour, provided that those penalties are actually used when that behaviour occurs.

Like brokers and fund managers, the directors of listed companies are entrusted with public money. In my view, the financial damage caused to the investing public by bad governance of listed companies is far in excess of that which has been caused by bad brokers or fund managers, even if you include the sometimes-spectacular brokerage collapses we have seen in Hong Kong. So there is every reason to introduce a new class of "regulated persons" within the SFO regime, being the directors of listed companies, who could then be subject to the same financial sanction system as financial intermediaries.

HKEx, in its criticism of the "Codes and Guidelines" route, confuses the situation by saying (para 41, p27):

> "the Listing Rules are (in the main) a set of prescriptive obligations…[which] cannot be formulated as anything other than rules".

But that does not prevent the rules being part of a Listing Code. For proof of this, there is another code already published under Section 399 of the SFO which does contain prescriptive obligations as rules. I refer, of course, to the Takeover Code.

3.4 Statutory Listing Rules versus Listing Code

Whether the introduction of statutory backing is done by a Listing Code, or by subsidiary legislation (Rules), is a matter for debate. Either way, listed companies and directors (including shadow directors) must become regulated persons subject to financial sanction. Statutory Listing Rules have the advantage that breaches would be directly actionable on their specifics, whereas breach of a Listing Code would have to be contributory evidence to a finding of misconduct of a regulated person, which may be harder to establish. On the other hand, a Code may be faster to adapt to changing circumstances as it does not require negative vetting as subsidiary legislation does. Given the benefits of certainty, I believe on balance that the more effective path would be to adopt the Listing Rules as subsidiary legislation, using Section 36 of the SFO (which already empowers the SFC to make statutory listing rules) or similar powers.

4. Why dual filing won't work

The existing dual filing system is a recipe for disaster. When I board an airliner at Chek Lap Kok, I like to believe that Hong Kong only has one air traffic control authority, not two, controlling the airspace over my head. If there were two, then neither would have full responsibility for preventing mid-air collisions. Secondly, air tickets would be more expensive in order to pay for both air traffic controllers.

Currently HKEx runs a Listing Division and the SFC runs a "dual filing" team duplicating the work on prospectus vetting. HKEx is paying the SFC HK$20m per year to support this team, and ultimately this duplicated cost is borne by market users. With two teams in two regulators reviewing each prospectus, nobody has clear responsibility for failure. HKEx says (paragraph 60, p35):

> "It is not evident why there needs to be any change from the present arrangements"

I have to disagree. It should be evident from any principled analysis that shared regulation is in neither cost-effective nor does it result in a focal point of accountability and responsibility. The higher costs ultimately are borne by the market, increasing the cost of capital for issuers.

The question of dual filing relates not only to initial listings but also to ongoing regulation of listed company disclosures, the vetting of which is currently done by HKEx alone, with copies of final documents filed with the SFC under the dual-filing system to ensure issuer liability for false and misleading disclosures.

At paragraph 52 on page 30 of its submission, HKEx suggests:

> "after the introduction of the proposed core statutory disclosure requirements, the SEHK would perform substantially the same role in connection with new listings and ongoing regulation of listed companies that it performs today."

This is not a workable solution. It is unworkable to allow one, non-statutory regulator (HKEx) to do the "front-end" vetting of company announcements and circulars, and then to leave the statutory regulator responsible for clearing up the "back-end" enforcement mess when a document is found, after the fact, to be defective by omission or misleading in content. Leaving the "front-end" disclosure vetting with HKEx and back-end enforcement with the SFC would also raise the hazard that a listed company could argue in court that the

announcement or circular had been cleared by HKEx and thus it had a reasonable belief that the document was not defective.

Alternatively, if front-end vetting of disclosures were shared between HKEx and SFC, in the same way that prospectuses are dual-vetted at present, then that would again leave us with the problem of no single point of accountability and responsibility for regulation, as well as causing enormous duplication of costs. Tens of thousands of company announcements are published every year.

Clearly, if the SFC is given sole responsibility for disclosure regulation, and there are subsequent lapses in that regulation (such as a failure to spot deficient disclosures prior to a corporate collapse), then there will no longer be any doubt about where responsibility lies. But this responsibility and accountability of the SFC is what investors deserve, and the SFC must be given the resources to do the job.

5. Sponsor Regulation

In other jurisdictions, there is a trend to stop front-end regulatory disclosure vetting altogether, and rely on listed companies to vet their own draft announcements and circulars with legal advisers or continuing sponsors who are familiar with the rules. In the long run, Hong Kong should aim for this, but it would be reckless to do so without ensuring key features of other markets are in place, including a named continuing "sponsor" (a regulated corporate finance adviser) which has a duty to review draft announcements and circulars for compliance with Listing Rules, before their listed company client publishes them. Mainland China has recently announced such a system.

Currently, all listed companies on the main board, and after 3 years on GEM, are not required to have any continuing sponsor. It is inconsistent policy to require listing applicants to have sponsors when they initially sell shares to the public, and then not to have sponsors to assist them in continuing compliance with the Listing Rules while investors continue to buy and sell the shares. By that way of thinking, applicants could just have an audit for the IPO and then never get their accounts audited again. Clearly this would be unacceptable. A sponsor should verify compliance with Listing Rules in the same way as an auditor verifies compliance with accounting standards.

Continuing sponsorship would not absolve the listed company's board of ultimate sole responsibility for compliance, but a regulated third party sponsor to verify compliance (or not, as the case may be) would give the investing public the assurance they need.

Sponsors are also SFC-licensed entities and their regulation should be part of the SFC's licensing regime, and not administered by HKEx.

There is in fact an embryonic sponsor regulation system already in place in Chapter 6 of the GEM Listing Rules, and it shows why HKEx should not be performing this role. Since GEM was launched in 1999, despite repeated regulatory failures, including companies which have imploded almost immediately after IPO, as far as is publicly known, not a single sponsor has been removed from the list of eligible GEM Sponsors for failing to discharge its responsibilities or obligations under the GEM Listing Rules. There are currently 52 firms on the list.

Again, HKEx has a natural incentive to work with sponsors to bring companies to the market. It often leads them on promotional roadshows around mainland China, pitching the HK market to would-be listed companies. It should be free to work with sponsors to promote the Hong Kong market without having to regulate them too – the conflict of interest is too great.

6. Branding and badge of quality

If Model-A is adopted (as I advocate) and the whole listing function is transferred to the SFC, then this means that the criteria for listing in Hong Kong would be contained in rules or a code administered by the SFC. These criteria would be modified by time to time after public consultation and due process.

In theory, the **approval of listing** by the statutory regulator and the **admission to trading** on an exchange are two separate matters. However, HKEx operates the only stock exchange in Hong Kong. It also operates the only central depository and clearing house for the settlement of transactions on its exchange. Both SEHK and HKSCC are *de facto* monopolies.

Given this situation, the question arises, what if the SFC approved a company for listing, but HKEx refused to admit it to trading on the exchange? A company which had met statutory criteria for access to the public capital market would then be refused access to public funds. It seems to me that as a matter of public policy, this is fundamentally unfair to the would-be listed company. In any industry, if a service provider has a monopoly, it should have a universal service obligation to anyone who wants its service, pays its published price and meets all the legal criteria for doing so.

To draw an analogy, imagine that all the roads in Hong Kong were operated by a single commercial entity, and that a young person had obtained a valid driving licence but was refused permission to drive on those roads, because the road company thought the person was “too young”, or working in the “wrong” industry. Is that fair?

If there were multiple exchanges in Hong Kong competing for the trading of listed company shares, then it would be feasible to let them compete for business, at least on price or service levels. In such an economy, there would always be one exchange willing to set its entry criteria as the lowest standards allowed by the statutory regulator. But there is only one exchange in Hong Kong, and personally I do not think that multiple pools of liquidity in competing exchanges are economically efficient. It is better to have a single exchange with centralised liquidity. As long as there is appropriate regulatory oversight to avoid abuse of the monopoly, this should lead to the most efficient pricing and execution of trade. That caveat is important.

So in a monopoly environment with a single exchange, the “branding” and “badge of quality” in fact belong to Hong Kong as a whole. The quality of that brand (or lack of it, as the case may be) will be established by the quality of the regulatory framework, including the initial listing criteria as well as the ongoing investor protection framework. These matters of public policy should be matters for the statutory regulator in consultation with the public. As long as a would-be listed issuer meets the statutory listing criteria and pays its bills to the exchange on a published tariff, it should not be refused service by the monopoly exchange.

HKEx has drawn the analogy of supermarkets, stating that they are free to choose what they puts on their shelves, and that by analogy, HKEx alone should determine whether a company is suitable for listing, with no approval from the SFC as long as disclosure is satisfied. That analogy breaks down when you consider that nearly every economy has a statutory body which determines whether food is fit for human consumption or drugs are suitable for sale without prescription. Furthermore, if there were only one supermarket in Hong Kong with a legally protected monopoly, then it would be required to sell anything approved by the food and drug administration and to set a tariff for doing so, in order not to prevent the supply of approved food and drugs to consumers. At least, one hopes that would be the case – Hong Kong still does not have a competition law.

7. Market Savvy, the Penny Stocks Incident and GEM

I was amused by the repeated references in the consultation document to "market savvy" and the implication that this is something that HKEx has and the SFC has not. It was, of course, HKEx who published the "Penny Stocks" delisting proposals, which begat the Panel of Inquiry into the Penny Stocks Incident, which begat the Expert Group report, which begat the PERL Paper. Investors should be grateful for the HKEx's savvy-deficit in catalysing the debate over regulatory structure.

7.1 The Penny Stocks Incident

The real harm in those proposals was not the notion of delisting stocks below $0.50, since that could easily be avoided by stock consolidation. No, the devil was in the detail, of proposing that stocks with qualified audit reports, or market caps below a certain threshold (neither of which is readily rectifiable), be delisted, thereby depriving minority investors of the protection of the Listing Rules and a marketplace for their shares. This proposal played right into the hands of the worst-governed companies in Hong Kong, who could engineer a delisting to squeeze out minorities. Anyone with "market savvy" should have recognised that.

Again, in a market with a monopoly exchange, there is no alternative marketplace for delisted stocks, and investors who have acquired these stocks have a legitimate expectation of access to the market so long as the listed company is solvent enough to pay the market access fee and has not been 100% privatised. Instead, a tagging system should have been proposed, in which existing listed companies which would not today meet the entry criteria for listing would be clearly identified as such on the SEHK trading system.

7.2 "Market Savvy" in Model-A

Returning to the question of market savvy, there is plenty of evidence that this would not be a problem under Model-A:

- The SFC already deals with listed companies as the administrator of the Takeover Code, as well as being a regulator of sponsors, brokers and fund managers
- The establishment of the HKLA (or as I propose, the HKLTA) would initially involve transfer of all the staff of the HKEx Listing Division to the new authority, so any "market savviness" they have would go with them
- Likewise, the Listing Panel (or as I propose, the LTP), would have access to the same pool of "savvy" market practitioners who currently serve on the Listing Committee, Takeovers Panel, SFAT and so on, and indeed, the savviness of more investor representatives would be introduced into the equation.
- Introducing much greater investor representation in the Listing Panel will mute any criticism when corporate failures occur, because it will then be a justifiable criticism that if investors are the majority on the Listing Panel, then they are eating their own cooking and should not complain if they get food poisoning.

HKEx often claims that the Listing Division is "closer to its own market" – but if they literally mean that the Listing Division is part of a group which runs the facilities of the stock exchange, then this is contradicted by its own claim that there is a separation or "Chinese wall" between the regulatory and business units of HKEx.

7.3 What is meant by "market savvy"?

I fear that in the minds of vested interests, "market savvy" is just a euphemism for being willing to bend and waive the listing rules from time to time to suit the interests of tycoons

rather than the investing public, and if this is what they mean, then I would agree that there would be less of it in the new Model-A structure.

One only has to recall the fiasco surrounding the launch of the GEM and the waiver of many rules for the benefit of tycoon spin-offs to understand how important this "market savvy" is in financial terms. Billions of dollars were made, not by the public, who often were balloted down to a 1-in-50 lucky draw for IPO shares, but by the placees of these deals who flipped the stock into the after-market for multi-fold profits, at the public expense. Meanwhile, the conglomerates received near-zero cost of capital, and the reputational damage to the GEM has stymied the capital-raising ability of small and medium enterprises, for whom GEM was designed.

8. Statutory investor rights, and class actions

I cannot conclude this submission without calling again for the effective introduction of investors into the regulatory system by means of class action rights and contingent legal fees.

Shareholder legal actions, or the lack of them, form a key part of the regulatory dynamics in any market. In constructing the overall deterrent to abuse of listed companies, societies can choose a combination of statutory rules, criminal prosecutions (leading to jail) and civil enforcement through class actions. To some extent, strength in one of these areas can compensate for weakness in another – it is the perceived overall deterrent that is important. Unfortunately, HK is weak in all of these areas.

Whilst there are various legal avenues theoretically open to HK investors to seek their own remedies, these avenues are in fact cul-de-sacs. No single investor, or small group of investors, is able to justify the costs involved in taking legal action relative to the dollar size of their individual claims. This is the classic "plaintiff fragmentation" problem. Together, investors in a company may have suffered hundreds of millions of dollars in damages, but individually, they cannot justify spending the tens of millions that it may take to go through three layers of courts, while the defendant often finances his defence out of shareholders' funds.

The very rare legal action we see by shareholders in HK-listed companies usually involves one or more well-funded large (20%+) shareholders battling for control of the company.

8.1 Quasi-class actions

In 2001, I proposed an alternative to the introduction of full class actions, in the form of a quasi-class action constructed as a massive joint action on behalf of members of a levy-funded body to represent investor interests, the Hong Kong Association of Minority Shareholders. For more on this proposal, see HAMS on *Webb-site.com*.

HAMS would also represent investor interests in the policy debate – which means that instead of me writing submissions like this one, an authoritative investor body, governed by investors and professionally staffed, would lobby full-time and respond to all proposals made by industry regulators and affecting investors, including the Government, SCCLR, SFC, HKSA and Law Society (and HKEx, if it is still a regulator). Any investor could join for a nominal fee (to cover the costs of communication with members), and half the governing body would be elected by individual investors and half by institutions.

The proposal met with widespread endorsement from different sectors of the investment community, both privately and (where conflicts permitted) publicly. However, in order to overcome the "free-rider" problem, to provide sufficient resources and to make it a user-pays system, HAMS had to be financed by a market levy (as are the HKEx and SFC), proposed to

be 0.005% on each trade, or just 0.01% of the free float market capitalization per annum. A levy requires legislation, and the Government rejected the proposal. Investors were more than willing to pay the levy to finance their own representation, but Government simply wasn't willing to enable it in the face of opposition from vested interests.

8.2 Statutory right to derivative action

The Standing Committee on Company Law Reform ("SCCLR") has proposed that shareholders be given a statutory right of derivative action on behalf of the company in which they have invested. However, these actions would still need to be financed until a win is secured. Secondly, even if the case is won, and the company receives the award of damages, the company is likely still to be controlled by the people who caused the damage in the first place, who may then set about expropriating the assets again.

Obviously any new legal right cannot have negative value, so I welcome it, but I personally doubt that many investors will find it worthwhile to use the statutory derivative action. For similar reasons, the Government recently withdrew proposals to empower the SFC to take derivative actions. Notably, one proposal was that these actions would be funded out of the SFC's market levy, diverting the levy from the compensation fund when this has been adequately funded. The concept was not dissimilar to the funding of HAMS, except that the SFC is governed by Government whereas HAMS would be governed by investors and hence more independent.

8.3 Class actions allow private-sector enforcement

Class actions in the USA have gained a bad reputation for frivolous law suits, but one key difference is that the USA does not have a loser-pays system, whereas HK does. A loser-pays system, whereby an unsuccessful plaintiff has to pay the defendant's costs, would deter frivolous actions in a class-action system.

If HK were to allow class actions, together with contingent legal fees, but retaining the loser-pays system, then lawyers would be able to make a calculated and commercial decision on the merits of a case, and decide whether to finance the case (and the potential costs of losing) in return for a no-win-no-fee deal. This way, only cases with a high probability of success would be brought.

There have been indications in the past that the CSRC, the mainland regulator, is considering introducing a formal class action system. This follows on from other moves to enhance the mainland market, including quarterly reporting since 1-Jan-02. The South Korean legislature has also recently passed legislation introducing class action rights.

HKEx, in its submission of 14-Jan-04, also calls for the enhancement of legal rights for investors, but falls short of advocating class action rights. If it is serious about empowering investors, and not just seeking to shift the focus away from the current debate, then it should advocate full class action rights for investors, and contingent legal fees for lawyers, against the wishes of vested interests (including sponsors and auditors) who might be on the receiving end of such actions. Empowering investors in this way would relieve the pressure on the regulator(s) and the Government, who are currently the only practical hope for remedy when corporate abuse occurs.

9. The Constitution of the SFC

At present, the Chairman and directors of the SFC are only as secure in their jobs as their relationship with Government allows, as the CEHK can appoint or remove them and direct the SFC. This does not make them independent of Government. To most outsiders, the SFC

is subordinate to Government, and boat-rockers are not welcome on its board. The SFC is kept on a short leash by Government, and that means that the Government ultimately decides how far the SFC goes to pursue its remit.

Hong Kong has an unelected Executive Branch, and as such it lacks public accountability through the ballot box. The only direct representation is through the directly elected members of LegCo, but LegCo has no say over who runs the SFC.

The Government has been and will continue to be a major player in the equity market. In 1998 it pumped HK$120bn of public money into the market, buying an estimated 15% of the free float with the stated goal of boosting the 33 companies in the Hang Seng Index (but not other stocks) to squeeze index short positions, and at the time asserted that the Government was not subject to the laws on disclosure of interests or market manipulation, an assertion it repeated last year after I raised the question of its total holdings in the MTRC.

The SFC, which normally prosecutes breaches of the disclosure of interests law, was hardly in a position to contest this. For several weeks after the intervention, investors had no idea what the Government owned or how much had been spent, although we knew it had acquired more than 3% of HSBC because it had to disclose that under UK law. It later emerged that Government had acquired more than 10% of three companies' shares.

The Government controls one listed company (MTRC) which may shortly be merged with a government-owned company (KCRC). With a substantial fiscal deficit, the government is expected to tap the equity markets in future and may control listed entities such as HK Airport, HK Water, HK Disney or HK Post. It also has *de facto* control of the HKEx through its appointment of a majority of the board, although it owns no shares in HKEx. The Government also holds billions of dollars in equities through the Exchange Fund, and has stated an intention to do so indefinitely.

For these reasons, the executive Government should distance itself from the regulatory process. In the US, the Commissioners of the SEC are nominated by the President and approved or rejected by the Senate. Not more than 3 out of 5 can be from the same political party. **To establish greater independent from administrative and political interference, in Hong Kong, the appointment and removal of the Directors of the SFC should be subject to the nomination of the Chief Executive in Council and the approval of the Legislative Council.**

9.1 Use of SFC's and Financial Secretary's Statutory Powers

It remains to be seen whether the SFC will be any more aggressive in intervening to defend shareholder interests (for example, by taking action to seek a remedy for unfair prejudice against minority shareholders) after using the strengthened powers of investigation under the SFO. It has been over seven years since the Mandarin Resources case began in 1996, and it can hardly be argued that there are no cases since then which justify such treatment.

9.2 Co-ordination with law enforcement

There also appears to me to be a lack of co-ordination between the SFC, the Commercial Crime Bureau and the ICAC. It is not clear to the public, in cases of suspected corporate fraud involving listed companies, to whom they should report the case. Fraud can also involve bribery or hidden advantages, so arguably all three apply. Furthermore, it is not clear to the public whether if one agency concludes that it cannot act, that it will pass the case to another agency or just file it. Greater clarity is needed.

10. Additional remarks

10.1 Reform is a matter of political will

The reality of reform is that it can only happen if the political will is there. When the Government wants to do something, then it can move quickly. For example, the merger and legislation which created HKEx was completed in less than a year. However, if vested interests (many of whom are on the Selection Committee which appoints the CEHK) are leaning on Government to slow down, then things can happen very slowly.

10.2 The competitive threat from mainland China

It is worth commenting on how the pace of reform here impacts on our competitive position with mainland markets. In some respects, such as quarterly reporting and the rules on independent directors, the mainland is already ahead of HK. All the corporate governance rules are promulgated by the CSRC, not the two exchanges, and with the minimum of fuss from issuers, most of which are controlled by the Government anyway. If there is a mandarin word for "U-turn", they don't use it often.

However, HK currently has two strategic advantages. First, the mainland has capital controls, and we don't. Secondly, we have an experienced and reliable (albeit expensive) judicial system used to dealing in commercial disputes and corporate law, while the mainland doesn't. Both of these advantages could disappear.

On the back of surging foreign reserves, within the next 5-10 years, China is expected to remove capital controls. This process, with offshore RMB clearing and mainland consumer credit cards in Hong Kong, has already begun. China will also likely merge its two exchanges and three share classes (A/B/H) into one and continue the privatisation of state-owned enterprises.

On the legal front, to avoid an inadequate legal infrastructure, it may outsource legal work, for example by allowing the incorporation of mainland listing vehicles in HK (or elsewhere) and listing in Shanghai, or it may choose to fast-track the PRC corporate courts to provide judicial training for a reliable and predictable legal system. After all, most HK-listed companies are domiciled in Bermuda and the Cayman Islands, so the concept of legal out-sourcing in China is well understood.

At the end of the day, for investors in mainland businesses, the domicile of the issuer is less important, because the underlying assets (subsidiaries, properties, licenses, whatever) will all be under PRC jurisdiction.

11. Summary and Conclusions

- Model A should be adopted. As a director of HKEx, I believe that this is in the public interest, and that as a business, HKEx will be more successful for its shareholders if it is relieved of regulation and allowed to focus on building better market facilities within the higher quality regulatory framework provided by a statutory Listings and Takeovers Authority.
- The Takeover Code should also have statutory backing, harmonising listed company regulation, and there should be a single authority for Listings and Takeovers, which could be named the "Hong Kong Listings and Takeovers Authority".
- All the Listing Rules and the Takeover Code should become subsidiary legislation under the SFO.
- A single panel of market practitioners, with a majority of investor-based representatives, should advise the HKLTA on the development and administration of the statutory rules. This panel could be called the "Listings and Takeovers Panel".
- The SFC should have statutory powers to fine listed companies and their directors for breaches of the rules, subject to the appeals process.
- Appeals may initially be handled by the LTP, and this could then be appealed to the existing Securities and Futures Appeals Tribunal.
- Once a company satisfies the statutory criteria for listing (which criteria would be set in the public interest and are Hong Kong's badge of quality), then as long as it pays the bills, it should not be denied access to the only stock market in Hong Kong. As a monopoly, HKEx should have a universal service obligation.
- All listed companies should have a continuing sponsor, regulated by the SFC, with a role of advising the listed company and verifying its compliance (or non-compliance) with Listing Rules, notwithstanding that the ultimate responsibility for compliance should rest with the Board of the listed company.
- The Government should introduce a right of class action to empower investors to bring their own enforcement against corporate abuse, coupled with the allowance of contingent legal fees for lawyers, but maintain the "loser pays" system to deter frivolous or nuisance actions.
- To make the SFC more independent of political or administrative interference, the appointment and removal of directors of the SFC should be nominated by the Chief Executive in Council but subject to the approval of the Legislative Council.

I am acutely aware that the ultimate governance problem in Hong Kong lies with the lack of universal suffrage for both the executive and legislative branches of government. Pressure at the ballot box from abused investors, who are also consumers and electors, is a wonderful thing. That is how the Sarbanes-Oxley act was passed so quickly while Hong Kong continues to debate, consult, and consult again.

But I do not think that Hong Kong can afford to wait until the introduction of universal suffrage if it wishes to be the leading capital formation centre of China a decade from now. To achieve that, you must take decisions which are not popular with an 800-member electorate, but will be popular with several million electors in years to come. Hong Kong's stock market is at the centre of its financial services sector, which is a key leg of its service-based economy. It is absolutely vital that you get this right.

Yours faithfully,

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