First Submission

To

Expert Group
To Review The Operation
Of The Securities & Futures Market
Regulatory Structure

November 2002

Hong Kong Exchanges and Clearing Limited

Executive Summary

Introduction

This submission covers the history of the "three tier" regulatory structure, recent events and the main issues in the current public debate. HKEx will make a further submission containing proposals for improving the operation of the listing regime.

Historical Background

In 1986, the then four stock exchanges were merged and the unified exchange was given a statutory monopoly. Following the events of 1987, the Securities Review Committee ("SRC") was appointed. The "three-tier" regulatory structure for listing matters originates in the SRC report, which recommended the repeal of the then-existing statutory listing rules and delegation of front line responsibility for listing matters to SEHK, as soon as the exchange was considered fit to perform this role. The SFC should approve the Listing Rules and act as statutory "watchdog", overseeing and auditing the performance of SEHK's listing functions. Delegation to SEHK took place in 1991.

In 1999, Government decided that the exchanges should be demutualised, merged (together with their clearing houses) and the new body listed. Demutualisation was designed to remove conflicts between the interests of members (brokers) and those of the market in general, which were hampering market development and causing regulatory friction. The listing of the new body was designed to align the interests of shareholders in the exchanges more closely with the public interest.

Because the merged entity would become a "for profit" organisation, it was recognised that new types of potential conflict of interest could arise. Consideration was given to the possibility of returning the listing function to SFC. However, Government and SFC recommended that the existing division of responsibilities should remain and Legco endorsed this position.

To deal with the new types of possible conflict, and to reflect the strong public interest in HKEx's operations, very extensive safeguards and representation of the public interest were built into the Merger Ordinance. Additional measures to address potential conflicts were included in the March 2000 MOU between SFC and HKEx. These included a clear separation between the decision-making process for listing matters (which was delegated to the Listing Committee) and HKEx's main business unit. Additionally, there continued to be close oversight by SFC of HKEx's performance of its listing duties.

These statutory arrangements were re-confirmed when the Securities and Futures Ordinance ("SFO") was debated and passed in 2000-2002. Consideration was given to making the listing rules statutory. It was decided not to do this.

In mid 2002, the "penny stock incident" and subsequent report of the related Panel of Inquiry ("PIPSI") gave rise to much public debate about HK's listing regime. A number of PIPSI's recommendations have already been implemented, including the establishment of a joint SFC-HKEX high level body to review systemic and policy issues.

HKEx's Experience of the Three-Tier Structure

HKEx considers that the "three-tier" system has generally worked well since it was established. In recent years, some lack of clarity became apparent about the role and expectation of the Listing Committee.

In July 2002, Government re-considered its earlier proposal that the Listing Committee should be abolished and replaced by a Listing Appeals Committee. HKEx simultaneously announced modifications to the listing regime which retain the Listing Committee and which will take effect in early 2003.

One initiative of HKEx in 2002 has been a consultation exercise on changes to the listing rules which relate to corporate governance matters.

Criticisms of the Present Listing Regime

The most persistent and serious source of dissatisfaction with HK's investor protection regime is the perceived "toothlessness" of the authorities and regulators generally in the face of abusive corporate conduct. Much of this conduct falls into the category of white-collar crime. HK's arrangements for dealing with such cases are widely perceived to be less comprehensive and effective than those in many other developed markets. The blame for "corporate scandals" is often laid at the door of the exchange. Expectations of the Exchange in this context are unreasonable. The problem, in HKEx's view, lies mainly in the absence of a corporate regulator with the mandate and resources to enforce company law, and the paucity of statutory powers available to SFC in relation to listed companies. Limited use has been made of the powers which do exist to investigate listed companies in cases of fraud or minority abuse.

Similarly, weaknesses in the statutory framework are the main factor which lies behind dissatisfaction with HK's regime for protecting minority shareholders. The sanctions under HKEx's Listing Rules are often perceived to be inadequate.

Should Listing Rules be Made Statutory?

Transferring the listing function to SFC is seen by some as a simple solution to this perceived problem, because such action would create a need for statutory listing rules to be issued in place of, or in parallel with, the Exchange's rules.

HKEx believes that making the listing rules statutory would represent a fundamental change to HK's regulatory regime with very far-reaching consequences. One consequence is that the rules would become subsidiary legislation and therefore be subject to "negative vetting" by Legco. This would make it more difficult to amend the rules to take account of new investor protection requirements and new financial products. The operation and interpretation of statutory rules would also be more legalistic and likely to generate recourse to the Courts. This would reduce the efficiency of HK's capital formation system. Nor does HKEx believe that statutory rules would in practice be more effective from an enforcement point of view.

New Primary Legislation is the Better Route

In HKEx's view, the correct remedy for defects in HK's regime for protecting minority shareholders is carefully targeted additions to primary legislation. Some steps have already been taken which will help in this respect, including the "dual filing" system under the SFO. There is scope for further strengthening of statutory disclosure obligations.

Shareholder remedies are also important. The new S.391 of the SFO is a step in this direction. The Standing Committee on Company Law Reform ("SCCLR") made a number of further proposals in its July 2001 Consultation Paper. These include a statutory requirement for disinterested shareholder voting on connected transactions, a statutory derivative right of action, a strengthening of the unfair prejudice remedy (including coverage of non-HK-incorporated companies) and provision for SFC to bring derivative actions. HKEx supports these proposals.

Present Listing Sanctions

The sanctions presently available to HKEx are not as ineffective as they are often made out to be. There has not been widespread flouting of the rules. HKEx accepts, however, that enforcement is vital to maintaining standards of market conduct and has recently upgraded resources devoted to the disciplinary function.

Admission and Continuing Eligibility Criteria

A common compliant is that the average quality of listed companies on the Main Board has been deteriorating. This is attributed to the admission criteria being too lax, or to a failure by the Listing Committee to filter out poor quality companies. In fact most of the admission criteria are set at quite high levels by international standards. It is difficult for the Listing Committee to reject applications which meet the criteria, on the basis of subjective factors.

HKEx recognises the need to tighten up continuing eligibility criteria and has recently issued revised proposals seeking views from the market in this regard.

Part of the solution to the problem of market quality lies in improving the standards of professional advisers, particularly investment banking sponsors. HKEx has some leverage in this context. SFC has more.

Further Reasons not to Transfer the Listing Function

There are other important reasons why transferring the listing function to SFC would be detrimental to HKEx and/or the HK market:

(a) It would represent a significant departure from the strategic vision and operational model described in HKEx's listing prospectus, with significant implications for HKEx's revenues.

(b) It would be likely to raise the overall cost to the market of listing regulation.

(c) It would weaken HKEx strategically. Without listing responsibility, HKEx would become no more than an operator of technology platforms. It would thus lose much of its "clout" vis a vis competitor or potential partner exchanges, as well as Mainland authorities and issuers. The effectiveness of HKEx in developing new listing products and promoting HK as a listing venue would be diminished.

(d) There are regulatory advantages in a "double-layered" system, with the owner and operator of the market exercising front line responsibility, overseen by a statutory watchdog. A layer of accountability would be lost if a single body performed all listing-related regulatory functions.

(e) The duplication of functions which existed prior to 1991 would be re-introduced, with added costs and probably increased market friction.

Conclusion

The existing "three-tier" listing structure has worked well for over a decade. There is no evidence that conflicts have resulted in decisions contrary to the public interest. The penny stock incident had nothing to do with conflicts. SFC audits have revealed no fundamental defects in the system or cases of abuse. If an instrument is not broken, it should not be discarded, especially if the available alternatives present serious drawbacks.

The perceived problems lie mainly in the enforcement mechanisms. These should be addressed not by removing listing responsibility from HKEx, but by adding to primary legislation well-chosen provisions for the regulation of listed companies, which are enforced by the SFC, together with improved rights of action in the hands of investors.

HKEx recognises, however, that there are ways in which the existing system can be improved. Our second-stage submission will deal with these.

First Submission

to

Expert Group To Review The Operation

Of The Securities & Futures Market Regulatory Structure

Introduction

1. Hong Kong Exchanges and Clearing Ltd. ("HKEx") appreciates the opportunity to submit views to the Expert Group. This first submission covers the background to the issues being considered by the Expert Group, HKEx's experience of the "three-tier" regulatory structure in relation to listing matters, some of the criticisms of the present regime, perceived weaknesses of the system, the subject of enforcement, and the main issues related to the division of listing responsibility between the Securities and Futures Commission ("SFC") and HKEx, including whether the Listing Rules should become statutory. A further submission will be made shortly containing HKEx's proposals for improving the operation of the listing regime within its existing overall framework.

2. HKEx supports the work of the Expert Group and will do all it can to assist in that work. Maintaining and enhancing the efficiency and reputation of HK's equity and derivative markets is both our public interest duty and the interest of our shareholders. The integrity and fairness of our market is HKEx's most important asset in attracting issuers and investors, which is the main driver of our revenues.

3. Recent events, notably the "penny stock" incident, have turned HK's listing regime into something of a "political football". Much of the public debate has centred around perceived conflicts of interest. It is clear that there is an imperfect understanding among sections of the public about the existing constitutional and institutional arrangements surrounding HKEx. At the same time, we recognise the need to address comprehensively the issue of potential conflicts. HKEx does not seek to pretend that there are no imperfections in the present listing arrangements. This submission will seek to identify these, with a view to addressing them also.

Historical Background

4. In 1986, the then four exchanges were merged, under strong pressure from Government, to form the Unified Exchange. The exchange was given a statutory monopoly in order to prevent fragmentation of the market and to create a body with the critical mass to develop HK's equity market more effectively. Unification of the exchanges was soon followed by the 1987 crash, which saw the failure of the guarantee corporation which supported the HK Futures Exchange ("HKFE") and the four-day closure of the Stock Exchange ("SEHK"), followed shortly by serious governance problems at SEHK. In response to these events, Government appointed the Securities Review Committee ("SRC") to review the whole regulation and operation of HK's securities and derivative markets.

5. "The three-tier" structure in relation to listing matters originates in the report of the SRC, which recommended that front line responsibility for regulating listed companies should be delegated to the SEHK, as soon as its staff were sufficiently professional, and that the previous statutory listing rules should be repealed. This occurred in 1991, following a complete overhaul of the Listing Rules, major changes in the composition and procedures of the Listing Committee and the SFC's first audit of the SEHK. The SRC's main reasons for recommending that listing matters should be handled primarily by the SEHK were that duplication of functions should be minimised and that practitioner-based regulation is more effective than statutory rules. Relevant extracts from the SRC report are contained in Appendix A. The first Memorandum of Understanding ("MOU") between SFC and SEHK was signed in 1991. The role of the SFC, as described in the SRC report, is to supervise closely and audit regularly the SEHK's performance of its listing responsibilities and to jointly develop policies to upgrade standards and address emerging issues.

6. At this time, the SEHK was a mutual organisation owned by its members, who were brokers on the exchange. This gave rise to periodic conflicts between the interests of the members and those of the market as a whole, particularly in relation to member regulation. Despite a further restructuring of the governance of the SEHK in 1991, these conflicts still tended to hamper market and product development initiatives by the exchange and to frustrate reform efforts. During this period, the stock exchange

was also prevented by its constitution from paying dividends. It was partly funded by a statutory levy on market turnover.

7. In March 1999, the Government determined that it would be in HK's best interest to see the two exchanges demutualised and (together with their clearing houses) merged and listed. A Policy Paper was issued setting out the reasons for the proposed changes. These included the following:

(a) Demutualisation would facilitate professional management and reduce or eliminate the conflicts between the interests of the members and those of other market users, including investors. Demutualisation was also expected to facilitate market development and improve the allocation of resources to regulatory functions.

(b) Public listing (preceded by removal of the restriction on payment of dividends) would subject the merged organisation to market discipline and enhance its accountability. This would also help to align the interests of the exchanges more closely with those of the public. Listing would simultaneously permit the investing public to participate in a "flagship" HK institution, playing a leading role in developing HK's markets.

(c)The merger of the stock and derivative markets, and their respective clearing houses, would bring economies of scale, greater operational efficiency, savings in infrastructure investment, facilitation of risk management and financial strength. This would increase the bargaining position of the merged entity with potential business partners. An integrated structure would also have the critical mass to develop new systems, products and services which would render HK more competitive as an international financial centre and a financial centre for China. In this context the importance was noted of maintaining a regulatory structure which is responsive to the strategic goal of attracting Mainland issuers.

8. While HKEx would thus become a "for profit" organisation, it was recognised that it performs very important public interest functions, including risk management in the clearing / settlement system, market surveillance, company news dissemination and the front-line regulation of listed companies. Despite the high degree of commonality between the public interest and the commercial interest of HKEx under the proposed new arrangements, it was recognised that situations could arise where the two sets of interests might diverge – for example:

(a) HKEx might be tempted to under-fund its regulatory functions in order to maximise profit;
(b) HKEx might be reluctant to disapprove listing applications, or to discipline listed companies, out of eagerness to obtain new listings or a desire not to displease its "clients";
(c) It would not be appropriate for SEHK to regulate its own holding company;
(d) Other listed companies might be either competitors of HKEx, or have commercial interests in common.

9. Various ways to address these issues were considered by Government and SFC. A Co-ordinating Committee on Market Structure Reform was established in May 1999 to advise the Administration on policy matters related to the merger. In respect of listing matters, two options for possible re-delineation of functions and responsibilities between SFC and the exchanges were considered – either to leave the structure as it was (i.e. with HKEx continuing to play the front line regulatory role) or to transfer the listing functions to the SFC. After careful consideration of the merits and demerits of these options, the SFC recommended, and Government endorsed, that the existing division of listing responsibilities should remain. This position was reflected in the Government's second Policy Paper of 8 July 1999.

10. To address the conflict of interest issues which had been identified, and in recognition of the strong public interest in efficient operation of the new merged entity, various safeguards were built into the Exchanges and Clearing Houses Merger Ordinance ("Merger Ordinance"), passed in February 2000. These include:

(a) A statutory duty for HKEx to give precedence to the public interest over any other of its interests;
(b) An initial majority of "public interest" directors on the HKEx board, appointed by the Financial Secretary, followed in 2003 by parity between appointed and elected directors;
(c) Appointment of the HKEx Chairman by the Chief Executive of the SAR;
(d) Approval by the SFC of the Chief Executive and Chief Operating Officer of HKEx (appointment of the CEO's of SEHK and HKFE was already required by previous legislation);
(e) Approval by SFC of all HKEx's fees and charges relating to its regulated business;
(f) Power for SFC to give directions to HKEx if it considers a conflict of interest has arisen;
(g) Provision that, when HKEx became a listed company, it would be regulated as such by SFC, not by SEHK.

These various provisions were, of course , debated in and passed by Legco. Copies of the relevant sections of the Merger Ordinance are contained in Appendix B. The roles of SFC and HKEx in relation to listing were the subject of a specific question by a legislator, to which the Secretary for Financial Services replied (Appendix C).

11. These statutory provisions were supplemented by various further measures dealing with the matter of conflicts:

(a) The 1991 MOU on Listing Matters between the SEHK and SFC was up-dated and extended in a new MOU dated 6 March 2000 ("Listing MOU") (Appendix D). This provides among other things for a clear separation between the Board of HKEx and the Listing Committee. The Board delegated all its listing-related powers to the Listing Committee and undertook not to duplicate their functions.

Thus, listing regulation is performed independently from HKEx's main business unit and by a Committee whose members have no interest in HKEx's bottom line. The Listing MOU also requires the exchange to ensure adequate staffing for the performance of its listing regulatory functions.

(b) The independence of the Listing Committee is further secured among other things by the existence of a Nominating Committee, on which HKEx and SFC are equally represented, which nominates candidates for appointment to the Listing Committee, as well as to the Listing Appeals Committee.

(c) Under a further MOU (dated 22 August 2001) between SFC and HKEx (Appendix E), which followed the listing of HKEx, there is provision for a Conflict Committee to review any situation where there might be a conflict between the interests of HKEx and those of any other listed company, together with a provision that SFC may act in place of HKEx as listing regulator in relation to any such company (7 cases have so far been referred to the Conflict Committee – see Appendix F).

12. In addition to these special provisions dealing with potential conflicts of interest, there is of course continuous oversight by SFC of HKEx's performance of its listing responsibilities, including monthly reporting, monthly meetings between HKEx and SFC staff and regular audits of HKEx's performance of the listing function. Since this function was delegated to the SEHK in 1991, these audits have (as far as HKEx is aware) generally confirmed the SEHK's ability to discharge its delegated functions efficiently and fairly.

13. The statutory monopoly of the SEHK was preserved in the Merger Ordinance, subject to certain safeguards to prevent its abuse. These include approval by the SFC of all HKEx's fees and charges related to its regulated business. Guidelines have been issued by the SFC setting out the factors to be taken into account in considering the levels of fees and charges proposed by HKEx. The monopoly's main significance nowadays is in relation to the listing function, since there is ample

potential and actual competition to HKEx's trading platform from exchanges and alternative trading systems located outside HK.

14. In the light of its listing regulatory function (among other things) HKEx was designated a "public body" for the purposes of the Prevention of Bribery Ordinance. All employees and Committee members of HKEx are covered by this.

15. The statutory arrangements were reviewed again at the time that Legco considered the Securities and Futures Ordinance ("SFO") between 1999 and 2002. In respect of listing matters, no changes were proposed to the respective roles of the SFC and HKEx. The statutory monopoly of SEHK was also retained. There was extensive discussion both in the public consultation process and within the Administration of whether statutory backing should be given to the Listing Rules, including power for the SFC to apply to the Court for orders compelling compliance with both the Listing Rules and SFC codes of conduct (such as the Takeovers Code). After careful consideration, Government decided not to give statutory backing to the Listing Rules or codes (see extract from Government's Consultation Document of April 2000 on the Securities and Futures Bill – Appendix G). This position was endorsed by Legco.

16. In June 2000, the HKEx became listed by way of introduction. The role of HKEx as primary regulator of listed companies, as well as SEHK's monopoly position, are described in the section of the Prospectus on the Business of the Group and elsewhere. The revenue from listing fees is included in the revenues of HKEx.

17. In mid 2002, the listing regime became the subject of much public debate as a result of the "penny stock" incident, which followed publication of a Consultation Document on initial listing and continuing listing eligibility criteria. The report of the Panel of Inquiry ("PIPSI") set up by Government following this incident quoted views expressed by a variety of parties. It concluded that the "three tier" structure itself is sound, had served HK well for the past 13 years and observed that there was overwhelming support for its retention. The comments and recommendations in the PIPSI Report (see analysis, Appendix H) focussed, particularly, on measures to improve engagement of the market and the public on policy issues at the formative

stage, to enhance consultative procedures, to delineate the respective roles of SFC and HKEx more clearly, and to clarify the role of the Listing Committee and improve its operational interface with the Listing Division. Recommendations which have already been implemented include the establishment of a high level joint SFC – HKEx body to review systemic and policy issues. HKEx is working closely with the Government and SFC on implementation of the other recommendations (a recent action checklist showing progress made on implementation forms part of Appendix H).

HKEx will in its second-stage submission describe ideas which it has under consideration for further improving the operation of the listing regime.

HKEx's Experience of the Three-Tier Structure

18. HKEx considers that the existing listing regime has, by and large, worked well since it was established in 1991. The Listing Committee has performed a very valuable role by injecting market-based experience into the consideration of both policy issues and individual cases. The SEHK Listing Rules (although non-statutory) have, with few major exceptions, been respected by listed companies and market practitioners. The flexibility of the rules has been an advantage in dealing with new investor protection requirements which arise as financial markets evolve. The non-statutory framework also made it easier to devise special arrangements to address investor protection issues raised by the introduction of Mainland-based companies when the "H" share market was first developed.

19. At the time of the merger, it was envisaged in the Government Policy Paper of July 1999 (entitled "Reinforcing Hong Kong's Position as a Global Financial Centre") that the Listing Committee would in due course be abolished and all listing decisions would be made by the Executive of HKEx, subject to appeal to the Listing Appeals Committee. Whether for this or other reasons, a certain lack of clarity developed about the role and expectation of this Committee. This was commented upon in the PIPSI report. Contributing to this problem was the fact that all members of the Committee are "volunteers" with many other calls on their time. This made it difficult for the Committee to "set the agenda" in a manner commensurate with the

considerable responsibility which the Committee carries. The main reason cited for this is that the Committee does not fully control the resource on which it depends (the Listing Division) for the preparation of papers and policy recommendations. This is an issue which HKEx is currently addressing and will comment upon further in its second-stage submission.

20. In July 2002, Government re-considered the proposal to abolish the Listing Committee and HKEx announced modifications to the proposed new listing regime. Under these modifications, the Listing Committee will continue to exist but will make decisions only on new applications and cancellations of listings. Such decisions will be appealable to the Listing Policy and Appeals Committee ("LPAC"), whose members will be nominated in the same manner as those of the Listing Committee. The LPAC will also carry the delegated power to make decisions on general policy matters related to listing, including proposals to amend the Listing Rules (thus including admission and ongoing eligibility criteria). The Listing Division will be responsible for making decisions on other non-disciplinary-related listing matters. The Adjudication Division (also part of the Regulation and Risk Management Functional Unit of HKEx) will make decisions on all disciplinary-related listing matters. Its decisions will be appealable to the Disciplinary Appeals Committee ("DAC"). The proposed new listing regime is described more fully in HKEx's News Release of 24th July 2002 (Appendix I).

21. One current initiative of HKEx which is also relevant is the consultation exercise initiated in January 2002 on amendments to the Listing Rules relating to corporate governance issues. This consultation document (Appendix J) deals with some important and controversial issues. It was initiated by HKEx and involved close consultation with the SFC at the formative stage. Problems were not encountered of the kind which arose in relation to the July 2002 Consultation Paper on continuing listing eligibility criteria. HKEx has taken account of market views on several of its corporate governance-related proposals and will shortly be submitting to the Listing Committee (and thereafter to the SFC) its recommendations for amendments to the rules.

Criticisms of the Present Listing Regime

22. The most persistent and serious source of dissatisfaction with HK's investor protection regime for some time past is the perceived "toothlessness" of the authorities and regulators generally in the face of abusive corporate conduct. In this context, HKEx's Listing Rules are only one plank in a large structure. However, they are a plank on which advocates of stronger investor protection have tended to place excessive weight, as a consequence of the relative weakness of other parts of the structure. As a result, the exchange often gets blamed for corporate "scandals" (e.g. Euro-Asia), where the problem has nothing to do with the Listing Rules or their administration. The function of the listing rules is to establish corporate processes which ensure disclosure and help to protect minorities. The Stock Exchange cannot be expected to prevent fraudulent conduct or act as prosecutor in the case of corporate fraud.

23. Much of the corporate conduct which has in the last decade tarnished HK's reputation falls squarely into the category of white collar crime – fraud, theft and corruption. The role of any stock exchange in such cases is necessarily confined to bringing matters worthy of investigation to the attention of the authorities. This HKEx has done on a number of occasions. However, it is evident that either the powers of investigation, or the resources, or the will to deal with many cases of corporate abuse are not present in HK to the extent that would be found in many developed markets. In particular, HK conspicuously lacks a corporate regulator analogous to (for example) the DTI in UK or the ASIC in Australia, with the mandate, powers and resources to enforce the provisions of the Companies Ordinance. This is certainly not the role of the Registrar of Companies in HK and the task has not been given to the SFC. The appointment of inspectors or investigators by the Financial Secretary under the Companies Ordinance or the SFC Ordinance is a cumbersome and expensive process which is only appropriate in a limited number of cases. The CCB is evidently under-resourced. Its investigations have led to few successful prosecutions. The SFC has certain powers, notably

Sections 29A and 37A of the Securities and Futures Commission Ordinance ("SFCO") (Appendix K) which enable it to start an investigation where it suspects fraud or misfeasance or abuse of minority shareholders. These powers could arguably be used more than they have been, but they remain more restricted in scope than equivalent provisions in many other jurisdictions.

24. In HKEx's view, a similar weakness in the statutory framework is the main factor which lies behind the widespread dissatisfaction with HK's regime for protecting minority shareholders from abuse. Because the statutory requirements are too narrow, heavy reliance is placed on the Listing Rules of the SEHK. These are represented as being "toothless" because the disciplinary sanctions available to the exchange are confined to suspension / delisting and the reprimand or censure of directors. These limitations are, of course, a product of the fact that the Listing Rules are based in contract rather than statute.

Should the Listing Rules be Made Statutory? – the Real Issue

25. This brings us to the real nub of the debate about the respective roles of the SFC and the HKEx in relation to listing matters. Transferring the listing function to SFC would create a need for statutory Listing Rules to be issued in place of, or in parallel with, the contractual provisions of the HKEx rules. Many advocates of stronger protection for minority shareholders (whose objectives HKEx shares) see this switch of administrative functions as a simple and effective method of giving to the HK regulatory system the "teeth" which are needed to deter abusive practices.

26. HKEx believes that it would be a serious mistake to imagine that transferring listing responsibility to the SFC would constitute merely a switch of administrative functions, or that it would be either simple or effective. Making the Listing Rules statutory would represent a fundamental change in HK's regulatory regime with very far-reaching consequences. HKEx does not believe these consequences have been sufficiently considered by those who advocate a transfer of functions.

27. One such consequence is that the Listing Rules would become rigid and legalistic. They would, HKEx believes, need to take the form of subsidiary legislation. Under

the prevailing HK legislative system, rules made by a statutory body (and any amendments to them) are subject to "negative vetting" by Legco (if "positive vetting", in the form of a resolution by Legco, is not stipulated in the relevant primary legislation). This creates an opportunity for debate in Legco not only when the rules are first issued, but every time an amendment is proposed. An inevitable consequence is that the rules would be difficult and cumbersome to amend in order to take account of new investor protection needs or to deal with new products generated by financial market innovation. Whenever listing rule changes were proposed, they would also become potentially hostage to vested interests in the political process and the involvement of Legco in the approval process could lead to the introduction of political factors unrelated to the market. The full procedure of public consultation and vetting by Legco would be extremely lengthy. These factors would probably create a reluctance to put forward amendments, leading to gradual "ossification" of the rules.

28. Nor should it be presumed that Legco would permit all the present provisions of the Listing Rules to become statutory, nor that the market would readily accept this. Proposed SFC statutory rules would require a very extensive public consultation exercise, in which it can be assumed that strong opinions would be expressed. It is virtually certain that debate in Legco would be called for.

29. If the Listing Rules were statutory, it is also likely that their administration would necessarily become more rigid, legalistic and constrained by "black letter law". Listing rules are not generally as precise as laws, and are not supposed to be so. They cannot be designed to fit every situation. As with the Takeovers Code, it is necessary for them to be interpreted with the help of people who have market experience, and for a commonsense view to be taken on how a rule applies to a given set of real-life circumstances. This would be very difficult to achieve if the rules were made statutory. The result of such action would almost certainly be more frequent recourse to the Courts, particularly when parties disliked the decisions they received. This would have a profound effect on the way the capital formation system operates, and would almost certainly reduce its efficiency.

30. Nor is it self-evident that the result would be a better quality market. The more the system relies on meeting technical legal requirements rather than the commercial spirit of a set of rules, the easier it would be for unscrupulous, but legally well-advised, company managers and controllers to get through holes in the net (which there will always be, and which - as noted above - it would be a slow process to close).

31. Nor, from an enforcement point of view, would statutory rules necessarily be more effective than the present regime. Again, there would need to be much more extensive recourse to the Courts, whose decisions might not always be as commercially acute without the practitioner involvement provided by the present system. The fact that a large and growing majority of HK-listed companies are not HK-registered (and many directors are not in the jurisdiction) would also reduce the "bite" of statutory "teeth".

Primary Legislation is the Better Route

32. In HKEx's view, the correct remedy for the perceived defects in HK's regime for protecting minority shareholders is carefully targeted additions to primary legislation. Transferring the listing function to SFC would represent a "back door" way of attempting to deal with the problem. We believe it would be messy to implement, would reduce HK's attractiveness as a capital-raising centre and would probably not be any more effective in practice from the enforcement point of view.

33. Fortunately, a number of steps have already been taken, and more are in contemplation, to address the gaps in the primary statutory framework. The recently-enacted SFO contains provision for the introduction of a so-called "dual filing" system, under which the SFC will issue rules for the statutory filing (which may still be done via HKEx) of corporate disclosure material such as listing documents, financial reports, circulars to shareholders (e.g. concerning connected transactions) and company announcements (e.g. explaining unusual share price movements). This will make it a criminal offence to knowingly file any false or misleading information, which thus brings into play the SFC's statutory investigation and enforcement powers. Introducing this dual filing system required

no change in the status of the Listing Rules, nor in HKEx's role as front-line regulator in relation to listing matters.

34. It is worth noting that there are in the primary legislation of many countries (notably the USA and Canada) ongoing statutory disclosure obligations after a company goes public. These typically include:
    - annual and interim financial statements prepared in accordance with GAAP, to be filed within specified time periods;
    - financial statements must include management discussion and analysis;
    - a requirement to disclose material price-sensitive information on a timely basis and follow this up with the filing of a more detailed material change report.

    Additional requirements have been added in the recent Sarbanes-Oxley Act.

Shareholder Remedies

35. One effective way of dealing with oppression of minority shareholders is to provide a right for investors to defend their own interests by bringing civil actions against directors and/or controlling shareholders, either on behalf of themselves or of the company. The US system, of course, relies heavily on such rights, combined with a legal system which permits class actions and "contingency fees". Without altering the entire HK legal system, it is possible to give investors rights which would act as a considerable deterrent to abusive conduct by company controllers. Indeed, a step was taken in this direction by the inclusion in S.391 of the SFO of an explicit right of action for an investor, or group of investors, who become victims of false or misleading statements made knowingly in corporate disclosure material. This is expected to come into force early next year.

36. The Standing Committee on Company Law Reform ("SCCLR") in its Consultation Paper of July 2001 (see extracts at Appendix L) makes a number of further proposals designed to enhance the protections and remedies available to minority shareholders. These include:
    - a statutory requirement for disinterested shareholder voting on transactions in which controllers have an interest;

- a statutory derivative right of action in cases of fraud, negligence or breach of duty;
- a considerable strengthening of the unfair prejudice remedy under S.168A of the Companies Ordinance (including, notably, a right for shareholders in non-HK-incorporated companies to commence actions in HK) (unfair prejudice would include the payment of excessive remuneration to directors, diversion of assets and the use of corporate assets to subsidise the business of related persons);
- provision for the SFC to bring derivative actions against wrongdoers for breaches of duty (including the case of overseas companies listed on the SEHK).

HKEx understands that the recommendations of the SCCLR on these matters are due to be published shortly. If they follow the lines described in last year's Consultation Paper, and if they are accepted by Legco, HKEx believes that the perceived weaknesses in HK's regime for protecting minorities would be largely addressed.

37. Some other jurisdictions have additional or different ways of seeking to protect, or provide redress, against oppression of minority shareholders. Appendix M describes some of these. In some markets, (e.g. Australia, Netherlands, Sweden, Switzerland) it appears not to be considered inappropriate for parts of the listing rules of an exchange (even a demutualised one) to receive statutory backing, provided the rules are approved by a statutory body (see Appendix N which provides a general comparison of the listing framework in various markets). Generally, however, such backing relates to disclosure obligations rather than (for example) the rules about related-party transactions. HKEx doubts whether this formula would work in HK. It would very probably run into the subsidiary legislation problem.

SEHK's Present Sanctions

38. Having said all this, HKEx does not believe that the sanctions available under the existing rules are as ineffective as they are often made out to be. Although the threat of suspension or delisting is a blunt instrument, there are few listed companies whose minds are not concentrated by it. Similarly, although public reprimand or censure brings no statutory consequences, the directors of numerous companies have

gone to great lengths to avoid this sanction (including many who might have been thought indifferent to such punishment). The London Listing Rules for many decades (in fact until 1999) relied on no heavier sanctions than these, and appear to have been quite effective. Nor have we in fact seen egregious flouting of the rules in Hong Kong, any more than we have of the similarly non-statutory Takeovers Code. To the extent there is a problem, it comes more from circumvention of the rules. As noted earlier, non-statutory rules are easier to amend to deal with this problem than statutory rules would be.

39. HKEx accepts, however, that enforcement of the rules (whether they are statutory or not) is as important as their content in maintaining standards of market conduct. The quality and extent of the resources committed to investigation of breaches, and the subsequent disciplinary process, are therefore vital. HKEx has recently created a new Adjudication Division whose responsibility will be to handle disciplinary cases. A regulator experienced in enforcement now heads this unit.

Admission and Continuing Eligibility Criteria

40. Another complaint levelled at the present listing regime is that the average quality of listed companies on the Main Board is perceived to have been deteriorating. This is attributed either to the admission criteria being insufficiently strict, or to a failure by the Listing Committee to exclude poorly-managed companies from the market.

41. HKEx acknowledges that there is an uncomfortably large number of third and fourth-line stocks listed on the exchange and that these are more prone to market abuse than the larger and more actively-traded stocks. However, it is an over-simplification to lay the blame for this situation at the door of either the entry criteria for the Main Board or the judgement of the Listing Committee. Most of the Main Board entry criteria are, by comparison with other developed markets, set at relatively high levels (Appendix O). The extent to which the Listing Committee can make qualitative judgements about the management of listing applicants is severely constrained; any decision to reject a listing application on the basis of non-objective factors would likely be appealed against successfully.

42. In its role as "gatekeeper", the Listing Committee also has to consider the Exchange's duty to assist in developing HK as a financial centre; this involves striking a delicate balance, both in setting entry criteria and in judging individual cases. This is particularly so where listing applicants from Mainland China are concerned. It is the role of a stock exchange to provide the mechanism for a vital economic function – the process by which companies raise capital and investors have an opportunity to participate in such companies. It is not the role of a stock exchange to eliminate financial risk. Financial success and failure are fundamental aspects of a market driven economy.

43. The number of poor-quality second and third line companies is partly due to historical accumulation. The problem has been aggravated by the economic downturn and bear market of recent years; at such times, the detritus usually becomes exposed. The solution to this problem would normally lie in stricter continuing listing requirements. This is, of course, what the consultation paper which sparked off the penny stock incident was attempting to address (among other things). In HKEx's recently-issued revised proposals, views are sought on whether delisting criteria should include financial measures (such as profits or assets), whether companies should be required to act in response to a low share price and what an appropriate trigger price should be. HKEx has also proposed alternative treatments of securities delisted from the main board.

44. As far as admission criteria are concerned, we consider the 25% level of public float to be fully in line with international standards. However we have adjusted upwards from 10% to 15% the minimum required public float for companies with large market capitalisations (now defined as HK$10 billion instead of HK$4 billion). These revised public float requirements will apply on a continuing basis. The minimum number of shareholders for listing applicants is also proposed to be increased from 100 to 300.

45. A large part of the solution to the problem of market quality should lie in improving the standards of professional advisers. Regulators (and indeed investors) all over the

world rely on the due diligence of sponsors and the thoroughness of the verification work by auditors and legal advisers. Implicit in an investment bank's sponsoring of a company's initial listing application is the investment bank's confidence in the integrity and competence of management, the solidity of the company's business model and in the prospects of the company going forward. Regulators cannot, and should not, be held accountable for companies that turn out to be poor performers but which have, according to all the information submitted to the exchange and contained in the prospectus, met the criteria for listing and been considered in good faith and approved for listing.

46. The SFC has a powerful handle on sponsors, since they are registered persons. Through its Code of Conduct for Corporate Finance Advisers, the regulatory framework is already being tightened in this area.

Further Reasons why Transfer of the Listing Function to SFC would be Detrimental

47. Apart from the undesirability of making the Listing Rules statutory, there are further reasons why HKEx considers that it would be both unfortunate for HKEx and detrimental to HK if the listing function were to be transferred:

    (a) This would represent a significant departure from the strategic vision and operational model described in HKEx's listing prospectus (Appendix P). This clearly states that the regulatory functions of the stock exchange include supervision of the listing process and ongoing compliance by issuers. It also includes the listing fees in HKEx's revenues. A proposal to alter these arrangements significantly only 2½ years after HKEx's listing would, HKEx believes, be viewed with concern by the market and might expose the directors to threats of legal action.

    (b) Assuming that the listing fee revenue remained with HKEx (in the event of a transfer of functions), the SFC would be likely to have a problem covering its additional costs, or the overall cost of listing regulation would rise (as is now happening in London).

(c) HKEx's strategic position internationally would be weakened. As noted in Government's Policy Paper of July 1999, without regulatory responsibilities (including listing) HKEx would rapidly lose a key element of its competitive advantage versus pure technology platforms. In fact, HKEx would be reduced to being an operator and developer of technology-based systems. This would diminish its "clout" vis a vis overseas exchanges (whether competitors or potential partners) and other counter-parties, including Mainland authorities and issuers. This in turn would reduce the effectiveness of HKEx's efforts to promote HK as a capital formation centre and weaken its ability to act as a "flagship" HK institution, playing a leading role in developing HK as a financial centre. It is difficult to envisage a statutory regulator promoting HK as a listing venue in the same way that HKEx has been doing.

(d) From a regulatory point of view, there are advantages in a "two-layer" system – the owner and operator of the market having "front line" responsibility and a statutory watchdog keeping the exchange under continuous and close scrutiny and taking enforcement action when breaches by listed companies of statutory requirements occur. This adds a dimension of accountability to the system as a whole which would be lost if a single body performed all listing-related regulatory functions.

(e) The duplication of functions which existed prior to 1991 would inevitably be re-introduced. There is an implication in the phrase "three tier structure" that somehow it would become a simpler "two-tier" structure if the listing function were transferred to SFC. This is not so. HKEx would still need an approval process and rules for the administration of listings (as virtually all stock exchanges do). A return to dual application / processing procedures would be unavoidable. This would be likely to increase, rather than reduce, friction with the market, as well as overall costs.

Conclusion

48. The existing "three-tier" structure in relation to listing matters has generally worked well for over a decade and has the "overwhelming support" of market participants. There is no probative evidence that perceived conflicts of interest have resulted in decisions by either the Listing Division or the Listing Committee that were not in the public interest. Such conflicts had nothing to do with the penny stock incident. Over the past decade, the stock exchange has been subject to close oversight and audits by the SFC. These have not revealed fundamental defects with the system or cases of abuse. If an instrument is not broken, and has worked, there is no good reason to throw it away. This is particularly so where the main suggested alternative raises serious problems and would, in the view of HKEx, considerably reduce the efficiency of the capital-raising process and have a negative impact on the attractiveness of HK as listing venue.

49. The problems that are perceived in the regulation of listed companies lie mainly in the lack of statutory requirements and enforcement mechanisms, which should be primarily the responsibility of the statutory regulator. This defect in the system should be addressed, not by removing listing responsibility from HKEx, but by adding to primary legislation specific statutory provisions for the regulation of listed companies which are enforced by the SFC, together with improved rights of action in the hands of investors who have the will to look after their own interests. Statutory provisions along these lines would also bring HK more into line with the standards prevailing in the world's leading securities markets.

Looking Forward

50. HKEx's objection to a transfer of listing regulatory responsibilities to the SFC (and, with it, the transformation of the Listing Rules into statutory form) does not mean that we see no respects in which the present operation of the system can be improved. We have already indicated some areas where we believe there may be genuine

weaknesses at present. Our plans to address these will be the subject of a second-stage submission to the Expert Group.