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Hong Kong Exchanges and Clearing Limited
12/F One International Finance Centre
1 Harbour View Street
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Re: New Board Concept Paper

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Dear Sir

New Board Concept/GEM's reform papers

The two consultation papers are written from the perspective of familiarity with the details of regulation and a desire not to make fundamental change . They do not start from first principles, nor analyse the needs of society. It is therefore difficult to answer the questions as posed. The following analysis and recommendations are offered in response: they go beyond the confines of the two papers to address changes needed to get the HKEX relevant to the future.

Situation

Looking broadly over the last 20 years the Hong Kong stock exchange has been successful in being a platform for (mostly) Chinese companies to raise capital from third parties by issuing shares. Their shares have traded well, so the main function of an exchange has been met. The record for listing smaller companies is mixed, and often the turnover is so low making the role of the HKEX as an exchange questionable.

It is worth noting that for the large IPOs (mostly China related) Hong Kong just organized gathering capital. The capital largely came from around the world, because investors round the world had a demand to invest in China related companies. Little of the capital came from within Hong Kong itself.

It is unlikely that the flow of new issues will continue at the same rate simply because there are not so many large Chinese companies left to list. Moreover, the stock exchanges within China are well able to provide capital, and in RMB too which is safer if the expectation is that the currency will be stable to weak.

The proposal paper acknowledges this, and expresses a hope that companies from around the world will list in Hong Kong. The effort to persuade them has been at best marginally successful. This lack of success is most likely because companies are likely to list successfully in places with familiarity: both for themselves with the law and custom, and for investors who are likely to be familiar with them, and the industry in which they operate.

In Hong Kong's case it is no accident that companies from China tend to list in Hong Kong for both have familiarity with each other. It is equally no accident that Hong Kong has few listed companies in pharmaceutical, biotechnology and life sciences, healthcare equipment and services and software services: there are few companies in these industries located in Hong Kong, and local investors are not familiar with them. To attract companies to list in Hong Kong something must distinguish the Hong Kong exchange from the alternatives. Twenty-four hour trading might be an possibility.

Analysis

What is the purpose of a stock exchange? It is to allow the exchange (sale/purchase) of rights to ownership in a business in a way that is fair, easy, reliable, secure and quick. To meet this objective institutions and regulation is required because financial transactions are easily manipulated by those wishing to profit at the expense of others. The question to answer is if the current structure is "fit for purpose" now and in the future.

Currently there is a "Main board" and a "GEM board". If a survey was done it will almost certainly show that few ordinary investors have any idea if a named Hong Kong listed company is on the "Main" or "GEM" board. Even fewer are likely to know that the difference between the boards is different regulatory requirements. The proposal to create a "third" board will be equally obscure to all but those in the financial or legal industry surrounding the exchange. It will not solve any problem nor meet a market need. It will just add to confusion. Indeed, the whole concept of a "board" is old-fashioned and without utility because few are left who remember a broker's office having physical boards.

Recommendations

- There should be one Unified list of tradable stocks incorporating companies in the current "Main", "GEM" boards and the proposed "Third" board.
- All companies that have a primary listing in Hong Kong should the subject to the same basic set of listing rules. If it is felt that smaller companies need greater supervision or more detailed guidance, they should be identified by size.
- Very large companies with sophisticated management and a history of a system of first class institutional governance should be able to apply for a status excusing them from minor listing rule restrictions and "vetting". They could be called "Premium" listed companies[1].
- To be listed in Hong Kong a company should be required to prepare a document with the same content as a prospectus so that the investor is fully informed. There should be no need for a profit record[2] but the management must prove they have practiced the skills necessary to run the business for at least three years, and if it is a new team that they have committed to employment contracts for another three years. There should be no requirement for an issue to the public.
- Prospectuses should have an additional requirement - that the directors/management prepare a five year forward profit forecast based upon clear and explicit assumptions. This is key information required to make a rational investment decision, but at present is unaccountably missing from the required IPO listing information. It would allow investment analysts and potential shareholders to debate the reasonableness of the assumptions intelligently.

[1] The regulator, be it the SFC or HKEX, needs to be willing to go beyond checking if rules are being followed to exercising subjective judgment.

[2] The term "Pre-profit" in the Papers should be discarded unless the HKX is going the follow through by guaranteeing a profit in the future. Please be intellectually honest and straight-forward and call them "loss-making" companies.

- There should be no objection to WVR structures so long as their corporate governance is clearly described and is subsequently not abused. [It is ironic that the HKEX itself has a WVR structure but does not currently allow new listings with such structures.]
- There should be minimum issue size for a primary listing set relatively high, say HKD380 million (USD50 million), and a free float of at least 25% of the total shares in issue held by at least 100 shareholders each holding an approximately equal number of shares. This should be a continuing requirement. "Cornerstone" investors should not be countered in free float.
- Liquidity should be a major factor for continuation of a listing. If a company does not trade each day so it is possible to clear 1% of the shares in issue fluidly it should be delisted or transferred to the Private Market. The primary job of the sponsor should be to ensure liquidity, not compliance.
- Identifying "new economy" industries for special treatment or consideration is a fool's game: the definition is subject to debate, every industry must have been "new" sometime in the past, so someone will have to maintain a continually changing list, and the "new" has no greater prospect of success than the traditional.
- Companies taking a secondary listing on the Hong Kong stock exchange should comply with the listing rule in their place of primary listing, which should be clearly displayed. There should be no requirement that they must provide investor protection equivalent to that required of Hong Kong companies. In today's world is meaningless, for the same share can be bought sitting in Hong Kong from the place of primary listing through an on-line broker. It needs to be recognized from the outset that trading on a secondary exchange has rarely been worth the cost over the last 50 years, and that on-line trading makes its significance even less than in the past.
- The role of independent non-executive director should be strengthened in two ways: (1) there should be an automatic right for a INED who has attended 75% or more of meetings to stand for re-election on the expiry of his term in office[3]; (2) shareholders with a controlling interest should not be able to vote.
- There is a clear case for giving disproportionately more votes per share to shareholders who have held their shares for long periods of time, and are thus committed to the future of the company. In a time of frenetic share trading – often purely mathematically driven - the "one share one vote" concept makes little sense.
- The ability of listed companies to suspend their shares should be severely restricted. The concept offends against an exchange's fundamental purpose – to provide liquidity. Suspensions of up to a maximum of 30 minutes to allow market participants time to read and assimilate new information published by the company should be more than enough.
- There is an urgent need to make circulars to shareholders easier to understand. Recently I received one that after a reading it twice I was unclear what was the effect of the proposed transaction had on the company. It began "Reference is made to [a previous document....]". Few would have a previous document to hand so the essence of the previous document should have been repeated in the new. Instead of using a real name there were references to "the Company". The deal involved many companies so it was confusing. Many companies were merely intermediate holding companies but were described as though they were the underlying real asset. The HKEX should campaign to make lawyers and advisors realize that these while these may be legal documents, their primary purpose is to make sure the ordinary shareholder understands what is proposed for the company in which he owns a share. They should be simply written and be self-contained.

[3] An exception might be if all independent directors deliver a factual and reasoned argument why he should step down and the regulatory agreed.

- In the same spirit, there is an urgent need to insist all intermediaries and nominees pass company documents to the ultimate shareholder free of charge, and/or that the details of the ultimate beneficiary holder of the shares is available to the company so the directors can communicate directly with the company's shareholders.

- The Private Market is an excellent idea to help small start-up companies establish themselves. However, it is meaningless unless it offers a matching service to find buyers and sellers, and requires the filing of audited accounts. With these added it would be very valuable. It would be a great place to transfer a company listed on the Unified exchange if it gets suspended for any reason, for it would allow the exchange of shares between a willing buyer and seller.
- Of equal value would be a structure for crowd-funding to allow individuals to make small investments in young and developing companies with ideas of promise.
- If the HKEX feels it cannot operate a true private or crowd-funded market it makes a good case for restrictions on new competitive exchanges to be removed.
- There is a good case for the HKEX to concentrate its activities on operating an exchange and monitoring the integrity of the transactions passing through it. The regulatory responsibility of approving and monitoring listed companies could then be given to the SFC.

Best regards.

Yours faithfully,

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