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Joint Consultation Paper: Proposed Enhancements to the Stock Exchange of Hong Kong Limited's Decision-making and Governance Structure for Listing Regulation

Response by the European Chamber of Commerce in Hong Kong

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This is a response by the European Chamber of Commerce in Hong Kong (the **Chamber**) to the proposals set out in the "*Joint Consultation Paper: Proposed Enhancements to the Stock Exchange of Hong Kong Limited's Decision-making and Governance Structure for Listing Regulation*" published by the Exchange and the SFC (the **Consultation Paper**). Except where otherwise stated, capitalised terms have the same meaning as in the Consultation Paper.

For European companies, the Exchange has a vital role to play as Asia's premier international stock exchange, while Hong Kong, with its advantages of the rule of law and concentration of skilled professionals, acts as the springboard to Asia for many European companies wishing to participate in the Asian growth story. Most importantly, perhaps, Hong Kong and the Exchange provide the gateway for the two-way flow of investment between China and Europe. It is from that perspective that the Chamber is keen to see the Exchange not only continue to thrive, but also to innovate to increase the opportunities for foreign issuers to list on the Exchange and to gain access to Chinese investment capital through the links established between Hong Kong and China, such as the successful Hong Kong-Shanghai Stock Connect scheme and the Hong Kong-Shenzhen Stock Connect scheme which is to be launched shortly.

Despite earlier moves to increase the number of overseas companies listing on the Exchange, notably the publication of the Joint Policy Statement Regarding the Listing of Overseas Companies in 2007 and its updating in 2013, there are still only a handful of European jurisdictions that are recognised as acceptable jurisdictions of incorporation. More disappointing still is that only 3 European companies are currently listed on the Exchange: Prada, L'Occitane and Samsonite, all companies in the luxury good sector. China's increasing opening-up should make a Hong Kong listing extremely attractive to European issuers. The reality however is that the expense and difficulty of listing European companies in Hong Kong does not encourage this. A Hong Kong listing is extremely expensive compared to listings on other international markets, primarily due to the extensive due diligence sponsors are required to undertake, which for European companies operating in a number of jurisdictions is incredibly expensive. For companies incorporated in jurisdictions not already recognised as acceptable jurisdictions, the procedure involved in satisfying the Exchange as to the acceptability of their jurisdiction is time-consuming and expensive. Even for companies from acceptable jurisdictions, the approval process is not straight-forward since new applicants are required to review the description of applicable laws in the relevant country guide and inform the Exchange of necessary changes. Given the already expensive and onerous listing process for overseas companies, the Chamber considers it essential that the Hong Kong regulators do not pursue any

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regime changes which will add to listing costs, or increase uncertainty in the listing process, unless such changes can be fully justified by demonstrable improvements to the efficiency of listing procedures.

The Chamber's principal concern in relation to the Consultation Paper is that it fails to set out any convincing reasons for the significant reforms proposed. Nor does it attempt to quantify or describe the enhancements to which it repeatedly refers. The Chamber considers that the proposals are unlikely to either improve the efficiency of the listing approval process or improve the quality of listed companies. Instead, the increased powers to be given to the SFC to determine the policy direction of the Exchange as well as the decisions as to which companies are able to list and remain listed on the Exchange, will abandon market practitioner regulation as currently practised by the 28-member Listing Committee in favour of regulator-based regulation and policy setting. This in turn could result in a failure to innovate and stunt the Exchange's development. If the primary objectives become preventing anything from going wrong and ensuring that investors do not lose money, the Exchange will lose out to other stock exchanges willing to innovate to provide a competitive and attractive listing venue for listed companies.

1. Policy development

Under the current regime, policy proposals and suggested amendments to the Listing Rules are submitted by the Exchange's Listing Department to the Listing Committee for consideration by its 28 members, the Exchange's CEO and 27 individuals independent of the Exchange who are market practitioners (lawyers, accountants and other professionals), listed company and investor representatives. The tremendous benefit of the Listing Committee is that it comprises highly experienced professionals representative of the different sectors involved in Hong Kong's IPO market. These are people at the top of their professions with years' of commercial experience who can have beneficial input in formulating policy and proposing amendments to listing regulation. The SFC however retains substantial control over policy and regulation since any change to the Listing Rules and any waiver which will have general effect must be approved in writing by the SFC before it takes effect. The SFC thus has an effective right of veto over any proposed change to listing regulation.

The Consultation's Proposals will see responsibility for policy setting moved to the proposed new Listing Policy Committee (**LPC**) composed of just 8 individuals: 3 paid employees of the SFC and the SFC-appointed Chairman of the Takeovers Panel and 4 members of the Listing Committee, individuals who are independent of the Exchange and under no obligation to represent its views. Although the Listing

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Committee will have the opportunity to comment on policy matters to be put to the LPC, the latter is not obliged to take those comments into account in reaching a decision, nor is it required to explain why the Listing Committee's comments were not followed. Major flaws in this proposal are that policy making power will be concentrated in the hands of a very small number of individuals whose decisions will not face challenge or be discussed directly with the Listing Committee or anyone else. Moreover, there will be no IPO sponsor on the LPC which will deprive it of front-line experience of issues facing listing applicants.

A major concern is that the SFC's representatives on the proposed new committee would be rightly focussed on the need to protect investors' interests and making sure that nothing goes wrong. This will likely lead to risk-averse decision-making, the consequence of which will result in a failure to innovate and lack of market development, that is the "straight-jacketing [of] the securities market by a strict regulatory regime which might all too easily lead to insensitive or heavy handed regulation", which the Hay Davison report aimed to avoid through implementation of the current practitioner-based regulatory system.

Given that the SFC already has the right to veto any policy change with which it disagrees, the Chamber considers that market development will be best fostered by the existing regime which allows policy direction to be influenced by those with market expertise and appreciation of the commercial realities.

2 Listing applications by new applicants

The current regime already gives the SFC the power to reject a listing application in a range of circumstances. Under the dual filing regime, the SFC receives all listing application documentation virtually simultaneously with the Exchange. It has the right to object to a listing application within 10 business days of its submission (or within 10 business days of receiving further information requested of the listing applicant) where, among others, the SFC considers that the applicant does not meet the requirements for listing, which would include the requirement that its business is suitable for listing, or that the listing is not in the public interest. These are statutory rights given to the SFC by the Securities and Futures Stock Market Listing Rules (**Stock Market Listing Rules**). The Listing Department also consults the SFC during its review of listing applications which can result in applications being rejected by the Listing Department. Listing applications which are not rejected or objected to proceed to a hearing by the Listing Committee where they benefit from the input of market practitioners as well as investor and listed company representatives.

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The proposals would see all listing applications flagged by the Listing Department as raising concerns as to suitability or having broader policy implications determined by the proposed new Listing Regulatory Committee (the **LRC**), composed of just 6 individuals. Our comments above as to the flaws of the proposed new LPC apply equally to the composition of the proposed LRC.

Of all the decisions to be made on a listing application, the assessment of "suitability for listing", a requirement not included in the criteria of other international stock exchanges, is the most subjective and the one best suited to consideration by those with broad market expertise. The issue of suitability is one that theoretically applies to all potential listing applicants. The criteria for assessing suitability are opaque at best with the Exchange's guidance on the subject couched in the broadest possible terms. For example, notwithstanding that there is no profit requirement for companies seeking to list on the Growth Enterprise Market, listing applicants may be rejected for lack of suitability due to concerns as to the sustainability of their business which will often turn on the applicant's profit forecast.

The Chamber considers that the existing Listing Committee is best placed to approve or reject listing applications and fears that vesting these powers in the proposed LRC would result in overly conservative decision-making.

3 Matters involving listed issuers

The Chamber's concerns regarding vesting decision-making powers on specified post-listing matters in the 6-person LRC are substantially the same as for decisions on new listing applications as set out in section 2 above.

Again the SFC already has substantial powers to require the Exchange to suspend trading in a listed issuer's securities where it appears to the SFC that this is appropriate for the protection of investors or in the public interest under section 8 of the Stock Market Listing Rules. The SFC thus already has the power to order the suspension of listed issuers which it believes to be listed shells which have attracted media attention. The case of Hanergy Thin Film Limited (**HTF**) is an example of the effectiveness of the SFC's powers to suspend dealings in a listed company's shares under the Stock Market Listing Rules. Following the Exchange's suspension of dealings in HTF's shares at the company's request, the SFC exercised its powers under the rules to direct the Exchange to continue the suspension due to concerns that HTF could not keep the market properly informed. Dealings in HTF's shares remain suspended pending the outcome of an SFC investigation. Given that the SFC already has this reserve power to order the suspension of any company it

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considers to be unsuitable to be listed, the Chamber considers that decisions on all post-listing matters should remain the responsibility of the Listing Committee. The primary decision maker will then remain the Listing Committee with its broad expertise and, if for any reason the SFC is not satisfied with its performance, the SFC is entitled to step in and order the company's suspension.

4 Reviews of Listing Decisions

The Chamber objects to the proposal that decisions of the LRC would be reviewed by another SFC-dominated committee, the proposed Listing Regulatory (Review) Committee (the **LRRC**). Under the existing regime, an SFC decision to object to a listing application under the Stock Market Listing Rules is subject to the right of the listing applicant to have that decision reviewed by the Securities and Futures Appeal Tribunal (**SFAT**), which is chaired by a judge and is completely independent of the SFC. Since the SFC's proposed powers under the Consultation Paper would be exercised by the SFC through its representative members on the new Exchange committees, the listing applicant will lose its right of appeal to the SFAT and the SFC will effectively be allowed to exercise its powers free of the checks and balances conferred by the Securities and Futures Ordinance. The SFC will thus be less, not more, accountable and transparency will be diminished rather than increased since the SFC's exercise of its powers will be presented as that of a committee of the Exchange. The role of the SFC under statute is to regulate the Exchange and protect investors. It thus acts as a vital check on the Exchange. Accordingly, it is essential that the function of the SFC should remain distinct from that of the Exchange and that the SFC should be accountable (as it is currently due to availability of judicial review and the right to appeal "specified decisions" to the SFAT under section 217 of the SFO).

The problem with the Consultation's proposals is that they would allow the SFC to move towards front-line regulation, while still allowing it to retain its role as regulator. Actions of the new LRC, comprised as to 50% of SFC employees, will be subject to review only by a further committee with substantially the same composition. Moreover, decisions of the SFC will be camouflaged as decisions of Exchange committees allowing the SFC to avoid the checks and balances on its powers which are built into the existing regulatory regime.

5 Disciplinary Matters

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The Consultation Paper fails to make the case for changing the manner in which disciplinary decisions are currently made. In the absence of an articulation of the mischief the proposal is intended to address, or the intended benefit, the Chamber disagrees with the proposals for change.

6 Oversight of the listing function

The Chamber opposes the proposal that the LPC should be responsible for oversight of the Listing Department. The Listing Committee was made responsible for Listing Department oversight precisely because it is independent of the Exchange. In contrast, the Consultation proposes that the LPC will be given primary responsibility for appraising senior executives of the Listing Department in performing their regulatory responsibilities and that assessment will be taken into account by the Exchange's Remuneration Committee in determining the remuneration of those senior executives. The Listing Department will have primary responsibility for categorising cases as LRC Matters which will see them determined by the LRC. The make-up of both new committees will be 50% SFC and 50% Listing Committee representatives. To maintain the independence of the Listing Department, its oversight should remain with the Listing Committee and remuneration of Listing Department senior executives must be entirely independent of any assessment of its referral of LRC Matters to the LRC.

7 Publication of Decisions

The Chamber suggests that decisions of the LRC should explain why Listing Committee comments were not reflected in its decision, where that is the case. Decisions of the LPC should also be published so that there is transparency as to regulatory proposals and, where appropriate, the reasons these are not implemented.

8 Composition and Procedures of the LPC, LRC, LDC and LDRC

Composition

The Consultation Paper suggests that decision making power on the new committees will be shared between the SFC and the Exchange as the committees will comprise equal numbers of representatives of the SFC and the Listing Committee.

In reality, however, the SFC will have full control of the composition of the LRC and LPC since its representatives on the Listing Nomination Committee have an effective veto on the nomination of any

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individual to the Listing Committee, and hence to the LRC and LPC. Neither the Listing Committee nor the Exchange will have a comparable right to control who represents the SFC on the new committees.

The major problem with the LPC and LRC however is their size: just 8 and 6 members, respectively, will be responsible for decisions currently made by members of the 28-member Listing Committee. Not only does this consolidate power on the most important listing matters in the hands of a very small group of individuals, the representatives of the new committees are comprised as to 50% of regulators. Of the 3 (or 4) non-regulator representatives, not one is an IPO sponsor. The decisions which the new committees will be required to make call for market expertise and experience currently provided by the Listing Committee, but which will be lacking on the two new decision-making committees. The composition of these committees will see a move from practitioner-based regulation to regulator led regulation which is likely to be overly risk averse resulting in a failure to pursue the innovative strategy the Hong Kong market requires.

Procedures

The procedures of the new committees also appear to be fundamentally flawed. While majority approval is required for any decision, the Chairman will not have a casting vote capable of resolving a deadlock. A particular problem is that the Consultation Paper does not spell out how a tied vote would operate. It seems to assume that a tie would mean that a listing application wouldn't proceed, although it is not clear why that should be the case. While there is no majority finding the listing to be acceptable, there is equally no majority opposing it. Whichever way it is intended to work, there must be consistency with the way post-listing matters are dealt with – e.g. suspensions for failure to comply with Rule 13.24. Presumably suspension will only occur where there is a majority finding that the issuer is in breach of Rule 13.24 (i.e. a tie would not be sufficient for an issuer to be suspended)? Greater clarity needs to be provided as to what will happen in the case of a deadlock on the new committees.

9 Other Matters

The Chamber also has the following particular concerns in relation to the proposals.

(i) Greater Inefficiency

It is difficult to see how a further level of approval (the LRC approval) will enhance efficiency for listing applications involving LRC matters. Moreover, there seems little point in the Listing Committee commenting on matters to go before the LRC if the LRC is under no obligation to take

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their comments into account or to give reasons for not reflecting Listing Committee comments in its decisions. The Listing Committee stage could become a waste of time and effort if its views are not taken into account by the LRC. Some measure therefore needs to be built in so that the LRC and LPC Listing Committee members are bound to vote in accordance with the majority view of Listing Committee members at the meeting held to consider the matter to be determined by the LRC.

(ii) **Lack of Innovation**

As already mentioned, the Chamber is concerned that the presence of regulators on the decision-making and policy-setting committees of the Exchange will lead to overly-cautious decision-making which in turn is likely to stifle innovation and market development. The small number of European companies listed in Hong Kong is disappointing and the Chamber urges the regulators to address this issue by giving consideration to what can be done to encourage more European companies to list on the Hong Kong market. Rather than make listing applicants prove the acceptability of standards of shareholder protection in their jurisdiction of incorporation, the Chamber would urge the Exchange to undertake this process itself for countries whose companies it would like to encourage to list in Hong Kong.

(iii) **Greater Certainty**

The Chamber would like to see greater certainty as to the criteria for listing in Hong Kong, particularly around the issues of "suitability for listing" and "shell companies". It is unfair for listing applicants to have to incur the substantial costs involved in preparing for listing, only to find out at the committee hearing that they or their businesses are considered to be unsuitable for listing. The position would be greatly improved if there could be a move towards bright-line tests where possible, and clearer more specific guidance on suitability and shells. It would also be helpful if guidance could be given pre-application so that concerns relating to suitability can be raised at the very outset and applicants can get a preliminary non-binding view on whether suitability is likely to be a problem. More guidance at the very preliminary stages would save applicants time and expense in preparing to list if there is a fundamental concern as to suitability.

(iv) **Dealing with Shell Listings**

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One of the major issues raised in the press surrounds shell company and backdoor listings. While the Chamber does not consider these to be inherently objectionable provided that shareholders are kept fully informed, it has concerns regarding the Exchange's attempts to screen listing applicants in an attempt to identify potential shells seeking to list purely to profit subsequently from a reverse takeover. It is extremely difficult for SMEs to establish beyond doubt that they are not seeking listing purely to benefit from their shell status. Yet the regulators' suspicions are causing SMEs to insist on excessively long lock-up periods on their controlling shareholders' holdings purely to disprove potential allegations of a shell listing. This is unfair on the SMEs and their controlling shareholders as there may be completely justifiable reasons for selling-down part of their holdings post-listing which do not involve a reverse takeover. Moreover, Hong Kong already has stringent rules on reverse takeovers, cash companies and delisting, enforcement of which would provide a far better way of dealing with concerns as to shell listings than the blanket application of a difficult and opaque screening process pre-listing which risks rejecting genuine SME companies and further increasing the difficulty and expense of listing.