JOINT CONSULTATION PAPER
BY
THE SECURITIES AND FUTURES COMMISSION
AND
HONG KONG EXCHANGE COMPANY
ON
PROPOSED ENHANCEMENTS TO
THE STOCK EXCHANGE OF HONG KONG LIMITED'S
DECISION-MAKING AND GOVERNANCE STRUCTURE
FOR LISTING REGULATION
("Consultation Paper")

Individual submission

The Consultation Paper proposes the first important though modest step in the evolution of a system inherited from history. So that the significance of this small step in evolution might be better understood, it may be helpful to go back briefly into history.

Prior to the Unification of Exchanges Ordinance, Hong Kong had four exchanges and in an ideal world, it might be assumed they would compete to provide the best services available to their clients. But the rudimentary system of market regulation then in existence did not assure this, and instead there was a race to the bottom, giving rise to rampant malpractice in the listing of new shares. These malpractices included preferential allotment of shares to members of the Listing Committee of each of the Exchanges and other favoured parties, and artificially depressing issue prices to assure a profit upon opening of dealing in the shares concerned.

The Unification of the four exchanges did not reduce the malpractice and probably made it worst, as the unification created a monopoly and the power to control the listing of new shares vested became vested in the few members of the Listing Committee of the Unified Exchange. Things came to a head, soon after the stock

market rout in 1987, by way of the prosecution of the then Chairman of the Stock Exchange, who headed the Listing Committee and its other members.

Among the Government interventions following the 1987 Stock Market Rout, the Securities Review Committee ("SRC") was appointed with wide terms of reference. The SRC was chaired by Mr. Ian Hay Davidson, then Chairman of Lloyds of London. The Committee produced a report with a large number of recommendations aimed at restoring confidence in the securities and futures markets in Hong Kong. The formation of the Securities and Futures Commission ("the Commission") owes its provenance to this Report, as does the present system of listing regulation and the sharing of duties between the Listing Committee.

One of the first tasks of the Commission was to reform the governance of the Unified Stock Exchange by appointing public interest directors to its Board and at the same time, the Commission entered into a Memorandum of Understanding ("Listing MOU") with the Unified Stock Exchange, whereby the Listings Committee would operate independently from the Board of the Stock Exchange and the members of the Listing Committee, representing, as much possible, the whole spectrum of the practitioner, issuer and investor community in the securities market in Hong Kong, would be appointed in consultation between the Exchange and the Commission. Under the MOU, the Commission would have oversight over the operation of the Listing Committee and the Listing Department, and the formulation of listing rules and waiver of the rules having market wide implications must receive the prior approval of the Commission. Over the years, there have been a few amendments to the Listings MOU, although its basic structure has remained much the same. But the world has moved on.

First, from 1993 onwards, the Hong Kong Unified Stock Exchange became an important listing platform for Chinese companies and by the end of 2015, the Stock Exchange of Hong Kong ("SEHK") was the world's top exchange in capital raising, raising some USD 33.5 Billion in new capital in IPO[1], followed by the New York Stock Exchange, Shanghai Stock Exchange and London Stock Exchange. But it might

[1] See: EY Global IPO Trend 2015

be noted that the overwhelming source of IPO companies is China. Chinese companies listed in the Stock Exchange of Hong Kong now command roughly two thirds of its market capitalization and daily turnover. One might ask why, Chinese companies would choose to list in the Unified Hong Kong Stock Exchange, when the Shanghai and Shenzhen Stock Exchanges together commands the second highest market capitalization and daily turnover in the world. The reason for this lies in a number of advantages which Hong Kong has historically, and still offers, and which the Chinese exchanges cannot in the short term duplicate.

The first is that there is no exchange control in Hong Kong and the Hong Kong's listing regulatory system allows international book building as well as regulated market stablisation and over-allocation options, just as New York and London would allow. Chinese exchanges cannot offer international offerings with the same degree of facility as the Unified Exchange, despite the QFII system. The regulation of listed companies coupled with the reputation of Hong Kong legal and regulatory system give a high degree of assurance to international investors. But with the increase of Chinese companies listed in Hong Kong in recent years, the regulation of listed companies has become more and more challenging.

Chinese listed companies come in various shapes and sizes, ranging from major international banks largely owned by the State to comparatively small enterprises owned by private persons from the burgeoning ranks of Chinese entrepreneurs. The quality of corporate governance therefore varies greatly and the market regulatory function has thereby become far more difficult and complex than in the days when the Listing MOU was first promulgated. The fact that only a handful of the many Chinese companies listed on the Exchange are incorporated in Hong Kong or have their headquarters in Hong Kong, means that effective market regulation frequently depends on the level assistance that can be mustered from PRC authorities. When regulating a market depends upon actions which have to take place out of the jurisdiction, the challenges are not difficult to imagine.

Second, Britain, from whom Hong Kong had drawn its self-regulation listings model, abandoned this system at the turn of the Century. In 2002, the United Kingdom

established the UK Listing Authority as part of the Financial Services Authority (now the Financial Conduct Authority). The reasons for this step were various.

By the beginning of the Millennium, reliance on essentially a self- regulatory model no longer ensured a level of market regulation to standards deemed acceptable by the constituents of the London market and by the Government of the day, who had just overhauled the entire system of financial regulation by the Financial Services and Markets Act 2000. It is also fair to say that the listing of the London Stock Exchange also played a part in the decision to create the Listing Authority. The listing made it impossible for the Stock Exchange to enforce the Listing Rules against itself. Another question raised was whether a listed entity with a primary remit to create shareholder value could be expected to expend sufficient resources in a market regulation function that did not create revenue, or worse still, what if a market regulation imperative conflicted with a commercial objective? The abandonment by the UK of the self- regulatory model for listings has by all appearances worked well for London. The London stock market is considered one of the best regulated in the world. Because of the European financial passport and the absence of exchange controls, European Exchanges compete with the LSE and investors and institutions reap the benefit of this competition. The LSE, freed from its previous regulatory burdens, was able to concentrate on pursuing its commercial objectives. The LSE is consistently among the top five in the world in attracting new listings. But at the same time, as a major market constituent, the LSE has an important voice in the formation of listing policy and rules, and in holding the Listing Authority to public account in performing its functions.

Given these developments and the listing of the Unified Stock Exchange in combination with the Futures Exchange and Clearing Company, there is a good case to be made for the regulation of all listings to be vested in a single Listing Authority residing within the Commission. The market would then deal with only one regulatory agency. The single listings regulator would be able to use as the situation demands, the entire investigatory and regulatory arsenal available in the Securities and Futures Ordinance and the Listing Rules to the best effect, and in syncopated time within its own organizational and command structure. Not only will regulation within Hong Kong be more efficient and effective, liaison with Chinese Authorities

would be much more efficient and timely, and hopefully therefore, produce better results. Hong Kong cannot allow its hard earned reputation as a well regulated market to be eroded, that being one of the reasons why international investors had trusted the Hong Kong market. In time, the Chinese market will catch up as the Chinese market is constantly building its regulatory and professional capacity. That means that Hong Kong must continue to excel in market regulation. A single Listing Authority in the Commission would probably provide the best chance of retaining Hong Kong's lead.

With a single Listing Authority in the Commission, the Stock Exchange would be able to pursue its commercial interests freed from the burdens of having to vet listings and ensure compliance with the Listing Rules. Although the Stock Exchange is still a monopoly, competition will come, whether it likes it or not, from regional and international exchanges and from the Chinese Exchanges as controls on the RMB eases with the internationalization of the currency.

One needs only take momentary pause to ponder the benefits of a single Listing Authority to the efficiency of the securities market and to assuring Hong Kong's future as an international market, and wonder why Hong Kong has not long ago chosen this path.

That the Securities and Futures Commission and the Stock Exchange have chosen to consult the market on the small evolutionary steps encapsulated in the Consultative Paper is perhaps an illustration of how difficult it is to take bold and necessary steps in Hong Kong, however logical and potentially beneficial to the public interest they might be. But as my former colleague in the Securities and Futures Commission, and good friend, Andrew Sheng says, all public proposals in Hong Kong represents compromises between the many interests which make up Hong Kong. The act of compromise hopefully brings parties closer together in mutual understanding and perhaps, by adopting the current compromises, the actors in the listings regulatory system will in future find a better, more lasting solution.

Andrew Sheng calls these proposals, no more than common sense steps in the evolution of the current system of listing regulation, which they clearly are. The Commission already under the Securities and Futures Ordinance and the MOU already has the power to regulate the Stock Exchange, to approve new listing rules or to require the drafting of new rules. These proposals enable the Securities and Futures Commission to work in closer, more formalized manner with the Stock Exchange and that can only enure to the benefit of the current system. I do not understand why the media has chosen to characterize the public discussion as a turf war between the Exchange Company (which is the listed company and holding company of the Stock Exchange) and the Securities and Futures Commission. The Consultative Paper is jointly issued by the Commission and the Exchange Company.

As these proposals are intended to provide better coordination, I would suggest that all three Committees should formulate work plans and objectives, which should be as transparent as possible and the work flow should ensure that all three committees work in close knowledge of each other's work and in close co-ordination with each other. In particular, performance indicators might be formulated to demonstrate that indeed the new system is working better than the old.

With the above remarks, I support the proposals set out in the Consultative Paper.

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