香港中文大學
The Chinese University of Hong Kong

29 August 2016

Corporate Finance Division
Securities and Futures Commission
35/F Cheung Kong Centre
2 Queens Road C.

BY ELECTRONIC & ORDINARY MAIL

Dear Sirs

CONSULTATION PAPER ON PROPOSED ENHANCEMENTS TO THE EXCHANGE'S DECISION-MAKING AND GOVERNANCE STRUCTURE FOR LISTING REGULATION

I refer to the above and take pleasure in attaching hereto my response to the same.

In principle I **SUPPORT** the proposals as set out in the foregoing ***SUBJECT TO*** the SFC and the HKEX collaborating to adequately address the issues that I have raised under the section titled '**CAVEATS**' in my submission.

As I have adopted a holistic approach to the issues I apologise for not setting out my submission strictly in the manner as prescribed in paragraph 141 of the Joint Consultation Paper. That said I have no objections to my submission as set out in the attachment being made publicly available on the websites of the SFC and/or the HKEX in the manner as it presently stands.

As always please do not hesitate to contact me either by e-mail at or by phone at should you require any further amplification of this submission.

With warmest regards

Yours sincerely

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CUHK BUSINESS SCHOOL

RESPONSE TO THE JOINT SFC-HKEX CONSULTATION ON PROPOSED ENHANCEMENTS FOR LISTING REGULATION

by

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SUMMARY OF SUBMISSION

A number of well-established capital markets globally are regulated by an independent regulator. For example, there is the Securities and Exchange Commission in the United States of America and the Financial Conduct Authority and the Listing Authority in the United Kingdom. Unlike these jurisdictions, Hong Kong maintains a hybrid system which inevitably results in perceived conflicts of interest as the Hong Kong Exchanges and Clearing Limited ('HKEX') performs a dual role as both a for-profit listed company with a monopoly in its principal business activity as well as being the front-line regulator for listings on the Stock Exchange of Hong Kong ('SEHK')

Contrary to what has been reported in some media, the issue should not be reduced to a simplistic 'turf war' between the Securities and Futures Commission ('SFC') and the HKEX as the former is empowered under the present regulatory framework to exercise most of the powers that are set out in the Joint Consultation Paper. For instance, the SFC presently provides 'parallel comments' on listing applications and has ultimate 'veto power' which it can exercise either by rejecting an application or by imposing certain restrictions on the same which may not have been considered by the Listing Committee. In addition, the approval of the SFC is necessary under the present framework for any changes to the Listing Rules to be effected.

For obvious reasons, companies are more 'compliant or submissive' at the stage of applying for listing on the SEHK and thus measures designed to promote the quality of a market are best and most effectively implemented at this stage. While most problems associated with the company post listing may be addressed by regulatory enforcement, there is anecdotal evidence to suggest that these measures are perceived to be less than effectual given the comparatively limited resources of the SFC and/or HKEX relative to the growing number of companies that are listed on the SEHK as well as the jurisdictional issues that may arise.

It is for these reasons – subject to the caveats as outlined in the ensuing paragraphs – that I **SUPPORT** in principle the proposals as set out in the Joint Consultation Paper. These concerns relate primarily to the ***process*** which is essential to ensure that the principal objectives of transparency and accountability are more effectively addressed should the proposals be adopted.

CAVEATS

1. *Quality or efficiency of market?*

To ensure the continued vibrancy of the stock market, is trite that we should strive for quality over quantity in terms of the companies that are listed on the SEHK and that the best filter to achieve this is during the listing application process as companies tend to be more 'receptive' to suggestions for changes. Regretfully a significant failure of the Joint Consultation Paper is its inadequacy in properly addressing the key issue of enhancing the '*quality*' of the market. My impression when reading the same is that the proposals contained therein relate more to enhancing the '*efficiency*' of listing regulation, which is equated primarily to involving the SFC at an earlier stage of the process.

The logical question that begs to be answered is how these proposals would prevent companies from – for example – issuing profit warnings soon after their listing and/or seeing their share prices drop significantly below that of their initial public offering and/or having limited turnover in the trading of their shares especially since the SFC is already very much involved in the listing process under the current regulatory framework albeit at a later stage. While it is conceded that the conditions of the market are difficult to predict and that some of the profit warnings and/or the drop in share prices and/or inactive trading are related to this, it nonetheless does not adequately explain the increase in the incidence or frequency of such events. In a nutshell, how will the involvement of the SFC at an earlier stage of the listing application process minimize such occurrences if indeed the proposals seek to enhance the quality of our markets?

2. *'Suitability and Broader Policy Implications'*

Contrary to common perception, Hong Kong does not have a disclosure-based system of regulation. While companies must mandatorily disclose information as set out in the Listing Rules, this does not automatically assure them of a listing as Hong Kong practises a hybrid regime which presently allows the Listing Committee of the SEHK to consider the 'suitability' of such applications. Markets dislike volatility but they absolutely loathe uncertainty, and the Joint Consultation Paper seeks to minimize uncertainty with an aspiration that the 'modified structure should enable greater coordination and consensus-building on important listing matters'[1] that would result in 'increased transparency and accountability to the public for important listing decisions.'[2]

To this end, HKEX Guidance Letter HKEX-GL68-13A titled '*Guidance on IPO Vetting and Suitability for Listing*'[3] which was issued in June 2016 goes some way towards providing some insights on how 'suitability' would be assessed. Paragraph 1.4 of the said Guidance Letter sets out seven characteristics which would either by themselves and/or in combination with others

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[1] Paragraph 32 at page 8.

[2] Paragraph 33 at page 9.

[3] Available at http://en-rules.hkex.com.hk/net_file_store/new_rulebooks/g/l/gl6813a.pdf (accessed 27 August 2016)

bring into question the issue of suitability for listing. While helpful, these 'bright line tests' cannot reasonably be expected to capture the entire spectrum of possibilities.

For example, the listing of a company may be more for attracting and retaining staff rather than for the purposes of raising funds. Similarly, a listing may be reasonably viewed as being an appropriate vehicle for 'inter-generational succession planning' whereby the patriarch and/or matriarch can seek to distribute his or her wealth amongst their children and/or family members while enjoying the fruits of their labour in building up the company over the years. Furthermore, as costs associated with the listing of companies increase, it is not difficult to envisage how these could represent a significant portion of the 'profit track record' especially for small and medium enterprises ('SME') thereby increasing the probability of their issuing 'profit warnings' soon after their listings. Do any of these factors by and of themselves make a company 'unsuitable' for listing?

By definition the scope of 'broader policy implications' is more difficult to determine given that these are inherently dictated by both the present state of development of the market as well as by the direction that is being pursued. For instance, should cornerstone investors be allowed in initial public offerings and if so should there be a strict upper limit on the number that they may collectively subscribe for?[4] What about companies which operate within an innovative sphere such as the 'Internet of Things' or the SME that does not fit neatly within the present 'standard' business model against which listing applications are judged? Should we – at this stage of our market development – continue to allow the important office of the independent non-executive director to be filled just ahead of the listing application?

The foregoing issues are important for two reasons. First, given that the Listing Department will be subject to the oversight of Listing Policy Committee it is not unreasonable to assume that the former will throw caution to the wind and adopt a more 'conservative' approach in its interpretation of 'suitability' and/or 'broader policy implications' which will in turn affect the expediency and efficiency of listings on the SEHK. Secondly, although the Joint Consultation Paper envisages that 'these matters will be small in number compared to the number of matters handled by the Listing Department and the Listing Committee'[5] this is highly likely to be overly optimistic. Given the potential ambiguity of the terms 'suitability' as well as 'broader policy implications' it is quite likely that the number of cases that have to be considered by – or referred to – the Listing Regulatory Committee ('LRC') will be greater than anticipated. Collectively these will have significant manpower and efficiency implications for the LRC.

Unless effectively addressed the foregoing issues could contribute towards the uncertainty that markets loathe. While I disagree with the observation by some quarters that the Listing Committee will be marginalized by the proposals or that it will give excessive powers to the SFC, I nonetheless firmly believe that more needs to be done – especially as regards the *process*

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[4] *See for example* C K Low, 'Cornerstone Investors and Initial Public Offerings on The Stock Exchange of Hong Kong' (2009) Volume XIV Number 3 *Fordham Journal of Corporate and Financial Law* 639-678 an earlier draft of which is available at www.ssrn.com/author=332882 (accessed 27 August 2016).

[5] Paragraph 74 at page 17.

– to minimize the degree of uncertainty that one must come to expect of any new regime even if it is packaged as an 'evolution' in line with market development.

3. *Listing Policy Committee ('LPC')*

In my opinion this is the most significant departure from the present regime as it effectively 'removes' the function of considering policy from the Listing Committee. This proposal is not necessarily a bad thing as it provides for the establishment of a different committee with a different focus and mandate from the 'day-to-day' oversight function of listing applications.

While I have no issues with the proposed Terms of Reference of the LPC I firmly believe that its membership should be expanded to include members from outside of the SFC and the HKEX. I would suggest that the membership of the LPC be expanded to at least twelve (12) persons with the inclusion of four (4) 'lay experts' – for the lack of a better term – who possesses a sound knowledge of the securities market and whose integrity is beyond reproach. These qualities are absolutely essential if the LPC is to enjoy a status commensurate with the responsibilities which it is entrusted to discharge. I firmly believe that the broad and prompt acceptance of LPC is vital to ensuring its success and the inclusion of 'lay experts' will allow for the contribution of invaluable feedback, suggestions and critique which can only serve to improve on the quality of policy making in Hong Kong.

To ensure consistency with the proposals, at least two of the 'lay experts' should be 'investor representatives'. To ensure a constant flow of ideas and vibrancy in the policy arena the tenure of the 'lay experts' should be limited to no more than 2 terms of two-years each with a separation of at least two years between appointments. In addition to enhance the perception of independence the 'lay experts' should be 'sanitized' of any relationships with the SFC and/or the HKEX be this as a board member; an employee or a member of any advisory or functional committee for at least twelve (12) months before his or her appointment as a 'lay expert'.

Given the important role that it will perform the quorum for meetings of the LPC should be set at a comparatively higher level than the other committees. In this regard a quorum of eight (8) members should be set as the baseline provided that its composition includes no less than two representatives each from the SFC, the HKEX and the 'lay experts'. In addition the quorum should comprise at least two 'investor representatives'.

4. *Listing Regulatory Committee ('LRC')*

In a sense the LRC serves an 'appellate' function in the listing process as the review body for decisions made by the Listing Committee with the exception of disciplinary matters. It also assumes primary responsibility for assessing listing applications that involve suitability and/or broader policy implications.

It is for these reasons – especially with the dearth of statistics and details – that I do not share the optimism as expressed in the Joint Consultation Paper that the LRC will only handle a comparatively small number of cases. I firmly believe that there is a need to significantly expand the membership of the LRC beyond the present six as proposed as I expect that its workload will be considerably higher than anticipated. In my opinion this number should at least

be doubled to twelve (12) with corresponding changes made to its composition as outlined in paragraph 77 of the Joint Consultation Paper.

It is interesting that while the Joint Consultation Paper discusses instances of 'escalation' to the LRC it does not allude to the possibility of 'de-escalation'. There is always a possibility – however remote – that the LRC may decide not to accept the referral of a listing application from either the Listing Department and/or the Listing Committee. I believe that the market would be better served with more certainty if we had some guidance on what would happen in the event that the LRC differs in opinion from the Listing Department and/or the Listing Committee over an issue which the latter had judged to involve an LRC Matter taking cognizance of the fact that time is of the essence in initial public offerings.

As I served as a member of the Listing Committee from May 2006 through July 2010 I must declare my potential conflict of interest as regards my eligibility for possible appointment as a member of the **Listing Regulatory (Review) Committee**. In the circumstances I shall refrain from offering any comment on the same and to further preserve my independence I shall decline any invitation to be a member of the said Committee during the first year of its establishment.

5. ***Disciplinary Matters***

Given the absence of any explanation I question the logic of restricting membership of the Listing Disciplinary Chairperson Group to 'at least five practising or retired senior counsel (or other individuals of equivalent qualification)'[6] as I would have thought that a prerequisite would be for members of this esteemed group to have a sound understanding of how the markets work. Disciplinary matters are not always entirely legal in nature and much of the assessment of whether there has been a breach of the Listing Rules involves an appreciation of how, what and why a particular activity or transaction was undertaken. The benefits of introducing practising or retired senior counsel may well be offset by the extended time taken to hear and determine a case if this were conducted in a highly legalistic manner in the absence of an appropriate level of understanding of how publicly listed companies and/or their officers function and interact within the commercial orientation of the market.

For avoidance of any doubt I wholeheartedly welcome the participation of senior counsel whose expertise in the law would certainly enhance the quality and acceptance of disciplinary decisions. My primary concern is that the proposals unnecessarily limit the type of persons of caliber who could provide invaluable service in disciplinary matters. For these reasons I am of the firm belief that this undue restriction should be removed.

6. ***Miscellaneous***

In my opinion two further issues warrant further discussion and assessment as neither were adequately addressed in the Joint Consultation Paper.

First is the proposal to allow the LPC to have a direct input in the evaluation of the performance of the staff of the Listing Department. While I appreciate that the LPC has a mandate to exercise oversight of the Listing Department I question how an evaluation of the performance of staff

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[6] Paragraph 119 at page 26.

members can be objectively conducted absent day-to-day interaction with the same. Indeed if the interaction were that significant it may call into question the independence of the evaluation.

Secondly I believe that the proposals are sufficiently significant to result in an increase in costs of implementation and administration. The omission in not addressing this issue should be rectified promptly and in a transparent manner so as to allay concerns that the proposals would result in regulations that are not only burdensome but also costly.

CONCLUSION

Despite the caveats which I have raised above, I would unequivocally state that I support the proposals as set out in the Joint Consultation Paper. Contrary to what some sectors have advocated, the issue is definitely not about a 'turf war' between the SFC and the HKEX as the proposals do not materially expand on the powers that the former already possess under the *Securities and Futures Ordinance*.[7] The proposals deserve to be judged objectively and rationally and on this basis the underlying rationale which supports the proposed regime are sound. Nonetheless there are some issues with respect to the process. That said these are not insurmountable but they do require close collaboration between the SFC and the HKEX.

However the longer term objective must be for the government to consider the establishment of an independent listing authority entrusted with the responsibility for *inter alia* approving listings on the SEHK. This will allow the HKEX to focus on the commercial aspects of market development while allaying worries that arise from excessive regulation by the SFC which some – perhaps unfairly – perceive to be bureaucratic and suffers from 'silo mentality'.[8]

The key drivers towards this end are similar to those which promotes good corporate governance namely the acronym '**FART**' which stands for Fairness, Accountability, Responsibility and Transparency. If these principles are enshrined and practised within our regulatory framework there should be no reason why Hong Kong cannot maintain its competitiveness and be the international financial centre of choice not just regionally but also globally.

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[7] *See for example* C K Low, 'Extending The Black Out Period On Share Trading By Directors In Hong Kong: In Whose Court Does The Ball Lie?' (2008) Volume 27 Number 3 *Company & Securities Law Journal* an advanced copy of which is available at www.ssrn.com/author=332882 (accessed 27 August 2016). These powers were also exercised in the listing of United Company RUSAL plc in 2010 when the SFC unilaterally imposed minimum trading blocks of HK$200,000 despite the company disclosing numerous risks in its 1141 page prospectus.

[8] *See for example* C K Low, 'Hontex – A Settlement of Convenience?' (2013) Volume 7 Number 2 *Law & Financial Markets Review* 75-87 an earlier draft of which is available at www.ssrn.com/author=332882 (accessed 27 August 2016) for the author's views of why section 213 *Securities and Futures Ordinance* may have been misapplied despite there being ostensibly 'no losers' in the settlement.