These are our views on SFC-HKEX proposals to reform regulation of listings and listed companies. If you are an investor who cares about the future of HK's markets, please submit your support. The proposals are better than the status quo, but a political compromise on the 2003 Expert Group recommendation to transfer regulation to the SFC, and that should be Plan B.

Submission to SFC-HKEX consultation on listing regulation

6 September 2016

On 17-Jun-2016, the Securities and Futures Commission (**SFC**) and Hong Kong Exchanges and Clearing Ltd (**HKEX**) launched a 3-month consultation on listing regulation. This followed months of negotiations and a statement by Financial Secretary John Tsang Chun Wah in his budget speech on 24-Feb-2016 that there would "shortly" be such a consultation. The full consultation paper is here and you can **submit your views here**. This is the submission of Webb-site. Feel free to support it, link to it, copy it or plagiarise it.

Although the stock exchange, the Listing Rules and the Listing Committee (**LC**) are actually associated with a 100% subsidiary of HKEX, "The Stock Exchange of Hong Kong Limited", in this submission we will refer to the companies collectively as HKEX. The distinction is lost on most people anyway.

HKEX Chief Executive Charles Li Xiao Jia, in his lukewarm endorsement of the proposals in the news release, claims that there is a "balance between market development and a trusted regulatory regime". This is a false proposition. Good regulation and market development go hand in hand, they are not opposing forces to be balanced. In a more trustworthy market, investors will pay more for stocks because they expect to get a fairer share of the returns and their money is less likely to be abused or expropriated.

Background

In 2003, the Government-appointed Expert Group recommended (report here) transferring the listing function to the SFC and giving statutory backing to the Listing Rules, freeing HKEX from its conflict of interests as a for-profit regulator and leaving it to focus on its commercial services. This was and remains the correct solution. Anything less is a political compromise.

Among the 3 major international markets of the USA, UK and Hong Kong, HK remains the laggard in having a listed, for-profit regulator. US listings are regulated by the SEC and UK listings by the UK Listing Authority under the Financial Conduct Authority. In no other field of commerce in HK do we have for-profit regulators, let alone listed ones.

HK is also the only one of the three with a statutory monopoly stock exchange. One of the side-benefits of regulatory transfer would be to remove the fig-leaf by which the Government justifies the monopoly, opening the door to competition, improving services and lowering costs. Through legislation, the Government appoints more than half the board of HKEX, approves its Chairman (who has always been a member of HK's Executive Council) and holds a veto over shareholdings exceeding 5% of HKEX. Imagine the US President approving the Chairman of the NYSE and appointing the majority of its board! This situation persists largely because of the regulatory function still embedded in HKEX.

The HK Government, represented by then Financial Secretary Antony Leung Kam Chung, briefly adopted the Expert Group recommendations on 21-Mar-2003. There then followed a concerted backlash by HKEX and local tycoons who indirectly elect both Hong Kong's Chief Executive and many of the "functional constituency" legislators. 20 days later, the Government caved in, and Antony Leung announced a fresh consultation on the regulation of listing matters which resulted in very little change. To cut a long story short, 13 years later, only one of the Listing Rules, the requirement to disclose price-sensitive information, has made it into law, and even then, only at the level of a civil offence to be dealt with by the Market Misconduct Tribunal, from 1-Jan-2013.

Not trustworthy

So, in the last 13 years, has HKEX demonstrated that it can be trusted to overcome its conflict of interests and put good regulation above vested interests and short-term gain? Emphatically not.

HKEX has made only minimal progress on reforms to corporate governance and disclosure and in some respects has stepped backwards, allowing issuers to obfuscate and reduce disclosure, raising thresholds at which independent shareholder approvals are required for connected

transactions, and issuing "decisions" which act as precedents for repeated waivers without amending the Listing Rules (which would require SFC approval). That isn't supposed to happen - Listing Rule 2.04 says that the Exchange will not grant a waiver "on a regularly recurring basis so as to create the same result as a general waiver".

But they do - for example, HKEX has been allowing listed companies (not being banks) to funnel their cash out through money-lending subsidiaries, and since a decision in May 2013, almost none of the borrowers are named in the required announcements, contravening Listing Rule 13.15. Instead we get meaningless announcements defining "the Borrower" to be "a customer of the Lender".

HKEX also allows (non-investment) companies to declare themselves to be "in the business" of securities investment and thereby exempt themselves from the Listing Rules on acquisitions and disposals when trading in large chunks of other listed companies. Indeed, listed companies can raise money in their IPOs or later and then divert the money into new lines of business without any approval from the public shareholders who funded them.

This state of affairs is unsurprising. The LC that makes the rules, even after a 2006 reform, is still stacked in favour of issuers and their paid advisers. Its agenda is set by HKEX, not the other way around. In HK, investors are to be seen but must not be heard, even though the market would not exist without them. Only 8 out of 28 LC members (up from 4/25 before 2006) are supposed to represent investor interests. It is often hard to identify who the 8 are - and who would want to serve in such a stifled environment? Only a few noble souls who don't see it as a lost cause.

The LC also spends most of its time (on Thursday afternoons, when its members are not busy creating IPOs as sponsors, lawyers or accountants) vetting Main Board prospectuses rather than handling regulatory reforms. Asset managers are naturally deterred from joining the LC by the potential conflict of interest in vetting prospectuses for companies in which they might invest.

Instead of moving HK forward to the "paragon of corporate governance" that then Financial Secretary Donald Tsang Yam Kuen famously aspired to in his final budget speech of 2001, HKEX has pursued pseudo-reforms to the Listing Rules. For example:

- The Listing Rules now require one third of the board to be "independent" while still allowing controlling shareholders to vote in the elections of the so-called independent non-executive directors, ensuring that INEDs are only as independent as the controller wants them to be. The result is a charade of "see no evil, hear no evil, speak no evil" as the three wise monkeys of HK boards take their seats. Requiring these so-called INEDs to form new committees (remuneration, nomination, etc) doesn't make them independent, it just rearranges the deck chairs on the Titanic. Requiring a "diversity policy" doesn't make them independent either. Any INED who misunderstands his or her role and acts as if he or she has a mandate to question the management's decisions can be quickly shown the door.
- On pre-emptive rights, despite the vast majority of votes cast by independent shareholders (who own the free float of HK) being against the general issue mandate, the LC has refused to cut it, allowing controlling shareholders to pass a mandate for involuntary dilution of shareholders by 20% at a 20% discount. In HK, boards choose shareholders, not the other way around. Yes, they can no longer obtain a second, third or nth mandate intra-year without a vote of "independent" shareholders, but they can evade this by seeking a "specific" mandate for a long-dated "best efforts" placing, on which controlling shareholders can vote. They can also issue equity by granting instantly-exercised options to "consultants" under a share option scheme.
- On disclosure, when some 90% of companies have a controlling shareholder, there is almost no market for corporate control, boards do not fear hostile takeover, and they have no incentive to disclose more than the minimum. Quarterly financial reporting, which would greatly increase disclosure in this environment, has not been forthcoming on the Main Board despite being mandatory in China, Singapore and other Asian markets since the early years of this century. GEM companies have been doing it since GEM launched in 1999, but it remains a "recommended best practice" (comply or don't explain) in the Code on Corporate Governance for the Main Board.

Listing profits no longer disclosed

HKEX has itself reduced disclosure on its lucrative listing function. The 2014 accounts (note 6) are the last time it disclosed the operating profit of the Listing Department (before central

overheads), of $666m, or a whopping 60.4% of the total listing fees of $1102m. Admittedly part of this comes from listing derivative warrants and callable bull-bear certificates, but most of these "products" only exist because the underlying shares are listed. HKEX's Chief Executive has claimed that setting the listing rules and granting waivers isn't a conflict of interest because HKEX makes more profit on trading, clearing and settlement than it does on the listing department, but of course, you can't trade what you don't list.

With a review of listing regulation pending, HKEX chose to cease disclosure of the listing division's profits. The 2015 accounts tell you (note 6) that listing fees were $1114m but the costs and operating profit are no longer disclosed. Too embarrassing.

The Listing Department

Webb-site receives a steady stream of complaints from the investing public about corporate behaviour under the Listing Rules. We often find these complaints to be valid and file corresponding complaints with HKEX, without revealing our readers' identities. We also file a substantial volume of our own complaints. All too often, we are told that the complaint does not relate to *serious* breaches of the Listing Rules and so no action will be taken. Apparently non-serious breaches are OK.

When we have asked for inaction to be referred to the LC under Listing Rule 2B.15 as an "aggrieved party", we are often knocked back with a response, not on the merits of the complaint, but on the basis that we are not an "aggrieved party". Apparently one cannot be aggrieved at the way Listing Rules are applied (or not) unless one is a shareholder of the company concerned. It is not enough to be aggrieved by the handling of a complaint, or just aggrieved enough to take the time to file a complaint in the first place.

Judging from the times of day that responses sometimes arrive, the Listing Division is clearly under a great workload. The commercial pressure to minimize regulatory action rather than seek more resources and reduce profits is obvious. Stop pre-vetting announcements wherever possible. Don't spend too much time post-vetting announcements unless someone complains. Reject complaints wherever an excuse for inaction can be found.

Political backing

We probably wouldn't be having the current consultation if HKEX hadn't pushed things too far in 2014-15 by banging on about listing second-class shares with lower or no voting rights, or what HKEX euphemistically called "weighted voting rights", or even letting companies carve themselves out of the Listing Rules by writing weird and wicked constitutions which entrench their management like a politburo in a one-party state. The SFC, to their credit, refused to endorse this proposal, and eventually on 25-Jun-2015 nixed it.

HKEX responded to that by proposing a "Third Board", as if they didn't have enough problems already with the first two boards. As we said in March, HKEX is rather like a village that refuses to build a proper sewerage system and instead digs another cesspit to accommodate a larger population, ignoring the fact that eventually nobody wants to live in a disease-ridden village. We'd rather build a proper sanitation system. HKEX and others have suggested that the Third Board could somehow be a "professionals only" affair, but this pre-supposes that professionals want crappy governance standards in their investments. They don't. It would inevitably also result in mutual funds (including index funds), insurance companies and pension funds holding these stocks, so it would not insulate the public.

This behaviour by HKEX, and more robust leadership at the SFC, has probably shifted the Government's path of least resistance. Something has to be done. What is now on the table is a politically compromised, half-way house to what the Expert Group recommended in 2003. It is achievable in the current political environment. It does not involve any legislation or transfer of functions or staff from HKEX to the SFC, but it does clear the way for a more rapid and meaningful pace of reforms to the Listing Rules on corporate governance and disclosure. That reform process should raise HK's future competitiveness in the face of competition from the mainland as capital controls are gradually lifted.

By falling short of the Expert Group recommendations, the proposals leave HKEX in a conflicted role. It will still be the case that the less HKEX spends on regulatory staffing, the more profit it makes. The Listing Rules and Takeovers Code are administered by separate regulators (HKEX and SFC respectively), yet both relate to corporate behaviour, and they overlap in areas such as

reverse takeovers. That will remain the case under these proposals. The "dual filing" regime will also still leave some duplication of resources.

So long as the framework remains under HKEX, whether with the proposed committees or the current LC, it can have no meaningful powers to sanction errant directors for breaching the Listing Rules. The LC merely issues "criticisms" (meaning "you've been bad") or "censures" (meaning "you've been *really* bad") and tells directors to take some classes without, of course, passing any tests at the end. Only statutory backing can fix that, and we can't have that for a non-statutory body.

So what is on the table?

Policy Reform: the LPC

Crucially under the proposals, the LC will no longer carry responsibility for making or weakening the Listing Rules. Instead, the proposals includes a new 8-member Listing Policy Committee (**LPC**), with equal representation from HKEX and the SFC. On the HKEX side, there will be the Chief Executive of HKEX, who can continue to argue for its commercial interests, and the Chairperson and two Deputy Chairpersons of the LC. On the SFC side, the members will be the Chief Executive of the SFC, the Chairperson of the Takeovers Panel, the Executive Director of the Corporate Finance Division of the SFC and a senior director of that division. Crucially, at least one of the members from the LC must be an "investor" representative, which provides hope that in the event of disputes, decisions will swing 5:3 in favour of investors.

Under the current Listing Rules 2A.21-2A.22, the members of the LC, and its Chairperson and Deputy Chairpersons, are chosen by a 50:50 Listing Nominating Committee (**LNC**) comprising 3 non-executive directors of HKEX and, from the SFC, its non-executive Chairman and two Executive Directors.

The LPC, going forward, would be held accountable by the investing public (including Webb-site) for getting meaningful reforms to the Listing Rules back onto the agenda. Any proposed Listing Rule changes emanating from the LPC will still be subject to market consultation and to approval by the board of the SFC, the majority of which is non-executive and all of whom are appointed by the Government.

New Listings: the LC and LRC

Much of the media and opponents' focus since the proposals were announced has been on the listing application process rather than ongoing regulation of listed companies. This is a shame, because in any given year, ongoing corporate behaviour causes far more damage to investor returns than IPOs do. Once a company is listed, it can quickly shed its skin and within two years can become a completely different business with different management, duly appointed by new controlling shareholders. So trying to bounce entrants at the front door of the club really just sends them round the back. What you really need is better rules on behaviour within the club.

The other new committee, the Listing Regulatory Committee (**LRC**), also a 50:50 arrangement (3 each) between HKEX and SFC, would consider any IPO application or a post-IPO matter that has "suitability concerns or broader policy implications". This should be a small minority of cases, as the "large majority" will be dealt with under the existing structure, although there is certainly scope for improvement in the way that is done. Currently GEM prospectuses are dealt with by the Listing Department. We think that should be the case for the Main Board too, with only appeals heard by the LC. This comment pre-supposes that HKEX is spending enough on staff, individually and collectively, to hire and retain enough experience to handle this rather than lose them to investment banks as soon as they become competent to argue with their former colleagues.

Note: paragraphs 89-90 of the paper state that the Listing Department of HKEX will decide which cases to refer to the LRC. We submit that that should not be an exclusive right; the SFC must also be responsible for referring problematic cases to the LRC when it sees them under the "dual filing" system. If the SFC simply abdicates responsibility for spotting problems and leaves it to the Listing Department of HKEX to decide which cases are LRC cases, then the conflict of interests, the fact that staff are hired and paid by HKEX, will deter the staff of the Listing Department from making such referrals.

Opponents of the proposals have raised concerns that the LRC will result in what they call a "regulator-based" regime. This makes no sense, because under the "dual filing" system, both

HKEX and the SFC are regulators and the SFC already has a veto over new listings, and can already direct suspension of dealings in securities under the Securities and Futures (Stock Market Listing) Rules, even after HKEX has allowed trading to resume.

Perhaps opponents are more concerned about a separate problem, that HK still has the remnants of a "suitability" based system in which committees (whether the LC or LRC) are supposed to decide whether a company merits a listing. So one area of the Listing Rules that the new LPC should be reviewing, as a matter of urgency, is the entry criteria for new listings, basing those criteria firmly on disclosure, not merit.

As we have said several times, the Main Board profit criteria of HK$20m in the last year before listing and HK$30m in the last 2 years, are not a measure of merit or quality, but are a target for accounting manipulation. We don't delist companies just for making a loss, so why do we require them to make a profit before listing? Disclosure is more important. If we have 3 years of audited, unqualified accounts, preferably under the same auditor, and substantially the same management throughout the period as is bringing the company to the market, and if all the required disclosures have been made, then investors should be allowed to decide for themselves whether to buy the stock. Anything less than 3 years old frankly should be seeking capital in the private equity/venture capital markets, not from the public.

Also, regulators should not get hung up about the fact that small companies tend to have concentrated ownership. Just disclose the allotment profile and warn investors accordingly. If they choose to gamble on an over-priced stock, that is their choice. Even requiring a 10% public offer tranche with 300 shareholders, as the Main Board does, does not prevent the other 90% of the issue being placed in a small number of hands, and in practice the 300 (or however many) initial shareholders can always be drummed up by brokers with discretionary managed accounts. The expenses of conducting a public offer, including printing forms and prospectuses, newspaper advertising and appointing a receiving bank to handle applications, are not always worthwhile, and the public offer tranche should be optional, as it is on the GEM board.

Eliminating the profit criteria, eliminating the public offer requirement and introducing mandatory quarterly reporting to the main board would remove any reason to have two separate boards in HK, a distinction which is often lost on investors anyway.

Plan B

If opponents of the proposals keep pushing, then the Government should have the courage and foresight to back the SFC and carry out the original Expert Group recommendations, which would produce a far better outcome than this compromise. Under Section 25(7) of the SFO, HK's Chief Executive may order that the SFC resumes the listing function from HKEX if it appears to the Chief Executive to be in the public interest to do so. This can be done in an orderly manner, and as previously offered in 2003, HKEX can be allowed to charge "admission fees" to compensate it for the lost profit on its listing function. Staff and systems can be transferred to the SFC.

Failing or pending that, on an individual rules basis, under Sections 23(3) to 23(5) of the SFO, the SFC can, after consulting the Financial Secretary, "request" HKEX to make rule changes, and if HKEX fails to do so, then the SFC can change the rules itself. So even if the Transfer of Functions Order is not revoked, the SFC could simply set up its own Listing Panel (or combine it with the Takeovers Panel), take its advice, conduct market consultations and then (after consulting the Financial Secretary) direct HKEX to amend the Listing Rules.

So yes, there is a workable Plan B, just not what some opponents would wish for. Doing nothing is not a viable option, unless you want HK to sink further into the mud and be marginalised.

With the reservations expressed herein, Webb-site supports the proposals. The proposals are better than the status quo, just not as good as HK deserves. If the proposals are adopted, the onus will be on the SFC to make them work and move forward with reforms to raise HK's game.

Have your say

These proposals are facing a well-organised, powerful opposition. If you are an investor who cares about the future of HK's markets, tell the SFC and HKEX why you support the proposals. Hurry, because submissions close on 19-Sep-2016.

David M. Webb

Disclosure: David M. Webb is a Deputy Chairman of the SFC's Takeovers and Mergers Panel and a former elected INED of Hong Kong Exchanges and Clearing Limited.