

Written Comments on the Consultation Paper on Proposed Enhancements to the Exchange's Decision-Making and Governance Structure for Listing Regulation

Abbreviations in the following paragraphs are those used in the Consultation Paper.

About myself: I started my career in Hong Kong back in the early 1980s working with Wardley's and Citicorp's respective corporate finance departments. I co-founded Anglo Chinese with 2 partners in 1988, left full time employment in 1993 and began a career sitting on the boards of a number of listed companies as INED. I follow listing regulatory changes as a matter of need for an INED and as a matter of interest. Due to the increasing heavy responsibilities placed on INEDs, I have resigned from most of my appointments some 10 years ago and am only sitting on the board of one listed company and also act as its Audit Committee Chairman.

Policy development

1. Your suggested heading "policy development" is generic, and I assume that you are seeking general comments on the "policy" to enhance the governance structure for listing regulation.
2. The thrust of the consultation is to solve the conflict of interest issue (between the commercial and regulatory roles of the Exchange) that exists under the current governance structure for listing regulation. This situation began to exist when the 4 exchanges in Hong Kong were merged into one, and augmented by the HKEX becoming a listed company.
3. The 4 exchange houses which existed up until the early 1980s have different regulatory standards, in practice rather than on their rule books (which were almost identical as far as I can remember). Market participants had their choices. One of my past IPO clients elected to list on the then Hong Kong Stock Exchange only (while most other IPOs were also listed on Far East and Kam Ngan). The 4 exchanges compete on, amongst other things, trading activity, regulatory standard and reputation. This competition ceased to exist when the 4 exchanges were merged into the HKEX, which monopolized the listing platform in Hong Kong.
4. This unsatisfying situation of a monopoly, owned privately, self-regulating on important listing matters, was augmented by the listing of HKSE. Government imposed oversight has since then been weakened. The "commercial" role of HKEX has been legitimately emphasized and the objective of forming a listing platform to serve the long term interest of Hong Kong as a major financial center has been played down (Shareholders' interest! Compared controversies regarding conflict of commercial and social

responsibilities of LINK REIT, MTR,..).

5. The delegation by the Exchange Board to the Listing Committee (LC) does not solve the problem. LC members are market practitioners, whose financial interests align with the level of activities of the Exchange, perhaps to a different extent (the LC investor representatives, most of them are fund managers, are no exceptions).
6. Remuneration packages of the senior executives of the Exchange are closely tied to the profitability (thus again to the level of activities) of the HKEX, not to mention the enormous gains on shares awarded to them.
7. I therefore argue that this proposed enhancement of regulatory structure is long overdue. Overall, I am in support of the individual enhancements proposed in the consultation paper. Specific comments on selected matters, mainly on the governance structure rather on the processes, are detailed under the headings below.

Oversight of the listing function

8. The replacement of the LC by the LPC as the oversight body of the Listing Department (LD) is absolutely the correct move. The LD is probably the most important element in the Exchange to carry out its regulatory duties (as opposed to its “commercial” duties).
9. Paragraph 5 above explains why the LC, with its composition and the financial interests of its membership, is not the appropriate body to oversee the function of the LD. Compare that to the internal audit department of a commercial establishment. It is clearly not acceptable for its internal audit function to have a single and direct line of responsibility to another body with short term profitability as its major focus.
10. Compensation of the senior executives of the LD is determined by the Remuneration Committee of the HKEX. To ensure that the LD properly places its regulatory role as its top priority, its compensation structure (primarily its KPIs, which as explained in note 40 of the Consultation Paper, should be aligned with the clear objectives of the LD) should avoid a heavy weighting on the profitability or other factors linking to the level of activities of the Exchange. The MOU Addendum should at least gives the LPC a power to veto an inappropriate compensation structure. Performance appraisal alone is not sufficient, especially in situation when the weighting of the KPIs are tilted towards financial objectives.
11. I consider it particularly important as the LD is performing the frontline role of designating LRC IPO Case and Post-IPO LRC Matters. I found no reference in the Consultation Paper to a safety valve to allow the SFC or the LRC to take LRC IPO Case or Post-IPO LRC Matters into the jurisdiction of the LRC unless either the LD or the LC designate them as such. This may be a loophole the proposal may wish to close. See my proposal in paragraph 25 below.

Mandate of the Listing Policy Committee

12. I am in support of the proposed mandate of the LPC, in particular proposed new Listing Rules and amendments and oversight of the LD (as explained in paragraphs 8 to 11 above).
13. Although currently new Listing Rules and amendments are subject to prior consent of the SFC under the SFO, I agree that to engage the SFC's view in a proper forum such as the LPC is a more effective way to iron out difference in views. I am, however, concerned that the proposed composition of the LPC will indeed weaken the SFC's position rather than maintaining its veto power (see explanation in paragraphs 16 to 25 below).
14. I shall give you one example here where I find amendment of Listing Rules (or rather the absence of amendment to Listing Rules) should be put under the LPC's oversight. In 2005, the HKEX adopted its Share Award Scheme (SAS). I failed to find whether it is the first of its kind in Hong Kong. Even if it is not, it is one of the pioneers. The SAS is an alternative to the Share Option Scheme (SOS), which has long been used by most Hong Kong listed companies. SOSs are properly and stringently regulated under Chapter 17 of the Listing Rules, whilst SASs are almost unregulated (perhaps regulated under the "discretion" of the LD, which is not transparent to outsiders). SASs can be dangerously abusive, since the issuer is to purchase its own shares on the market, using its own funds, although on paper through a "Trustee". Shares acquired, while unvested, remain on the balance sheet of the issuer. Many issuers, following the pioneer effort of the HKEX, adopted such SASs and aggressive ones set unreasonably high limits to the amount of shares that can be purchased under the SAS (As far as I can remember, these limits were subsequently revised downwards, perhaps under the pressure of the Exchange when the LD started to sense the abusive nature. I have no way to find out the truth.). "Treasury stock operation", which is prohibited in Hong Kong, has always been an extremely controversial topic. SAS contains the feature of using the issuer's own funds to purchase its own shares on the market. Listing Rules amendments (or the lack of them) should have been properly consulted before the operation of such schemes is allowed.
15. The adoption of SASs "cleverly" avoids any amendment of the Listing Rules. The SFC was therefore not in a position to withhold its consent. The exercise of power under SFO Section 23(3) is probably a very sensitive matter and can only be used extremely sparingly. If the proposed enhancement structure is adopted, incidents like this will, can, and should, be proactively discussed in the LPC.

Composition and Procedures of the Listing Policy Committee

16. The composition is clearly designed to allow a balance of voice between the regulators and the market participants.
17. A proper balance can ensure that a single securities trading platform serves Hong Kong's best long term interests. It is important for market participants to have easy access to the Exchange (both in terms of IPOs and post-IPO operation), so that we can compete with other exchanges. But equally important is for Hong Kong to maintain its reputation as a superbly regulated market.
18. To this end, I am more inclined to have a composition skewed towards a heavier regulatory influence. The proposed composition is an 8-member committee, with 4 from the Exchange, 1 from the Takeover Panel, and 3 from the SFC. In terms of mindset, the 3 from the SFC are regulatory oriented (so I label them Regulatory Members, or RM); the 3 from the Exchange and the chairman of the Takeover Panel (currently Stephen Clark? My ex-partner) are all market participants (including the LC investor representative), to different extents benefitted financially by a more vibrant market, so is the Chief Executive of the HKEX (so I label all 5 of them Market Members, or MM).
19. I am not suggesting that regulation and market vibrancy necessarily conflict, but they do in some important moments (the different-voting-right-shares saga; the SAS and SOS choice, IPO of issuers whose businesses are of a morally debatable nature, such as brothel house, and many more cases) arouse long-term versus short-term interests arguments.
20. My opinion is that Hong Kong's long term interests is better served by having a reputable exchange, so be it if we lose ground in terms of IPO money raised or turnover volume. To market participants, tight regulation is a pain. I have had dealings with many unreasonable regulators in my past career. I grew up and was educated under the heavy influence of free market economy and so am well versed with the argument of "buyers beware". But we have to face the reality that not all market participants play on level fields. In fact most are not! That is why regulations and regulators are needed.
21. Having said so much, I am in favor of at least evening out the number of RM and MM, ie. 4 against 4. To do this less controversially, the representative from the Takeover Panel can be chosen from one without clear financial interest in the market (not many of them but can still be found), rather than automatically represented by its chairman.
22. The quorum of 4 should include at least 2 from each side of the RM and MM.
23. I cannot find reference in the Consultation Paper regarding how to resolve a deadlock, as the chairman of the LPC will not have a casting vote.

Mandate of the Listing Regulatory Committee

24. The matters covered in paragraph 73 (a) to (d) in the Consultation Paper are welcome. It is however, unclear to me whether the power of interpretation falls entirely in the hands of the LC and the LD (see my concern in paragraph 11 above).
25. To avoid ambiguity, the mandate may cover any matters referred to the LRC by any of its members which in his/her reasonable opinion falls into the matters listed in 73 (a) to (d).

Composition and Procedures of the Listing Regulatory Committee

26. My views on the composition of the LPC applies to the LRC as well. As the Consultation Paper acknowledges, potential conflict of interests are more likely to arise in the LRC than in the LPC. It is therefore more crucial for the RM to have a majority say in the LRC.
27. The proposed membership structure is now 3 RM against 3 MM. Balance of power can be tilted towards the RM by designating a RM as the chairman with a casting vote. This will also solve the problem of deadlock.
28. The propose quorum provision is somewhat strange. If I understand it correctly, LRC meetings can only be convened when either 4 or 6 members are present (paragraph 81 of consultation paper). What if 5 members turn up?

Other matters

29. I concur that the proposals do not change the power structure between the SFC and the HKEX, but only change how such powers are being exercised.
30. The proposed structure promotes consensus building and reasoned arguments within close doors and avoids public confrontation, which often turns into a media contest. Transparency can be achieved by publishing decisions in summary form and even allow the public to access minutes of LPC (with sensitive and confidential information withheld).

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