

Comments by Charles Grieve on the joint consultation paper by the SFC and HKEx on enhancements to the Stock Exchange of Hong Kong Limited's decision-making and governance structure for listing regulation

Overall

Essential to meet the needs of institutional investors

1. It is important for the development of the Hong Kong stock market that the market is seen to protect the interest of investors. To succeed Hong Kong has to provide international investors, especially international institutional investors, with an environment that gives these investors confidence. It is therefore essential that the HKEx and the SFC listen carefully to any institutional investor that responds to this consultation.
2. In considering the appropriate governance structure for the Hong Kong market it is necessary to recognise that Hong Kong is and will continue in essence to be a market for shares of companies that operate in the greater China market. In this it competes with the Mainland stock markets
3. Despite efforts to attract enterprises enterprises from outside Hong Kong and the Mainland to list in Hong Kong there are only a few examples of such companies listing on the Hong Kong market. Most of these were enterprises that had a China story that was likely to be of interest to investors already active in the Hong Kong market. It is not realistic to expect this is to change and for Hong Kong to become the market for enterprises with little connection to China.
4. If Hong Kong ceases to provide a forum for investing in China enterprises that is attractive to international investors, the market will stop expanding and may well contract as Mainland enterprises return to the Mainland markets. If this happens the prospects, which I believe are already small, of non-Mainland enterprises representing a significant part of the Hong Kong market will vanish.
5. My many years of speaking to international institutional investors in Hong Kong convinces me that they will welcome the direction of the proposals in this paper. Some will argue that they do not go far enough and that as recommended by the Expert Group report in 2003 the listing function should be transferred to the SFC and that listed companies should be subject to statutory listing rules. Whilst I support the Expert Group recommendations I recognise that is probably a step too far at this stage.
6. Provided that institutional investors have confidence in the market and support the changes they will remain and their presence will attract companies to list in Hong Kong.
7. Concerns expressed in the media that companies will be discouraged from listing in Hong Kong by the threat of strong regulation are unfounded and

would seem to be self serving. Indeed the experience of the London market shows that high standards attracts both listing applicants and investors. London offers listing applicants the choice of a standard listing, providing a minimum level of regulation specified under EU regulations, and a premium listing with higher standards. Many companies listed in London prefer the premium listing as that is the preference of investors.

Specific areas of comment

8. Paragraph 141 calls for comments under 11 headings. I comment below on some of these areas. Where I have not commented I support the proposals set out in the consultation paper.

Policy development

9. I support the proposal for a Listing Policy Committee that comprises market practitioners, through the Listing Committee members, the SFC, HKEx and the Takeovers panel.

Listing applications by new applicants

10. The proposals, paragraph 91, state that the Listing Division will refer LRC IPO cases to the Listing Regulatory Committee and, paragraph 92, that the Listing Committee may designate any IPO presented to it as an LRC IPO case. The text of the box in paragraph 90 headed "Listing Department" states that it "seeks to resolve the matter with the staff of the SFC". However, there seems to be no provision for the Listing Regulatory Committee, or one of its members, or SFC staff to challenge a determination by the Listing Division that a listing application is not an LRC IPO case. It is essential that the SFC staff or the SFC representatives on the Listing Regulatory Committee are empowered to call for any new listing application to be designated as a LRC IPO case.

Matters involving listed issuers

11. Similar to paragraph 10 above it is essential that the SFC staff or the SFC representatives on the Listing Regulatory Committee are empowered to call for any matters involving listed issuers to be referred to Listing Regulatory Committee.

Disciplinary Matters

12. I question whether rules of natural justice require a Listing (Disciplinary Review) Committee. The proposed arrangements for disciplinary matters appear adequate without a review. The Exchange has limited powers of discipline and aggrieved persons have recourse to judicial reviews.

Composition and procedures of the Listing Policy Committee

13. As discussed in the SFC's report on its 2015 annual review of the Exchange's performance in its regulation of listing matters¹ in the 5 years 2010 to 2014 the Exchange published over 230 documents that provide interpretations and guidance in the form of Listing Decisions, guidance letters, frequently asked questions (FAQs) and other guidance materials such as practices and procedures for handling listing-related matters.
14. Some of these documents deal with purely procedural matters but many deal with matters that by their nature will need to come under the oversight of the Listing Policy Committee to ensure that the policy implications are clearly understood and where necessary are approved by the committee. The Listing Policy Committee will need to establish procedures to review guidance that has already been issued by the Exchange.
15. In paragraphs 23 to 25 below I explain why the Listing Regulatory Committee needs to have a mechanism to break a deadlock where votes of members are tied on an interpretation of existing rules and requirements. From my reading of the consultation proposals I do not expect that the Listing Policy Committee will be asked to interpret the Listing Rules. If it is expected to decide on interpretations it will also need a mechanism to break a deadlocked vote.

Listing Regulatory Committee

Composition

16. The need for a Listing Regulatory Committee that ensures the involvement of the SFC can be seen from Listing Decision LD8-2011 which dealt with the question of whether preference shares form part of share capital for the purposes of Rule 8.08 that requires at least 25% of a listed company's total issued share capital to be held by the public. This Listing Decision was referred to in the SFC's report on its 2015 annual review of the Exchange's performance in its regulation of listing matters, see paragraphs 50 to 55.
17. The Exchange took the view that the listed company would not be required to include its non-listed convertible preference shares for the purpose of calculating public float. The reason given for this decision, as set out in the Listing Decision, was simply "...having considered the terms of the CPS, they were similar to debt securities".
18. Listing Decision LD8-2011 and the policy approach it reflects has had a very significant impact on the profile of many companies listed on the Exchange much to the detriment of the market and of investors in the

¹ Paragraph 45 of the SFC's report on its 2015 annual review of the Exchange's performance in its regulation of listing matters

market. As a consequence of this policy approach many listed companies have issued convertible preference shares that represent many multiples of their ordinary shares. In most cases the convertible preference shares are in all material aspects akin to ordinary shares. They rank *pari passu* with the ordinary shares as to dividends which would be paid with respect to the ordinary shares on an “as converted” basis. Most of the listed companies that have issued these convertible of preference shares treat them in their financial statements as equity that forms part of their share capital. They are not counted as debt.

19. As a consequence an investor can obtain or increase its economic interest in and effective control of a listed company (as the investor can at will convert the preference shares into ordinary shares with votes) without triggering any of the obligations set out in the Takeovers Code as the Code’s provisions are linked to existing rather than potential voting rights.
20. As well as negating some of the shareholder protection elements of the Takeovers Code, the phenomenon of having a very significant portion of the capital that underpins a listed company in the form of unlisted preference shares whilst the ordinary shares represent a much smaller, and in some cases even insignificant, portion of capital results in the ordinary shares being susceptible to wide fluctuations in price from market activity² that may be relatively small compared to the size of the company. In 2015 many of the companies with highly volatile share prices had a significant portion of their capital in the form of unlisted preference shares
21. Allowing listed companies to have a significant portion of their capital in the form of unlisted preference shares is not in the interest of shareholders nor of the market as a whole. It only serves the interest of larger/controlling shareholders.
22. An effective regulatory system would ensure that the issue of convertible preference shares was looked at in the wider regulatory context, not whether it reflected the “policy intent of the public float Rules (that is, to ensure sufficient float of each class of *listed* securities would be available for trading) and followed the established practice”.³ The Listing Regulatory Committee constituted as proposed would ensure that regulatory issues were considered in the wider context.

Procedures

23. In paragraph 81 the consultation paper recommends that when any matter is put to a formal vote among members of the Listing Regulatory Committee a majority vote in support will be required for any decision (e.g., the approval of a relevant listing or waiver application) to be taken and the

2 Whether from independent market forces or from manipulation

1. 3 Paragraph 54 of the SFC’s report on its 2015 annual review of the Exchange’s performance in its regulation of listing matters.

Chairperson of the Listing Regulatory Committee will not have a casting vote.

24. This assumes that in all cases the Listing regulatory Committee will be approving a request by a listing applicant for a listing or a request for a waiver of the rules by a listed company. In such cases a tied vote results in a rejection of the request and there is a clear decision by the Listing Regulatory Committee. However, there will be cases where a the Listing Regulatory Committee will need to give an interpretation of a Listing Rule before deciding whether a particular action proposed or undertaken by listed company is in accordance with Listing Rules and thereby requires a waiver. In these cases a tied vote on the interpretation of a Listing Rule will not result in a clear decision by the Listing Regulatory Committee.
25. For example the Listing Regulatory Committee should determine whether in the case of convertible preference share, discussed above, Rule 8.08 applies. A tied vote by the Listing Regulatory Committee on such a matter would not represent a clear decision. There needs to be a mechanism to break a deadlock vote in such cases.