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Dear Sirs

Re: Consultation Paper on Proposed Enhancements to the Exchange's Decision-Making and Governance Structure for Listing Regulation (the "Consultation Paper")

We refer to the Consultation Paper and set out our comments on the Proposals contained therein. Capitalised terms used in this letter have the same meanings as in the Consultation Paper unless otherwise stated.

Introduction

The Proposals set out in the Consultation Paper represent a fundamental overhaul of the current listing regulatory system and will result in a considerable increase in the SFC's power to approve or reject listing applicants, interpret and administer the Listing Rules and regulate listed issuers.

However, the Consultation Paper appears to play down the significance of changes being proposed, characterizing them as "enhancements". It declares that under the Proposals, "the listing function will remain within the Exchange which will continue to be the frontline regulator for listing matters. The Listing Committee, together with the Listing Department, will continue to decide a large majority of IPO applications and post-IPO matters"¹. In describing the new committees proposed to be established, the Listing Policy Committee and the Listing Regulatory Committee, the Consultation Paper emphasizes that the SFC and the Exchange are equally represented in their composition and that they "will decide listing policy and policy-related listing matters with advice from the Listing Committee"². As can be seen below, this very much downplays the effect of the Proposals on the listing regulatory system, in particular, the control the SFC will be able to exert over the Listing Policy Committee and the Listing Regulatory Committee.

Control in hands of SFC

Despite suggestions to the contrary in the Consultation Paper, the Proposals represent a significant increase in the SFC's powers over the powers of the Exchange to determine listing policy, approve or reject IPO applications, interpret the Listing Rules and regulate listed issuers for the following reasons.

(i) Composition of the Listing Regulatory Committee

Under the Proposals, the Listing Regulatory Committee will be responsible for deciding on listing matters, including IPO applications, that involve suitability concerns or broader policy implications, replacing the Listing Committee which currently has this role. The Exchange and the SFC appear to be equally represented in the composition of the Listing Regulatory Committee. However, in substance, the SFC is likely to have effective control as described below.

The Listing Regulatory Committee has a total of six members, with three representatives from the SFC (three senior executives of the Corporate Finance Division of the SFC) and three representatives from the Listing Committee (the Chairperson and two Deputy Chairpersons of the Listing Committee). SFC's representatives on the committee are all employees of the SFC and thus could be expected to represent its views and vote as a bloc. On the other hand, members of the Listing Committee do not represent the views of the Exchange, typically have other full-time professional commitments and are therefore more likely to vote independently of each other. Accordingly, where consensus cannot be reached, it would be easier for the SFC to secure a majority of votes for any decision to be taken by the Listing Regulatory Committee. This is

¹ Paragraph 1 of the Consultation Paper

² Paragraph 1 of the Consultation Paper

particularly the case as one of the three members of the Listing Committee on the committee must be an investor representative. Since a main focus of the SFC is protection of the investing public, it can be expected that the SFC and the LC investor representative would share a similar viewpoint on many issues. In addition, the LC investor representative must be one of the four members present in person in order for a quorum of the committee to be constituted.

Furthermore, the three Listing Committee representatives on the Listing Regulatory Committee (i.e. the Chairperson and Deputy Chairpersons of the Listing Committee) are nominated by the Listing Nominating Committee, which is made up of the Chairperson and two executive directors of the SFC and three non-executive directors of the Exchange's Board. In effect, the SFC will have the right to veto the nomination of any individual as Chairperson or Deputy Chairperson of the Listing Committee, thus giving SFC the power to control which individuals are appointed as the Listing Committee's representatives on the Listing Regulatory Committee. Therefore, control by the SFC over the composition of the Listing Regulatory Committee is much more dominant than the equal representation described by the Consultation Paper.

Moreover, even if the votes of six members are divided, no one has a second or casting vote, which means that in the remote case where all three Listing Committee members are up against the three SFC regulators, their view cannot prevail resulting in a deadlock. This will mean that unless the SFC agrees, nothing can be decided in the Listing Regulatory Committee.

(ii) Composition of the Listing Policy Committee

Similarly to the Listing Regulatory Committee, the SFC and the Exchange appear to be equally represented in the composition of the Listing Policy Committee, which will replace the Listing Committee as the body responsible for formulation of listing policy under the Proposals. The Consultation Paper notes that the "even number of market representatives and full time executives is intended to achieve a better balance between regulatory and market perspectives"³. In practice, however, the SFC is likely to be able to control and dominate the Listing Policy Committee as described below.

The Listing Policy Committee will comprise the Chief Executive Officer of the SFC and two senior executives from the SFC Corporate Finance Division, the Chairperson and two Deputy Chairpersons of the Listing Committee as well as the Chief Executive of HKEX and the Chairperson of the Takeovers Panel. Therefore, the SFC will directly control half of the members of the Listing Policy Committee i.e. the CEO and two senior executives of the SFC plus the Chairperson of the Takeovers Panel who is appointed by the SFC under section 8(3) of the Securities and Future Ordinance (Cap. 571) ("SFO"). Of the remaining four members, the appointment of three of them (the Chairperson and two Deputy Chairpersons of the Listing Committee) are within the control of the SFC for reasons stated in the section above entitled "Composition of the Listing Regulatory Committee".

³ Paragraph 57 of the Consultation Paper

Our observations in the section above entitled “Composition of the Listing Regulatory Committee” regarding voting by members of the Listing Regulatory Committee, the presence of the LC investor representative in the composition and quorum of the Listing Regulatory Committee and the deadlock structure, apply equally to the Listing Policy Committee.

Thus, the SFC will control the composition of the Listing Policy Committee (as well as that of the Listing Regulatory Committee).

(iii) Listing Department remuneration

Under the Proposals, the Listing Policy Committee will replace the Listing Committee as the body responsible for oversight of the listing function and the performance of the Listing Department of its regulatory responsibility within the Exchange. The Listing Policy Committee will have primary responsibility for reviewing the work performance of senior executives of the Listing Department which will be taken into account by the HKEX's Remuneration Committee in determining the overall compensation of the Listing Department and its senior executives. We are of the view that this manner of determining remuneration would compromise the independence of the Listing Department from the Listing Policy Committee and the SFC.

Furthermore, given that the Listing Department will be subject to the oversight of the Listing Policy Committee and their remuneration dependent upon appraisals by such committee, it is likely that the Listing Department will err on the side of caution when interpreting whether a case has suitability concerns or broader policy implications. Even though the Consultation Paper anticipates that “these matters will be small in number compared to the number of matters handled by the Listing Department and the Listing Committee”⁴, it is likely that the number of cases that are referred to the Listing Regulatory Committee will be higher than suggested by the Consultation Paper given the wide scope and potential ambiguity of the terms “suitability” and “broader policy implications”.

(iv) SFC influence over the most important listing decisions

Under the Proposals, the Listing Regulatory Committee will be responsible for regulatory decision-making for IPO applications and matters involving listed issuers with suitability concerns or broader policy considerations. So even if the actual number of cases decided by the Listing Regulatory Committee is small, their influence will be significant as such decisions will determine which companies will be considered unfit for listing in Hong Kong even where they meet the objective listing criteria and other listing matters which present novel, controversial or complex issues. These decisions may have far-reaching implications for other listing applicants and listed issuers. Whereas under the existing system, these matters would be screened by a Listing Committee comprising 28 members, the Proposals will mean that these subjective assessments

⁴ Paragraph 74 of the Consultation Paper

will be carried out by even less individuals, namely six with at least half of them full-time regulators.

(v) SFC's powers under current listing regulatory regime

At present, SFC approval is required for any amendment to the Listing Rules under section 24 of the SFO; and the Exchange must obtain the SFC's prior approval of any proposed waiver or modification of any Listing Rules, or decision not to require compliance with any Listing Rule, which will have a general effect under Rule 2.04 of the Listing Rules. Furthermore, the SFC has a right to object to a listing application within 10 business days of its submission under section 6 of the Securities and Futures (Stock Market) Listing Rules (Cap. 571V).

Therefore, SFC already has considerable powers in overseeing the listing regulatory process. However, by allowing the SFC to have earlier and more direct input on listing policy matters and listing regulation in the manner set out in the Proposals, there is concern that as regulators, the SFC's representatives on the Listing Policy Committee and Listing Regulatory Committee in determining listing policy and regulation of listing applicants and listed issuers, may be focused on insensitive and heavy handed over-regulation and undue protection of investor's interest at the expense of market needs, development and innovation. This may have a negative impact on the competitiveness of the Hong Kong securities market and affect its status as a leading international financial centre.

Fundamental change in listing regulatory regime

(i) Deviation from the Hay Davison Report

The dominant presence of the SFC in the listing regulatory process as proposed in the Consultation Paper deviates from the intent and spirit of the Report of the Securities Review Committee on "The Operation and Regulation of the Hong Kong Securities Industry" dated 27 May 1988 chaired by Ian Hay Davison (the "Hay Davison Report").

The Hay Davison Report called for a "two-tier system of supervision with exchange regulation of its own affairs being conducted under the watchful eye of a single statutory body. The statutory supervisor is thus the watchdog, with the market handling the day-to-day supervision and regulatory tasks"⁵. The report said it wished "to avoid the danger of straight-jacketing the securities markets by a strict statutory regime which might all too easily lead to insensitive or heavy handed over-regulation"⁶. It argued that the benefits of such two-tier system is that "[m]arket management and regulation by practitioners offers scope for flexibility and adaptability in a rapidly changing market. Moreover, it draws on the market knowledge of practitioners and

⁵ Paragraph 3.32 of the Hay Davison Report

⁶ Paragraph 3.24 of the Hay Davison Report

thereby is better able to win the support of market members and statutory regulators will not always have the necessary knowledge and experience”⁷.

Recommendations from the Hay Davison Report laid the basis for the present system of listing regulatory regime whereby:

- (a) the Exchange is the frontline regulator of all listing-related matters and issuers listed on its markets with its powers and functions in respect of all listing matters discharged by the Listing Committee and/or its delegates, subject to the review procedures set out in Chapter 2A of the Listing Rules; and
- (b) the SFC plays a lead role in market regulation and some areas of listing regulation such as taking enforcement action against any failure to disclose inside information, the disclosure of interests in securities and activities governed by the Takeovers Code.

We note that the Consultation Paper praises the current listing regulatory structure as having “served the market well”⁸. It also notes that the current arrangements “under the Listing MOU have worked well to reduce unnecessary duplication and administrative burden and costs to the market; and the experiences and mutual understanding derived from those arrangements provide a basis for closer regulatory cooperation between the SFC and the Exchange for the benefit of all who participate in Hong Kong’s listing market”⁹.

(ii) Penny Stock Incident Report

The “Report of the Panel of Inquiry on the Penny Stocks Incident” dated September 2002 written by Robert G. Kotewall and Gordon C.K. Kwong (the “**Penny Stock Incident Report**”), looked at the three-tier system of having:

- (a) the Government being responsible for providing an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre;
- (b) the SFC serving as an independent statutory regulator of the Exchange; and
- (c) the Exchange to play a self-regulatory role and perform certain public functions, such as risk management and market surveillance.

The report went on to examine the checks and balances between the various tiers. Some of the checks and balances to which the Exchange is subject include:

- “(a) Under the Merger Ordinance (Cap. 555), the HKEx must act in the interest of the public, having particular regard to the interests of the investing public;
- (b) The Government has the power to appoint a specified number of members to the Board of the HKEx;

⁷ Paragraph 3.25 of the Hay Davison Report

⁸ Paragraph 6 of the Consultation Paper

⁹ Paragraph 50 of the Consultation Paper

- (c) The SFC is the statutory regulator of the HKEx The SFC is responsible, in general, for supervising and monitoring the activities of the HKEx. The SFC, as the regulator, may serve “restriction notices” and “suspension orders” on the HKEx;
- (d) The SFC may direct the HKEx to cease to provide or operate specified facilities or services in emergencies; and
- (e) The SFC is empowered to approve any new or amended listing rules before they can be implemented.”¹⁰

In turn, the SFC was subject to certain checks and balances such as having an independent Securities and Futures Appeals Panel to hear appeals from parties aggrieved by certain decisions made by the SFC and judicial review by the Court of First Instance of SFC decisions being available¹¹.

The Penny Stock Incident Report stated that the three-tier structure was “based on a solid foundation and has worked reasonably well”¹²; and goes on to conclude that “[t]here is overwhelming support for the continuation of the three-tier regulatory structure. It has served Hong Kong well over the past 13 years. At the same time, there are calls for clearer delineation of responsibilities among the three parties and better co-ordination among them.”¹³

Even though the report stated that “[o]ur considered view is that the structure itself is sound”¹⁴, it noted that they received feedback that there was still room for some refinements and improvements of the system. In the circumstances, the report recommended there should be a critical review of “how the existing structure, roles and operation of the Listing Committee can be fine-tuned so that it can fully perform its role as the unit of the HKEx with final responsibility over listing matters”.¹⁵ The report also observed that many respondents had “suggested that if a Listing Committee is to be retained, as most believe it ought to be, it cannot be housed under the HKEx. With the current structure, the only entity under which it can be accommodated is the SFC”¹⁶.

In essence, the report recommended maintaining the three-tier system of Government-SFC-Exchange, with a review of whether the Listing Committee should be under the authority of the SFC rather than the Exchange. This is quite different to what is being proposed in the Consultation Paper, whereby in form the Listing Committee still exists under the Exchange hierarchy but in substance all of the functions of the Listing Committee with regard to listing policy, IPO applications and other listing related matters will have been effectively taken over by the SFC. The three-tier system will effectively be reduced to a two-tier system.

¹⁰ Paragraph 3.22 of the Penny Stock Incident Report

¹¹ Paragraph 3.17 of the Penny Stock Incident Report

¹² Paragraph 3.25 of the Penny Stock Incident Report

¹³ Paragraph 13.15 of the Penny Stock Incident Report

¹⁴ Paragraph 14.18 of the Penny Stock Incident Report

¹⁵ Paragraph 14.19 of the Penny Stock Incident Report

¹⁶ Paragraph 14.21 of the Penny Stock Incident Report

What is of particular concern is that such a radical change in the listing regulatory regime is being presented as merely an “enhancement” of the current system and that the composition of the two new committees proposed to be set up, which will determine listing policy and policy-related listing matters, is seemingly evenly represented by the Exchange and SFC but will in fact be controlled and dominated by the SFC. We doubt that the Proposals are really conducting a “critical review” of the existing structure as suggested by the Penny Stock Incident Report.

(iii) MOU

It should be noted that the Memorandum of Understanding Governing Listing Matters between the SFC and the Exchange entered into on 28 January 2003 (the “MOU”) already sets out arrangements between the two bodies which reflect some of the changes proposed in the Consultation Paper. For example, the MOU talks about the establishment of a “High-Level Group”, a liaison group between the two organizations, to review systemic and policy issues concerning listing-related matters.¹⁷ The group comprises the Chairperson of HKEx, the Chief Executive of HKEx, the Head of Listing of HKEx, the Chairperson of the Listing Committee, the Chairperson of the SFC, the Executive Director of the SFC Corporate Finance Division and the Chairperson of the Takeovers Panel. The composition and purpose of the High-Level Group is similar to the proposed Listing Policy Committee.

Furthermore, it is already set out in the MOU that the Exchange shall forward to the SFC any policy decision it intends to implement that will have mandatory effect or be of general application, and the Exchange shall not publish, rely upon or impose on any person such decision until the SFC has approved it in writing.¹⁸ Also, the Exchange will inform the SFC, as soon as is reasonably practicable, of any matter of a novel or potentially controversial or sensitive nature, or which appear to involve public policy implications, whether arising from a listing application, a transaction by a listed issuer, or otherwise.¹⁹ It would seem that the objective of the Listing Regulatory Committee is already achieved by these arrangements set out in the MOU.

(iv) Marginalization of the Listing Committee

Under the current system, the Exchange Board has delegated its powers and functions relating to listing matters, including the formulation of listing policy, to the Listing Committee. The Listing Committee comprises 28 members which include (but are not limited to) representatives of investors, listed companies and market practitioners. As observed by the Consultation Paper, “[m]embers of the Listing Committee enable the Exchange to draw on the commercial and business knowledge and experience of market users for policy formulation and regulatory decision-making”²⁰.

However, under the new proposed listing regulatory system, the Listing Committee’s role in policy formulation will be taken over by the Listing Policy Committee and the Listing Regulatory

¹⁷ Paragraph 5 of the MOU

¹⁸ Paragraph 6.5 of the MOU

¹⁹ Paragraph 6.6 of the MOU

²⁰ Paragraph 5 of the Consultation Paper

Committee will be responsible for IPO applications and matters involving listed issuers where there are suitability concerns or broader policy implications. Therefore, the Listing Committee's only remaining area of regulatory decision-making will be IPO applications and matters involving listed issuers that do not involve suitability concerns or broader policy implications, i.e., the most straightforward and non-controversial cases.

The Listing Committee will be asked to put forward its views to the Listing Policy Committee and the Listing Regulatory Committee on matters reserved for their decision. However, since such views of the Listing Committee are non-binding, the Listing Policy Committee and the Listing Regulatory Committee are free to disregard and override the Listing Committee's views and recommendations.

The collective knowledge and experience of the 28 members of the Listing Committee in the business and financial industry make it the ideal body for the development of listing policy and the determination of whether a listing applicant or its business are suitable for listing in light of overall market conditions and developments. On the other hand, given that the composition of both the Listing Policy Committee and the Listing Regulatory Committee is effectively controlled by the SFC, the Proposals may lead to a regime "which might all too easily lead to insensitive or heavy handed over-regulation" as warned in the Hay Davison Report. Such a listing regulatory structure would hamper, rather than facilitate, the development of both the IPO market and the continuing fund raising capability of the capital market in Hong Kong.

We further note that the composition of the Listing Regulatory Committee is purposely designed to replicate the composition of the Listing Policy Committee to the extent practicable in order to align important listing decisions with the policy direction set by the Listing Policy Committee²¹. This in effect means that the most important and challenging decisions which are likely to have far-reaching implications on the Hong Kong securities market will be decided by six committee members, half of whom are regulators who may block any decision of the Listing Regulatory Committee.

Under the new regime, even though the role of the Listing Committee will be marginalized and its power reduced, their workload is not likely to decrease as they are tasked with providing their non-binding views on the policy matters coming before the Listing Policy Committee and on IPO cases or post-IPO matters with suitability concerns or broader policy implications to the Listing Regulatory Committee. We believe that it may be extremely difficult to attract capable individuals with appropriate qualifications and experience to join the Listing Committee in the future. We strongly believe that a strong and assertive Listing Committee is essential to counterbalance the SFC's tendency to over-regulate in a sometimes insensitive or heavy handed manner.

Conclusion

If the Proposals are to remove the existing powers of the Listing Committee and transfer them to the SFC, this should be stated explicitly in the Consultation Paper. This change will have

²¹ Paragraph 76 of the Consultation Paper

significant repercussions for the financial markets in Hong Kong and deserves an open and full debate on the pros and cons of dismantling the three-tier system.

In our view, the present system, with appropriate checks and balances between the Exchange and the SFC, has worked well to help Hong Kong develop into the major international financial centre that it is today. Given the SFC's effective control over the listing regulatory regime coupled with the marginalisation of the role of the Listing Committee under the Proposals, rather than achieving a better balance between over-regulation and ever-changing market needs, the new listing regulatory regime is likely to move towards more emphasis on regulation and become less responsive to a rapidly changing market. With the wealth and diversity of knowledge and experience brought by the 28 members of the Listing Committee, the present Listing Committee always strives to strike a balance between regulations and the needs of the market.

We believe that the SFC already has considerable power under the current listing regulatory regime and the arrangement under the MOU is already able "to achieve closer coordination and cooperation between the SFC and the Exchange on policy formulation and to provide the SFC with earlier and more direct input on listing policy matters and listing regulation"²².

Yours faithfully

WOO KWAN LEE & LO

²² Paragraph 1(a) of the Consultation Paper