Third Submission

To

Expert Group
To Review The Operation
Of The Securities & Futures Market
Regulatory Structure

December 2002

Hong Kong Exchanges and Clearing Limited

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MARKET QUALITY

Background

1. **Hong Kong's Competitive Advantage** - One of principal competitive advantages of the Hong Kong Exchanges and Clearing Limited (the "HKEx") is the maturity and quality of Hong Kong's market infrastructure in relation to that of other Asian financial centres. Key elements in our market infrastructure are the regulatory and legal framework, a large community of sophisticated financial intermediaries and professional service providers, a retail and institutional investor base with a strong "equity culture", and a critical mass of issuers who attract international investor interest. Maintaining the quality of this issuer base is one of HKEx's important priorities.

2. **Main Board** - The Main Board at present contains a great diversity of companies, ranging from global concerns with investors from many parts of the world to small companies with a very narrow local retail following. There is also considerable geographical diversity, with a growing proportion of the market made up of Mainland-based or Mainland-controlled companies, some of them also very large. The next phase of the market's growth may well be led by Mainland-based

private (as opposed to state-controlled) companies, some of which are likely to be smaller but potentially higher-growth (and higher-risk) concerns.

3. **GEM** – The Growth Enterprise Market (the "GEM") is also acquiring greater diversity, having initially been focussed heavily on technology-related stocks, most of which have suffered badly in the shake-out of this sector during the past two years. A growing number of Mainland companies are also accessing this market.

4. **Balance** - Maintaining the overall quality of issuers is not easy in a period of negative or slow growth for the Hong Kong economy. HKEx is acutely conscious of the need to strike a balance between the objective of developing the market (in particular of maintaining Hong Kong's position as the premier international centre for China listings) against the need to maintain the quality of issuers in the market. The competition for China listings from other financial centers is intensifying rather than abating.

5. **The Quality Issue** - As mentioned in our first Submission, HKEx is also well aware that there exists a public perception that the average quality of Hong Kong's listed companies has been deteriorating in recent years. This has been attributed by some commentators to a desire on the part of HKEx to list as many companies as possible (regardless of quality) in order to boost its revenues. This suggestion has no foundation whatever in fact, for the reasons described in paras 8-12 of HKEx's First Submission. HKEx believes that those involved in the approval process of initial listings (particularly the members of the Listing Committee) would universally vouch for the fact that their

decisions were not influenced in any way by any interest in HKEx's profitability. Nevertheless, the accumulation of financially distressed, illiquid or otherwise problematic listed companies (mentioned in our First Submission) is a source of genuine concern to HKEx.

6. **Third Submission** - The purpose of this Third Submission is therefore to make the Expert Group aware of some of the ideas being considered by HKEx internally (which have not yet been fully discussed within HKEx or with the Securities and Futures Commission (the "SFC"), let alone floated publicly) with a view to addressing this problem.

<u>Causes of the Problem</u>

7. HKEx believes the principal causes of the problem are:
   (a) normal business failures, which were exacerbated first by the Asian financial crisis of 1997-98 and subsequently by the depressed market of the last few years;
   (b) the listing of companies with emerging market characteristics, whose modus operandi are different from those normally found in mature markets and whose listing calls for a particularly high level of due diligence and professional integrity from sponsors and advisers;
   (c) the influx of higher-risk companies onto GEM (which is natural, given the focus of this market, whose establishment was strongly encouraged by Government); and
   (d) the flotation of some companies which, in retrospect, can be seen to have had questionable public floats.

   The number of companies in categories (c) and (d) above may be due in part to the inadequate level of professional standards maintained by some financial intermediaries and advisers, who may have allowed (or even assisted) unethical company controllers to circumvent the spirit of the admission criteria (in particular the public float requirement).

8. **Addressing the Problem** - HKEx is concerned, first, to stop the growth in the number of problematic listed companies (which was the objective of the July 2002 Consultation Paper and may call for a further review of the admission criteria); second, to reduce the number of existing distressed/problematic companies by finding ways to encourage their revitalization or relegating them to a lower-tier market or, where necessary, de-listing them; and, third, to ensure that means are available to enforce high standards of disclosure at the time of listing and on an ongoing basis (via, for example, the dual filing system and the legislative changes recommended in HKEx's previous submission).

Admission Criteria

9. **Public Float** - As mentioned in HKEx's First Submission, most of the Main Board entry criteria are set at relatively high levels compared with other developed markets (see Appendix O to HKEx's First Submission). HKEx believes the focus of its efforts to introduce further remedial measures should be companies in category 7(d) above. In this context, the public float is the most appropriate target area. There is evidence that some unscrupulous controlling shareholders seeking listings (for whatever reasons) have tried to manipulate the public float in IPO's (often with the help of compliant issuing houses) by such means as financing purchases of shares by friends or purchasing through nominees, so that a genuine public float did not exist. In poor market conditions, when small company IPO's generally attract little investor

interest, the risk of this phenomenon occurring is particularly high. The resulting illiquidity of such stocks has made them fertile ground for manipulation.

10. **Increasing Distribution and Size of Qualifying Shareholding** - Adjusting the absolute level of the "public float" (which, at 25% and HKD50m, is not low by international standards) may not be the most effective way to address this problem. The minimum distribution requirement (currently proposed to be raised to 300 shareholders in HKEx's Consultation Paper of July 2002) may be a more precise instrument. HKEx has already proposed a rule which would require that the top five public shareholders should not hold in aggregate more than 50% of the public float. There may be scope for either a further increase in the minimum number of public shareholders or additional requirements concerning the size of individual holdings which might help to ensure that each of the public shareholders has a sufficient number of shares to genuinely contribute to a free and open market. In addition, HKEx proposes to increase the onus on the sponsor/lead underwriters (see paragraphs 17-18 below) to ensure that the placees are bona fide public investors with no connection to the controlling shareholder(s).

11. **Certification of Independence** – At present, sub-underwriters are required to make a declaration to the Exchange that their placees are independent of the controlling shareholders of the IPO company. However, neither the time-frame of an IPO, nor the Exchange's investigation powers, permit independent verification of such declarations. The SFC's power to question individual investors in relation to such matters is also limited. HKEx proposes to consult the

market on what additional measures may be possible within the existing statutory framework (perhaps making greater use of the SFC's leverage over sponsors and brokers) to ensure that such declarations are supported by fuller due diligence, that brokers' relationships with clients are bona fide, and that any underlying declarations by placees are truthful (e.g. by the inclusion of a statement to the effect that the acquisition of the shares is not funded by the controlling shareholders of the company, and possibly by tightening the wording of the relevant forms).

12. **Lock-up** - Another measure which might reduce the scope for abuse in relation to newly-listed companies would be to extend the "lock-up" period for the principal pre-IPO shareholders from 6 months to 12 months or more.

Continuing Eligibility Criteria

13. **Reducing the Number of Problematic Companies** - In its Consultation Paper of July 2002, HKEx made certain suggestions aimed at reducing the number of "problem companies" (i.e. companies with financial problems or inadequate public floats or insubstantial businesses or other factors which make their suitability for listing questionable). This Consultation Paper gave rise to the Penny Stock Incident. As a result, modified (and more tentative) proposals were included in the Consultation Paper issued in November 2002 on Continuing Listing Criteria. These include criteria related to financial performance, shareholder spread, assets, share price level, earnings and market capitalisation. Public feedback is still awaited. However, even if this shows support for the application of criteria along the lines

suggested, these would be likely to bite in only a limited number of more egregious cases. A large residue of problematic companies would almost certainly remain.

14. The only means to reduce this number are, essentially, either to find ways of delisting problem companies or to make it easier for them to be revitalised through business injections. HKEx is reluctant to propose a general relaxation of the rules regarding "back door" listings. However, a more liberal application of the present rule permitting such listings in “rescue” situations may be something which HKEx and SFC could contemplate. If the term “rescue” were interpreted to include evidently moribund (as well as financially-distressed) companies, this would catch a considerable number of problem companies. However, careful thought is necessary to ensure that avenues are not created by which this “rescue” route can be abused.

15. **GEM**

The GEM raises somewhat different market quality issues. Investors accept a higher level of risk when entering this market, which relies very explicitly on the caveat emptor principle, accompanied by extensive disclosure requirements. The main problem in relation to GEM has been the poor share price performance of a large number of the companies listed on this market, many of which (particularly in its first year of operation) were in the technology sector. This poor performance has not generally been associated with regulatory or corporate governance lapses. In fact, there have been relatively few (given the circumstances) serious cases of false or misleading disclosure or minority shareholder abuse. HKEx was criticised in 2000 for being too liberal in granting waivers to listing applicants. This was at a time when the market was new and needing to get established, and when the rules were untested in practical circumstances. Since that time, the rules have been reviewed and amended in the light of international market development and local experience , and applied strictly (without unusual waivers). This market is now gradually acquiring greater maturity and diversity of listed companies.

Role of the Listing Committee

16. The world-wide trend continues to be away from "merit-based" listing regulation towards disclosure-based regimes. Hong Kong is moving with this trend. This reduces the scope for the Listing Committee to apply qualitative judgement in approving or rejecting listings or making other decisions, but it does not make the Committee redundant. The commercial experience of its members is a valuable element in controlling market quality and one which HKEx would like to see used more actively, particularly in relation to companies with emerging market characteristics. While it is difficult for the Committee to reject applications as unsuitable on merit grounds if they clearly meet the criteria, there is scope for the Committee to probe the substance of an applicant's business, the rationale for its application and the relationship between the proposed listing vehicle and any private companies of the controlling shareholders. If the Committee finds the application suspicious, or does not receive convincing answers to its questions, it can refer the matter back to the applicant until it is satisfied. The extent to which the Committee adopts a critical stance is to some extent a function of its collective approach. HKEx hopes and expects that the proposal outlined in its Second Submission to adapt the

modus operandi of the Committee will help in this regard. HKEx will certainly encourage the new Committee to adopt a robust stance and to be particularly mindful of the Committee's role in maintaining market quality.

Role of Intermediaries

17. **Sponsors** - HKEx mentioned in its First Submission that part of the "solution" to the accumulation of poor quality companies lies in raising the standards of professional advisers - especially of investment bank sponsors. This is particularly relevant in relation to companies which fall into the emerging market caregory, especially if their assets and management are located outside Hong Kong (e.g. in the Mainland). HKEx already requires every issuer on the GEM to have a Sponsor for its first two years of operation, whose duties are specified in the GEM Listing Rules and who is required to monitor the issuer's compliance with the Rules. HKEx has set certain criteria for the eligibility of sponsors, including the involvement of a specified number of employees with sufficient relevant experience. HKEx can refuse to deal with a sponsor who repeatedly attempts to bring poor quality companies to the market.

18. HKEx proposes to issue a Consultation Paper in the early part of 2003 containing proposals which would extend the sponsor responsibility system to the Main Board and establish a more formal and extensive quality assurance framework to ensure that sponsors adopt a critical approach to the business models of the companies they bring to market and undertake thorough due diligence on the competence, integrity and background of controlling shareholders and management, as well as the

financial history of the companies concerned. The duties of a sponsor would be spelt out fully in the Listing Rules and would include familiarizing itself thoroughly with the business of the company to be listed and the background of its principals. The quality assurance procedures would include the creation of an Approved List of Sponsors. An agreement would be concluded with each sponsor, which would permit the taking of disciplinary measures if the sponsor acted incompetently or in a manner which brought its professional integrity into question (for example, colluding with company controllers to create artificial placements). Reprimands and other disciplinary measures might be accompanied by the award of a certain number of “black marks” analogous to demerit points on a driving licence. A certain number of such marks would result in the sponsor concerned being struck off the Approved List for a period of time. Sponsors would also be required to report to HKEx that they had discharged their duties, and to immediately report material breaches of the Listing Rules by the relevant issuer. Co-operation in introducing these requirements is expected from the SFC, whose leverage over sponsors via their licensing is considerable.

19. **Other Professionals** - The concept of an Approved List may also be applied to other categories of professional adviser such as reporting accountants, legal advisers, financial advisers and valuers / appraisers. The duties of such parties would also be laid down clearly in the Rules. Qualifications for professional advisers would be introduced. Any failure to meet the standards required would earn a "black mark" in the same way as unprofessional conduct by sponsors. An accumulation of black marks could cause HKEx to decline to handle IPO's or other transactions in which such advisers were involved. However, the SFC

and Government will need to play a lead role in dealing with professional advisers such as accountants, lawyers and valuers / appraisers. It may be that some form of statutory oversight is desirable to reinforce the present self-regulatory arrangements of accountants and lawyers.

20. A further step which HKEx might recommend (which has been taken in the UK and has long existed in North America) would be to create a statutory liability for professional advisers (including sponsors) in the event of material misrepresentations in listing documents. The adviser would have a defence where he could demonstrate that he had undertaken proper verification of information.

Mainland Private Enterprises

21. **Special Regulatory Issues** - Particular issues arise in relation to Mainland-controlled private enterprises seeking to list in HK. Such companies are not subject to pre-vetting (or ongoing supervision) by the China Securities Regulatory Commission in the manner applicable to state-controlled enterprises. Most of them use companies registered outside China as vehicles for their Hong Kong listings. Verifying the activities of the company and its controlling shareholder(s) poses considerable challenges. There may be questions about the identity of the true controllers. The risks of misrepresentation, fraud and poor governance involved in listing such companies are greater than in the case of traditional "H" share companies.

22. Placing a blanket moratorium on the listing of such companies, or attaching prohibitive conditions, might from a regulatory point of view appear an attractive course. However, such action would run counter to Hong Kong's objective of retaining its position as the principal international financial service centre for the Mainland. HKEx must therefore use whatever instruments it has at its disposal to try to control the quality of mainland private enterprises allowed for entry to the Hong Kong capital market. Such instruments include the experience of the Listing Committee (see paragraph 16 above) and the hold which HKEx and the SFc have over sponsors and other professional advisers. Placing a heavier responsibility on these parties is a key part of HKEx's general strategy for improving market quality (see paragraphs 17-20 above). The risks for public shareholders might also be mitigated if the "lock up" period for pre-IPO owners were extended. In addition, Mainland private sector companies could be encouraged to maintain a more meaningful physical presence in Hong Kong, including an office with permanent staff and operational records, and at least two directors resident in Hong Kong. This would facilitate communication with the company and assist (where necessary) in statutory enforcement.

Market Segmentation

23. A parallel and different line of approach to the issue of market quality may lie in greater segmentation of the market. As already noted, there is much diversity among companies listed on Hong Kong's Main Board. International investors tend to focus principally on the top 30 or so companies by market capitalization. The reputation of the market as a whole can nevertheless be tarnished by the conduct or performance of so-called third and fourth line stocks, as well as by the residue of problem companies already mentioned. In larger markets overseas (e.g.

the USA) there is a high level of natural market segmentation by virtue of the number of stock exchanges in the market. One market (NASDAQ) currently has two tiers (the National Market and the Small Cap board); a third will be added next year when the Bulletin Board becomes an exchange on which companies can list.

24. There are various means by which market segmentation might be achieved. The most radical would be to create one or more new boards with differing admission and continuing eligibility criteria, one of which might be the size of the public float in absolute, as well as percentage, terms. If this is not found to be acceptable, an alternative would be to attach an identification code to stock numbers denoting companies which fall into particular categories. A symbol could also be attached if a company became the subject of a reprimand or failed to meet specified corporate governance standards.

25. Such segmentation would have the effect of increasing the visibility of the risks which investors take when buying the shares of particular types of company, and limiting any "contamination" of the top tier companies by those of questionable quality. The existence of different tiers would also act as an incentive for companies to climb up the "ladder", since it is likely that their cost of capital would be influenced by the category into which they fall.

26. HKEx does not underestimate the difficulty of gaining market acceptance of the criteria for differentiating between "tiers" in the market, nor the possible extent of resistance from companies who might feel they were being "relegated" to a lower league. Nevertheless, HKEx believes the concept should be explored in a serious and determined way.

Conclusion

27. This paper is designed to give the Expert Group greater insight into HKEx's thinking at a formative stage on issues related to market quality. Before any of these ideas become the subject of public consultation, further deliberation at the Listing Committee and staff level and with the HKEx Board and SFC will be required. However, any feedback which the Expert Group feels able to give to HKEx on these ideas would be warmly welcomed.