

1. The Financial Services and the Treasury Bureau (FSTB) invites public comments on the proposals in this consultation paper.
2. The consultation paper can also be found on the website of FSTB at <http://www.info.gov.hk/fstb>.
3. Members of the public are invited to send their views in writing on or before 31 December 2003 -

By mail to Financial Services Branch
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 (Attn.: Proposals to Enhance the Regulation of
 Listing)

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By e-mail to consult@fstb.gov.hk

By online <http://www.info.gov.hk/fstb>
submission to

4. Please note that the names of respondents and their comments may be posted on the website of FSTB or referred to in other public documents. If a respondent does not wish his/her name to be disclosed, he/she should state that he/she wishes his/her name to be withheld from publication when sending in his/her comments.

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GLOSSARY

“Carve-out”	Exemptions, provided for in the statute, from certain statutory provisions. These exemptions are usually intended to protect certain legitimate market activities from being outlawed by a regulatory framework backed by the statute.
CSRC	China Securities Regulatory Commission.
“Dual filing”	A system introduced under the Securities and Futures (Stock Market Listing) Rules on 1 April 2003. Copies of listing applications and public disclosure materials by listed companies are required to be filed to the Securities and Futures Commission, in addition to the Stock Exchange of Hong Kong Limited. The Securities and Futures Commission has the powers to make comments and object to a listing application. It can also exercise its statutory powers to take action against false or intentionally misleading disclosure.
Expert Group	The Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure.
GEM	Growth Enterprise Market. It is a stock market operated by the Stock Exchange of Hong Kong Limited. It was set up in November 1999 to provide fund raising opportunities for growth companies.
HKEx	The Hong Kong Exchanges and Clearing Limited. It is the holding company of the Stock Exchange of Hong Kong Limited.
IPO	Initial public offering.
Listing requirements	We have used this term in this consultation paper in general to refer to all rules and requirements concerning admission to listing and ongoing obligations of listed companies. The rules and requirements are now contained in the Rules

Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited and Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited, the Securities and Futures (Stock Market Listing) Rules and the Companies Ordinance.

mens rea

The state of mind that the prosecution must prove a defendant to have had at the time of committing a crime in order to secure a conviction.

MMT

Market Misconduct Tribunal established under section 251 of the Securities and Futures Ordinance which has jurisdiction to hear and determine in accordance with Part XIII and Schedule 9 of the Ordinance any question or issue arising out of or in connection with market misconduct proceedings.

“Red Book”

Rules governing the listing of securities on the Stock Exchange of Hong Kong Limited are commonly referred to by market practitioners as the “Red Book”.

“Safe harbour”

Same as “carve-out” mentioned above.

SCCLR

The Standing Committee on Company Law Reform.

SEHK

The Stock Exchange of Hong Kong Limited. It is the operator of the Main Board and the Growth Enterprise Market and is a subsidiary of the Hong Kong Exchanges and Clearing Limited.

SEHK Listing Committees

Set up by the Stock Exchange of Hong Kong Limited to perform functions and exercise powers in relation to listing matters delegated by the Board of the Hong Kong Exchanges and Clearing Limited. There are currently two Listing Committees, one for the Main Board and the other for the Growth Enterprise Market.

SEHK’s Listing Rules

Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited and Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited.

They are made by the Stock Exchange of Hong Kong Limited; have non-statutory status; and are subject to approval by the Securities and Futures Commission under the Securities and Futures Ordinance.

SFC The Securities and Futures Commission. It is the statutory regulator of the securities and futures market.

SFO The Securities and Futures Ordinance (Cap. 571). It commenced operation on 1 April 2003 and is the principal ordinance regulating the securities and futures industry.

SFSMLR Securities and Futures (Stock Market Listing) Rules made by the Securities and Futures Commission under section 36 of the Securities and Futures Ordinance. They provide for the “dual filing” system.

Shared regulation More than one entity performing the role of a regulator under a regulatory framework to monitor the same market activity and/or conduct.

Trading platform Facilities that a stock exchange operates for the trading of securities and futures products.

EXECUTIVE SUMMARY

1. Over the last two decades, Hong Kong has established its position as a major international financial centre. It is important to our future economic growth that we continue to strengthen this position, and to build on our strengths to further develop Hong Kong as the premier capital formation centre for the Mainland. The strengthening of the foundations of our financial services is therefore one of the principal planks in the Government's economic policy agenda.
2. In a rapidly globalizing economy, reputation is the key to success. It is vital, therefore, that we benchmark ourselves against other major financial centres and that we keep our legal and regulatory framework under constant review. While taking lessons from events elsewhere and evolving to keep pace with best international standards, ultimately we must develop systems, which build on the experience of local institutions to meet modern market needs. This consultation paper is part of that process and seeks public views on the most appropriate next steps in adjusting the regulatory regime for listing with a view to maintaining and improving the quality of our equity market.
3. In light of the Report of the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure and public comments thereon, we have identified a number of issues which we believe to be critical for the better regulation of listing. These include the legal status of certain fundamental requirements in the Listing Rules of the Stock Exchange of Hong Kong Limited (SEHK), the manner of their enforcement, and the roles of both the Securities and Futures Commission (SFC), as the statutory regulator, and the Hong Kong Exchanges and Clearing Limited (HKEx), as the market operator, in performing the listing functions. We would like to seek public views on these issues.
4. A unique feature of Hong Kong's market is that an unusually large proportion of listed companies, about 80%, are incorporated off-shore. The principal tool for regulating these overseas-incorporated listed companies is thus the non-statutory Listing Rules of SEHK, rather than the Companies Ordinance.

5. In other jurisdictions such as the United States, United Kingdom, Australia and the Mainland, listed companies are regulated through statutorily backed rules. It has been suggested that it would be beneficial to Hong Kong's market development if we were to follow their example.
6. By giving certain fundamental requirements in the Listing Rules statutory backing, we would be able -
 - (a) to create a positive statutory obligation for compliance with these requirements;
 - (b) to allow more effective investigation of a suspected breach of these statutory requirements; and
 - (c) to enable the imposition of a wider range of statutory sanctions in respect of any proven breach of these statutory requirements, sanctions which would be commensurate with the seriousness of the breach and therefore more effective.

Promoting compliance and facilitating enforcement in this manner should help enhance market quality thus attracting investors and issuers to our market.

7. The "dual filing" system introduced under the Securities and Futures (Stock Market Listing) Rules on 1 April 2003, when the new Securities and Futures Ordinance commenced operation, has provided a limited form of statutory backing.
8. Building on the "dual-filing" system, we would like to invite public views on whether statutory backing should be extended to other fundamental requirements set out in the Listing Rules of SEHK (paragraph 2.16); and if so -
 - (a) which fundamental listing requirements should be given statutory backing (for example, disclosure requirements and provisions governing related party transactions) (paragraphs 2.34-2.36);
 - (b) how to give these listing requirements statutory backing, i.e. by a balanced mix of legislative instruments in the primary and subsidiary legislation, supplemented by non-statutory codes and guidelines (paragraphs 2.17-2.25); and

- (c) what sanctions should be imposed for breaches of the statutory listing requirements, in particular civil sanctions (paragraphs 2.37-2.48).
9. It should be noted that giving certain fundamental listing requirements statutory backing does not necessarily imply that those requirements would be removed from the Listing Rules of SEHK. SEHK could, as at present, preserve and continue to administer its Listing Rules, which are subject to SFC's approval under the Securities and Futures Ordinance.
10. Clearly, as a for-profit commercial entity and a listed company, SEHK would have some difficulty administering statutory listing requirements. Unlike a law enforcement agency, it does not have the statutory investigative powers to inquire into other listed companies. We therefore envisage that most, if not all, of the statutory listing requirements would have to be administered by a statutory regulator. On the other hand, it should have ultimate control over which companies should be listed on its trading platform as this is essential to establishing and maintaining its "badge of quality".
11. We have drawn reference from public comments on the regulatory structure governing listing functions over the past year in developing four broadly alternative models of regulatory structure for the purpose of facilitating public discussion. In outline they are -
- (a) Transferring listing functions to a new division set up under SFC:
- This model would provide clearer accountability, remove the possibility for conflict of interests and facilitate synergy with other regulatory functions of SFC. On the other hand, it might result in an over-concentration of powers in SFC and the risk of over-regulation (paragraphs 3.23-3.27).
- (b) Transferring listing functions to a new HKEx subsidiary:
- The board members of such a subsidiary may be appointed by HKEx with input from SFC. Such an arrangement could help strengthen the separation of HKEx's business and regulatory

functions. However, as its funding would still be dependent on HKEx, its effectiveness in removing any real or perceived conflict of interests might be limited (paragraphs 3.28-3.30).

(c) Transferring listing functions to a new statutory independent authority:

The new statutory independent authority, envisaged in this model, would be led by a board appointed by the Government, with nominations from SFC and HKEx. This could help remove any conflict of interests while not giving rise to an over-concentration of powers in SFC. This would, however, be a costly alternative. It may also complicate the regulatory structure and result in more regulatory gaps and/or overlaps, red tape and bureaucracy (paragraphs 3.31-3.35).

(d) Expanding the “dual filing” system:

This model builds on the success of the “dual filing” system. Under it, SFC would take on responsibility for administering any new statutory listing requirements. This could strengthen the regulatory regime, by giving certain fundamental listing requirements more “teeth”, without drastically revamping the existing structure or diluting the market savvy inherent in the existing system. However, it might not wholly remove any conflict of interests or any regulatory overlaps in the present system (paragraphs 3.36-3.41).

12. The above models involve, in different ways and to differing degrees, the transfer and re-distribution of listing functions among the regulators. The models are by no means exhaustive. However, they have been drawn up based on past feedback from market users, market operators and regulators. They assume no fundamental change to the three-tiered regulatory structure for the securities and futures industry that has served Hong Kong well for the past decade, allowing the regulators to operate independently under a clear policy and legislative framework, and preserving market savvy in the listing process provided by SEHK Listing Committees which comprise a balanced mix of market users.

13. We welcome public views on how the existing regulatory structure should be improved, so that it could achieve a reasonable balance between market savvy and regulatory expertise, with a view to protecting investors and facilitating market development.
14. The consultation will close on 31 December 2003. We will, in light of the comments received, work closely with SFC and HKEx in considering possible measures to improve the regulatory regime in respect of listing matters.

CHAPTER 1 INTRODUCTION

HONG KONG AS AN INTERNATIONAL FINANCIAL CENTRE AND THE PREMIER CAPITAL FORMATION CENTRE FOR THE MAINLAND

- 1.1 Hong Kong is recognised as an important international financial centre with an active securities industry. With a total market capitalisation of HK\$4,620 billion as at end August 2003, the Hong Kong stock market ranked 8th in the world and second in Asia¹. The daily turnover averaged HK\$12 billion during the first eight months of 2003. As at end August 2003, 1,014 companies were listed on the Stock Exchange of Hong Kong Limited (SEHK) including both Main Board and Growth Enterprise Market (GEM).
- 1.2 Our stock market is an important fund raising centre for Mainland enterprises. As at end August 2003, of the 82 Mainland enterprises listed outside Mainland, 81 were quoted on SEHK. Last year, about HK\$70.8 billion was raised in new listings of H-shares and red chips in Hong Kong, accounting for some 64% of the total funds raised in the Hong Kong market during the year. It is expected that Mainland issuers will continue to be a major growth driver of the securities market of Hong Kong in the future.

NEED FOR CONTINUOUS IMPROVEMENT OF THE QUALITY OF THE EQUITY MARKET

- 1.3 Competition at the international level is increasingly fierce. The future of Hong Kong as an international financial centre and the premier capital formation centre for the Mainland depends on our ability to maintain and improve the quality of the equity market. Following the announcement of the Corporate Governance Action Plan by the Administration in January 2003, we have been pressing ahead with various initiatives to improve the quality of our market. For example, the Securities and Futures Ordinance (SFO) (Cap. 571) was successfully brought into effect on 1 April 2003, including the

¹ For the purpose of ranking, the market capitalisation of stock exchanges is aggregated on a per-jurisdiction basis. This methodology is in line with the practice adopted by the International Finance Corporation and Standard & Poor's in their Annual Fact Book entitled *Emerging Stock Markets*.

joint efforts made by the Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx) in launching the “dual filing” system. HKEx announced in June 2003 initiatives to simplify and streamline the listing process and to improve the quality of vetting. This consultation exercise is one of the initiatives under the Corporate Governance Action Plan to improve the listing functions.

- 1.4 We recognise that a review of regulatory arrangements for listing matters needs to be conducted, having regard to international standards and practices, in order for the listing regime to evolve with market needs and local characteristics in the longer term. The three-tiered regulatory structure has served Hong Kong well over the past decade. There is however room for fine-tuning from time to time as the market develops. The recommendations of the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure (“the Expert Group”) published in March 2003² provide a useful basis for further public discussion on specific measures for longer term improvement.

SCOPE OF CONSULTATION

- 1.5 We would like to consult the public on the following issues which we believe to be critical for the better regulation of listing matters –
- (a) *whether statutory backing should be given to certain fundamental requirements in the current Listing Rules of SEHK³ and associated issues (Chapter 2); and*
 - (b) *how the existing regulatory structure governing the performance of listing functions should be improved after certain fundamental listing requirements are given statutory backing and associated issues (Chapter 3).*

Our aim is to arrive at a set of specific measures which are suitable for Hong Kong’s circumstances and in line with international

² The full text of the Report is available at the Government’s website:
<http://www.info.gov.hk/info/expert/expertreport-e.htm>

³ It refers to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited and the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Stock Exchange of Hong Kong Limited.

standards through a better understanding and more thorough consideration of these important issues.

- 1.6 To facilitate consideration of these important issues, we have attempted to define the listing functions for the purpose of this consultation paper (paragraph 3.18).
- 1.7 In considering possible measures to improve the regulatory regime in respect of listing, we have been working closely with the relevant parties including SFC and HKEx. We are sensitive to the needs of the market. We will continue to ensure that the regulatory regime has an appropriate balance of market savvy and regulatory expertise, and is conducive to healthy market development. This is the key to enhancing market quality without stifling market innovation.

CHAPTER 2 STATUTORY BACKING FOR CERTAIN FUNDAMENTAL LISTING REQUIREMENTS

NEED FOR STATUTORY BACKING

- 2.1 About 80% of the listed companies in Hong Kong are incorporated off-shore and are governed primarily by laws in those jurisdictions. The Listing Rules of SEHK, instead of the Companies Ordinance (Cap. 32), have thus become the principal tool for regulating overseas-incorporated listed companies in Hong Kong. As such, the Listing Rules have greater significance than their equivalent in other major markets. As pointed out by the Standing Committee on Company Law Reform (SCCLR)⁴, “the Listing Rules have assumed the role of ‘quasi company law’, but without statutory status, to a greater extent than the listing rules in other jurisdictions”, and SCCLR has sought public views on whether, in principle, statutory backing should be given to the Listing Rules.
- 2.2 SEHK, the administrator of its Listing Rules, faces constraints in enforcing the Listing Rules. It does not have any statutory investigative powers to inquire into any suspected breach of its Listing Rules. This limits SEHK’s enforcement efforts to detect, pursue or deter corporate misconduct. SEHK may only resort to non-statutory sanctions such as public censures, public statements of criticisms and private reprimands in sanctioning breaches of SEHK’s Listing Rules. Suspension and delisting cannot be used lightly as they would deprive investors of the right to dispose of their shares. In view of this, there has been discussion on giving statutory backing to certain fundamental requirements in SEHK’s Listing Rules so that breaches would, where appropriate, attract more effective sanctions.
- 2.3 The apparent lack of “teeth” of SEHK’s Listing Rules was pointed out in the Expert Group’s report and one of the major recommendations of the Expert Group is to give statutory backing to SEHK’s Listing Rules. SCCLR shares similar views and considers that relying primarily on the non-statutory Listing Rules is no longer

⁴ See paragraphs 23.11 and 23.16 of the Consultation Paper on Proposals made in Phase II of the Corporate Governance Review released by SCCLR in June 2003.

appropriate, nor is it sufficient⁵.

- 2.4 In other jurisdictions such as the United States, United Kingdom, Australia and the Mainland, listed companies are regulated through statutorily backed rules. Therefore, it can be said that by giving the Listing Rules more “teeth”, we can upgrade our regulatory regime in respect of listing in line with international standards. With SFC’s assistance, we outline at Annex A statutorily backed listing requirements in other jurisdictions.

PURPOSES OF GIVING CERTAIN FUNDAMENTAL LISTING REQUIREMENTS STATUTORY BACKING

- 2.5 Giving SEHK’s Listing Rules statutory backing does not entail that all the principles and requirements in the Listing Rules would be turned into statutory provisions. Some market users are concerned that turning all listing requirements into statutory provisions may make the application of the listing requirements rigid and legalistic, thus increasing the cost of raising capital, reducing the efficiency of our market and adversely affecting our competitiveness. At the same time, there are market views that providing statutory backing for certain fundamental listing requirements could help promote compliance.
- 2.6 One possible way to address the market’s concern about the impact of turning all listing requirements into statutory provisions is to enshrine only those fundamental requirements in SEHK’s Listing Rules in the law, be it in the primary or subsidiary legislation, so that these requirements may be enforced with more effective investigative powers and any proven breaches thereof may be subject to statutory sanctions.
- 2.7 The purposes of giving statutory backing to certain fundamental listing requirements in SEHK’s Listing Rules are –
- (a) to create a positive statutory obligation for compliance with these requirements;
 - (b) to allow more effective investigation of a suspected breach of

⁵ See paragraph 23.12 of the Consultation Paper on Proposals made in Phase II of the Corporate Governance Review released by SCCLR in June 2003.

these statutory requirements; and

- (c) to enable the imposition of a wider range of statutory sanctions in respect of any proven breach of these statutory requirements, sanctions which would be commensurate with the seriousness of the breach and therefore more effective.

2.8 The types of statutory sanctions that may be imposed are discussed in paragraphs 2.37-2.48 below. Together they will help promote compliance and facilitate enforcement of those statutory listing requirements which are fundamental to enhancing market quality and investor protection.

2.9 A possible drawback is that those listing requirements enshrined in the law (i.e. “statutorily backed” listing requirements) would be less flexible in both interpretation and application than those prescribed as administrative rules, which have no statutory backing. Interpretation of legislative provisions is subject to a number of principles of interpretation and the common law rule that decisions of a higher court are binding on a lower court. In addition, because amendments to statutorily backed listing requirements would have to go through the necessary legislative process, more time would be required to adjust to changing market needs. There is therefore a need to balance statutory enforceability and flexibility.

“DUAL FILING” AS A LIMITED FORM OF STATUTORY BACKING

2.10 The “dual filing” system introduced under the Securities and Futures (Stock Market Listing) Rules (SFSMLR)⁶ on 1 April 2003 is, to a limited extent, a way of granting statutory backing to certain fundamental requirements in SEHK’s Listing Rules. Under SFSMLR, listing applicants are required to file a copy of their applications with SFC. Listed companies are also required to file with SFC their post-initial public offering (post-IPO) public announcements, circulars and other documents, if made or issued pursuant to SEHK’s Listing Rules. Listing applicants and listed companies may authorise SEHK to file the relevant documents with SFC on their behalf.

⁶ Made by SFC under section 36(1) of the SFO, which allows the Commission to make statutory rules in respect of, inter alia, the listing of securities.

- 2.11 Under section 6(2) of SFSMLR, if the disclosure in the listing application is false or misleading or it would not be in the interest of the investing public or in the public interest for the securities to be listed, SFC may object to the listing.
- 2.12 Pursuant to sections 182 and 384 of SFO, SFC will be able to employ its statutory powers to investigate and gather evidence of persons who knowingly or recklessly provide false or misleading information in a statutory filing with SFC. Offenders are liable to criminal fines and imprisonment.
- 2.13 Under SFSMLR, SFC may also direct SEHK to suspend dealings in securities for false or misleading disclosure, or in other circumstances as prescribed in SFSMLR (e.g. in the public interest). In certain circumstances, SFC may also direct SEHK to cancel the listing of any securities that have been so suspended.
- 2.14 SFC's regulatory experience since 1 April 2003 indicates that the operation of the "dual filing" system has been smooth so far. It has not caused any additional compliance burden on those issuers who make proper disclosure. The average response time to date of seven working days for SFC, which operates within SEHK's vetting process and timetable, has not prolonged the overall listing process. In most cases, SFC gives comments only on substantive issues and will only conduct a more thorough review when there are apparent matters of concern about disclosure.
- 2.15 While the "dual filing" system has strengthened the gate-keeping mechanism for the securities market in respect of disclosure at IPOs, the system has two major limitations. First, the criminal burden of proof and the *mens rea* threshold of intention or recklessness are very high. Second, its effectiveness in ensuring ongoing compliance is limited. The "dual filing" system allows SFC to resort to its investigative powers in cases of intentional or reckless disclosure of false or misleading information pursuant to the statutory requirements of SFO. However, it does not impose a positive obligation on listed companies to disclose information and therefore does not address cases of non-disclosure, late disclosure or selective disclosure of price sensitive or relevant information.
- 2.16 Building on the "dual filing" system, *we would like to invite views from the public on whether statutory backing should be extended to*

other requirements in the current Listing Rules.

HOW TO EXTEND STATUTORY BACKING?

Primary legislation (i.e. ordinances)

- 2.17 Broad principles governing listing; definition of key terms; powers to investigate, make subsidiary legislation and impose sanctions such as civil fines and other disciplinary measures, may be set out in the primary legislation.
- 2.18 However, the legislative process of making and amending primary legislation takes time and thus makes it less flexible in responding to the rapidly changing market environment.
- 2.19 Unless otherwise specified in the relevant ordinances, amendments to primary legislation can only be initiated by the Government or the legislature.

Subsidiary legislation

- 2.20 Subsidiary legislation is made under the primary legislation. It may be used to set out certain requirements which expand on and satisfy the broad principles laid down in the primary legislation. For example, SFC has made the Securities and Futures (Financial Resources) Rules pursuant to sections 145 and 397 of SFO to require licensed brokers to maintain certain financial resources, as part of the overall regulatory framework laid down in SFO.
- 2.21 Subsidiary legislation may stipulate statutory requirements, and prescribe the level of penalty for breaches of such requirements, as in the primary legislation, if there is such an enabling provision in the primary legislation. There is a limit to which the subsidiary legislation could impose a penalty, either specified in the relevant primary legislation or subject to provisions under the Interpretation and General Clauses Ordinance (Cap. 1). An example can be found in section 146(17) of SFO⁷. Investigative powers stipulated

⁷ Under section 146(17) of SFO, the Securities and Futures (Financial Resources) Rules may provide that a licensed corporation which contravenes any specified provision of the financial resources rules that applies to it commits an offence and is liable to a specified penalty.

in the primary legislation may also be employed for enforcing the requirements stipulated in the subsidiary legislation.

2.22 Generally speaking, the legislative process of making and amending subsidiary legislation is simpler than that for primary legislation. If the primary legislation empowers an entity to make subsidiary legislation, the entity may initiate amendments to that piece of subsidiary legislation. In the case of section 36 of SFO, it is SFC that has the power to make statutory listing rules (e.g. SFSMLR) which are subsidiary legislation subject to negative vetting⁸ by the Legislative Council. Although a number of specific provisions exist, there is currently no power in the primary legislation for SFC to prescribe the level of or impose penalties for breaches of rules made under section 36 of SFO.

2.23 Legislation governing listing matters has to evolve in tandem with market development and innovation, taking into account the standards and practices in other international financial centres. It must allow sufficient flexibility for the market to remain attractive to users. Through the making of subsidiary legislation, “safe harbours” or “carve-outs” from some specific requirements in the primary legislation can be created for certain market activities in order to facilitate market innovation without compromising investor protection.

Non-statutory codes and guidelines (as a supplementary tool)

2.24 Codes and guidelines are not part of the legislation. They have no legally binding force and cannot on their own impose any legal obligations for compliance. But they could be used to set out detailed guidance on how the statutory requirements may be interpreted and applied by the responsible agency and can be amended flexibly to cope with changing market needs. For example, SFC’s Code on Unit Trusts and Mutual Funds and SFC Code on MPF Products contain the non-statutory requirements as allowed by the relevant statutory provisions on the public offering of those investment products. Similarly, SFC’s Fit and Proper Guidelines set out detailed non-statutory guidance on the conditions

⁸ It refers to the placing of subsidiary legislation before the Legislative Council under section 34 of the Interpretation and General Clauses Ordinance. The subsidiary legislation shall be deemed to be passed or amended, as the case may be, by the Legislative Council within a certain period of time specified under Cap. 1.

of “fit and proper”, as required by law, for licensed intermediaries.

2.25 We envisage that statutory backing could be granted to certain fundamental listing requirements by making amendments to the primary legislation; enshrining further requirements in the subsidiary legislation; and introducing comprehensive codes and guidelines to articulate in detail the statutory requirements in the relevant primary legislation and subsidiary legislation so as to assist compliance. The relevant primary and subsidiary legislation may, where appropriate, provide for the making of “safe harbours” and “carve-outs” to promote market innovation. A balanced mix of these instruments could strike a reasonable balance between enforceability and flexibility.

IMPLICATIONS FOR THE “RED BOOK” ADMINISTERED BY SEHK

2.26 Giving certain fundamental listing requirements statutory backing does not mean that these requirements would be removed from the Listing Rules of SEHK (the “Red Book”⁹). SEHK may preserve these requirements in the “Red Book” as at present and continue to administer them as non-statutory requirements for admission to and continued use of SEHK’s trading platform and other facilities. The “Red Book” will continue to be subject to the approval of SFC as laid down in SFO.

2.27 There are two ways to deal with those listing requirements in the “Red Book” that have been given statutory backing –

(a) to retain these requirements in the “Red Book” provided that –

- (i) they do not contradict the relevant statutory provisions; and
- (ii) the level of requirements provided for in the “Red Book” is not lower than that set out in the relevant statutory provisions;

or

⁹ The Listing Rules administered by SEHK are commonly referred to by market practitioners as the “Red Book”. (Although the “Red Book” technically only contains the Listing Rules for the Main Board and not the GEM, for ease of reading the term is used in this consultation paper to refer to both.)

- (b) to remove these requirements from the “Red Book” if they duplicate the relevant statutory provisions.

2.28 Therefore, the statutorily backed listing requirements can either replace the relevant provisions in the “Red Book”, or be complemented by the “Red Book”. Whether option (a) or option (b) should be adopted is a subject to be dealt with by SEHK which initiates amendments to the “Red Book”, and SFC which has the statutory duty to approve changes to the “Red Book”; and the arrangement may vary from one listing requirement to another.

WHICH LISTING REQUIREMENTS TO BE MADE STATUTORY?

2.29 As advised by HKEx, the matters covered by the “Red Book” can be classified into the following categories –

- (a) constitutional issues (establishment, roles and procedures governing the operation of the Listing Committees and Listing Division);
- (b) initial suitability to be listed;
- (c) means of bringing securities to the market;
- (d) initial disclosure obligations;
- (e) approval of subsequent issues of securities;
- (f) disclosure in relation to subsequent issues of securities;
- (g) ongoing disclosure (continuous disclosure, financial reporting and those notifiable transactions, except for connected party transactions requiring prior shareholder approval);
- (h) other initial and ongoing obligations of issuers (corporate governance, restrictions on purchases and subscription, obligations to obtain prior shareholder approval for certain connected party transactions);
- (i) duties of directors; and
- (j) duties of sponsors and independent financial advisers.

Importance of disclosure

- 2.30 The securities market stakes its credibility on transparency and the integrity of information disclosed to the investing public. Timely disclosure of reliable information, including price sensitive information, will enable investors to make informed decisions for themselves.
- 2.31 Key to this is information disclosure by companies with public shareholders, or disclosure by companies seeking to raise funds from the public. In reaching the investing public, these companies take on an obligation to provide timely, accurate, and full disclosure of material information.
- 2.32 There has been some discussion on the “merit-based” and the “disclosure-based” approaches to listing regulation. While the “disclosure-based” approach is increasingly the international norm, some people are concerned that this could lead to the application of merely quantitative criteria for admission to listing, which would not be able to screen out poor quality companies. At the same time, there are suggestions that a regulator may not be in a good position to apply qualitative judgement to the merits of a listing applicant or its business model.
- 2.33 Whatever approach a market adopts, we must emphasize that no system of listing regulation can or should provide any guarantee of the financial or commercial success or performance of a particular listed company, and that full and timely disclosure of price sensitive or relevant information is always the key to enhancement of market quality.

Disclosure requirements in the “Red Book”

- 2.34 The principal disclosure requirements in the “Red Book” include –
- (a) disclosure in prospectuses and other listing documents (mostly in Chapter 11 and Appendix 1);
 - (b) disclosure in periodic reports by listed issuers (mostly in Chapter 4);
 - (c) disclosure in financial statements and management discussion and analysis (mostly in Appendix 16 and parts, e.g. paragraphs

- 9 and 10, of the Listing Agreement);
- (d) disclosure of price sensitive or material events and information (e.g. paragraph 2 of the Listing Agreement); and
 - (e) disclosure of particular transactions, e.g. connected and larger transactions (in parts of Chapter 14), some of which require shareholder approval.

2.35 Given the importance of information disclosure, *we would like to invite public comments on what types of disclosure requirements in the “Red Book” should be given statutory backing.*

2.36 *We would also like to invite public views on whether there are fundamental requirements in the “Red Book”, other than those on disclosure, which should also be statutorily backed. For instance, there are market views that the requirement for disinterested shareholder approval of related party and larger transactions as per the “Red Book” (e.g. Listing Rule 14.26), and other conduct rules such as directors’ dealings in securities and other directors’ duties should be statutorily backed.*

SANCTIONS FOR BREACHES OF STATUTORY LISTING REQUIREMENTS

2.37 Currently, options available to SEHK for taking actions against breaches of the listing requirements provided for in its Listing Rules are limited by the fact that those requirements are contractual obligations. They are considered not effective in providing adequate incentive for compliance and deterring non-compliance in cases where the prospect of financial gain outweighs the fear of public disapprobation. Breaches of statutory listing requirements could attract statutory sanctions which are considered to be more effective deterrents. Civil fines, for instance, would be an appropriate civil sanction. The power to impose statutory sanctions could be made available to the court or a statutory regulator. However, the suggestion to empower a regulator such as SFC by statute to impose civil sanctions for contraventions of provisions in the primary or subsidiary legislation relating to listing matters requires careful consideration.

2.38 If the public supports giving certain fundamental listing

requirements in the “Red Book” statutory backing (“statutory listing requirements”), *we would like to seek public views on the types of statutory sanctions (e.g. civil fines, orders which restrain certain acts and imprisonment, etc.) to be imposed on breaches of statutory listing requirements.* This will be discussed further in the ensuing paragraphs.

STATUTORY SANCTIONS

- 2.39 Not all breaches of statutory requirements warrant criminal prosecution or the imposition of financial penalties. A spectrum of enforcement responses will facilitate a more calibrated approach towards enforcement by the regulators.
- 2.40 The statutory sanctions that may be imposed for contraventions of statutory listing requirements could be broadly classified into civil and criminal sanctions.

Civil sanctions

- 2.41 Civil sanctions enable the use of civil procedures with a high civil standard of proof (i.e. on the balance of probabilities) without being bound by the civil or criminal laws of evidence. This has the advantage of enabling the regulator and the court to deal relatively swiftly with suspected breaches of statutory listing requirements.
- 2.42 However, there is a limit to which the sanctions may be enhanced if the sanctions are to be administered under a civil regime. Previous legal advice given is that substantial financial penalties may in certain cases turn the regime into a criminal one for human rights purposes, that is, requiring the incorporation of all safeguards necessary for a fair hearing in a criminal regime, for instance, if the fines appear to be punitive in nature in addition to having a compensatory function.
- 2.43 On the basis of past experience in drafting SFO, in particular Part XIII concerning market misconduct, we envisage that the range of civil sanctions that may be imposed on a person for breaching statutory listing requirements include –
- (a) civil fines up to a specified limit;

- (b) compliance orders, i.e. an order that any person who has breached a statutory listing requirement should henceforth comply with that requirement, failure to do which would lead to punishment as contempt of court;
- (c) disqualification orders, e.g. to prohibit a person from being involved in the management of any named corporations for a specified period of time;
- (d) disgorgement orders, e.g. to pay the Government an amount equal to the profit made or loss avoided as a result of a breach of the statutory listing requirements in question;
- (e) cease and desist orders, e.g. to prohibit a person from breaching a particular statutory listing requirement;
- (f) disciplinary referral orders, i.e. an order that any body which may take disciplinary action against the person as one of its members be recommended to take disciplinary action against him or her; and
- (g) costs orders, e.g. to require the person to pay to the regulator an appropriate amount for any investigation of his or her conduct in breaching statutory listing requirements.

2.44 The range of civil sanctions that may be imposed on breaches of statutory listing requirements will therefore have to be carefully calibrated so that they could bring in sufficient deterrent effect without being turned into criminal ones. Subject to public comments on the preference for the types of sanctions to be imposed, this would be a subject of detailed legal research by the Administration for future law drafting and other implementation efforts.

2.45 *We welcome public views on the types and levels of civil sanctions that should be imposed on breaches of statutory listing requirements. We recognise that they would have to be calibrated in accordance with the nature of the statutory listing requirements which itself is also a subject of consultation in this exercise.*

Criminal sanctions

2.46 *We also welcome public views on whether severe breaches of certain fundamental statutory listing requirements should be administered under the criminal regime, i.e. through the imposition of criminal*

sanctions such as punitive fines or even imprisonment. We appreciate the difficulties in securing criminal conviction for “white collar” crimes, arising from the requirement to meet the criminal standard of proof beyond reasonable doubt and the need to comply with the criminal rules of evidence. However, we also recognise that criminal sanctions such as punitive fines and even imprisonment will have stronger deterrent effect.

Dual regime

2.47 Civil and criminal sanctions are not necessarily mutually exclusive. Criminal sanctions may be introduced to bolster the deterrent and punitive effect of a civil regime. Again reference can be made to the recently commenced SFO, in particular Part XIII and Part XIV which seek to combat market misconduct. SFO provides for a dual regime, i.e. parallel civil and criminal regimes, to deter market misconduct. SFC, following an investigation, has the power to refer the investigation report to the Financial Secretary to consider the institution of civil proceedings before the Market Misconduct Tribunal (MMT), or to the Secretary for Justice to consider the institution of criminal proceedings. SFO also allows SFC to institute in its own name summary criminal proceedings before a Magistrate for less serious criminal market misconduct offences.

No double jeopardy

2.48 No person should be subject to any double jeopardy under a dual civil and criminal regime in enforcing statutory listing requirements. This could be achieved by arrangements similar to those for the market misconduct regime under SFO. To avoid a person being subject to double jeopardy before MMT and criminal prosecution for the same conduct, SFO contains provisions to ensure that there is no double jeopardy of MMT inquiry under Part XIII and criminal prosecution under Part XIV. A person who has been acquitted or convicted of an offence under Part XIV cannot be made subject of an MMT hearing in respect of the same conduct. Similarly, someone who is the subject of an MMT order or who has been exonerated at the end of an MMT inquiry into suspected market misconduct under Part XIII cannot be prosecuted under Part XIV in respect of the same conduct.

CHAPTER 3 REGULATORY STRUCTURE GOVERNING THE PERFORMANCE OF LISTING FUNCTIONS

- 3.1 The “Red Book” contains the vast majority of requirements to be satisfied before a company may access public investors through the stock market and trade publicly in the secondary market. It covers most IPO disclosure requirements¹⁰, the majority of requirements mandating disclosure and governing corporate conduct following IPO, as well as all quantitative admission to trading requirements (track record and management continuity, etc.) and exit criteria.
- 3.2 All leading markets distinguish between the statutory or statutorily backed rules that must be satisfied before a company may go public, and those additional non-statutory requirements laid down by stock exchanges that must be satisfied before companies are admitted to their trading platforms. The dividing line between the two varies among markets but, as noted above, in Hong Kong most of the relevant requirements are to be found in the non-statutory “Red Book”.

IMPLICATIONS OF GIVING CERTAIN FUNDAMENTAL LISTING REQUIREMENTS STATUTORY BACKING

- 3.3 SCCLR¹¹ pointed out that “the statutorily backed rules would have to be enforced by a statutory entity. It would be wholly inappropriate to give the powers of imposing the necessary penalties to a trading company. Since HKEx has recently become a public company, it would be structurally flawed if it were to be charged with the responsibility of enforcing the Listing Rules by imposition of meaningful sanctions. It would mean that a trading company with an obligation to its shareholders would be required to impose

¹⁰ Requirements for registering a prospectus (applicable to offer of both listed and unlisted securities) authorised by SFC with the Registrar of Companies are set out in the Companies Ordinance. SFC’s functions to vet and authorise prospectuses relating to listed securities under the Companies Ordinance were transferred to SEHK by virtue of the Transfer Order made by the Governor in Council first under the Securities and Futures Commission Ordinance (Cap. 24) in 1993 and then by the Chief Executive in Council under SFO in 2002.

¹¹ See paragraph 23.14 of the Consultation Paper on Proposals made under Phase II Corporate Governance Review released by SCCLR in June 2003.

sanctions and penalties of serious effect on persons outside its own organisation.”

- 3.4 Under the existing regulatory framework, SFC is equipped with statutory powers of investigation, making subsidiary legislation, and imposing fines and other disciplinary sanctions on its regulatees.
- 3.5 Following this line of thought, giving statutory backing to certain fundamental listing requirements now in the “Red Book” would imply that there would continue to be more than one regulator involved in listed company regulation under their respective rules (“**shared regulation**”), with those prescribed in the statute being enforced by SFC, and those without statutory backing continuing to be enforced by SEHK. To a certain extent, this is the present situation under the “dual filing” system, where disclosure requirements in SFO and its subsidiary legislation (i.e. SFSMLR) and the “Red Book” overlap, and the ability to reject an IPO application is now shared between SFC and SEHK (see paragraph 2.11).
- 3.6 Some market users have expressed concern that in terms of enforcement and accountability, the shared responsibility of SFC and SEHK in regulating listed companies may give rise to **regulatory gaps and overlaps**. This may impair their ability to detect breaches early, as well as their efficiency and consistency in decision making. This may also carry an additional compliance burden for the issuers. They suggest that appropriate measures be introduced to minimise such possibility.
- 3.7 At the same time, some market users have pointed out that the existing arrangement for shared regulation between SFC and SEHK would help ensure that the regulatory regime for listing functions strikes a reasonable balance between market savvy and regulatory expertise. They also consider that some overlaps of regulatory functions between the two would help close any regulatory gaps. SEHK, being a commercial entity and the market operator, may deal with contractual breaches, while SFC, the statutory regulator, may take investigative and enforcement actions to deal with breaches of statutory requirements at its own initiative or on referral from SEHK. Such an arrangement has the advantage of providing a wider range of non-statutory and statutory enforcement tools and sanctions to deal with a full array of breaches from minor to serious ones.

- 3.8 *We would like to invite public views on whether, and if so, how the existing regulatory structure governing the performance of listing functions should be improved after certain fundamental listing requirements in the “Red Book” are provided with statutory backing. This will be further discussed in paragraphs 3.20-3.41 below.*

ANY CONFLICT OF INTERESTS?

- 3.9 Since HKEx demutualised and became a listed company in June 2000, there have been questions as to whether its subsidiary, SEHK, should retain the role as the primary regulator of entry to the market. Some consider there exists a conflict of interests (be it real or perceived) between HKEx’s regulatory role and listed company status. Some have also expressed concern about the independence, the role and the membership of the existing SEHK Listing Committees¹², and the Committee’s relationship with the staff of the Listing Division of HKEx.
- 3.10 These are not new issues, nor are they unique to Hong Kong. Governments, regulators and stock exchanges in all mature financial centres encounter similar problems and each has addressed them in ways suited to their individual circumstances. In Hong Kong’s case these issues were seriously considered during the merger of the stock and futures exchanges and their clearing houses in March 2000. A review had been conducted by SFC in conjunction with SEHK on, among other things, the listing function and the possible alternative options for the future division of regulatory responsibilities between SFC and HKEx. That review did recognise that in certain circumstances conflict of interests might arise between the roles of HKEx/SEHK as a commercial market operator and service provider on the one hand, and regulator and enforcer of the “Red Book” on the other. It concluded that sufficient safeguards exist in the regulatory measures against possible compromise of investors’ interest by the business pursuits

¹² The Listing Committees are set up by SEHK to perform functions and exercise powers in relation to listing matters delegated by the HKEx Board. It is HKEx’s “gatekeeper” for all listing matters. There are currently two Listing Committees, one for the Main Board and the other for GEM. The appointment and functions of the Listing Committees are set out in SEHK’s Listing Rules and the Memorandum of Understanding Governing Listing Matters signed between SFC and SEHK on 28 January 2003. For the purpose of this consultation paper, the term “Listing Committee” covers the Listing Committees for both the Main Board and GEM.

of the company including its listing function. Some of these safeguards were incorporated in the Exchanges and Clearing Houses (Merger) Ordinance (Cap. 555). They were thoroughly considered during the passage of the Ordinance through the legislature.

3.11 The system of checks and balances, which currently exists to address any real or perceived conflict of interests, thus includes –

- (a) statutory safeguards as provided for under SFO¹³ – HKEx (including SEHK) shall act in the interest of the public, having regard to the interest of the investing public, and ensure that the interest of the public prevails where it conflicts with the interest of HKEx (including SEHK);
- (b) institutional safeguards, e.g. the internal “Chinese wall” between HKEx’s business and regulatory sides; and
- (c) memoranda of understanding between SFC and HKEx (and SEHK in some cases) to minimise any conflict of interests, and delineate their respective roles under the “dual filing” system.

3.12 Thus a “Chinese wall” exists within HKEx, which segregates the business units from the regulatory unit. This mechanism was designed to ensure that HKEx is, and is seen to be, performing its regulatory functions in a fair and independent manner. Similarly, on paper, the Board of HKEx has delegated all its functions and powers in relation to listing matters to the Listing Committee. Decisions on listing matters are made by the Listing Committee, Listing Division or in a limited set of circumstances the Chief Executive of SEHK. The Listing Committee, supported by staff of the Listing Division, considers and makes decisions on applications for listing, hears and decides on appeals and makes decisions on disciplinary matters.

3.13 As regards supporting staff, according to the Memorandum of Understanding Governing Listing Matters signed by SFC and SEHK on 28 January 2003, SEHK in discharging its responsibilities as the frontline regulator of all listing-related matters shall maintain an adequate strength of staff in the Listing Division with an adequate level of professionalism and experience to discharge the

¹³ The safeguards were introduced first under the Exchanges and Clearing Houses (Merger) Ordinance which was repealed after SFO came into operation on 1 April 2003.

responsibilities of the Listing Division. Whether SEHK has adequately fulfilled its obligations set out in that Memorandum of Understanding would be kept under review by SFC and SEHK.

3.14 Notwithstanding these safeguards, it has been pointed out that there is no document approved by either SFC or the Board of HKEx, which sets out and clearly defines the roles, powers and responsibilities of the Listing Committee, its Chairman or its members, and their relationship with staff of the Listing Division.

3.15 *We would like to invite public views on whether, and if so, how the existing safeguards should be improved to enhance the integrity of the regulatory structure governing the performance of listing functions.*

3.16 In inviting public comments on paragraphs 3.8 and 3.15, our aim is –

- (a) to minimise any regulatory gaps or overlaps after certain fundamental listing requirements in the “Red Book” are prescribed in the statute; and
- (b) to remove any real or perceived conflict of interests.

MAJOR PUBLIC ARGUMENTS

3.17 In examining the various models of regulatory structure governing the performance of listing functions, we have given due regard to the views expressed by market users over the past year. In particular, we have taken note of the strength of the following arguments -

- (a) “Statutorily backed rules will be more effectively enforced by a statutory entity.”: As mentioned in paragraph 3.3 above, SCCLR pointed out that “the statutorily backed rules would have to be enforced by a statutory entity”. As a market operator and a subsidiary of a listed company, SEHK does not have the necessary investigative powers of a law enforcement agency like SFC to inquire into breaches of statutorily backed rules. There is therefore the view that the more fundamental listing requirements, especially those on disclosure, should be made statutory and their enforcement entrusted in SFC for more

effective investigation and sanctions.

- (b) “SEHK must have the discretion over issues relating to the ‘branding’ of the exchange and product development.”: SEHK, being a for-profit commercial entity, should have the discretion over the eligibility of the companies whose shares are to be traded on its trading platform. Its authority to decide whether the securities of a company should be traded on its trading platform would provide a means whereby SEHK can assure the quality of its products, which is essential to establishing and maintaining its “badge of quality”. There is therefore the view that SEHK should be allowed to set and administer its own rules governing the trading of securities on its trading platform; and have the final discretion to decide whether a company may be listed on its Main Board or GEM. This is part and parcel of SEHK’s “branding” and development of listing products.
- (c) “It is important to preserve the Listing Committee to ensure market savvy in the regulatory regime.”: The success of the regulatory regime in respect of listing does not depend solely on the effectiveness of “regulatory control” to ensure compliance. It also requires an intimate knowledge about the market on the part of the gatekeeper to ensure effective vetting of listing applications. The SEHK Listing Committee comprising market practitioners such as Exchange participants, fund managers, lawyers and accountants, as well as other market users, has been providing a valuable channel for tapping the professional knowledge, skill and experience of these market players in the process of vetting listing applications. There is therefore the view that the Listing Committee and its “market savvy” should be preserved.

REGULATORY FUNCTIONS IN RESPECT OF LISTING

3.18 Before examining alternative models of the regulatory structure governing listing, it would be useful to set out what we mean by regulatory functions in relation to listed companies and candidates for listing. For the purpose of this consultation paper, we have attempted to classify regulatory functions in respect of listing into seven broad categories, as follows –

IPO

- (a) approval for public offering (i.e. enforcement of **statutory entry** requirements);
- (b) admission to HKEx's trading platform (i.e. enforcement of **non-statutory entry** requirements);

Post-IPO

- (c) **ongoing** compliance with **statutory** requirements;
- (d) **ongoing** compliance with **non-statutory** requirements;

Maintenance of requirements

- (e) updating statutory requirements in (a) and (c) above;
- (f) updating non-statutory requirements in (b) and (d) above; and
- (g) approval of non-statutory requirements in (f) above.

3.19 A table summarising the role of responsible agencies in performing the listing functions under the existing regulatory structure is at **Annex B**. The nature of market participation in the present listing process and setting listing requirements is summarised at **Annex C**.

POSSIBLE MODELS OF REGULATORY STRUCTURE

3.20 We have drawn reference from public comments over the past year and outlined below four alternative models of regulatory structure governing listing functions to facilitate discussion. *We welcome public views on the four alternative models.* They are by no means exhaustive.

3.21 For illustration purpose, the division of work among concerned parties under these regulatory models is summarised below in Table 3.1, based on the regulatory functions in respect of listing categorised in paragraph 3.18 above.

**Possible Models of Regulatory Structure
Agencies responsible for regulatory functions governing listing matters¹**

[for illustration purpose]

REGULATORY FUNCTIONS GOVERNING LISTING MATTERS	Model A: Listing functions transferred to SFC (Paras 3.23-3.27)		Model B: Listing functions transferred to HKEx subsidiary (Paras 3.28-3.30)		Model C: Listing functions transferred to independent statutory authority (Paras 3.31-3.35)		Model D: Expanding “dual filing” system (Paras 3.36-3.41)	
	SFC	HKEx	SFC	HKEx Subsidiary	Independent authority	HKEx	SFC	HKEx
² (a) Approval for public offering (i.e. enforcement of statutory entry requirements) ³	✓		✓	✓	✓		✓	
² (b) Admission to HKEx’s trading platform (i.e. enforcement of non-statutory entry requirements)		✓		✓		✓		✓
(c) Ongoing compliance (statutory obligation) ³	✓		✓	✓	✓		✓	
(d) Ongoing compliance (non-statutory obligation)	✓			✓	✓			✓
(e) Updating statutory requirements in (a) and (c) above	✓		✓		✓		✓	
(f) Updating non-statutory requirements in (b) and (d) above	✓ (d)	✓ (b)		✓	✓ (d)	✓ (b)		✓
(g) Approval of non-statutory requirements in (f) above	✓		✓		✓		✓	

¹ Assuming positive response to Chapter 2, i.e. giving statutory backing to certain listing requirements.

² Requirements in (a) and (b) may not be mutually exclusive – see para 2.26.

³ Content of these statutory listing requirements is contingent on public views on Chapter 2.

3.22 All models assume that a decision-making setup similar to the SEHK Listing Committee will be established to assist the entity, be it SFC, HKEx or a new authority, to perform the regulatory functions in respect of listing.

Model A: Transfer of listing functions to a new division set up under SFC

Key features

3.23 A division would be set up under SFC, staffed by SFC executives, to perform the listing functions. Funding for this division would form part of SFC's budget and would be strictly on a cost-recovery basis.

3.24 Under this model, HKEx would retain certain regulatory functions in respect of listing as it should have the say as to which issuers, who have fulfilled the statutory public offering requirements, should be allowed to use its trading platform.

Issues for consideration

3.25 Some market users have pointed to the following benefits of this model –

- (a) clear accountability – with removal of co-ownership of key regulatory functions (including all the disclosure requirements that must be satisfied before companies can tap the public market), the problem of shared regulation would be minimized;
- (b) synergy – by putting regulation of listed companies and intermediaries (corporate finance advisers in particular) under the same umbrella, i.e. SFC;
- (c) facilitating issuers – by removing the “dual process” under which disclosure and related requirements are enforced by both SFC and SEHK; and
- (d) removal of any real or perceived conflict of interests.

3.26 The administration of statutory public offering requirements and ongoing obligations by SFC should also enhance cross-border cooperation which, especially in enforcement between Hong Kong and the Mainland, has become critical. As the statutory regulator

with principal responsibility for the securities market, SFC is well positioned to be an effective single point of contact with its statutory counterpart agency in the Mainland, the China Securities Regulatory Commission (CSRC). This is a factor which must be taken into account given the market trend foreshadowed in paragraph 1.2.

3.27 At the same time, others have highlighted the following potential shortcomings –

- (a) possible over-concentration of powers in SFC - *the public is invited to comment on whether the existing safeguards against any abuse of powers by SFC¹⁴ are sufficient should this model be adopted;*
- (b) insufficient market savvy within the SFC staff. This concern could be addressed through the establishment of a listing committee with a balanced mix of market practitioners and market users (see paragraph 3.22); and
- (c) risk of over-regulation and hence stifling market innovation.

Model B: Transfer of listing functions to a new HKEx subsidiary

Key features

3.28 HKEx would set up a subsidiary with its own board of directors to perform the listing functions. The board members of the subsidiary would be appointed by HKEx with input from SFC. They could be drawn from a wide spectrum of market users, including issuers, intermediaries and investors. Resources of the subsidiary would be allocated by HKEx and the budget would be approved by the Board of HKEx.

Issues for consideration

3.29 Some market users have pointed out that this model would help strengthen the present “Chinese wall” arrangement within HKEx in so far as there would be a separate budget for the subsidiary.

3.30 Others have however pointed out that this model would not be effective in –

¹⁴ SFC is accountable to the public in exercising its statutory powers. It is subject to a number of administrative and statutory checks and balances, for example, the Process Review Panel, the Ombudsman, and its various statutory committees and advisory bodies. It is also subject to a host of statutory duties and requirements including approval of its budget by the Chief Executive.

- (a) removing any real or perceived conflict of interests as the subsidiary is still part of HKEx (for example, there would be no guarantee that adequate resources would be made available to this subsidiary and ultimate control over funding would still reside with HKEx); or
- (b) eliminating duplication of work between SFC and SEHK in respect of the shared administration of statutory listing requirements, i.e. shared regulation.

Model C: Transfer of listing functions to a new statutory authority independent of both SFC and HKEx

Key features

- 3.31 A new statutory independent authority would be set up to perform the listing functions. In other words, it would assume all the listing functions envisaged for SFC under Model A.
- 3.32 The new statutory independent authority would have a board appointed by the Government with nominations from SFC and HKEx. It would be funded by fees to be paid by issuers. It would be equipped with investigative powers similar to those of SFC to enable it to investigate any alleged non-compliance. It would be subject to appropriate checks and balances similar to those for SFC. For instance, its budget would require Government's approval and would need to be laid before the Legislative Council.
- 3.33 SFC would cease to have the powers to make and enforce any statutory public offering requirements and ongoing obligations. These powers will go to the new authority. SFC would also cease to have the power to approve the requirements governing admission to SEHK's platform and ongoing obligations which are non-statutory and enforced by HKEx. This would be transferred to the new authority. SFC would need to have close cooperation with the new authority in, for instance, sharing of information in detecting insider dealing and other market misconduct, the administration of laws on disclosure of interests in securities, the administration of the Codes on Takeovers and Mergers and Share Repurchases, and in combating fraud and other securities market crimes. It would inevitably have to share with the new authority its regulatory role over the performance of public duties by HKEx in maintaining an orderly, informed and fair market.

Issues for consideration

- 3.34 Some market users have pointed out that this model could remove any real or perceived conflict of interests. It would also bring along the benefits discussed in paragraph 3.26 provided that the new authority would enjoy the same relationship as SFC with CSRC.
- 3.35 Others have suggested that this model has the following disadvantages –
- (a) the new authority may be seen as the fourth tier, or to coexist with SFC as a new entity on the second tier of the regulatory structure, thus complicating the existing three-tiered structure and creating yet another regulatory body which may in turn result in more red tape and bureaucracy;
 - (b) it would require the enactment of a significant body of new legislation to establish the new agency which would be time-consuming;
 - (c) the structure may create more gaps and/or overlaps in regulating listed companies with multiple ownership of regulatory functions;
 - (d) it would be costly to set up a new regulatory body and hence undermine our market competitiveness; and
 - (e) it could not ensure sufficient market savvy within the new authority. This concern could be addressed through the establishment of a listing committee with a balanced mix of market practitioners and market users (see paragraph 3.22).

Model D: Expanding the “dual filing” system

Key features

- 3.36 SFC would continue to perform its existing listing functions, but would also take on new functions, as a result of giving statutory backing to certain fundamental listing requirements as discussed in paragraphs 2.17-2.36.
- 3.37 HKEx would continue to perform its existing listing functions, with possible **modification** if and when certain fundamental listing requirements are to be statutorily backed.

Issues for consideration

- 3.38 Some market users have pointed out that this model, which builds on the success of the “dual filing” system introduced on 1 April 2003, is familiar to both regulators and market practitioners. It would cause minimal disruption to the existing structure. The market would therefore be more prepared to adapt to the arrangements under this model. Some have also pointed out this model would help preserve market savvy of the listing process and thus facilitate market development.
- 3.39 This model would also enjoy the benefits discussed in paragraph 3.26 insofar as the administration of statutory listing requirements is concerned.
- 3.40 Others have suggested that this model may not remove any conflict of interests of HKEx. It may add to public confusion and uncertainty about the accountability and responsibility of SFC and SEHK. *We welcome public views on whether additional safeguards and clearer delineation of roles between SFC and SEHK should be introduced should this model be adopted.*
- 3.41 There are market views that this model may increase regulatory overlaps between SFC and SEHK, thus increasing the risk of inconsistency. Others, however, consider that it is not necessarily undesirable, as existence of regulatory overlaps may have the benefits of reducing the risk of regulatory gaps and may result in more effective enforcement. HKEx may deal with the majority of cases which are less serious, while SFC may handle more serious cases, notably those involving breaches of statutory provisions.

CHAPTER 4 SUMMARY OF ISSUES FOR PUBLIC COMMENTS

- 4.1 As the premier capital formation centre for Mainland issuers, it is critical for Hong Kong that we continue to enhance our regulatory regime in respect of listing, with a view to improving the quality of our equity market. That will enable us to take advantage of the rapid expansion and opening up of the Mainland market and further develop our role as a leading international financial centre.
- 4.2 Other leading international markets are introducing different reforms to improve their listing functions. Some markets have their eyes on the rapidly expanding Mainland market and are keen to capture a share. Increasing competition from other markets implies that Hong Kong should be geared up to face the challenge. Maintaining the status quo would cost us lost opportunities in the long run.
- 4.3 Models set out in this consultation paper are drawn up based on feedback from market users, market operators and the regulators. They seek to address market concerns about any real or perceived inadequacies of the existing listing regulatory regime. They are built on the foundation provided by the three-tiered regulatory structure for the securities and futures industry that has served Hong Kong well for the past decade.
- 4.4 We summarise here the matters on which this consultation exercise seeks to collect public views for the improvement of the regulatory regime governing listing matters –
- (a) whether statutory backing should be extended to some of the requirements in SEHK's Listing Rules (paragraph 2.16);
 - (b) what types of disclosure requirements in the "Red Book" should be given statutory backing (paragraph 2.35);
 - (c) whether there are fundamental requirements in the "Red Book", other than those on disclosure, which should be statutorily backed (paragraph 2.36);
 - (d) sanctions to be imposed on breaches of statutory listing requirements –
 - (i) the types of statutory sanctions (e.g. civil fines, orders which restrain certain acts, etc.) to be imposed (paragraph 2.38);

- (ii) in relation to (i) above, the types and levels of civil sanctions to be imposed (paragraph 2.45); and
 - (iii) in relation to (i) above, whether severe breaches of certain fundamental listing requirements should be administered under the criminal regime (paragraph 2.46).
- (e) whether, and if so, how the existing safeguards to address any real or perceived conflict of interests between HKEx's role as the primary regulator of entry to the stock market and a for-profit listed company should be improved to enhance the integrity of the regulatory structure governing listing functions (paragraph 3.15); and
- (f) whether, and if so, how the existing regulatory structure governing the performance of listing functions should be improved after certain fundamental listing requirements are provided with statutory backing (paragraph 3.8). (Alternative models of regulatory structure are set out in Table 3.1 following paragraph 3.21.)

4.5 Following the receipt and analysis of responses, we will in light of the comments received work with SFC and HKEx in considering appropriate measures to improve the regulatory regime for listing.

ANNEXES

Statutorily Backed Listing Requirements in Other Jurisdictions

1. In the United States, disclosure requirements for public offerings and public companies are set out in the Securities Act, the Securities Exchange Act, and in detail in regulations promulgated by the Securities and Exchange Commission (SEC). Violation of these requirements could lead to criminal liability, administrative fines by SEC, and civil liability in private action.
2. The United Kingdom (UK)'s disclosure requirements are found in the Financial Services and Market Act (FSMA) and in rules of the UK Listing Authority as part of the Financial Services Authority (FSA). FSA is empowered under FSMA to make extra-parliamentary statutory rules i.e. rules made by FSA have statutory force, and they are not subject to any vetting by the Parliament. In other words, the UK Parliament has conferred its rule-making role to FSA. Violation of FSA rules could lead to criminal liability and/or administrative fines by FSA.
3. Australia has a post-vetting system for initial public offerings (IPOs). A prospectus has to comply with the disclosure requirements in the Corporations Act. The Australian Securities and Investments Commission (ASIC) has the statutory power to issue a "stop order" to halt the IPO process if it finds the prospectus defective. As for post-IPO regulation, the Corporations Act expressly requires listed companies to comply with the rules of the stock exchange and provides that violation of those rules would attract statutory sanctions¹.
4. In Mainland China, the disclosure requirements for public offerings and public companies are set out in the Securities Law, the Company Law, and various regulations promulgated by the State Council and China Securities Regulatory Commission (CSRC). Violation could lead to criminal liability and/or fines by CSRC.

¹ Similar proposal was included in our composite Securities and Futures Bill exposed to the public in July 1999. The Government has sought extensive legal advice in developing the proposal. The advice received confirmed that the proposal would render SEHK's Listing Rules having the status of law and effectively becoming statutory provisions which would be subject to normal rules of legislative interpretation and procedures for amendment.

**Listing Functions
and responsible agencies under existing arrangements**

Listing Functions	Requirements / Provisions governing the listing functions	Responsible agencies
<p>1. Approval for public offering (i.e. meeting requirements for offering to the public)</p>	<p><u>Companies Ordinance</u></p> <ul style="list-style-type: none"> • Statutory requirements for registering a prospectus (applicable to offer of both listed and unlisted securities) authorised by SFC with the Registrar of Companies. 	<p><u>SEHK</u>²</p> <ul style="list-style-type: none"> • The function of the Securities and Futures Commission (SFC) to vet and authorise prospectuses relating to listed securities under the Companies Ordinance has been transferred to SEHK by virtue of the Transfer Order made by the Chief Executive in Council under the Securities and Futures Ordinance (SFO).

² The Stock Exchange of Hong Kong Limited.

Listing Functions	Requirements / Provisions governing the listing functions	Responsible agencies
	<p><u>Securities and Futures (Stock Market Listing) Rules</u></p> <ul style="list-style-type: none"> Subsidiary legislation made under section 36 of SFO which introduces the “dual filing” system. Under the system, listing applications (including prospectuses) made pursuant to SEHK’s Listing Rules must be filed with SFC. 	<p><u>SFC</u></p> <ul style="list-style-type: none"> Under the “dual filing” system, SEHK passes a copy of any listing application materials it receives to SFC. SFC has the powers to make comments and object to a listing application. It may also take action against false and misleading disclosure.
	<p><u>SEHK’s Listing Rules</u></p> <ul style="list-style-type: none"> Non-statutory rules for the listing of securities on the stock market operated by the Hong Kong Exchanges and Clearing Limited made under section 23 and approved by SFC under section 24 of SFO. Applicable to offer of listed securities only. 	<p><u>SEHK</u></p> <ul style="list-style-type: none"> Through the administration of SEHK’s Listing Rules.
2. Admission to trading platform (i.e. trading on the Main Board or GEM)	<p><u>SEHK’s Listing Rules</u></p> <ul style="list-style-type: none"> Admission criteria. Disclosure obligations for admission. Means of bringing securities to the trading platform. 	<p><u>SEHK</u></p> <ul style="list-style-type: none"> Through the administration of SEHK’s Listing Rules.

Listing Functions	Requirements / Provisions governing the listing functions	Responsible agencies
	<ul style="list-style-type: none"> • Duties of sponsors and independent financial advisers. 	
3. Ongoing obligations for listed companies	<p><u>SEHK's Listing Rules</u></p> <ul style="list-style-type: none"> • Disclosure in relation to subsequent issues of securities. • Ongoing disclosure obligations. • Other ongoing obligations of issuers, e.g. corporate governance, restrictions on purchases and subscription, etc. • Duties of directors. 	<p><u>SEHK</u></p> <ul style="list-style-type: none"> • Through the administration of SEHK's Listing Rules.
	<p><u>Securities and Futures (Stock Market Listing) Rules</u></p> <ul style="list-style-type: none"> • Subsidiary legislation made under section 36 of SFO which introduces the "dual filing" system. Under the system, public statements and other ongoing public disclosure of information pursuant to requirements under SEHK's Listing Rules must be filed with SFC. 	<p><u>SFC</u></p> <ul style="list-style-type: none"> • Under the "dual filing" system. [Note: "Dual filing" only covers disclosure-related matters such as companies announcements, and does not catch non-disclosure and late disclosure.]
4. Updating of Listing Rules	<p><u>SFO</u></p> <ul style="list-style-type: none"> • SEHK's Listing Rules and any amendments thereto are subject to SFC's approval under section 24 of SFO. 	<p><u>SEHK</u></p> <ul style="list-style-type: none"> • Initiates amendments to SEHK's Listing Rules for SFC's approval.

Listing Functions	Requirements / Provisions governing the listing functions	Responsible agencies
		<p><u>SFC</u></p> <ul style="list-style-type: none"> • Approves amendments to SEHK's Listing Rules initiated by SEHK. • It may also - <ul style="list-style-type: none"> (a) make statutory listing rules under section 36 of SFO; and (b) direct SEHK to make or amend SEHK's Listing Rules (which are non-statutory).

Market Participation in the Present Listing Process

Forum under the Hong Kong Exchanges and Clearing Limited (HKEx)

The Stock Exchange of Hong Kong Limited (SEHK) Listing Committees

- Decision-making bodies responsible to –
 - (a) examine listing applications; and
 - (b) consider policy matters, i.e. updating of SEHK’s Listing Rules.
- Except one ex-officio member (the Chief Executive of HKEx), the Listing Committees comprise Exchange participants, listed company representatives, market practitioners and users (including fund managers, lawyers and accountants, etc.).

Fora under the Securities and Futures Commission (SFC)

(1) Dual Filing Advisory Group

- An advisory body to advise SFC on –
 - (a) policy matters and direction relating to SFC’s performance of “dual filing” functions; and
 - (b) treatment of cases under the “dual filing” system.
- While the Advisory Group does not examine all individual cases filed by listing applicants with SFC through SEHK, SFC executives seek advice from the Group on “problematic” listing applications.
- Membership comprises investors as well as market practitioners, including fund managers, corporate finance advisers, legal advisers and accountants.

(2) SFC Shareholders Group

- A standing committee set up under section 8 of the Securities and Futures Ordinance (SFO) to gauge investors’ views on issues relating to shareholders’ rights and interests.
- HKEx consults the SFC Shareholders Group on amendments to SEHK’s Listing Rules proposed by SEHK Listing Committees, either

on a presounding basis or with draft consultation papers.

- Membership comprises retail and institutional investors, professionals, academics and a Consumer Council representative, etc.

(3) SFC Advisory Committee

- An advisory body set up under section 7 of SFO to advise SFC on matters of policy regarding any of its regulatory objectives and functions.
- To engage the market and the public, HKEx consults the SFC Advisory Committee on amendments to SEHK's Listing Rules proposed by SEHK Listing Committees, either on a presounding basis or with draft consultation papers. Unlike the SFC Shareholders Group, the SFC Advisory Committee will only be consulted on **major** amendments or policy changes.